MANAGING RISKS TO FINANCIAL STABILITY

Financial stability continued to be preserved

Financial stability was sustained throughout the quarter amidst continued challenges in the global environment. Stable financial conditions were underpinned by sound and well-capitalised financial institutions, orderly financial market conditions and sustained confidence in the financial system, which provided continued support for effective financial intermediation.

A major milestone was accomplished with the passage of the Financial Services Bill 2012 and Islamic Financial Services Bill 2012 during the quarter. The new regulatory legislation significantly strengthens the foundations for the effective regulation and supervision of financial institutions under the Bank's purview. The bills combine six pre-existing statutes, namely the Banking and Financial Institutions Act 1989, Insurance Act 1996, Payment Systems Act 2003, Exchange Control Act 1953, Islamic Banking Act 1983 and the Takaful Act 1984, to provide a comprehensive and cohesive legal framework for the financial sector. Key enhancements in the legislation include increased transparency in regulatory matters, a more differentiated regime for different categories of financial intermediaries that reflects the risks posed by institutions to the stability of the overall financial system, strengthened provisions for business conduct and consumer protection, as well as broader powers and instruments for enforcement and supervisory interventions by the Bank.

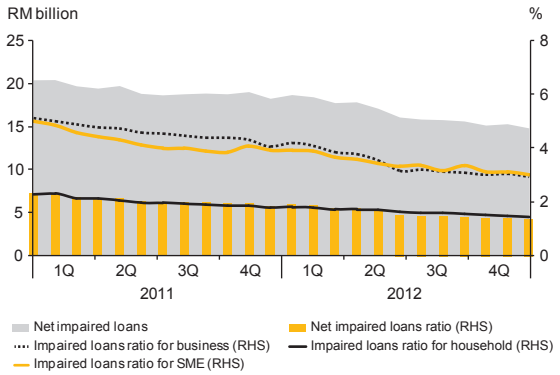
Overall risks to financial stability were contained during the quarter. Sustained economic growth and generally healthy financial positions of borrowers supported the stable credit risk of the banking system. The loan quality of banks remained intact, with the ratio of net impaired loans unchanged at 1.4% whilst loans-in-arrears improved marginally to 3.4% (3Q 12: 3.5%) of total loans. Credit risk exposures of the insurance industry, largely from holdings of private debt securities and reinsurance counterparties, were similarly stable at 3.4% of insurers' total capital.

Household debts rose at a moderate pace of 3.1% during the quarter (3Q 12: 3.4%). Financing for the purchase of residential properties grew at the same level as the previous quarter at 3%. However, outstanding credit card balances grew at a stronger pace at 3% (3Q 12: 0.2%) due mainly to year-end seasonal factors. At the aggregate level, debt accumulation by households was stronger than the increase in household financial assets which grew by 2.3% (3Q 12: 2.9%). Notwithstanding this, the financial buffers of households at the aggregate level remained comfortable. Total household financial assets remained above 2 times of household debts (3Q 12: 2.2 times) while the ratios for impaired loans and arrears of between one month and less than three months for household borrowings from banking institutions were stable at 1.5% and 2.8% of household loans (3Q 12: 1.6% and 2.7%) respectively, indicating households' continued ability to service debt.

Financing extended to businesses by the banking system moderated and grew by 1.2% during the quarter (3Q 12: 1.9%) due mainly to the slower activity in lending to the transportation (-6.2%; 3Q 12: -0.4%) and construction (-2.4%; 3Q 12: 9.3%) sectors which have raised funds mainly via the capital market for funding of long-term projects. Impairment improved further during the quarter driven mainly by the construction sector and the wholesale and retail trade segment which benefited from the implementation of mega projects by the Government and sustained domestic demand. As a result, gross impaired loans ratio remained low at 3% (3Q 12: 3.1%) of business loans while the leading indicator of loans-in-arrears of between one month and less than three months improved to 1.2% (3Q 12: 1.5%) of total business loans during the quarter. The debt servicing capacity of businesses remained intact, as evidenced by a comfortable interest coverage ratio of 6.3 times (2Q 12: 6 times).

The credit risk outlook for the banking system remained favourable against the backdrop of sustained economic growth and debt servicing capacity of borrowers. This is further supported by continued discipline observed in the credit risk management and underwriting practices of financial institutions. The level of household financial assets continues to provide adequate financial buffers for most households in mitigating any unexpected shocks to income. Similarly,

Banking System: Loan quality



Source: Bank Negara Malaysia

businesses are expected to sustain the ability to withstand challenges under an adverse operating environment, based on their strong financial positions as demonstrated by sustained profitability, low leverage and healthy liquidity positions. The expected default frequency for the business sector improved further to 0.5% as at the end of the quarter (3Q 12: 0.53%).

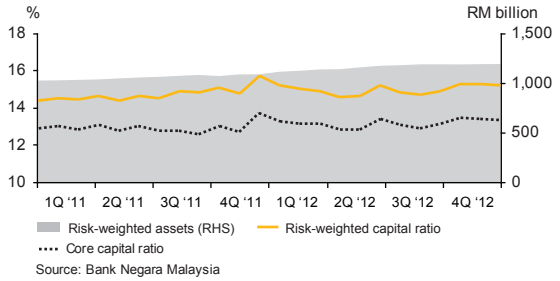
Volatile movements in short-term capital flows continued to be smoothly intermediated by the financial system without disruptive effects on the domestic financial markets. Volatility in the equity market eased further during the quarter to 6.7% (3Q 12: 7.2 %) while the benchmark index ended the quarter at an all-time high of 1,689 points. Trading liquidity in the debt and equity markets remained intact with relatively stable bid-ask spreads ranging between 0.05-0.14% and 0.31-0.79% of their respective price levels, amidst slightly lower turnover ratios. Interest rate and equity risk exposures of banks were unchanged at 4.8% and 0.6% (3Q 12: 4.8% and 0.6%) of capital base respectively. Similarly, the insurers' exposures to interest and equity risks were well-contained at 3.7% and 6.6% (3Q 12: 3.2% and 6.4%) of total capital available respectively.

Potential risks emanating from direct exposures of financial institutions to Europe and from deleveraging by European financial institutions remained limited. Direct credit exposures of the banking and insurance sectors to Europe accounted for less than 10% of banks' capital base and 0.3% of insurers' capital available respectively. Locally incorporated European banks continued to report healthy profits and showed no evidence of retrenchment from their operations in Malaysia, as demonstrated by the stable market share of assets, loans and deposits.

Financial sector continued to remain sound and resilient to weather potential adverse conditions

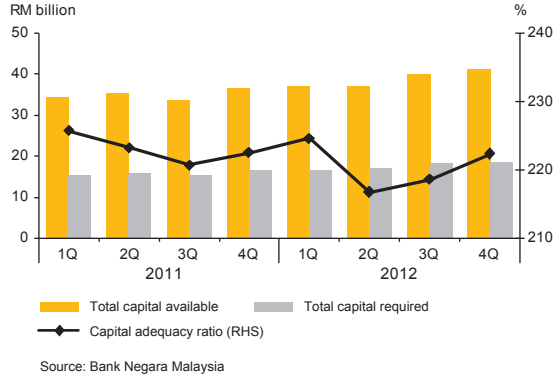
The banking sector is assessed to have the capacity to withstand shocks in the macroeconomy and financial markets, with a capital buffer in excess of RM80 billion at the end of 2012. Core capital ratio and risk-weighted capital ratio improved to 13.4% (3Q 12: 13.2%) and 15.2% (3Q 12: 14.9%) respectively. The banks are also well positioned to meet the Basel III requirements which will be phased in from January 2013. Banks also continued to maintain high quality capital, comprising paid-up capital, retained earnings, share premium and reserves, which accounted for 85% of total capital. Similarly, the insurance sector also maintained a sound capital adequacy ratio of 222.3% (3Q 12: 218.6%) with an excess capital buffer of RM22.5 billion.

Banking System: Capitalisation



Source: Bank Negara Malaysia

Insurance Sector: Capitalisation



Source: Bank Negara Malaysia

The profitability of the banking system improved to RM7.7 billion (3Q 12: RM7.4 billion) on account of higher trading and investment gains, as well as fee income. Net trading and investment income was 22% higher compared with the previous quarter following favourable developments in the financial markets. Returns on assets and equity were sustained at 1.6% (3Q 12: 1.6%) and 17.5% (3Q 12: 17.7%) respectively.

Banking System: Profitability

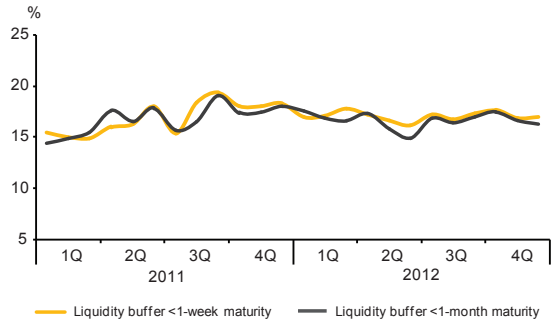


Source: Bank Negara Malaysia

The insurance and takaful industry recorded sustained profitability during the quarter. Excess of income over outgo in the life insurance and family takaful sector amounted to RM4.4 billion (3Q 12: RM5.2 billion) during the fourth quarter. The decline in profits was due to the one-off exceptional gains recorded in the third quarter which related to a divestment of investment assets by one of the insurers. Adjusting for the exceptional gains, the excess of income over outgo for the quarter would continue the upward trend observed throughout the year. General insurers and takaful operators registered a higher operating profit of RM882.6 million (3Q 12: RM688.4 million) following a more favourable underwriting performance resulting from a reduction in net claims incurred. Notably, the claim ratio for the 'motor act' cover (mandatory insurance cover required under the Road Transport Act 1987) improved to 237.1% (3Q 12: 242.2%).

The resilience of the banking system is also supported by ample liquidity in the system. Liquidity buffers to meet liquidity needs over a one-week and one-month horizon remained comfortable at 16.9% and 16.2% of total deposits (3Q 12: 17.3% and 17%) respectively. Net placements by banks with BNM which can be drawn on to meet additional liquidity needs stood at a further RM114 billion. The US dollar mismatch position in the less than one-month maturity bucket rebounded to a surplus of RM3.1 billion during the quarter from a shortfall of RM4.1 billion in the third quarter while the mismatch position in the less than one-week maturity bucket continued to record a surplus position.

Banking System: Liquidity Buffer to Total Deposit Ratio



Source: Bank Negara Malaysia

Insurance and Takaful Sectors: Indicators

	2011		2012				
	4Q	Year	3Q	4Q	Year	4Q	Year
	RM million		RM million			Annual Change (%)	
Life Insurance & Family Takaful							
Excess of Income Over Outgo	4,314.5	12,641.7	5,240.7[1]	4,365.8	17,635.1	1.2	39.5
General Insurance & General Takaful							
Operating profit	234.3	1,787.1	688.4	882.6	2,926.7	276.7	63.8
Claims ratio (%)	65.8	65.8	58.7	57.3	57.3	-1.4 (ppt)	-1.4 (ppt)

[1]Significant increase due to one-off exceptional gains in the life insurance segment.

Source: Bank Negara Malaysia