

Overview

Global financial markets remained volatile in the second half of 2023, driven by shifting expectations on the timing of policy rate cuts in major economies, renewed geopolitical tensions and China's slower-than-expected economic growth. Despite the global volatility, domestic financial markets remained orderly with continuous intermediation of two-way flows in the bond and equity markets. The Financial Market Stress Index (FMSI) rose in the fourth quarter but subsequently subsided towards the end of the year amid growing expectations of a reduction in the US Federal Funds Rate. Market liquidity remained healthy in the Malaysian government bond market while credit spreads of corporate bonds narrowed further. This has continued to support favourable funding conditions.

In the foreign exchange (FX) market, the yield differential between Malaysian Government Securities and US Treasuries continued to weigh on the ringgit. Since the beginning of 2024, the ringgit has depreciated by 1.8%¹ against the US dollar, driven by external developments. The ringgit remains undervalued and does not reflect Malaysia's positive economic fundamentals and prospects. Coordinated actions by the Government, Bank Negara Malaysia (BNM), government-linked companies (GLCs) and government-linked investment companies (GLICs) have contributed towards encouraging more sustained inflows into the FX market, while structural reforms will provide more enduring support for the ringgit. The impact of recent currency movements on financial stability remains manageable. Foreign currency borrowings by non-financial corporates are mostly hedged. Only a small number of corporates with unhedged external borrowings (1.8% of total business debt) may be susceptible to exchange rate volatility. Banks' external funding and net foreign currency open positions also remain low.

Businesses remained resilient, supported by domestic demand. However, cost pressures continued to weigh

on businesses' financial performance in some sectors. Further improvements in leverage coupled with higher cash buffers maintained by businesses have supported overall debt-servicing ability. The share of firms-at-risk continued to decline, led by firms in the manufacturing and construction sectors, although they remain higher than that observed before the pandemic. A small proportion of SMEs are showing signs of financial vulnerabilities, such as higher instances of missed repayments due to cashflow difficulties. However, most SMEs have been able to sustain their debt repayments, including SMEs that have exited repayment assistance programmes introduced during the pandemic. Going forward, leading indicators point to business impairments remaining relatively contained. The share of business loans identified by banks as having higher credit risk (classified as Stage 2) improved further to 12.4% (June 2023: 13.8%), with banks starting to write-back provisions on some large corporate exposures. Enhanced access to debt resolution mechanisms with the recent amendments to the Companies Act 2016 will serve to further reduce risks of business defaults.

Improving income and employment conditions continue to preserve household resilience. Measures of debt repayment capacity remained healthy. The median debt service ratios (DSRs) for newly approved and outstanding household loans have been stable as banks continued to observe sound lending standards. Household borrowings that may be at higher risk of default increased slightly to 4.8% of total household loans (June 2023: 4.3%). This remains within banks' expectations and is about 40% lower in value terms than at the height of the pandemic. Households facing repayment difficulties were contained to a small segment of borrowers with pre-existing financial vulnerabilities and are more constrained in their ability to adjust to higher costs of living. Help for these borrowers remains in place through the services of the Credit Counselling and Debt Management Agency (AKPK). Enrolments into AKPK's Debt Management Programme (DMP) increased notably in 2023 in tandem with a higher level

¹ Data as of 12 March 2024.

of awareness among borrowers of AKPK's services. However, household borrowings managed under the DMP remain very small at 0.54% of total household loans from banks and development financial institutions.

The banking system remains strong. Banks continue to hold large buffers of high-quality liquid assets to withstand liquidity and funding shocks. The aggregate Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) stood at 160.9% and 118.2% respectively. As the need for precautionary cash buffers subsides, ongoing shifts by depositors towards longer-term deposits will continue to underpin the stability of banks' funding sources. During the year, a number of measures were taken by BNM to further strengthen the regulation and supervision of liquidity risk. This included a stronger focus on the ability of banks to monitor depositor concentrations at a granular level and the adequacy of their contingency funding plans.

Higher funding costs contributed to lower year-on-year profitability for banks relative to the first half of 2023. Nevertheless, sustained lending activities and an improvement in trading and investment income provided some support to bank earnings. Annualised credit costs have also declined significantly from earlier peaks recorded during the pandemic. Banks continue to be well-capitalised to absorb unexpected shocks and support financial intermediation in the economy, with the total capital ratio of the banking system at 18.5% and capital buffers in excess of the regulatory minimum amounting to RM142.6 billion as at end-December 2023.

The insurance and takaful sector similarly remained resilient. The life insurance and family takaful funds continued to record underwriting losses in the second half of 2023 amid higher medical benefit payouts.

Overall profitability however continued to be supported by investment income and sustained growth in total new business premiums. In the general insurance and takaful sector, gains in operating profits were mainly attributed to higher premium growth in the motor segment. Going forward, insurers and takaful operators (ITOs) are expected to remain resilient against a number of risks stemming from elevated financial market volatility affecting investment performance, higher motor and medical claims costs as well as an increasing occurrence of climate events. This is supported by their strong capital positions. The aggregate capital adequacy ratio of ITOs stood at 222.2% with excess capital buffers above the regulatory minimum totalling RM38.6 billion as at end-December 2023.

The latest macro solvency stress tests conducted by BNM further affirm the resilience of financial institutions against unexpected losses from severe macroeconomic and financial shocks. Under the latest stress tests published in this Review which capture additional downside risks, the worst post-shock aggregate capital ratios over the stress horizon for banks (15.4%), life insurers (148%) and general insurers (181%) remain comfortably above the regulatory minima.

Strengthening operational and cyber resilience remains a top priority for BNM and financial institutions amid increasing digitalisation and technology adoption in the financial industry. BNM continues to require financial institutions to adopt strong cyber hygiene standards and to remain vigilant of evolving technological risks and cyber threats. Strengthened requirements were introduced around measures to combat online banking fraud, cloud risk management and the reporting of operational risks. In addition, measures continued to be taken to further improve coordinated system-wide surveillance and crisis response capabilities.