

Overview

In the first half of 2023, global financial markets continued to be significantly influenced by shifting expectations around developments in major economies that could indicate changes in the path of monetary policy. More recently, China's property sector downturn and a slower-than-expected pace of China's economic recovery have also contributed to financial market volatility. Domestic market stress levels have declined since end-March as contagion fears associated with global banking sector stress subsided. Towards the end of September however, there was a slight uptick in the domestic market stress levels amid renewed expectations for the US Federal Reserve (Fed) to hold interest rates higher for longer. Stress levels, nonetheless, remained well below the peak observed at the onset of the pandemic in March 2020. Domestic market conditions have remained orderly, supported by two-way flows in the bond and equity markets. Conditions in the interbank money market also improved with the easing of banks' seasonal year-end funding demands and diminishing expectations of further Overnight Policy Rate (OPR) hikes. In the domestic foreign exchange (FX) market, the ringgit continued to be primarily influenced by external developments. FX risk exposures in the corporate and banking sectors remain manageable, underpinned by sizeable FX liquid asset buffers held by banks and largely hedged FX exposures of corporates.

Domestic business activity has improved considerably. However, some sectors continue to face challenges arising from elevated input costs and weak external demand. Businesses have remained generally resilient against these challenges. Measures of overall debt-servicing capacity remained healthy, while the share of firms-at-risk has also declined. Stronger liquidity buffers built up during the pandemic have further supported business resilience.

Small and medium enterprises (SMEs) have been more affected by challenging operating conditions, although emerging risks observed among SMEs

in the wholesale and retail trade, construction and agriculture subsectors are within banks' expectations. Total SME loans identified as having higher credit risk (classified as Stage 2) remains small (2.1%) as a share of overall banking system loans. Most SMEs that have exited repayment assistance programmes also continue to be able to sustain their loan repayments. The credit quality of overall business loans was sound with impairments remaining low (1% of total banking system loans). Going forward, uncertainties surrounding global and domestic growth outlooks and cost challenges are expected to persist in the near term, with climate-related risks and opportunities increasingly becoming important considerations for businesses. Most businesses are expected to be better placed to respond to potential new shocks given improvements in business leverage, healthy cash buffers and more agile business models.

Household resilience continued to be supported by improvements in income and employment conditions. The median debt-to-income (DTI) ratio for overall households had been broadly stable at 1.4 times amid sound lending standards maintained by banks. Other measures of households' debt repayment ability also indicate limited new risks, with the median debt service ratios (DSRs) for newly approved and outstanding household loans remaining prudent at 42% and 36%, respectively. Additionally, the share of household loans under Stage 2 has declined further to 4.6% (or 2.7% of banking system loans) from 6.7% as at December 2022. Banks expect some deterioration in asset quality among higher risk borrowers amid higher borrowing costs and as existing repayment assistance programmes extended during the pandemic come to an end. These include lower-income borrowers and those employed in business sectors that continue to face challenges from the external environment. Banks continue to be vigilant over these risks and expect any deterioration to be well within existing provisioning and capital buffers.

The banking system remains well-capitalised. The total capital ratio of the banking system stood at 18.5% at the end of June 2023, with capital buffers of RM138.5 billion in excess of the regulatory minimum. Banks also continued to maintain strong liquidity buffers that ensure their resilience against both short- and longer-term liquidity shocks. The aggregate Liquidity Coverage Ratio and Net Stable Funding Ratio remained well above regulatory minima at 154.4% and 117.0%, respectively. Meanwhile, profitability improved at a more moderate pace during the period amid higher funding costs. Banks' profitability continued to be sustained by loan growth and to a lower extent, trading and investment activities. Annualised credit costs have reverted to pre-pandemic levels, although banks have generally maintained higher than historical provisioning buffers given ongoing uncertainties in the operating environment. Sustained profits have continued to strengthen banks' buffers against negative shocks, enabling them to support lending to the economy and avoid a broad-based tightening of credit conditions during periods of heightened stress.

The insurance and takaful sector similarly remained resilient, with an aggregate capital adequacy ratio of 225% and excess capital buffers of RM38.8 billion as at end-June 2023. Overall profitability of insurance and takaful funds improved primarily due to better underwriting performance. Profitability was also supported by sustained investment income and unrealised gains from lower bond yields. Medical and surrender payouts continued to weigh on underwriting performance of life insurance and family takaful business amid rising utilisation rates, higher hospital admissions and higher average cost

of claims in selected segments. In the general insurance and takaful sector, the financial impact of climate-related risks continued to be observed as profitability was adversely affected by flood events, in addition to normalising motor claims from the lows seen during the pandemic. Ongoing reforms to improve transparency and address fraud in the motor insurance and repairs sectors are helping to create conditions for a smooth transition to better risk-based pricing. Meanwhile, harder reinsurance market conditions have not so far materially affected domestic insurance and takaful rates or coverage. This is largely owing to generally prudent underwriting practices observed by insurers and takaful operators, and adequate capital buffers.

Preserving operational and cyber resilience remains a key focus of the Bank and financial institutions. Through coordinated efforts with law enforcement agencies, financial institutions now have the capacity to better identify and act on mule accounts used in financial scams. Increasing public cooperation in reporting fraud incidents and raising awareness of the risks of deliberately allowing bank accounts to be used for fraudulent activities remain a priority for the Bank and financial institutions. Financial institutions continue to make progress in managing risks associated with climate change, primarily through sustainable investment and lending practices as well as expanding green financial solutions. To this end, addressing data needs and capacity building in climate risk management continue to be an ongoing priority for financial institutions, through collaborative efforts supported by the Joint Committee on Climate Change (JC3) with private industry and government agencies.