

Overview

The COVID-19 pandemic has placed a substantial strain on the global economy and financial system. As the number of infections and fatalities rose, movement controls and physical distancing measures including travel restrictions were widely implemented, affecting consumption and investment activity. This led to a marked deterioration in labour market conditions. Global financial conditions tightened significantly as the pandemic escalated in March and April, with sharp declines in prices of financial assets, a surge in bond yields amid rising vulnerabilities in global corporate credit markets, and an abrupt reversal in portfolio flows, particularly from emerging markets. In Malaysia, the implementation of the Movement Control Order (MCO) and weak external demand similarly led to a contraction in economic activity and heightened levels of domestic market stress.

The Malaysian financial system entered the crisis from a strong position, which has enabled it to support substantial relief measures and sustain intermediation activity to tide households and businesses through a highly challenging period. In particular, the resilience of banks at the core of the financial system has acted to absorb rather than amplify the macroeconomic shocks arising from the pandemic. Policy actions by policymakers to address market stresses have also helped stabilise financial conditions, along with the gradual lifting of lockdowns and signs of a recovery in global economic activity. Collectively, this has mitigated risks to domestic financial stability. Financial market volatility is, however, expected to remain elevated with renewed concerns over a resurgence in COVID-19 infections.

The financial health of businesses deteriorated across most sectors amid significant business disruptions and weak demand. While businesses have started to recover with the gradual easing of the MCO, the recovery remains uneven. Relief

measures introduced by the Government and banks are helping many businesses cope with temporary financial difficulties, although conditions will remain highly challenging in some industries. Despite the expected weakening in financial health, the aggregate indicator of the debt servicing capacity of non-financial corporates have remained above the prudent threshold, reflecting the reasonably healthy financial conditions prior to the pandemic. The pandemic has also taken a toll on household incomes and employment prospects, but most households have remained reasonably resilient. This is supported by comfortable financial buffers, particularly among the higher income group, and the generally prudent debt servicing levels of households.

More borrowers have been able to resume loan repayments in recent months with improvements in business and labour market conditions as economic activity gradually recovers. However, pockets of risk remain. Vulnerabilities will likely persist for some high-touch service industries and those that remain under strict constraints such as the tourism sector. Household borrowers who are more highly leveraged, with variable incomes, and/or employed in more adversely impacted sectors could also continue to face difficulties servicing their debt. With the automatic loan moratorium in place, aggregate banking system impairments and delinquencies have remained low, but are expected to increase in the period ahead.

Wide-ranging measures introduced by the Bank, in coordination with the industry, have been key in assisting individuals and businesses to weather this difficult period. The measures are focused on supporting the economy at large through the temporary shocks experienced, minimising long-lasting economic scarring, and supporting post-COVID-19 economic recovery, restructuring and reforms. The transition from a blanket moratorium

to more targeted repayment assistance measures would continue to extend temporary relief to viable borrowers that may still face challenges, while also improving visibility on loan performance for banks, which is a necessary condition to reduce risk aversion and encourage credit supply to support the economic recovery.

Conditions in the Malaysian property market were considerably weaker in 1H 2020. The combined effects of border closures, lower footfalls and more pervasive work-from-home arrangements are likely to amplify risks from pre-existing oversupply conditions in the non-residential property segment. While risks in the housing market have increased due to a deterioration in income and weaker demand conditions, the impact on overall financial stability remains largely mitigated by the sound quality of banks' existing housing loan exposures, measures by the Government to support housing demand, as well as the targeted assistance packages that will contain any large increase in housing loan defaults.

Despite a marked decline in earnings reported in 1H 2020, capital and liquidity buffers held by financial institutions remain high. In anticipation of a more challenging economic outlook, banks are taking additional measures to shore up their buffers, including capital retention measures. Along with the implementation of sound capital adequacy, liquidity and risk management standards over the years, this will preserve the ability of banks to continue supporting targeted assistance to borrowers and credit flows to the real sector as the economy recovers.

The pandemic presented new operational challenges which tested the agility of the crisis response arrangements of financial institutions and payment system operators. Critical operations of financial institutions largely continued to function within their recovery time objectives, while operational risk losses have remained low and stable during the period. Malaysia's payment systems also continued to operate smoothly without major disruptions, maintaining high system availability above 99.9%. Financial institutions and payment system operators have learnt crucial lessons from this experience and are taking steps to further enhance existing business continuity plans to improve their capacity to respond to future crises.

Under updated stress tests conducted by the Bank, banks are expected to remain resilient to potential economic and financial shocks that could still arise from the pandemic. While the Malaysian economy is expected to recover as business activities progressively normalise and external demand improves, the pace and strength of the recovery remain susceptible to multiple downside risks. This includes the prospect of subsequent waves of COVID-19 outbreaks leading to the re-imposition of containment measures. Persistent weakness in labour market conditions and a weaker-than-expected recovery in global growth are also factors that may affect the economy and financial stability. Under these conditions, a key priority will be preserving healthy financial buffers of banks to provide continued support to households and businesses, while reducing risk aversion that could amplify stresses in the economy.