

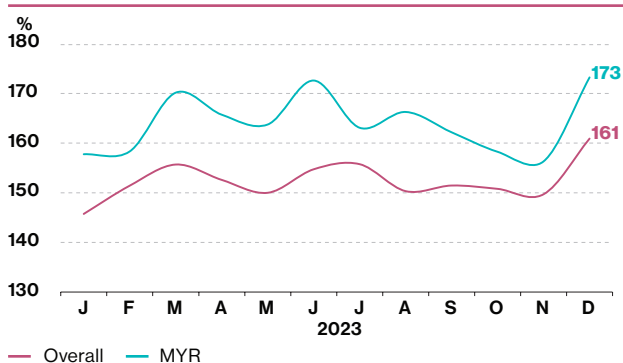
Financial Institution Soundness and Resilience

THE BANKING SECTOR

Banks' strong funding and liquidity positions supported intermediation activities

The liquidity and funding positions of the banking system remained strong in the second half of 2023. The aggregate Liquidity Coverage Ratio (LCR) (Chart 2.1) and Net Stable Funding Ratio (NSFR) (Chart 2.2) remained healthy and well above regulatory minima, at 160.9% and 118.2% respectively as at end-December 2023 (June 2023: 154.7% and 117.0% respectively). Banks' holdings of high-quality liquid assets (HQLA) increased further (RM758.3 billion; June 2023: RM744.3 billion), mostly in the form of central bank placements and government bonds, which banks can pledge in the interbank market or with BNM for access to additional liquidity.¹

Chart 2.1: Banking System – Liquidity Coverage Ratio

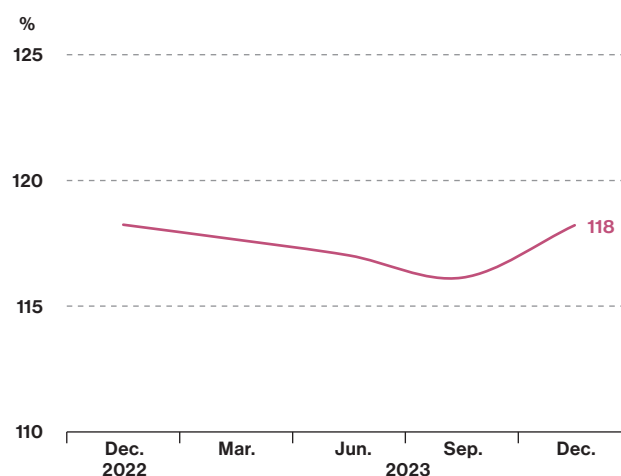


Note: 1. MYRLCR is calculated based on HQLA and expected net cash outflows denominated in ringgit.
2. Overall LCR is calculated based on HQLA and expected net cash outflows denominated in all currencies.

Source: Bank Negara Malaysia

¹ All banks have access to standing facilities and Restricted Committed Liquidity Facility (RCLF) with BNM to meet liquidity needs. The RCLF was introduced by BNM in 2016 to allow banks to obtain liquidity for tenures greater than 1 month from BNM. 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.

Chart 2.2: Banking System – Net Stable Funding Ratio



Source: Bank Negara Malaysia

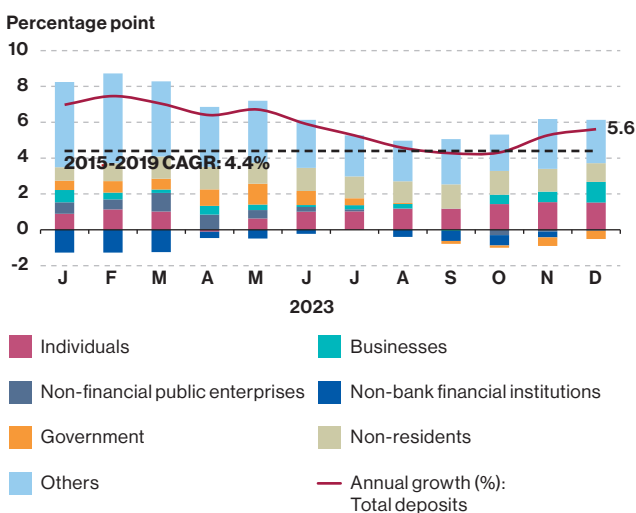
Banking system deposits continued to grow (Chart 2.3), mainly driven by businesses and individuals, in line with the improvements in business activities and household incomes. Resident individual and business (including non-financial public enterprises) deposits accounted for the bulk of banking system deposits at 35.6% and 34.1% respectively. These continued to provide a stable source of funding for banks amid lower deposits of non-bank financial institutions (NBFIs) and the Government in some periods during the second half of 2023. Longer-term fixed deposits (including Commodity Murabahah) grew faster than other major deposit types for the second consecutive year to make up nearly half (48.5%) of total banking system deposits (Chart 2.4). This remains lower than the historical average share of fixed deposits (2015–19 average: 51.2%). As the need for precautionary cash buffers subsides, the ongoing shifts observed from current and savings (CASA) deposits to longer-term fixed deposits will continue to underpin the stability of banks' funding sources. BNM's sensitivity analysis,² which assumes adverse deposit outflows and severe bond yield shocks further affirms

² Stressed outflows applied vary by bank depending on the bank's historical deposit outflow volatility and deposit composition (residents versus non-residents and retail versus corporate). The resultant outflow is at least 300% higher than each bank's historical average monthly outflow since 2016.

the banking system's resilience against liquidity shocks. Results of the analysis show that banks possess sufficient HQLA to withstand such adverse liquidity conditions (refer to the section on 'Assessing the Resilience of Financial Institutions' for further details).

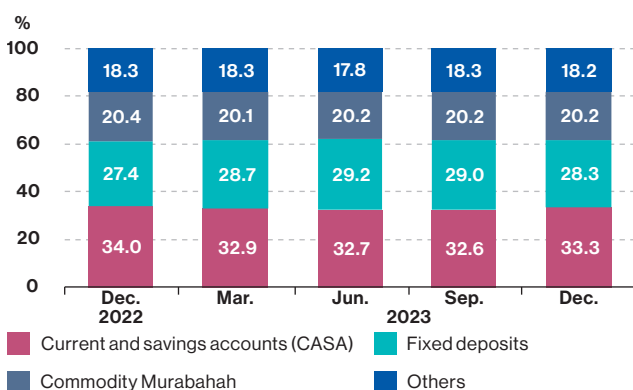
Similar to previous seasonal trends, deposit competition picked up towards the end of the year as banks shored up buffers in anticipation of larger year-end withdrawals, particularly from large depositors. Compared to previous years, the extent of deposit competition was relatively muted as rate-hunting behaviour by corporates moderated amid expectations that the Overnight Policy Rate (OPR) has peaked. Banks were also observed

Chart 2.3: Banking System – Contribution to Growth in Deposits Accepted



Source: Bank Negara Malaysia

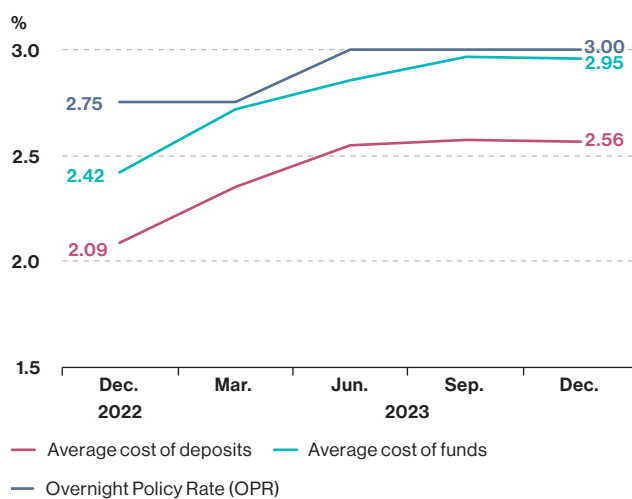
Chart 2.4: Banking System – Composition of Deposits by Type



Source: Bank Negara Malaysia

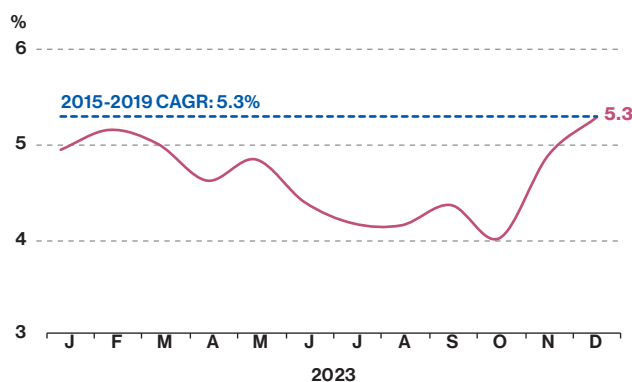
tapping the interbank market for longer-term funding, which saw interbank rates move slightly higher in the fourth quarter of 2023 (year-on-year increase in 3-month interbank rate: +4 bps).³ This had a minimal impact on banks' cost of funds as ringgit interbank funding remained a small share of the banking system's overall funding mix at an estimated 2% of total funding. Going forward, continuing measures by banks to diversify and extend the maturity profile of funding sources will further strengthen their resilience to funding shocks. Overall, the average cost of funds rose by 10 bps between June and December 2023 to 2.95% (Chart 2.5). The bulk of the increase in banks' cost of funds was attributable to the higher share of longer-term

Chart 2.5: Banking System – Average Cost of Deposits, Average Cost of Funds and OPR



Source: Bank Negara Malaysia

Chart 2.6: Banking System – Annual Loan Growth



Source: Bank Negara Malaysia

³ Increase between end-December 2022 and end-December 2023.

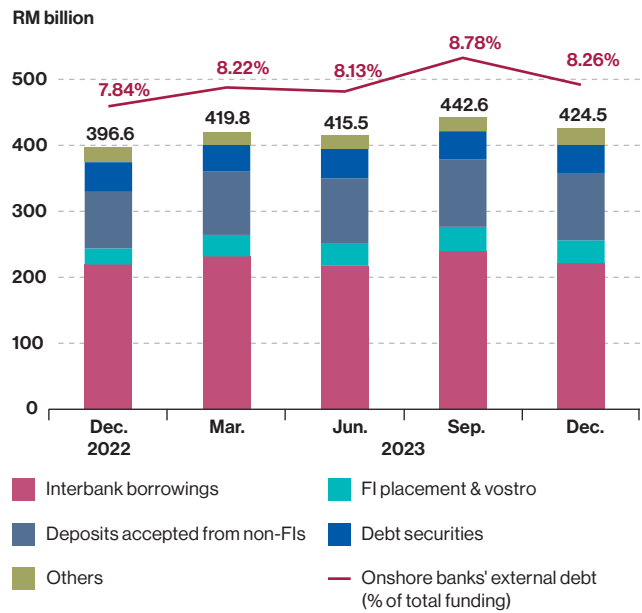
fixed deposits as the series of previous OPR increases worked through the system. The increase in banks' cost of funds has not resulted in any notable tightening of credit conditions. Bank lending to households and businesses continued to expand at a healthy rate (+5.3%; June 2023: +4.4%) (Chart 2.6). The weighted average lending rates for new business and retail loans have also remained broadly stable (+10 bps and -9 bps from June to December 2023 respectively) amid healthy competition observed among banks.

Contagion risks from banks' exposures to external counterparties remained manageable

Banks' external debt increased by RM9 billion in the second half of 2023 to RM424.5 billion (Chart 2.7). The increase was largely driven by foreign currency (FCY) interbank borrowings, which some banks used to obtain ringgit funding via FCY swap arrangements. Depending on prevailing market conditions, such funding arrangements could be a source of ringgit funding at a lower cost compared to directly borrowing ringgit from domestic money markets. This remained relatively small as a share of banking system total funding, consistent with the historically low level of dependence on external debt by banks in funding their ringgit operations.

Overall risks from banks' external debt continued to be limited. The bulk of total banking system external debt exposures (78.6%; June 2023: 79.3%) are with related counterparties or in the form of long-term, stable debt, thereby limiting rollover or withdrawal risks. Banks maintained sizeable FCY liquid asset buffers, sufficient to cover up to 2.4 times (June 2023: 2.4 times) of total FCY external debt-at-risk⁴ (Chart 2.8).

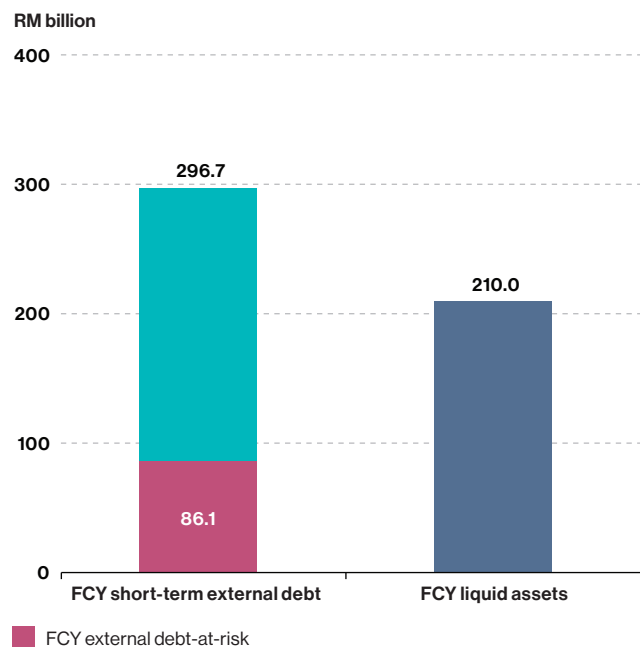
Chart 2.7: Banks' External Debt – by Instrument



Note: Banks' external debt in this context refers to external debt of DBGs, LIFBs and banks in the Labuan International Business and Financial Centre (LIBFC).

Source: Bank Negara Malaysia

Chart 2.8: Banking System – FCY External Debt-at-Risk and Liquid Assets



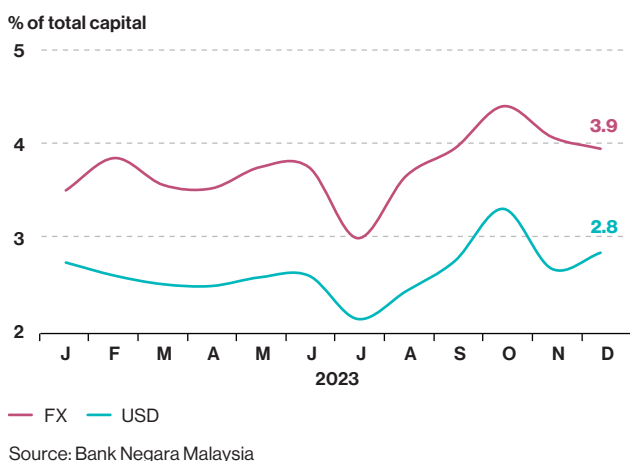
Note: Liquid assets comprise cash and cash equivalents, unencumbered debt securities held and interbank placements.

Source: Bank Negara Malaysia

⁴ Banks' external debt-at-risk comprises financial institutions' deposits, interbank borrowings and short-term loans from unrelated non-resident counterparties, which are considered to be more susceptible to sudden withdrawal shocks.

Banks' foreign exchange net open position (FX NOP) from domestic operations remained manageable at 3.9% of banks' total capital (June 2023: 3.7%; 2020–22 average: 4.2%) (Chart 2.9) amid the market volatility during the period. This conservative FX NOP position reflects banks' relatively low risk appetite for uncovered exposures, limiting further FCY liquidity risks from movements in the ringgit.

Chart 2.9: Banking System – FX and USD Net Open Positions



Banks' asset quality improved but downside risks remain

Banks' asset quality continued to improve in the second half of 2023. The share of loans classified under Stage 2 continued to decline, to 7.2% of total banking system loans (Chart 2.10). Total loans under repayment assistance programmes⁵ improved to 2.4% of total banking system loans (June 2023: 2.5%) amid a steady recovery in borrowers' repayment capacity. New requests for restructuring and rescheduling from borrowers facing financial strains remained small at 0.16% of banks' total loans (June 2023: 0.1%). The gross impaired loans ratio correspondingly moderated slightly (1.6% of total loans; June 2023: 1.7%) (Chart 2.11). Moving forward, banks expect a modest increase in impairments as repayment assistance programmes are progressively reviewed. Persistent cost pressures could also start to weigh more heavily on the debt-servicing capacity of a

small segment of borrowers. Higher potential losses are expected to remain comfortably within banks' provisioning buffers as the vast majority of borrowers continue to show improvements in their debt-servicing ability.

Chart 2.10: Banking System – Stage 2 Loans Ratio

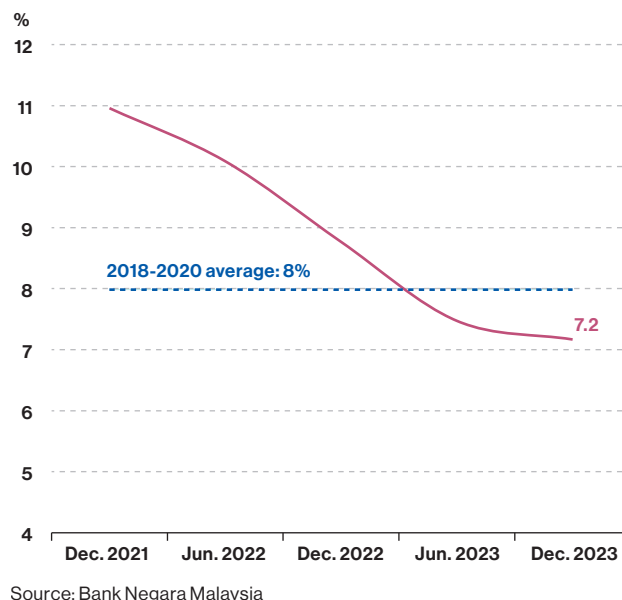
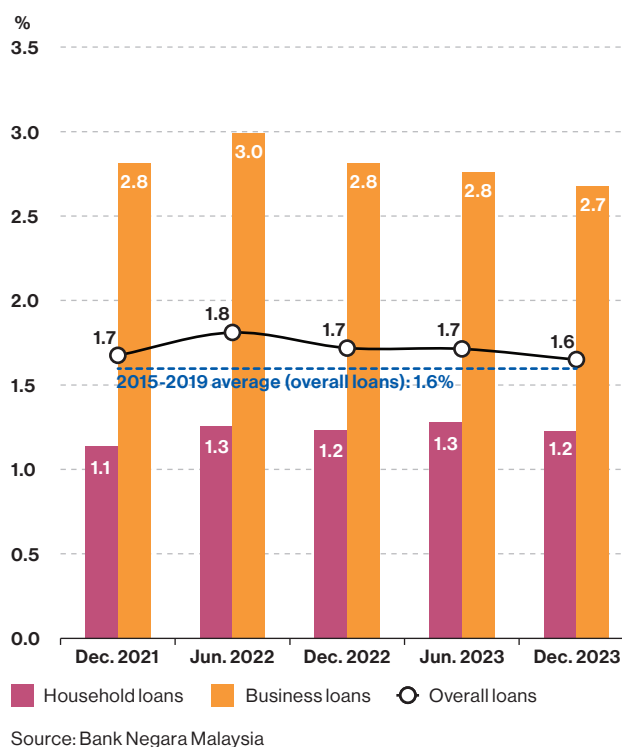


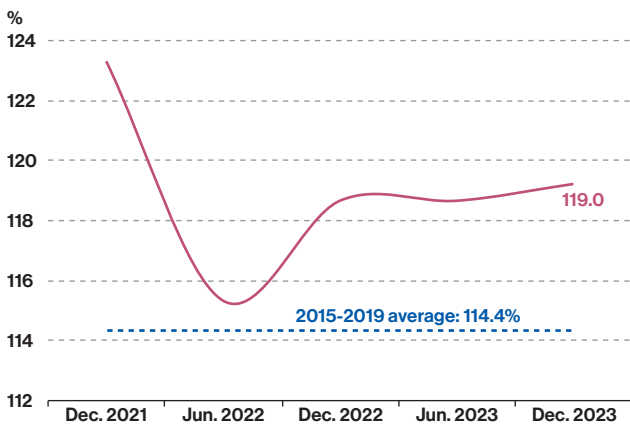
Chart 2.11: Banking System – Gross Impaired Loans Ratio



⁵ Refers to all types of repayment assistance programmes including remaining loans under assistance extended under COVID-19, banks' bespoke packages, and restructuring and rescheduling (R&R).

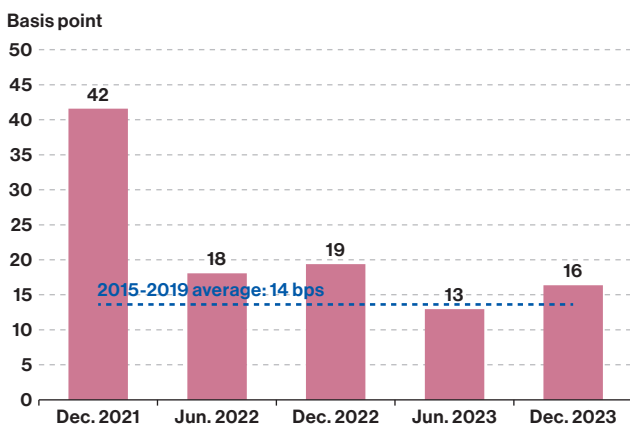
Consistent with the improvements observed in overall repayment trends, banks' provisions declined by 5.3% year-on-year. Banks continued to use management overlays⁶ to account for uncertainty in the operating environment, particularly for high-risk borrowers. Such management overlays have been maintained by banks at around 28% of model-based expected credit loss (ECL) provisions for loans, broadly unchanged from June 2023. The banking system loan loss coverage ratio (including regulatory reserves) was correspondingly sustained at a high level of 119% (June 2023: 118.6%) (Chart 2.12) as banks continued to be vigilant. Annualised credit costs remained slightly elevated relative to pre-pandemic levels but have declined significantly from earlier peaks (Chart 2.13).

Chart 2.12: Banking System – Loan Loss Coverage Ratio (Including Regulatory Reserves)



Source: Bank Negara Malaysia

Chart 2.13: Banking System – Annualised Credit Cost Ratio



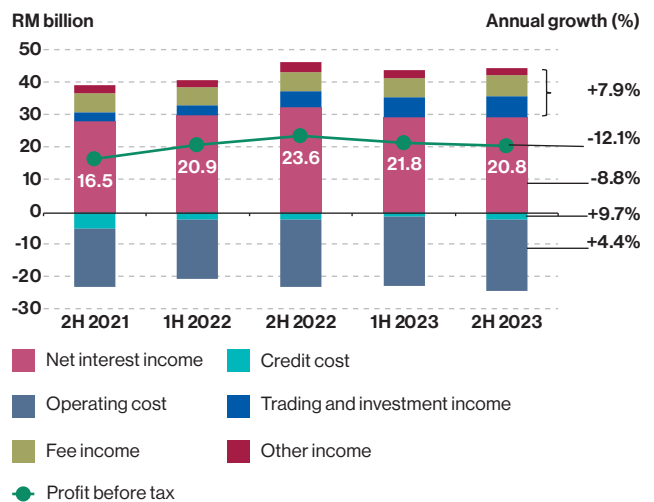
Source: Bank Negara Malaysia

⁶ Management overlays are additional provisions set aside on top of provisions derived from expected credit loss (ECL) models. It reflects adjustments to account for data deficiencies or uncertainties not adequately captured by the ECL models.

Banks' earnings moderated amid continued narrowing interest margins

Banks' earnings declined year-on-year and were lower relative to the first half of 2023 (Chart 2.14). However, profitability continued to be supported by lending activities amid continued compression in interest margins due to higher funding costs. A slight improvement in trading and investment income (2H 2023: RM6.3 billion; 1H 2023: RM6.1 billion) provided some support to banks' profitability. This was partially driven by a decline in domestic bond yields in the second half of 2023. While banks' holdings of government bonds increased marginally (10.3% of total banking system assets; June 2023: 10.1%), their exposure to interest rate risk remains manageable.⁷ This has been helped by strategies to reduce the duration of government bond holdings. Amid expectations of interest rates having peaked, banks of late have rebalanced their new government bond holdings from amortised cost to fair value through other comprehensive income (FVOCI). Potential revaluation gains could provide further support to banks' capital positions, should yields decline going forward.

Chart 2.14: Banking System – Income, Cost and Profit before Tax



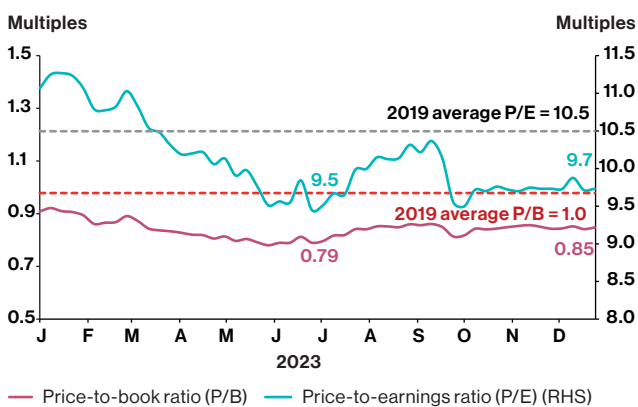
Note: 1. Annual growth computed based on figures for 2H 2022 and 2H 2023.
2. Figures may not add up due to rounding.

Source: Bank Negara Malaysia

⁷ Interest rate risk in the banking book (IRRBB) reflects the current or prospective risk to the banks' capital and earnings arising from adverse movements in interest rates that affect banking book positions. It is measured as a percentage of banks' capital (December 2023: 7.2%; June 2023: 7.4%).

In line with the lower earnings, returns on asset and equity of the banking system declined to 1.2% and 11.2% respectively (June 2023: 1.3% and 11.6% respectively). Market valuations of listed banks, as measured by the price-to-book (P/B) and price-to-earnings (P/E) ratios, remain below their pre-pandemic average levels (Chart 2.15). This partly reflects prevailing credit and economic conditions. The moderation in market valuations observed among listed Malaysian banks was also largely in line with regional peers.⁸ An improving outlook for the economy in the period ahead coupled with the relatively strong position of banks to capitalise on growth opportunities will provide sustained support for bank profitability going forward.⁹

Chart 2.15: Banking System – Price-to-Book and Price-to-Earnings Ratios of Publicly Listed Banks in Malaysia



Note: Refers to the median ratio of all publicly listed banks in Malaysia.

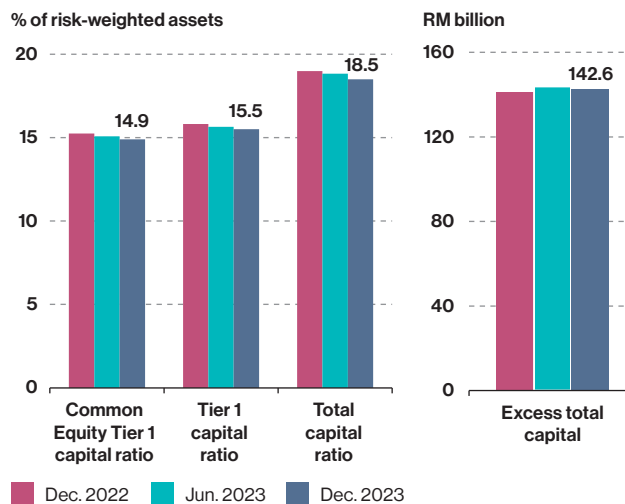
Source: Bloomberg

Banking system remained well-capitalised

The banking system total capital ratio remained strong (18.5%; June 2023: 18.8%), with capital buffers of RM142.6 billion in excess of the regulatory minimum (Chart 2.16). These buffers continue to preserve banks' capacity to support credit to the economy, as well as absorb unexpected losses. The large capital buffers have also enabled banks to sustain dividend payouts which have largely returned to payout ratios observed before the pandemic for most banks. Banks' capital

buffers were further supported by revaluation gains from bond holdings in the banking book, driven by a decline in domestic bond yields.

Chart 2.16: Banking System – Capitalisation



Note: Excess total capital refers to total capital above the regulatory minimum, which includes the capital conservation buffer requirement of 2.5% and bank-specific higher minimum requirements.

Source: Bank Negara Malaysia

Contagion risk from DBGs' overseas operations remained low

The profitability of overseas operations of domestic banking groups (DBGs) declined in the second half of 2023 (Chart 2.17). The decline in profitability was mainly observed in operations in Thailand (9% of total overseas operations in terms of assets) (Chart 2.18), reflecting higher credit costs that were mainly driven by non-retail borrowers which have yet to recover from the pandemic. Notwithstanding that, spillover risks to parent banks in Malaysia remain manageable, as operations in Thailand contributed only up to 2% of DBGs' total consolidated assets (overall total overseas operations accounted for 22.6% of DBGs' total consolidated assets). Similar to Malaysia, the share of loans under repayment assistance programmes in the overseas operations continued to trend lower (1.3% of total overseas operations loans; June 2023: 1.7%), following the conclusion of pandemic-related repayment assistance programmes in most jurisdictions.

⁸ Based on comparison of valuations of financial indices in Thailand, Indonesia, Hong Kong SAR and the three largest financial institutions in Singapore.

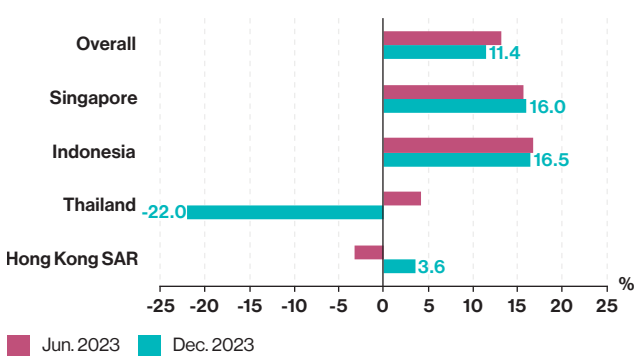
⁹ Refer to the box article on 'Malaysian Banks' Profitability – Past Trends and Future Prospects' in the BNM Financial Stability Review for First Half 2019 for a more detailed discussion on trends and key drivers of bank profitability in Malaysia.

The write-off of some legacy loans in Hong Kong SAR, coupled with improved repayment performance of borrowers in Indonesia and Singapore, further contributed to improved asset quality (Chart 2.19).

Liquidity and funding risks posed by DBGs' overseas operations remained limited. Key overseas operations

continued to be primarily funded by stable customer deposits (Chart 2.20). Capital levels maintained at DBGs' overseas operations remained strong (average total capital ratio as at December 2023: 20.7%, June 2023: 20.5%), providing strong buffers to absorb unexpected losses without relying on parental support.

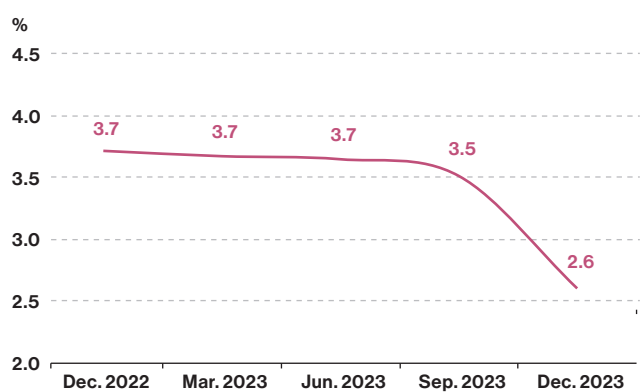
Chart 2.17: Banking System – Return on Equity of Overseas Operations by Jurisdiction



Note: 1. Overall average ROE is weighted by the asset size of selected overseas operations.
2. Average ROE is weighted by the asset size of each domestic banking group's overseas operations in respective jurisdictions.

Source: Bank Negara Malaysia

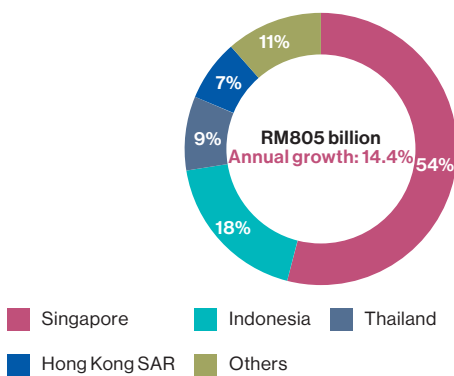
Chart 2.19: Banking System – Gross Impaired Loans Ratio of Overseas Operations



Note: The average gross impaired loans ratio is weighted by the asset size of selected overseas operations.

Source: Bank Negara Malaysia

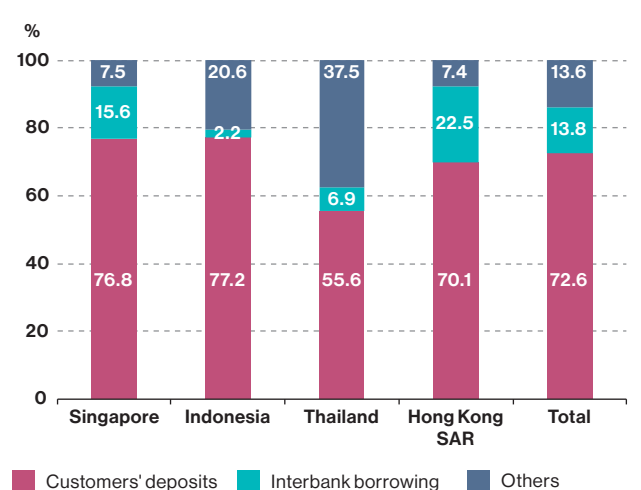
Chart 2.18: Banking System – Asset Profile of Major Overseas Operations



Note: Figures may not add up due to rounding.

Source: Bank Negara Malaysia

Chart 2.20: Banking System – Funding Profile of Major Overseas Operations



Note: Figures may not add up due to rounding.

Source: Bank Negara Malaysia

Digital Banks: Supervisory Focus Around Key Risks

Three recently licensed digital banks have passed operational readiness assessments and entered their foundational phase¹⁰ of operations. During this period, digital banks are progressively expected to execute strategies that are compatible with long-term viability and investments in strong risk management capabilities. The supervisory activities of BNM over digital banks adopt the principle of proportionality. Initial supervisory scrutiny prioritises digital banks' progress in meeting the prudential requirements to 'graduate' from the foundational phase. Increased rigour in supervision is applied as the scope of business activities expand along with heightened expectations on risk management practices. This supervisory approach enables digital banks to stabilize their business models and build financial sustainability during the foundational phase. It also anticipates and aims to be facilitative of the prospect that digital banks may have to refine their strategies for delivering on BNM's intended policy objectives of financial inclusion and innovation.

BNM's supervisory focus and expectations are informed by its assessment of key risks in the operations of digital banks. Among these, the rise in fraud cases involving mobile banking apps, coupled with fully digital onboarding of customers without face-to-face interaction underscores the need for digital banks to have strong electronic Know-Your-Customer (eKYC) controls to deter criminal activities. A common trait in a digital bank set-up is the outsourcing of key infrastructure and capabilities to cloud and software-as-a-service (SaaS) service providers. A greater reliance on such external service providers could increase digital banks' vulnerabilities to the operational failures of these providers. This may, in turn pose systemic risks to the extent that multiple banks are reliant on the same service providers for their key infrastructure. Supervisory scrutiny is therefore directed at digital banks' governance and risk management practices (including the capacity to recover critical business functions) to ensure these outsourcing arrangements do not create sources of excessive vulnerability to ongoing operations. Focus is also directed at the controls in place to guide the deployment of artificial intelligence (AI) or machine learning models in use cases such as credit approvals to ensure they are fit-for-purpose.

Digital banks may face additional risk arising from the exclusive use of digital channels by customers to perform banking transactions. Given the digital set-up, the impact of negative social media on reputational risks, which in turn could lead to a sharp and sudden withdrawal of deposits, warrants particular attention. As digital banks do not operate with physical branches, there is also a need to be able to mitigate operational risks under a range of scenarios, in the event of any disruptions to digital infrastructure. Therefore, supervisory focus is also given to digital banks' ability to effectively manage technology and operational risks, including ensuring there are robust business continuity and disaster recovery plans to preserve the continuous availability of banking services to customers.

¹⁰ Foundational phase is for a period of three to five years during which an asset limit of RM3 billion and simplified regulatory requirements apply. Refer to the policy document on Licensing Framework for Digital Bank issued on 31 December 2023 for details.