MANAGING RISKS TO FINANCIAL STABILITY

Domestic financial system remains resilient

Financial stability was sustained despite global uncertainties associated with developments in PR China and the outcome of the UK's EU referendum. Domestically, the direct impact from the UK's EU referendum on financial institutions has been minimal given the limited exposure to the UK. Volatility in the domestic financial markets rose on 24 June 2016, but resumed its easing trend to end the quarter at levels below that recorded in the first quarter. Overall liquidity conditions remained supportive of financing needs of businesses and households. While businesses and households continue to adjust to the more challenging business conditions and higher cost of living, this is expected to have modest impact on financial institutions' earnings and asset quality. Supported by strong capital and liquidity buffers, financial institutions have the capacity to weather adverse economic and market developments without disruptions to domestic financial intermediation.

Sustained debt servicing capacity of households and businesses

The debt servicing capacity of borrowers remained intact. Loan delinquencies (measured by loans-in-arrears of between one and three months) were unchanged at 2.0% of total bank loans. Loan impairments rose marginally in value terms but remained low at 1.3% of net loans (1Q 2016: 1.2%). Banks' provisions against loan losses stood at 90%. Including regulatory reserves for loans and financing, banks' buffers for potential credit losses remained at satisfactory levels. In the insurance and takaful industry, credit exposures were broadly stable at 4.2% of total capital available (1Q 2016: 4.3%). These are mainly in the form of holdings of the Malaysian Government Securities and highly-rated corporate bonds.

Household debt sustained its slower growth momentum, increasing by 6.2% at the end of the quarter (1Q 2016: +6.5%; 2Q 2015: +8.3%). House financing continued to be the main driver of the increase in household debt. Underpinned by sustained demand for affordable housing, house financing grew by 10.2% (1Q 2016: +10.7%; 2Q 2015: +12%). Overall employment and income conditions are expected to remain favourable amid on-going process and man-power reviews by businesses given the current environment. Along with strengthened affordability assessments by lenders, these further support the debt servicing capacity of households.

Most household borrowers have some flexibility to respond to income shocks and rising living expenses. Highly leveraged borrowers in the lower income group are, however, beginning to show weaker repayment capacity. Bank exposures to these borrowers have declined over the years to now account for 19.5% of total bank lending to households (2013: 25.1%). Improvements in non-bank lending standards have further reduced the overall proportion of vulnerable household borrowers to 22.6% (2013: 28.4%) of total household debt from banks and non-banks.

Household delinquencies remained unchanged at 1.4%, while impairment improved to 1.6% of total household debt (1Q 2016:1.7%), respectively. This suggests that households are actively managing their finances, thus limiting potential wide-scale losses to banks. The Bank's stress tests continue to show that excess capital buffers of banks, currently at RM120.8 billion, are more than sufficient to absorb extreme losses under adverse scenarios.

Banks' credit risks from exposures to the business sector are manageable. In recent years, a number of Malaysian corporates have ventured overseas for business opportunities and to diversify revenue base. For those with significant operations in the UK, the direct impact from the result of the UK's EU referendum has been limited. These corporations are mainly involved in property development, where projects have already been locked in with strong take up rates. This contains any potential spillovers to the domestic financial system.

The expected default frequency for businesses improved slightly to 0.61% (1Q 2016: 0.69%), largely reflecting expectation of better domestic

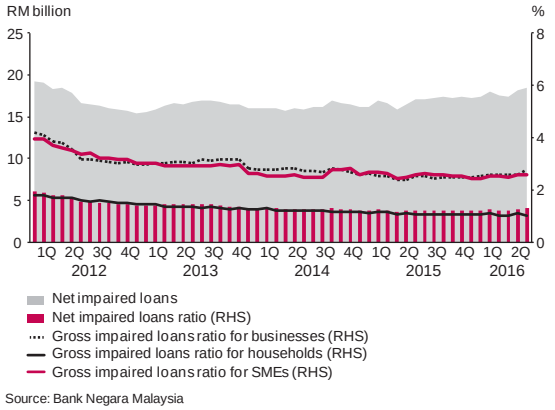
demand and low input cost. Aggregate leverage of Malaysian businesses[3], as measured by the median debt-to-equity ratio, improved further to 41.9% in 1Q 2016 (4Q 2015: 44.5%).

Credit conditions remained conducive for businesses, including SMEs. There is limited evidence of broad-based tightening in the supply of credit observed thus far. As at the end of the quarter, total debt of businesses expanded by 6.7% (1Q 2016: 7.5%). This was largely led by higher fund raising from the capital market. Outstanding bank financing to businesses grew at a slower pace (2Q 2016: 4.2%; 1Q 2016: 5.2%). The growth was driven mainly by financing to small and medium enterprises (SMEs) (9.9%). External borrowings by businesses declined (1Q 2016: RM273.3 billion; 4Q 2015: RM289.9 billion), largely on account of smaller effects from currency translations. Growth in new external borrowings was almost flat. Rollover and funding risks from external borrowings continued to be limited, with more than 40% of external borrowings in the form of inter-company obligations by multinational corporations with operations in Malaysia. In addition, more than 70% of the external borrowings have maturity beyond one year.

Businesses' financials remained healthy. The median interest coverage ratio (ICR) stood at 4.2 times in the first quarter of 2016 (4Q 2015: 4.4 times). Aggregate liquidity to meet short-term debt obligations also remained intact. The median current assets-to-current liabilities ratio (current ratio) and cash-to-short-term debt ratio (CASTD) were largely unchanged at 1.7 times and 1.1 times, respectively (4Q 2015: 1.7 times and 1.2 times, respectively). Across the industries and sectors, the performance was however mixed. Businesses in the export-oriented sectors continued to exhibit sustained financial health backed by stronger financial buffers and modest leverage levels. This was despite weak commodity prices and subdued global demand. Banks' exposures to the crude palm oil and oil and gas sectors, which remained challenged by low commodity prices, accounted for 3.9% and 2.1% of total credit exposures to businesses, respectively. Businesses in the domestic-oriented sectors, however, were more affected by continued weakness in consumer demand and stiff competition in the retail sector. This resulted in higher delinquencies and impairment, mainly in domestic-oriented sectors, namely real estate, oil and gas, construction and wholesale and retail trade sectors. However, banks' overall business portfolio remained of high quality. The ratios of impaired and delinquent loans were unchanged at 2.8% and 0.4% of bank lending to businesses, respectively at end-2Q 2016. Banks' exposures to large business borrowers with weak financials (ICR below two times and CASTD below one time) remained limited at 6.5% of total banking system credit exposures to corporations.

The housing market remained soft amid more cautious consumer sentiment. Total housing transactions, in terms of volume and value, declined by 16.6% to 49,612 units (4Q 2015: -3.1% to 58,859 units) and 9.5% to RM16.2 billion (4Q 2015: -4.1% to RM19.3 billion), respectively, during the first quarter of 2016. This trend was observed across all house price segments, particularly in major states such as Selangor, Johor and Penang. Moving forward, the demand for affordable housing will continue to lend support to housing market, while encouraging continued shift in supply towards low-to-medium priced segments. Consistent with these trends, speculative activity in the housing market has remained subdued. The number of borrowers with at least three outstanding housing loans expanded at a slower annual rate of 1.9% in 2Q 2016 (1Q 2016: 2.4%). The number of housing loans being settled in under three years (as a proxy for borrowers who engage in speculative buying and selling) remained stable at 10.8% of total housing loans settled during the quarter (1Q 2016: 12.0%).

Banking System: Loan Quality



Source: Bank Negara Malaysia

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

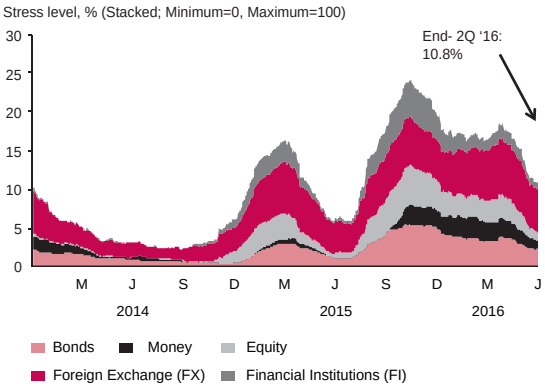
Domestic financial market conditions remained orderly

Conditions in the domestic financial markets remained orderly throughout the quarter. The effects of the UK's EU referendum on domestic financial markets were limited and short-lived. The government bonds, corporate bonds and money markets remained stable. Volatility in the ringgit foreign exchange market was higher than usual around the time leading to the outcome of the EU referendum and just following the release of the outcome. However, market volatility eased at the end of the day as liquidity remained supported by financial market participants. For the quarter as a whole, average volatility for the 10-year MGS yield and FBM KLCI trended lower (2Q 2016: 9.5% and 9.9%, respectively; 1Q 2016: 13.5% and 11.3%, respectively). This continues the trend that was observed since October 2015. Portfolio investments recorded a marginal net inflow of RM77 million (1Q 2016: net inflows of RM13.1 billion) as higher non-resident inflows into the government bond markets was offset by non-resident outflows from the equity market and investments abroad by the domestic institutional investors.

Non-residents continue to show interest in the Malaysian financial markets. At the end of the second quarter, non-residents held about half of total outstanding MGS (49.8%; 1Q 2016: 48.7%). A total of 59.1% of the holdings comprised MGS with maturities of up to 5 years. Correspondingly, yields on the 3, 5 and 10-year MGS eased to 3.15%, 3.37% and 3.74%, respectively (1Q 2016: 3.21%, 3.43% and 3.80%, respectively). The FBM KLCI ended the quarter lower at 1,654.1 points (1Q 2016: 1,717.6 points). This was largely driven by weaker performance of some corporates and continued uncertainty in US monetary policy. The price-to-earnings (PE) ratio of FBM KLCI eased to 18.2 times during the second quarter (1Q 2016: 19.2 times) but remained above the 10-year average PE ratio of 16.2 times. Equity holdings by non-residents accounted for 22.8% of total market capitalisation (1Q 2016: 23.0%).

Trading volume was higher. The bid-ask spreads were unchanged, at 0.1% of the mid-price for MGS and 0.4% of mid-price for FBM KLCI. The monthly turnover ratio averaged at 14.9% for MGS and 2.1% for FBM KLCI (1Q 2016: 11.9% and 2.0%, respectively). In the currency market, ringgit depreciated by 2.5% against the US dollar to end the quarter at RM4.0225 per US dollar (1Q 2016: RM3.9220). The 5-year sovereign credit default swap spread rose marginally to 156.1 basis points (1Q 2016: 153.9 basis points, 3Q 2015: 238.9 basis points), while the 5-year cross-currency basis swap spread increased to 83 basis points (1Q 2016: 73 basis points). This was, however, still lower than the level observed in 3Q 2015 (115 basis points) when ringgit was at its weakest level against the USD in recent years.

Financial Market: Financial Market Stress Index (FMSI)



Note: The FMSI is a risk monitoring tool for the financial market that is 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 the domestic financial markets - the foreign exchange (FX), equity, bond, money markets and financial institutions (FIs). The stress level 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

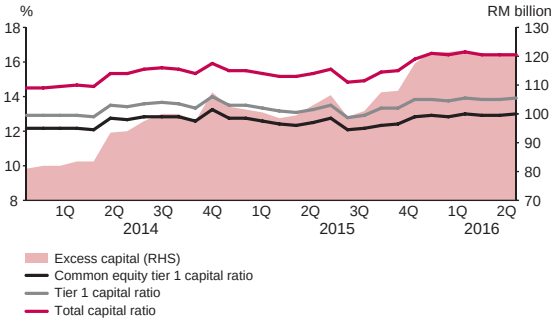
Sustained strength and resilience of financial institutions

Financial institutions maintained strong levels of capitalisation. The common equity tier-1 capital ratio of the banking system stood at 12.9%, whilst tier-1 capital and total capital ratios were at 13.9% and 16.4%, respectively. More than 90% of banking system capital comprises retained earnings, paid-up capital and reserves which have strong loss-absorbing qualities. Similarly, the capital adequacy ratio for the insurance and takaful sectors remained high at 228.1% (1Q 2016: 242.6%). At the end of the quarter, the combined capital buffers of financial institutions amounted to RM153.8 billion.

Earnings were resilient amid more moderate financing performance. The banking system interest/financing margin net of operating costs and loss provisions remained stable at 0.56 percentage points (ppts) (1Q 2016: 0.55 ppts) while returns on assets and equity edged higher to 1.4% and 13.2% respectively (1Q 2016: 1.3% and 12.4%, respectively). Pre-tax profit for the banking system increased to RM9 billion (1Q 2016: RM7.7 billion) on account of sustained net interest income from financing activities and higher dividend income from subsidiaries. Income from treasury and fee-based activities edged lower during the quarter.

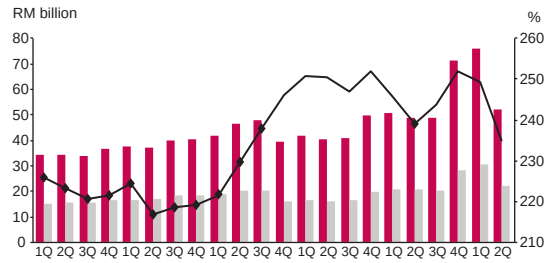
In the insurance and takaful sector, general insurers and takaful operators recorded slightly lower operating profit of RM809.6 million (1Q 2016: RM821.0 million), on account of higher claims ratio, particularly in fire and motor businesses. On the other hand, the weaker equity market continued to weigh on the performance of life insurers and family takaful operators. This resulted in a lower excess income over outgo of RM2.7 billion (1Q 2016: RM4.7 billion).

Banking System: Basel III Capitalisation



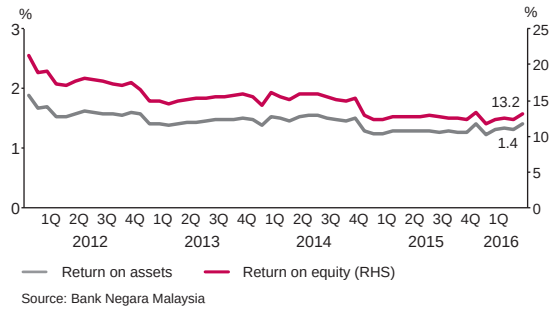
Source: Bank Negara Malaysia

Insurance Sector: Capitalisation



Source: Bank Negara Malaysia

Banking System: Profitability



Source: Bank Negara Malaysia

Insurance and Takaful Sectors: Indicators

	2015		2016		
	2Q	1H	1Q	2Q	1H
	RM million				
Life insurance & family takaful					
Excess of income over outgo	1,844	7,180	4,703	2,668	7,371
General insurance & general takaful					
Operating profit	682	1,463	821	810	1,631
Claims ratio (%)	64.9	57.4	54.0	56.5	55.3
	Annual Change (%)				
Life insurance & family takaful					
Excess of income over outgo	-59.8	-8.0	-11.9	44.7	2.7
General insurance & general takaful					
Operating profit	-15.2	-10.1	5.1	18.8	11.5
Claims ratio (percentage points)	6.0	0.4	3.7	-8.3	-2.2

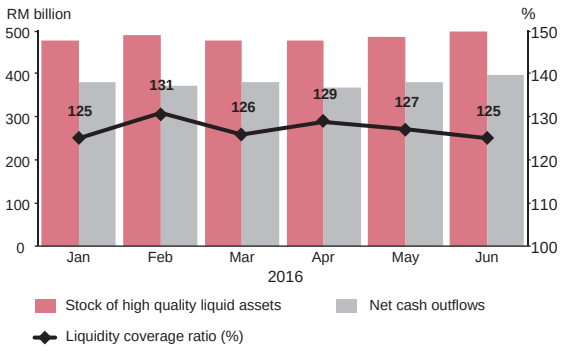
Source: Bank Negara Malaysia

Market risk exposures of financial institutions were at manageable levels, supported by active risk management and hedging strategies. Bank exposures to interest rate risk in the trading book and equity risk accounted for 1.2% and 0.9% of total capital, respectively (1Q 2016: 1.1% and 0.8%, respectively). The foreign exchange (FX) net open position of banks stood at 7.2% of total capital (1Q 2016: 6.5%), with banks continuing to actively manage FX exposures amid ringgit volatility. For the insurance and takaful industry, market risk exposures edged higher to 13.7% (1Q 2016: 13.1%) of total capital available, driven largely by increase in interest rate risk. Equity risk, which forms the bulk of insurers' market risk exposures, remained broadly stable at 7.4% (1Q 2016: 7.3%) of total capital available.

Liquidity in the banking system remained ample to support intermediation activities. Total banking system placements, reverse repos with Bank Negara Malaysia and statutory reserve requirements amounted to RM178.5 billion. This represents the amount that can be unwound to meet banks' liquidity needs. The banking system Basel III Liquidity Coverage Ratio (LCR)[4] stood at 125% (1Q 2016: 126%), well above the current minimum regulatory requirement of 70%. A total of 44 banks recorded LCR levels above 100%.

Domestic funding conditions continued to improve during the quarter. Competition for corporate deposits eased following the reduction in the statutory reserves requirement in February. The quoted 1-month and 3-month fixed deposit rates for large corporate depositors fell between 5 and 40 basis points during the quarter. Overall, the average cost of deposits was unchanged at 2.55% while the 3-month KLIBOR eased to 3.65% (1Q 2016: 3.71%). On aggregate, banking system deposits were marginally lower (2Q 2016: -0.5%; 1Q 2016: -0.9%). This partly reflected a decline in corporate and non-bank financial institutions' deposits (2Q 2016: -0.8% and -1.7%, respectively; 1Q 2016: -4.2% and 1.8%, respectively) due to continued investments in other asset classes. Including Islamic investment accounts[5], total bank funding recorded a growth of 3.4% during the quarter (1Q 2016: +2.3%).

Banking System: Basel III Liquidity Coverage Ratio



Source: Bank Negara Malaysia

[4] 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%.

[5] 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.

While banks' funding structure remains predominantly deposit-based (69.8% of total funding) and in local currency (92.1% of total deposits), banks have been diversifying their funding structure in recent periods. This is, in part, a reflection of financial deepening and banks' efforts to narrow maturity mismatches in the funding structure. The amount of outstanding medium- and long-term ringgit and foreign currency denominated instruments issued by banks expanded by 5% (1Q 2016: +12%) annually to RM100 billion. At present, such medium term instruments account for 4.2% of total banking system funding. Taking into account the broader funding base, the loan-to-funds ratio remained stable at 82.6% (1Q 2016: 82.6%).

Net external liabilities of banks were smaller at RM128 billion at end-1Q 2016 (4Q 2015: RM139 billion), driven mainly by moderating interbank borrowings. Malaysian banks have small exposures to counterparties in the UK, at approximately 1% of total banking system assets and liabilities respectively. This limits the domestic contagion risk from developments in the UK. Exposures via the currency channel were also contained as external claims denominated in pound sterling accounted for only 7% of total banking system capital.