BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Preface

This Financial Stability Review provides Bank Negara Malaysia's assessment on current and potential risks to financial stability and the resilience of the Malaysian financial system to sustain its financial intermediation role in the economy. It also reports on any actions that have been taken to manage risks to financial stability and contains box article(s) on topics of special interest.

This publication is intended to promote greater awareness on issues and developments affecting financial stability.

This document uses data available up to 30 June 2018.

The Financial Stability Review is available in PDF format at www.bnm.gov.my

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Key Highlights on
Financial Stability Review – First Half 2018

Financial institutions remained resilient

Strong capitalisation and sound profitability of FIs

Banking sector

17% **Total capital ratio** (2017: 17.8%)

13.3% **Return on equity** (2017: 13%)

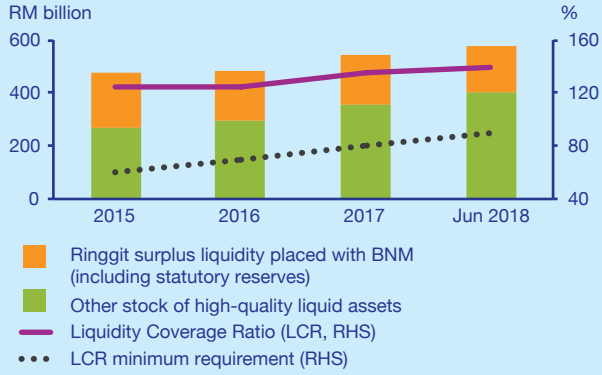
Insurance sector

239.3% **Capital adequacy ratio** (2017: 233%)

15.5% **Return on equity** (2017: 16%)

Ample liquidity in the banking system to support financial intermediation

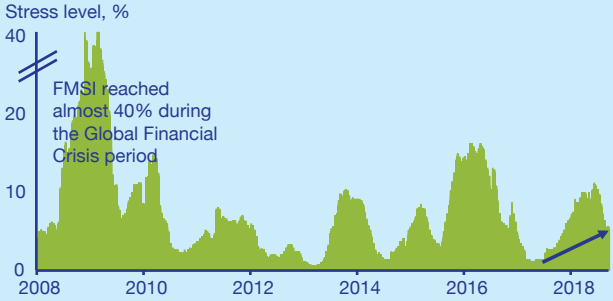
Banking System: Liquidity Coverage Ratio and Liquid Assets



Domestic financial markets remained orderly despite heightened market stress

Stress level in domestic financial markets increased in 2018 albeit lower than past highs

Financial Market Stress Index (FMSI)



Domestic institutional investors (DIIs) continued to support domestic financial markets on the back of attractive valuations

Non-resident investors' net sell-off of government bonds and equities
RM24.7 billion

Net purchase of government bonds and equities by DIIs
RM59.7 billion

Financing by financial institutions continued to support economic activities

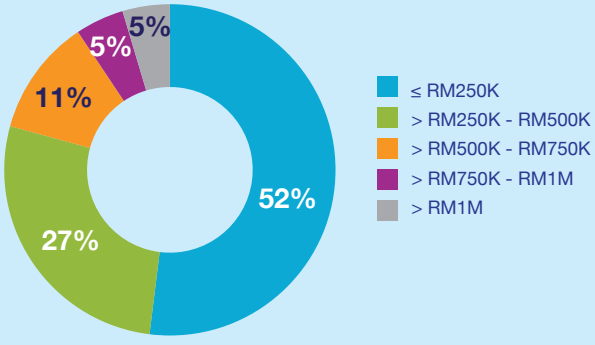
Eligible households and businesses continued to have access to financing

Banking System: Annual Growth of Loan Disbursements



More than 70% of loans approved were for first-time home buyers of properties priced below RM500K

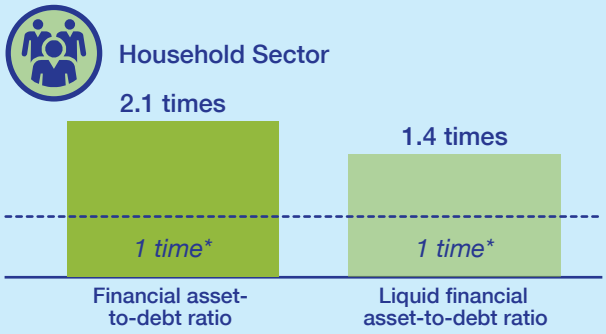
Composition of Borrowers by House Price

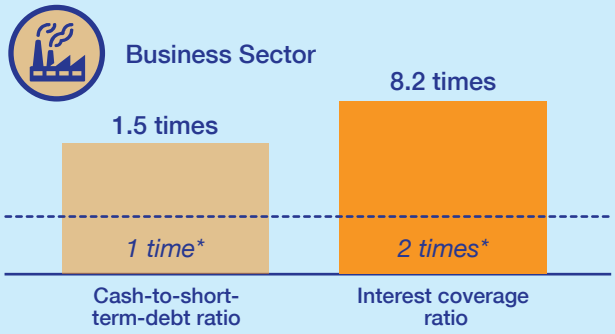


Source: Bank Negara Malaysia

Debt servicing capacity of households and businesses remained intact

Healthy financials continued to support debt servicing capacity of households and businesses



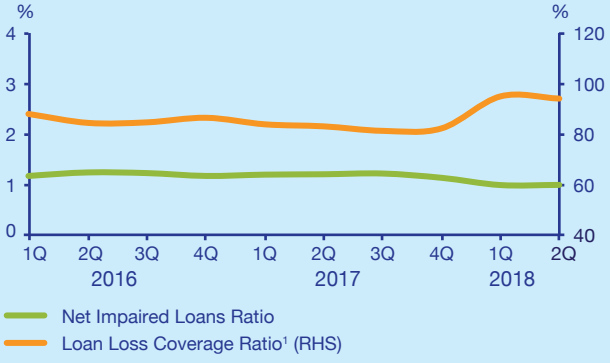


* Prudential threshold

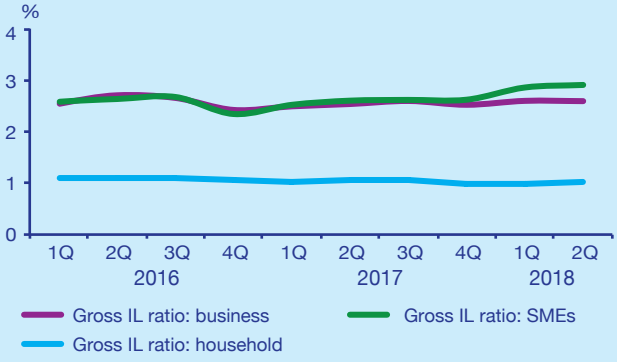
Sound asset quality in the banking system

Impairment levels remained low and stable as banks continued to observe prudent provisioning practices, which ensure strong financial buffers to absorb potential losses

Banking System:
Overall Asset Quality



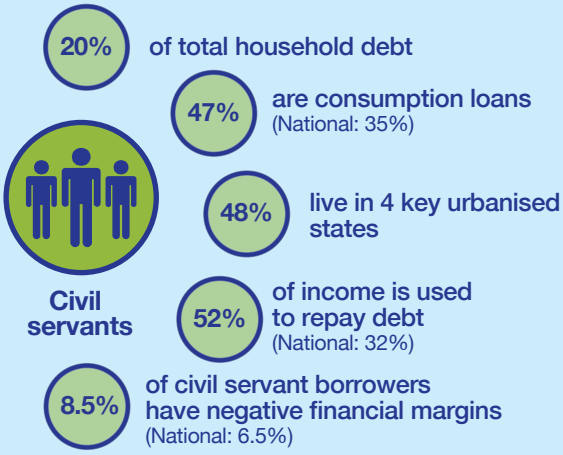
Banking System:
Gross Impaired Loan (IL) Ratio by Sector



[1] Refers to ratio of individual plus collective impairment provisions to total impaired loans

Key Highlights on
Box Article | Civil Servants' Debt: Risks and Policy Considerations

Civil servants are more indebted and have lower financial buffers



Risks to financial stability are limited



Low aggregate impairment ratio of civil servant debt of 1.3%



Debt-at-risk accounts for only 2.2% of total household debt or 16% of banks' excess capital buffers

Source: Bank Negara Malaysia

OVERVIEW

Domestic financial stability was sustained amid heightened uncertainties driven by both domestic and external factors in the first half of 2018. Global financial market volatility remained elevated, as trade-related tensions persisted while emerging markets experienced capital outflows following rising interest rates in the US, and a stronger US dollar. This follows a period of increased capital inflows to emerging market economies amid low yields in the advanced economies. On the domestic front, policy uncertainties following the outcome of the 14th Malaysian general election (GE14) also contributed to increased market volatility. Domestic financial markets have remained resilient against reversals of non-resident portfolio flows, supported by domestic institutional investors including financial institutions. Financial institutions continue to maintain strong fundamentals underpinned by high levels of capitalisation, healthy funding and liquidity profiles and sound asset quality – lending firm support to credit intermediation.

The Financial Stability Committee (FSC) of the Bank assessed the overall level of risks to domestic financial stability to be broadly unchanged (Diagram 1). While indicators of financial market stress have trended upwards, prudent risk management and hedging strategies by banks have contained market risk exposures. Liquidity and funding conditions also remain conducive to support financial intermediation despite increased market volatility. Credit risks are assessed to be low with banks continuing to observe sound underwriting and risk management practices. The overall debt servicing capacity of borrowers continues to be supported by sustained income growth of households and healthy financial positions of businesses. Pockets of risks however remain. Impaired loans have grown a little faster among households that are more exposed to income variability and facing higher cost pressures. However, impairment levels remain low. Overall household debt accumulation has also been on a more sustainable path in line with income growth. In the non-residential property segment, excess supply of office space and shopping complexes is expected to persist with vacancy rates deteriorating further in the first quarter of 2018. Conditions also remain challenging for firms in the oil and gas (O&G) sector amid a slow pick-up in capital spending by major oil producers. Bank exposures to these segments remain low with current capital levels providing strong buffers against potential losses even under severe stress scenarios. Financial institutions have also increased their vigilance of emerging risks in their overseas operations amid tightening global financial conditions.

For the remainder of 2018, risks to financial stability are expected to be contained despite continued uncertainties from both the domestic and external fronts. Globally, economic growth is expected to moderate in the second half of 2018 and into 2019. Uncertainties surrounding the on-going trade disputes between major economies and a faster-than-expected pace of monetary policy normalisation amid increasing inflationary pressures in a few major economies remain key risks to business performance and financial market conditions in emerging economies. Domestic financial markets are nevertheless expected to remain resilient and orderly. This will continue to be supported by the strong fundamentals of the Malaysian economy and the larger presence of stable, long-term investors that increase market resilience to sudden significant withdrawals of capital. Credit intermediation will continue to be underpinned by the healthy funding profile of banks and sustained surplus liquidity in the banking system. The FSC remains vigilant to signs of increasing financial stress in segments of the household and business sectors. Current policy measures and risk management practices of financial institutions will continue to play a critical role in containing attendant risks to domestic financial stability.

CREDIT RISK

Household Debt Growth Increased Driven by Secured Loans

As at end-June 2018, the annual growth of household debt[1] increased to 5.2% (2017: 4.9%) (Chart 1). Loans for the purchase of residential properties continued to be the key driver of growth (8.4%; 2017: 8.6%; contribution to growth as at end-June 2018: 4.3 percentage points, ppt; 2017: 4.3 ppt) underpinned mainly by sustained demand for houses priced between RM250,000 and RM500,000. Total household debt growth was

[1] Extended by banks, development financial institutions and major non-bank financial institutions (NBFIs).

Diagram 1

Direction of Risks that Impact Domestic Financial Stability

			Direction of risks (1H 2018 vs 2017)
Credit risk	Household	• Debt servicing capacity of households remained broadly intact • Households maintained aggregate financial assets at more than two times of debt • Banks are resilient to shocks from households, with potential losses from the lower income segment accounting for less than one-fifth of excess capital buffers	↔
	Property market	• Continued mismatch in the demand and supply for affordable houses • Oversupply situation persists in the office space and shopping complex segments with banks exposures to these segments accounting for 5% of total loans • Banks are resilient against potential shocks arising from the property market and related sector developments	↔
	Non-financial corporations	• Overall asset quality remained intact, despite weaker debt servicing capacity of borrowers in oil & gas and real estate sectors • Banks' exposures to oil & gas related sectors accounted for 6% of total business exposures • Majority of large borrower groups able to support debt repayments even under stressed scenarios • Risks to financial stability arising from external debt are largely mitigated given 30% are intercompany loans, with the remainder largely hedged with foreign currency revenue and/or financial derivatives	↔
Market risk		• Domestic financial markets remained orderly despite increased market stress • Market risk exposures of financial institutions are stable	↑
Liquidity and funding risk		• Ample liquidity in the banking system to meet liquidity needs • Funding structure of banks remained healthy; predominantly funded by deposits • Banks maintained liquidity coverage ratios well in excess of the regulatory minimum, mitigating short-term liquidity risk	↔
Contagion risk	Interlinkages with NBFIs	• No material change in the nature and magnitude of risk transmission from non-bank financial institutions (NBFIs) • Slight reduction of NBFIs' interlinkages with the financial system following merger of an NBFI with a licensed bank	↔
	External exposures	• Widening of net external liability position as banks reinforce foreign currency (FCY) liquidity buffers • More than two-thirds (68%) of external FCY interbank borrowings are from related counterparties, which are less likely to be subjected to sudden withdrawal shocks • Banks continued to be predominantly funded by ringgit-denominated domestic funding sources with little sign of undue reliance on external and cross-currency funding • Banks remained prudent in managing maturity and currency mismatches; banks hold substantial liquid FCY assets that could be drawn upon to meet their external obligations	↑
	Banks' overseas operations	• Risks arising from overseas operations are assessed to be low as these operations are supported by strong capital and liquidity buffers as well as sound asset quality	↔

↔ Stable ↓ Decreased ↑ Increased

also driven by loans for the purchase of securities[2] which grew by 8.4% (2017: 1.8%) and contributed 0.5 ppt (2017: 0.1 ppt) to the overall expansion in household borrowings. This partly reflected a rebalancing of exposures towards more secured lending by some banks. The ratio of household debt-to-GDP has sustained its downward trend since 2015 (Chart 2).

Risks to financial stability from household sector exposures continue to be largely mitigated by sound underwriting standards, risk management practices and loan affordability assessments. New household borrowings remained of high quality. About three-quarters of new loans approved were to borrowers with debt service ratios (DSR) of less than 60%. The bulk of household debt (64.5%) continued to be secured by properties and principal-guaranteed investments, thereby substantially reducing net exposures on household debt.

[2] 85% was for the purchase of unit trust funds including *Amanah Saham Bumiputera.*

The debt servicing capacity of households remained intact, supported by sustained income and stable employment growth. The annual growth of household financial assets moderated to 5.1% (2017: 8.6%) driven mainly by valuation changes in unit trust funds and equity holdings, in line with the weaker equity market performance in the second quarter (Chart 3). At the aggregate level, financial buffers remained ample as both financial assets and liquid financial assets stood at 2.1 and 1.4 times of debt, respectively. Including housing wealth, the total household assets-to-debt ratio also remained high at four times (2017: 4.1 times).

The ratio of impaired loans to total outstanding household debt for both banks and non-banks were sustained at 1.6% while delinquencies (loans-in-arrears of between one and three months) improved to 1.2% of total loans (2017: 1.4%). However, total impaired loans grew annually by 2% as at end-June 2018 (2017: 1.9%). In particular, impaired personal loans, loans for the purchase of residential and non-residential properties in the banking system recorded an annual growth of 7.5%, 4.4% and 20.4%, respectively. The uptick in impaired residential and non-residential property loans was mainly for properties valued at above RM500,000,

Chart 1: Household Sector – Annual Growth of Debt

Household debt driven by sustained demand for affordable housing

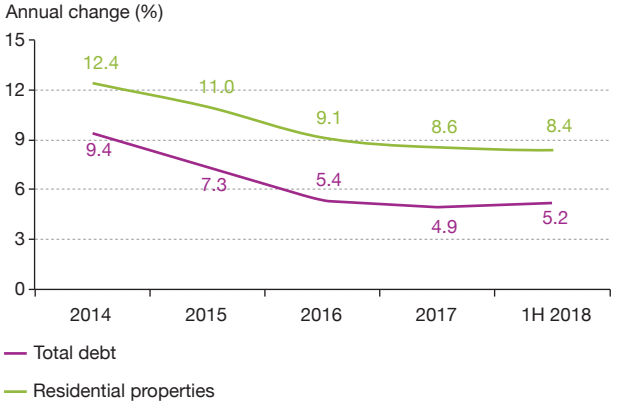


Chart 2: Household Sector – Key Ratios

Debt-to-GDP ratios declined further

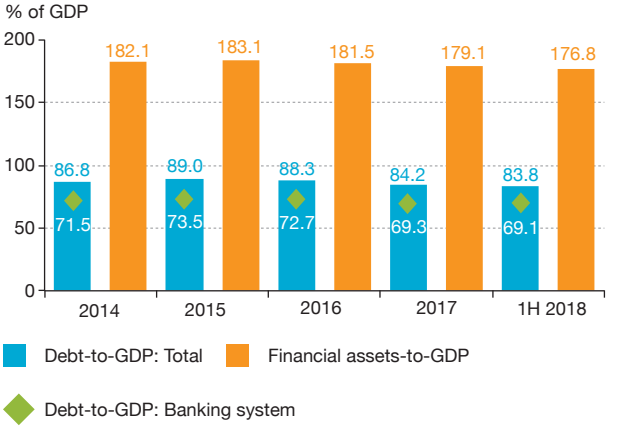


Chart 3: Household Sector – Debt and Financial Assets

Households maintained aggregate financial assets at more than two times of debt

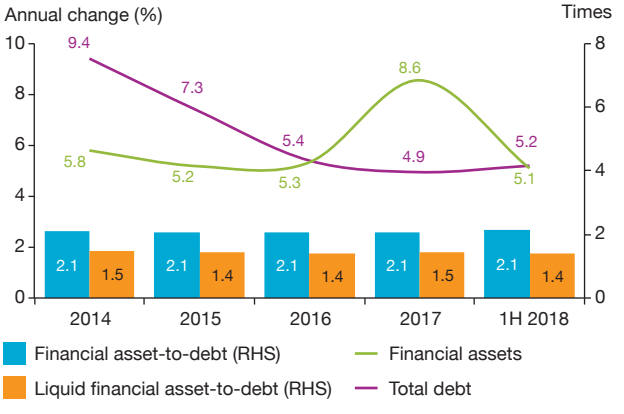
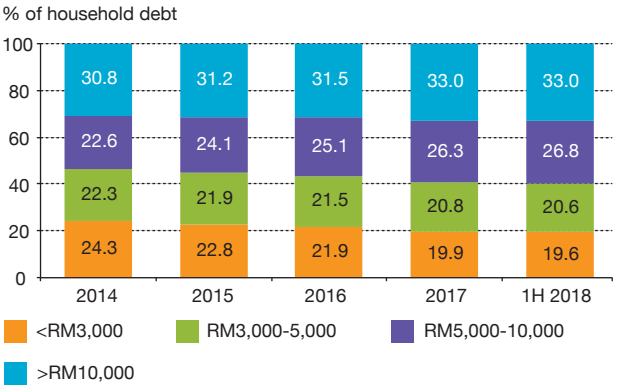


Chart 4: Household Sector – Debt by Monthly Income Group

Share of borrowings by low-income borrowers declined further



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

with higher incidents of impairments observed among self-employed borrowers who are more exposed to income variability. Higher impairments in personal loans were meanwhile largely observed among borrowers (i) with monthly salary of less than RM5,000; and (ii) living in major employment centres, which generally have higher cost of living.

While the amount of debt acquired by individuals earning less than RM3,000[3] per month increased by RM1.6 billion to RM228.5 billion as at end-June 2018, the share of borrowings to total household debt declined further (1H 2018: 19.6%; 2017: 19.9%), reflecting sustained improvements in affordability assessments (Chart 4). Half of the borrowings in this segment are in the form of fixed-rate financing, thereby reducing their susceptibility to changes in borrowing costs. Nevertheless, aggregate outstanding debt to annual gross income ratio for this segment has continued to edge higher to 8.4 times (2017: 8.3 times), driven largely by residential property loans. Thus, ensuring that further debt accumulation by this segment is undertaken prudently will be important to avert excessive debt burdens and financial hardship.

Existing macroprudential measures remain relevant

Overall, household debt accumulation has been on a more sustainable trend, as a result of the series of cross-cutting measures that have been implemented since 2010. Given the elevated level of household indebtedness, coupled with pockets of financial stress observed in certain segments, the Bank judges that existing macroprudential measures remain relevant.

Even under stressed scenarios, banks are able to withstand potential losses from household sector

The banking system continues to be resilient to shocks from household lending. In an unlikely event of simultaneous default incidents under simulated stress shocks, potential losses to the banking system would remain comfortably within the excess capital buffers (above the regulatory minimum of 8%) of RM138.5 billion held by banks as at end-June 2018 (Table 1). Potential losses attributable to households in the lower income segments (earning less than RM5,000 per month) account for 40% of total potential losses.

Imbalances in the Property Market Persisted, with No Imminent Risks to Financial Stability

As at end-June 2018, total exposures of Malaysian financial institutions to the domestic property market grew by 6.8% (2017: 7.2%) to RM878.9 billion (Chart 5), accounting for a higher share of total assets (28%; 2017: 27.4%). Banks remained the largest lender to the domestic property market, representing approximately 97% (RM852.2 billion) of total financial institutions' exposures to the property market. Of this, about 90% were end-financing for the purchase of residential and non-residential properties.

Table 1

Household Sector: Potential Losses in the Banking System Based on Severe Assumptions on Probability of Default (PD) and Loss Given Default (LGD)

		Residential properties	Motor vehicles	Personal financing	Credit cards	Total[1]
Stressed PD (%)		6.7	7.2	14.5	14.5	
(Baseline PD[2], %)		(1.7)	(1.8)	(3.6)	(3.6)	
Stressed LGD (%)		40.0	75.0	95.0	95.0	
(Baseline LGD[2], %)		(16.7)	(45.5)	(70.5)	(70.5)	
Potential losses (RM billion)	All borrowers	**13.8**	**7.9**	**13.1**	**5.0**	**65.1**
	- Borrowers earning ≤ RM3,000 per month	1.7	2.4	4.3	0.7	14.5
	- Borrowers earning ≤ RM5,000 per month	4.1	4.5	7.2	1.9	26.5[3]

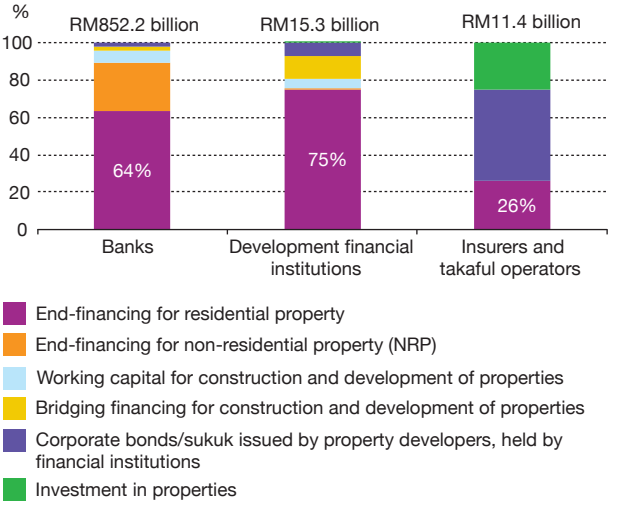
[1] Includes other household loans such as financing for the purchase of non-residential properties and consumer durables
[2] Based on PD and LGD of banks adopting the Internal Ratings-Based (IRB) approach
[3] 19.1% of excess capital buffers held by banks

Source: Bank Negara Malaysia

[3] These borrowers are more vulnerable to shocks.

Chart 5: Property Market – Financial Institutions' Exposures to the Property Market

Financial institutions' exposures are mostly related to end-financing for the purchase of residential and non-residential properties



Source: Bank Negara Malaysia

Exposures to Residential Property Market

The mismatch between housing demand and supply, particularly in the affordable segment, continued to exert upward pressure on house prices. Only 25% of newly launched houses between 2016 and 1Q 2018 were priced below RM250,000 (average 2007-2009: 70%), against 35% of households who can only afford houses within this price range. The number of unsold[4] housing units, of which more than 80% were priced above RM250,000, correspondingly increased to 146,196 units as at end of first quarter of 2018.

Risks from a significant correction in house prices are assessed to remain low on account of several factors. Demand for housing remains firm. Outstanding bank financing for the purchase of residential properties expanded by 8.3% as at end-June 2018, (2017: 8.7%; 2010-2016 average: 12.5%), with outstanding financing extended to first-time buyers of houses priced below RM500,000 accounting for about 71% of total residential property loan borrowers (below RM250,000: 54%). The approval rate[5] for residential property loan applications remained above 70%, thus supporting continued access to house financing for eligible borrowers. Speculative activities have also remained in check. As at end-June 2018, the number of borrowers with three and more outstanding residential property loan accounts, a proxy for speculative purchases, grew slower at 0.8% (2017: 0.9%; 2010: 15.8%). This segment accounted for less than 3% of total residential property loan borrowers. The share of residential property loans settled within three years, another gauge of speculative purchases, also continued to decline to 8% of total residential property loans settled (2017: 9.7%).

Eligible borrowers continued to have access to house financing. First-time home buyers accounted for more than 70% of total house financing borrowers

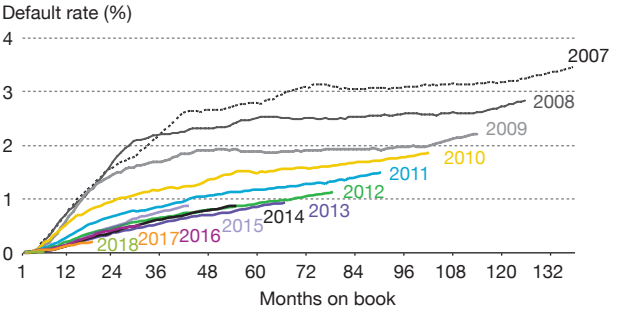
The overall quality of banks' residential property loan portfolio remained sound, in line with responsible lending and strengthened valuation and underwriting practices (Chart 6). The aggregate delinquent and impaired residential property loan ratios in the banking system remained low, both at 1.1% (2017: 1.3% and 1%, respectively). Total impaired residential property loans grew by 6.2% driven mainly by impairments for the purchase of houses priced above RM250,000. However, the impairment ratio for this segment remained low at 0.9% (2017: 0.9%).

[4] Includes both unsold properties that have been completed (overhang) and unsold properties currently under construction. These properties encompass all residential properties as well as serviced apartments and small office home offices (SOHO). (Source: National Property Information Centre).

[5] The approval rate is the ratio of the number of residential property loan applications approved by all banks in Malaysia to the number of residential property loan applications received by the banks during the same period. This ratio is derived based on monthly data submissions from banks to Bank Negara Malaysia.

Chart 6: Property Market – Vintage Analysis for Housing Loans in the Banking System

Vintage default rates of housing loans originated since 2007 have shown improvements



Note: Data include impaired loans written off by banks

Source: Bank Negara Malaysia

Exposures to Non-residential Property[6] Market

Market conditions in the non-residential segment remained subdued given the excess supply in certain segments, particularly for office space and shopping complexes which is expected to persist. The number of commercial properties (shops, office space and shopping complexes) transacted during the first quarter of 2018 declined by about 9% (4Q 2017: 8%), although values transacted saw an increase of 15.6% (4Q 2017: 32%). This reflected the higher average value of commercial properties being transacted, especially for those priced above RM1 million.

For office space, the incoming supply in the Klang Valley in the next four years remains sizeable at 37.9 million square feet as at 2Q 2018 (4Q 2017: 38.1 million square feet). In the retail segment, while some property developers have either deferred or downsized their projects to help secure higher occupancy amid softer market conditions, the addition of new shopping complexes in the Klang Valley, Penang and Johor has continued to exert downward pressure on occupancy and rental rates. As at the end of the first quarter of 2018, vacancy rates for both office space and shopping complexes deteriorated further (1Q 2018: 17.2% and 19.8%, respectively; 2017: 16.7% and 18.7%, respectively). While overall rental rates remained broadly unchanged, some office space owners continued to offer rental holidays to attract tenants.

Banks' end-financing for the purchase of non-residential properties grew by 2.6% to RM216.5 billion as at end-June 2018 (2017: 2.3% at RM213.4 billion). This accounted for about 26% of banks' exposures to the property market or 13.3% of banks' total outstanding loans. End-financing for the purchase of shops accounted for the largest share (40%), followed by office space and shopping complexes (23%).

Oversupply in the office space and shopping complex segments persists in key employment centres

Banks have remained cautious when lending to the office space and shopping complex segments where excess supply has been more pronounced (for detailed information on the oversupply situation, refer to 3Q 2017 BNM Quarterly Bulletin, Box Article 2 on 'Imbalances in the Property Market'). Following the issuance of the finalised Credit Risk policy document by the Bank in January 2018, banks are expected to strengthen their assessment of financing proposals for new property development or construction projects. This includes more robust assessments of the viability of projects, the financial strength of the property developer and location-specific factors such as effects of the development to properties in the surrounding area. Loan approval rates for the construction and purchase of office space and shopping complexes were correspondingly lower at 63.5% and 69.5%, respectively, during the first six months of 2018 (2017: 72.5% and 75.8%, respectively). Banks' exposures to these segments in the form of loans (including end-financing to purchase office space and shopping complexes, and financing for construction and development of non-residential properties) and holding of corporate bonds and sukuk have remained broadly stable at RM89 billion. These exposures accounted for just 5% and 6.7% of banks' total outstanding loans and holding of corporate bonds and sukuk, respectively. Asset quality in these segments has also remained sound with the impaired loan ratio little changed at 1.6% as at end-June 2018 (2017: 1.5%). Going forward, excess supply will continue to weigh on conditions in the office space and shopping complex segments in the medium term. As such, banks should remain prudent in lending to these segments.

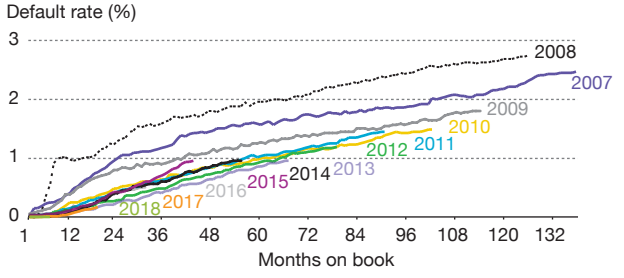
[6] Include purpose-built office segments, shopping complexes, shops, industrial buildings and factories, and other non-residential properties.

Banks are resilient to withstand severe shocks from property market and related sectors developments

Overall, the impaired loan ratio for the non-residential property segment remained low at 1.4% as at end-June 2018 (2017: 1.2%). Vintage default rates for loans to purchase non-residential properties continued to show improvement (Chart 7). Banks also continue to have sufficient capital buffers to absorb any potential losses arising from a severe property price correction and the potential spillovers to other industries that are highly dependent on the performance of the property sector (for detailed information on the sensitivity analysis, refer to BNM Financial Stability and Payment Systems Report 2017, Chapter 1, Info Box on 'Can Banks Absorb Potential Shocks from the Property Sector? A Sensitivity Analysis').

Chart 7: Property Market – Vintage Analysis for Non-Residential Property Loans in the Banking System

Vintage default rates of non-residential property loans originated since 2007 continued to improve



Note: Data include impaired loans written off by banks

Source: Bank Negara Malaysia

Financing to Business Sector Remains Supportive of Investment Growth, Amid Weaker Debt Servicing Capacity

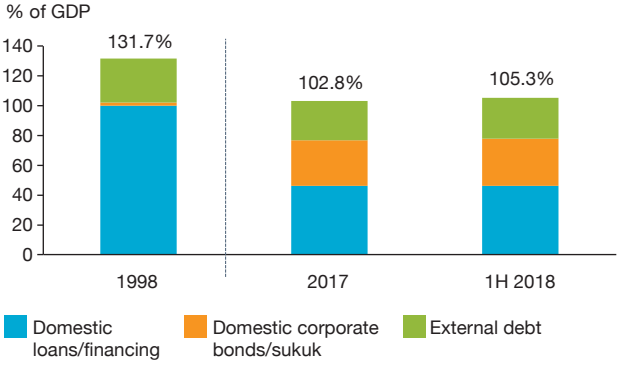
As at end-June 2018, aggregate non-financial corporate (NFC) debt grew at an annual rate of 7.2% to RM1,465 billion or 105.3% of GDP (Chart 8), reflecting higher growth in financing to the construction, manufacturing and real estate sectors. This was largely contributed by the growth in domestic borrowings of 6.7%, which represented 73.6% of total NFC debt. Outstanding bonds and sukuk[7] expanded by 14.1%, accounting for 30% of total NFC debt. Loans from banks and DFIs also grew higher by 2.2% (December 2017: 1.3%), mainly from the expansion in loans to SMEs, by 4.6%.

Notwithstanding heightened uncertainty in business conditions, particularly in the second quarter, there were no signs of broad-based credit tightening among banks. Overall business loan rejection rates remained stable at 16.3% (5-year average: 16%), although in some sectors with a weaker credit risk outlook, such as construction, real estate and mining & quarrying, marginally higher rejection rates were observed.

Total outstanding corporate external debt increased by 8.7% as at end-June 2018 (December 2017: -4.4%), driven mainly by new borrowings in the manufacturing sector, bulk of which was for a specific petrochemical project with a natural hedge of foreign currency export proceeds. Total corporate external debt accounted for 26.4% of total business debt or 27.8% of GDP (December 2017: 25.3% and 26.1%, respectively). 69% of external debt is denominated in USD, posing additional risks given the strengthening of USD in the recent period. Nonetheless, a firm-level analysis suggests that these corporates are able to withstand severe ringgit depreciation, with the median interest coverage ratio (ICR) estimated to decline to 6.2 times (pre-shock: 6.9 times).

Chart 8: Business Sector – Non-financial Corporate Debt-to-GDP Ratio

Higher debt driven by new bond and sukuk issuances



Source: Bank Negara Malaysia

[7] Corporate bonds and sukuk excluding issuances by Cagamas, financial institutions and non-residents.

Risks to broader financial stability emanating from corporate external debt, however, remained largely mitigated. About two-thirds of corporate external debt is medium- to longer-term debt, limiting rollover risk. Intercompany loans also constitute the largest share (30.4%) of corporate external debt, posing lower risk due to more flexible and concessionary terms. Regulatory measures in place[8] have additionally served to rein in external borrowings that have no productive purposes or which expose businesses to excessive risk.

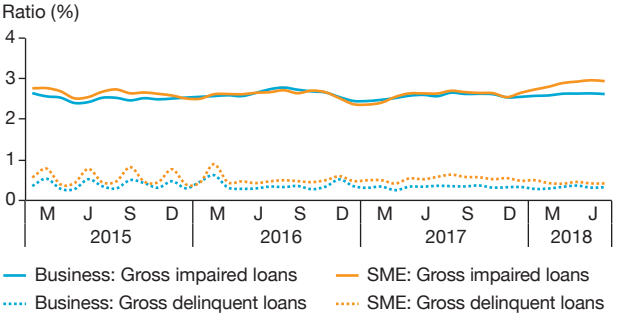
Healthy overall financial performance, although vulnerabilities may persist in certain sectors

Overall, the financial position of Malaysian firms[9] remained reasonably healthy during the first half of the year amidst uncertainties leading up to the GE14. As at June 2018, aggregate leverage[10] of Malaysian NFCs increased to 50.4% (2017: 47%), driven mainly by the manufacturing sector. While debt servicing capacity[11] declined to 8.2 times (2017: 9.1 times) given relatively weak earnings performance across most business sectors, it remained well above the prudent threshold level of two times. The liquidity position of firms, as measured by the median cash-to-short-term debt ratio (CASTD), was stable at 1.5 times, above the one time prudent threshold. The ratio of impaired and delinquent loans were little changed at 2.6% and 0.3%, respectively (Chart 9).

Firms in the O&G-related and real estate sectors continued to face headwinds. Although oil prices have been on an upward trend, capital expenditure spending by major oil producers have yet to pick up in pace, with contract awards to O&G service providers remaining slow. Structural weaknesses in the drilling, shipping and fabrication segments are also expected to persist in the near term. The median ICR for the sector worsened in the first half of 2018 to 1.5 times (2017: 2.5 times), driven mainly by weaker earnings performance of players involved in the fabrication and floating production, storage and offloading segments (Chart 10). The liquidity position of firms in the sector also remained weak with the median CASTD at 0.5 times (2017: 0.5 times). Nonetheless, most O&G players, particularly those in the upstream segment have rationalised their debt levels. This was reflected in the lower median leverage ratio of 46.5% (2017: 56.7%). Exposures of financial institutions to O&G-related sectors remained small. Banks' exposures (including both on- and off-balance sheet, and those via domestic banks' overseas operations and the Labuan International Business and Financial Centre) to firms in O&G-related sectors accounted for about 6% and 19% of total business exposures and total capital, respectively, with potential credit losses already largely provided for by banks.

Chart 9: Business Sector – Gross Impaired Loans and Gross Delinquent Loans

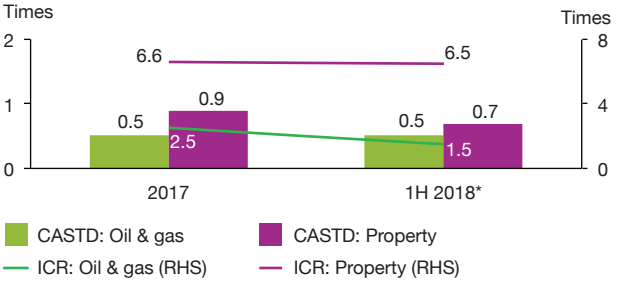
Overall quality of lending remains sound



Source: Bank Negara Malaysia

Chart 10: Business Sector – Liquidity and Debt Servicing Capacity Indicators for Selected Sectors

Sectors with weaker credit risk outlook exhibited worsening financial performance



* Twelve months ending June 2018
Note: Prudent thresholds for ICR and CASTD are two times and one time, respectively

Source: Bloomberg and Bank Negara Malaysia estimates

[8] Firms must obtain the Bank's approval for foreign currency-denominated (FCY) borrowings in aggregate amounts exceeding the equivalent of RM100 million from non-resident financial institutions, special purpose vehicles and other unrelated entities. Firms must be able to demonstrate adequate debt servicing capacity from FCY revenue streams or through the use of financial derivatives to hedge against currency risks. Such borrowings must also be for productive purposes.

[9] Based on financial data of 120 companies that are listed on Bursa Malaysia, covering major economic sectors and about 85% of market capitalisation (excluding financial institutions).

[10] Measured by the median debt-to-equity ratio.

[11] Measured by the ICR, using data for the twelve months ending June 2018.

In the real estate sector, the sluggish sales performance within the primary market continued to weigh on earnings of businesses. The debt servicing capacity of property developers remained stable with the median ICR at 6.5 times in the first half of 2018 (2017: 6.6 times). The liquidity position of property developers also slightly moderated to 0.7 times (2017: 0.9 times). Nonetheless, firm demand in the affordable housing segment should lend support to business performance going forward as developers step up efforts to clear existing inventories and review strategies for new developments. The review of mega infrastructure projects by the new government has also impacted some construction and property development businesses. However, financial institutions' exposures to affected businesses remain small, at 3.5% of total business lending and holding of corporate debt instruments.

Financial institutions' exposures to large borrower groups[12] declined to 41.1% (December 2017: 42.2%) of exposures to the business sector as at end-June 2018. While the CASTD of large borrowers fell to 0.9 times (2017: 1 time), they remain well-placed to service their debt with the median ICR above prudent threshold at 6.5 times (2017: 7.2 times). Credit exposures of financial institutions to weaker large borrower groups with an ICR below two times, declined to 5.0% (December 2017: 5.2%) of total business exposures of banks and DFIs, and 0.8% (December 2017: 1.1%) of business exposures of insurers and takaful operators. These exposures are largely to borrowers in the O&G sector.

The majority of large borrower groups is expected to be able to support debt repayments in the event of a substantial decline in profitability, significant weakening of the ringgit and higher borrowing costs. Under a scenario of simulated severe shocks (that is, up to 30% depreciation in the ringgit, a 50% decline in operating profit and 50 and 200 basis points increase in borrowing costs for RM and FCY borrowings, respectively), cumulative potential credit losses from exposures to large borrower groups would remain comfortably within banks' excess capital buffers. These buffers currently stand at about three times the estimated potential credit losses.

For the second half of 2018, the implementation of the Sales and Services Tax (SST) in September could have a transitory impact on the sales performance of the services and manufacturing sectors, as consumers adjust their spending patterns. Nonetheless, SMEs could benefit from more favourable cash flows under the new tax regime. The business performance of firms in the agriculture and O&G sectors could also be affected by supply disruptions, which are expected to persist until end 2018. Nonetheless, business earnings for most other sectors would be supported by continued positive consumer and business sentiments, higher retail spending during the tax-free period, as well as favourable demand and stable labour market conditions.

MARKET RISK

Domestic Financial Markets Remained Orderly Despite Increased Market Stress

Orderly conditions in the financial markets continued to be preserved amid heightened volatility in the first half of 2018. Indicators of financial market stress as reflected by the Financial Market Stress Index (FMSI) trended upwards (June 2018: 11.7%; December 2017: 8.3%) (Chart 11). In early 2018, investors' sentiment around the region, including in Malaysia, was affected by external developments including uncertainties surrounding the pace of monetary policy normalisation in the US, escalating trade tensions between the major economies and rising geopolitical risks. Domestically, policy uncertainty following the outcome of the GE14 also contributed to increased market volatility.

In the first half of 2018, total portfolio investments registered a net outflow of RM40.9 billion (Chart 12). Non-residents recorded net portfolio investment outflows of RM29.3 billion. Meanwhile, portfolio investments abroad by resident investors contributed to net outflows of RM11.6 billion (2H 2017: net outflow of RM4.6 billion).

[12] Large NFC borrower groups represent corporations with aggregate credit exposures (includes direct financing and holdings of corporate bonds and sukuk) exceeding RM1 billion with Malaysian financial institutions.

Malaysian Government Securities (MGS) yields rose between 17 and 32 basis points across the three- to ten-year tenures in the first half of 2018, in line with the rising US treasury yields (Chart 13). Sizeable outflows by non-residents from the Malaysian government bond market saw a decline in non-resident holdings of outstanding government bonds to 23.7% (December 2017: 27.7%) as at end-June 2018. Notwithstanding this, market liquidity in the MGS market remained intact, with stable average bid-ask spreads at 0.1% of the mid-price (2H 2017: 0.1%). The strong presence of domestic institutional investors, including financial institutions, has continued to provide support and liquidity to the domestic financial markets, thus preserving orderly market conditions. During the period, domestic investors increased their government bond holdings by RM53.4 billion. A higher proportion of stable and long-term non-resident investors in the government bond market has also contributed to greater market stability (Chart 14).

In the equity market, the FBM KLCI rallied to an all-time high of 1,895.2 points in April ahead of GE14 before a reversal to 1,691.5 points by end-June amid a confluence of external factors which also affected regional markets as a whole (1H 2018: -5.9%) (Chart 15). Net outflows by non-residents from the Malaysian equity market amounted to RM6.8 billion. For the first half of 2018, the impact of foreign attrition from the equity market was offset by increased participation by domestic institutional investors amounting to RM6.3 billion, on the back of more attractive valuations. Liquidity in the equity market remained intact with stable average bid-ask spreads at 0.4% of the mid-price (2H 2017: 0.4%). The price-to-earnings ratio of FBM KLCI stood at 17.4 times (2000-2017 average: 16.8 times).

In contrast to most regional currencies, the ringgit strengthened against the US dollar by 5.3% in March from end-2017 before ending the first half of 2018 at RM4.0385 against the US dollar (YTD appreciation of 0.6% for the first half of 2018) (Chart 16). The market recorded a healthy daily average FX transaction volume of USD11.7 billion (2H 2017 average: USD10.1 billion), as the measures introduced in late 2016 continued to deliver their intended effect of rebalancing ringgit demand and supply in line with economic activity. Daily average USD/RM bid-ask spreads widened slightly to 38 pips (2H 2017: 32 pips). Going forward, regional currencies including the ringgit will continue to be influenced by external developments, in particular broad US dollar strength.

Financial institutions continued to actively manage market risk exposures

Active risk management and hedging by banks continued to contain market risk exposures at manageable levels, well within prudent value-at-risk and loss limits set by individual banks. Banks' FX net open position accounted for only 5.2% of total capital (December 2017: 6.1%; average 2014-2017: 6.2% of total capital). Interest rate risk in the trading book and equity risk also remained low at 1.2% and 0.7% (December 2017: 1% and 1.9%) of total capital, respectively. Interest rate risk in the banking book rose to 4.2% (December 2017: 3.7%) of total capital, as banks increased holdings of longer maturity goverment bonds.

Insurers and takaful operators also continued to actively manage their market risk exposures while maintaining prudent risk-taking behaviour. Equity holdings remained stable ahead of GE14 at 12.9% of total assets (December 2017: 13%) before being pared down to 11.7% amidst the weaker equity market performance post-election. Capital allocated for equity risk correspondingly decreased to 8.1% (December 2017: 9.1%) of total capital available, contributing to lower market risk capital charges of 14.1% of total capital available (December 2017: 15.4%). Similarly, interest rate risk declined to 2.5% of total capital available (December 2017: 3%) as market yields increased.

Chart 11: Financial Market – Financial Market Stress Index (FMSI)

Overall market stress increased in first half of 2018

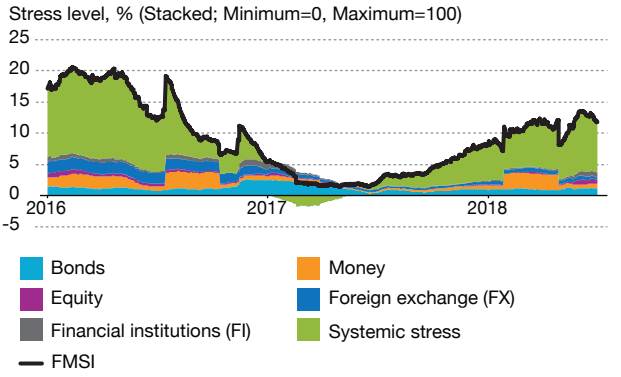


Chart 12: Financial Market – Net and Gross Portfolio Flows and Ringgit Exchange Rate Movement

Reversal of portfolio inflows mainly in the second quarter of 2018

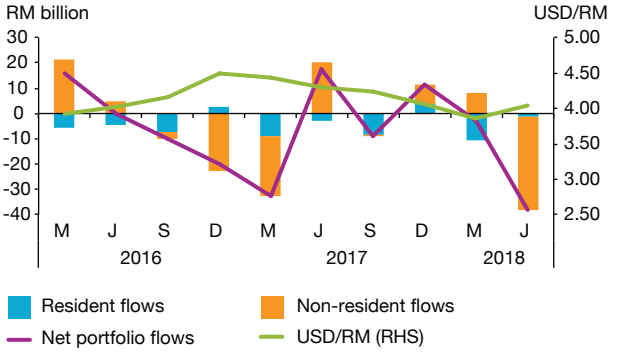


Chart 13: Financial Market – MGS Yields, Corporate Bond Yields and Quarterly Net Portfolio Flows

Rising MGS yields partially driven by higher US treasury yields

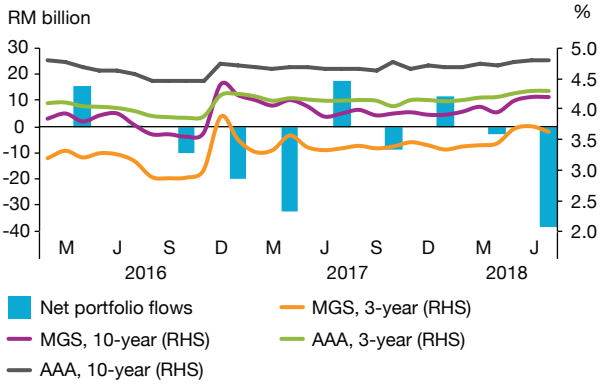


Chart 14: Financial Market – Distribution of Non-resident (NR) Holdings of Government Bonds

Higher proportion of long-term non-resident investors contributed to greater stability in the market

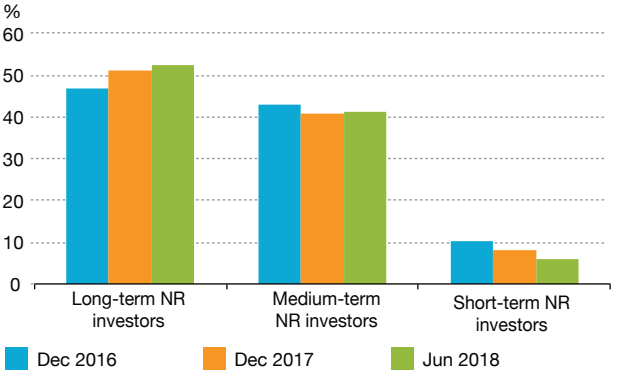


Chart 15: Financial Market – Performance of Regional Equity Markets

FBM KLCI experienced large sell-off, with performance in line with regional markets

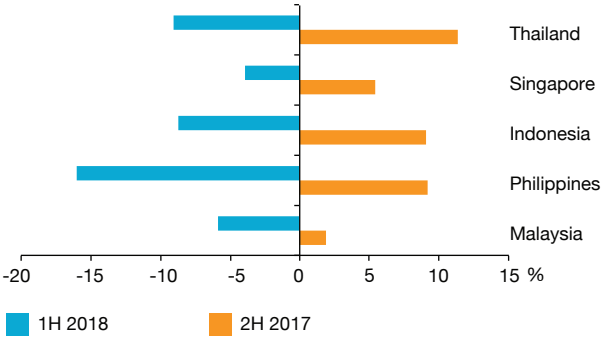
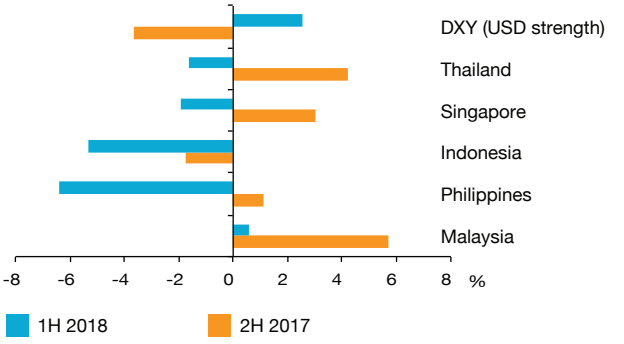


Chart 16: Financial Market – Performance of Regional Currencies against US dollar

Most regional currencies depreciated against the US dollar, except ringgit



Source: Bank Negara Malaysia, Bloomberg, Reuters and Department of Statistics, Malaysia

LIQUIDITY AND FUNDING RISK

Banking System Maintained Sufficient Liquidity to Meet Exigent Needs

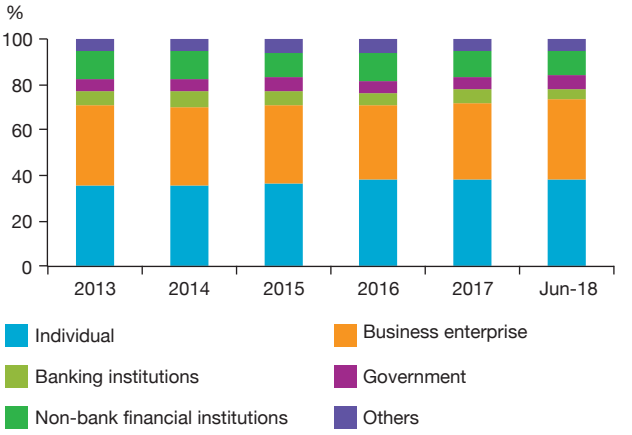
Liquidity and funding conditions remained conducive to support financial intermediation throughout the first half of 2018 despite heightened market volatility observed in 2Q 2018. Banking system liquidity comprising placements, reverse repos and statutory reserves with the Bank remained ample (June 2018: RM156.2 billion; December 2017: RM176.2 billion) to meet liquidity needs of banks. The funding structure of the banking system remained unchanged, with deposits constituting the bulk of total bank equity and liabilities (69%) (Chart 17).

The growth of bank deposits continued to trend upwards (June 2018: 5.1%; December 2017: 4.1%). This was partly driven by deposits from individuals which grew at a higher rate of 5.4% (December 2017: 3.9%). Recent growth trends in individuals' deposits remained lower than that seen earlier in the decade partly due to some preferring to invest in higher-yielding assets such as unit trust funds and equities, and higher costs of living. Deposits from non-residents remained relatively stable, even during recent periods of sizeable outflows and increased market volatility post-GE14, accounting for about 4.7% of banking system deposits (end-2017: 4.9%).

Banks continued to diversify their funding base to better manage maturity and currency mismatches. Issuances of banks' equity and debt instruments expanded by 3.4%, outpacing the growth of assets of 3% as at end-June 2018. Given this continued trend, the banking system's loan-to-fund (LTF) and loan-to-fund-and-equity ratios (LTFE), which capture the broader funding base of banks, stood at 83.9% and 73.2%, respectively (end-2017: 83.9% and 73.5%, respectively) (Chart 18). The industry-level Basel III Liquidity Coverage Ratio (LCR) stood at 139.3%, providing comfortable liquidity buffers to withstand any funding shock over a 30-day period. All banks continued to record LCR levels above the transitional regulatory minimum requirement of 90% in 2018.

Chart 17: Banking System – Composition of Deposits by Holder

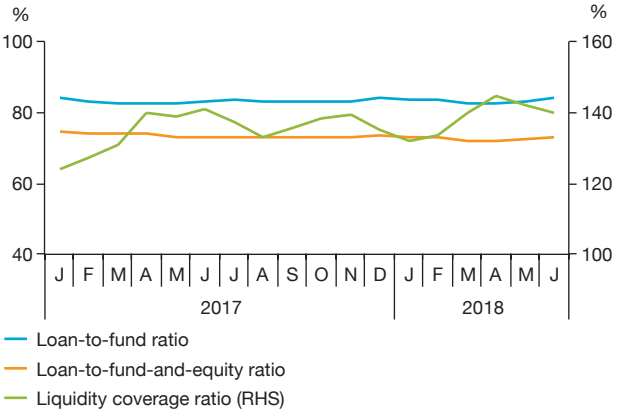
Deposits from households and businesses account for 73% of total bank deposits



Source: Bank Negara Malaysia

Chart 18: Banking System – Basel III Liquidity Coverage Ratio, Loan-to-Fund Ratio and Loan-to-Fund-and-Equity Ratio

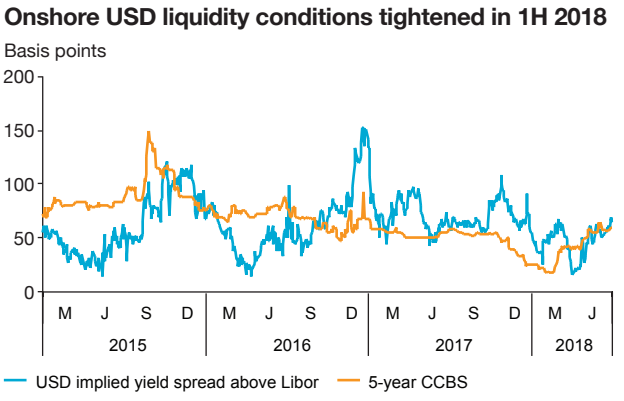
Banking system liquidity sufficient to support financial intermediation activities



Source: Bank Negara Malaysia

Banks' funding costs increased in February 2018 following the 25 basis points (bps) hike in the overnight policy rate (OPR) in January 2018 but has since stabilised. The average cost of deposits was at 2.60% (end-February 2018: 2.53%; end-2017: 2.51%) while the 3-month Kuala Lumpur Interbank Offered Rate (KLIBOR) remained stable at 3.69%

Chart 19: Financial Market – USD Implied Yield Spread Above Libor and 5-year USD/RM Cross-currency Basis Swap Spread (CCBS)



Source: Bank Negara Malaysia and Bloomberg

(end-February 2018: 3.69%; end-2017: 3.44%). In the first half of 2018, onshore USD liquidity conditions tightened coinciding with monetary policy normalisation in the US and trade tensions between the US and People's Republic of China (PR China). Spreads on short-term onshore USD liquidity, as reflected by the USD implied yield spread above the London Interbank Offered Rate (Libor), widened to 64 bps (2017: 55 bps). Meanwhile, the five-year cross-currency basis swap spread (CCBS), a reflection of spreads on long-term USD liquidity, increased to 60 bps (2017: 25 bps) (Chart 19). Risks remain of further tightening of USD liquidity in the second half of 2018 should trade tensions escalate or yield differentials against US Treasuries and other sovereign bonds narrow further.

The banking system remained a net FCY borrower in the interbank market (RM32.1 billion or 8.9% of FCY liabilities). This is largely a reflection of interbank placements by parents of locally-incorporated foreign banks (LIFBs) in Malaysia, as part of group-wide liquidity management strategies. Despite the higher amount of parent placements via the interbank market, the primary source of FCY funding continued to be from customer deposits and long-term FCY borrowings, which accounted for 47.6% of total FCY liabilities. These remained sufficient to fund banks' long-term FCY-denominated loans. Correspondingly, the FCY LTF ratio remained low at 65.2%.

CONTAGION RISK

Potential Risks and Shocks from Non-Bank Financial Institutions to the Financial System Remain Manageable

Risks to domestic financial stability presented by the interlinkages of non-bank financial institutions (NBFIs[13]) with the domestic financial system remained broadly stable (Chart 20). NBFIs' investments[14] in equities and bonds continue to be the main channel for the transmission of contagion risks to the financial sector. On aggregate, these investments remained significant at 28.8% of total market capitalisation and 40.5% of total outstanding bonds (2017: 27.5% and 40.7%, respectively). NBFIs are also significant shareholders of banks, accounting for 32.9% of total market capitalisation of domestic banking groups (2017: 34.6%). During periods of heightened volatility in the first half of 2018, NBFIs continued to provide support and liquidity to domestic financial markets. Given NBFIs' medium- to longer-term investment horizon, risks to profitability remained manageable despite some impact on profit growth from lower equity returns amid the weaker market performance in May and June 2018.

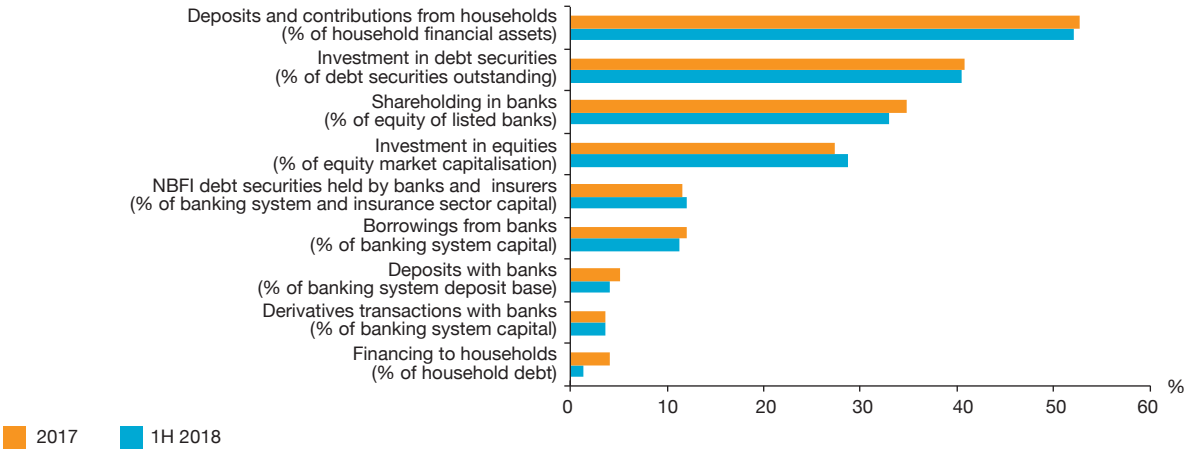
NBFIs continued to mobilise a significant portion of household deposits and statutory contributions amounting to 52% of household financial assets (2017: 52.6%). Withdrawal risks of large NBFIs are mitigated by sizeable holdings of liquid assets in the form of cash, deposit placements and government securities. Overall, NBFIs held liquid assets ranging between 18% and 32% of total assets of individual NBFIs to meet potential withdrawals.

Direct credit exposures of banks and insurers (including takaful operators) to NBFIs through holdings of NBFIs' securities, bank lending to NBFIs and derivatives exposures were little changed. NBFIs' financing to households as a share of overall household debt declined following the merger of an NBFI with a licensed bank. This brought the NBFI within the remit of formal regulation by the Bank.

[13] Refers to NBFIs which are not regulated by the Bank.
[14] Including those managed by external fund managers.

Chart 20: Interlinkages of NBFIs with the Financial System

No material change to channels and magnitude of NBFIs' interlinkages with the financial system



Source: Bank Negara Malaysia, Securities Commission Malaysia, Malaysia Co-operative Societies Commission, published financial statements and internal estimates

Contagion Risk from External Exposures of Banks and Insurers Remains Manageable

As at end-June 2018, the net external liabilities of Malaysian banks widened to RM195.6 billion. Excluding banks operating in Labuan International Business and Financial Centre (LIBFC), external liabilities of onshore banks[15] increased by 8% to RM331.9 billion (December 2017: RM307.2 billion). This reflected precautionary efforts taken by several domestic banking groups (DBGs) to reinforce FCY liquidity buffers via interbank borrowings. The increase in interbank borrowings was also driven partly by higher foreign bank placements with their Malaysian banking subsidiaries. These were channelled mainly towards FCY lending in the domestic interbank market and short-term investments. External liabilities of LIBFC banks also increased by 17.7% to RM156.3 billion (December 2017: RM132.8 billion), reflecting predominantly placements by related entities to fund FCY intermediation activities. Liquidity and funding risks are limited for LIBFC banks given that a significant proportion of these borrowings is from related parties and 'back-to-back'[16] in nature. Correspondingly, banks' external debt[17] grew to RM353.2 billion (December 2017: RM312.1 billion), representing 72% of total external liabilities, while external assets increased to RM292.6 billion (December 2017: RM257 billion).

There is little sign of undue reliance on external and cross-currency funding among onshore banks. The domestic operations of Malaysian banks continued to be funded predominantly by ringgit-denominated domestic funding sources. Onshore banks' external debt comprised less than 8% of total banking system liabilities, and non-residents accounted for only 4.7% of total banking system deposits. To support their FCY lending activities, onshore banks relied primarily on stable FCY funding sources such as customer deposits and medium- to long-term borrowings, roughly half of which were locally sourced. Consequently, the FCY LTF ratio rose to 65.2% (2017: 61.7%).

Expansion of Banks' External Exposures Reflects Proactive Funding and Liquidity Management Practices

Structurally, the profile and activities of Malaysian banks' external exposures remain relatively unchanged and continue to support manageable funding, liquidity and market risks (Charts 21, 22 and 23). Capital funds maintained in Malaysia by LIFBs represent 11.7% of overall external liabilities. 42.2% of external debt is in the form of interbank borrowings from related counterparties (i.e. intra-group placements), which are less likely to be subjected to sudden

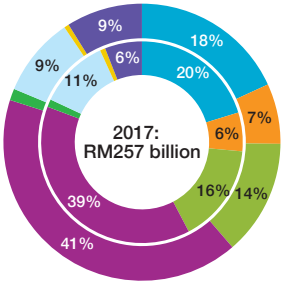
[15] Refers to domestic banking groups and locally-incorporated foreign banks (LIFBs).
[16] Funding received from the related office typically matches financing extended in terms of amount, currency and tenure.
[17] External debt refers to all external liabilities that require payment of principal and/or interest. In addition to external debt, external liabilities comprise (i) custodial securities held on behalf of non-resident (NR) clients, (ii) capital funds maintained by NR in resident banks, primarily for LIFBs and (iii) financial derivative balances.

Chart 21: Banking System – External Assets and Liabilities

External exposures of banking system reflect centralised liquidity management and strong presence of foreign banks in Malaysia

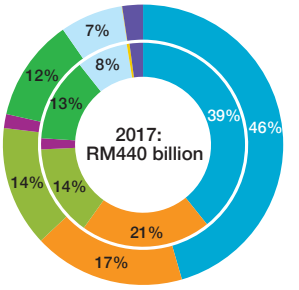
External Assets

Jun '18: RM292.6 billion



External Liabilities

Jun '18: RM488.1 billion



Interbank | Deposits & nostro | Capital funds | Loans | Securities under custody | Debt securities | Equity securities | Others

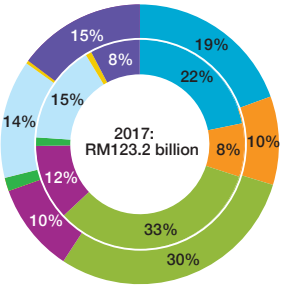
Note: Banking system includes entities operating in LIBFC

Chart 22: Banking System – External Assets and Liabilities of DBGs

Capital funds and placements with overseas operations formed bulk of DBGs' external assets

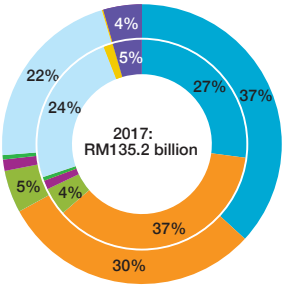
External Assets

Jun '18: RM133.4 billion



External Liabilities

Jun '18: RM149.7 billion



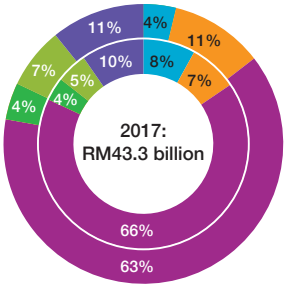
Interbank | Deposits & nostro | Capital funds | Loans | Securities under custody | Debt securities | Equity securities | Others

Chart 23: Banking System – External Assets and Liabilities of LIFBs

Stable capital funds and securities under custody formed the bulk of LIFBs' external liabilities

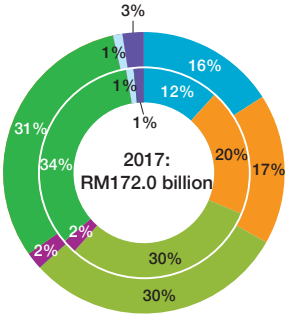
External Assets

Jun '18: RM44.9 billion



External Liabilities

Jun '18: RM182.2 billion



Interbank | Deposits & nostro | Capital funds | Loans | Securities under custody | Debt securities | Others

Note: External exposures comprise on- and off-balance sheet exposures

Source: Bank Negara Malaysia

withdrawal shocks. This sizeable share of intra-group placements reflects largely the pooling and redistribution of excess liquidity among related entities within regionally-active DBGs and LIFBs which are part of global banking groups. Local liquidity regulations applied by financial authorities to entities within each group further mitigate liquidity risks. Medium- to long-term debt securities issued by DBGs to meet capital and liquidity requirements account for 10.1% of external debt. 16.2% of banks' external debt was denominated in ringgit, largely in the form of non-resident deposits, and thus impervious to valuation changes from ringgit exchange rate fluctuations (Chart 24).

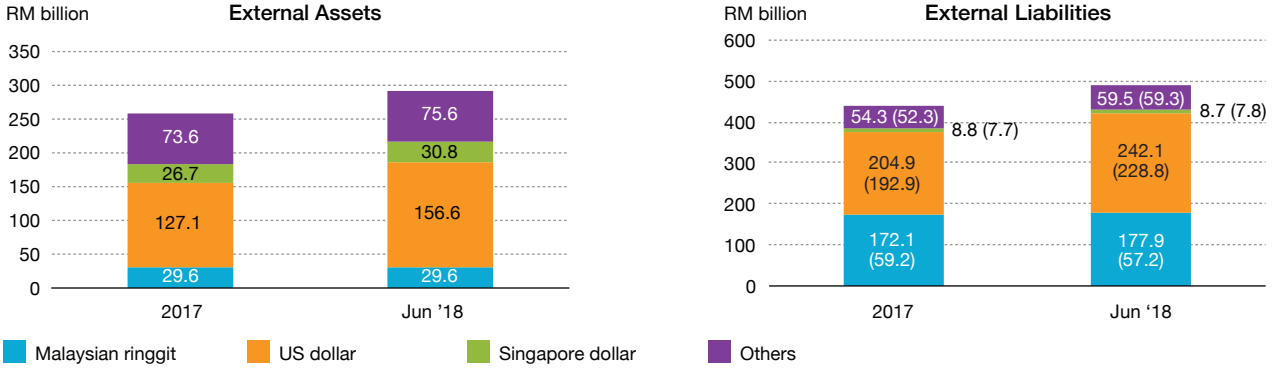
Malaysian banks remained prudent in managing maturity and currency mismatches. Banks hold substantial liquid FCY assets that could be drawn upon to meet their external obligations without creating a claim on Bank Negara Malaysia's international reserves. Total banks' liquid FCY assets comprising cash and cash equivalents, short-term interbank placements and debt securities held amounted to RM90.2 billion, bolstering their capacity to mitigate the impact of potential short-term FCY liquidity shocks. In the wholesale funding market, taking into account banks' cross-currency swap positions, banks have also maintained a net long FCY position amounting to RM29.9 billion with FCY interbank borrowings observed to be broadly matched with FCY assets in terms of amount, currency and tenure.

As part of effective liquidity management practices, banks are also required to monitor and report liquidity needs in significant currencies, including USD and SGD, on an on-going basis with contingency plans in place to meet FCY obligations. This is further supported by (i) regular stress testing across various currencies and maturity profiles; and (ii) prudent internal limits observed for interbank borrowings, FCY funding and liquidity positions as well as FCY market risk exposures. At the system level, the FX net open position of banks remained low and stable at 5.2% of total capital. Of this, USD and SGD net open positions stood at 3.7% and 0.7% of total capital, respectively. Macro stress tests conducted by the Bank continue to affirm the banking system's resilience to external funding and currency shocks, including that associated with a withdrawal of funding from non-resident counterparties (for more details, refer to 'Multi-year Solvency Stress Test for Banks and Insurers').

External claims by insurers (including takaful operators) remained predominantly in the form of general reinsurance exposures. During the first half of 2018, risks ceded by Malaysian general insurers to (re)insurers overseas amounted to RM1.6 billion, or 15.7% of total business underwritten. Reinsurance arrangements continued to be driven by the large and specialised risk segments such as aviation, offshore oil-related, marine hull and engineering (Chart 25), with risks mainly ceded to (re)insurers with strong credit standings in Germany, Switzerland, and

Chart 24: Banking System – External Assets and Liabilities by Currency

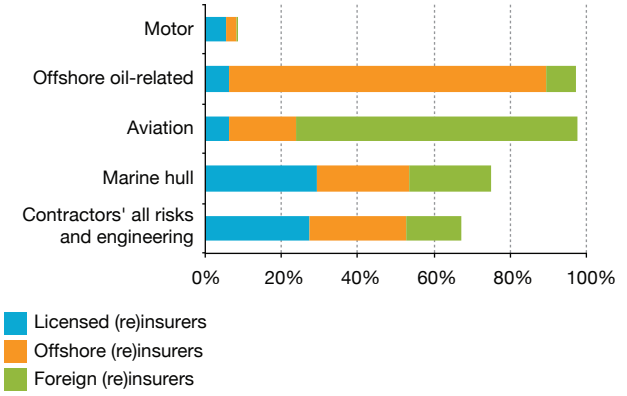
Sizeable share of external liabilities is denominated in Malaysian Ringgit



Note: Figures in parentheses indicate amount of external debt
Source: Bank Negara Malaysia

Chart 25: General Insurance and Takaful Sector – Reinsurance Ceded Ratio

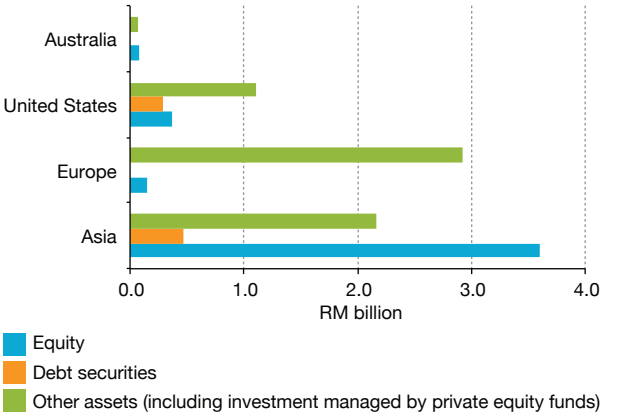
Main risks ceded out are from aviation, offshore oil-related, marine hull and engineering segments



Source: Bank Negara Malaysia

Chart 27: Insurance and Takaful Sector – External Investment Exposures by Region

External investments are mainly in liquid equity markets in Asia

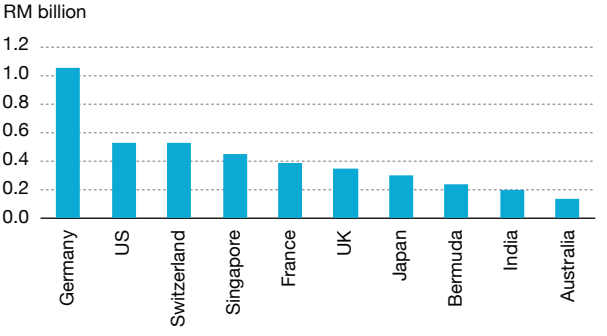


Source: Bank Negara Malaysia

the US (Chart 26). These exposures therefore pose limited counterparty risks. Meanwhile, risks ceded by life insurers remained small at less than 5% of total business underwritten. Investments abroad by Malaysian insurers and takaful operators also remained limited at 4.1% of total assets, comprising primarily equity holdings in Asia (Chart 27).

Chart 26: General Insurance and Takaful Sector – Foreign-Based Reinsurance Exposures by Major Countries

Reinsurance exposures are mainly to Europe and US



Source: Bank Negara Malaysia

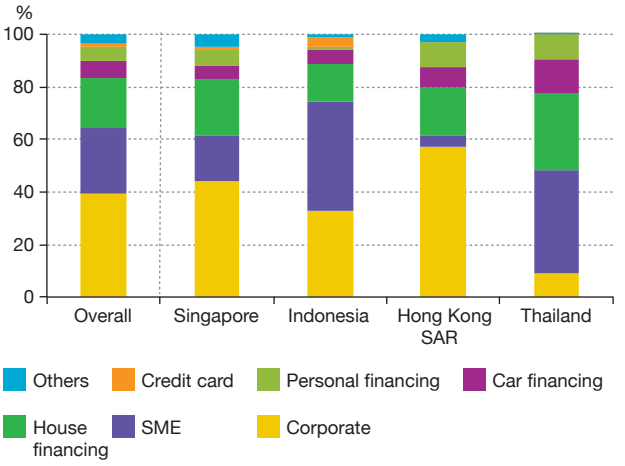
Risks from Domestic Banking Groups' Overseas Operations to the Malaysian Banking System Remain Contained

Total assets of overseas subsidiaries and branches of DBGs (overseas assets) increased marginally by 2.1% to RM562.7 billion as at end-June 2018 (December 2017: RM551 billion). The slower pace of growth was largely due to the ringgit's strong performance vis-à-vis regional currencies in the first quarter of 2018[18]. At the institutional level, overseas assets represented between 6.8% and 33.7% of total assets of individual DBGs. The bulk of these exposures continued to be concentrated in Singapore (49.9%) and Indonesia (21.7%), where the DBGs have a significant presence. The primary business of overseas operations of DBGs remained in lending and investment activities and are funded predominantly by local currency deposits, with loans and holdings of investment-grade securities comprising 62.3% and 9% of overseas assets, respectively. Loans extended by the overseas operations of DBGs were largely to individual and SME borrowers, cumulatively accounting for 60.9% of total overseas operations' loan exposures (Chart 28).

[18] Excluding FX translation effects, overseas assets of DBGs expanded by 5.4%.

Chart 28: Banking System – Loan Composition of Selected Overseas Operations

Bulk of overseas loans was extended to individuals and SMEs



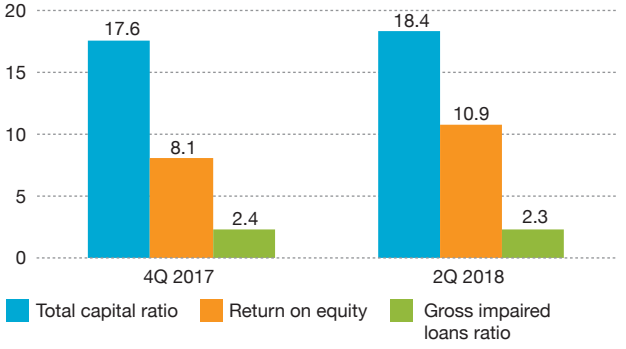
Note: Data as at end-2Q 2018

Source: Bank Negara Malaysia

On aggregate, DBGs' overseas operations recorded improved earnings in the first half of 2018, on the back of improving asset quality and sustained economic growth. Earnings were further bolstered by continued efforts to enhance operational efficiency. Consequently, the profit contribution from non-Malaysian operations rose to between 0.8% and 28.2% of total group profits (December 2017: between 1.2% and 23.5%) of individual DBGs.

Chart 29: Banking System – Key Financial Soundness Indicators of Selected Overseas Operations

Financial performance of overseas operations remained sound



Note: Refers to median key financial soundness indicators of selected overseas operations

Source: Bank Negara Malaysia

Risks to the domestic banking system arising from overseas operations of DBGs are closely monitored under the Bank's consolidated supervision framework. These risks are assessed to be low, supported by strong capital and liquidity buffers as well as sound asset quality of overseas operations (Chart 29). Total capital ratios of the major overseas subsidiaries of DBGs remained high, ranging between 11% and 20.4% (December 2017: between 9.9% and 17.6%). Risks associated with cross-border funding and currency mismatches continued to be limited as local currency deposits remain the predominant source of funding for these overseas operations. The limited reliance on wholesale funding sources further insulates Malaysian parent banks against potential short-term liquidity shocks affecting their overseas operations. The major overseas subsidiaries of DBGs also maintained Basel III LCR well above 100%.

Overall asset quality of overseas operations remained sound in the first half of 2018, with the median gross impaired loans ratio of the major overseas operations[19] improving to 2.3%. Banks remained vigilant and continued to take proactive measures to manage the quality of their overseas credit exposures. Of note, banks have continued to strengthen underwriting standards and provisioning practices, and intensified the monitoring of accounts which exhibit signs of potential distress amid financial market developments in the more recent period. This has been further reinforced by heightened oversight of the loan approval process and asset quality monitoring at the head office.

BANKING SECTOR

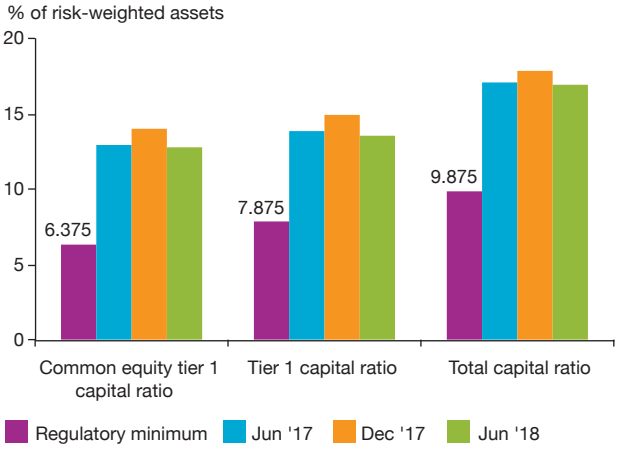
Banking Sector Maintained Sound Financial Position

The banking sector[20] maintained strong capitalisation throughout the first half of 2018, with excess total capital buffers of RM105.9 billion above the regulatory minimum[21] (Chart 30). A substantial portion of capital (74.9%) is in the form of highest quality loss-absorbing instruments such as paid-up capital, retained earnings

[19] Refers to top 15 overseas operations of DBGs by asset size, representing 93% of total overseas assets.
[20] Comprising conventional, Islamic and investment banks.
[21] The regulatory minimum in this context takes into account the 2018 capital conservation buffer requirement and bank-specific higher minimum requirements.

Chart 30: Banking Sector Capital Ratios

Banks maintained strong capitalisation

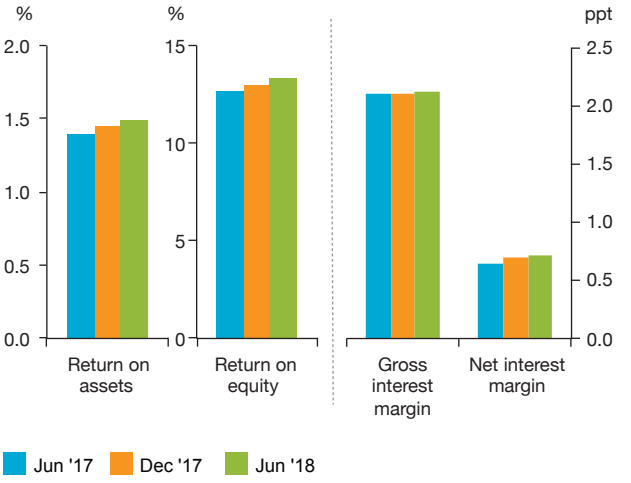


Note: The minimum regulatory requirements include the capital conservation buffer for 2018 amounting to 1.875% of risk-weighted assets

Source: Bank Negara Malaysia

Chart 31: Banking Sector Profitability

Banking profitability continued to improve



Source: Bank Negara Malaysia

and reserves. Banking system capitalisation was further bolstered by new equity issuances (1H 2018: RM9.1 billion or 6.9% growth since December 2017), which helped offset the impact of the phasing out of Basel II capital instruments under the Bank's Basel III transitional arrangements and higher provisions made under Malaysian Financial Reporting Standards 9: Financial Instruments (MFRS 9).

Strong capitalisation and sustained profitability of banks

The banking system recorded sound profitability as margins improved due to continued efficiency gains and improved asset quality. In the first half of 2018, pre-tax profits grew by 12% compared to the same period last year to RM19.3 billion (1H 2017: RM17.2 billion). Annual returns on assets and equity were mostly unchanged at 1.5% and 13.3%, respectively (2017: 1.5% and 13%, respectively) (Chart 31). Banks' earnings performance was largely driven by sustained growth in income from financing activities (5.1%), which remains the largest component of banks' gross income (66% of banks' gross income). Meanwhile, total operating costs grew at a slower pace (4.6%), supported by stable administrative, marketing and general expenses (0.4%) relative to the first half of the preceding year. This resulted in a lower cost-to-income ratio (1H 2018: 43.9%; 1H 2017: 45.5%). Consequently, banks' interest/ financing margins (net of impairment provisions and operating costs) edged marginally higher to 0.72 percentage points (2017: 0.71 percentage points). Banks' earnings performance is expected to be sustained amid continued efforts to enhance operational efficiency.

Banks' credit portfolio also remained sound. In the first half of 2018, newly-impaired loans declined by 5% compared to the same period last year to RM10.9 billion (1H 2017: RM11.6 billion). Accordingly, total impaired loans (net of individual impairment provisions) contracted by 10% to RM16 billion or 1% of total net loans (2017: RM17.8 billion or 1.1%). Total loan loss provisions nonetheless increased to RM24.4 billion or 1.5% of total loans as at end-June 2018 (2017: RM20.1 billion or 1.3% of total loans) following the implementation of MFRS 9. Under MFRS 9, banks are required to adopt a more forward-looking approach to provisioning, by estimating expected credit losses for credit facilities over a set time horizon and utilising a wider range of information. Consequently, banks' loan loss coverage ratio improved to 94% of total impaired loans (December 2017: 82.2%). While higher provisioning under MFRS 9 was expected to reduce banks' earnings, the magnitude of the impact has remained manageable, as the increase in provisions was partly absorbed by regulatory reserves already maintained by banks.

INSURANCE AND TAKAFUL SECTOR

Insurance and Takaful Sector Remained Resilient with Strong Capital Position and Sound Profitability

The insurance and takaful sector remained resilient with the aggregate capital adequacy ratio (CAR) standing at 239.3% (December 2017: 233%), well above the regulatory minimum of 130% (Chart 32). Capital in excess of the minimum regulatory amount remained strong at RM30 billion. Capital held against insurance and takaful risk, which measures the risk of underestimation of insurance and takaful liabilities, adverse claims experience, expense[22] and lapse[23], continued to form the largest component of total capital required (47% of total capital required). This is followed by capital held against market and credit risks which stood at 34% and 9.3% of total capital required, respectively.

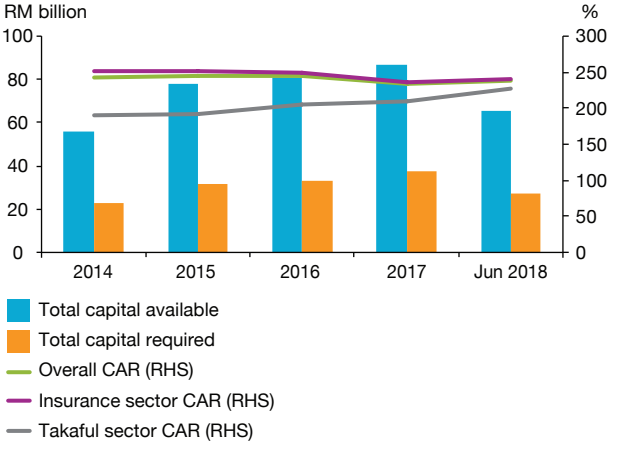
The insurance and takaful risk charges remained largely unchanged, reflecting the stable business mix and stable level of reserves held. Market risk exposures, which mainly comprise equity risk, trended lower in line with lower valuations observed post-GE14 and some equity disposals by insurers and takaful operators to manage their market risk exposures. Blue chip stocks[24] continued to account for a significant portion of total equities held at 49%. Credit risk exposures in the forms of corporate bonds held and reinsurance claims remained stable with counterparties largely maintaining strong credit ratings and a stable outlook. 91% of corporate bonds held continued to be in the form of at least AA-rated and government-guaranteed securities.

Insurance and takaful sector remained profitable albeit weaker investment performance

Overall, the insurance and takaful sector recorded lower profitability of RM4.2 billion in the first half of 2018 compared to the same period last year (1H 2017: RM11.8 billion). Excess income over outgo of the life insurance and family takaful sector was significantly lower at RM2.9 billion (1H 2017: RM10.5 billion), driven by large net unrealised losses in the investment portfolio amounting to RM5 billion (1H 2017: net unrealised gains of RM3.6 billion) (Chart 33). The losses were mainly attributed to equity holdings amid a weaker market performance towards the end of June 2018. Similarly, lower valuations in the bond market also contributed to overall capital losses albeit to a lesser extent. Correspondingly, the 12-month

Chart 32: Insurance & Takaful Sector – Capital Adequacy Ratio

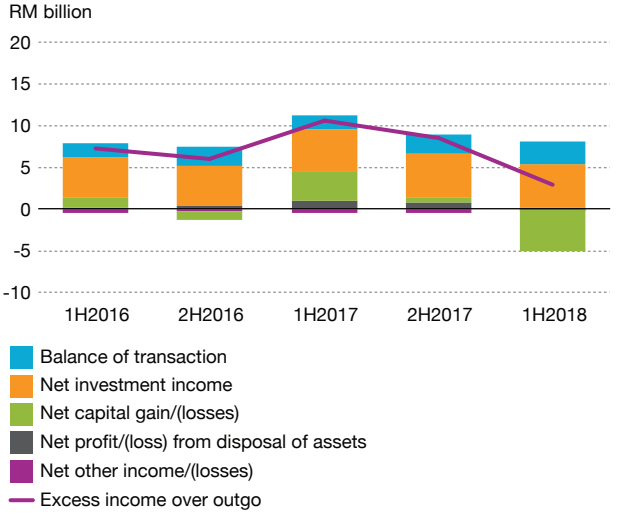
Aggregate capital adequacy ratio (CAR) remain well above the regulatory minimum of 130%



Source: Bank Negara Malaysia

Chart 33: Life Insurance and Family Takaful Sector – Composition of Excess Income over Outgo

Lower excess income over outgo driven by unrealised losses



Source: Bank Negara Malaysia

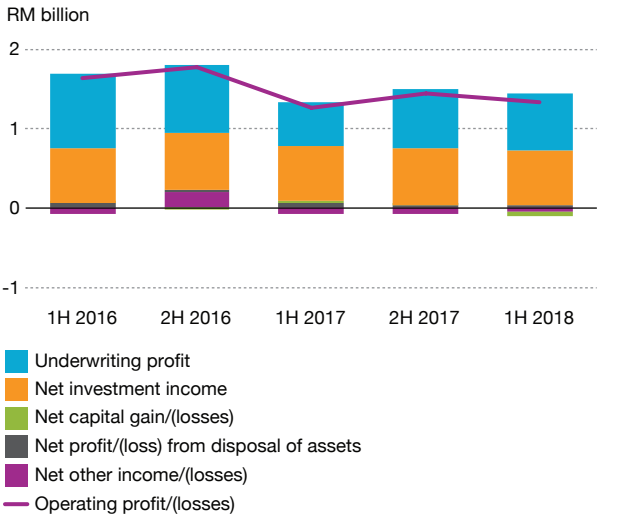
[22] Refers to expenses assumed throughout the policy contract.
[23] Refers to policy termination and lapse by policyholders.
[24] Blue chip stocks refer to stocks of the largest 30 companies by market capitalisation on Bursa Malaysia's main board.

investment yield which consists of dividends, coupons received, realised and unrealised net gains declined to 3.1% (June 2017: 7%) of total investments. Income, however, continued to be supported by growth in total net premiums from new and existing policies, in particular investment-linked insurance policies. Net premiums from these policies maintained double-digit growth, albeit lower at 15.7% (1H 2017: 18.2%) due to a moderation in the volume of new products sold by insurers. Net premiums of investment-linked policies accounted for RM9.4 billion or 45.3% of total net premiums. Total net policy benefits paid out remained relatively stable at RM13.1 billion (1H 2017: RM12.7 billion).

New business of life insurers and family takaful operators recorded a higher growth rate of 7.7% (1H 2017: 6%), largely supported by Mortgage Reducing Term Assurance and Takaful (MRTA/MRTT) insurance policies, which grew at 18.6% (1H 2017: 13.1%). This trend is consistent with the sustained growth in housing loans during the same period. In line with the requirement for life insurers and family takaful operators to offer pure protection term products through direct channels to consumers beginning 1 July 2017, the distribution of new products through such channels[25] posted stronger growth of 12.3% (1H 2017: 9.8%).

Operating profit of general insurance and takaful sector remained unchanged at RM1.3 billion. While underwriting profits increased to RM0.7 billion (1H 2017: RM0.6 billion), this was largely offset by losses from equity investments (Chart 34). The overall claims ratio decreased slightly to 58% (1H 2017: 59%). In the motor segment, some realignment between premiums and risks were observed as general insurers and takaful operators began to adopt more differentiated pricing in line with risks following the liberalisation[26] of the motor 'Comprehensive' and 'Third Party, Fire and Theft' tariffs. The claims ratio of the compulsory motor third-party bodily injury and death cover (motor 'Act') improved to 98.6% (1H 2017: 155.8%) while that for other motor covers increased to 63.8% (1H 2017: 60.6%). Overall, the claims ratio for the motor segment improved marginally to 70.9% (1H 2017: 72.1%).

Chart 34: General Insurance and Takaful Sector – Composition of Operating Profits



Source: Bank Negara Malaysia

Gross direct premiums of the general insurance and takaful sector were sustained at RM10.5 billion (1H 2017: RM10.3 billion). The motor segment continued to form the largest line of business at 48.1% of total gross direct premiums (1H 2017: 48.1%). The medical and health segment recorded higher gross direct premiums growth of 9% (1H 2017: 6.4%), due to higher demand for group medical policies and the continued increase in medical costs. The offshore oil-related business on the other hand, continued to contract by 10.9% (1H 2017: -24.7%) amidst the slow recovery in the oil and gas sector. However, the contraction has had a limited impact on overall performance of the general sector as it only accounted for less than 5% of total gross direct premiums.

[25] Direct distribution channels refer to distribution of products through the head office and branch premises, or an online platform. The Bank plans to issue specifications for direct offerings of critical illness, and medical and health products in 2H 2018, which will come into effect beginning 2019.

[26] The tariff liberalisation of the two motor policies, which include coverage for third-party bodily injury and death commenced on 1 July 2017 as part of Phase II of the overall pricing reform. Phase 1, which took effect on 1 July 2016, allows for premiums of new motor and fire products outside the scope of the tariff to reflect market rates. Further liberalisation will be subject to a review in 2019 on the readiness of the market to support subsequent phases of liberalisation.

MULTI-YEAR SOLVENCY STRESS TEST FOR BANKS AND INSURERS

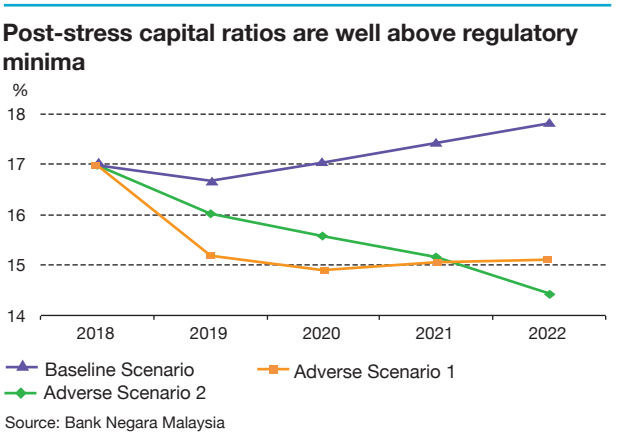
The Bank regularly conducts supervisory solvency stress tests on Malaysian banks and insurers to assess the institutions' resilience against severe macroeconomic and financial strains over a four-year stress horizon. The stress test is based on three hypothetical macroeconomic scenarios[27] (one baseline and two adverse), which simulate a series of tail-risk shocks on the institutions' income and capital (Table 2). The exercise excludes: (a) any policy intervention by authorities; or (b) management actions by the institutions. This is to allow the Bank to assess the banks' and insurers' immediate capacity to withstand severe shocks without additional assistance.

Results from the exercise affirmed the shock absorbing capacity of both banks and insurers. At the end of the stress horizon, the post-shock total capital ratio (TCR) of the banking system is estimated to be above 10% under both stress scenarios (Chart 35). Similarly, the capital adequacy ratio of the insurance sector is expected to remain well above 130% (Chart 36). At the institutional level, seven banks with a cumulative market share of 9.8% were unable to maintain Basel III total, tier 1 and CET1 capital ratios above the minimum requirements, while only a single insurer recorded a CAR below the minimum requirement of 130%.

Stress tests affirm financial institutions' shock absorbing capacity under simulated severe scenarios

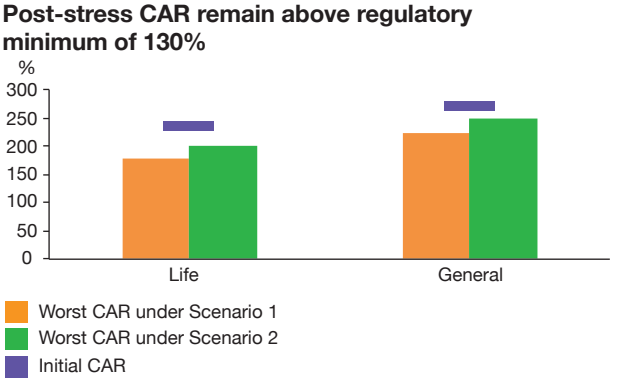
For the banking system, credit risk losses comprise more than 90% of total losses, with the gross impaired loan ratio expected to rise to 5%-9% under the adverse scenarios. Of the credit losses incurred, loans for the purchase of transport vehicles account for the largest portion of such losses (19%-23%), followed by defaults of large corporate borrowers (16%-23%) (Diagram 2). Even under such severe scenarios, banks are well-positioned to absorb potential losses using available capital and earnings buffers.

Chart 35: Banking System – Post-shock Total Capital Ratio



Source: Bank Negara Malaysia

Chart 36: Insurance Sector – Results of Stress Test on Capital Adequacy Ratio (CAR)



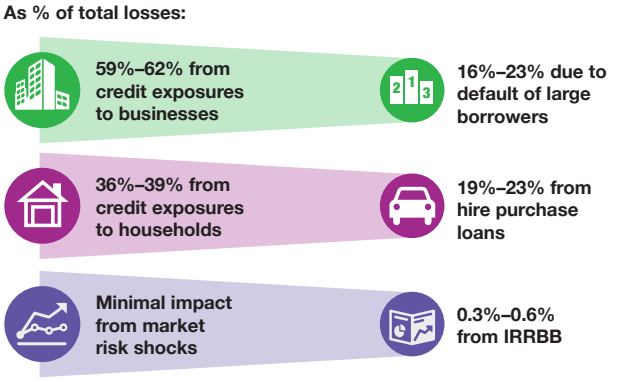
Source: Bank Negara Malaysia

In the insurance sector, life insurers are expected to be heavily affected by the simulated market risk shocks, as most assets (74%) are held in the trading portfolio (Diagram 3). Accordingly, the CAR for life insurers is estimated to initially decline by 33-56 ppt in the first year and recover to 236%-248% by the end of the stress horizon. The recovery is mainly attributed to capital gains from a stronger financial market performance from the second year onwards, improved premium growth, and a reduction in liabilities following the increase in MGS yields[28]. For general insurers, CAR remains above 200% under both adverse scenarios, with the main impact arising from shocks related to higher motor claims.

[27] For more details on the adverse scenarios, refer to the Info Box titled 'An Overview of the Solvency Stress Test Scenarios for Banks and Insurers'.

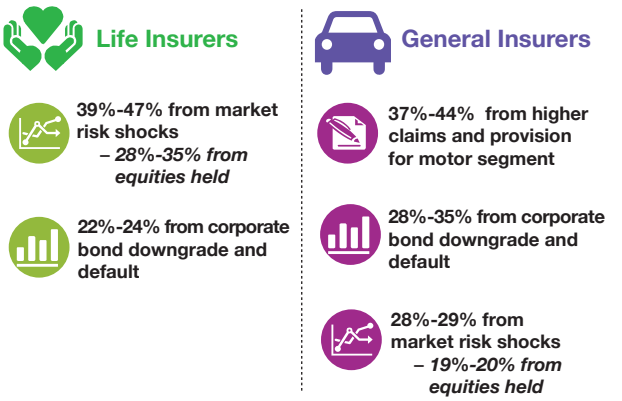
[28] MGS yields are used as discounting factors on guaranteed liability. An increase in discounting factor would lead to a decrease in the present value of liability.

Diagram 2: Banking System – Key Loss Drivers under Adverse Scenarios



Note: IRRBB = Interest Rate Risk in the Banking Book

Diagram 3: Insurance Sector – Key Loss Drivers under Adverse Scenarios



An Overview of the Solvency Stress Test Scenarios for Banks and Insurers

The multi-year solvency-based stress test exercise models a series of tail-risk events based on three hypothetical domestic GDP growth paths (one baseline and two adverse scenarios) and the corresponding macroeconomic and financial conditions over a four-year horizon from 2019 to 2022. The adverse scenarios are designed to be sufficiently severe for stress test purposes and, based on counterfactual analysis, are unlikely to occur.

The first adverse scenario (AS1) is a V-shaped growth path with an initial sharp recession in 2019, followed by a strong rebound before normalising to the baseline growth trajectory. The magnitude of the recession is equivalent to a 2.5 standard deviation of the long-term GDP growth rate from the baseline. This scenario assumes: (i) heightened trade tensions that escalate into a multilateral trade war among major economies; (ii) a sharp slowdown in the People's Republic of China (PR China) from tightened credit conditions; and (iii) increased financial market volatility as the ongoing monetary policy normalisation in advanced economies triggers rapid capital outflows and causes sovereign debt crises in vulnerable emerging market economies. The global economy is assumed to improve from 2020 onwards, as policymakers react swiftly with counter-cyclical stimuli.

The second adverse scenario (AS2) simulates an L-shaped growth path with an initial mild decline, followed by prolonged weakness in GDP growth. This protracted sluggish period is equivalent to a cumulative decline (over four years) of seven standard deviations from the baseline. This is triggered by: (i) a synchronised slowdown in the US and PR China, with escalating trade tensions weighing on global growth and trade; (ii) prolonged political uncertainties in the UK and EU regarding Brexit negotiations; and (iii) depressed commodity prices, which reduces Malaysia's fiscal space for stimulus, leading to rising unemployment and worsened sentiments.

Table 2

Solvency Stress Test: Key Assumptions and Shock Parameters Applied under Assumed Adverse Scenarios

Key assumptions	AS1 – V-shaped recession	AS2 – L-shaped, protracted recession
Balance sheet and income projections		
• Decline in loan growth (compound annual growth rate)	• -1.5%	• -3%
• Annual decline in banks' income growth, differentiated across segments (interest income, fee-based and other income)	• Up to 19%	• Up to 15%
• Annual decline in insurers' premium income	• Up to 25%	• Up to 24%
Credit risk shocks		
• Probability of default (PD) shocks		
• Business loans	• 5% to 12%	• 5% to 15%
• Household loans	• 2% to 12%	• 1% to 13%
• Loss given default (LGD) shocks		
• Business loans	• 46% to 62%	• 45% to 67%
• Household loans	• 20% to 77%	• 19% to 83%
• Default of corporate borrowers with large exposures to the banking system	• Corporations that have weak financial standings (below prudent thresholds) under simulated shocks	
Market risk shocks		
• Annual increase in MGS yields	• Up to 38 bps	• Up to 29 bps
• Annual increase in corporate bond yields	• Up to 69 bps	• Up to 65 bps
• Annual decline in FBM KLCI	• Up to 34%	• Up to 23%
• Annual depreciation against major currencies	• 17% to 30%	• 9% to 15%
External funding risk shocks		
• Reversal of claims by non-residents	• Up to 30% of interbank borrowing and deposits	• Up to 15% of interbank borrowing and deposits
General insurance risk shocks		
• Increase in claims ratio	• Up to 30%	• Up to 16%
• Increase in premium liabilities (motor classes)	• Up to 1.5 times additional provision for adverse deviation	• Up to one time additional provision for adverse deviation

Civil Servants' Debt: Risks and Policy Considerations

By Muhammad Khairul Muizz Abd Aziz, Rafidah Mohamad Zahari and Siti Hanifah Borhan Nordin

Introduction: A Closer Look into Civil Servants' Debt

Malaysia's level of household indebtedness trended lower to 83.8% of GDP as at end-June 2018 (2015 (peak): 89% of GDP), following a series of cross-cutting measures since 2010 to strengthen lending practices by both banks and major non-bank financial institutions (NBFIs[1]). Risks associated with the accumulation of unsecured borrowings, which drove the earlier expansion in household debt, have also receded considerably with growth of personal loans decelerating from its peak of 25.2% in 2008 to 2.4% as at end-June 2018. Despite these positive developments, the Bank remains vigilant towards attendant risks from household debt. One segment that has received special attention is the civil servants, which accounts for one-fifth of total household debt. Since 2012[2], household debt by civil servants has increased by a compound annual growth rate (CAGR) of 7.6%, outpacing the overall nominal GDP growth (CAGR: 6.2%). This box article highlights the key findings of a recent study on civil servants' indebtedness undertaken as part of the Bank's on-going surveillance of household debt. It examines the profile of civil servants' borrowings, trends and risks in civil servant debt, and the potential impact to financial stability. Policy considerations to support more sustainable and prudent debt accumulation among the civil servants are also discussed.

I. Stylised Facts of Civil Servants' Borrowings: Debt for Consumption

As at end-February 2018, total outstanding civil servants debt stood at RM236 billion, equivalent to 20% of total household debt or 17% of GDP, higher than levels observed in 2012 (18% total household debt or 15% of GDP). A closer profiling of indebted civil servants revealed notable differences compared to the overall national profile of household debt (Diagram 1). Almost all civil servants (97%) have some form of borrowings, with 62% of credit obtained from NBFIs (national average: 18%). Almost half of their borrowings are for consumption purposes (personal financing, motor vehicles, credit cards and others), substantially higher than the national average of 35%. By geographical location, close to half of those indebted live in four key urbanised states, where costs of living are relatively higher. About two-thirds of civil servants earn less than RM5,000 per month.

II. Trends in Civil Servant Debt and Potential Risks

(a) High debt service ratio (DSR) and low financial buffers

Civil servants' debt repayment capacity remained lower than the average borrower at the national level. More than half of their monthly income is used to repay debt compared to one-third for average borrowers (Chart 1). Significantly higher DSR levels are also observed for civil servants across all income groups. After considering their monthly expenditure on basic necessities[3] and debt obligations, civil servants are left with limited financial buffers to weather shocks. This is more acute among those earning less than RM5,000 per month with only 15% of monthly income (equivalent to about RM360 to RM586) available for expenditure on discretionary items and savings. It should be noted that discretionary expenditures include spending on communication, clothing and recreational services, which would be considered essential for most people today to participate meaningfully in society.

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[1] Including development financial institutions and major credit providers such as hire purchase lenders.
[2] Earliest data on civil servant indebtedness.
[3] The average monthly expenditure on basic necessities is estimated from the Household Income and Expenditure Survey (HIES) by the Department of Statistics, Malaysia. For this study, basic necessities are defined as: (i) food and non-alcoholic beverages; (ii) housing rental and maintenance; (iii) water, electricity, gas and other fuels; (iv) transportation; (v) education; and (vi) healthcare.

Diagram 1: Profile of Indebted Civil Servants



* This study covers 1.26 million out of 1.6 million civil servants. This comprises permanent Federal Government employees and police only (excluding army, State Governments, statutory bodies and local authorities)
** Personal financing, motor vehicles, credit cards and others

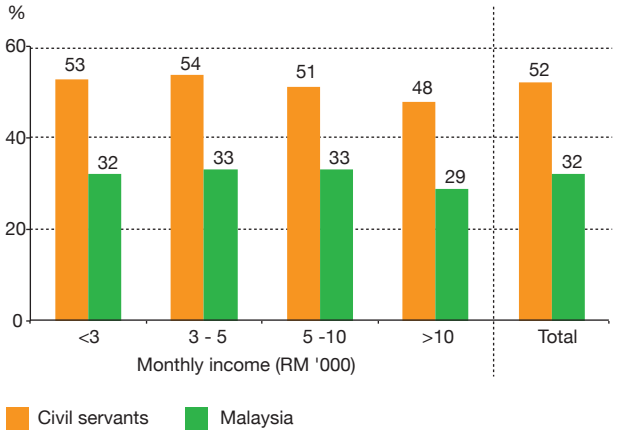
Source: Accountant General's Department of Malaysia and Bank Negara Malaysia

(b) Increased growth and share of personal financing

While the expansion in civil servants' debt over the past six years has been marginally slower than total household debt (CAGR of 7.6% and 7.7%, respectively), notable differences can be observed in terms of the growth drivers (Chart 2). Personal financing has been one of the major contributors to debt accumulation by the civil servants with a 2.3 percentage points (ppt) contribution to civil servants' debt growth, about four times higher than its contribution to growth in overall household debt (0.6 ppt). This has resulted in the larger share of personal financing to civil servants' total debt (34%), compared to the national level (15%) (Chart 3). Civil servants' personal financing share to total debt has also been on an increasing trend since 2012, in contrast to the declining share observed at the national level. Based on anecdotal evidence, personal financing is commonly used to sustain the standard of living and lifestyle choices of borrowers and for small business use.

Chart 1: Debt Service Ratio (DSR) by Income Group

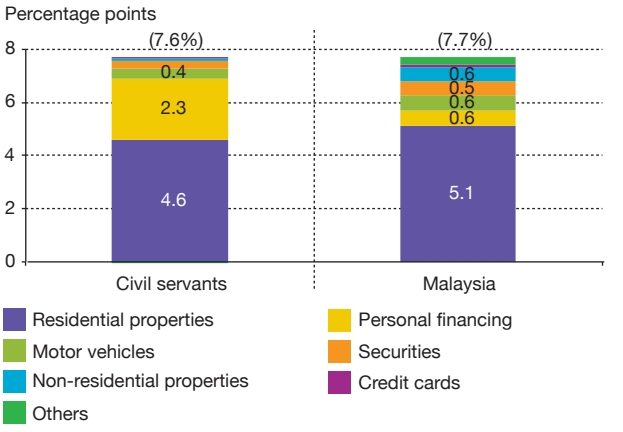
More than half of civil servants' monthly income is used to repay debt compared to one-third for average borrowers



Source: Accountant General's Department of Malaysia and Bank Negara Malaysia

Chart 2: Contribution to Growth in Debt

The contribution of personal financing to civil servants' debt growth was about four times that of national levels



Note: (..%) denotes the CAGR 2012-2018

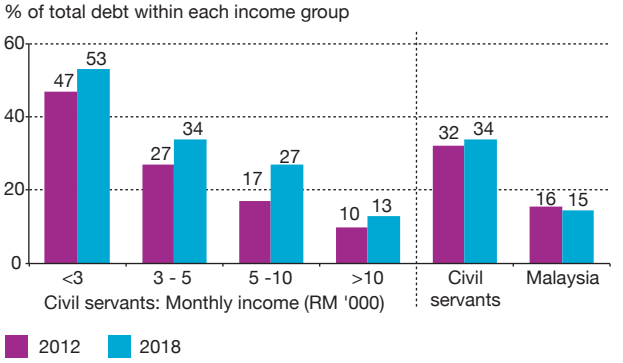
Source: Accountant General's Department of Malaysia and Bank Negara Malaysia

(c) Higher share of borrowers in negative financial margins[4] (FMs)

Notwithstanding the lower financial buffers among civil servants, differences in the share of civil servant borrowers with negative FMs were modest (8.5% of total civil servant borrowers compared to the national average of 6.5%) (Chart 4). Notably, negative FMs were more pronounced among civil servants in the mid- to higher-income groups, including those earning more than RM10,000 per month. This is in contrast to the observations at the national level, where those earning less than RM3,000 per month have the highest share of negative FM borrowers. This may be attributed to the differences in the salary structures. Within the lower income segments, the average starting salary of civil servants was observed to be higher than the national

Chart 3: Personal Financing by Income Group

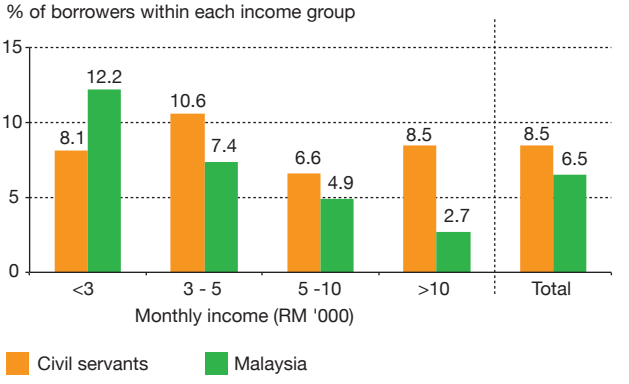
Civil servants' share of personal financing to total debt has been on an increasing trend since 2012, across all income groups



Source: Accountant General's Department of Malaysia and Bank Negara Malaysia

Chart 4: Borrowers with Negative FMs by Income Group

Civil servant borrowers have higher share of borrowers with negative FMs compared to the national average



Source: Accountant General's Department of Malaysia and Bank Negara Malaysia

[4] Financial margin is defined as the balance of borrower's monthly disposable income and liquid financial assets, after deducting debt repayments and expenditure on basic necessities.

average. However, for borrowers earning above RM3,000, faster salary increments in the private sector contribute towards bolstering financial buffers which in turn reduces the incidence of negative FMs. Civil servant borrowers with negative FMs were also consistently observed to have a high proportion of personal financing, with overall debt servicing commitments consuming more than 60% of income.

III. Limited Impact from Credit Exposures of Financial Institutions to Civil Servants

Asset quality of civil servant borrowings from banks and NBFIs remained sound with an aggregate impairment ratio of 1.3%, which is lower than the ratio for overall households of 1.6% (Chart 5). This is given that a significant portion of the monthly repayment of civil servant borrowings are deducted via automatic salary deduction facilities. This mechanism has played an important role in reducing credit risk exposures to civil servants. However, the overall impairment ratio of civil servants and in particular for those earning below RM5,000 per month has been gradually rising since 2012. Of significance, personal financing accounted for more than two-thirds of impaired loans by the civil servants. These findings are consistent with the profile of participants enrolled under *Agensi Kaunseling dan Pengurusan Kredit's* (AKPK) Debt Management Program which point to poor financial planning skills and cost of living pressures, associated with lower income borrowers as key factors contributing to financial distress.

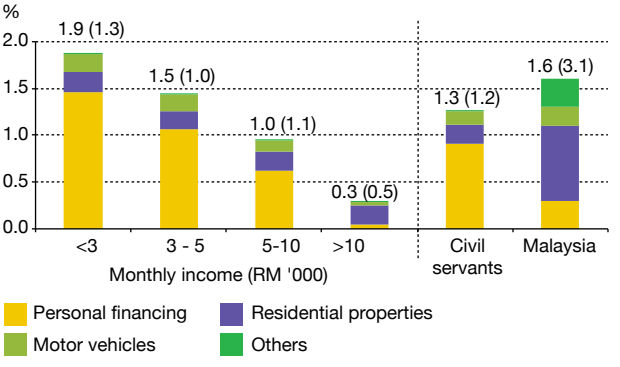
An assessment of the debt-at-risk[5] (DAR) was also conducted to assess the potential impact of risks to financial institutions emanating from lending to civil servants. This assessment was based on a set of conservative assumptions, namely:

- 100% probability of default of borrowers with negative FMs;
- 100% loss given default for all loans, except housing loans, where a 40% loss is applied; and
- Automatic salary deduction schemes that mitigate credit risks are disregarded.

Under this scenario, the DAR of civil servants is estimated to be about RM24 billion, representing only 2.2% of total household debt or 10% of total civil servants' debt. Across income groups, the bulk of the DAR is from the RM3,000-5,000 group, accounting for 42% of total DAR (Chart 6). This is similar to the profile observed at the national level, underscoring higher risks from borrowers in this income group (refer to Financial Stability and

Chart 5: Impairment Ratio of Civil Servants' Debt by Purpose and Income Group

Impairment ratios for overall civil servants and those earning below RM5,000 per month have been gradually rising since 2012

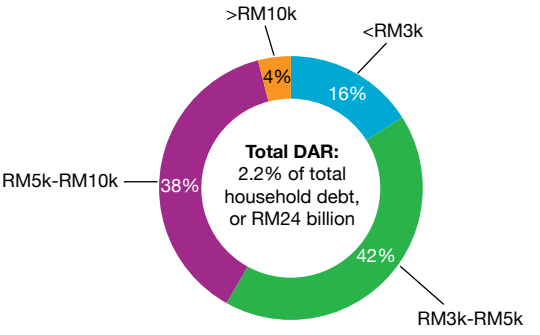


Note: (...) denotes impairment ratio in 2012

Source: Accountant General's Department of Malaysia and Bank Negara Malaysia

Chart 6: Debt-at-Risk (DAR) of Civil Servants by Income Group

Bulk of the DAR is from those earning RM3,000-5,000 per month



Source: Accountant General's Department of Malaysia and Bank Negara Malaysia

[5] The proportion of debt of borrowers with negative FMs to total household debt after taking into account the collateral value.

Payment Systems Report 2017, Box Article, 'Indebted to Debt: An Assessment of Debt Levels and Financial Buffers of Households'). These results affirm that risks to financial stability emanating from direct lending to civil servants remain limited. Risks are further mitigated with the expanded coverage of financial education and debt management programmes provided by AKPK to include civil servant borrowers and NBFIs since 2014.

Policy Considerations

While the civil servants' indebtedness poses limited risks to financial stability, the higher share of borrowings from NBFIs, and relatively weaker financial resilience could see risks of financial hardship increasing within this group of borrowers. This in turn could have broader socio-economic implications.

Several policy priorities will be key to promote more sustainable debt accumulation among civil servants and households more broadly:

(i) Expediting the legislation of the Consumer Credit Act to improve consumer welfare and protection

NBFIs account for 18% of total household debt, the bulk of which is to civil servant borrowers. A significant part of NBFIs lending, including lending by money lenders and credit co-operatives which focus on low- to middle-income groups, remains unevenly regulated. A review of existing oversight arrangements for all consumer credit providers is important to strengthen the regulatory framework for consumer credit activities in Malaysia. To this end, the Consumer Credit Act which is currently being formulated by the Government and the Bank aims to (i) promote a prudent and responsible credit culture among borrowers and lenders; (ii) strengthen the protection of consumers in their dealings with consumer credit providers; and (iii) promote a coordinated and coherent regulatory and oversight framework for consumer credit activities.

(ii) Formulation of a National Strategy for Financial Literacy

Increasing awareness on financial matters and strengthening financial management skills will contribute to better and more informed financial decisions. The Bank, in collaboration with AKPK[6], has already introduced various programmes such as Money Sense and *Program Pengurusan Wang Ringgit Anda* (POWER!) to enhance financial literacy and debt-management capabilities across various target groups. This needs to be expanded to deliver a national, coordinated approach to financial education across various aspects of financial management and demographics. The Financial Education Network, established by the Bank together with other Government agencies[7] in 2016 is currently formulating a National Strategy for Financial Literacy with the following thrusts to: (i) nurture responsible financial values from young; (ii) encourage the adoption of a healthy financial lifestyle; (iii) inculcate positive financial attitudes and behaviour among targeted groups; (iv) support long term financial and retirement planning; and (v) empower individuals to manage risks and returns.

(iii) Pursuing a more sustainable strategy towards housing the nation

Housing debt accounts for 49% of civil servants' debt. In the current environment where houses are "seriously unaffordable", the Government is taking steps to increase the supply of affordable homes and improve the rental market as a viable alternative to home ownership, thereby reducing the level and need for housing debt. Measures being pursued to promote a more vibrant rental market with strengthened protection of the rights of both tenants and landlords include the formulation of a Residential Rental Act, establishing a Tenancy Tribunal, and the provision of tax relief on rental income that meet specified eligibility criteria. These should be accelerated.

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[6] For a more detailed account, please refer to Financial Stability and Payment Systems Report 2017, Box Article, 'AKPK – Advancing Prudent Financial Behaviour'.

[7] A collaboration between the Bank and other agencies (Securities Commission, AKPK, Ministry of Education, Ministry of Higher Education, Employee Provident Fund, Perbadanan Insurans Deposit Malaysia, and Permodalan Nasional Bhd).

(iv) Strengthen underwriting practices among large NBFI lenders to civil servants

As NBFIs account for more than 60% of lending to civil servants, continued efforts to strengthen their underwriting practices will have an important role in promoting more sustainable civil servant debt accumulation going forward. Access for NBFIs to the civil servants' automatic salary deduction facility should be contingent upon NBFIs demonstrating responsible financing practices. DSR limits applied under such facilities should also be informed by the outcomes of affordability assessments for different borrower groups and subjected to review to reflect the changing circumstances of the borrowers. Limits should be strictly enforced.

(v) Enhance income growth prospects

Given that income is one of the main determinants of financial buffers and debt servicing capacity, relevant reforms to strengthen links between civil servants' pay and rewards to productivity would have an important impact in improving the financial resilience of civil servants. This would also improve the delivery of public services as well as enhance the efficiency of the broader economy.

Conclusion

This study reveals that civil servants are highly indebted with their debts continuing to accumulate in recent periods. It also shows the weaker debt servicing capacity of borrowers in this segment compared to the national average. The high level of indebtedness and low financial buffers, while currently posing limited financial stability risks, could have broader socioeconomic implications. Policy priorities, including measures to improve financial literacy and strengthen the oversight and lending practices of NBFIs, are key to achieve a more sustainable level of civil servant debt accumulation, and avert the build-up of risks in future.

References

Bank Negara Malaysia (2017): 'Indebted to Debt: An Assessment of Debt Levels and Financial Buffers of Households', Financial Stability and Payment Systems Report 2017, Page 39-48.

Bank Negara Malaysia (2017): 'AKPK – Advancing Prudent Financial Behaviour', Financial Stability and Payment Systems Report 2017, Page 64-69.

Department of Statistics, Malaysia (2016): 'Household Income and Expenditure Survey'.

Annex

Table A.1

Key Financial Soundness Indicators

	As at end				
	2014	2015	2016	2017	1H 2018*p*
	% (or otherwise stated)				
Banking System					
Total Capital Ratio	15.9	16.6	16.5	17.8	17.0
Tier 1 Capital Ratio	14.0	14.2	14.0	14.9	13.5
Common Equity Tier 1 Capital Ratio	13.3	13.3	13.1	14.0	12.7
Return on Assets	1.5	1.3	1.3	1.5	1.5
Return on Equity	15.2	12.3	12.5	13.0	13.3
Liquidity Coverage Ratio[1]	-	125.1	124.3	134.9	139.3
Net Impaired Loans Ratio	1.2	1.2	1.2	1.1	1.0
Capital Charge on Interest Rate Risk in the Trading Book to Capital Base	1.4	1.2	1.1	1.0	1.2
Net Open Position in FCY to Capital Base	4.7	6.1	6.3	6.1	5.2
Equity Holdings to Capital Base	1.3	0.7	1.5	1.9	0.7
Insurance and Takaful Sector					
Capital Adequacy Ratio	243.5	245.2	243.7	233.0	239.3
Life Insurance and Family Takaful					
Excess Income over Outgo (RM billion)	13.8	12.0	13.3	19.0	2.9
New Business Premiums / Contributions (RM billion)	12.9	13.2	14.2	15.1	8.2
Capital Adequacy Ratio[2]	235.8	242.5	239.1	226.2	230.3
General Insurance and General Takaful					
Underwriting Profit (RM billion)	1.8	1.3	1.8	1.3	0.7
Operating Profit (RM billion)	3.2	2.7	3.4	2.7	1.3
Gross Direct Premiums / Contributions (RM billion)	19.1	19.5	19.7	19.9	10.5
Claims Ratio	57.5	60.2	55.9	58.6	58.0
Capital Adequacy Ratio[3]	272.2	258.2	266.2	268.8	263.9
Household (HH) Sector					
HH Debt (RM billion)	960.1	1,030.5	1,086.2	1,139.9	1,165.7
HH Financial Asset (RM billion)	2,015.0	2,119.3	2,232.4	2,423.5	2,458.4
HH Debt-to-GDP Ratio	86.8	89.0	88.3	84.2	83.8
HH Financial Asset-to-Total HH Debt Ratio	209.9	205.7	205.5	212.6	210.9
HH Liquid Financial Asset-to-Total HH Debt Ratio	147.5	142.4	140.7	145.2	144.1
Impaired Loans Ratio of HH Sector	1.9	1.6	1.6	1.6	1.6
Business Sector					
Return on Assets	6.0	4.9	4.6	4.4	4.5[4]
Return on Equity	10.2	8.8	7.9	7.7	7.6[4]
Debt-to-Equity Ratio	39.2	43.2	43.0	47.0	50.4
Interest Coverage Ratio (times)	12.0	10.6	11.5	9.1	8.2[4]
Operating Margin	15.9	14.8	14.5	15.4	13.9[4]
Impaired Loans Ratio of Business Sector	2.6	2.5	2.5	2.6	2.6
Development Financial Institutions[5]					
Lending to Targeted Sectors (% change)	7.0	5.5	5.7	0.1	-1.9
Deposits Mobilised (% change)	5.3	2.0	6.4	4.8	2.4
Impaired Loans Ratio	5.0	4.8	5.9	5.1	6.0
Return on Assets	1.6	1.4	1.0	1.4	1.2

[1] The Basel III Liquidity Coverage Ratio (LCR) Framework takes effect on 1 June 2015 and supersedes the guidelines on Liquidity Framework and Liquidity Framework-i issued on 1 July 1998
[2] Figures include composite insurers and takaful operators with larger proportion of life or family business
[3] Figures include composite insurers and takaful operators with larger proportion of general business
[4] Based on data for the twelve months ending June 2018
[5] Refer to development financial institutions under the Development Financial Institutions Act 2002
p Preliminary

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

Table A.2

List of New Standards and Guidelines Issued in 1H 2018

No.	Sector/Area	Standard/Guideline	Type	Description
1	Banks, insurers and takaful operators	Credit Risk	Policy Document	Sets out to elevate credit risk management practices among financial institutions (FIs), taking into account (i) developments in the size and diversity of product offerings; (ii) greater internationalisation of the financial system; and (iii) the growing role of the domestic capital market as an alternative source of financing.
2		Employee Screening		Aims to promote an ethical workforce within the financial sector by strengthening screening practices for recruitment by FIs. Greater transparency on the conduct history of prospective employees will facilitate FIs in making informed hiring decisions.
3		Bai' al-Sarf (Currency Exchange)		Issued to promote consistency in the application of the Bai' al-Sarf contract in Islamic financial products and services. This will strengthen the legal certainty of the financial product and enhance Islamic financial institutions' Shariah compliance practices.
4		Responsibility Mapping	Discussion Paper	Aims to clarify the responsibilities of individuals holding leadership positions in FIs and ensure these individuals take greater ownership in fostering a sound culture and addressing misconduct risk.
5	Banks	Pillar 3 Disclosure	Exposure Draft	Sets out revised minimum requirements on the disclosure of key information relating to an FI's regulatory capital, liquidity and risk exposures. The revised requirements introduce common templates to improve consistency and usability of disclosures within and across jurisdictions. These disclosures will complement existing minimum capital and other regulatory requirements, supervisory review process and financial reporting.
6		Qard	Policy Document	Aims to promote consistency of use of Qard in Islamic financial transactions and sets out Shariah and operational requirements on the application of the Qard contract.
7		Value-based Intermediation (VBI): Strengthening the Roles and Impact of Islamic Finance	Discussion Paper	Aims to respond to key comments received during the consultation period for the earlier paper issued in 2017, covering issues including: 1. Definition of VBI; 2. Potential implications of VBI adoption to business modalities and risk management; 3. VBI strategies: Implementation approach; and 4. Streamlining of VBI with existing initiatives.
8	Insurers and takaful operators	Trade Credit Insurance and Trade Credit Takaful	Exposure Draft	Sets out proposed requirements on trade credit insurance and trade credit takaful that qualify as credit risk mitigation under the Capital Adequacy Framework (Basel II – Risk-Weighted Assets) and Capital Adequacy Framework for Islamic Banks (Risk-Weighted Assets). The proposed requirements are part of efforts to position insurance and takaful products to better meet the protection needs of businesses.
9	Development financial institutions (DFIs)	Credit Risk – Best Practices for Development Financial Institutions	Notification	Sets out to elevate credit risk management practices of DFIs by encouraging the adoption of relevant standards and practices set out in the Credit Risk policy document issued to financial institutions.
10	AML/CFT	AML/CFT Policy for Digital Currencies (Sector 6)	Policy Document	Aims to increase the transparency of digital currency activities in Malaysia and strengthen regulatory safeguards against money laundering/terrorism financing (ML/TF) risks associated with the use of digital currencies.

Note: Banks include conventional, Islamic and investment banks. All documents are available on the Bank's website.

Table A.3

List of Revised Standards and Guidelines Issued in 1H 2018

No.	Sector/Area	Standard/Guideline	Type	Description
1	Banks, insurers and takaful operators	Financial Reporting	Policy Document	Updated to include requirement for banks to maintain regulatory reserves. The update also (i) includes the requirement for banks, insurers and takaful operators to disclose intercompany charges and placement of funds via an investment account with an Islamic banking institution; and (ii) clarifies the impairment classification of a credit facility.
2		Financial Reporting for Islamic Banking Institutions		
3		Financial Reporting for Takaful Operators		
4	Banks and DFIs	Operational Risk Integrated Online Network (ORION) Policy Document		Introduces revisions in reporting requirements for breaches in safeguarding customer information, reporting on Business Disruption and System Failures and key operational risk indicators.
5		Standing Facilities		Expands the eligible collateral for standing facility operations to include Bankers Acceptances (BAs) and Negotiable Instruments of Deposits (NIDs) issued by AAA-rated onshore licensed banks.
6	Banks	Capital Adequacy Framework (Capital Components)		Updated to account for the implementation of MFRS 9 Financial Instruments, covering: 1. Definition of general provisions and its recognition in Tier 2 Capital; 2. Definition of specific provisions; and 3. Alignment of new terminologies used for the purpose of capital recognition and regulatory adjustments. The update also clarifies the capital treatment of bargain purchase gains and right-of-use assets.
7		Capital Adequacy Framework for Islamic Banks (Capital Components)		
8		Capital Adequacy Framework (Basel II – Risk-Weighted Assets)		
9		Capital Adequacy Framework for Islamic Banks (Risk-Weighted Assets)		
10	Islamic banks	Ijarah		Incorporates the latest resolution of the Shariah Advisory Council of the Bank on: 1. Permissible defects that merit the customer's right to terminate the Ijarah contract; 2. The provision of promise by a customer to bear losses arising from damages to leased assets that are not covered by takaful or insurance protection; and 3. The use of conventional insurance to protect leased assets.
11	Takaful operators	Takaful Operational Framework	Exposure Draft	Revised regulatory requirements to strengthen takaful fund management practices to ensure its sustainability and prudent management. Collectively, these revisions seek to spur greater innovation in the takaful sector while further safeguarding the position of takaful participants.
12	DFIs	Capital Framework for Development Financial Institutions	Notification	Informs DFIs on the amended definition of provisions in the Capital Framework for Development Financial Institutions, aligned with MFRS 9 requirements.

Note: Banks include conventional, Islamic and investment banks. All documents are available on the Bank's website.

Table A.4

Enforcement Actions Taken in 1H 2018

Area	Enforcement Actions
Non-compliance with money services business requirements	• Five entities were convicted for unauthorised provision of money services business under section 4(1) of the Money Services Business Act 2011 (MSBA).
	• One entity was convicted for unauthorised use of words indicating provision of money services business under section 23(1) of the MSBA.
	• Compounds amounting to RM135,000 were imposed on two money services business providers for failure to comply with appointment requirement under section 30(1) of the MSBA.
Non-compliance with regulatory requirements	• Administrative monetary penalties (AMP) amounting to RM10.6 million were imposed on 31 banks for failure to comply with statistical reporting requirements under section 143 of the Financial Services Act 2013 (FSA) and section 155 of the Islamic Financial Services Act 2013 (IFSA).
	• AMPs amounting to RM4.8 million were imposed on three banks for failure to comply with standards issued by BNM under section 48 of the FSA and section 58 of the IFSA.
	• AMP amounting to RM725,000 was imposed on one bank for failure to comply with corporate governance requirements under section 63 of the IFSA.
	• Compound amounting to RM100,000 was imposed on one bank for failure to comply with the United Nations Security Council Resolutions under section 82(1) of the Central Bank of Malaysia Act 2009.
Non-compliance with foreign exchange administration requirements	• Compound amounting to RM650,000 was imposed on one bank for failure to comply with foreign exchange administration requirements under section 214(2) of the FSA.
Non-compliance with AML/CFT policies	• Compound amounting to RM160,000 was imposed on one bank for failure to comply with reporting obligations and customer due diligence requirements under section 14 and section 16 of the Anti-Money Laundering, Anti-Terrorism Financing and Proceeds of Unlawful Activities Act 2001 (AMLA).