

# Financial Institution Soundness and Resilience

## THE BANKING SECTOR

### Strong liquidity position enabled banks to support financial intermediation and the implementation of various relief measures

The liquidity position of banks has remained healthy despite the deferment of close to 90% of retail loan repayments under the automatic moratorium.<sup>1</sup> This has been supported by the strong initial buffers of banks as well as higher deposit growth from precautionary cash holdings, particularly among individual depositors in the second quarter (Chart 2.1). Along with the reduction in the Statutory Reserve Requirement (SRR) by 100 basis points (bps) in March and the additional SRR flexibilities which released more liquidity into the banking system, banks consequently had less need for interbank funding and had not resorted to the flexibility granted for banks to operate below the minimum Liquidity Coverage Ratio (LCR) of 100%. Throughout the first half of 2020, the banking system LCR remained around 140% or higher (December 2019: 149.1%) (Chart 2.2). Funding conditions in the banking system also remained stable with the loan-to-fund ratio at 82.0% (December 2019: 83.2%) (Chart 2.3). All banks were well-positioned to meet the minimum Net Stable Funding Ratio (NSFR) requirement of 80% which came into effect in July 2020.

Chart 2.1: Banking System – Contribution to Growth in Deposits Accepted

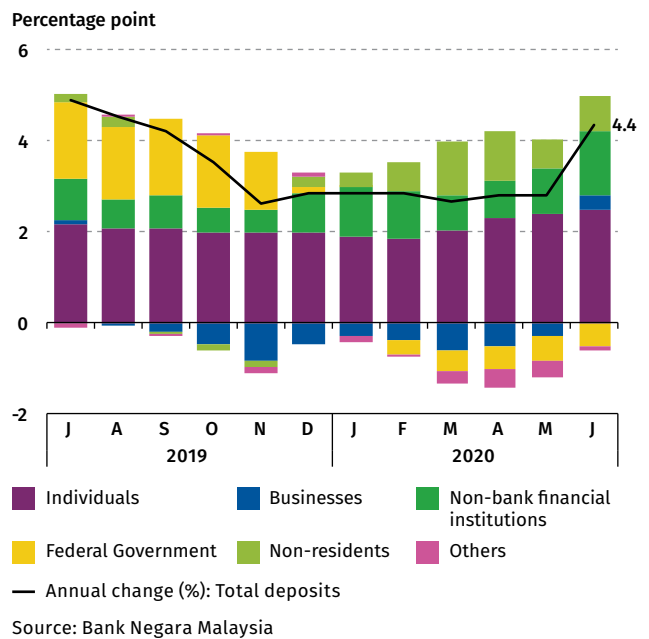
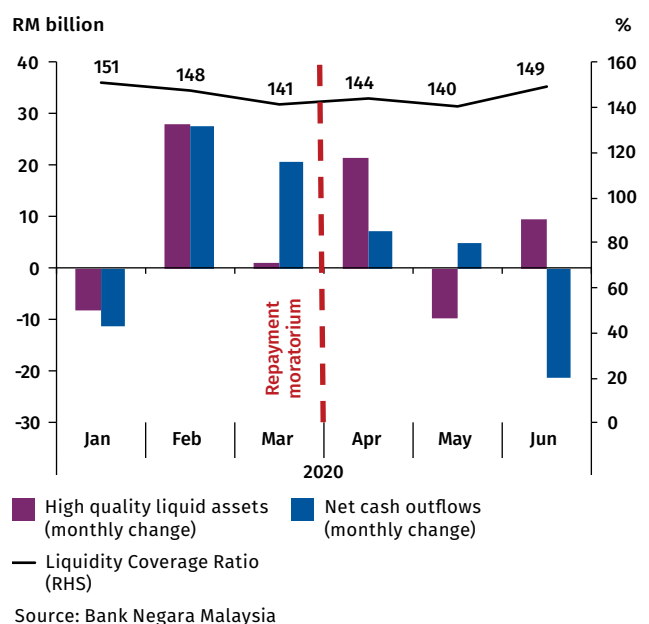
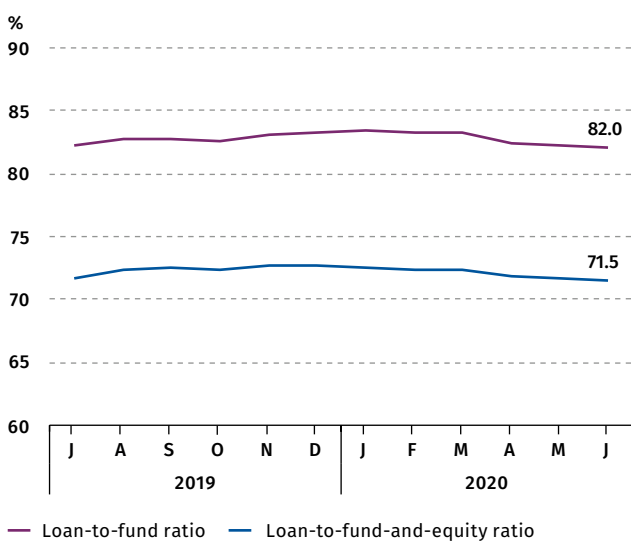


Chart 2.2: Banking System – Liquidity Coverage Ratio, High Quality Liquid Assets and Net Cash Outflows



<sup>1</sup> Malaysia was among the first and only few countries in the world to implement an automatic deferment of loan/financing repayments for eligible borrowers.

**Chart 2.3: Banking System – Loan-to-Fund Ratio and Loan-to-Fund-and-Equity Ratio**



Source: Bank Negara Malaysia

### Risks posed by external and cross-currency funding remained manageable

Risks from external debt exposures of banks continue to be manageable given their low dependence on external funding which has remained broadly stable below 10% of total funding over the years. Most of the increase in banks' external debt of RM22.9 billion in 1H 2020 was attributable to increased intragroup borrowings by foreign banks in the Labuan International Business and Financial Centre (LIBFC) in line with their 'out-out'

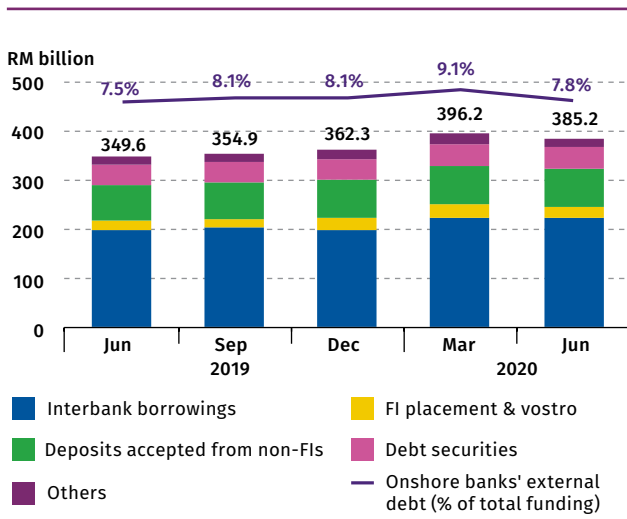
business activities (Chart 2.4). While some onshore banks<sup>2</sup> increased cross-currency borrowings in 1Q 2020 to manage short-term liquidity needs from maturing deposits and demand for domestic FCY loans, this has since been pared back in 2Q 2020 amid lower domestic funding costs. More than 60% of banks' external exposures continue to be in the form of intragroup placements and long-term debt securities, which are less susceptible to sudden withdrawal or rollover risk (Chart 2.5). Banks' foreign exchange net open position (FX NOP) also remained below levels recorded in recent history (5-year average: 5.6%) (Chart 2.6). It has, however, risen from end-2019 levels amid an increase in banks' risk appetite particularly after the earlier stress in the USD funding market subsided following significant liquidity injections by the Federal Reserve to ease market strains. Banks continued to maintain steady holdings of liquid FCY assets which are sufficient to cover more than three times their FCY external 'debt-at-risk' (Chart 2.7).<sup>3</sup>

Banks' cost of funds continued to be on a declining trend amid strong pass-through of the successive Overnight Policy Rate (OPR) cuts to deposit and money market rates (Chart 2.8). The shift towards more liquid and shorter-term deposits has also kept the costs of funds relatively low. Greater uncertainty among households and businesses has led to a preference for holding cash in more liquid current and savings accounts (CASA), while competition among banks for longer-dated fixed deposits has also eased on expectations of further OPR cuts. (Chart 2.9). In the near term, banks' funding costs are expected to remain low as banks gradually reprice deposits to incorporate the most recent OPR cuts.

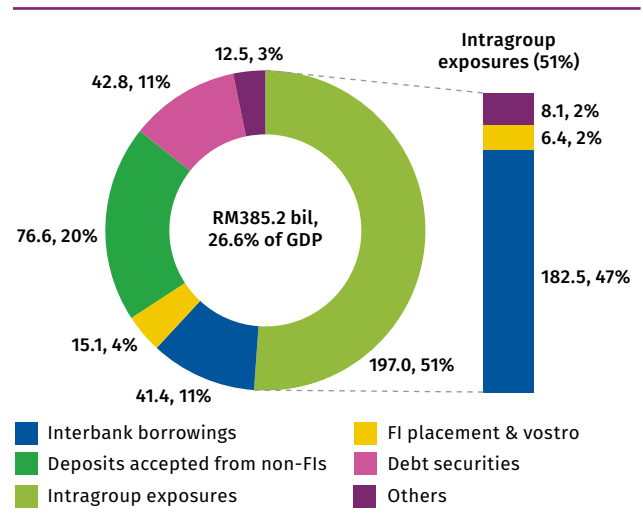
<sup>2</sup> Refers to domestic banking groups (DBGs) and locally-incorporated foreign banks (LIFBs).

<sup>3</sup> Banks' external 'debt-at-risk' comprises financial institutions' deposits, interbank borrowings and short-term loans from unrelated non-resident counterparties which are considered more susceptible to sudden withdrawal shocks.

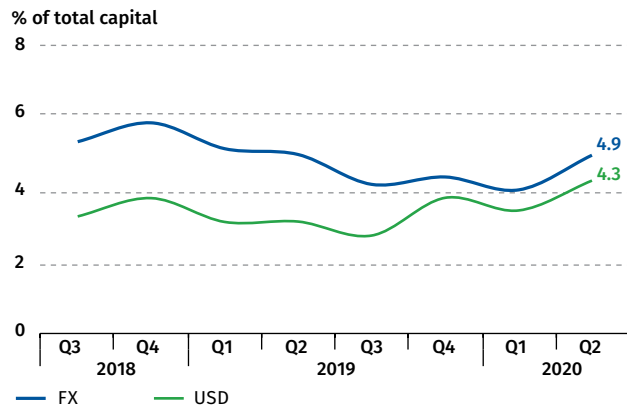
**Chart 2.4: Banks' External Debt – by Instrument**



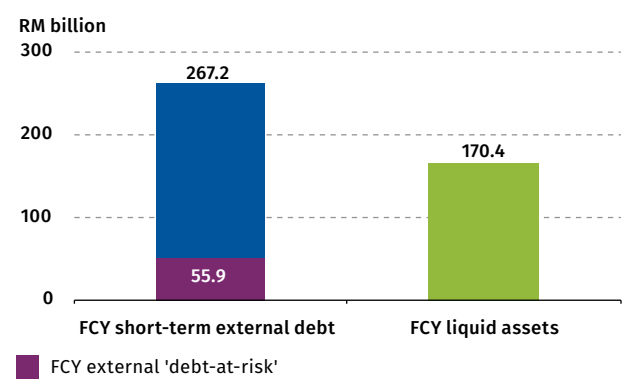
**Chart 2.5: Banks' External Debt – by Type of Exposure and Instrument**



**Chart 2.6: Banking System – FX and USD Net Open Positions as Percentage of Capital**

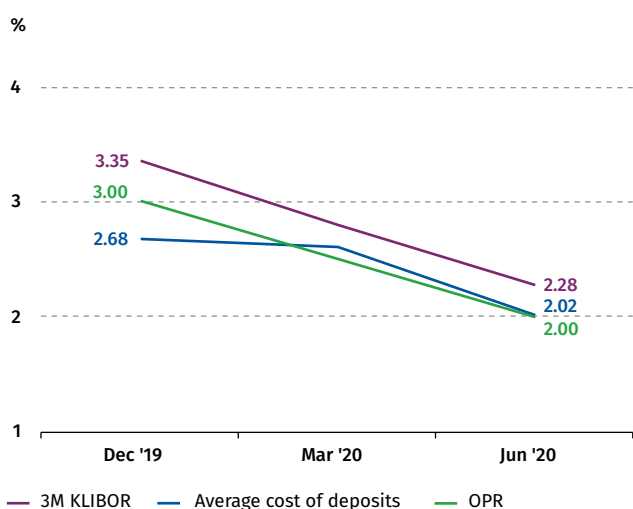


**Chart 2.7: Banking System – FCY External 'Debt-at-Risk' and Liquid Assets**



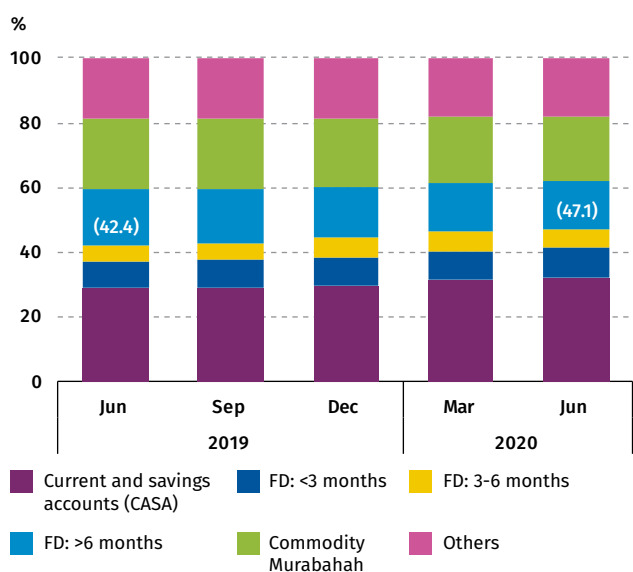
Note: 1. Banks' external debt in this context refers to external debt of DBGs, LIFBs, and LIBFC banks  
 2. Banking system or onshore banks refer to only DBGs and LIFBs  
 3. Liquid assets comprise cash and cash equivalents, unencumbered debt securities held and interbank placements  
 Source: Bank Negara Malaysia

**Chart 2.8: Banking System – Average Cost of Deposits, Kuala Lumpur Interbank Offered Rate (KLIBOR) and Overnight Policy Rate (OPR)**



Source: Bank Negara Malaysia

**Chart 2.9: Banking System – Composition of Deposits by Type and Original Maturity**



Note: (...) refers to the total share of CASA and fixed deposits (FD) with original maturity of up to 6 months

Source: Bank Negara Malaysia

## Impairments remained low, but banks are cautious on the credit risk outlook

In April 2020, an automatic repayment moratorium was put in place for retail and SME loans that were performing prior to that date. This has kept banking system impairments low at 1.5% of total loans (2019: 1.5%; 5-year average: 1.6%) (Chart 2.10). At the same time, continuing debt recovery efforts on defaulted loans have also helped to reduce outstanding impairments.

A key challenge for banks in monitoring credit risk developments during this period has been the absence of borrowers' repayment information due to the extensive coverage of the loan moratorium. In response, banks have taken proactive measures to assess and manage risks by (i) engaging borrowers more directly on their recovery prospects; (ii) increasing the use of data analytics and alternative sources of information (such as facility utilisation rates, cash conversion cycles, and operating account balances) to establish the condition of borrowers; and (iii) working with credit reporting agencies to identify early-warning indicators. This has enabled banks to identify loans with higher credit risks and pre-emptively build up provisions against future potential losses to ensure their continued resilience. Provisions for loans classified as Stage 2<sup>4</sup> under MFRS 9 increased by RM1.7 billion in the first half of 2020 (June 2020: +27.9% annual growth; 2019: -5.9%), driven by businesses most affected by the pandemic.<sup>5</sup> Higher overall provisions set aside by banks in 1H 2020 (+RM2.7 billion to RM24.6 billion as at end-June 2020) also reflected banks' consideration of forward-looking information that takes into account the considerable uncertainty over the recovery path. While asset quality can be expected to deteriorate, the recovery in business activities amid continued fiscal and financial support to businesses and households will mitigate risks of defaults. Importantly, impairment levels have stabilised at historically low levels in recent years due to strengthened underwriting standards. This, together with prudent provisioning practices observed by banks, provides a strong starting position for banks to weather the expected rise in impairments in the period ahead.

<sup>4</sup> Stage 2 loans refer to underperforming loans, for which banks are required to set aside provisions based on lifetime expected losses.

<sup>5</sup> For example, construction, manufacturing, wholesale and retail, hotels and restaurants sectors.

## Despite downward pressure on earnings, banks maintained healthy capital buffers

Banks reported a marked decline in earnings from domestic banking activities during the first half of the year (Chart 2.11), weighed down by further margin compression and higher provisions for credit losses. Annualised credit costs as a share of total outstanding loans<sup>6</sup> rose significantly from the low levels over the past decade to 56 bps (average for 2010-2019: 20 bps) – a level last seen during the 2008 Global Financial Crisis. Banks were also impacted by a one-off contract modification loss due to the waiver of additional interest charges for hire-purchase loans and fixed rate Islamic financing under the repayment moratorium measures. This further compressed narrowing margins from successive OPR cuts (Chart 2.12).

Trading and investment income, however, provided some support to profits as banks recorded gains from the sale of debt securities and fair value changes amid declining yields (Chart 2.13). By end-June 2020 however, banks had increased their holdings of government bonds to nearly half of the treasury portfolio (June 2020: 49%; December 2019: 42%; 2017-2019 average: 43%) amid higher issuances, additional liquidity from the SRR-related measures, and slower lending growth. Interest rate risks in the banking book correspondingly increased to 5.5% of total capital (2019: 4.4%), but remained well within prudent limits observed by individual banks. Measures to improve cost efficiency also continue to be pursued by banks to support profitability, including reviewing the timing of non-critical expenditures, renegotiating vendor contracts and accelerating ongoing digitisation efforts.

Market valuations of banks as measured by the median price-to-book (P/B) ratio have fallen further since 2019, reflecting the weaker

macroeconomic outlook and earnings expectations. Bank-specific factors and more cautious investor sentiment also contributed to a fairly wide dispersion of P/B ratios across banks, with several banks reporting P/B ratios below one. Nonetheless, Malaysian banks' returns on equity and assets remain broadly in line with other banks in the region, and have declined to a lesser extent so far this year (Charts 2.14 and 2.15). The strong financial position of banks will also provide some support to earnings and preserve their ability to raise capital at lower costs from the market to support financial intermediation activities.

## Limited spillover risks arising from banks' overseas operations despite the challenging economic environment

The overseas operations<sup>7</sup> of domestic banking groups (DBGs) also experienced a decline in profitability for the first half of 2020, as banks in the region were similarly affected by slower economic activity as a result of COVID-19 containment measures and a deterioration in asset quality (Chart 2.16). Risks from the overseas operations of DBGs are likely to be manageable, as banks' overseas credit exposures to sectors directly affected by the pandemic are relatively small, ranging between 0.1%-5.3% of overall group exposures. Major overseas subsidiaries also continue to maintain relatively high levels of capital, which serve as strong buffers against potential credit losses. This will limit the need for capital support from the domestic parent banks. Based on stress tests conducted by DBGs on their major overseas operations, most foreign subsidiaries have sufficient capital to withstand severe shocks amid the COVID-19 pandemic. Overseas operations of the DBGs also continue to be largely funded by local currency deposits, with liquidity ratios remaining above local regulatory requirements and internal targets (Chart 2.17).

<sup>6</sup> Excluding loans from domestic banks' overseas operations.

<sup>7</sup> Refers to DBGs' material offices (branches and subsidiaries) operating outside of Malaysia. Cumulatively, DBGs have presence in 14 overseas jurisdictions, with major operations in Singapore, Indonesia, Thailand and Hong Kong SAR.

Chart 2.10: Banking System – Gross Impaired Loans Ratio

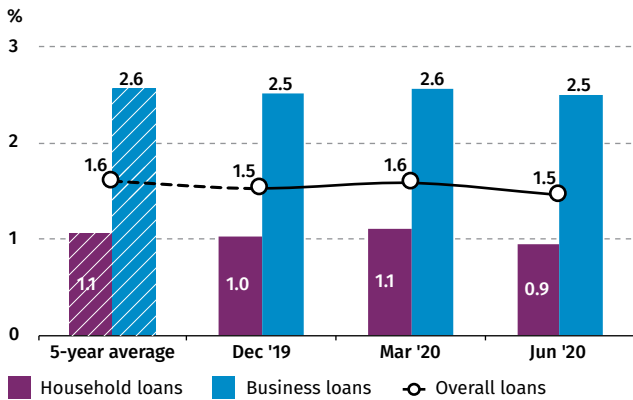


Chart 2.11: Banking System – Profitability

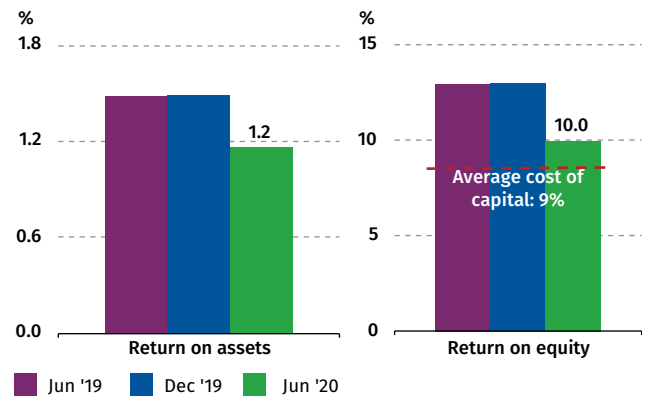


Chart 2.12: Banking System – Interest Margin

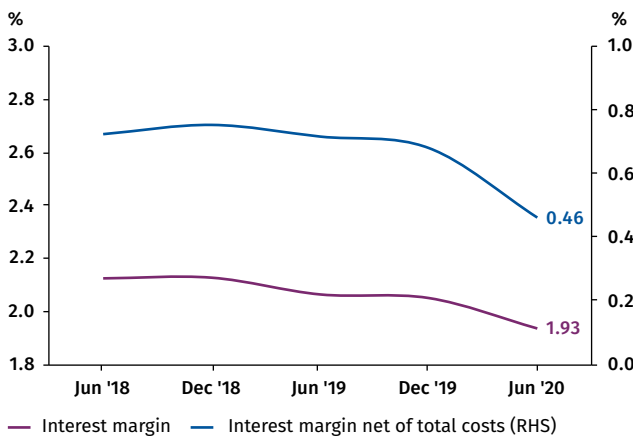


Chart 2.13: Banking System – Income, Cost and Profit before Tax

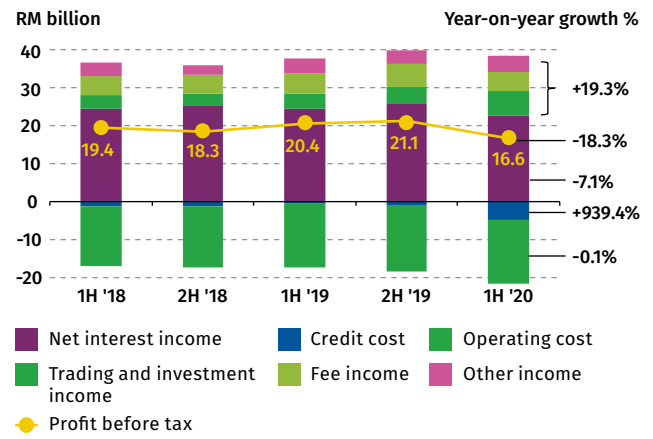


Chart 2.14: Banks' Return on Assets – Cross-country Comparison

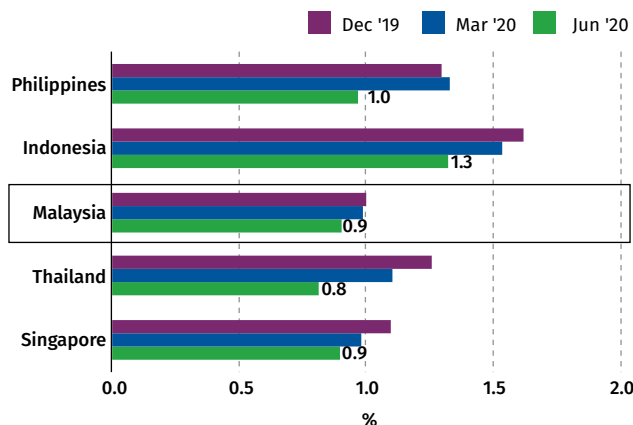
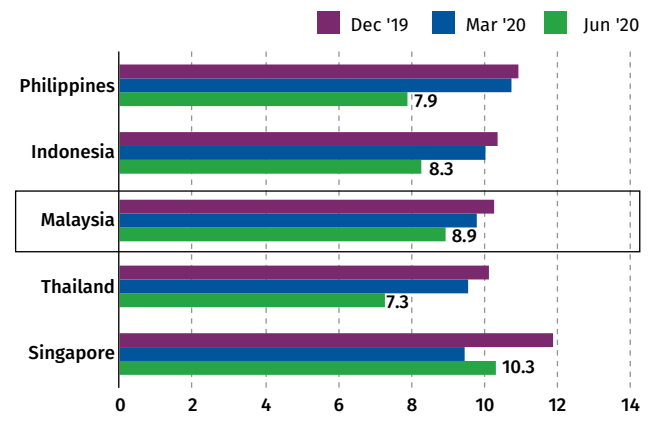


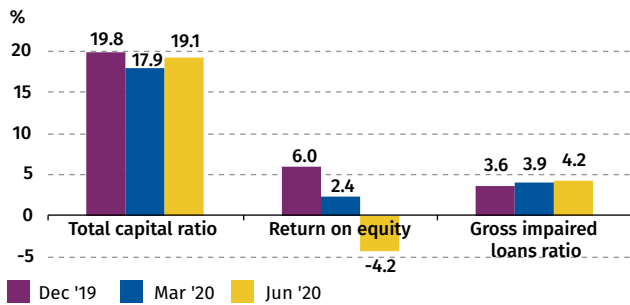
Chart 2.15: Banks' Return on Equity – Cross-country Comparison



Note: 1. The average cost of capital for Malaysian banks refers to the average expected annual stock returns for all listed banks estimated using a Capital Asset Pricing Model  
 2. Total costs refer to impairment provisions and operating costs  
 3. Year-on-year growth computed based on figures for 1H 2019 and 1H 2020  
 4. Cross-country comparisons refer to median figures reported by selected listed banks in each jurisdiction

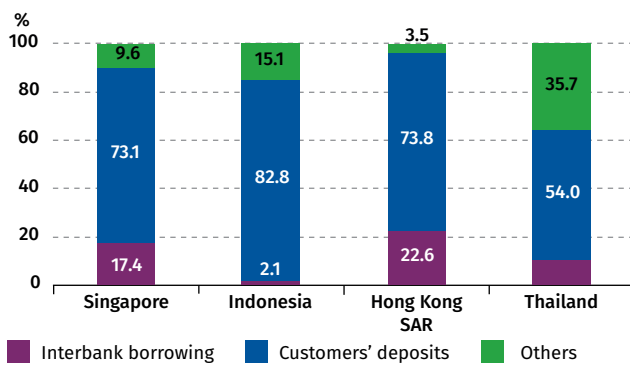
Source: Bank Negara Malaysia and Bloomberg

**Chart 2.16: Banking System – Key Financial Indicators of Overseas Operations**



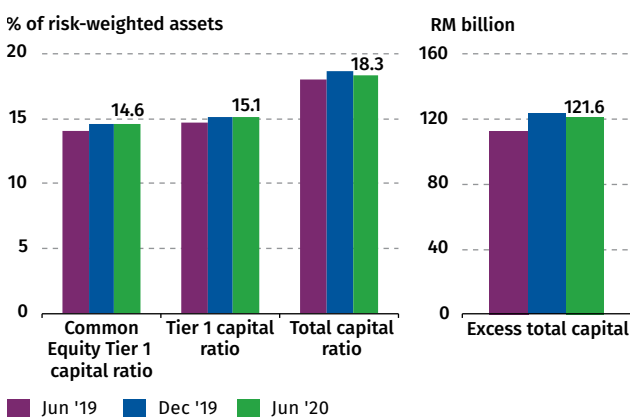
Note: The average key financial indicators are weighted by the asset size of selected overseas operations  
 Source: Bank Negara Malaysia

**Chart 2.17: Banking System – Funding Profile of Major Overseas Operations**



Source: Bank Negara Malaysia

**Chart 2.18: Banking System – Capital Ratios**



Note: Excess total capital refers to total capital above the regulatory minimum, which includes the capital conservation buffer requirement (2.5%) and bank-specific higher minimum requirements  
 Source: Bank Negara Malaysia

All banks remained well-capitalised throughout the first half of 2020, with aggregate capital buffers<sup>8</sup> amounting to RM121.6 billion as at June 2020 (Chart 2.18). In anticipation of the more challenging economic outlook, banks are shoring up their buffers, either through new capital issuances or dividend reinvestment plans. Most banks have also reduced or deferred dividend payouts to shareholders.

As part of an annual cycle, the Bank completed its latest assessment on domestic systemically important banks (D-SIBs) based on end-2019 data submissions. The three banking groups designated as D-SIBs remain unchanged from the list published on 5 February 2020 (Table 2.1).<sup>9</sup> The identification of D-SIBs is based on an assessment methodology that combines an indicator-based measurement approach with supervisory judgment which considers factors not fully captured under the quantitative-based assessment. The designated D-SIBs already meet the higher loss absorbency (HLA) requirements that D-SIBs must comply with to reduce the probability of distress or failure during periods of stress.

**Table 2.1: D-SIBs HLA Requirement**

D-SIBs	HLA Requirement (% of risk-weighted assets)
Malayan Banking Berhad	1.0
CIMB Group Holdings Berhad	
Public Bank Berhad	0.5

Source: Bank Negara Malaysia

Underpinned by healthy buffers, the banking system continues to be well-positioned to support credit flows to the real sector as the economy gradually begins to recover. Banking system loans recorded an annual growth of 4.1% as of June 2020, mainly driven by growth in outstanding business loans in the wholesale and retail trade, hotels and restaurants, and manufacturing sectors. Following the gradual relaxation of the MCO, high disbursements for working capital needs were recorded in June. There was also strong demand for loans under the Special Relief Facility (SRF) and other targeted funds for SMEs established by the Bank. Financing conditions have been further supported by lower borrowing costs following recent monetary policy easing. In contrast, demand for financing by households was generally weaker reflecting more uncertain income and employment prospects. Banks are expecting some recovery in household loan growth in the second half of 2020 amid low borrowing costs and improving labour market conditions.

<sup>8</sup> Refer to capital held in excess of regulatory minimum, which includes the capital conservation buffer (2.5%) and bank-specific requirements.

<sup>9</sup> Please refer to [https://www.bnm.gov.my/index.php?ch=en\\_press&pg=en\\_press&ac=4988&lang=en](https://www.bnm.gov.my/index.php?ch=en_press&pg=en_press&ac=4988&lang=en).