Managing Risks to Financial Stability

HIGHLIGHTS

- **Businesses and households continued to demonstrate sound debt servicing capacity.**
- **Domestic financial stability is expected to remain intact, supported by sound financial institutions, orderly markets and liquidity conditions.**

Financial stability sustained with financial intermediation and domestic market conditions remaining orderly

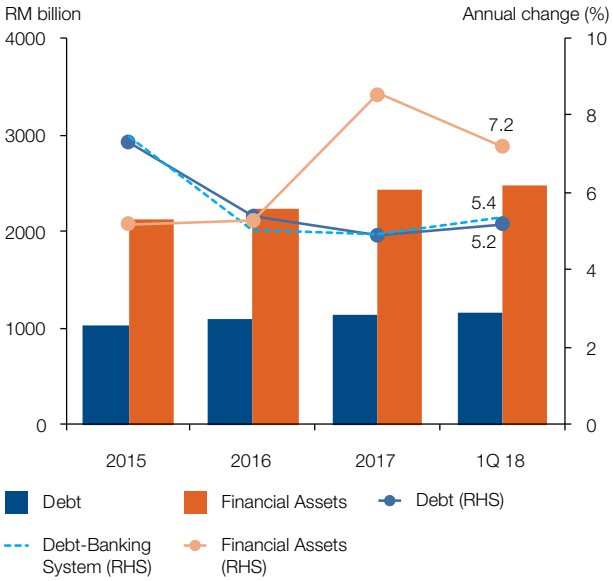
Credit intermediation activities continued to be supportive of real economic activities. Credit risk remained stable, supported by sound debt servicing capacity of both households and businesses. Domestic financial market conditions remained orderly despite heightened volatility driven by developments on the external front. Domestic financial institutions demonstrated resilience with healthy asset quality, sound profitability and ample liquidity. These sustained overall financial stability.

Stable debt servicing capacity of households and businesses

The annual growth in household debt[9] increased to 5.2% in the first quarter of 2018 (4Q 2017: 4.9%). Of this, banking system loans[10] extended to households registered a higher growth of 5.4% (4Q 2017: 4.9%) while the growth of loans extended by development financial institutions and non-bank financial institutions (NBFIs) moderated to 4.3% (4Q 2017: 5.1%).

Expansion in household financial assets continued to outpace that of debt

Chart 28: Household Sector Debt and Financial Assets



Source: Bank Negara Malaysia, Bloomberg, Department of Statistics, Malaysia, Securities Commission Malaysia and internal computation

[9] Loans extended by banks (including MBSB Bank), development financial institutions and major NBFIs
[10] Including MBSB Bank

Total business borrowings was driven by stable corporate issuances in the capital market

Chart 29: Business Sector NFC-Debt-to-GDP



Source: Bank Negara Malaysia

The increase in overall household debt was attributed to loans for the purchase of residential properties (contribution to growth in 1Q 2018: 4.4 ppt; 4Q 2017: 4.3 ppt), primarily for houses priced between RM500,000 and RM750,000. The increase was also supported by loans for the purchase of securities (contribution to growth in 1Q 2018: 0.3 ppt; 4Q 2017: 0.1 ppt), both in unit trust funds and equities.

The overall debt repayment capacity of households is expected to remain sound, supported by sustained wage growth as a result of favourable labour market conditions. Aggregate household financial assets and liquid financial assets continued to be adequate at 2.1 and 1.5 times of debt, respectively. In addition, the growth of household financial assets (7.2%) continued to outpace debt (5.2%) for the fifth consecutive quarter. At the end of the first quarter of 2018, total household debt stood at 84% of GDP (4Q 2017: 84.2%). Excluding lending by non-banks, the total banking system loans to households as a share of GDP was 69.2% (4Q 2017: 69.3%).

The overall asset quality of banks and non-banks remained sound. The aggregate impairment ratio for loans to households was sustained at 1.6%, while the aggregate delinquency ratio improved to 1.2% (4Q 2017: 1.4%). Strengthened affordability assessments by lenders further contributed towards receding risks of financial imbalances arising from the household sector. The majority of new household borrowers have prudent debt service ratios (DSR), with most having DSR of below 60%. The share of borrowings by vulnerable borrowers (those with monthly earnings below RM3,000) declined to account for 19.9% of total household debt by end of 2017 (2016: 21.9%) of total household debt. Potential losses to banks from vulnerable households under a simulated scenario based on assumptions of a tripling of prevailing probabilities of default and severe loss given default were estimated at less than 10% of banks' excess capital buffers (above the regulatory minimum).

Borrowings by the business sector grew by 5.1% on an annual basis in the first quarter of 2018 (4Q 2017: 3.2%). This was driven by increased fund raising in the capital market which grew by 15.3% (4Q 2017: 14.3%), led by non-financial corporations in the infrastructure, utilities and real estate sectors. Corporate external borrowings were higher as new borrowings offset the positive exchange rate valuation effects. New borrowings mainly comprised loans by businesses in the manufacturing and oil and gas (O&G) sectors. Financing by banks and development financial institutions (DFIs) to businesses sustained its expansion at 1.3% (4Q 2017: 1.3%). Of this, financing to SMEs expanded by 5.1% in the first quarter (4Q 2017: 5.3%).

The financial position of firms remained healthy supported by improving domestic and external demand. The aggregate leverage of non-financial corporations (NFCs)[11] as measured by the median debt-to-equity ratio decreased in 4Q 2017 (47%; 3Q 2017: 51.9%). This was attributed to lower debt levels among firms in the telecommunications, transportation and construction-related sectors.

Aggregate debt servicing capacity and liquidity positions remained sound. The median interest coverage ratio (ICR) was sustained at 9.6 times in 4Q 2017 (3Q 2017: 9.6 times), comfortably above the prudent threshold of two times. The median current cash-to-short-term debt ratio (CASTD) was also above the prudent threshold of one time, at 1.5 times in 4Q 2017 (3Q 2017: 1.6 times). Overall, the ratio of impaired and delinquent loans in 1Q 2018 remained low at 2.6% and 0.3% of total bank lending to businesses, respectively (4Q 2017: 2.5% and 0.3%, respectively).

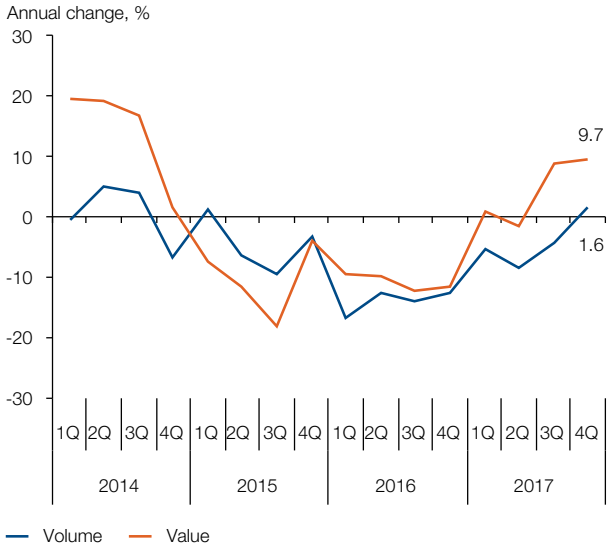
The ratio of impaired loans in the O&G sector increased to 8.7% (4Q 2017: 5.5%), in the first quarter of 2018. The higher impairment was driven by non-SMEs in the shipping and fabrication segments. Risks to the banking system from exposures to the O&G-related sector continued to be small (6% of total domestic exposures to businesses), with provisions against potential credit losses fully accounted for. The anticipated higher capital expenditure by major oil and gas firms for the year amid an increasing trend in oil prices may positively impact the earnings of service providers in this sector moving forward.

The modest increase in housing market activities has yet to translate into better debt repayment capacity in the real estate sector. The impaired loans ratio marginally increased to 1.9% of total bank lending to businesses in the real estate sector (4Q 2017: 1.7%), driven mainly by SMEs in the real estate services segment. The median ICR and median CASTD of property developers[12] were stable at 5.7 times and 0.9 times, respectively (3Q 2017: 5.8 times and 0.8 times, respectively). Risks to domestic financial stability arising from exposures to property developers remained minimal. Based on the sensitivity analysis conducted on banks' overall credit exposures (including investments in bonds and sukuk) to the property market and related sectors, banks have sufficient buffers to absorb potential cumulative losses (For more details, please refer to Chapter 1 of the Bank Negara Malaysia Financial Stability and Payment Systems Report 2017).

[11] Based on 120 listed firms on Bursa Malaysia with 85% market capitalisation (excluding financial institutions).
[12] Based on 94 listed property developers on Bursa Malaysia.

Housing market activities picked up in 4Q 2017

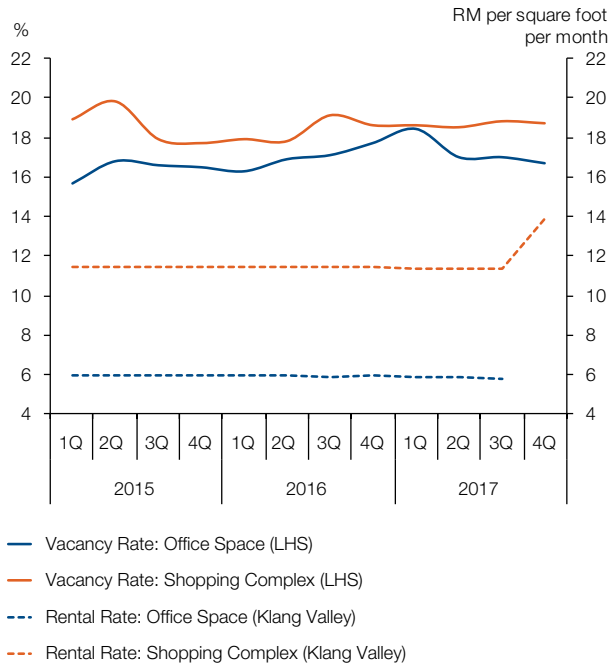
Chart 30: Residential Property Transaction Volume and Value



Source: National Property Information Centre

Rental rate of shopping complexes improved slightly in 4Q 2017

Chart 31: Office Space and Shopping Complex Vacancy and Rental Rates



Source: National Property Information Centre, Knight Frank, Jones Lang Wootton and internal computation

Modest improvements in housing market activities

In the housing market, both total housing transaction volume and value increased by 1.6% and 9.7%, respectively in 4Q 2017 (3Q 2017: -4.2% and 8.7%, respectively). The improvement was driven largely by transactions of houses priced between RM500,000 and RM1 million. House prices (as measured by the Malaysian House Price Index) grew by 6.5% in 3Q 2017 (2Q 2017: 6.8%; 4Q 2017 preliminary: 5.8%). A similar upward trend was observed across almost all house types and states.

Banks continued to extend loans for the purchase of residential property to eligible borrowers, including to first-time house buyers. Outstanding loans extended by banks for house financing were sustained at 8.9% on an annual basis in 1Q 2018 (4Q 2017: 8.9%). Loan approval rates for houses priced below RM500,000 stood at 71.5%, with most major states recording housing loans approval rates above 70%.

Demand for financing for speculative house purchases continued to be low. During the quarter, the share of the number of housing loans settled within three years (the typical duration required to complete construction after a property is acquired) stood at 7.5% of total settled housing loans (4Q 2017: 7.9%). The annual growth in the number of borrowers with three or more outstanding housing loans (a proxy for speculative buyers) remained low at 0.8% (4Q 2017: 0.9%). The credit quality for overall housing loans remained sound, with both impairment and delinquency ratios remaining low at 1.1% of total bank loans (4Q 2017: 1% and 1.3%, respectively).

The oversupply situation in the office space and shopping complex segment continued to persist despite some pickup in rental rates for selected shopping complexes in choice locations. Direct risks to banks from end-financing exposures to the office space and shopping complex segments have been small at 3.1% of total bank loans. Banks continue to maintain sound underwriting and valuation practices, even though excess supply in these segments were apparent. Banks remained cautious in extending lending to these segments as reflected in the lower loan approval rates for the construction and purchase of such properties (1Q 2018: 62% and 71.3% respectively; 4Q 2017: 66.9% and 74.7% respectively). The delinquency and impairment ratios for the non-residential property segment remained low at 0.6% and 1.3%, respectively (4Q 2017: 0.7% and 1.2%, respectively).

Orderly domestic financial market conditions despite higher volatility

Investor sentiments have been affected by developments on the external front. This includes the global equity market correction in early February, the interest rate hike by the Federal Reserve in March and heightened concerns over trade disputes between the US and PR China. Despite the continued uncertainties, overall volatility in the domestic financial market rose. The 90-day volatility of the FBM KLCI and ringgit increased to 8.7% and 4.8%, respectively (4Q 2017: 5.6 % and 3.9%, respectively). However, the 90-day volatility of 10-year MGS yields declined to 7.3% (4Q 2017: 9.9%).

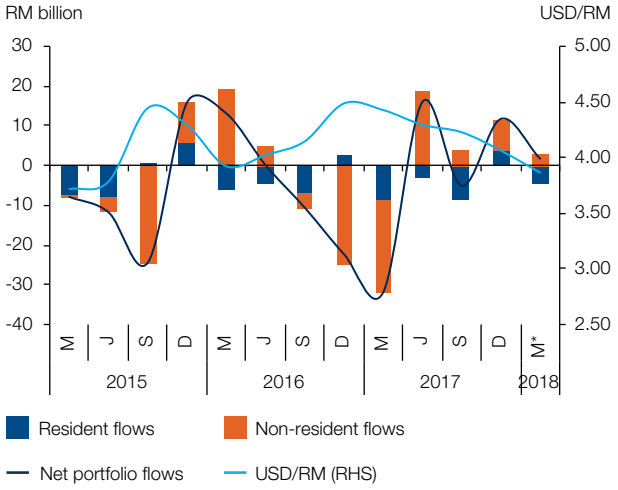
In the first quarter of 2018, portfolio investments recorded net outflows of RM2.6 billion (4Q 2017: net inflows of RM11.6 billion) attributed mainly to a resumption in net acquisitions of foreign financial assets by resident fund managers and banks. However, this was offset by non-resident investments in the equity and bond markets. Non-resident investor holdings of government bonds decreased slightly to 27.4% of total outstanding Malaysian government bonds (4Q 2017: 27.7%). The composition of non-resident investors in government bonds remained broadly unchanged, consisting mainly of long-term investors such as central banks, governments, pension funds and insurance companies (52% of total non-resident holdings). In addition, non-resident holdings were mostly concentrated in medium and longer-dated bonds of more than 3 years (68%).

Non-resident participation in the domestic equity market increased to 24.2% of total equity market capitalisation (4Q 2017: 23.2 %). The FBM KLCI ended the quarter at 1,863.46 points (4Q 2017: 1,796.81 points), reaching a high of 1,876.87 points on 22 March 2018 before settling lower on the announcement of potential higher tariffs on PR China's imports by the US. The price-to-earnings (PE) ratio for the FBM KLCI stood at 17.6 times (4Q 2017: 16.2 times; 2010-2017 average: 16.8 times).

Market liquidity continued to remain ample. The average bid-ask spread for MGS and FBM KLCI remained unchanged at 0.1% and 0.4% of the mid-price, respectively (4Q 2017: 0.1% and 0.4%, respectively). Daily average USD/MYR bid-ask stood at 26.1 pips (4Q 2017: 24.3 pips). Liquidity in the foreign exchange market improved, as the transaction volume for all currency pairs increased to a daily average of USD11.2 billion (4Q 2017: USD9.9 billion).

Net portfolio investment inflow mainly driven by continued investment by non-residents in the domestic asset market

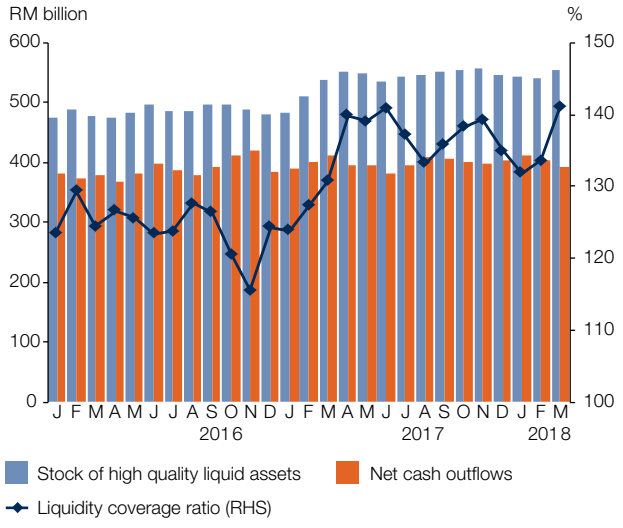
Chart 32: Financial Market Net and Gross Portfolio Flows and Ringgit Exchange Rate Movement



Source: Department of Statistics, Malaysia

Banking system liquidity sufficient to buffer for adverse liquidity shocks

Chart 33: Banking System Basel III Liquidity Coverage Ratio



Source: Bank Negara Malaysia

The ringgit continued to appreciate against the US dollar by 5.2% to end the quarter at RM3.8620 per US dollar (4Q 2017: RM4.0620). A similar trend was observed against most other major currencies. However, spreads on long-term onshore USD liquidity, as reflected by the 5-year cross-currency basis swap spreads, widened to 40 basis points (bps) (4Q 2017: 25 bps) as external developments weighed on market sentiment. The 5-year sovereign credit default swap spread increased to 73.1 bps, although it remained lower than the 2017 peak of 139.6 bps (4Q 2017: 58.4 bps).

Market risk exposures largely mitigated by risk management strategies

Banks' aggregate market risk exposures remained stable. FX risk, measured in terms of the net open position of foreign currency denominated exposures, declined to 5.3% of total capital (4Q 2017: 6.1%). Interest rate risk in the trading book and equity risk remained low at 1.1% and 0.8% of total capital, respectively (4Q 2017: 1% and 1.9%, respectively). Interest rate risk in the banking book also declined to 3.3% (4Q 2017: 3.7%) of total capital.

For the insurance and takaful industry, market risk exposures stood at 14.9% of total capital available (4Q 2017: 15.4%). Equity risk, which formed the bulk of insurers' market risk exposures, decreased slightly to 9% of total capital available (4Q 2017: 9.1%).

Ample liquidity conditions continued to support intermediation activities

Outstanding ringgit surplus liquidity placed with Bank Negara Malaysia stood at RM198.5 billion as at end 1Q 2018 (4Q 2017: RM188.7 billion) in the form of placements, reverse repos and statutory reserves. The Liquidity Coverage Ratio (LCR)[13] for the banking system stood at 141% as at end-March 2018 (4Q 2017: 135%). All banks recorded LCR levels well above the current minimum regulatory requirement of 90%.

[13] 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. As of 1 January 2018, the minimum requirement is set at 90%.

Domestic funding conditions remained stable during the quarter. Both the average cost of deposits[14] for banks and the 3-month KLIBOR increased to 2.54% and 3.69%, respectively as at end 1Q 2018 (4Q 2017: 2.51% and 3.43%, respectively) following the 25 bps hike in the overnight policy rate (OPR). Banks continued to be predominantly funded by deposits (70.1% of total funding) and in local currency. On aggregate, bank deposits including Islamic investment accounts recorded a higher growth of 5.2% (4Q 2017: 4%), supported by stronger growth in business sector deposits (1Q 2018: 11.3%, 4Q 2017: 7.1%). Banks maintained a diversified funding structure through the utilisation of medium-term ringgit and foreign currency denominated funding instruments. The loan-to-funds ratio[15] (LTF), which takes into account the broader funding structure of Malaysian banks, stood at 82.4% (4Q 2017: 84%).

Strong capitalisation and sustained profitability of financial institutions

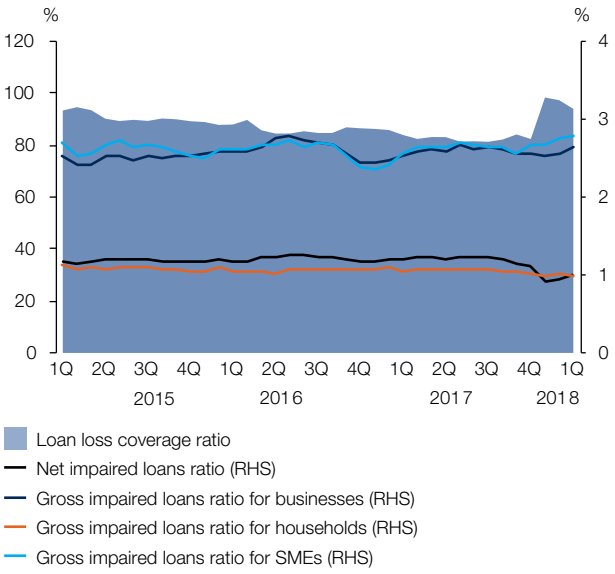
Malaysian financial institutions remained well-capitalised. In the banking system, the Common Equity Tier 1 capital ratio, Tier 1 capital ratio and total capital ratio stood above minimum regulatory requirements at 13.2%, 14% and 17.5%, respectively (4Q 2017: 13.5%, 14.5% and 17.3%, respectively). Similarly, the insurance and takaful sector reported an aggregate capital adequacy ratio of 237.3% (4Q 2017: 233.8%), above the 130% minimum required.

At the banking system level, asset quality remained sound. Overall gross impaired loans ratio stood at 1.57% (4Q 2017: 1.54%). Following the adoption of MFRS 9[16] in January 2018, banks' provisioning levels increased to RM23.7 billion (4Q 2017: RM20.1 billion). The increase was anticipated given refinements in impairment provisioning methodologies under the new standard. Consequently, the loan loss coverage ratio (including regulatory reserve) was higher at 126.9% (4Q 2017: 114.7%).

Net interest income from lending/financing activities was sustained while higher income was recorded from treasury activities. This was offset by a reduction in income from non-recurring items (e.g. dividend and sale of non current assets). Correspondingly, pre-tax profit of the banking system reduced to RM9 billion (4Q 2017: RM10 billion) in the first quarter of 2018. Banks' financing (including interest) margin net of operating costs and loan loss provisions increased to 0.81 percentage points (ppts) (4Q 2017 average: 0.71 ppts), largely due to higher recoveries from impaired loans.

Healthy Asset Quality Observed in the Banking System

Chart 34: Banking System Asset Quality



Source: Bank Negara Malaysia

[14] The average cost of deposit is computed based on rolling 12-months average of interest expense on deposit over total deposit.
[15] Funds comprise deposits and all debt instruments issued (including subordinated debt, debt certificates/sukuk, commercial papers and structured notes).
[16] Malaysian Financial Reporting Standards 9: Financial Instruments

In the insurance and takaful sector, life insurers and family takaful operators recorded lower excess income over outgo of RM4.0 billion (4Q 2017: RM 4.9 billion). This was partly attributed to net capital losses from holdings of debt securities together with lower valuations. The operating profits of general insurers and takaful operators also declined to RM563.3 million in the first quarter (4Q 2017: RM783.4 million) driven by higher claims cost in the motor line of business. The industry overall claims ratio increased to 56.9% (4Q 2017: 54.9%).

imSME, an online SME referral platform, reduces search costs for businesses

The imSME platform, launched by Credit Guarantee Corporation (CGC) on 9 February 2018, matches SMEs to suitable financing products according to their business profile, credit standing and financing needs. The platform currently offers 28 financing products from 15 institutions, including both conventional and Islamic products. As at 3 April 2018, RM2.4 million in financing to SMEs was approved as a result of successful matches through the platform.

The imSME platform has been effective in reducing search costs for businesses seeking financing. SMEs that previously had to visit multiple banks for financing successfully reduced travel and waiting time by up to 3 hours[17] per financial institution. In addition, SMEs saved up to 10 days in preparing loan documentation, freeing up resources to focus on their core business operations.

A dedicated Financial Advisory Team formed by CGC was also established to conduct diagnostics and provide structured assistance to unmatched and rejected applicants, benefitting 350 SMEs to-date. Most unmatched or rejected SMEs were found to have submitted inaccurate financial information, which affected their eligibility for financing. The Financial Advisory Team provided various forms of targeted assistance to address specific challenges faced by SMEs, including:

- Advise and guidance on providing the correct information in re-submissions of financing applications;
- Advise on the amount and tenure of financing, which would be more in line with repayment capacity;
- Referrals to capacity building agencies such as Centre for Development and Research (CEDAR) and Institut Keusahawanan Negara (INSKEN) for assistance on financial management and business planning to improve eligibility for financing; and
- Information on alternative financing avenues, including peer-to-peer (P2P) financing platforms for SMEs which lacked financial track records.

The imSME platform is accessible at https://imsme.com.my.

[17] Based on a survey conducted by CGC on successful imSME applicants to determine the impact of imSME on businesses applying for financing.