MANAGING RISKS TO FINANCIAL STABILITY

Domestic financial stability preserved

The Malaysian financial system remained resilient throughout the quarter despite the environment of heightened market volatility amid uncertainties in global growth and energy prices. Domestic financial intermediation continued to be well-supported by sound and well-capitalised financial institutions. Liquidity in the banking system remained ample despite occasional tight funding conditions. While investors' take a cautious approach in the period ahead, domestic financial system stability is expected to be maintained. The deep and well-developed domestic financial markets have continued to support orderly market conditions and sustained confidence in the financial system.

Manageable credit risk exposures amid sustained debt servicing capacity

The debt servicing capacity of borrowers remained generally intact. Delinquencies, measured in terms of loans-in-arrears (LIA) of between one and three months, remained low and stable at 2.2% of total bank loans, while the ratio of net impaired loans held steady at 1.2% of total bank loans. In the insurance industry, credit exposures, mainly in the form of holdings of private debt securities, were unchanged at 4.1% of total capital available.

The pace of year-on-year growth in household debt moderated further in the final quarter of the year to 7.3% (3Q 2015: +7.6%; 4Q 2014: +9.4%). This continued to be mainly driven by the modest growth of 3.4% in the financing for personal use by non-bank financial institutions (NBFI). Stable income and employment conditions continue to support the repayment capacity of the majority of households. Correspondingly, the performance of household loans from the banking sector was sustained with the impaired and delinquent loan ratios at 1.1% and 1.5%, respectively, across all types of financing facilities. Nevertheless, borrowers in the more vulnerable income segments faced some challenges in adjusting to the higher cost of living. Based on the Bank's on-going engagements with banks and key NBFI lenders, higher delinquencies were observed in the compact car hire purchase and personal financing segments, likely reflecting difficulties faced by more highly leveraged households in the lower income group of borrowers. For some borrowers, this has also started to increase challenges faced in maintaining regular home financing repayments, resulting in slightly higher house financing delinquencies.

Household financial assets increased by 4.8% over the same period last year (3Q 2015: +3.4%) largely attributed to a continued expansion in deposits and deposit-like instruments of 4.8% (3Q 2015: +6.5%). The recovery in the equity market during the quarter also helped boost the value of household investments in equities and other unit trust funds. Overall, household financial assets remained above two times of total debt. Based on the Bank's supervisory assessments, banks were observed to have maintained generally sound underwriting practices and loan affordability assessments. 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%.

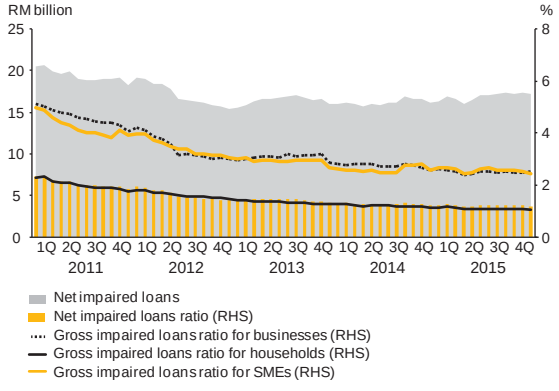
Total business sector borrowings expanded further by 14.1% as at end of the year (3Q 2015: +14.8%). This reflected the higher growth in external borrowings in the third quarter, about half of which was attributed to exchange rate valuation effects. New external borrowings by domestic conglomerates and GLCs comprised funds for domestic and overseas operations and investments and intra-company loans from multinational corporations for operations in Malaysia. These are generally supported by foreign currency denominated receivables which act as a natural hedge against exchange rate movements. Business loans from the banking system recorded a slower growth of 8% as at end-2015 (3Q 2015: +11%), with the growth in financing to small and medium enterprises (SMEs) remaining robust at 15% (3Q 2015: +17.6%). Aggregate leverage of Malaysian businesses[5], as measured by the median debt-to-equity ratio, was 46.8% in 3Q 2015, little changed from the previous quarter (2Q 2015: 46.5%).

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

Overall debt servicing capacity of Malaysian businesses remained largely intact amid the weaker ringgit, lower oil prices and more moderate growth. The median interest coverage ratio (ICR) was stable at 5.2 times in the third quarter (2Q 2015: 5.3 times). Businesses in the export-oriented sectors experienced some deterioration in the median ICR to 5.8 times (2Q 2015: 7.3 times) on lower demand for crude palm oil from China which added to the effect of lower global oil prices. In the domestic-oriented sectors, the median ICR was stable at 4.8 times (2Q 2015: 4.9 times), despite weaker consumer sentiment following the implementation of the goods and services tax. Businesses also generally maintained satisfactory liquidity positions with the median current ratio (current assets-to-current liabilities) and cash-to-short-term debt ratio stable at 1.7 times and 1.2 times respectively. This supported the overall quality of business loans in the banking system which remained sound. The ratio of business sector impaired loans stood at 2.5% while the ratio of LIA of up to 2 months was at 0.3% (3Q 2015: 2.5% and 0.4% respectively). In the SME segment, the ratio of impaired loans improved to 2.4% (3Q 2015: 2.6%). At an aggregate level, the credit risk outlook for businesses, as measured by the overall expected default frequency, remained steady at 0.61% (3Q 2015: 0.63%).

In 2Q 2015, the annual growth of the Malaysian House Price Index moderated slightly to 7.5% (1Q 2015: +7.8%). Housing transactions remained soft, particularly in the high-end market, as buyers remained on the sideline. On an annual basis, total transaction volume and value declined by 9.4% to 57,662 units and 18.1% to RM17.7 billion respectively in the third quarter (2Q 2015: -6.4% and -12%). In contrast, transactions in the affordable segment (houses priced below RM250,000) continued to register positive growth, reflecting strong demand for affordable housing. Speculative financing for house purchases remained subdued and continued to account for only a small proportion (2.8%) of housing loan borrowers.

Banking System: Loan Quality



Source: Bank Negara Malaysia

Orderly market conditions despite persistent volatility

Portfolio investments registered a net inflow of RM15.9 billion during the quarter (3Q 2015: net outflows of RM24.4 billion), driven by sustained demand for the Malaysian Government Securities (MGS). Declining crude oil prices, anticipation of the US policy rate normalisation and concerns on global growth weighed on the ringgit throughout the quarter. Nevertheless, the ringgit appreciated by 3.6% against the US dollar by the end of the quarter to RM4.2920 (3Q 2015: RM4.4455), in line with the performance of the domestic bond and equity markets towards the end of the year, which were driven by improved sentiments among global investors after the first policy rate increase in the US in seven years. The yield curve steepened with yields for the 10-year MGS rising slightly to 4.19% (3Q 2015: 4.15%), while yields at the shorter term of the curve declined (3-year MGS declined to 3.27% (3Q 2015: 3.71%)). In the equity market, the FBM KLCI ended the quarter higher at 1,692.51 points (3Q 2015: 1,621.04 points) in line with most regional equity markets. The price-to-earnings (PE) ratio of the FBM KLCI remained broadly stable at 18 times against a long-term average PE ratio of 17 times. While average volatility of both the 10-year MGS yield and FBM KLCI rose to 17.2% and 14.5%, respectively, for the quarter (3Q 2015: 11.8% and 10.8%, respectively), market volatility moderated towards the end of the year with more clarity emerging after the US policy rate increase. 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 monthly turnover ratio for the MGS and FBM KLCI remained firm at 10.4% and 2.1% respectively (3Q 2015: 14.4% and 2%, respectively). At the end of the fourth quarter, non-resident holdings accounted for

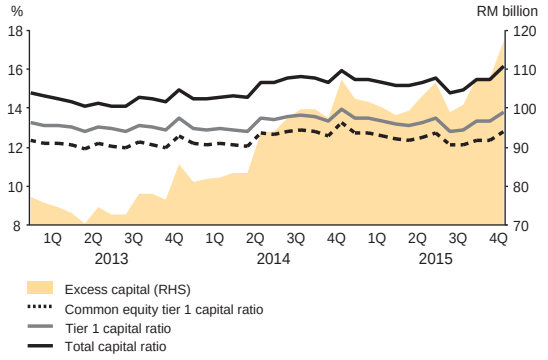
47.7% of total outstanding MGS and 22.3% of equity market capitalisation (3Q 2015: 45.6% and 23%, respectively). Investors' perception of Malaysia's sovereign credit risk and onshore US dollar liquidity conditions also improved during the quarter. The 5-year sovereign cross default swap spread eased to 180.2 basis points (3Q 2015: 238.9 basis points) while the 5-year cross-currency basis swap spread declined to 75 basis points (3Q 2015: 115 basis points).

Sustained resilience of financial institutions

The Malaysian financial institutions remained well-capitalised. The common equity tier-1 capital, tier-1 capital and total capital ratios of banks were sustained well above the minimum regulatory levels at 12.8%, 13.8% and 16.1%, respectively. More than 80% of the 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 245.5% (3Q 2015: 243.8%). In aggregate, banks, insurers and takaful operators have capital buffers totalling RM147.4 billion (banks: RM117.3 billion; insurers / takaful operators: RM30.1 billion), that would be able to absorb any potential losses from adverse credit and market events.

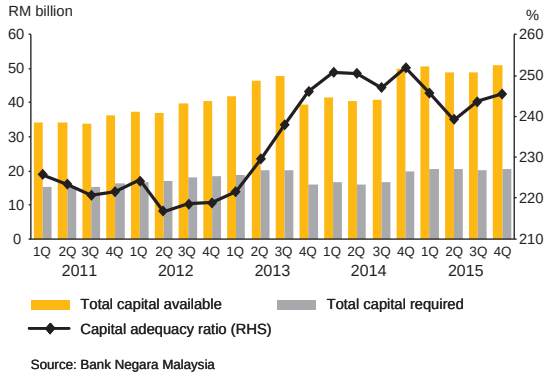
The pre-tax profit of the banking system amounted to RM7.2 billion in 4Q 2015 (3Q 2015: RM7.3 billion), as higher staff cost and overhead expenses partly offset the growth in interest- and fee-income and lower provisioning. Returns on assets and equity remained healthy at 1.3% and 12.4% respectively (3Q 2015: 1.3% and 12.7% respectively). In the general insurance and takaful sector, higher operating profits were recorded, boosted by higher investment income of RM659.9 million (3Q 2015: RM555.7 million). Underwriting performance also improved (4Q 2015: RM335.9 million; 3Q 2015: RM69.7 million) mainly due to lower claims costs. Similarly, the earnings performance of life insurers and family takaful operators improved during the quarter with a positive excess income over outgo of RM5.2 billion (3Q 2015: negative excess income over outgo of RM0.4 billion). This stemmed from a net capital gain of RM2.0 billion (3Q 2015: net capital loss of RM3.1 billion) following higher valuation in equity holdings, in line with the rise in the FBM KLCI towards year-end. As part of on-going portfolio rebalancing strategies, life insurers have slightly reduced asset allocation to domestic equities since end-2014, reflecting the more volatile equity market outlook.

Banking System: Basel III Capitalisation



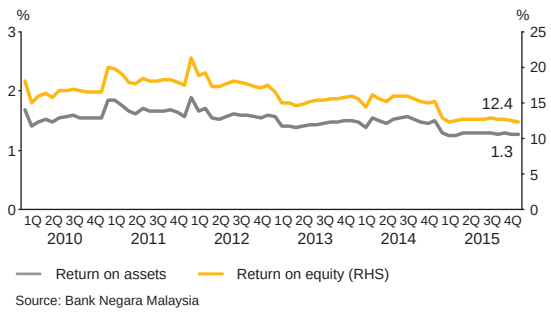
Source: Bank Negara Malaysia

Insurance Sector: Capitalisation



Source: Bank Negara Malaysia

Banking System: Profitability



Source: Bank Negara Malaysia

Insurance and Takaful Sectors: Indicators

	2014		2015		
	4Q	Year	3Q	4Q	Year
	RM million				
Life insurance & family takaful					
Excess of income over outgo	2,120	13,760	-417	5,230	11,993
General insurance & general takaful					
Operating profit	760	3,176	556	660	2,678
Claims ratio (%)	57.5	57.5	60.1	60.2	60.2
	Annual Change (%)				
Life insurance & family takaful					
Excess of income over outgo	4.3	-36.6	-110.9	146.6	-12.8
General insurance & general takaful					
Operating profit	-27.0	-1.5	-29.5	-13.2	-15.7
Claims ratio (percentage points)	0.4	0.4	3.3	2.7	2.7

Source: Bank Negara Malaysia

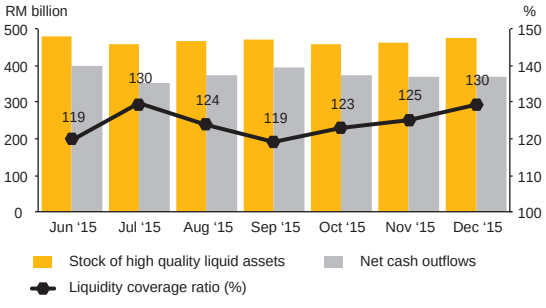
Market risk exposures remained manageable. The banking institution's exposures to interest rate risk in the trading book and equity risk remained low at 1.2% and 0.7% of total capital, respectively (3Q 2015: 1.4% and 0.7%, respectively). The foreign exchange net open position of banks meanwhile rose to 6.1% (3Q 2015: 5.9%) of total capital, largely reflecting developments in the ringgit. Market risk exposures of the insurance industry increased to 13.1% (3Q 2015: 12.2%) of total capital, reflecting higher valuations of investments particularly in the equity market. Correspondingly, equity risk, which forms the bulk of insurers' market risk exposures, rose to account for 7.7% (3Q 2015: 7.3%) of total capital.

Aggregate liquidity in the banking system remained firmly supportive of financing activities. As at end-2015, banking system placements and reverse repos with Bank Negara Malaysia, which can be unwound to meet liquidity needs, were in excess of RM100 billion, preserving comfortable buffers against unexpected cash outflows or adverse liquidity shocks. The reduction in the Statutory Reserve Requirement (SRR) effective 1 February 2016 added additional liquidity to the domestic financial system. In addition, as provided for under the rules of the Basel Committee on Banking Supervision, the Bank will establish a committed liquidity facility that can be utilised by banking institutions with the undrawn portion of this facility eligible for recognition as a high-quality liquid asset for purposes of compliance with the Liquidity Coverage Ratio (LCR). Under the standards which have been phased in since 1 June 2015[6], the banking system LCR stood at 130% as at end-December 2015 (August 2015: 124%), with all banks reporting LCR levels that are above the 2015 minimum regulatory requirement of 60%.

Domestic funding conditions were tighter amid continued competition in the deposit market which also drove the KLIBOR higher. During the quarter, the banking system average cost of deposit[7] remained stable at 2.53% (3Q 2015: 2.53%, 2014: 2.38%). The 3-month KLIBOR edged higher to 3.84% at the close of the year (3Q 2015: 3.74%) as competition for year-end placements by corporate depositors remained elevated but further improved to 3.75% as at 16 February 2016 as competition eased. While bank funding continues to be predominantly deposit-based and in local currency, banks have increasingly tapped the deeper domestic capital markets to maintain a stable funding profile through issuances of medium term funding instruments. This also reflects the wider avenues available for funding instruments, which has led in part to more moderate deposit growth over the years. Taking into account the broader funding base of banks, the loan-to-funds ratio[8] (LTF) stood at 83% compared with a loan-to-deposit ratio[9] of 88.7% at the end of the quarter (3Q 2015: 82.8% and 88.3%, respectively).

[6] In the first phase, compliance is set at 60% with progressive increment of 10% each year to the full compliance beginning 2019
[7] Revision in the computation of the average cost of deposits (calculated as the interest expense on deposits as a percentage of total deposits accepted)
[8] Fund comprises deposits and all debt instruments (including subordinated debt, debt certificates/sukuk issued, commercial papers and structured notes).
[9] Beginning July 2015, loans exclude financing funded by Islamic investment accounts

Banking System: Basel III Liquidity Coverage Ratio



Source: Bank Negara Malaysia

External exposures of the banking system expanded in-line with banks' regional operations and regional trade activities. The growth in banks' external assets slightly outpaced that of external liabilities. At the end of the third quarter, banks' net external liabilities increased to RM149 billion (2Q 2015: RM142 billion), driven primarily by higher interbank borrowings (+19.4%) and an increase in debt securities issued (+28.4%). This is largely reflective of the centralised liquidity management operations of Malaysian banks, particularly those with larger overseas operations. Banks have also been actively diversifying into medium to longer term funding instruments via issuances of multicurrency subordinated debt and structured notes, in efforts to lengthen the maturity profile and reduce currency mismatches.