

# Overview

Global financial conditions tightened in the second half of 2022 as major central banks aggressively increased policy rates to combat elevated levels of inflation. Markets remained volatile amid uncertainties in the global growth outlook and shifts in expectations on monetary policy. More recently, banking system stresses in some advanced economies have resulted in further volatility in the bond and equity markets globally. These global developments also affected the Malaysian financial markets, resulting in higher volatility observed in the foreign exchange (FX), bond and money markets.

Domestically, market stress levels in the second half of the year rose to levels last seen in mid-2020, but remained well below the peak observed at the onset of the pandemic in March 2020. Despite the heightened volatility in domestic financial markets, market conditions have remained orderly with the smooth intermediation of two-way flows in the bond and equity markets. This has supported fundraising by businesses through the capital market. Liquidity in the government bond market has remained healthy. Notably, liquidity conditions in the banking system have been largely unaffected by the withdrawal of regulatory flexibilities provided during the pandemic and recent banking stress in the US and Europe. In the foreign exchange market, movements in the ringgit continued to be influenced by external factors amid an evolving global growth and inflation outlook. Adjustments to the ringgit have been orderly, supported by sustained liquidity in the onshore foreign exchange market. This will continue to help businesses and market participants manage their foreign exchange exposures.

Businesses benefitted from the reopening of economic sectors, which supported consumer spending on discretionary goods and services. The overall debt-servicing ability of businesses remained healthy with an interest coverage ratio (ICR) of 6.0 times, although sector- and firm-level variations

continued to reflect an uneven recovery. In some sectors, firms continue to face challenges from significantly higher input costs due to supply-side disruptions, geopolitical developments, and a weaker ringgit. The share of firms-at-risk remains elevated and has increased slightly to 25.1% (2Q 2022: 24.6%). Notwithstanding this, leading indicators from banks suggest that business impairments should remain relatively contained. The share of business loans with increased credit risk (Stage 2 loans) continued to decline, while the share of loans, including SME loans, under repayment assistance programmes has continued to fall sharply to 5.9% of total business loans (June 2022: 14.8%). A small number of SMEs continue to face repayment difficulties given higher input cost pressures, exacerbated by their lower buffers and limited pricing power. Nevertheless, increases in delinquencies from this segment remain within banks' expectations. Going forward, the global and domestic growth outlook and cost pressures will remain the key drivers of credit risks in the near term, while the impact of climate transition and physical risks on businesses pose longer-term risks to the financial sector. Banks remain vigilant over these risks and are making good strides towards strengthening climate risk management practices and supporting the financing needs of businesses in transition.

Improvements in income and labour market conditions have helped preserve the overall resilience of households amid a slightly faster expansion of household lending. The aggregate value of household financial assets remains above two times that of household debt. The median debt-to-income (DTI) ratio has been stable at 1.5 times, as credit growth continues to closely track household incomes. Other measures of debt repayment ability also remained healthy, including prudent debt service ratios (DSRs) observed for newly approved and outstanding household loans (median: 43% and 37%, respectively). A review of new floating-rate loans disbursed by banks when Overnight Policy Rate (OPR)

was at a historical low of 1.75% affirmed that these loans continue to hold up well following the successive OPR increases – indicating that banks continue to observe sound lending standards during this period. More broadly, household borrowers are expected to be able to withstand increases in borrowing costs, consistent with past studies by the Bank which show that household debt servicing is more affected by income and employment shocks rather than borrowing costs. In the lower-income segment of households, the larger share of loan accounts that are on fixed-rate terms, which do not fluctuate with changes in OPR, further mitigates credit risk.

The share of household loans classified as Stage 2 by banks has declined further to 6.7% (June 2022: 8.0%), as more borrowers continue to exit repayment assistance programmes and complete a minimum 6-month observation period of loan servicing. Looking ahead, household impairment and delinquency ratios are expected to normalise closer to pre-pandemic levels as the broad-based repayment assistance programmes gradually unwind. Overall, household asset quality measures are so far unfolding well within banks' earlier expectations. This is also supporting the capacity and willingness of banks to continue providing bespoke repayment assistance to borrowers that still need it.

Banks in Malaysia continue to maintain healthy liquidity buffers above the regulatory minimum. At the system-wide level, the Liquidity Coverage and Net Stable Funding ratios remained healthy at 154.0% and 118.2%, respectively. This has enabled banks to support lending activities, while providing buffers against the impact of rising interest rates on high-quality liquid assets (HQLA) held to meet liquidity needs and other liquidity shocks. Liquidity and funding risks associated with banks' exposure to large depositors, who are generally more sensitive to rate movements, remain manageable although some upward pressure on interbank rates has been observed. The bulk (80%) of banks' HQLA are in the form of placements with the Bank or holdings of government bonds, which can be pledged in the interbank market or with the Bank for additional liquidity under the Bank's existing standing facilities and Restricted Committed Liquidity Facility (RCLF).<sup>1</sup>

<sup>1</sup> The RCLF was introduced by the Bank in 2016 to allow banks to obtain liquidity for tenures greater than one month from the Bank. Banks that intend to use the RCLF will be charged a fixed facility rate and will be required to designate a pool of unencumbered eligible securities that would be sufficient to support the total size of the RCLF.

Significant deposit concentrations combined with weak capital buffers that could materially increase vulnerabilities to deposit runs are also not currently observed among banks in Malaysia.

The banking system remains well-capitalised. The total capital ratio of the banking system stood at 18.8% at the end of 2022, with capital buffers of RM134.8 billion in excess of the regulatory minimum. Improvements in profitability, along with capital conservation strategies being maintained by most banks, will further reinforce the capacity of banks to support intermediation and absorb unexpected losses. Credit costs have begun to normalise to pre-pandemic levels and are expected to decline further as banks start to write back some of the pandemic-related management overlay provisions. This will provide additional support for banks' earnings and capital going forward. Banks, however, remain vigilant over downside risks. This could arise from weaker-than-expected economic growth and rising cost pressures affecting loan performance, as well as heightened financial market volatility.

The insurance and takaful sector similarly remained resilient, with an aggregate capital adequacy ratio of 226% and excess capital buffers of RM37.5 billion above the regulatory minimum as at December 2022. Overall profitability for insurance and takaful funds improved on the back of higher investment returns which helped to offset the higher payouts for medical claims. The general insurance and takaful sector also performed better, in part due to the absence of large claims recorded in the first half of the year which were caused by severe floods at the end of 2021. Looking ahead, insurers and takaful operators (ITOs) will remain vulnerable to heightened financial market volatility given their sizeable bond and equity investments. The continued normalisation of claims experience in the medical and motor segments, as well as the increasing frequency and severity of physical events such as floods will have a bearing on ITOs' future performance. Strong capital and sound reinsurance arrangements remain important to ensure that ITOs are adequately resilient against downside risks from such developments.

The latest macro and micro stress tests by the Bank, incorporating augmented and additional stress factors, continue to affirm the resilience of financial institutions against unexpected losses from severe macroeconomic and financial shocks. Post-shock aggregate capital ratios for banks (16.3%), life insurers (164%) and general

insurers (211%) remain comfortably above regulatory minima at the end of the stress horizon (2025). This will continue to firmly underpin the capacity of financial institutions to meet the financing and protection needs of households and businesses.

Operational and cyber resilience remains a top priority for financial institutions and the Bank amid the increase in digitalisation and technology adoption in finance. Although operational losses of financial institutions have remained low, the number of reported cases of online banking fraud have been rising in line with similar trends observed globally. In response, international bodies, governments and financial regulators are increasingly focused on strengthening the

national and financial system's prevention, defence, recovery and response capabilities against cyber-financial crimes and fraud. In Malaysia and several other countries, national anti-scam centres have been established. The Bank and the financial industry continue to focus on raising public awareness on cyber hygiene measures and various scam tactics. More broadly, financial institutions continue to prioritise the management of technology risks and invest heavily in upgrading their information technology (IT) infrastructure. This is accompanied by ongoing work led by the Bank to conduct joint crisis simulation exercises in the financial industry aimed at testing and further strengthening existing response and recovery plans in mitigating widespread operational disruptions.