



BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Financial Stability
Review
First Half

2024

F S R



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Preface

This Financial Stability Review – First Half 2024 provides Bank Negara Malaysia's assessment on current and potential risks to financial stability and the resilience of the Malaysian financial system to sustain its financial intermediation role in the economy. It also reports on any actions that have been taken to manage risks to financial stability and contains box article(s) on topics of special interest.

This publication is intended to promote greater awareness on issues and developments affecting financial stability.

This document uses data available up to 30 June 2024, unless otherwise stated.

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Key Highlights

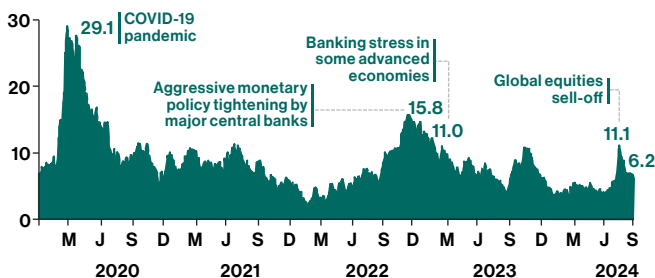
Financial Stability Review – First Half 2024

Domestic financial markets remained resilient despite heightened global market volatility

Market stress eased after a temporary global equity sell-off in August

Financial Market Stress Index (FMSI)

Stress level, % (Minimum=0, Maximum=100)

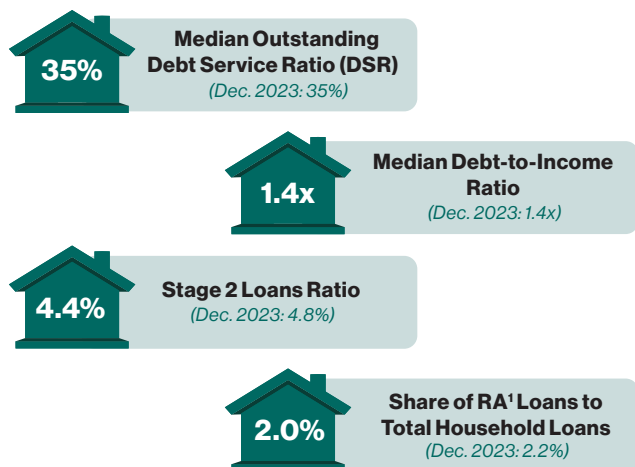


Orderly domestic market conditions continued to be preserved, supported by several key factors

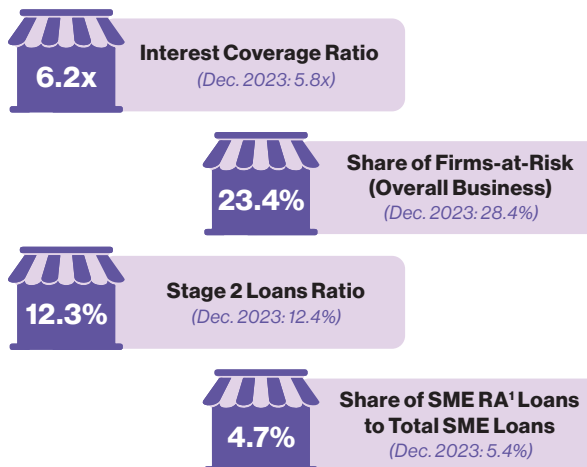
- Deep and liquid domestic capital markets
- Continued participation of domestic institutional investors
- Positive investor sentiment
- Manageable foreign exchange risk and adequate foreign exchange buffers

Credit quality of households and businesses remained sound, underpinned by favourable economic and labour market conditions

Households' repayment capacity continued to be sustained, with further improvements in loans with higher credit risks

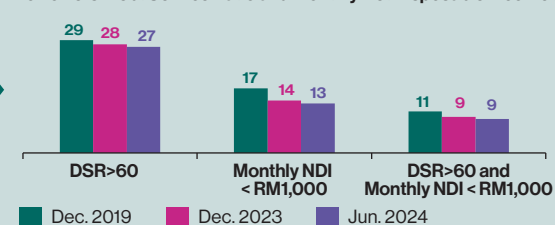


Businesses continued to demonstrate resilience



Overall household resilience is further affirmed by a lower share of borrowers that have both high DSR and low net disposable income (NDI)

Composition of Outstanding Borrowers in Default² and Distress³ by Borrowers' Debt Service Ratio and Monthly Net Disposable Income (%)



¹ Repayment assistance (RA) comprises restructured or rescheduled (R&R) programmes offered by banks and development financial institutions (DFIs) to both households and businesses respectively, as well as Credit Counselling and Debt Management Agency's (AKPK) Debt Management Programme (DMP) to households.

² Default is defined as loan accounts with three months or more in arrears.

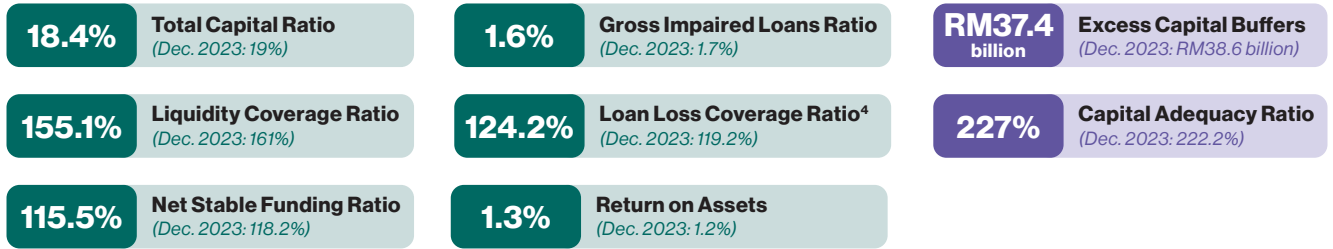
³ Distress is defined as loan accounts in delinquency or default, as well as loan accounts under repayment assistance from financial institutions or AKPK.

Financial institutions remained well-positioned to support financing and protection needs

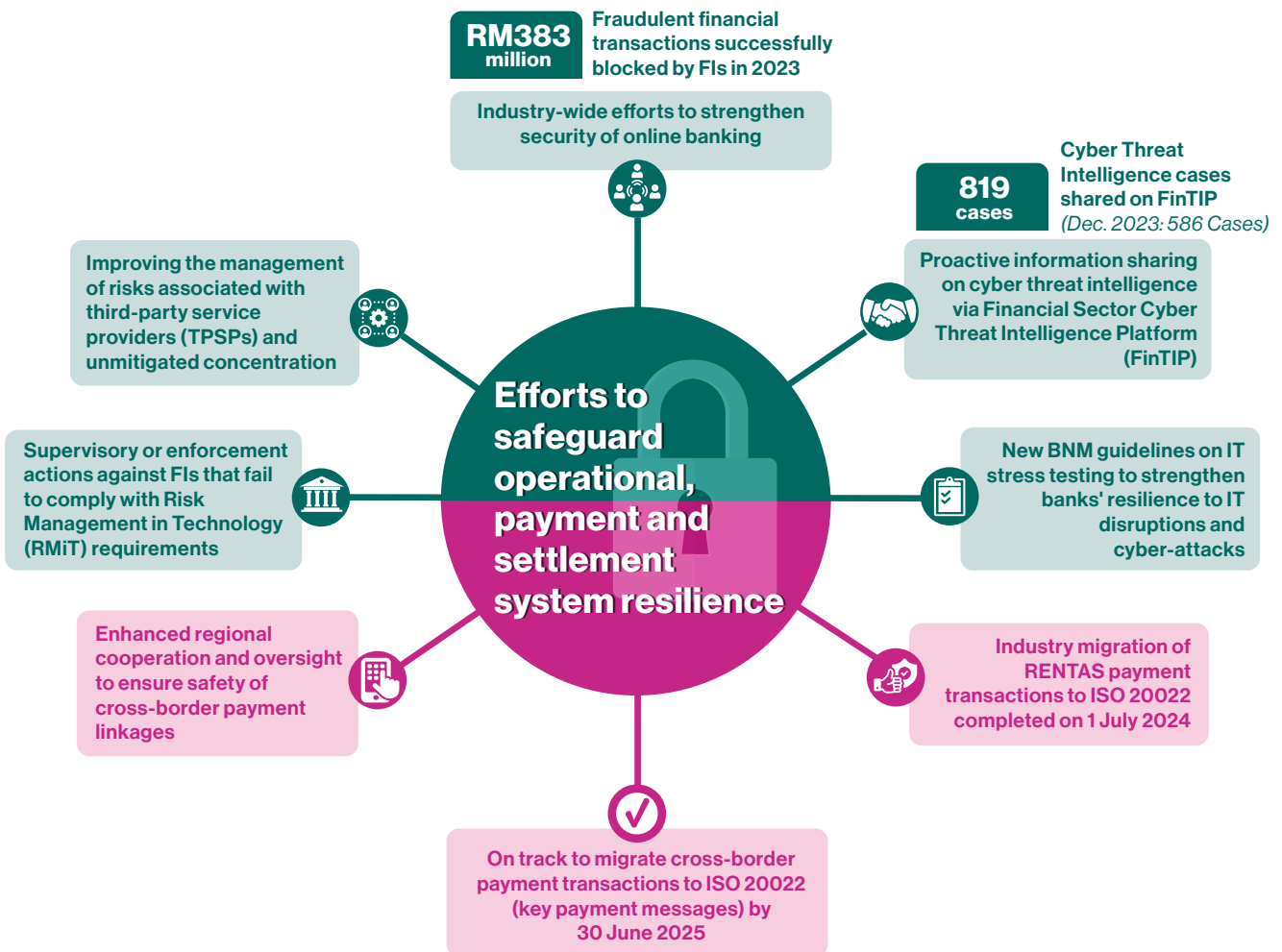
Banks maintained healthy capital and liquidity buffers...

... with potential loan losses expected to remain comfortably within available buffers

Insurers and takaful operators continued to be well-capitalised



Operational resilience remains a key priority for financial institutions (FIs)



⁴ Including regulatory reserves.

Overview



Overview

Global financial markets continued to experience heightened volatility through the second and third quarters of 2024 from shifting investor expectations as major central banks begin to ease monetary policy. Financial market volatility peaked in early August, amid fears of a 'hard landing' triggered by the release of weaker-than-expected US labour market data. Market expectations for earlier and more substantial rate cuts by the US Federal Reserve Board subsequently led to improved investor appetite for emerging market assets, including Malaysia. Domestic financial markets remained orderly with uninterrupted two-way flows in the bond and equity markets. Funding conditions remained favourable, supported by healthy liquidity in the government bond market and stable corporate bond credit spreads. In the domestic foreign exchange (FX) market, the ringgit continued to be primarily driven by external developments. Since the beginning of the year, the ringgit has appreciated by 11.4% against the US dollar.¹ Positive economic prospects and domestic structural reforms, complemented by ongoing initiatives to encourage foreign exchange flows, will continue to provide enduring support to the ringgit.

Business activities improved in the first half of 2024 in line with the recovery in both global and domestic economic conditions. Some business sectors continue to face challenges arising from continuing cost pressures and slower recovery in consumer demand in some product sub-segments. Businesses have remained generally resilient against these challenges. Measures of overall debt-servicing capacity of businesses remained healthy while the overall share of firms-at-risk has continued to decline to 23.4%. The overall credit quality of business loans remained sound with the impairment ratio remaining low at 2.6%. Banks remain vigilant over the loan performance of small and medium enterprises (SMEs) and continue to maintain prudent buffers against potential losses. So far, risks continue to be well contained. The share of SMEs with delinquent loans

has declined. SMEs that have exited repayment assistance programmes have also been able to sustain prompt loan repayments. Going forward, overall business resilience is expected to improve further in the second half of the year amid a sustained expansion in economic activity.

Household resilience continued to be supported by favourable economic and labour market conditions. The ratio of household debt-to-GDP stood at 83.8%, broadly unchanged since December 2023 as household debt grew in line with the pace of economic activity. Risks from buy now pay later (BNPL) schemes continue to be limited, with outstanding exposures remaining small at just over 0.1% of overall household debt. Further, banks' prudent lending standards continue to play an important role in keeping household debt accumulation in check and in line with debt-servicing capacity. During the period, household financial assets expanded at a faster pace and remained adequate to cover more than two times of overall household debt. Household borrowings that may be at higher risk of default decreased to 4.4% of total household loans (December 2023: 4.8%). Looking ahead, favourable economic and labour market conditions as well as sound lending standards will continue to underpin household resilience.

The banking system remained strong and well-positioned to withstand shocks and support financial intermediation. Banks continue to be well-capitalised, with the aggregate total capital ratio at 18.4% and excess capital buffers of RM136.1 billion as at end-June 2024. Funding and liquidity positions also remained sound as evidenced by the healthy Liquidity Coverage Ratio (155.1%) and Net Stable Funding Ratio (115.5%). Banks' profitability continued to be supported by sustained interest income amid stronger loan growth and higher trading and investment income. Improved operational efficiency further bolstered profitability and has helped cushion the impact of compressed net interest margins as well as supported banks' significant ongoing investments in

¹ Data as of 30 September 2024.

strengthening technology and cyber resilience. While asset quality has remained sound, banks continued to be cautious in releasing provisioning buffers built up during the pandemic. This has kept annualised credit costs broadly stable around pre-pandemic historical averages. Stress tests conducted by Bank Negara Malaysia (BNM) affirmed that banks remained resilient under adverse stress scenarios and are able to continue to meet the financing needs of the economy.

The insurance and takaful sector also maintained its resilience with an aggregate capital adequacy ratio of 227% and excess capital buffers of RM37.4 billion. Profitability improved due to higher net unrealised gains from the strong equity market performance and sustained investment income. New business premium growth provided further support. However, elevated medical benefit payouts continue to weigh on underwriting performance in the life and family takaful segment. General insurance and takaful operating profits were broadly sustained despite higher motor claims provisions, in line with robust business growth. Nevertheless,

exposure to climate events could see increased volatility in the performance of general insurers and takaful operators going forward.

Technology and cyber-related risks will continue to pose challenges to the management of operational risks within the financial system. Continuous efforts by financial institutions, including payment service providers, to reinforce their technology and cyber defences, and strengthen fraud controls, remain paramount to support the financial system's operational resilience. While financial losses from operational risks reported by financial institutions remained low, moderate disruptions to online banking services have called for stronger measures to ensure more robust incident response plans and closer monitoring of risks arising from a growing reliance on third-party service providers. BNM continues to raise standards expected of financial institutions in response to new and emerging threats. These include enhanced expectations on managing third-party risks, fraud countermeasures and information technology (IT) stress testing.

Key Developments in the First Half of 2024

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Key Developments in the First Half of 2024

MARKET RISK

Domestic financial markets remained orderly and resilient

Throughout the year, many major central banks have begun monetary policy easing as inflation continued to trend downwards, with the US Federal Reserve Board (Fed) the latest to follow suit. Global financial markets continued to experience heightened volatility through the second and third quarters of 2024, which peaked in early August amid fears of a 'hard landing' triggered by the release of weaker-than-expected US labour market data.¹ Since then, market expectations for earlier and more substantial rate cuts by the Fed² have improved investors' appetite for assets of emerging markets, including Malaysia. Nevertheless, uncertainties remain as investors stay vigilant ahead of the US presidential election and ongoing geopolitical risks.

Domestic financial markets have continued to remain orderly. Overall domestic market stress, as measured by the Financial Market Stress Index (FMSI), rose briefly in early August following a temporary sell-off in global equities on US recession fears, but has since stabilised below 10% (Chart 1.1). Throughout the period,³ market volatility was driven mainly by the foreign exchange (FX) markets amid the appreciation of the ringgit exchange rate against the US dollar as investors' appetite for Malaysian assets improved. Financial asset mispricing risks from a higher-for-longer interest rate environment have receded somewhat given clearer signals from major central banks on the path to unwinding tight monetary policy as well as stronger-than-expected economic outturns supporting a positive outlook for the domestic economy.

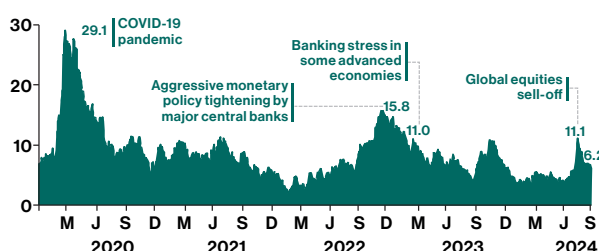
¹ The continued unwinding of Japanese yen carry trades since end-July amid the strengthening of the Japanese yen has further amplified market volatility. A carry trade is an investment strategy where investors borrow a low-interest rate currency and then use that to purchase a higher yielding currency to gain from the interest rate differential, usually with a view that the funding currency will continue to depreciate.

² Following a 50-bps rate cut by the Fed on 18 September 2024, market participants priced in another 75-bps cut for the rest of the year, higher than the Fed officials' median forecast of another 50-bps cut.

³ All data and assessments in the Market Risk section are as at 20 September 2024, unless stated otherwise.

Chart 1.1: Financial Market – Financial Market Stress Index (FMSI)

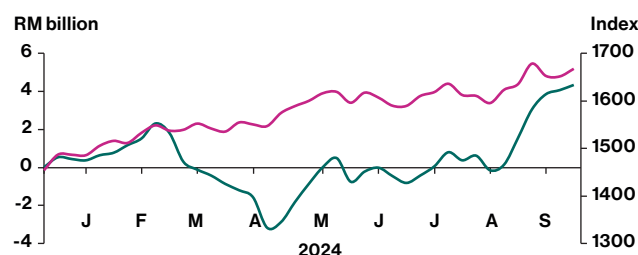
Stress level, % (Minimum=0, Maximum=100)



Source: Bloomberg, Reuters and Bank Negara Malaysia estimates

The domestic equity market has staged a strong recovery since the start of this year, with the benchmark FBM KLCI gaining 7.6% since the last Review in March. This has been supported by non-resident net inflows of RM4.3 billion for the year-to-date, reflecting positive investor sentiment on domestic growth prospects (Chart 1.2). The construction, utilities and property sectors benefitted significantly from investments in data centres and the continued implementation of mega infrastructure projects and national master plans. Financial stocks also gained on sustained earnings. Domestic institutional investors (DIIs)⁴ continued to provide firm support to domestic equities with a net purchase of equities amounting to RM3.0 billion between March and September 2024 (March-20 September 2023: RM2.3 billion, 2015-19 annual average: RM8.2 billion).

Chart 1.2: Financial Market – Cumulative Non-resident Equity Flows and Performance of the Domestic Equity Market



— Cumulative non-resident equity flows — FBM KLCI (RHS)

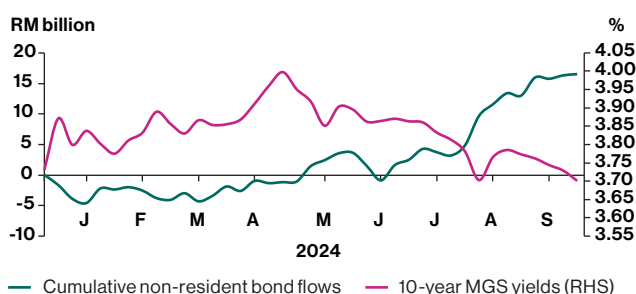
Source: Bloomberg

⁴ Domestic institutional investors include banks, non-bank financial institutions (NBFIs) and insurers and takaful operators (ITOs).

Non-resident flows in the government bond market continued to be largely influenced by external factors

The 10-year Malaysian Government Securities (MGS) yields peaked in April before trending downwards, tracking broad declines in global bond yields. The 10-year MGS yields traded at 3.71%, remaining broadly unchanged compared to its level at the beginning of the year. Non-residents recorded inflows into sovereign bonds amounting to RM20.6 billion from March to September 2024 (September 2023 to February 2024: -RM2.7 billion), reflecting investor expectations of more attractive relative returns of emerging market bonds in anticipation of lower US Treasury yields (Chart 1.3). During this period, yield differentials between 10-year MGS and 10-year US Treasuries (UST) narrowed to -4 basis points (bps) (end-February 2024: -38.6 bps). Importantly, the share of bond holdings by non-resident investors typically regarded as more stable has remained broadly unchanged. This will continue to mitigate excessive volatility in market conditions. Market liquidity remained healthy, with sustained demand for government bonds in the primary market as evidenced by the healthy weighted average bid-to-cover ratio of 2.4 times. This is further supported by Dlls' continued active participation in both the primary and secondary markets.

Chart 1.3: Financial Market – Cumulative Non-resident Government Bond Flows and Performance of the Domestic Government Bond Market



Source: Bank Negara Malaysia and Bloomberg

Funding conditions in the corporate bond market remained healthy. The yields for 10-year AAA-rated corporate bonds declined by 19 bps between January and September, enabling corporates to tap the bond market for funding at a more attractive level. Total gross issuances amounted to RM56.9 billion between March and July 2024 (March-July 2023: RM56.8 billion), mostly in government-guaranteed (GG) and AAA-rated papers. Overall, credit quality of outstanding corporate bonds remains high, with GG and AAA-rated papers accounting for more than half of the outstanding size.

Movements in the ringgit remained largely driven by global developments, including the changing expectations on the timing and magnitude of reduction in the US Federal Funds Rate (FFR) and geopolitical concerns that continued to drive the US dollar strength. Between January and end-September, the ringgit strengthened by 11.41% against the US dollar to 4.1235. This was mainly driven by the greater clarity surrounding the trajectory of the US FFR reduction. Firm improvements in the performance of the domestic economy and the positive impact from the implementation of domestic structural reforms, such as the New Industrial Master Plan (NIMP) and National Energy Transition Roadmap (NETR), also provided support for the ringgit. While ringgit volatility has increased to 6.44%⁵ following the strong appreciation of the currency, it remains manageable and remains close to the 10-year average of 5.76%. FX turnover volume has also improved, reflecting more balanced flows, with the year-to-date daily average volume increasing to USD17.6 billion (2023 daily average: USD15.5 billion).

Global financial market conditions in the remainder of the year remain susceptible to continued uncertainty over the pace of the Fed's monetary policy easing and slower growth momentum in major economies. The escalation of geopolitical and trade tensions, and materialisation of risks arising from country-specific vulnerabilities could renew heightened volatility in global and domestic financial markets. Notwithstanding this, Malaysia's strong banking system, deep financial markets and diversified investor base will continue to support orderly domestic market conditions.

⁵ Implied volatility based on USDMYR 1-month at-the-money options as at 30 September 2024.

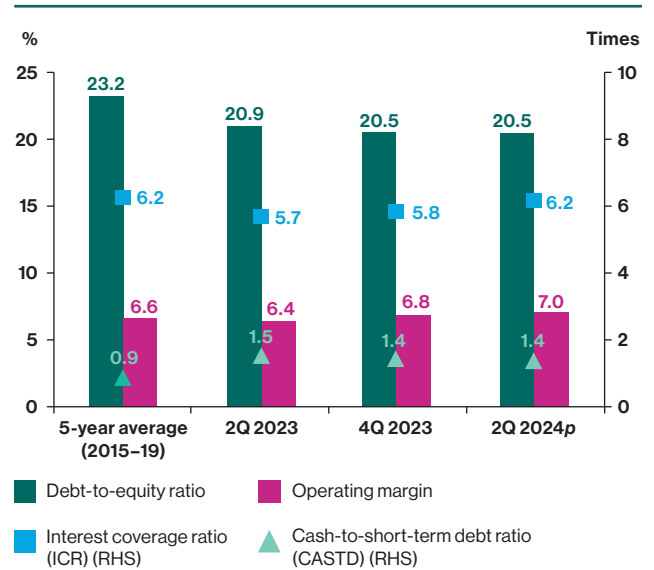
CREDIT RISK

Business activities improved, supported by recovery in economic conditions

Business activities improved in the first half of 2024, supported by the recovery in exports and firm domestic demand conditions. Export-oriented companies benefitted from a recovery in external demand and the global tech upcycle. The continued increase in tourist spending improved earnings for firms in the hotels and restaurants subsector. Earnings for firms in the commodity-related and utility sectors were also stronger on the back of higher production, tariff adjustments⁶ and stabilising cost conditions. The recovery in operating margins for most firms has been sustained and remained above their pre-pandemic levels despite ongoing cost pressures. These improvements in business conditions have continued to sustain the debt-servicing ability of businesses, as measured by the median interest coverage ratio⁷ (ICR) of 6.2 times (Chart 1.4).

Firms continued to face general cost pressures which have capped overall improvements in earnings. These include higher logistical and compliance costs amid ongoing geopolitical tensions, the rationalisation of diesel subsidies and the implementation of e-invoicing.⁸ However, this was partially offset by accompanying mitigating measures such as the availability of diesel fleet cards for key business segments. As a result, aggregate input costs, as measured by the median cost of goods sold ratio,⁹ declined slightly for overall businesses to 76.3% (December 2023: 76.7%; 2015–19 average: 75.9%).

Chart 1.4: Business Sector – Key Financial Performance Indicators



p Preliminary

Note: Prudent thresholds for ICR and CASTD are two times and one time respectively.

Source: S&P Capital IQ and Bank Negara Malaysia estimates

Business performance also remains somewhat uneven across segments, with firms in some segments continuing to face weaker earning prospects. Businesses in the wholesale and retail, and primary-related manufacturing¹⁰ sectors recorded lower profit margins in the first half of the year. Apart from cost pressures that continued to weigh on margins, consumer demand in some segments of non-essential products have also yet to recover to pre-pandemic levels. Smaller firms in the construction sector were also affected by fewer new project starts as existing ones near completion. The share of firms-at-risk¹¹ in these sectors remains elevated relative to their pre-pandemic levels, although stronger economic activity has improved overall ICRs and contributed to fewer firms-at-risk compared to the fourth quarter of 2023 (Chart 1.5). Debt-servicing ability, including for firms in sectors still facing headwinds, has been further supported by healthy cash buffers with the cash-to-short-term debt ratio above historical levels (Chart 1.6).

⁶ The water tariff adjustment for domestic users in Peninsular Malaysia and the Federal Territory of Labuan took effect on 1 February 2024, involving an average increase of 22 sen per cubic meter (source: National Water Services Commission, SPAN).

⁷ Prudent threshold for interest coverage ratio is two times.

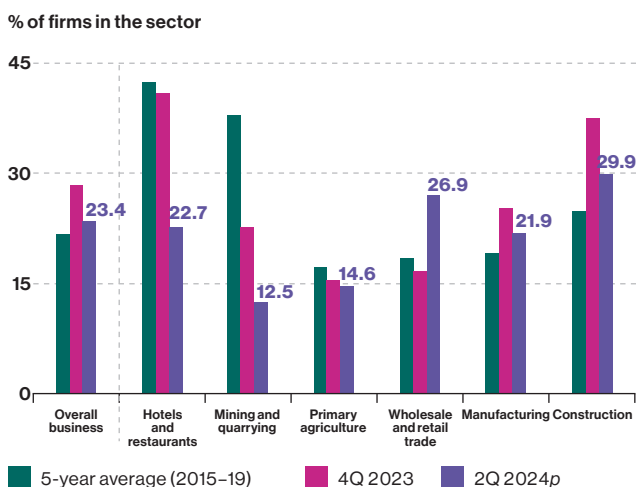
⁸ The first stage of e-invoicing implementation starts in August 2024 and is mandatory for businesses with annual revenue of more than RM100 million.

⁹ Cost of goods sold (COGS) ratio is calculated by taking a firm's COGS divided by its revenue. A higher ratio indicates that COGS makes up a higher proportion of revenue.

¹⁰ Primary-related manufacturing subsectors include the manufacturing of furniture, wood, paper, rubber and plastic products.

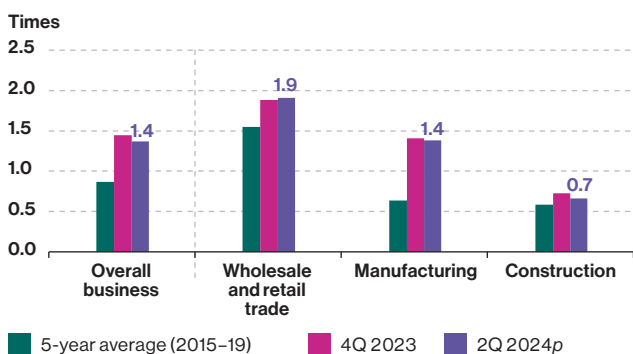
¹¹ Firms-at-risk refers to firms with interest coverage ratio below the prudent threshold of two times.

Chart 1.5: Business Sector – Firms-at-risk for Selected Sectors



p Preliminary
Source: S&P Capital IQ and Bank Negara Malaysia estimates

Chart 1.6: Business Sector – Cash-to-Short-term Debt for Selected Sectors



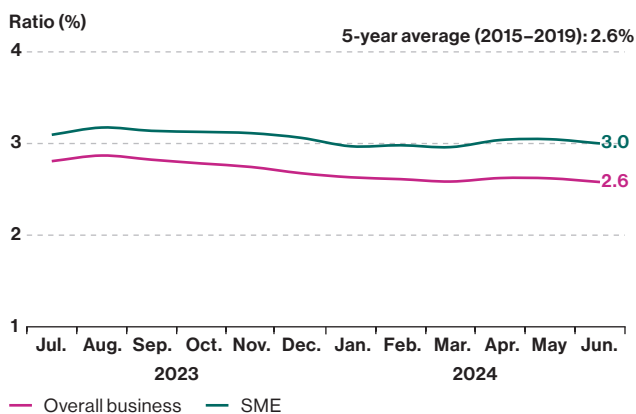
p Preliminary
Source: S&P Capital IQ and Bank Negara Malaysia estimates

The credit quality of business loans continues to be generally sound. The overall business loan impairment ratio remained stable at 2.6% of business loans (Chart 1.7). Leading indicators of loans with significant increase in credit risks (Stage 2 loans) have also been stable (June 2024: 12.3% of business loans; December 2024: 12.4%). The share of small and medium enterprises (SME) that were delinquent¹² on their loans declined further to 1.7% of total SME loans (December 2023: 2%). Consistent with this, SME loans under repayment assistance continued to trend lower to 4.7% of total SME loans (December 2023: 5.4%), or 0.8% of total banking system and development financial institution (DFI) loans. Banks remained proactive in identifying and offering rescheduling and restructuring

¹² Refers to loans with one or two months in arrears, or between 30 and 90 days past due.

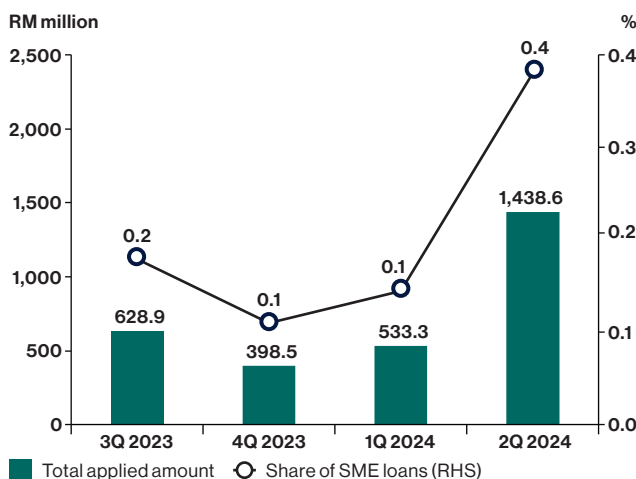
(R&R) programmes that are facing temporary financial difficulties, and have further improved coordination with the Credit Counselling and Debt Management Agency (AKPK) to refer distressed borrowers with multiple bank relationships to AKPK. This partly explained the notable increase in the amount of SME loans enrolled into AKPK’s repayment assistance schemes (RAS) for small businesses, although the share of debt managed under the schemes remains very small at only 0.4% of total SME loans (Chart 1.8). Higher RAS applications were also attributed to AKPK’s increased outreach programmes this year which helped raise awareness among SMEs on avenues available for them to seek help to manage their debt. The vast majority of SMEs that have exited repayment assistance have been able to resume and sustain prompt repayment of their loans. New R&R enrolments by banks and DFIs also continued to remain small at 0.2% of total SME loans.

Chart 1.7: Business Sector – Gross Impaired Loans



Source: Bank Negara Malaysia

Chart 1.8: Business Sector – SME Applications for AKPK Repayment Assistance



Source: Bank Negara Malaysia

The credit quality of borrowings of larger corporates remained stable amid firm economic growth. The median ICR for the top 50 percentile of listed firms (by asset size) was comfortably above the prudent threshold at 6.2 times (December 2023: 5.8 times). The quality of corporate bond issuers also remained strong, with fewer issuers (five compared to seven issuers in 2023) or 0.8% of total outstanding domestic corporate bonds, downgraded in the first half of 2024.

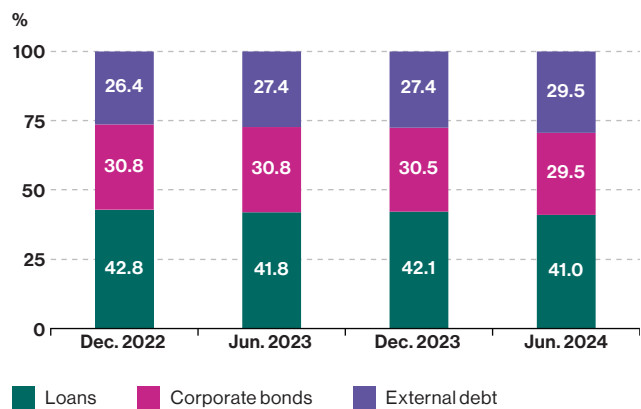
Corporates' external borrowings increased in the first half of the year, mainly driven by trade credit and intercompany loans to fund existing operations and business expansions. Risks arising from these exposures remained manageable given the self-liquidating nature of trade credits and more flexible terms of intercompany loans. Meanwhile, despite higher volatility associated with movements in the ringgit experienced during the first half-year, currency risks from non-financial corporate external debt were largely mitigated. Close to 80% of large resident corporate external exposures¹³ are hedged either naturally or financially. Corporate external exposures also remained adequately covered by assets, with the external asset to debt coverage ratio of 1.1 times.

Financing conditions continued to be supportive of economic activity with businesses, including large corporates, continuing to deploy a healthy mix of funding sources between loans and bonds (Chart 1.9). Business loans grew by 5.7% (December 2023: 3.7%), driven by higher growth in both investment-related and working capital loans. Over 50% of new bank financing to businesses in the first half of the year was also directed towards climate-supporting and transition activities, with banks continuing to play a pivotal role in supporting business financing for transition to greener and more sustainable practices. Additionally, activities in the

corporate bond market remained robust with broad-based issuances across sectors by firms of high credit standing. This was supported by favourable costs of raising funds with corporate bond yield spreads (over MGS) remaining stable and lower compared to pre-pandemic averages.

Looking forward, business resilience is expected to improve further in the second half of the year amid a sustained expansion in economic activity. Cost pressures are expected to moderate in line with lower commodity prices and the ringgit appreciation. Measures by the Government¹⁴ to mitigate the impact of higher business costs from the targeted implementation of fuel subsidy rationalisation will further contain cost pressures. Downside risks to business resilience will continue to stem mainly from external shocks, including weaker global growth outturns, geopolitical conflicts and financial market volatility that could lead to higher input prices and dampen earnings growth.

Chart 1.9: Business Sector – Composition of Debt by Type



Source: Bank Negara Malaysia

¹³ Corporate external exposures comprise of borrowings from non-related entities, bonds and notes only (excluding low risk external debt such as intercompany loans which are normally more flexible and trade credits which are backed by export earnings).

¹⁴ These measures include the availability of fleet cards provided under the Subsidised Diesel Control System 2.0 (SKDS 2.0) for approved logistics vehicles.

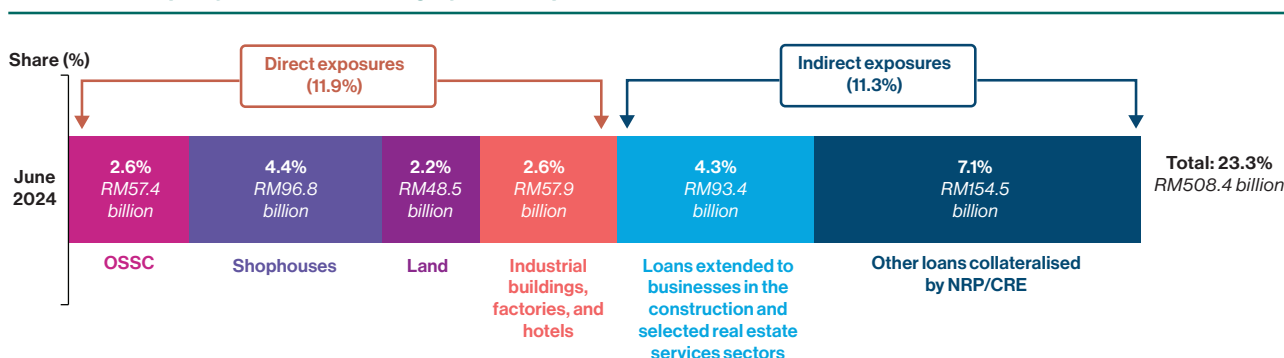
Developments in the Non-Residential Property Market

Commercial real estate (CRE) markets drew renewed attention globally over the past year as weak market conditions in several jurisdictions led to heightened concerns over the quality of banks' CRE exposures. As economies transitioned into an environment of higher interest rates, many borrowers who had taken out CRE loans during the preceding period of exceptionally low interest rates struggled to cope with higher borrowing costs. This problem was especially prevalent in the office and retail space segments where rental incomes could not keep up with now-higher loan repayments, precipitating concerns over a possible wave of defaults. These segments were further beset by post-pandemic remote working and consumption trends which affected demand for office and commercial retail space. As losses on CRE loans emerged, concerns have increased over the health of banks with large CRE exposures, as well as broader spillovers from tighter credit conditions and a sharp correction in commercial property prices.

In Malaysia, pre-existing vulnerabilities in the non-residential property (NRP)¹⁵ sector continue to be an area of focus in Bank Negara Malaysia's (BNM) surveillance of financial stability risks. The bulk (51%) of NRP exposures of banks in Malaysia is in the form of end-financing for the purchase of NRP. As at end-June 2024, direct end-financing exposures to NRP accounted for 11.9% of total outstanding banking system loans (Chart 1.10). Of this, over half (56%) of NRP end-financing by banks is for the purchase of land and shophouses which presents substantially lower risks. Unlike shopping complexes, shophouses are mostly purchased by households and SMEs for their own business activities and living, and thus have been observed to exhibit risks comparable to owner-occupied residential properties (Chart 1.11). Meanwhile, banks typically apply very conservative practices for the purchase of land, with a median outstanding loan-to-value (LTV) ratio of only 37% (overall NRP financing: 52%).

The office space and shopping complex (OSSC) subsegments which tend to be of higher risk represent a much smaller share of 2.6% of total banking system loans.¹⁶ Past Financial Stability Reviews¹⁷ have highlighted risks from the persistent oversupply in these subsegments which have led to depressed rental yields and elevated vacancy rates which pre-dated the pandemic, and have since deteriorated further especially for office spaces (Chart 1.12). As a result, the impairment ratio for exposures to the OSSC subsegment (June 2024: 2.1%) has been consistently higher than the overall NRP segment (June 2024: 1.6%).

Chart 1.10: Property Market – Banking System Exposure to NRP



Note: Figures may not add up due to rounding.

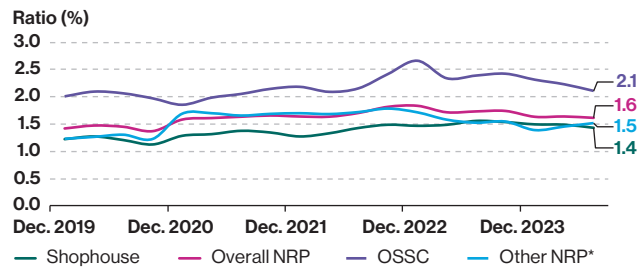
Source: Bank Negara Malaysia

¹⁵ When discussing the Malaysian market in this box, we use the term 'non-residential property' which covers the office space & shopping complex (OSSC) segments and shophouses (which are typically classified as CRE in Malaysia), in addition to other non-residential exposures such as industrial buildings and land purchases.

¹⁶ Shopping complexes only: 1%; office space only: 1.6%.

¹⁷ Refer to the section on 'Risk Developments and Assessment of Financial Stability – Credit Risk' in the BNM Financial Stability Review for Second Half 2019 for further details.

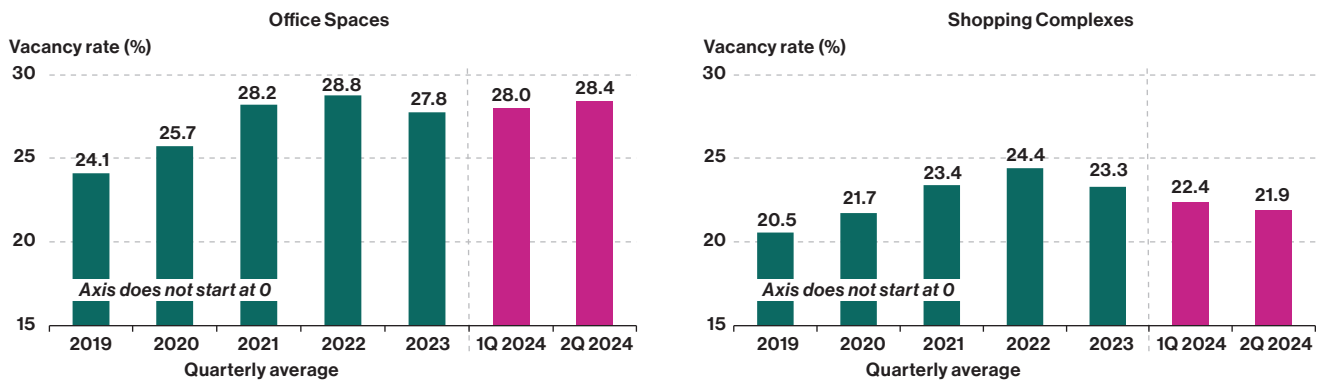
Chart 1.11: Property Market – Loan Impairment by Type of Property Purchased



* Refers to loans for the purchase of industrial buildings, factories and land.

Source: Bank Negara Malaysia

Chart 1.12: Property Market – Vacancy Rate of Office Spaces and Shopping Complexes



Source: National Property Information Centre (NAPIC) and Bank Negara Malaysia estimates

Risks to banks from direct NRP exposures continue to be limited. As noted earlier, banks' end-financing exposures to the higher-risk OSSC subsegment remain small and have been declining over the years (June 2024: 2.6%; December 2019: 3.2%; December 2013: 4%). The median LTV ratio on outstanding NRP financing also remains prudent at 52% (OSSC subsegment only: 59%). This provides substantial buffers against a significant price correction, although risks of this occurring are expected to recede further with the continued expansion of economic and business activities. Moreover, almost all NRP financing in Malaysia are amortising loans¹⁸ over the financing tenure. This further reduces risks to both banks and borrowers by allowing for better monitoring and management of debt over the loan tenure compared to loans that are structured under bullet repayment terms.

Banks are also exposed to risks from indirect NRP exposures. This can arise from bridging loans and working capital loans extended to businesses in the construction sector and selected real estate services. Such exposures have remained a relatively small share (4.3%) of total banking system loans. A more significant source of indirect risks is that associated with loans for other purposes (typically working capital) that are collateralised by NRP. These exposures account for 7.1% of total outstanding banking system loans. The performance of these loans continues to be primarily driven by the financials of businesses. This reflects banks' lending practices that prioritise the borrower's ability to repay the loan from its ongoing business cashflow rather than a reliance on the underlying collateral. They are therefore shielded from adverse developments in the NRP sector as long as the borrower's core business activities continue to perform.

¹⁸ Amortising loans are loans which require borrowers to repay both principal and interest gradually over a regular repayment schedule.

Quality of household borrowings remained intact, supported by favourable economic and labour market conditions

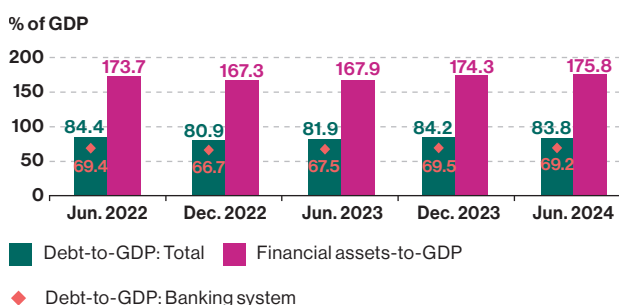
The aggregate household debt-to-GDP and banking system household debt-to-GDP ratios stood at 83.8% and 69.2% respectively (Chart 1.13), broadly unchanged as household debt¹⁹ continued to expand in line with economic activity in the first half of 2024 (Chart 1.14). Housing loan growth was sustained by robust demand for residential property and the continued availability of government support measures to encourage homeownership (see Information Box on ‘Developments in the Residential Property Market’). Car loans, meanwhile, expanded faster on the back of higher passenger vehicle sales, including electric and hybrid models, compared to the first half of 2023.

Unsecured financing by households, comprising credit card debt and personal financing, remained stable at 15.2% of total household debt as at June 2024 (December 2023: 15.5%) (Chart 1.15). Outstanding credit card debt declined slightly but remains above pre-pandemic levels. This corresponds to the higher usage of credit cards as a payment instrument rather than an indication of higher debt accumulation. Revolving balances as a proportion of outstanding credit card balances remain well below pre-pandemic levels (June 2024: 48.5%; December 2023: 47.9%; 2015–19 average: 60.6%). Credit card cash advance transactions have also trended lower at 1.2% of total card transactions (December 2023: 1.3%; 2015–19 average: 2.2%). Despite ongoing cost of living pressures faced by lower-income households, personal financing growth has remained modest across most income segments. This is consistent with continued positive income growth and a lower share of households reporting difficulties in meeting monthly expenditures.²⁰

Over the past year, buy now pay later (BNPL) schemes have continued to gain traction. As at end-June 2024, users of BNPL schemes have increased to 4.3 million active users, a 27.6% increase since end-December 2023. Young and middle-aged adults make up over 90% of the active user base. With wider familiarity, demand for BNPL schemes is expected to increase further. However, risks to financial

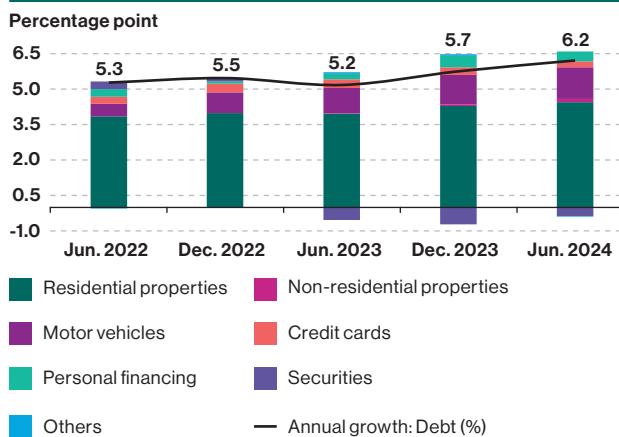
stability are currently assessed to be limited on account of low credit limits leading to predominantly low-value transactions,²¹ short financing tenures (typically between one and three months), expectations²² of providers to conduct affordability assessments for higher risk transactions, and prudent measures²³ observed by providers to avoid excessive debt burdens when repayment difficulties emerge. Consistent with this, outstanding BNPL exposures as a share of overall household debt remain small at just over 0.1% as of June 2024. The share of overdue²⁴ BNPL financing is also low and declining at 2.6% of total exposures (December 2023: 3.4%).

Chart 1.13: Household Sector – Key Ratios



Source: Bank Negara Malaysia, Bursa Malaysia, Department of Statistics, Malaysia, Employees Provident Fund and Securities Commission Malaysia

Chart 1.14: Household Sector – Annual Growth of Debt

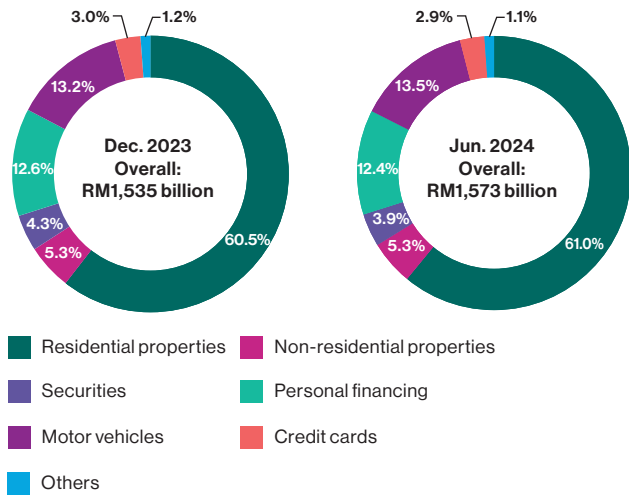


Source: Bank Negara Malaysia

¹⁹ Extended by both banks and non-bank financial institutions.
²⁰ Based on BNM’s monthly Consumer Sentiment Survey (CSS). The survey aims to gauge general economic and financial sentiments and expectations of Malaysian households on a variety of topics such as household financial positions, labour market developments and cost of living. The survey is based on a representative sample of households across all income levels nationwide. In the July 2024 CSS, the share of households reporting difficulties in meeting monthly expenditures decreased to 40% from 43% in December 2023.

²¹ About 80% of active BNPL users have a credit limit of RM3,000 or less, while the average transaction value was RM75 in the first half of 2024.
²² Providers adopt an affordability threshold (AT), above which an affordability assessment must be carried out. The AT serves to prevent users from accumulating unaffordable debt. Currently, the AT is set at RM1,000 per user of each non-bank provider. However, a lower AT may be set for a specific segment of users with higher credit risk.
²³ Providers will automatically suspend accounts with any missed payments from being further utilised for new transactions until all arrears are fully settled.
²⁴ Refers to BNPL accounts with one or more days past due.

Chart 1.15: Household Sector – Composition of Debt by Purpose



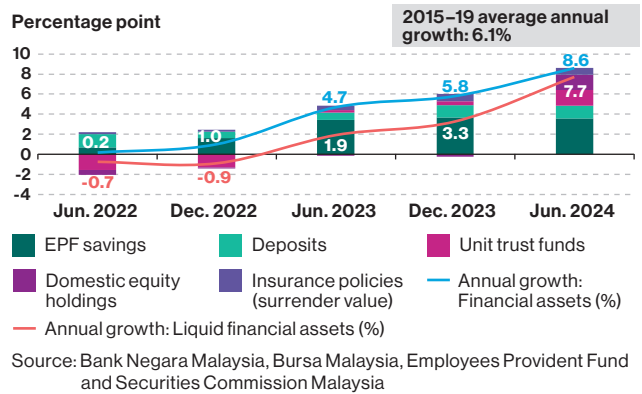
Note: Figures may not add up due to rounding.
Source: Bank Negara Malaysia

On aggregate, household balance sheets remain healthy. Household financial assets continued to outweigh household debt by 2.1 times. During the period, household financial assets expanded at a faster pace (8.6%; December 2023: 5.8%; 2015–19 average: 6.1%) (Chart 1.16), mainly driven by (i) higher Employees Provident Fund (EPF) balances and deposits on the back of favourable labour market conditions, and (ii) higher valuations of domestic equity holdings in line with the strong market performance of Bursa Malaysia. The introduction of a flexible account under EPF’s account restructuring initiative will further contribute to household resilience.²⁵ This initiative aims to strengthen retirement income security by raising income allocations that are set aside for retirement savings, while providing greater flexibility for members to access a part of their savings without restrictions to meet more immediate financial needs as necessary. As of July 2024, household retirement accounts were bolstered by RM5.6 billion, while RM12.6 billion was placed in flexible accounts that can be drawn upon by households when needed following the one-time permitted transfers effected by members. The increase in household retirement savings saw an additional 43,000 members achieve Basic Savings.²⁶

²⁵ Through the restructuring initiative, members’ savings will now be distributed among Akaun Persaraan (75%), Akaun Sejahtera (15%), and Akaun Fleksibel (10%), shifting from the previous structure of Akaun 1 (70%) and Akaun 2 (30%).

²⁶ Basic Savings refers to a pre-determined amount in Akaun Persaraan set according to age, designed to enable members to achieve a minimum savings of RM240,000 by age 55.

Chart 1.16: Household Sector – Annual Growth of Financial Assets



Banks’ prudent lending standards continue to play an important role in keeping households’ debt accumulation in check and in line with debt-servicing capacity. Debt expansion continued to closely track income levels, resulting in relatively stable median debt-to-income (DTI) ratios among households (Chart 1.17). Higher-income borrowers (earning more than RM5,000 per month) remain the primary contributors to household debt growth, accounting for 72.1% of outstanding household debt (Chart 1.18). Prudent debt service ratios (DSRs) for newly approved and outstanding household loans continued to be observed at 41% and 35% respectively (December 2023: 41% and 35%), providing adequate buffers for households to meet their loan obligations. Reflecting better income conditions, the share of borrowers with high DSR (exceeding 60%) also continued to decline (June 2024: 24.1%; December 2023: 25.0% of total household borrowers). More than two-thirds of high-DSR debt is held by middle- and high-income borrowers who typically have larger financial reserves to sustain loan repayments in the event of financial shocks. Of the high-DSR borrowers, those that also have low net disposable income in level terms are considered more at risk. Signs of stress among such borrowers remain limited, with the value of loans with three or more month-in-arrears declining further (June 2024: 2.4%; December 2023: 2.9%; December 2019: 3% of total exposures) amid continued positive income growth (see Box Article ‘Looking Beyond DSR to Assess Households’ Debt-Servicing Capacity’).

Chart 1.17: Household Sector – Median Debt-to-Income Ratios by Income Group

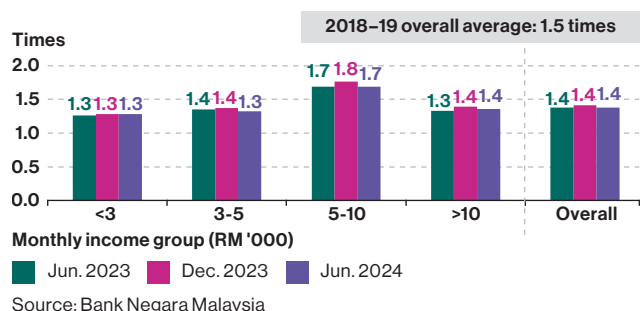
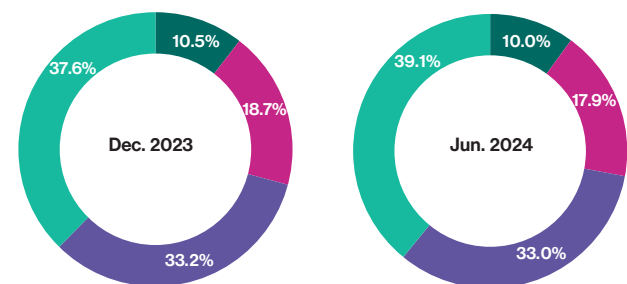


Chart 1.18: Household Sector – Composition of Banking System Debt by Income Group



Monthly income group (RM '000)

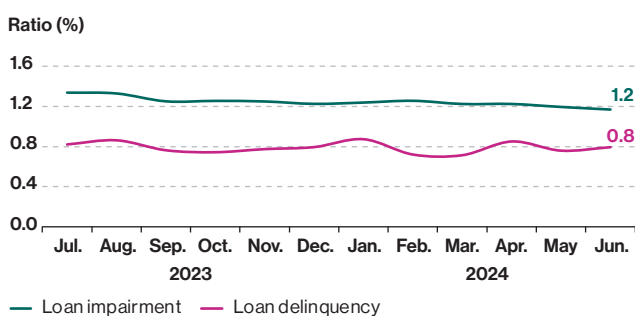
<3 3-5 5-10 >10

Note: 1. Figures exclude loan accounts with incomplete income information.
2. Figures may not add up due to rounding.

Source: Bank Negara Malaysia

The overall quality of household borrowings remained intact during the period, as the vast majority of borrowers continued to be able to service their debts (Chart 1.19). The share of household loans classified as Stage 2 (identified as having higher credit risk) decreased further to 4.4% (December 2023: 4.8%) reflecting sustained loan repayments by most households, including those that have exited repayment assistance programmes. Further, new signs of stress have been muted, as newly R&R household loans declined to RM3.3 billion in the first half of 2024 (2H 2023: RM 4.6 billion), equivalent to 0.1% of total banking system and DFI loans.

Chart 1.19: Household Sector – Loan Impairment and Delinquency Ratios in the Banking System



Source: Bank Negara Malaysia

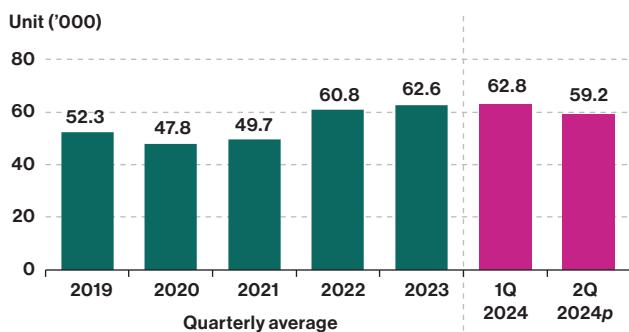
While banks have largely returned to their pre-pandemic R&R practices, borrowers who remain in need of further assistance but are ineligible for banks' R&R programmes are referred to AKPK for a more holistic debt restructuring assistance. Along with intensified outreach and awareness efforts undertaken by AKPK, this partly contributed to slightly higher enrolments into AKPK's Debt Management Program (DMP) in the first half of 2024. The total share of household borrowings under repayment assistance (banks' R&R and AKPK's DMP) however remains low at 2% of total banking system and DFI loans (December 2023: 2.2%).

Looking ahead, favourable economic and labour market conditions as well as sound lending standards will underpin the sustained debt repayment capability of households. Cost of living pressures could continue to challenge some households with pre-existing vulnerabilities (e.g. from lower-income segments), but any impact on broader financial stability risks is expected to be well contained. Amid improving economic conditions, prospects of further subsidy rationalisation initiatives that are paired with mitigating measures by the Government (in the form of cash transfers and other targeted assistance to lower-income borrowers) is also not expected to materially affect household financial resilience.

Developments in the Residential Property Market

Housing market transactions were broadly sustained above pre-pandemic levels in the first half of 2024 (Chart 1.20). The mass-market segment (houses priced RM500,000 and below) continued to be the primary driver of activity, accounting for almost 80% of total transactions during this period. Demand has been further supported by stamp duty exemptions under the Malaysian Home Ownership Initiative (i-Miliki) that remain in place for first-time home buyers purchasing residential properties valued at RM500,000 and below until end-2025. Furthermore, over 60% of new launches in 2023²⁷ were in the RM500,000 and below price category. This is a positive development towards improving supply-demand mismatches that reduce housing affordability and contribute towards higher household debt. The stock of unsold housing units (Chart 1.21), however, inched upwards in recent months (June 2024: 134,170 units; 2015–19 average: 130,210 units), driven by an increase in unsold units under construction. This appears to reflect a pick-up in new launches post-pandemic in line with the recovery of the housing market. Meanwhile, completed units that remain unsold continued to decline.²⁸

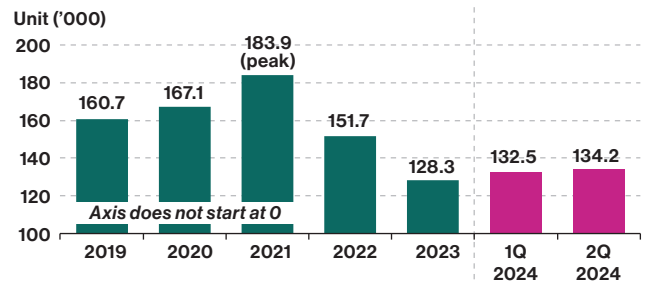
Chart 1.20: Property Market – Housing Transaction Volume



p Preliminary

Source: National Property Information Centre (NAPIC)

Chart 1.21: Property Market – Volume of Unsold Housing Units



Note: Figures include both overhang and unsold under construction for residential, serviced apartments and small office, home office (SOHO) units.

Source: National Property Information Centre (NAPIC) and Bank Negara Malaysia estimates

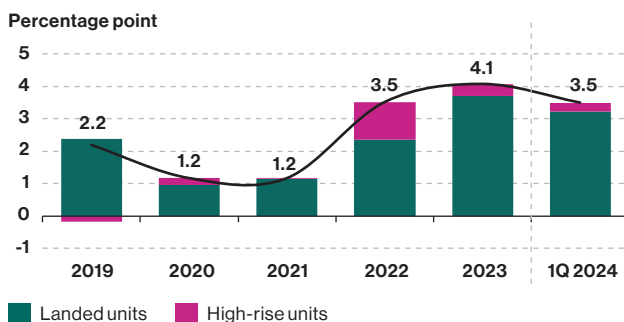
House prices expanded at a moderate pace of 3.5% in the first quarter of 2024 (4Q 2023: 3.8%), largely driven by higher prices for landed properties (Chart 1.22). Properties in the high-rise segment continued to exhibit weaker and more volatile price movements. This may be attributed to several factors, including a higher elasticity of supply compared to landed properties and a persistent overhang of unsold units. Of late, a notable development has been the rising popularity of serviced apartments which are constructed on commercial-titled land, allowing for denser developments. Imbalances could build up fairly quickly in this segment if the rate of supply significantly outstrips demand and purchases are fuelled by inflated expectations of price appreciation. Recent efforts by the National Property Information Centre (NAPIC) to collect and publish price data on the serviced apartment segment are both welcome and timely to promote better-informed purchasing decisions among market participants. At present, the serviced apartment segment remains relatively small (6% of total dwelling stock) compared to traditional high-rise properties (28.7% of total dwelling stock).²⁹

²⁷ Preliminary data for first half of 2024, which may be revised over the next two quarters, indicates that 63% of new launches were priced at RM500,000 or below.

²⁸ Unsold units under construction refer to properties that have been on the market for at least nine months after launch but are still under construction. Overhang units denote properties that are unsold for at least nine months after launch but are completed and have received a Certificate of Completion and Compliance.

²⁹ This calculation includes serviced apartments as part of the overall dwelling stock. Serviced apartments are however excluded from NAPIC's residential property statistics.

Chart 1.22: Property Market – Malaysian House Price Index (MHPI) Growth by Type

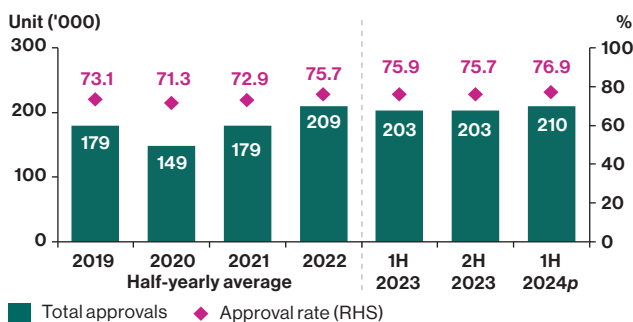


Note: High-rise units include condominiums, apartments and flats but exclude serviced apartments.

Source: National Property Information Centre (NAPIC) and Bank Negara Malaysia estimates

Financing for residential property purchases remained forthcoming, with stable growth in loan applications and approvals in the first half of 2024 (Chart 1.23). Outstanding housing loan growth (June 2024: 7.5%; December 2023: 7.3%) continued to be primarily driven by owner-occupiers, who accounted for 76% of the increase in outstanding loans over the past year. The share of new loans associated with investment purchases (proxied by borrowers with two or more housing loans) increased slightly (June 2024: 24%; December 2023: 23%) amid the improvements in market activity and continued strong competition among lenders that has kept lending rates low (average lending rate in 1H 2024: 4.1%; 2H 2019: 4.4%). This contributed to a higher-than-average level of housing transactions. Despite these observations, speculative activity in the property market remains contained. Notably, the number of borrowers with three or more housing loans has been on a downtrend with consecutive negative annual growth over the last three quarters. As of June 2024, such borrowers form a very small share of all housing loan borrowers at 2.9%.

Chart 1.23: Property Market – Volume of Approvals and Approval Rate for Housing Loans



p Preliminary

Note: Approval rate calculated based on volume of approvals.

Source: Bank Negara Malaysia

The median loan-to-value (LTV) ratio of overall outstanding housing loans remained prudent (June 2024: 68.9%; December 2023: 68.2%), providing comfortable buffers for banks and borrowers against possible corrections in house prices. Prudent LTV ratios were also observed for the high-rise segment (median outstanding LTV ratio: 69.8%). Under current relatively stable market conditions and sustained repayment capacity of households, risks of a broad-based, steep and sudden correction in house prices remain low. Nevertheless, a lack of transparency over the provision of discounts and rebates for the purchase of new properties could distort LTV calculations where such discounts and rebates are not disclosed to financing banks, increasing residual risks to banks and borrowers. Recent engagements with market players and industry professionals suggest that where such practices are present, actual LTVs could be eight to 33 percentage points higher than reported LTVs. Potential risks are compounded for high-rise properties, where the combined effects of muted price growth and a higher propensity of discounts and rebates could increase vulnerabilities to a potential house price correction. Improving house price transparency therefore remains crucial.

Looking Beyond DSR to Assess Households' Debt-Servicing Capacity

Introduction

Debt service ratio (DSR) is a common indicator used to assess borrowers' debt-servicing capacity.¹ It refers to the portion of a borrower's monthly net income (gross income minus tax and other statutory deductions) that is used to pay the borrower's total debt obligations. Borrowers with high DSRs can point to household debt vulnerabilities as a large portion of borrowers' monthly net income is being used to pay their monthly debt obligations, leaving little for other expenditures or savings. Given this, several countries, including Malaysia, have regulations in place that mitigate risks from lending to all or a segment of borrowers beyond a certain DSR threshold.² This is to ensure borrowers are not overburdened by debt and to contain the potential build-up of household debt vulnerabilities.

In general, borrowers with high DSRs are likely to be more susceptible to repayment stress as they have a smaller income buffer to cushion them from financial shocks that can arise from the loss of income, increases in cost of living or higher loan repayments due to rising interest rates. This is corroborated by Bank Negara Malaysia's (BNM) macro solvency stress test results³ which show that household borrowers with DSR exceeding 60% (hereafter referred to as high-DSR borrowers) are significantly less resilient to severe unemployment and income shocks. Under such scenarios, high-DSR borrowers are up to 5.5 times more likely to default on their loan obligations compared to low-DSR borrowers (borrowers with DSR below 60%).

This article provides further insights into household debt vulnerabilities by examining trends in Net Disposable Income (NDI) as an additional indicator to complement assessments of borrowers' debt-servicing capacity based on DSR.

Why the need to look beyond DSR when assessing debt-servicing capacity?

The assessment of household vulnerabilities based on DSR alone suffers from several drawbacks.

Firstly, it overlooks other factors that are also relevant in assessing loan affordability. This includes factors such as the consideration of differences in the expenditure needs, stock of financial buffers or wealth of borrowers across different income segments, demographics and locations, among other things. High-DSR borrowers that successfully obtain loans tend to be those who also have higher absolute income that enable them to sustain the higher debt burden. They may also have other sources of wealth that can be pledged as collateral, thereby lowering credit risks for financial institutions.

Secondly, the availability of repayment assistance through financial institutions and Credit Counselling and Debt Management Agency (AKPK) has helped support loan repayments during periods of financial distress. This is more notable for high-DSR borrowers that typically account for a larger share of borrowers that take up loan repayment assistance programmes (Chart 1), and explains why even during periods of severe economic and financial distress such as that experienced during the COVID-19 pandemic, the quality of borrowings remained stable among high-DSR borrowers.⁴

These factors are borne out by evidence from household loan performance in Malaysia across periods of both normal and stressed economic conditions. There is little differentiation in the performance of borrowings held by high- and low-DSR borrowers. During periods of stress, borrowings held by high-DSR borrowers are associated with lower incidents of missed loan repayments compared to borrowings held by low-DSR borrowers (Chart 2).

¹ Exact computation can differ across countries. In Malaysia, DSRs are computed using net income while in other countries such as the UK and Singapore, DSRs are computed using gross or pre-tax incomes. Coverage of debt can also vary across countries. DSR computation in Malaysia considers loans taken from banks and non-banks, whereas in some countries, the coverage of debt in computation of DSRs is confined to banking system loans.

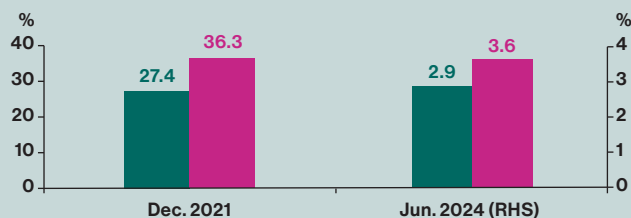
² DSR thresholds varies across countries based on the Committee on Global Financial System's paper on 'Macroprudential policies to mitigate housing market risks' (2023).

³ Refer to Financial Stability Review Second Half 2021 on 'Assessing the Resilience of Financial Institutions'.

⁴ Quality of borrowings during this period was also supported by the extraordinary support measures taken by the Government and relevant agencies to contain the impact of the COVID-19 pandemic. These include moratorium on loan repayments, cash transfers for individuals, and wage subsidies to encourage businesses to retain employees.

Given these observations, relying on non-differentiated⁵ DSR measures alone may be insufficient to fully explain borrowers' debt-servicing capacity – both during periods of normal and stressed economic conditions.

Chart 1: Household Sector – Share of Loans Under Repayment Assistance by Borrower Debt Service Ratio



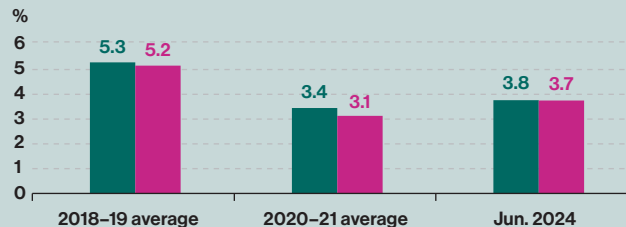
Borrower debt service ratio:

■ < 60 ■ > 60

Note: 1. Data refers to loans under restructured and rescheduled programmes offered by financial institutions as well as Debt Management Programme offered by Credit Counselling and Debt Management Agency.
2. Data refers to banking system and development financial institution (DFI) loans.

Source: Bank Negara Malaysia

Chart 2: Household Sector – Share of Missed Loan Repayments by Borrower Debt Service Ratio



Borrower debt service ratio:

■ < 60 ■ > 60

Note: 1. Data refers to loans with 1 month or more in-arrears.
2. Data refers to banking system and development financial institution (DFI) loans.

Source: Bank Negara Malaysia

The use of NDI alongside DSR to assess debt-servicing capacity

In practice, financial institutions rely on NDI, alongside DSR, in their loan affordability assessments and lending decisions. NDI is commonly calculated by deducting borrowers' total monthly loan repayments⁶ from their monthly net income to arrive at the residual income available to borrowers to cover their consumption expenditure. A borrower's consumption expenditure is in turn influenced by individual circumstances and lifestyle choices such as marital status, number of dependents, and location of residence.⁷

NDI enables financial institutions to better account for borrowers' income and consumption expenditure, as it is more easily adapted to borrower-specific circumstances. For example, in assessing loan affordability among borrowers with similar incomes and DSR levels, it would be appropriate to apply a higher NDI to a married borrower with children who is likely to face higher expenditures compared to an unmarried borrower without dependants. Correspondingly, borrowers with low NDI are more likely to be associated with low or negative financial margins,⁸ which in turn increases their susceptibility to distress.

Minimum NDI levels observed by financial institutions vary across institutions and may be differentiated by loan product, borrowers' income, risk profile, location and marital status. Financial institutions review these internal thresholds on a periodic basis, some as frequent as annually, to account for changes in the cost of living.

Based on an analysis of a sample of 21.1 million loan accounts (92% of outstanding household loan accounts) over a period of 12 months, BNM found that loan accounts held by borrowers with an NDI of RM1,000⁹ or less were more likely to experience distress¹⁰ by the end of the 12-month horizon compared to loan accounts held by borrowers with higher levels of NDI (Chart 3). By combining NDI and DSR indicators, clearer evidence of household vulnerabilities emerged as observed from the higher share of loan accounts in default and distress (Chart 4), compared to observations based on DSR alone.

⁵ E.g. to take into account differences in income levels and costs of living based on place of residence.

⁶ Total monthly loan repayments include the amount from new lending.

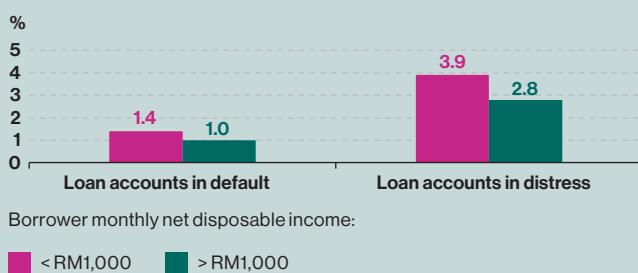
⁷ For example, cost of living is typically higher for borrowers living in urban locations.

⁸ Financial margin is defined as the residual of a borrower's monthly net income (defined as gross income less statutory deductions), debt repayments, and basic expenditures. More information about the use of financial margin by BNM can be found in the article 'Forecasting Households' Time to Default – Enhancements to the Financial Margin Framework' in BNM Financial Stability Review for First Half 2020.

⁹ For purposes of this analysis, a representative NDI threshold of RM1,000 was selected from a range of NDI thresholds that financial institutions use in loan affordability assessments. Staff analysis also finds a larger share of borrowers with NDI below RM1,000 having at least 1 loan account in default. As at June 2024, around 13% of household borrowers have NDI of RM1,000 and below.

¹⁰ Distress is defined as loan accounts in delinquency or default, as well as loan accounts under repayment assistance from financial institutions or AKPK. Default is defined as the loan accounts with three months or more in-arrears.

Chart 3: Household Sector – Share of Loan Accounts in Default and Loan Accounts in Distress by Borrower Monthly Net Disposable Income



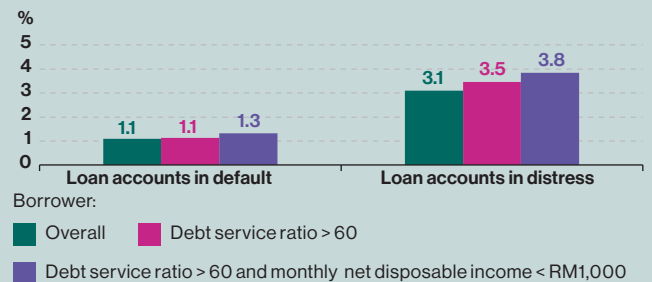
Borrower monthly net disposable income:

■ < RM1,000 ■ > RM1,000

Note: Data refers to banking system and development financial institution (DFI) loans.

Source: Bank Negara Malaysia

Chart 4: Household Sector – Share of Loan Accounts in Default and Loan Accounts in Distress by Borrower Debt Service Ratio and Monthly Net Disposable Income



Borrower:

■ Overall ■ Debt service ratio > 60
■ Debt service ratio > 60 and monthly net disposable income < RM1,000

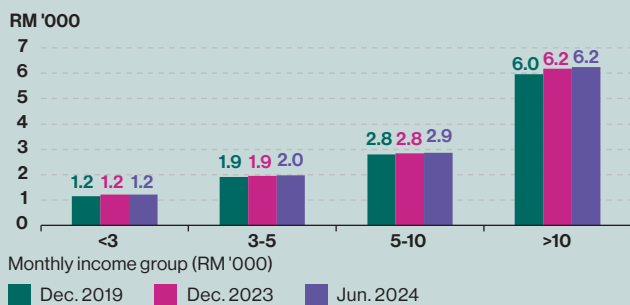
Note: Data refers to banking system and development financial institution (DFI) loans.

Source: Bank Negara Malaysia

Trends in NDI

Since 2019, the median NDI for newly approved loans has been broadly unchanged across all income groups. The median NDI for newly approved loans to the low-income borrower segment stood at around RM1,210 (Chart 5). While this is above the current NDI thresholds adopted by most banks, it is below the average expenditure¹¹ of between RM1,840 and RM2,440 guided by the Employees Provident Fund (EPF)¹² for single individuals to attain a reasonable and acceptable standard of living in major cities. This may suggest scope for further differentiation of NDI thresholds for specific borrower circumstances as part of ongoing efforts within banks to ensure that affordability assessments are sufficiently robust. Notwithstanding, it is worth noting that the share of borrowers with low NDI (as a measure of more vulnerable borrowers) is significantly lower than that suggested by measures of DSR alone (Chart 6), and drops further for borrowers that have both high DSR and low NDI. This further affirms current assessments of overall household resilience.

Chart 5: Household Sector – Median Borrower Monthly Net Disposable Income for Newly Approved Loans by Income Group



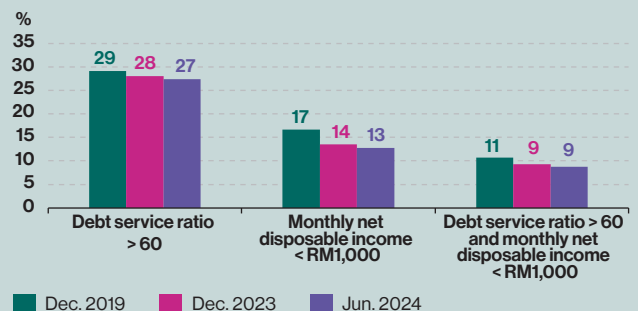
Monthly income group (RM '000)

■ Dec. 2019 ■ Dec. 2023 ■ Jun. 2024

Note: Data refers to banking system and development financial institution (DFI) loans.

Source: Bank Negara Malaysia

Chart 6: Household Sector – Share of Outstanding Borrowers by Borrower Debt Service Ratio and Monthly Net Disposable Income



■ Dec. 2019 ■ Dec. 2023 ■ Jun. 2024

Note: Data refers to banking system and development financial institution (DFI) loans.

Source: Bank Negara Malaysia

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¹¹ Expenditure comprises spending on basic necessities and discretionary expenses such as recreational activities, vacation, social events and allocation for savings.

¹² Based on EPF Belanjawanku 2023 Guide.

OPERATIONAL RISK

Continued vigilance in the financial sector to safeguard operational resilience against persistent threats

Continuous efforts by financial institutions to ensure strong operational risk management practices and fraud controls remain critical to support the financial system's operational resilience in an environment of rapid digitalisation of financial services with increasing reliance on third-party service providers (TPSPs). Operational incidents continue to test the detection, monitoring and recovery capabilities of financial institutions. While financial losses from operational risks reported by financial institutions remained low (1H 2024: RM183.9 million; 1H 2023: RM188.6 million), moderate disruptions to online banking services occurred in a few incidents during the period. This called for stronger measures in some institutions to ensure more robust incident response plans and closer monitoring of third-party risks. Financial institutions that fail to meet prescribed regulatory standards to ensure a high level of availability³⁰ of services will be subject to strong supervisory or enforcement actions, including directives to strengthen controls, increased capital requirements for operational risk and administrative monetary penalties (AMP).

Technology and cyber-related risks will continue to pose challenges to the management and supervision of operational risks within the financial system. The growing sophistication of tools and techniques used by threat actors, as well as the targeting of TPSPs as a means of gaining access to financial institutions' systems or data, further increases the demands faced by financial institutions in their ongoing efforts to secure their environment. Financial institutions continue to invest significant resources in enhancing their cyber security detection and mitigation processes. The annual information technology (IT) expenditure on cyber security alone by financial institutions has increased the most in 2024, extending successive years of double-digit increases in cyber security budgets.

Higher operational risk management standards applied by BNM to payment service providers have also raised the level of cybersecurity risk controls observed by

e-money issuers (EMIs) and merchant acquirers, with ongoing improvements observed in the cybersecurity maturity level of these players. Proactive information sharing between BNM and the industry on cyber threat intelligence via the Financial Sector Cyber Threat Intelligence Platform (FinTIP) continues to support financial institutions' threat detection and incident response capabilities. The number of cyber threat intelligence reports shared on FinTIP increased by 40% in the first half of 2024 compared to the same period last year. In addition, efforts to educate and enforce strong cyber hygiene practices among staff and customers remain crucial to build and maintain strong foundational cyber security defences.

To further strengthen financial institutions' operational resilience, BNM will be introducing enhanced expectations on managing cyber risks associated with TPSPs. These include expectations for financial institutions to:

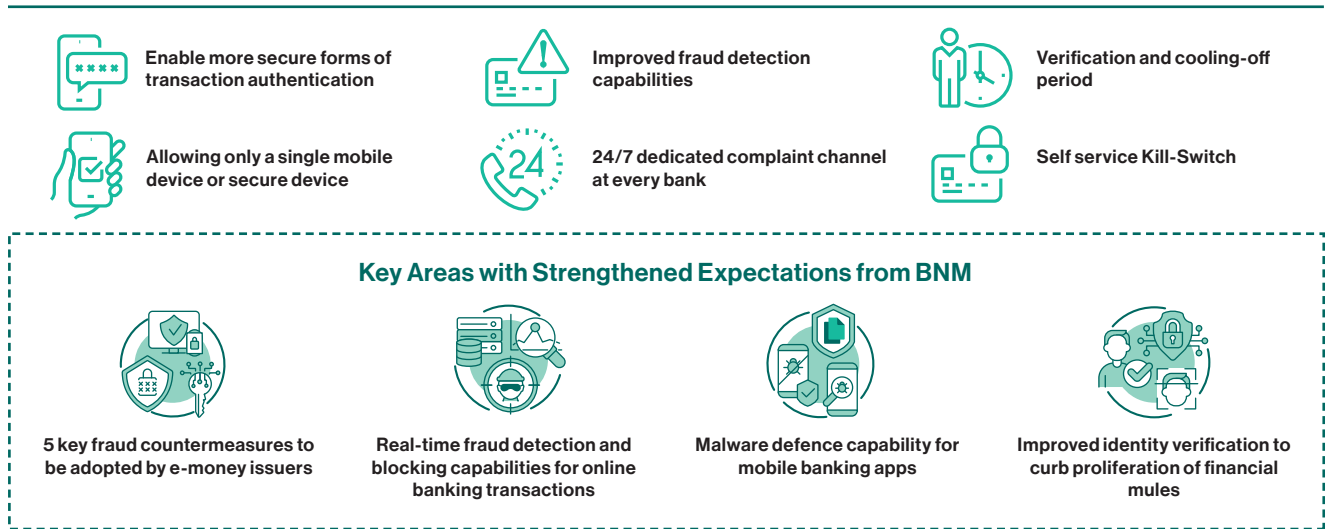
- obtain information necessary to understand and identify potential vulnerabilities associated with their TPSPs' cyber security posture and supply chains;
- conduct regular joint testing of business continuity plans (BCP) and disaster recovery plans (DRP) with material TPSPs; and
- identify and prepare alternate TPSPs to provide redundancy and maintain essential services during disruptions.

Regular IT stress testing remains an integral step to improve financial institutions' capacity to respond and recover from extreme events or external shocks arising from IT disruptions and cyber-attacks. Following a recent thematic review conducted by BNM on banks' IT stress testing programmes, BNM issued guidance on common stress scenarios and minimum shock parameters for IT stress testing to encourage greater consistency in the rigour of IT stress tests conducted by banks, and identify common response and recovery actions across banks that could pose systemic risks.

Financial institutions remain vigilant against new forms of financial fraud and are continuously refining their fraud detection capabilities. Enhancements of fraud prevention measures by banks as part of broader efforts to strengthen the overall multi-layered defence of online banking security (Diagram 1) have resulted in a downward trend of cases of unauthorised online banking transactions (2022 vs 2023: 28% reduction) reported to the National Scam Response Center (NSRC). In 2023, fraudulent financial transactions amounting to RM383 million were successfully blocked by financial institutions. The fraud countermeasures have also been extended to all eligible EMIs to secure more effective sector-wide protection.

³⁰ As stipulated in S10.32 in the Risk Management in Technology (RMiT) policy document.

Diagram 1: Industry-wide Efforts to Strengthen Security of Online Banking



Source: Bank Negara Malaysia

Continuous efforts are in place to ensure resiliency of payment and settlement systems

The Real-time Electronic Transfer of Funds and Securities System (RENTAS) and major retail payment systems (RPS) continued to maintain high system availability throughout the first half of 2024. While no major incidents or service disruptions were observed for RENTAS, the DuitNow services under the Real-time Retail Payment Platform (RPP) and cheque services under the National Electronic Cheque Information Clearing System (eSPICK) experienced a service disruption in May due to hardware failure. Both services were promptly recovered following the successful activation of contingency and recovery plans which operated as expected. No recurrent incidents have been observed.

Since 1 July 2024, all RENTAS participants have successfully migrated their RENTAS payment transactions to ISO 20022, marking the conclusion of a project that began in 2019 to support the futureproofing of a key domestic payment infrastructure. Adopting the ISO 20022 messaging standard provides financial institutions access to richer and more structured data, including payment

references, invoice details and regulatory information. With this information, RENTAS participants can enhance compliance screening, increase process automation and provide better customer service. Participants are now shifting their focus to the migration for cross-border payments which is expected to be completed by June 2025 for key payment messages, and November 2026 for non-key messages to meet the timeline prescribed by SWIFT.³¹ As of July 2024, around 32% of participants have completed the migration for cross-border payments, with the remaining participants on-track to meet the prescribed timelines.

Malaysia's regional cross-border instant payments connectivity with Indonesia, Thailand and Singapore has contributed to the increasing usage of the cross-border Quick Response (QR) payments. The total QR payment transactions in the first six months of 2024 alone already doubled the transaction volume recorded for the whole of 2023. With volumes poised to grow further, ensuring that payment system operators continue to fulfil prescribed technical specifications on an ongoing basis will be critical to minimise service disruptions and improve security. This is being further reinforced by BNM's continuing efforts to enhance cross-border cooperative oversight arrangements with regulatory bodies in the respective jurisdictions.

³¹ The Society for Worldwide Interbank Financial Telecommunication (SWIFT) is a global network operator facilitating secure financial transactions and communication between banks and other financial institutions.

Financial Institution Soundness and Resilience

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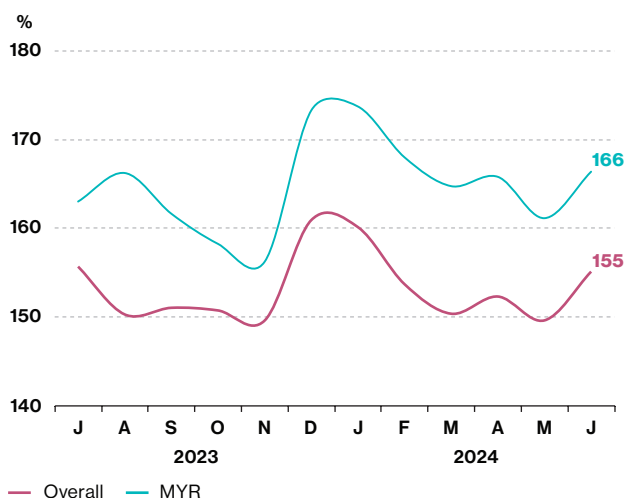
Financial Institution Soundness and Resilience

THE BANKING SECTOR

Banks' strong funding and liquidity positions remained supportive of intermediation activities

In the first half of 2024, the liquidity and funding positions of the banking system remained resilient against liquidity shocks. The aggregate Liquidity Coverage Ratio (LCR) (Chart 2.1) and Net Stable Funding Ratio (NSFR) (Chart 2.2) remained healthy and above regulatory minima, at 155.1% and 115.5% respectively as at end-June 2024 (December 2023: 161.0% and 118.2% respectively). Banks continued to hold large amounts of high-quality liquid assets (HQLA) (RM762.7 billion; December 2023: RM758.2 billion), mostly in the form of government bonds and central bank placements, which can be pledged in the interbank market or with Bank Negara Malaysia (BNM) for access to additional liquidity.

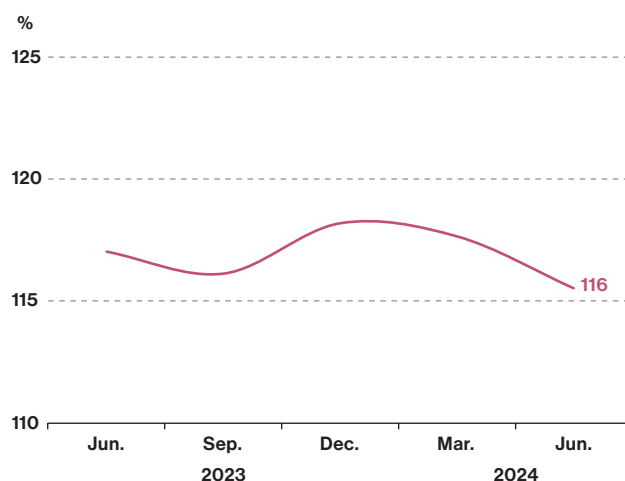
Chart 2.1: Banking System – Liquidity Coverage Ratio



Note: 1. MYR LCR 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

Chart 2.2: Banking System – Net Stable Funding Ratio



Source: Bank Negara Malaysia

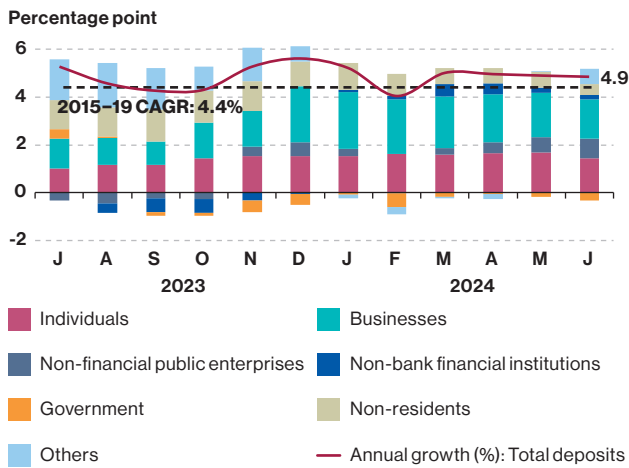
Total banking system liquidity remained supportive of financial intermediation, ranging between RM95 billion and RM127 billion between March and September 2024 (average: RM106.7 billion). Overnight and shorter-term interbank rates also remained relatively stable, reflecting orderly conditions in the interbank money market. Meanwhile, banking system deposits continued to grow at a healthy pace of 4.9% (2015–19 CAGR: 4.4%) (Chart 2.3), driven by both resident individuals and businesses (including non-financial public enterprises). These segments continued to form the bulk of the deposit base at 36.2% and 33.6% respectively, in line with the improvements in household incomes and business activities. Nearly half of the total banking system deposits (48.7%; December 2023: 48.5%; 2015–19 average: 51.2%) consists of fixed deposits (including Commodity Murabahah) (Chart 2.4) that provide banks with a stable funding source. The share of fixed deposits has risen again over the past year after a steady decline since the pandemic, reflecting a gradual unwinding of excess contingency cash buffers held by households and firms in line with improving confidence, as well as firmer expectations of unchanged policy interest rates going forward. Banks have also continued to bolster their stable funding base through the issuance of medium-term notes, which comprised 4.9% of banks'

total liabilities (2015–19 average: 5.6%). To further reinforce sound liquidity risk management by banks, BNM will soon finalise the policy document on Liquidity Risk following the close of the consultation period on the exposure draft in November 2023. The policy document, which will be published in the second half of 2024, will codify BNM's expectations on liquidity risk management, including additional guidance on liquidity stress testing, intra-day liquidity management and disclosure of high-quality liquidity-related information.

Banks' average cost of funds moderated slightly by six basis points (bps) to 2.90% between December 2023 and June 2024 (Chart 2.5), in line with easing competition for corporate deposits. Compared to the pre-pandemic

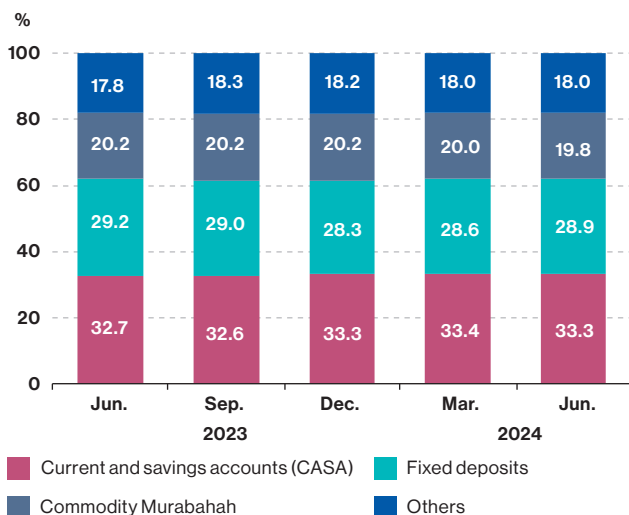
level however, the average cost of funds is around 10 bps higher despite policy rates returning to the pre-pandemic level. This reflects the lower level of overall banking system liquidity compared to earlier periods and to some extent, an uneven distribution of liquidity across banks. Ample HQLA buffers continue to preserve the ability of individual banks to tap central bank and market-based sources of funding to meet their liquidity needs. Consistent with this, there has been little evidence of a notable tightening in credit conditions. Lending to households and businesses continued to expand at a healthy rate (+6.4%; December 2023: +5.3%) (Chart 2.6). The weighted average lending rates for new business and retail loans have also remained broadly stable (-4 bps and -1 bps from December 2023 to June 2024, respectively) amid the healthy competition observed among banks.

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



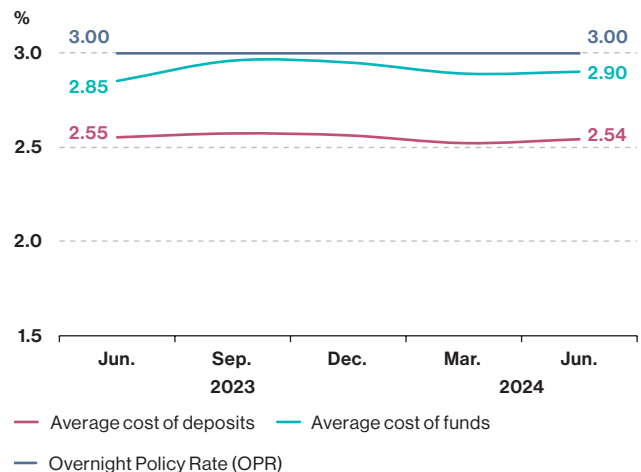
Source: Bank Negara Malaysia

Chart 2.4: Banking System – Composition of Deposits by Type



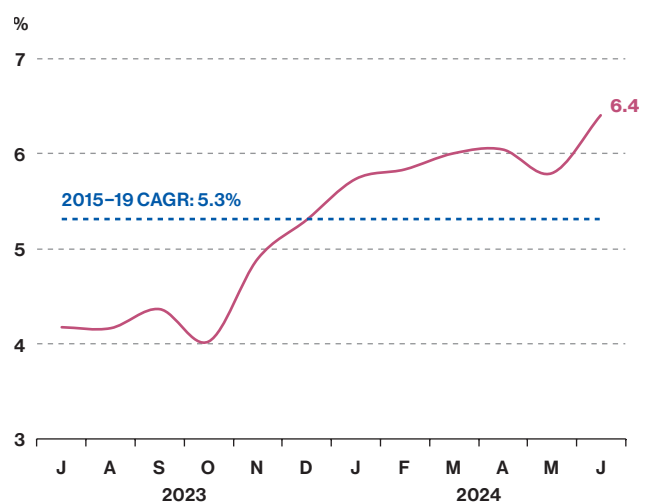
Source: Bank Negara Malaysia

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

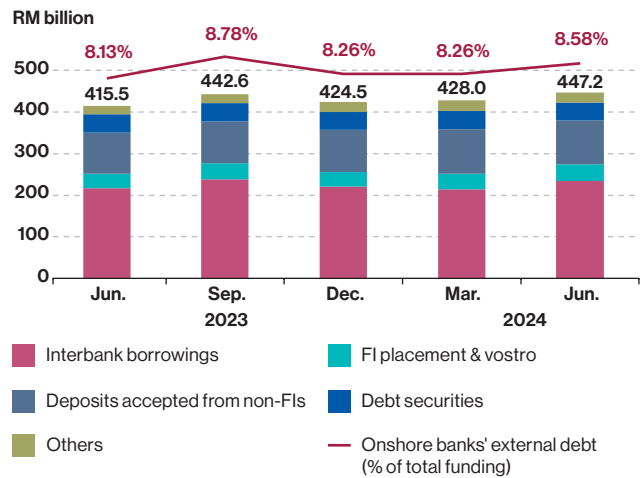
Contagion risks from banks' exposures to external counterparties remained manageable

Banks' external debt increased by RM22.7 billion in the first half of 2024 (Chart 2.7), driven largely by higher interbank borrowings. More than half of this were intra-group exposures, mainly by locally-incorporated foreign banks (LIFBs) sourcing funds from parent companies located abroad and by banks located in the Labuan International Business and Financial Centre (LIBFC) to facilitate transactions arranged and managed by foreign head offices. Additionally, some banks have increased their foreign currency borrowings to obtain cheaper ringgit funding via FCY swap arrangements. However, this accounted for only around 3% of total bank funding and is not expected to grow significantly amid the strengthening ringgit and expectations of further Fed rate cuts.

The low reliance on external counterparties for domestic funding needs has thus continued to limit risks from banks' external debt exposures. The bulk of banks' external exposures continued to be with related counterparties or in the form of long-term stable debt (78.4%; December 2023: 78.6% of total external debt), minimising rollover and withdrawals risks. Meanwhile, short-term external debt with unrelated counterparties is adequately buffered as banks continue to hold sizeable FCY liquid assets, sufficient to cover up to 2.5 times (December 2023: 2.4 times) of total FCY external debt-at-risk¹ (Chart 2.8).

Banks also continued to be resilient against foreign exchange (FX) risk. The overall FX net open position (FX NOP) of banks rose in line with increased market volatility (Chart 2.9) during the period under review, but remained manageable at 5.2% of total capital (December 2023: 3.9%; 2020–22 average: 4.2%). Moving forward, risks are expected to remain manageable with the strengthening ringgit amid lower global policy interest rates and Malaysia's positive economic growth prospects.

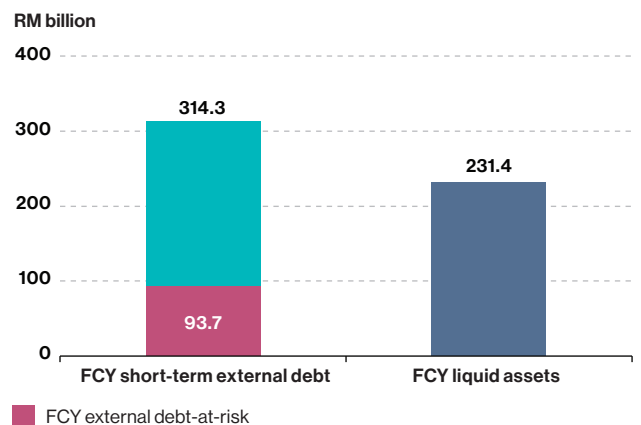
Chart 2.7: Banks' External Debt – by Instrument



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

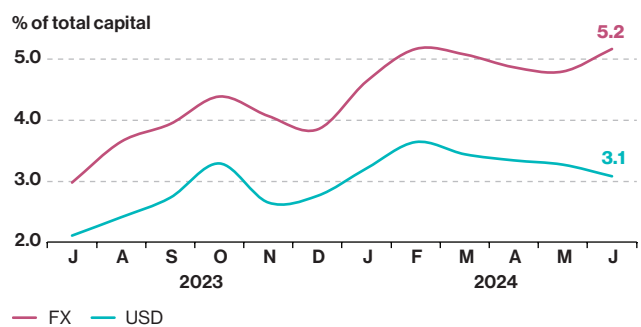
Chart 2.8: Banking System – FCY External Debt-at-Risk and Liquid Assets



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

Source: Bank Negara Malaysia

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



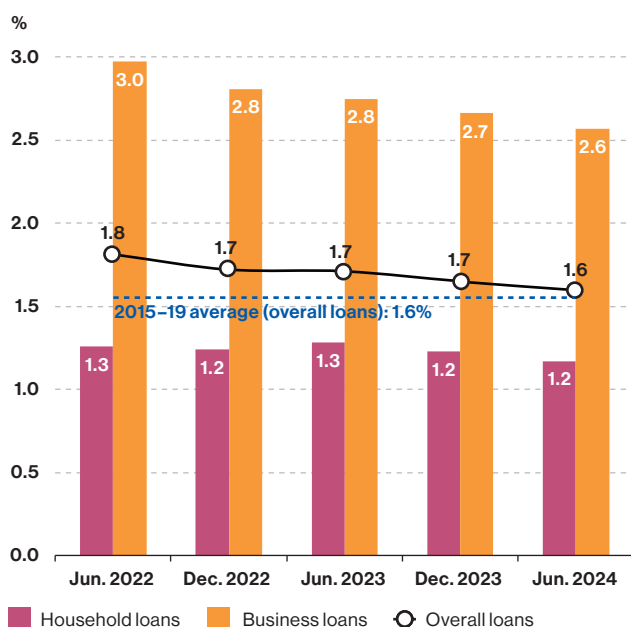
Source: Bank Negara Malaysia

¹ 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' asset quality improved but downside risks remain

Banks' asset quality remained sound as most borrowers continue to show improvements in their debt-servicing ability. The gross impaired loans ratio declined to 1.6% in the first half of 2024 (December 2023: 1.7%) (Chart 2.10). The outlook for asset quality also improved, with the share of loans classified as Stage 2 declining further below the pre-pandemic average to 7.0% of banking system loans (December 2023: 7.2%; 2018–20 average: 8%) (Chart 2.11). Consistent with this, loans under repayment assistance programmes² declined to 2.0% of total banking system loans (December 2023: 2.4%), while new rescheduled and restructured loans from borrowers facing financial strains remained small at 0.09% of banks' total loans (December 2023: 0.16%). Ongoing improvements in economic activity will continue to underpin sound asset quality. That said, banks continue to closely monitor pockets of vulnerable borrowers impacted by higher cost pressures particularly from the lower-income households and small businesses in the wholesale and retail, and manufacturing sectors. Most banks are gradually releasing the management

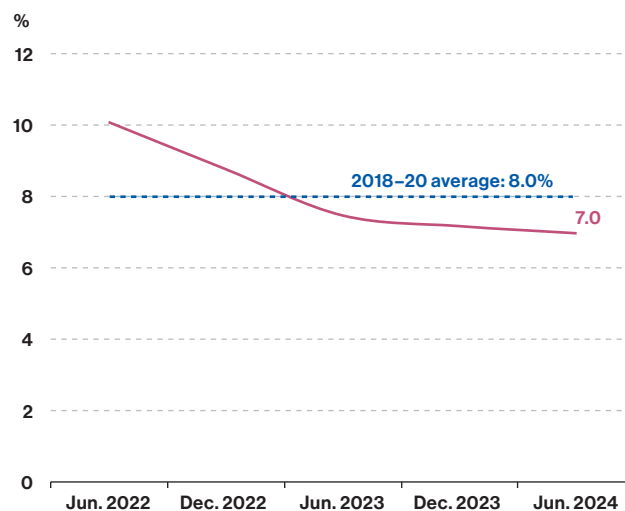
Chart 2.10: Banking System – Gross Impaired Loans Ratio



Source: Bank Negara Malaysia

² 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).

Chart 2.11: Banking System – Stage 2 Loans Ratio

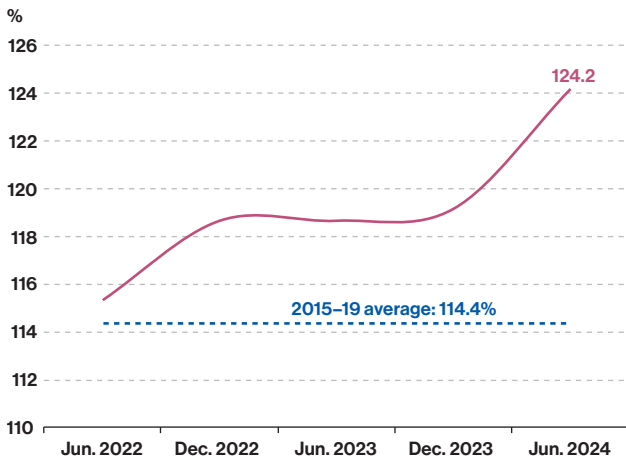


Source: Bank Negara Malaysia

overlays³ accumulated since the COVID-19 pandemic, contributing to lower overall provisions. As of June 2024, management overlays stood at around 25% of banks' expected credit loss (ECL) provisions for loans, a decline from 27% in December 2023. ECL provisions as a share of total loans have correspondingly declined from recent peaks but remain higher than their historical average as banks stay vigilant of continuing cost challenges among some higher-risk borrower segments. The banking system loan loss coverage ratio (including regulatory reserves) also remained high at 124.2% (December 2023: 119.2%) (Chart 2.12). Potential losses from vulnerable borrower segments are therefore expected to remain comfortably within banks' available buffers, standing banks in good stead to withstand earnings shocks. Additionally, a few banks have applied management overlays for borrowers highly exposed to physical climate risk. With conservative provisioning practices remaining in place, annualised credit costs have been broadly stable around the pre-pandemic historical average (Chart 2.13).

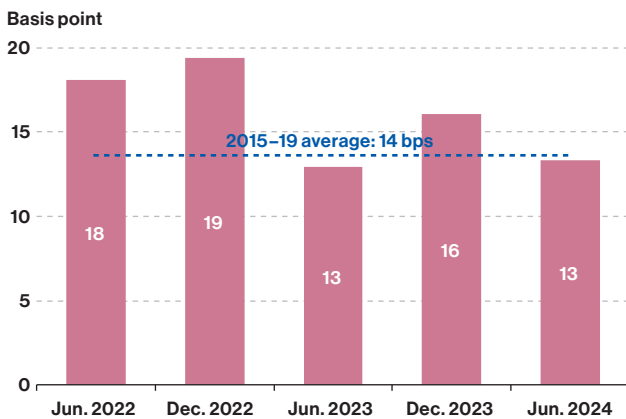
³ Management overlays are additional provisions set aside on top of provisions derived from expected credit loss (ECL) models. It reflects adjustments to account for data deficiencies or uncertainties not adequately captured by the ECL models.

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

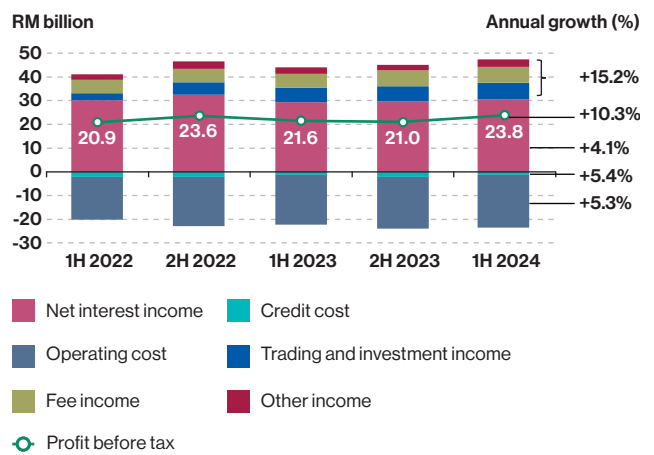


Source: Bank Negara Malaysia

Banks' earnings improved amid signs of stabilising interest margins

Banks' profitability continued to be supported by sustained interest income amid stronger loan growth and improvements in operational efficiency (Chart 2.14). The cost-to-income (CTI) ratio⁴ decreased to 46.9% in the first half of 2024 (December 2023: 48.5%). This helped to cushion pressures on net interest margins (June 2024: 1.96%; December 2023: 1.97%; 2015-19 average: 2.11%) arising from the elevated cost of funds. Margins have improved modestly in more recent months on the back of easing deposit competition and stabilising share of fixed deposits as a proportion of total funding.

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



Note: 1. Annual growth computed based on figures for 1H 2023 and 1H 2024.
2. Figures may not add up due to rounding.

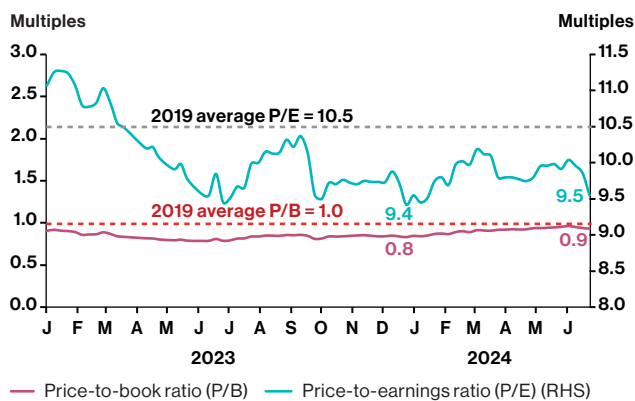
Source: Bank Negara Malaysia

⁴ CTI ratio refers to the costs of running operations (i.e. operating costs), over banks' total income.

Trading and investment income (1H 2024: RM6.8 billion; 2H 2023: RM6.4 billion) provided additional support to banks' profitability. While banks' overall holdings of government bonds continued to increase marginally (10.6% of total banking system assets; December 2023: 10.3%), their exposure to interest rate risk in the banking book remains manageable.⁵ This has been supported by active strategies to reduce duration.

In line with higher earnings, returns on asset and equity of the banking system rose to 1.3% and 12%, respectively (December 2023: 1.2% and 11.2%, respectively). This in turn supported improved market valuations of listed banks, as measured by the price-to-book (P/B) and price-to-earnings (P/E) ratios (Chart 2.15) along with broader improvements in investor sentiment which further lifted the performance of equities during the period.

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 domestic banking groups in Malaysia.

Source: Bloomberg

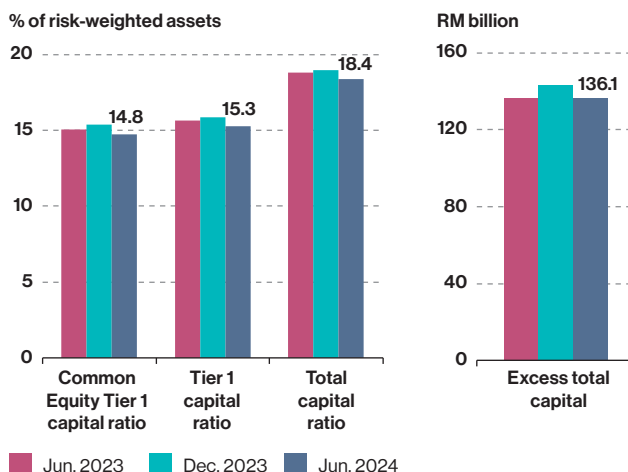
⁵ Interest rate risk in the banking book (IRRBB) reflects the current or prospective risk to the bank's capital and earnings arising from adverse movements in interest rates that affect the banks' banking book positions. It is measured as a percentage of banks' capital (June 2024: 6.7%; December 2023: 6.9%).

Banking system remained well-capitalised

The banking system total capital ratio remained healthy at 18.4% of total risk-weighted assets (December 2023: 19.0%), with excess capital buffers of RM136.1 billion (December 2023: RM143.4 billion) (Chart 2.16). The strong buffers continue to enable banks to withstand unexpected shocks and facilitate credit intermediation to the economy.

Based on BNM's latest assessment of domestic systemically important banks (D-SIBs) using end-2023 data submissions, the list of banking groups designated as D-SIBs and their respective higher loss absorbency (HLA) requirements to reflect their systemic importance remained unchanged (Table 2.1). All D-SIBs continued to maintain Common Equity Tier 1 (CET1) capital comfortably above the regulatory minima, including the HLA requirements.

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

Table 2.1: D-SIBs HLA Requirement

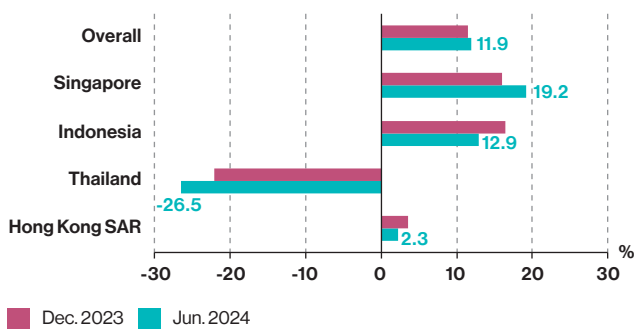
D-SIBs	HLA Requirement (% of risk-weighted assets)
Malayan Banking Berhad	1.0
CIMB Group Holdings Berhad	1.0
Public Bank Berhad	0.5

Source: Bank Negara Malaysia

Contagion risk from DBGs' overseas operations remained limited

The overseas operations of domestic banking groups (DBGs) remained profitable (Chart 2.17). This was mainly driven by operations in Singapore (representing 55% of overseas operations' assets) (Chart 2.18) which recorded improvements in operating income and higher write-backs of loan loss allowances. Operations in Thailand continued to record losses due to the high credit costs for selected non-retail borrowers that have yet to recover from the effects of the pandemic.

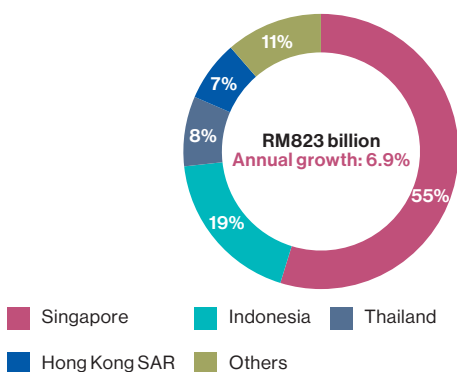
Chart 2.17: Banking System – Return on Equity of Overseas Operations by Jurisdiction



Note: 1. Overall average return on equity (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 2.18: Banking System – Asset Profile of Major Overseas Operations



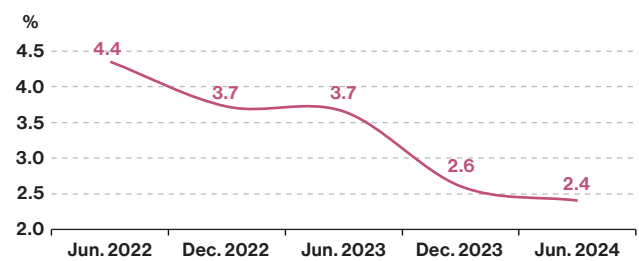
Note: Figures may not add up due to rounding.

Source: Bank Negara Malaysia

Notwithstanding this, spillover risks to parent banks in Malaysia remain manageable, as operations in Thailand contributed only up to 2% of DBGs' total consolidated assets.

Similar to Malaysia, asset quality of overseas operations continued to improve (Chart 2.19). The share of loans under repayment assistance programmes continued to decline (0.9% of total overseas operations loans; December 2023: 1.3%). Liquidity and funding risks posed by DBGs' overseas operations remain limited as major overseas operations are primarily funded by stable customer deposits (Chart 2.20). DBGs' overseas operations also continue to be supported by strong capital buffers (average total capital ratio as at June 2024: 20.9%; December 2023: 20.7%).

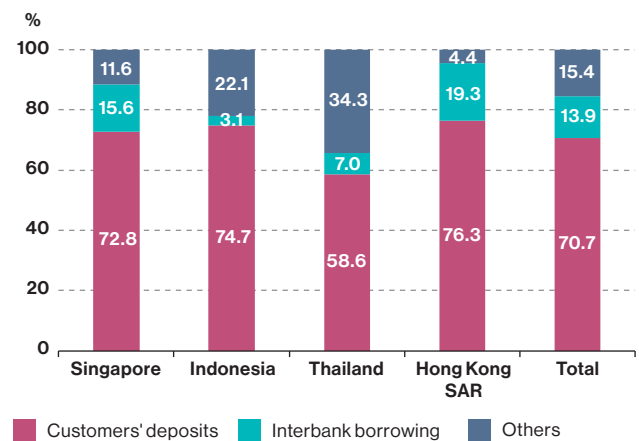
Chart 2.19: Banking System – Gross Impaired Loans Ratio of Overseas Operations



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

Source: Bank Negara Malaysia

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



Note: Figures may not add up due to rounding.

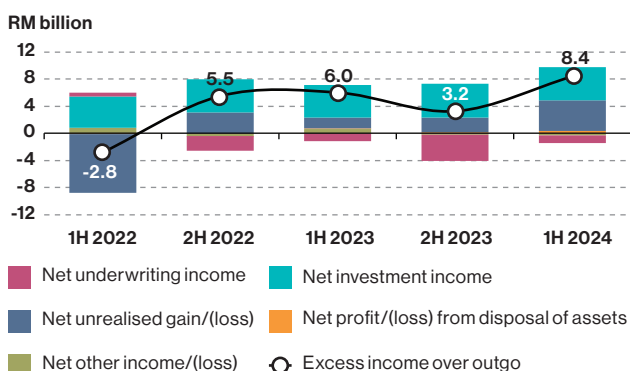
Source: Bank Negara Malaysia

THE INSURANCE AND TAKAFUL SECTOR

Overall profitability of insurance and takaful funds increased on strong investments and improved underwriting performance

Overall profitability of life insurance and family takaful funds, as measured by excess income over outgo, was higher in the first half of 2024 (RM8.4 billion; 2H 2023: RM3.2 billion) (Chart 2.21). This was largely due to higher net unrealised gains from equity investment portfolios, driven by the strong market performance of Bursa Malaysia, and sustained investment income.

Chart 2.21: Life Insurance and Family Takaful Fund – Composition of Income and Outgo



Note: 1. Data excludes investment-linked unit funds.
2. Net underwriting income refers to excess of net premium after deducting benefit payouts, agency remuneration and management expenses.

Source: Bank Negara Malaysia

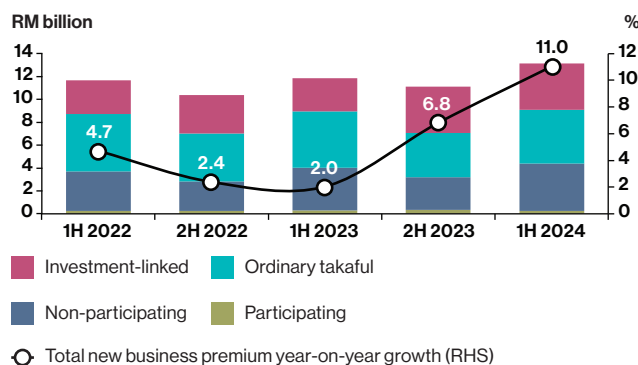
Life insurers and family takaful operators (life and family ITOs) recorded lower net underwriting losses in the first half of 2024, reflecting seasonally lower maturity and vested benefits payouts typically observed in the first half of the year. However, underwriting performance continued to be weighed down by medical benefit payouts, which remained elevated (1H 2024: RM5.3 billion; 2H 2023: RM5.3 billion; 1H 2023: RM4.7 billion), driven by increasing incidence rates, particularly from chronic and acute cases, coupled with the rising overall average cost of medical treatment. In response, most ITOs continue to conduct repricing exercises for medical and health policies. The effects of these adjustments on underwriting margins are expected to be gradual, as price adjustments are only applied at policy anniversaries. Measures by ITOs to preserve

policy affordability such as capping price increases, and staggering these increases over time further moderate the impact on pricing and margins.

Measures to contain medical inflation remain critical to ensure continued access to affordable medical insurance and takaful coverage. To this end, the revised policy document on Medical and Health Insurance/Takaful (MHIT) Business issued by BNM in February 2024 requires all ITOs to offer consumers the choice to purchase MHIT products with a co-payment feature as a more affordable option, starting from September 2024. Over time, greater uptake of co-payment MHIT products is expected to improve accessibility of MHIT offerings while aligning incentives with needs-based utilisation of healthcare services, which will help contain medical cost inflation. This complements broader healthcare and health financing reforms being pursued by the Government which are essential to further improve the delivery of quality healthcare services and health outcomes.

Sustained growth in new business premium⁶ continued to support the overall profitability of life insurance and family takaful funds. New business premium expanded by 11% in the first half of 2024 (1H 2023: 2%; 2017–19 half-yearly average: 9.8%) (Chart 2.22), led by medical and health products as well as investment-linked products. In contrast, the participating life insurance segment has continued to contract. Despite the continued decline in the participating life insurance segment, the overall impact on the sector's profitability has been limited, largely due to strong substitution effects, with policyholders shifting from participating policies to alternative products, mainly investment-linked and non-participating policies (refer to box article titled 'Participating Life Insurance Business in Malaysia' for further details).

Chart 2.22: Life Insurance and Family Takaful Sector – New Business Premium Growth and Product Composition

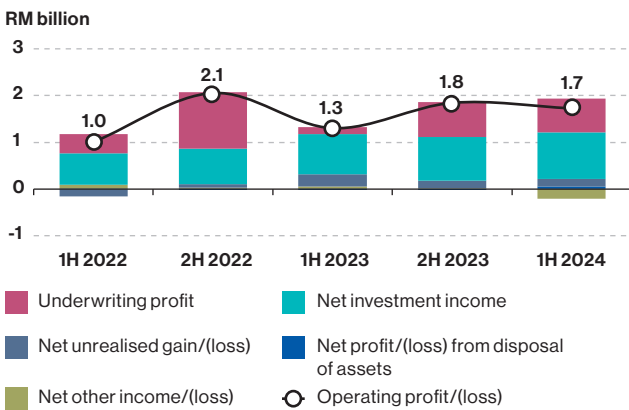


Source: Bank Negara Malaysia

⁶ Refers to both insurance premium and takaful contribution, unless stated otherwise.

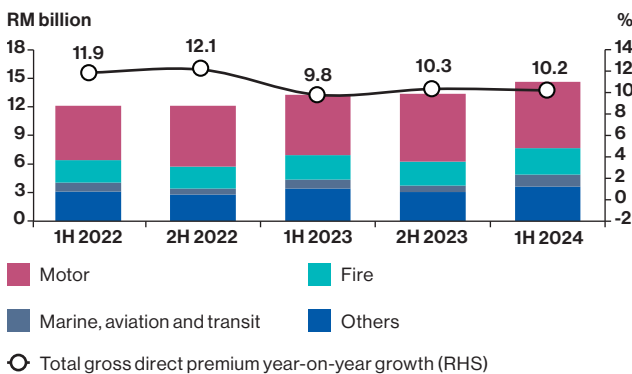
In the general insurance and takaful sector, operating profits were broadly sustained in the first half of 2024 (RM1.7 billion; 2H 2023: RM1.8 billion; 1H 2023: RM1.3 billion) (Chart 2.23). Underwriting performance was supported by sustained growth in gross direct premium from the motor segment (Chart 2.24), stemming from higher car sales in tandem with favourable economic conditions and successful new model launches, including electric vehicles. This was despite higher provisions for motor claims (1H 2024: RM0.6 billion; 2H 2023: RM0.3 billion) commensurate with robust business growth, as well as rising repair costs. Meanwhile, lower claims from significant flood events compared to previous years and sustained investment income also helped support the operating profits of general ITOs.

Chart 2.23: General Insurance and Takaful Fund – Composition of Operating Profits



Source: Bank Negara Malaysia

Chart 2.24: General Insurance and Takaful Sector – Gross Direct Premium Growth and Product Composition



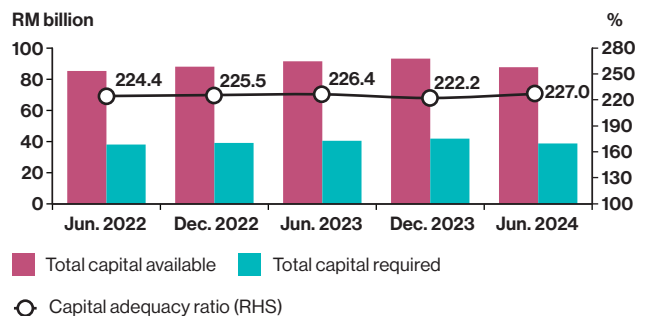
Source: Bank Negara Malaysia

As of June 2024, all general ITOs have met the requirements to transition to Phase 2A⁷ of the ongoing motor and fire tariff liberalisation process. The increased pricing flexibility introduced in Phase 2A has facilitated a gradual adjustment of premium and contribution rates to better reflect risk profiles of insured motorists and strengthen incentives to support road safety outcomes. Under the transition, both premium increases and decreases have been observed, reflecting more differentiated pricing of insured segments based on risks. Following these adjustments, the industry has continued to observe some stabilisation in the net claims incurred ratio⁸ for the motor line of business over the past 12 months (1H 2024: 69%; 2H 2023: 68%; 1H 2023: 69%).

The industry's aggregate capital adequacy ratio remains strong at 227.0% in the first half of 2024 (December 2023: 222.2%), well above the regulatory minimum of 130% (Chart 2.25). Aggregate capital buffers in excess of regulatory requirements also remained sound at RM37.4 billion (December 2023: RM38.6 billion).

In June 2024, BNM issued the exposure draft on Risk-Based Capital Framework for Insurers and Takaful Operators⁹ for public consultation as part of BNM's ongoing multi-phase review of the capital adequacy requirements for ITOs (including reinsurers and retakaful operators). The exposure draft sets out proposed enhancements to the capital framework, aimed at improving the comprehensiveness of risk coverage, risk sensitivity and comparability of capital adequacy measures across the insurance and takaful industry.

Chart 2.25: Insurance and Takaful Sector – Capital Adequacy Ratio



Source: Bank Negara Malaysia

⁷ ITOs that commit to reforms to improve the motor claims ecosystem (encompassing prudential and market conduct conditions, along with a commitment to digitalise the motor claims process for greater control and efficiency) will gradually receive greater pricing flexibility for motor and fire insurance/takaful products. This will happen in two stages: Phase 2A and then Phase 2B.

⁸ Refers to the ratio of net claims incurred to earned premium income.

⁹ The exposure draft is available at <https://www.bnm.gov.my/-/ed-rcpito>.



Financial Institution Soundness and Resilience

Looking ahead in the near term, uncertainty in financial market conditions will continue to present a key downside risk to ITOs' earnings, given their sizeable exposures to bond and equity investments. Additionally, exposures to climate events, particularly floods, could see increased

volatility in the performance of general ITOs. Meanwhile, further losses from medical inflation could increase risks of reduced access to affordable medical insurance and takaful coverage, leaving households potentially more vulnerable to financial shocks.

Participating Life Insurance Business in Malaysia

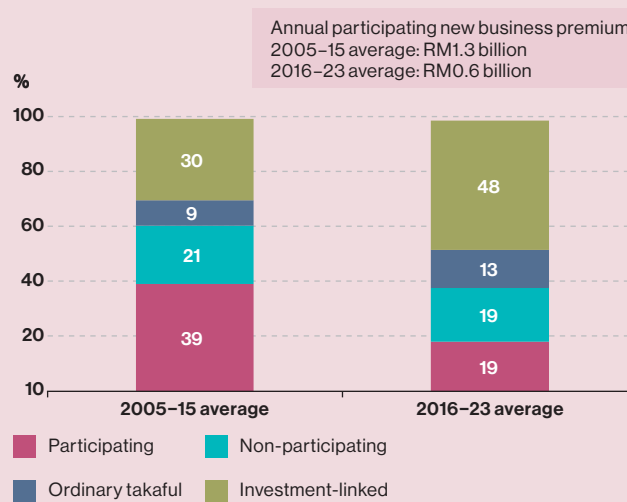
A participating life insurance policy is a type of insurance product that provides policyholders with the opportunity to participate in the profits of the insurance fund, in addition to receiving guaranteed benefits upon claims for insured events such as death or total and permanent disability. The profits of the participating life insurance fund may be distributed as non-guaranteed benefits¹ on a regular basis and/or upon termination, as determined by the policy terms. Participating life insurance policies typically include a savings element, where policyholders expect to receive maturity payouts upon termination or at the end of the policy term. In some markets, a participating life insurance policy is also referred to as a with-profit insurance policy.

This article reviews the developments in the participating life insurance business in Malaysia, provides insights into the factors driving the recent trends in the industry, and assesses the implications for the insurance sector.

Current developments in the participating life insurance business in Malaysia

In the recent decade, participating life insurance policies have seen a significant decline in their share of net premium in the life insurance and family takaful sector (Chart 1). This has been attributed to a prolonged reduction in participating life insurance new business premium, coupled with lower renewal premium arising from the termination and maturity of participating life insurance policies over time.

Chart 1: Life Insurance and Family Takaful Sector – Net Premium by Product Composition



Factors driving the decline in participating life insurance business

The trend of declining participating life insurance policies is not unique to Malaysia. Some markets in Asia and Europe² are also facing similar situations. Several common challenges faced by insurers across Asia³ include the historically prolonged low-interest rate environment that has put pressure on investment returns, stronger regulatory requirements including changes to risk-based capital frameworks, and the availability of more attractive alternative policy offerings.

¹ Benefits can take the form of bonuses and/or dividends payouts, in addition to guaranteed benefits.

² Based on Milliman's article dated 17 March 2021, titled 'The with-profits end-game: A consideration of the potential approaches to winding up with-profits fund'.

³ Based on a survey conducted by Milliman in the second quarter of 2023 amongst 76 life insurers across Asia including Malaysia, China, Hong Kong, India, Indonesia, Philippines, Singapore, Sri Lanka, Thailand, and Vietnam (Participating business in Asia 2023 (milliman.com)).

Life insurers in Malaysia face similar challenges. In a survey conducted by Bank Negara Malaysia (BNM),⁴ more than half of the insurers surveyed cited the shift in consumer preferences towards insurance policies that provide greater protection against life uncertainties as a key contributing factor to the decline of participating life insurance policies. This preference partly reflects the heightened awareness and demand among Malaysians for financial protection to meet medical and health expenses, which are typically not covered under participating life insurance policies. Participating life insurance policies generally provide coverage for events such as death or total and permanent disability, which may not align with the current preferences of potential policyholders who are looking for coverage that addresses a broader range of financial needs.

Participating life insurance policies are also perceived to be less flexible compared to other life insurance policies. They typically have fixed premiums, with a guaranteed minimum coverage that is pre-determined at inception. In contrast, other life insurance policies such as investment-linked (IL) policies⁵ allow policyholders to make partial withdrawals or additional payments to their unit fund corresponding to their financial circumstances, as well as to choose and switch unit fund investments according to their risk tolerance and financial objectives.

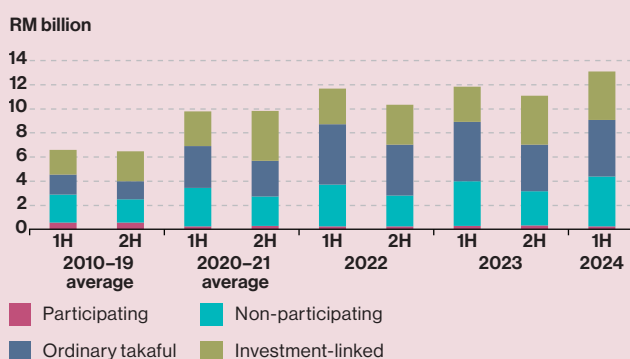
Furthermore, participating life insurance policies may be more difficult for policyholders to fully understand or appreciate due to the way in which profits are shared with policyholders. For example, the actual investment performance of a participating life insurance fund is not directly reflected in the declared bonuses due to smoothing practices.⁶ This contrasts with IL policies, where the return from an IL fund is directly reflected in the unit fund's value, with investment risks fully borne by the policyholders.

From the supply perspective, life insurers face heightened challenges in meeting expected investment returns of insurance funds in an uncertain macroeconomic environment. Life insurers are also factoring in enhanced regulatory requirements⁷ in their long-term strategies for participating life insurance business. These considerations have seen some insurers gradually scale back their offering of participating life insurance policies.

Impact on the insurance sector

The longer-term decline in the volume of new participating life insurance policies has led to a persistent trend of underwriting losses recorded for participating life insurance funds. However, the financial impact on the sector remains limited. Excluding the participating life insurance funds, the sector continues to record positive net underwriting performance, driven by other life insurance policies. Overall, total new business premium, including savings-based policies, continues to experience positive growth. This is supported by the sustained growth in alternative insurance policies, reflecting strong substitution effects associated with new business premium shifting from participating policies to IL and non-participating policies (Chart 2). Such effects have continued to support overall earnings performance.

Chart 2: Life Insurance and Family Takaful Sector – New Business Premium by Product Composition



Source: Bank Negara Malaysia

⁴ The survey was conducted by BNM in April 2024 on 11 life insurers in Malaysia writing participating life insurance policies.
⁵ A policy that combines life insurance coverages with investment components, where the investment risks are borne by policyholders.
⁶ Smoothing is a unique feature of participating life insurance policies, whereby life insurers may withhold some returns during periods of strong fund performance to maintain bonuses during periods of poor fund performance.
⁷ Refer to BNM policy document on Management of Participating Life Business issued on 10 July 2023 (<https://www.bnm.gov.my/documents/20124/948107/pd-Participating-Life-Business-Mgmt-July2023.pdf>).

Despite the shrinking participating life insurance funds, life insurers have allocated sufficient reserves to fund payouts for participating life insurance policies. Guaranteed benefits for policyholders are well covered by ample buffers, with a coverage ratio of 166% in June 2024.⁸ As of June 2024, the total surplus arising⁹ from participating life insurance funds remained positive at RM2.4 billion, adding to the overall capital buffers of ITOs.

Outlook

Insights from the BNM survey indicate that growth in new participating life insurance business will likely remain low in the foreseeable future.

For some insurers, the persistent decline of participating life insurance funds could reduce economies of scale for risk and expense pooling to an unsustainable level. Under the policy document on the Management of Participating Life Business issued by BNM in July 2023, insurers must observe specific requirements for managing small¹⁰ and shrinking participating life insurance funds to preserve the safety and soundness of the funds and safeguard policyholders' interests. These include requirements for insurers to take appropriate remedial or mitigation actions to address risks emanating from the decline of participating life insurance funds, including revisions to bonus management strategies, timely and proper communications with policyholders and increasing reserves, to ensure that payouts are commensurate with policyholders' reasonable expectations.

⁸ Ratio of participating life insurance funds total benefit reserves relative to guaranteed benefit reserves.

⁹ Surplus arising refers to the amount of change or increase in unappropriated surplus (excess of assets over liabilities, including reserves). The surplus can be used to support the capital requirement of the insurance funds.

¹⁰ Based on BNM policy document on Management of Participating Life Business, a participating life insurance fund is deemed small if (i) the size of the participating life insurance fund is less than RM2 billion; (ii) the number of in-force policies is less than 200,000; and (iii) the annual office premium is less than RM200 million.

Annex



Table A.1

Key Financial Soundness Indicators

	As at end				
	1H 2022	2H 2022	1H 2023	2H 2023	1H 2024 ^p
	% (or otherwise stated)				
Banking System					
Total Capital Ratio	18.4	19.0	18.8	19.0	18.4
Tier 1 Capital Ratio	15.2	15.8	15.7	15.9	15.3
Common Equity Tier 1 Capital Ratio	14.7	15.2	15.1	15.4	14.8
Return on Assets ¹	1.3	1.4	1.3	1.2	1.3
Return on Equity ¹	11.8	12.3	11.5	11.2	12.0
Liquidity Coverage Ratio	148.2	151.4	154.7	161.0	155.1
Net Impaired Loans Ratio ²	1.1	1.1	1.1	1.1	1.0
Capital Charge on Interest Rate Risk in the Trading Book to Capital Base	0.9	0.9	1.0	1.0	1.3
FX Net Open Position to Capital Base	4.1	3.4	3.7	3.9	5.2
Equity Holdings to Capital Base	1.3	1.2	1.2	1.4	2.3
Insurance and Takaful Sector					
Capital Adequacy Ratio	224.4	225.5	226.4	222.2	227.0
Life Insurance and Family Takaful					
Excess Income over Outgo (RM billion) ³	-2.8	5.5	6.0	3.2	8.4
New Business Premium / Contribution (RM billion)	12.3	10.8	12.6	11.5	14.0
Capital Adequacy Ratio	217.3	216.4	217.5	211.2	220.0
General Insurance and General Takaful					
Operating Profit (RM billion)	1.0	2.1	1.3	1.8	1.7
Underwriting Profit (RM billion)	0.4	1.2	0.2	0.8	0.7
Gross Direct Premium / Contribution (RM billion)	12.1	12.1	13.3	13.3	14.6
Claims Ratio	63.8	52.0	60.7	56.7	58.5
Capital Adequacy Ratio	246.2	249.5	250.0	253.0	243.1
Household (HH) Sector					
HH Debt (RM billion)	1,409.1	1,451.4	1,481.8	1,534.7	1,573.6
HH Financial Assets (RM billion)	2,901.9	3,002.0	3,038.7	3,176.8	3,300.1
HH Debt-to-GDP Ratio	84.4	80.9	81.9	84.2	83.8
HH Financial Assets-to-Total HH Debt Ratio	205.9	206.8	205.1	207.0	209.7
HH Liquid Financial Assets-to-Total HH Debt Ratio	137.5	135.4	133.3	132.3	135.2
Impaired Loans Ratio of HH Sector (Bank Loans) ²	1.3	1.2	1.3	1.2	1.2
Impaired Loans Ratio of HH Sector (Non-Bank Loans) ⁴	1.1	1.1	1.3	1.2	1.2
Business Sector					
Return on Assets	2.8	2.5	2.4	2.4	2.4
Return on Equity	4.7	4.6	3.8	4.0	4.0
Debt-to-Equity Ratio	22.2	22.6	20.9	20.5	20.5
Interest Coverage Ratio (times)	8.2	7.4	5.7	5.8	6.2
Operating Margin	7.7	7.0	6.4	6.8	7.0
Impaired Loans Ratio of Business Sector ²	3.0	2.8	2.8	2.7	2.6
Development Financial Institutions⁵					
Lending to Targeted Sectors (% change) ⁶	2.7	1.3	2.4	5.9	5.3
Deposits Mobilised (% change)	2.3	3.9	1.8	-0.1	4.3
Impaired Loans Ratio ⁶	5.9	5.5	5.9	5.6	6.0
Return on Assets	1.0	1.1	1.2	1.3	1.4

¹ Banking system profits are aggregated at the entity level and adjusted for dividend income received from domestic banking subsidiaries.

² Based on Stage 3 loans under the Malaysian Financial Reporting Standard 9 (MFRS 9).

³ Excess income over outgo excludes investment-linked unit funds to reflect the core performance of ITOs' profitability more accurately and thus, may not be directly comparable to the data reported in previous publications.

⁴ Based on loans with 3 months or more in-arrears.

⁵ Refers to development financial institutions under the Development Financial Institutions Act 2002.

⁶ Data on loan/financing by DFIs from 2022 onwards are based on updated statistical reporting requirements to reflect more accurate data definition and reporting methodology.

^p Preliminary

Note: Figures may not necessarily add up due to rounding.

Source: Bank Negara Malaysia, Bursa Malaysia, Department of Statistics Malaysia, Employees Provident Fund, Securities Commission Malaysia, S&P Capital IQ and Bank Negara Malaysia estimates

Table A.2

Key Financial Indicators: Islamic Banking and Takaful Sectors

	As at end				
	2H 2021	1H 2022	2H 2022	1H 2023	2H 2023 ^p
Islamic Banking System	RM million (or otherwise stated)				
Total Assets ¹	1,191,622.4	1,236,239.2	1,316,121.5	1,343,223.8	1,398,150.3
% of total assets of entire banking system ¹	35.5	35.5	36.3	36.2	36.6
Total Financing ¹	879,159.0	915,901.3	974,383.5	993,226.8	1,049,707.5
% of total loans / financing of entire banking system ¹	42.3	43.0	44.5	44.7	45.6
Total Deposits and Investment Accounts ¹	968,918.4	1,001,104.9	1,058,671.8	1,075,999.2	1,121,984.0
Total Deposits ¹	844,293.4	865,763.1	926,471.6	933,153.2	968,569.3
Total Investment Accounts ¹	124,625.0	135,341.8	132,200.2	142,845.9	153,414.7
% of total deposits and investment accounts of entire banking system ¹	39.8	40.2	41.6	41.6	42.0
	%				
Total Capital Ratio	19.2	18.3	18.9	18.2	18.0
Tier 1 Capital Ratio	15.5	14.5	15.5	14.8	14.8
Common Equity Tier 1 Capital Ratio	15.0	14.0	14.8	14.1	14.0
Return on Assets	1.1	1.2	1.3	1.0	1.0
Net Impaired Financing Ratio	0.9	1.0	1.0	1.1	1.1
Takaful Sector	RM million (or otherwise stated)				
Takaful Fund Assets	45,803.0	46,780.0	49,864.4	52,461.9	55,639.8
Family	40,258.9	41,182.8	43,645.1	45,969.0	48,477.3
General	5,544.1	5,597.2	6,219.4	6,492.9	7,162.5
% of insurance and takaful industry	12.6	13.2	13.4	13.7	14.0
Net Contribution Income	6,614.6	8,588.5	7,715.3	8,973.5	8,310.5
Family	5,093.2	6,886.3	5,853.9	7,053.3	6,218.9
General	1,521.5	1,702.1	1,861.4	1,920.2	2,091.6
% of insurance and takaful industry	19.4	24.3	21.6	24.7	22.1
Family Takaful					
New Business Contribution	3,817.5	5,439.9	4,618.9	5,225.6	4,364.7
General Takaful					
Gross Direct Contribution	1,966.4	2,229.5	2,407.2	2,679.0	2,764.4
Claims Ratio (%)	50.7	60.0	61.0	64.3	62.2

¹ Including development financial institutions under the Development Financial Institutions Act 2002.

^p Preliminary

Note: Figures may not necessarily add up due to rounding.

Source: Bank Negara Malaysia