Managing Risks to Financial Stability

HIGHLIGHTS

- **Growth in household debt continued to moderate, while access to financing remains available to eligible house buyers.**
- **Domestic financial market conditions remained orderly, with the support of domestic institutional investors including financial institutions.**
- **Sustained profitability of financial institutions, supported by sound asset quality and liquidity position.**

Domestic financial system remains resilient

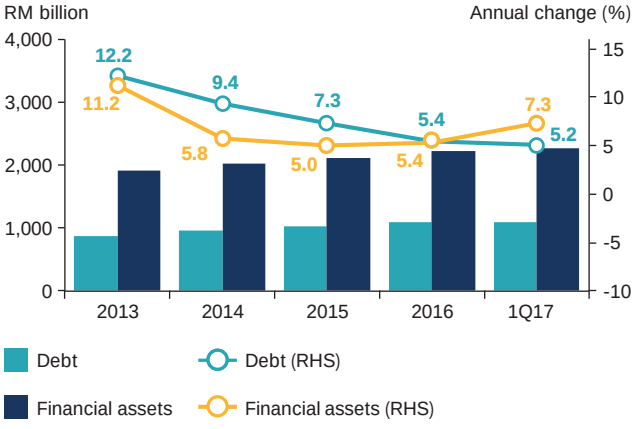
Financial stability was sustained despite global uncertainties associated with policy adjustments in some major economies. Credit conditions in the domestic banking system continue to remain conducive for businesses and households amid an economic environment that remains challenging and the higher cost of living. The asset quality and earnings of financial institutions are expected to remain intact as domestic financial intermediation activities continue to be supported by the liquidity buffers of financial institutions. In addition, domestic financial markets demonstrated sound capacity to weather challenges from the more volatile investor sentiments and global developments.

Credit risk exposures remain supported by sustained debt servicing capacity of borrowers

In the first quarter of 2017, the annual growth of household debt extended its moderating trend to 5.2% (4Q 2016: +5.4%). Demand for affordable house financing remains the main driver of the increase in household debt, with outstanding housing loans expanding annually by 8.5% (4Q 2016: +9.1%). Overall household debt repayment capacity remains sound, supported by stable labour market conditions and adequate financial buffers. Both household financial assets and liquid financial assets remained high on aggregate, accounting for 2.1 and 1.5 times of debt, respectively.

Chart 32: Household Sector Debt and Financial Assets

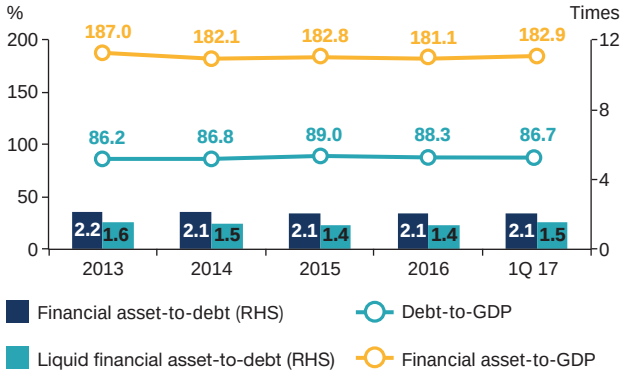
Growth in Household Financial Assets Outpaced that of Household Debt



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

Chart 33: Household Sector Key Ratios

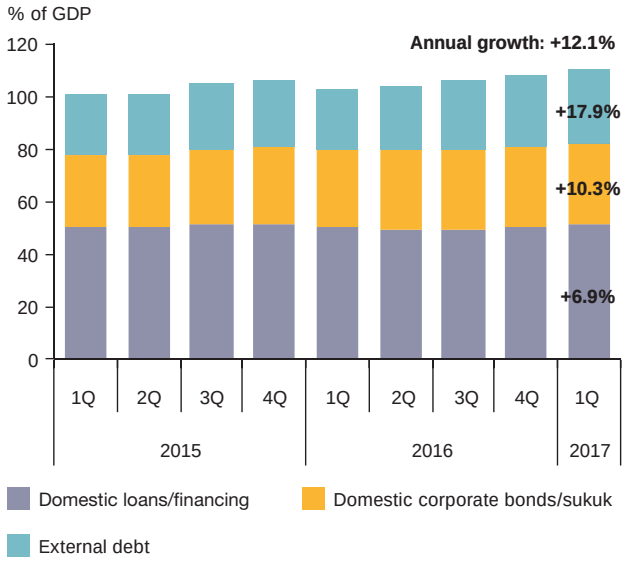
Households Maintained Aggregate Financial Assets at Two Times of Debt



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

Chart 34: Business Sector NFC Debt-to-GDP

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



Source: Bank Negara Malaysia

The quality of the household debt portfolio has remained intact with signs of further strengthening. First, affordability assessments by lenders continued to improve as about 42% of borrowers with newly approved loans have debt service ratios (computed based on income net of statutory deductions) of less than 40%. Second, the share of borrowings by vulnerable borrowers (those earning less than RM3,000 per month) reduced further to account for 21.9% (4Q 2016: 22.2%) of total bank and non-bank lending to households. Third, the sensitivity of this group to changes in interest rates is to a certain degree buffered as close to half of their total borrowings are in the form of fixed-rate financing. These developments contributed towards sustaining the low and stable levels of delinquent and impaired loans ratios of 1.3% and1.6%, respectively (4Q 2016: 1.5% and 1.6%, respectively).

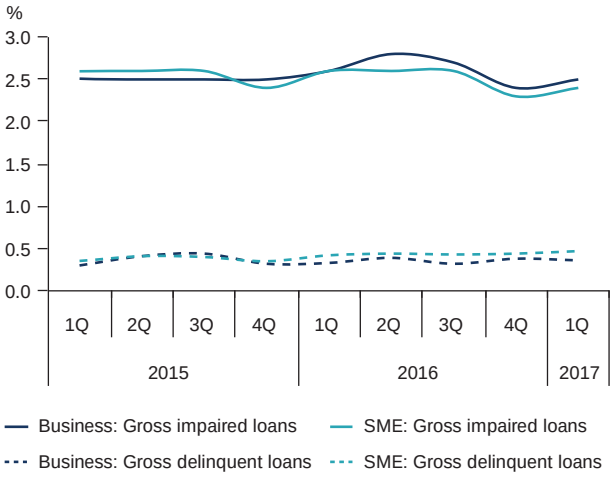
Credit conditions remained conducive with limited evidence of broad-based tightening in the supply of financing to businesses. In the first quarter, total business borrowings grew annually by 12.1% (4Q 2016: +8.6%). This was driven by new fund raising in the corporate bond and sukuk markets, which expanded by 10.3% (4Q 2016: +7.3%), mainly in the oil and gas (O&G) and real estate activities sectors. External borrowings were also higher due to new borrowings and exchange rate valuation effects. Outstanding bank financing to businesses was driven by higher disbursements to the manufacturing, retail and transportation sectors. Total financing by banks and development financial institutions to SMEs also maintained a robust annual growth of 9.2% (4Q 2016: +9.0%).

Financial health of firms remained intact. The aggregate leverage of Malaysian non-financial corporations[5], as measured by the median debt-to-equity ratio, remained stable at 43.5% at the end of the fourth quarter of 2016. This was supported by satisfactory debt servicing capacity and liquidity positions. On aggregate, the median interest coverage ratio (ICR) remained significantly above the prudent threshold of two times, at 11.8 times (3Q 2016: 10.5 times). The strengthened debt servicing capacity was driven by the export-oriented sectors on the back of a recovery in commodity prices. The aggregate median cash-to-short-term debt (CASTD) ratio also remained stable at 1.2 times. These factors contributed to support the low and stable levels of delinquent and impaired business loans, although higher delinquencies continued to be observed among players in the civil engineering, post and telecommunications sectors.

O&G companies are expected to record better earnings from the second half of 2017 onwards. This will largely stem from anticipated higher average prices and improvements in rig utilisation. These developments have contributed to improvements in the median ICR of the sector to 28.2 times (3Q 2016: 12.4 times), while the median CASTD ratio remained satisfactory at 2.4 times (3Q 2016: 2.9 times). The impaired and delinquent loan ratios were at 4.3% (4Q 2016: 4.1%) and 0.1% (4Q 2016: 0.3%), respectively. Risks to the banking system remain limited as exposures to the sector only account for about 5% of total exposures to businesses.

Chart 35: Business Sector Gross Impaired Loans and Gross Delinquent Loans

Overall Banking System Business Loans Portfolio Remains Sound

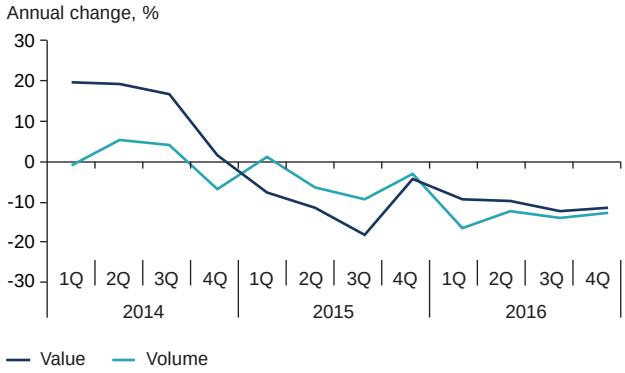


Source: Bank Negara Malaysia

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

Chart 36: Property Sector Annual Change of Transaction Volume and Value

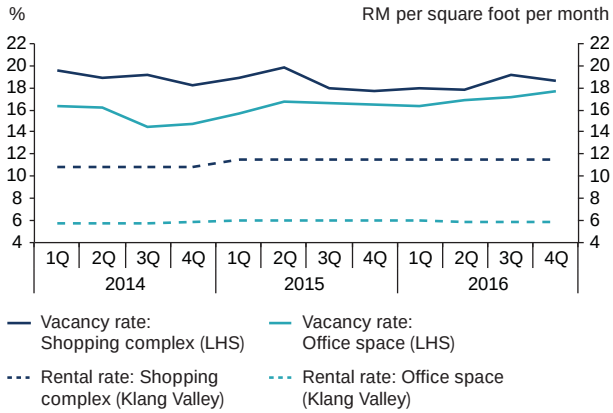
Housing Transactions Declined Further Both in Terms of Volume and Value



Source: National Property Information Centre

Chart 37: Property Sector Vacancy and Rental Rates

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



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

House prices in Malaysia continued to grow at a more moderate pace of about 7% during third quarter of 2016, while the preliminary growth figure for the Malaysian House Price Index was 5.5% for the final quarter. This was driven by gradual price adjustments in the higher-end segments. Correspondingly, total primary and secondary housing transactions declined further both in terms of volume and value. Demand for affordable housing remains strong, with about 60% of new housing loan approvals for the purchase of houses priced below RM500,000. Housing loan approval rates remain high at 74.2% (4Q 2016: 75.2%). The ongoing rebalancing of supply is expected to improve overall housing affordability, particularly for first-time buyers.

Risks of slower house price growth on bank exposures to the housing segment are assessed to be limited. About 72% of housing loan borrowers constituted first-time buyers of houses priced below RM500,000. Overall, about 84% of housing loan borrowers only have one outstanding housing loan. Such borrowers have strong incentives to maintain loan repayments in the event of financial stress or negative equity on their homes, compared to investment buyers. Speculative activity in the housing market remained subdued. The annual growth in the number of borrowers with three or more outstanding housing loans (a proxy for speculative buyers) remained stable 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.

Oversupply remains a concern in the office space and shopping complex segments. Vacancy and rental rates of these segments remained depressed in the final quarter of 2016, partly reflecting softer tenant demand and consolidation of some retailers. The glut in the commercial property segment may lead to deeper imbalances in the property market with spillovers to the other parts of the economy. Direct risks to banks from end-financing exposures to the office space and shopping complex segments remained small at 3.4% of total bank loans, supported by sound lending and valuation practices. The delinquency and impairment ratios for these exposures remained low at 0.8% and 1.1%, respectively (4Q 2016: 0.7% and 1%, respectively).

Box Article 2

Debunking the Myth: Property Measures Have Led to Higher Loan Rejection Rates

Author: Lim Le Sze

HIGHLIGHTS

- **The overall housing loan approval rate remains high at 74.2% in 1Q 2017.**
- **First-time house buyers continue to have access to financing.**
- **Rental as an alternative option to house-ownership.**

Myth 1: Housing loan rejection rates are as high as 60%

The overall housing loan approval rate remains high at 74.2%[1] (average 2012-2016: 74.1%). The approval rate is the ratio of the number of housing loan applications approved[2] by all banks in Malaysia to the number of housing loan applications received by the banks during the same period. In 1Q 2017, banks approved a total of RM22.3 billion of house financing to 90,137 borrowers. Of these, more than half was for buyers of affordable housing units priced below RM500,000.

Generally, housing loan applications were rejected if the borrower was already highly leveraged with weak credit history and had insufficient documentation to support ability to repay loan obligation.

Myth 2: First-time buyers are unable to obtain housing loans because of the impositions of macroprudential measures

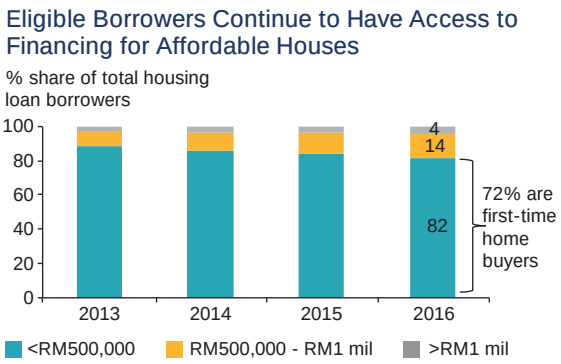
The measures introduced by the Bank since 2010 were for two specific purposes: (i) curb excessive speculative activity in the housing market; and (ii) deter over-borrowing. The maximum loan-to-value ratio (LTV) of 70% introduced in 2010 is imposed only on borrowers with three or more outstanding housing loans. Therefore, this measure does not affect eligible first-time house buyers, who typically qualify for an LTV of up to 95% (including Mortgage Reducing/Decreasing Term Assurance). In fact, it improves the chances of first-time buyers getting a loan as it shifts financial institutions' focus away from the speculators. In 2016, about 72% of housing loan borrowers are first-time buyers of homes priced below RM500,000 (Chart 1).

The maximum housing loan tenure of 35 years is more than sufficient for borrowers to settle their loans by retirement. Increasing the housing loan tenure will further add to the total cost of financing and also would not significantly improve one's debt service ratio. To illustrate this point, assuming the tenure for a housing loan of RM500,000 is increased from 35 to 40 years, the total cost of financing will increase by 17.4% or RM97,428 while the monthly instalment will only reduce by 4.4% or RM112 (Chart 2).

[1] This ratio is derived based on monthly data submissions from banks to Bank Negara Malaysia. The Bank notes that other sources have quoted different estimates based on broad surveys extended to a limited sample of developers.
[2] Regardless of whether it is accepted or subsequently cancelled by the applicant.

Developer interest bearing schemes (DIBS) are similar to adjustable rate mortgages, one of the key causes of the subprime mortgage crisis. These schemes should not be allowed as they encourage excessive speculative activity in the property market and cause artificial increases in house prices. Property valuers indicated that the price difference between houses with DIBS and without DIBS can be as high as 30%. Homebuyers generally were unaware of this fact due to lack of transparency and non-disclosure of material information.

Chart 1: Housing Loan Borrowers by House Price Range



Source: Bank Negara Malaysia and internal computation

Table 1: Comparison Table for Different Loan Tenures

Increasing Loan Tenure Will Further Add to the Total Financing Cost

	Loan tenure of 35 years	Loan tenure of 40 years	Difference
Loan amount (RM)	500,000	500,000	
Financing rate (%)	5	5	
Monthly instalment (RM)	2,523	2,411	112
Total cost of financing (RM)	559,844	657,272	**97,428**
Difference in total cost			17.40%

Source: Internal computation

Myth 3: Roof over one's head = Need to own a house

Buying and owning a house is a long-term commitment and represents a significant financial obligation for an individual. Rigorous financial planning and the availability of sound financial buffers against unexpected events are critical. To illustrate this point, the table below shows the monthly obligation associated with the purchase of a house priced at RM300,000. For a household earning RM5,000 a month, there is very little amount of money left for savings or emergencies after deducting the monthly instalment for the housing loan and monthly household expenditures.

Table 2: Illustration on Residual Income

Owning a Home is a Significant Commitment

	RM
Assumed household monthly income	**5,000**
Net monthly income after statutory deductions	**4,272**
Housing loan (RM300, 000) monthly instalment*	1,283
Household monthly expenditures**	2,946
Residual monthly income for savings and emergencies	**43**

*Based on 35-year loan tenure, loan-to-value ratio of 90% and lending rate of 5%
**Based on Household Expenditure Survey 2014 (Department of Statistics Malaysia)

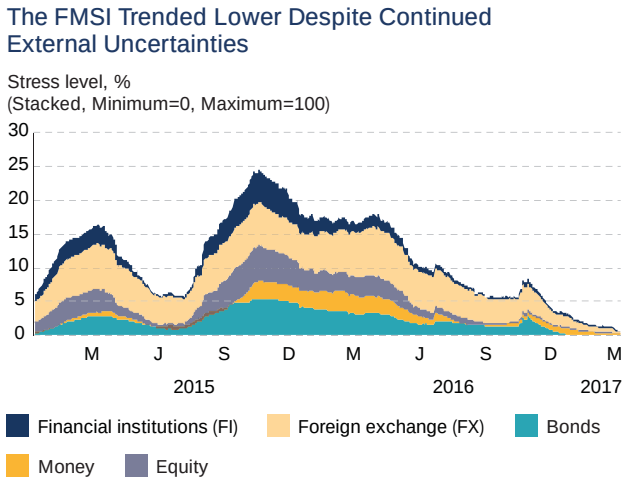
Measures to promote responsible lending and borrowing are intended to deter borrowers from incurring debts that could lead to financial hardship. It minimises the risk of borrowers having to carry an excessive debt burden, and losing their homes to foreclosure if they are unable to service the debt.

Domestic financial market conditions remained orderly

Investor sentiment continues to be affected by policy developments in the US, uncertainty surrounding the pace and timing of the US Federal Reserve interest rate normalisation, on-going volatility in the commodities market and heightened geopolitical risks. Despite these external developments, overall stress in the domestic financial markets trended downwards during the quarter, as seen in the Financial Market Stress Index (FMSI)[6].

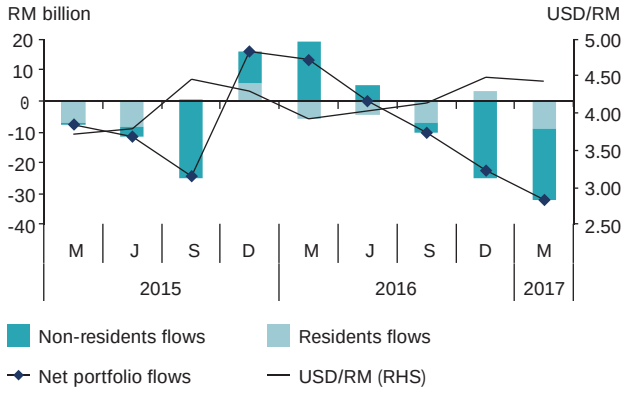
Domestic financial market conditions remained orderly despite larger net portfolio investment outflows of RM31.9 billion (4Q 2016: net outflows of RM22.3 billion). This was partly attributable to non-resident outflows from shorter term bonds (with maturity of less than three years) following external developments and the unwinding of non-deliverable forward position by non-resident financial institutions. The quarter also saw the maturity of two Malaysian Government Securities (MGS) in February and March, of which RM11.5 billion was held by foreign investors as at end-2016. Non-resident holdings in the equities market were sustained at 22.4% (4Q 2016: 22.3%) of total market capitalisation. The FBM KLCI rallied with global equity markets to end higher at 1740.09 points (4Q 2016: 1641.73 points).

Chart 38: Financial Market Stress Index (FMSI)



Source: Bloomberg and internal computation

Chart 39: Financial Market Net and Gross Portfolio Flows and Ringgit Exchange Rate Movement

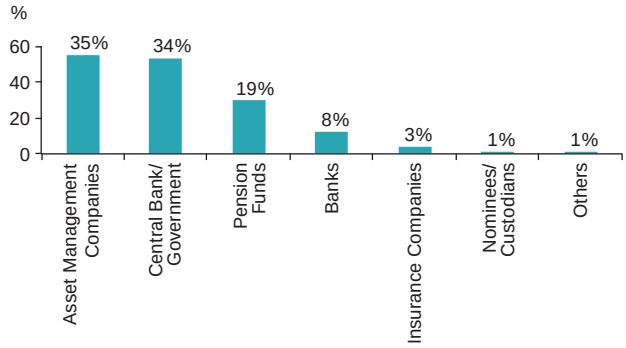


Source: Department of Statistics, Malaysia

[6] The FMSI is a risk monitoring tool for the financial market that is developed based on the European Central Bank's (ECB) 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.

Chart 40: Distribution of Non-resident Holdings of Government Bonds as at end-March 2017

Diversified Non-resident Investor Base with Majority Held by Long-term Investors



Source: Bank Negara Malaysia

As at end of the quarter, non-resident investor holdings amounted to 24.7% (4Q 2016: 30.6%) of total outstanding public debt securities, decreasing from its peak of 34.7% recorded in November 2016. Long-term investors, such as pension funds, insurance companies, governments and central banks, and asset managers, accounted for more than 90% of these holdings. However, on an aggregate basis, risk exposure to a single non-resident investor is well diversified as none of the non-resident investors accounted for more than 0.75%, while the top 50 non-resident investors only hold 10.6% of the total outstanding bonds. A more diversified investor base would provide more balanced two-way flow given their varied investment needs.

In addition, domestic institutional investors continue to have the capacity to absorb selling by non-residents. Trading liquidity in the capital markets were sustained with the monthly turnover ratio for MGS increasing to 14.1% (4Q 2016: 11.8%), while the turnover ratio for FBM KLCI edged higher to 2.1% (4Q 2016: 1.9%). The bid-ask spreads were unchanged at 0.4% and 0.2% of mid-price for FBM KLCI and MGS, respectively.

In the currency market, the ringgit appreciated by 1.3% against the US dollar to end the quarter at RM4.4265 per US dollar (4Q 2016: RM4.4860). As at end of the quarter, the 5-year cross-currency basis swap spread and the 5-year sovereign credit default swap spread had narrowed to 50 basis points (bps) and 107.6 bps, respectively (4Q 2016: 68 bps and 137.8 bps, respectively).

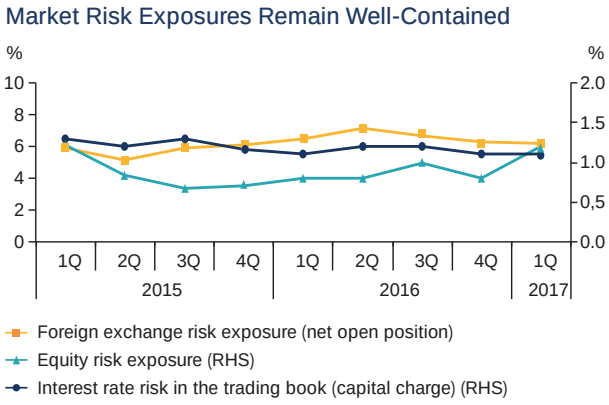
Market risk exposures supported by risk management and hedging strategies

Banks' exposures to market risks remain largely in the form of foreign exchange (FX) risk. At end-March 2017, FX net open position of banks stood at 6.2% (4Q 2016: 6.3%) of total capital, as banks continued to actively manage FX exposures amid ringgit volatility. Exposures to interest rate risk in the trading book remained low at 1.1% while equity risk rose to 1.2% of total capital, respectively (4Q 2016: 1.1% and 0.8%, respectively). For the insurance and takaful industry, market risk exposures were higher at 14.4% (4Q 2016: 13.3%) of total capital available, driven by increase in equity risk amidst new purchases by a few large insurers. Equity risk, which forms the bulk of insurers' market risk exposures, rose to 8.7% (4Q 2016: 7.8%) of total capital available.

Sound profitability and sustained liquidity position of financial institutions

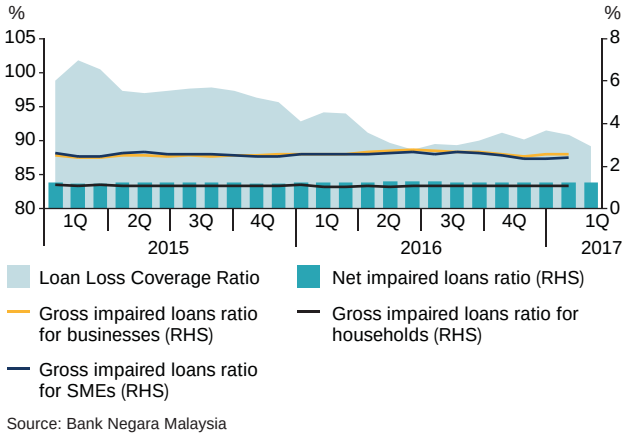
Pre-tax profit of the banking system amounted to RM8 billion (4Q 2016: RM7.7 billion) in the first quarter, driven by higher net interest income from lending/financing activities and stronger fee-based income. Lower loan loss provisions were recorded, supported by sound asset quality. Notwithstanding this, financing (including interest) margin net of operating costs and loss provisions remained stable at 0.60 percentage points (ppts) (4Q 2016: 0.62 ppts). In the insurance and takaful sector, general insurers and takaful operators recorded lower operating profit of RM491.1 million in the first quarter of 2017 (4Q 2016: RM890.8 million), on account of higher claims particularly in the motor and marine, aviation and transit (MAT) businesses. On the contrary, life insurers and family takaful operators recorded a significant increase in profitability with excess income over outgo rising to RM6.1 billion (4Q 2016: RM0.7 billion). This was largely attributed to improved net capital gains from both bond and equity holdings, in line with the improved valuations in the financial markets.

Chart 41: Banking System Equity, Foreign Exchange and Interest Rate Risks (% of Total Capital)



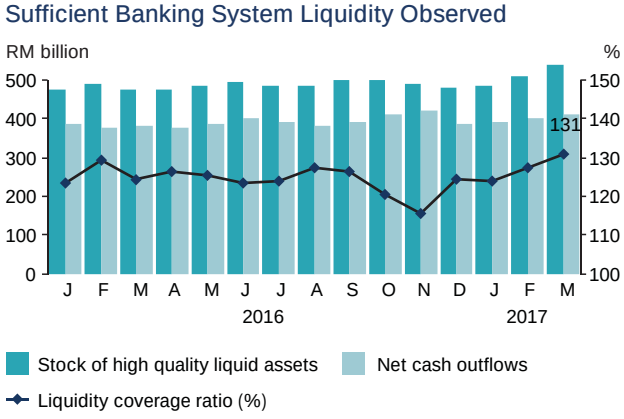
Source: Bank Negara Malaysia

Chart 42: Banking System Loan Quality



Source: Bank Negara Malaysia

Chart 43: Banking System Basel III Liquidity Coverage Ratio



Source: Bank Negara Malaysia

Liquidity in the banking system remains sufficient to support intermediation activities. Total banking system placements, reverse repos and statutory reserves with Bank Negara Malaysia which can be unwound to meet liquidity needs, stood at RM166.8 billion. The banking system Basel III Liquidity Coverage Ratio (LCR)[7] stood at 131% as at end-March 2017, well above the current transitional minimum regulatory requirement of 80% (4Q 2016: 124%). More than 90% of banks recorded LCR levels above 100%.

Domestic funding conditions remained stable during the quarter. Average cost of deposits for banks declined marginally by 4 bps to 2.55% while the 3-month KLIBOR was stable at 3.43%, respectively (4Q 2016: 2.60% and 3.41%, respectively). Banks' funding structure remained stable and predominantly deposit-based (69% of total funding) and in local currency. On aggregate, banking system deposits recorded a higher growth of 3.3% (4Q 2016: +1.5%). Household and business sector deposits continued to grow at a rate of 5.7% and 2.8%, respectively (4Q 2016: +5.1% and -2.3%, respectively).

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 net issuance of debt securities for 1Q 2017 amounted to RM12.6 billion (4Q 2016: RM4.8 billion). This contributed towards further reducing maturity and currency mismatches in the banks' funding structures. Taking into account the broadened funding structure, the loan-to-funds ratio[8] (LTF) stood at 82.8% (4Q 2016: 84.3%) at the end of the quarter.

[7] 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 2017, the minimum requirement is set at 80%.

[8] Funds comprise deposits and all debt instruments issued (including subordinated debt, debt certificates/sukuk, commercial papers and structured notes).

Improved accessibility to financial services

The Bank actively pursues the financial inclusion agenda along four key dimensions, namely convenient access, high take-up, responsible usage and high satisfaction. In recent years, financial inclusion in Malaysia has advanced significantly, driven by an expansion in financial access points nationwide. All 144 districts and 97% (2011: 46%) of the 886 sub-districts now have at least one financial access point, enabling 99% of Malaysians to conveniently tap safe, reliable and affordable financial services. This achievement can be mainly attributed to the agent banking initiative (Table 11).

Moving forward, the Bank is leveraging on geo-spatial mapping analytics to better visualise and monitor the distribution of financial access points. The geo-spatial mapping tool generates maps via satellite imaging and includes relevant information on financial access points, population density, economic activity, road network and surface conditions. The analytics are expected to unlock significant benefits including:

- More granular assessment on the effectiveness of financial access points, by taking into account relevant geographical and socioeconomic information. This supports the development of sound branching and product delivery strategies.
- More robust assessment on the impact of disasters on SMEs operations, which will improve the responsiveness of operational and policy interventions (e.g. delivery of assistance funds).
- Ability to provide better information to consumers on the nearest financial access points.