Managing Risks to Financial Stability

HIGHLIGHTS

- **Debt servicing capacity of businesses and households remained sound, although upticks in impairment were observed in some segments.**
- **The presence of long-term foreign and domestic investors have provided stability and liquidity to the domestic bond market.**
- **Domestic financial stability is expected to remain preserved, supported by the sustained health of financial institutions, and orderly markets and liquidity conditions.**

Domestic financial stability remains intact

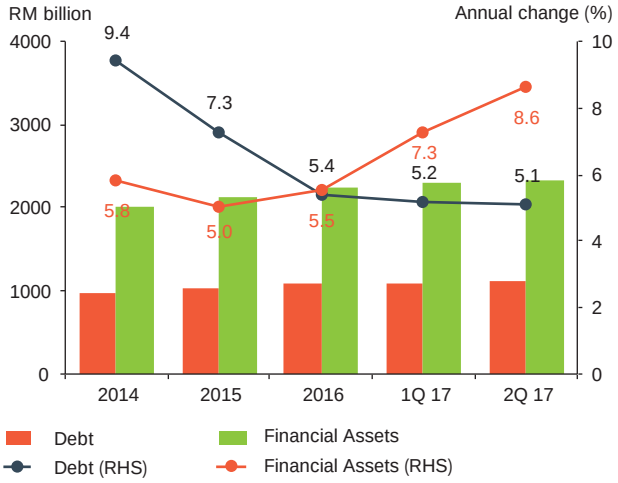
Domestic financial stability was supported by strong institutions and orderly market conditions. In line with global trends, overall volatility in the domestic financial markets was low amid improved sentiments. In addition, domestic financial institutions continued to demonstrate sound overall asset quality and profitability. Liquidity and funding conditions remained conducive for the financing needs of businesses and households.

Sustained debt servicing capacity of businesses and households

Household debt recorded an annual growth of 5.1% in the second quarter of 2017 (1Q 2017: +5.2%). Loans for the purchase of residential property continued to be the key driver of growth, expanding by 8.7% (1Q 2017: +8.6%). Bulk (64%) of household debt is for wealth accumulation. The overall debt repayment capacity of households is expected to remain sound and continue to be supported by steady income growth and stable labour market conditions. Further, aggregate household financial assets and liquid financial assets remained high at 2.1 and 1.5 times of debt respectively. At the end of the quarter, total household debt amounted to 85.6% (1Q 2017: 86.7%) of GDP.

Growth of Household Financial Assets Continued to Outpace That of Debt

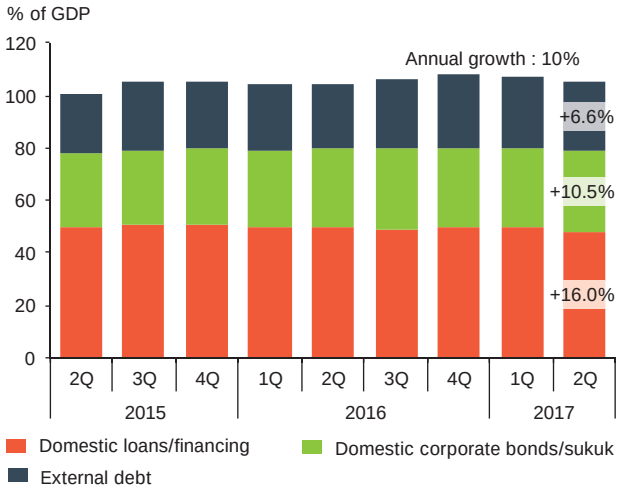
Chart 26: Household Sector Debt and Financial Assets



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

Total Business Borrowings in the Quarter was Driven by New Corporate Bonds/Sukuk Issuances

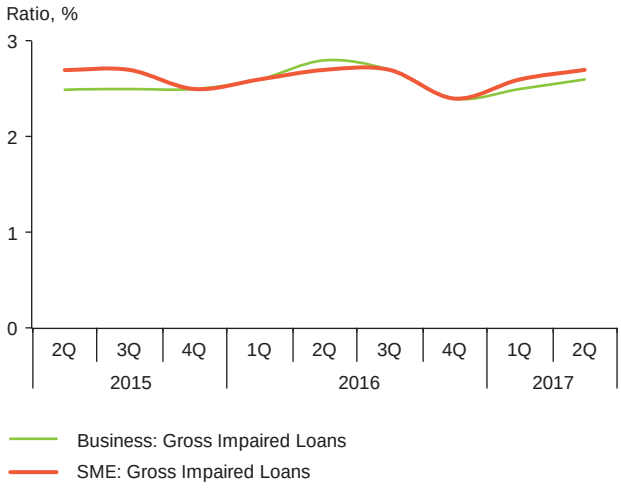
Chart 27: Business Sector NFC-Debt-to-GDP



Source: Bank Negara Malaysia

Overall Banking System Business Loans Portfolio Remains Sound

Chart 28: Business Sector Gross Impaired Loans



Source: Bank Negara Malaysia

Household delinquencies and impairment for banks and non-banks as a group remained at low levels of 1.5% (1Q 2017: 1.3%) and 1.7% (1Q 2017: 1.6%) respectively. Both recorded slight upticks as some borrowers in the vulnerable income segment (earning less than RM3,000 per month) continue to be affected by the higher cost of living. This particularly contributed to higher impaired personal financing granted by non-banks, which grew annually by 4.7% during the quarter. However, potential systemic risks arising from financial institutions' exposures to the household sector are limited. First, the majority of new household borrowers have prudent debt service ratios (DSR), while 41% of borrowers with newly approved loans have DSR of below 40%. Second, the share of borrowings by the vulnerable income segment is now lower at 21.9% (2013: 28.4%) – for banks, this share is at 19.1% (2013: 25.1%) as loan affordability assessments continue to improve. Third, potential losses to banks for vulnerable households under a simulated scenario were estimated at less than 10% of banks' excess capital buffers (above regulatory minimums). This is under the assumption of a tripling of prevailing probabilities of default and severe loss given default.

In the second quarter of 2017, total business borrowings grew annually by 10% (1Q 2017: +11%). This was driven by new fund raising in the corporate bond and sukuk markets, which expanded by 10.5% (1Q 2017: +10.3%). Recent issuances were mainly in the real estate, infrastructure and power sectors. External borrowings were slightly lower due to exchange rate valuation effects, following the strengthening of the ringgit against some major and regional currencies during the quarter. This was partly offset by increases in non-resident holdings of domestic debt securities issued by non-financial corporations (NFCs) and a marginal increase in net borrowings. The annual growth in outstanding bank financing to businesses moderated slightly to +6.6% (1Q 2017: +7.1%), due to slower growth in financing to the real estate, agriculture and transportation sectors. Total financing by banks and development financial institutions to SMEs recorded an annual growth of 7% (1Q 2017: +9.3%).

Financial health of firms remained intact, given improving domestic and external demand. The aggregate leverage of Malaysian NFCs[2], as measured by the median debt-to-equity ratio, increased marginally to 45.4% (4Q 2016: 43.5%) in the first quarter of 2017. This was supported by satisfactory debt servicing capacity and liquidity

[2] Based on 120 listed firms on Bursa Malaysia with 85% market capitalisation (excluding financial institutions).

positions. On aggregate, the median interest coverage ratio (ICR) remained significantly above the prudent threshold of two times, at 9.6 times, albeit lower than 11.8 times recorded in fourth quarter of 2016. The lower ICR was due to moderate earnings in the consumer-related sectors (i.e. automotive and retail sectors) amid cautious discretionary spending. The aggregate median cash-to-short-term debt (CASTD) ratio remained stable at 1.2 times, above the prudent threshold of one time. Overall, the ratios of impaired and delinquent loans recorded marginal increases, but remained low at 2.6% and 0.4% (1Q 2017: 2.5% and 0.3%) of total bank lending to businesses respectively. Higher impairment and delinquencies were observed in the real estate activities, wholesale and retail and oil & gas (O&G) sectors.

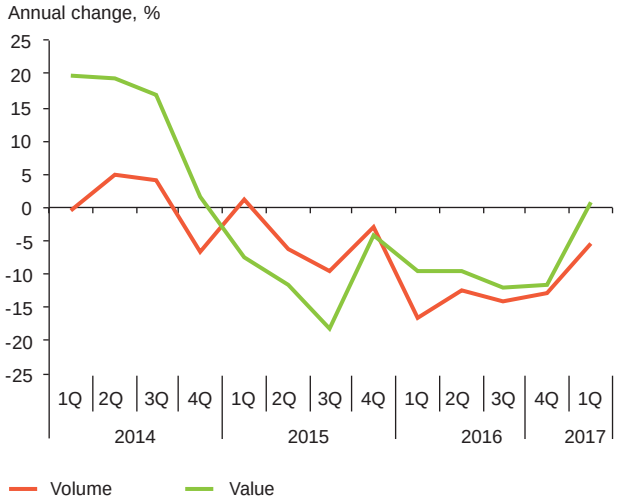
Given the persistent low oil prices, the credit risk outlook for the O&G sector is expected to remain challenging. Notwithstanding this, the overall debt servicing capacity and liquidity positions of O&G companies remained satisfactory, with the median ICR at 23.4 times (4Q 2016: 28.2 times) and median CASTD ratio at 3.4 times (4Q 2016: 2.4 times). The impaired loans ratio recorded slight improvement to 4.2% (1Q 2017: 4.3%) while the delinquent loans ratio remained stable at 0.1% (1Q 2017: 0.1%) as at second quarter of 2017. Risks to the banking system remained limited as exposures to the sector accounted for about 6.7% of total exposures.

Activities in the housing market have shown some signs of a pick-up, with total housing transaction value recording a positive annual growth of 0.9% (4Q 2016: -11.6%), the first time since 2015. Housing transaction volume has also showed improvement, recording a smaller contraction of 5.4% (4Q 2016: -12.7%) in the first quarter of 2017. This was mainly contributed by transactions for the purchase of houses priced above RM500,000 in both the primary and secondary markets. Based on preliminary data, the average house price registered an annual growth of 5.3% in the first quarter of 2017 (4Q 2016: +7%). Financing by banks for the purchase of affordable houses remains available as reflected by the loan approval rate of about 72% for houses priced below RM500,000. New launches of houses in this price segment, however, remains lagged, a trend observed since 2015. Consequently, housing affordability remains challenging, particularly for first-time house buyers.

Risks to financial stability arising from speculative activity in the housing market remains muted. The annual growth in the number of borrowers with

Housing Transactions Improved Both in Terms of Volume and Value

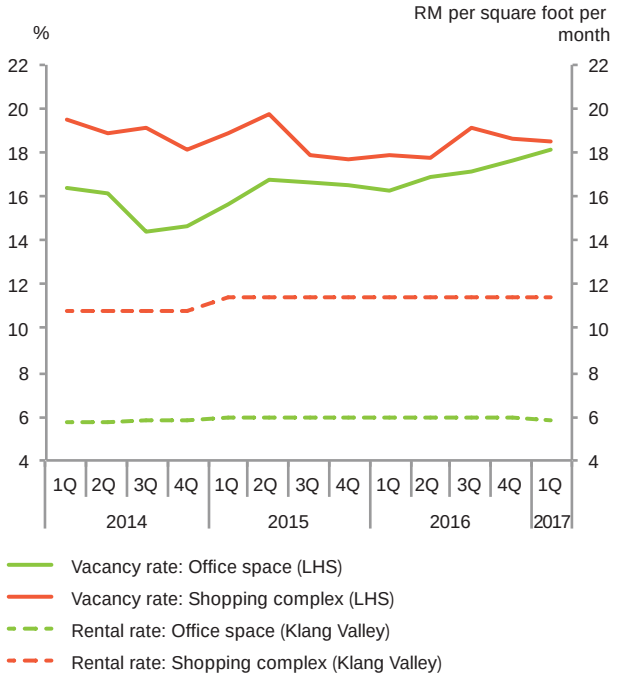
Chart 29: Property Sector Transaction Volume and Value



Source: National Property Information Centre

Vacancy and Rental Rates of Office Space and Shopping Complex Remained Depressed

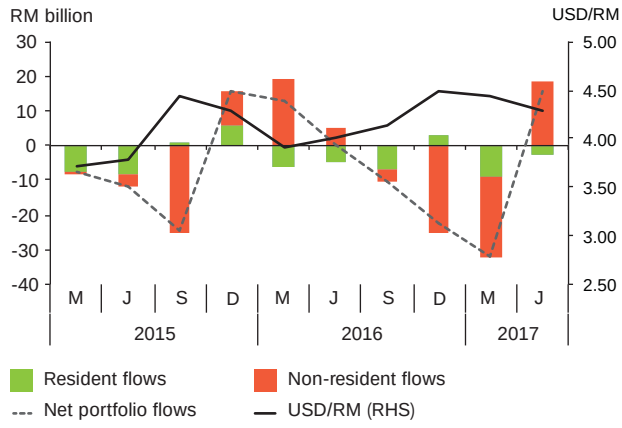
Chart 30: Office Space and Shopping Complex Vacancy and Rental Rates



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

Both Government Bonds and Equities Recorded Net Foreign Inflows

Chart 31: Financial Market Net and Gross Portfolio Flows and Ringgit Exchange Rate Movement



Source: Department of Statistics, Malaysia

three or more outstanding housing loans (a proxy for speculative buyers) stood at 1.4% (4Q 2016: +1.4%). The number of housing loans settled within three years (the typical duration required to complete construction after a property is acquired) – another indication of speculative purchases – eased to 9.2% (4Q 2016: 11.9%) of total settled housing loans.

Vacancy and rental rates in the office space and shopping complex segments remained depressed in the first quarter of 2017, reflecting sanguine tenant demand on the ground. The continued excess supply in the commercial property segment, if left unaddressed, could become a long-term structural issue with wide implications to the economy. Direct risks to banks from lending to property developers, including end-financing, in the office space and shopping complex segments remained small at 5.1% of total bank loans. This is supported by sound lending and valuation practices. The delinquency and impairment ratios for these exposures remained low at 0.7% and 1%, respectively (1Q 2017: 0.8% and 1.1%, respectively).

Domestic financial market conditions remained orderly

Investor sentiment continued to be affected by concerns on the US administration's ability to execute pro-growth policies, uncertainty surrounding the pace and timing of the US Federal Reserve interest rate normalisation, volatility in the commodities market and geopolitical risks. Despite these external developments, overall volatility in the domestic financial markets remained low. Average volatility of 10-year MGS yields, the equity market and the ringgit declined to 10.3%, 6.4% and 2.6% in the second quarter of 2017, respectively (1Q 2017: 17.4%, 7% and 4.7%, respectively). This was partly attributed to improved domestic sentiments amid better-than-expected GDP growth in the first quarter and favourable corporate earnings. The implementation of the Financial Markets Committee (FMC) measures also contributed to the stability in the foreign exchange market.

In the second quarter of 2017, there were net portfolio investment inflows of RM16 billion (1Q 2017: net outflows of RM31.9 billion). This was partly due to a resumption of inflows into the government bond market across all tenures. As at end of the quarter, non-resident investor holdings amounted to 26% (1Q 2017: 24.7%) of total outstanding Malaysian government bonds.

The quarter also saw continued inflows into the domestic equity market, leading to higher non-resident holdings of 23% (1Q 2017: 22.4%) of total equity

market capitalisation. Along with global equity markets, the FBM KLCI rallied by 1.4% in the second quarter of 2017 to end higher at 1763.67 points (1Q 2017: 1740.09 points). Technology, construction, financial and consumer sector stocks had driven gains in the market. The average price-to-earnings (PE) ratio for the FBM KLCI stood at 16.8 times, comparable against a long-term average of 16.5 times (1Q 2017: 16.8 times).

In addition, trading liquidity in the capital markets was sustained with the bid-ask spreads for MGS and FBM KLCI at 0.1% and 0.4% of mid-price, respectively (1Q 2017: 0.2% and 0.4%, respectively). The monthly turnover ratios for MGS and FBM KLCI were lower at 11.3% and 2%, respectively (1Q 2017: 14.1% and 2.1%, respectively).

In the currency market, the ringgit appreciated by 3.1% against the US dollar to end the quarter at RM4.2940 per US dollar (1Q 2017: RM4.4265). A similar trend was observed against other major currencies. As at end of the quarter, the 5-year cross-currency basis swap spread stood at 59 basis points (bps) (1Q 2017: 50 bps), lower than the 2016 peak of 93 bps following the US presidential election outcome. The 5-year sovereign credit default swap spread narrowed to 85.5 bps (1Q 2017: 107.6 bps).

Market risk exposures supported by risk management and hedging strategies

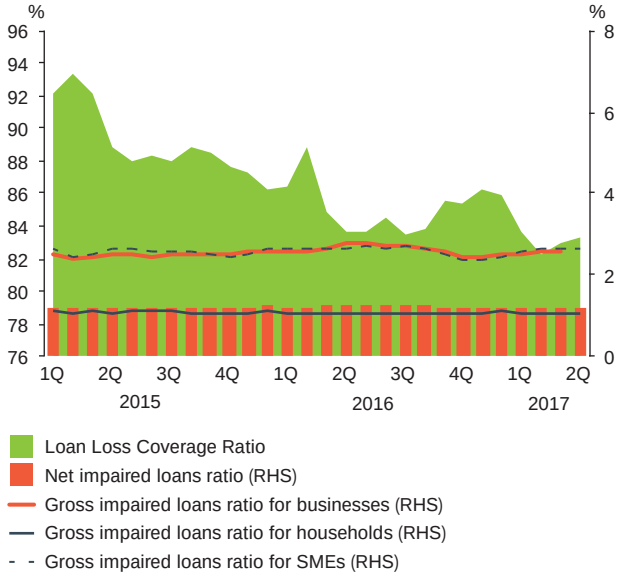
Banks' exposures to market risks remained largely in the form of FX risk, with FX net open position of 7% of total capital as at end-June 2017 (1Q 2017: 6.2%). Exposures to interest rate risk in the trading book and equity risk remained low at 1.1% and 1.1% of total capital, respectively (1Q 2017: 1.1% and 1.2%, respectively). For the insurance and takaful industry, market risk exposures were slightly higher at 14.9% (1Q 2017: 14.4%) of total capital available, in line with higher valuation in the financial markets. Equity risk, which formed the bulk of insurers' market risk exposures, rose to 9.1% (1Q 2017: 8.7%) of total capital available.

Sustained financial health of the banking system

In the second quarter of 2017, the banking system recorded a higher pre-tax profit of RM9.2 billion (1Q 2017: RM8 billion), contributed by dividend income from subsidiaries and higher net interest income from financing activities. The average cost of funds declined marginally to 2.71% as at end-June 2017, lower than the 3-year average of 2.75%. The weighted average lending and financing rates of

Healthy Asset Quality Observed in the Banking System

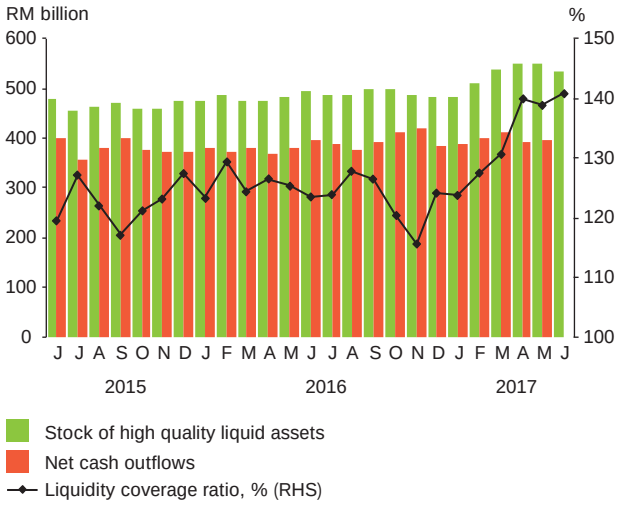
Chart 32: Banking System Loan Quality



Source: Bank Negara Malaysia

Banking System Liquidity Sufficient to Buffer for Adverse Liquidity Shocks

Chart 33: Banking System Basel III Liquidity Coverage Ratio



Source: Bank Negara Malaysia

conventional and Islamic banks declined marginally to 5.19% and 5.17%, respectively (1Q 2017: 5.21% and 5.18%, respectively). Healthy asset quality supported the lower loan loss provisions that were observed during the quarter. Banks' interest margin (net of operating costs and loss provisions) increased marginally to 0.65 percentage points (ppts) (1Q 2017 average: 0.62 ppts), attributed to lower interest expense and provisions.

In the insurance and takaful sector, general insurers and takaful operators recorded higher operating profit of RM761 million in the second quarter (1Q 2017: RM495 million) on account of improved claims incurred across key business lines. In particular, claims incurred on fire insurance and takaful decreased by 40%. Correspondingly, industry claims ratio improved to 55.2% (1Q 2017: 62.9%). On the other hand, life insurers and family takaful operators recorded a reduction in profitability with excess income over outgo decreasing to RM4.4 billion (1Q 2017: RM6.1 billion). This was largely attributed to lower net capital gains particularly from equity holdings, as the FBM KLCI index rallied at a slower rate compared to the previous quarter.

Domestic funding conditions remained favourable and supportive of financing activities. Total banking system placements, reverse repos and statutory reserves with Bank Negara Malaysia which can be unwound to meet liquidity needs, stood at RM175.7 billion, providing comfortable buffers against unexpected cash outflows or adverse liquidity shocks. Under the Basel III Liquidity Coverage Ratio (LCR), the banking system LCR stood at 141% (1Q 2017: 131%), with all banks reporting LCR levels above 100%, well above the current minimum regulatory requirement of 80%.

Both the average cost of deposits for banks and the 3-month KLIBOR were relatively unchanged at 2.51% and 3.43% (1Q 2017: 2.55% and 3.43%, respectively) as at June 2017, respectively. Domestic operations were predominantly funded by ringgit deposits (65% of total funding). Banking system deposits annual growth moderated slightly to +3% (1Q 2017: +3.3%), driven by lower deposit growth from individuals (2Q 2017: +3.9%; 1Q 2017: +5.7%).

While the bulk of banks' funding remained in the form of deposits, banks continued to diversify their funding structure through the issuance of medium-term ringgit and foreign currency denominated funding instruments. The total new issuance of debt securities by the banking sector for the second quarter of 2017 amounted to RM7.1 billion (1Q 2017: RM3.4 billion). This contributed towards further reducing maturity and currency mismatches in the banks' funding structure. Taking into account the broadened funding structure, the loan-to-funds[3] ratio (LTF) stood at 83.3% (1Q 2017: 82.8%) at the end of the quarter.

Online SME Financing Platform: A one stop platform for convenient access to financing and structured assistance

The Credit Guarantee Corporation Malaysia Berhad (CGC), in collaboration with the Bank and the financial industry, is developing an Online SME Financing Platform (the Platform). Originally mooted by the Bank to reduce search costs and improve access to financing, the Platform is expected to provide a more convenient, efficient and transparent process catering to a wider group of SMEs, through the following:

- An **Online Application Platform** that matches SMEs' financing needs with suitable financing products from various institutions and funds catering to SMEs. The Platform would substantially reduce time costs for SMEs[4], by providing fast, convenient and simultaneous access to products through a single interface with online processing. Among other things, SME applicants will be able to submit loan documents digitally (paperless), which will be accessible by multiple banks.

- Unmatched and rejected applications will be referred to the **Financial Accelerator Lab**, which provides structured assistance to enable SMEs to improve their eligibility for financing in the future, by connecting them to alternative fund providers and capacity building programmes.

The Platform is expected to be launched in the fourth quarter of 2017. Potential future enhancements to enhance the inclusiveness of the Platform include integration with other agencies to facilitate more efficient customer onboarding and leveraging on psychometric analysis and big data analytics to support credit evaluation, in particular for startups and small businesses without a credit track record or collateral.

[3] Funds comprise deposits and all debt instruments issued (including subordinated debt, debt certificates/sukuk, commercial papers and structured notes).
[4] Research from the Federal Reserve Bank of New York finds that small business borrowers often spend almost 25 hours of their time on paperwork for bank loans and approach multiple banks during the application process (September 2013) 'Fall 2013 Small Business Credit Survey'.

With More Than 40 Financial Institutions and 152 Dedicated Government Programmes, Applying for Financing Poses Significant Time Costs for SMEs

Chart 34: Avenues for SME Financing in Malaysia

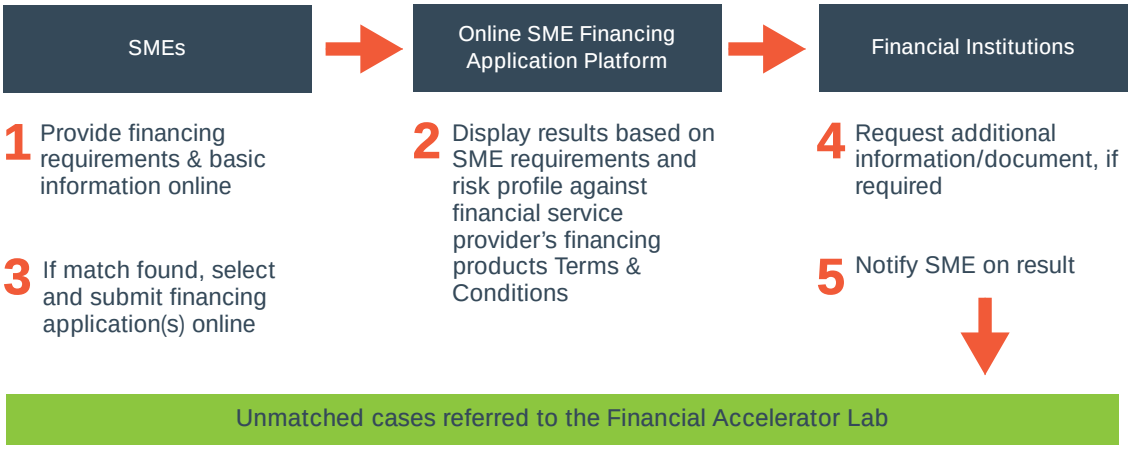


FINANCIAL INSTITUTIONS	GOVERNMENT PROGRAMMES	OTHERS
Banking Institutions	Guarantee Schemes	Leasing & Factoring
Development Financial Institutions	Government Funds	Ar-Rahnu / Pawn Broking
	Government Crisis Funds	Microfinance Institutions
		Venture Capital
		Crowdfunding / P2P

Source: SME Integrated Plan of Action 2016, National SME Development Council

Unmatched and Rejected Applications Will be Referred to the Financial Accelerator Lab

Chart 35: Referrals to Financial Accelarator Lab



Source: Credit Guarantee Corporation Malaysia Berhad (CGC)