MANAGING RISKS TO FINANCIAL STABILITY

Domestic financial stability continues to be preserved

Financial system resilience remained intact amid continued volatile financial and commodity market conditions during the quarter. Financial intermediation activities were well-supported by sound financial institutions, orderly financial market conditions and continued ample domestic liquidity. Domestic financial system stability is expected to be maintained and this will continue to support sustained growth of the domestic economy.

Credit risk exposures remained manageable underpinned by sustained debt servicing capacity of borrowers

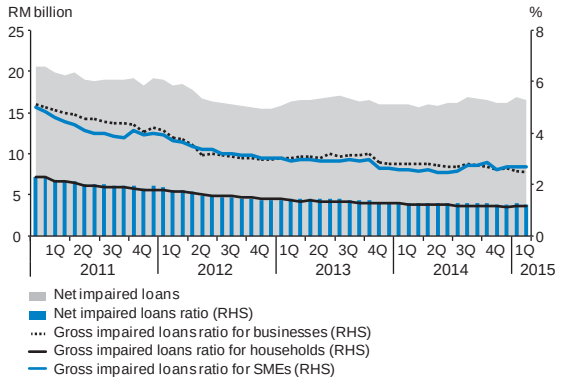
Credit risk exposures of banks remained broadly stable during the quarter, supported by sustained debt servicing capacity of most borrowers. Loan-in-arrears of between one and three months decreased slightly to 2.4% (4Q 2014: 2.5%) of total loans. Net loan impairment were unchanged at 1.2% as a percentage of net loans. In the insurance industry, credit exposures, largely via holdings of private debt securities, remained stable at 3.9% of total capital base (4Q 2014: 3.9%).

Credit risk exposures to the household sector continued to be well-contained. Expansion in household borrowings slowed further to 2.0% for the quarter (4Q 2014: 2.3%) driven by the flat quarterly growth of personal financing (1Q 2015: 0.1%; 4Q 2014: 1.2%) and modest quarterly expansion of 2.8% (4Q 2014: 3.0%) of house financing. The improved performance of the KLCI is the main driver of the expansion in aggregate household financial assets (1Q 2015: +2.7%, 4Q 2014: +1.3%). As at end-1Q 2015, household financial assets remained above two times of debt. Impaired loans and loan-in-arrears ratios for the banking system continued to be at low levels of 1.1% and 1.5% of total household borrowings respectively. This is further supported by continued prudence in underwriting standards of banks where about 80% of new loans were to borrowers with an aggregate debt service ratio (DSR) of below 60%.

Potential credit losses from banks' exposures to the business sector remained contained on account of sustained financial strength of most businesses. The leverage position of businesses, as measured by the median debt-to-equity ratio, improved to 41.5% (3Q 2014: 42.7%) at the end of 2014. In terms of debt level, growth in total business sector borrowings was slower at 1.2% at end-1Q 2015 (4Q 2014: +2.9%). External debt expanded by 2.5% in 4Q 2014 after a negative growth of 4% in the preceding quarter. On an annual basis, the growth in external debt as at end-2014 was only marginal at 0.05% (2013: 22.6%). This rebound in the fourth quarter was attributed mainly to intra-group funding and bond issuances for the overseas operations with matching currencies. Thus far, developments in commodity prices and ringgit exchange rates have had minimal overall impact on the business sector. The median interest coverage ratio (ICR), which indicates debt servicing capacity, stood firm at 6.3 times in 4Q 2014, while the ratio of current asset-to-current liability held steady at 1.8 times. Lower input costs (from lower commodity prices) and higher ringgit equivalent earnings on exports outweighed the adverse effects of higher import payments for the affected sectors. Despite the lower ICR recorded by the oil and gas, and crude and palm oil producers, the debt servicing capacity of businesses in these sectors remained above two times. The risk of overall potential delinquency, using the expected default frequency as a proxy, remained unchanged at 0.19%.

In the property market, average house prices recorded a slower overall growth for four successive quarters. The annual growth of Malaysian House Price Index (MHPI) moderated further to 7.9% in the third quarter of 2014 (2Q 2014: 8.4%), reflecting the slower growth in residential property transactions (3Q 2014: 4.3%, 2Q 2014: 5.3%), particularly in the secondary market, across all price range. Growth in house prices is expected to remain stable going forward supported by sustained demand in the primary market amid strong marketing activities by developers. New launches are also seeing a shift towards properties priced below RM1 million. Credit-induced speculative purchases of residential properties remained well contained. The growth in the number of borrowers with three or more outstanding housing loans stood at 3.3% (4Q 2014: 3%) and accounted for 3% of individuals with outstanding housing loans.

Banking System: Loan Quality



Source: Bank Negara Malaysia

Exposures to market risk was well-contained

Domestic financial markets remained resilient despite heightened volatility during the quarter. Portfolio investments recorded a lower net outflow position of RM7.9 billion (4Q 2014: net outflow of RM20.3 billion) for the quarter. The outflow was attributable mainly to domestic institutional investors' portfolio investment abroad. The average volatility of the FBM KLCI rose to 11.7% (4Q 2014: 7.7%) while the average volatility of the 10-year MGS yield doubled to 13% (4Q 2014: 6.7%). The FBM KLCI ended the quarter higher at 1,830.8 points (4Q 2014: 1,761.3 points) in line with other regional equity markets on investor expectations of a possible delayed increase in US interest rates. Yields for the 10-year MGS eased to 3.9% (4Q 2014: 4.1%), reflecting sustained interest by non-residents in the MGS market. The price-to-earnings ratio of the FBM KLCI remained broadly stable at 16.9 times (4Q 2014: 16.3 times), underpinned by strong economic fundamentals of the country. Trading liquidity, both in terms of price and volume, remained intact. The bid-ask spreads for MGS and FBM KLCI were unchanged at 0.1% and 0.4% of the mid-price respectively. The turnover ratio for MGS and FBM KLCI was higher at 14.5% and 2.0% respectively (4Q 2014: 10.8% and 1.8% respectively) reflecting active trading activities by domestic institutional investors and financial institutions.

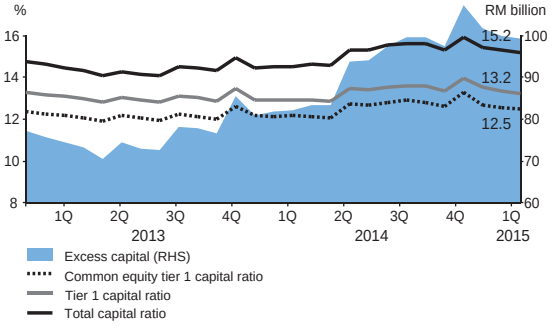
Market risk exposures of financial institutions remained within manageable levels, supported by continuous active risk management and hedging strategies by the institutions. Bank exposures to interest rate risk in the trading book remained limited at 1.4% of total capital. Exposures to equity risk were almost unchanged at 1.2% (4Q 2014: 1.3%) of total capital. The foreign exchange net open position of banks edged higher to 5.9% (4Q 2014: 4.7%) of total capital during the quarter mainly driven by higher foreign currency deposit placements by Malaysian banks. Similarly, market risk exposures of the insurance industry remained manageable to account for 12.9% of total capital (4Q 2014: 12.2%) amidst higher investments in equities as a result of portfolio rebalancing. Equity risk continues to form the bulk of insurers' market risk exposures at 7.7% of total capital.

Financial institutions continued to remain sound and resilient

The strong capitalisation of the banking system was well-preserved with the common equity tier 1 (CET1) capital ratio, tier 1 capital ratio and total capital ratio remaining well above the minimum regulatory levels at 12.5%, 13.2% and 15.2% respectively. More than 80% of banks' total capital consists of high quality capital - retained earnings, paid-up capital and reserves. The excess total capital buffer for banks was sustained in excess of RM90 billion. The capital adequacy ratio of the insurance sector similarly remained strong at 246.5% (4Q 2014: 252.1%) with an excess capital buffer of RM30.1 billion.

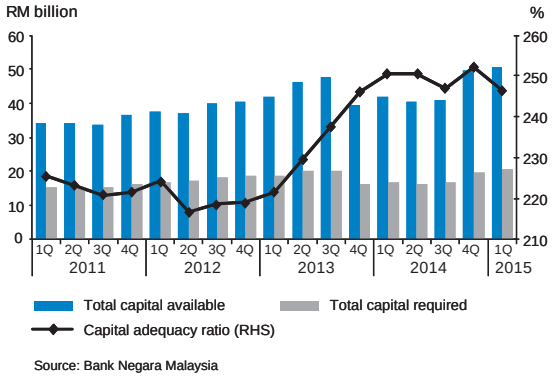
The banking system registered pre-tax profit totalling RM7.1 billion (4Q 2014: RM7.8 billion) in the first quarter. This was due mainly to lower contribution of revenue from dividend income segment. Returns on assets and equity were at 1.2% and 12.4% respectively (4Q 2014: 1.5% and 15.2% respectively). The operating profit for

Banking System: Basel III Capitalisation



Source: Bank Negara Malaysia

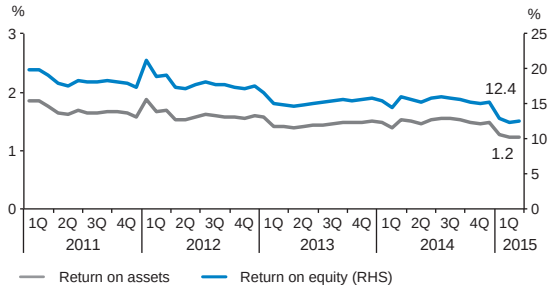
Insurance Sector: Capitalisation



Source: Bank Negara Malaysia

the general insurance and takaful businesses increased to RM806.1 million (4Q 2014: RM763.4 million) due to stronger underwriting profits recorded during the quarter. Excess income over outgo of the life insurers and takaful operators improved to RM5.4 billion (4Q 2014: RM2.1 billion) due to net capital gains of RM2.1 billion (4Q 2014: net capital loss of RM0.9 billion) mainly from investment in equities.

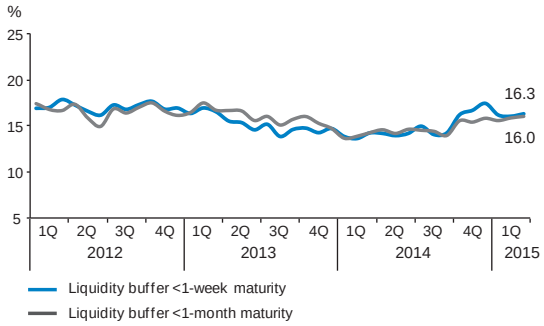
Banking System: Profitability



Source: Bank Negara Malaysia

Competition for deposits eased slightly following the Bank's clarification of the Liquidity Coverage Ratio rules, although it remains at an elevated level. Liquidity in the banking system remained ample with liquidity buffers for maturities over the 1-week and 1-month horizons standing well above the minimum regulatory levels under the existing liquidity framework at 16.3% and 16% of total deposits respectively (4Q 2014: 17.4% and 15.8% respectively). In addition, the net interbank placements and reverse repo by banking institutions with Bank Negara Malaysia, which can be unwound to meet liquidity needs, remained above RM100 billion. In terms of US dollar liquidity, banks recorded a higher surplus position of RM20 billion in the less than 1-week maturity bucket (4Q 2014: surplus of RM15 billion) following a lower amount of net outflows from maturing FX derivative contracts payable. For the less than 1-month maturity bucket, banks recorded a surplus of RM2.4 billion compared to a surplus of RM5.5 billion at end-2014.

Banking System: Liquidity Buffer to Total Deposit Ratio



Source: Bank Negara Malaysia

Insurance and Takaful Sectors: Indicators

	2014			2015
	1Q	4Q	Year	1Q
	RM million			
Life insurance & family takaful				
Excess of income over outgo	3,211	2,127	13,767	5,354
General insurance & general takaful				
Operating profit	824	763	3,179	806
Claims ratio (%)	55.0	57.5	57.5	49.3
	Annual Change (%)			
Life insurance & family takaful				
Excess of income over outgo	-15.2	-36.4	4.4	66.7
General insurance & general takaful				
Operating profit	11.4	-26.7	-1.4	-2.2
Claims ratio (percentage points)	-3.4	0.4	0.4	-5.7

Source: Bank Negara Malaysia