MARKET, LIQUIDITY AND FUNDING RISK

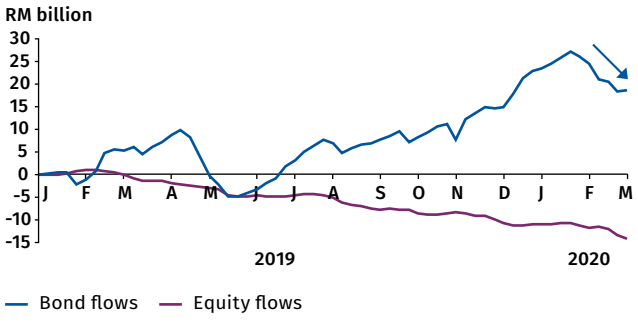
Domestic Financial Markets were Affected by External and Domestic Headwinds, but Adjustments have been Orderly

In the second half of 2019, the escalation of trade tensions in the third quarter led to episodes of risk-off sentiment which affected the performance of the domestic bond and equity markets. Global investor sentiment, however, improved towards the end of the year in anticipation of the signing of the Phase 1 trade deal between the US and PR China. In the domestic government bond market, accomodative global financial conditions from monetary policy easing in a number of advanced economies and Malaysia's continued inclusion in the FTSE Russell World Government Bond Index (WGBI) sustained non-resident inflows in the second half of 2019 (Chart 1.20). In contrast, the Malaysian equity market continued to experience non-resident outflows, reflecting lacklustre corporate earnings and the flight towards safer assets such as government bonds.

Investor sentiment turned more cautious in late-January 2020 as the COVID-19 outbreak dampened prospects of stronger global growth. The global spread of COVID-19 and measures taken to contain the spread have further weighed on sentiment, leading to non-resident outflows from

Chart 1.20: Financial Market – Cumulative Non-resident Portfolio Flows

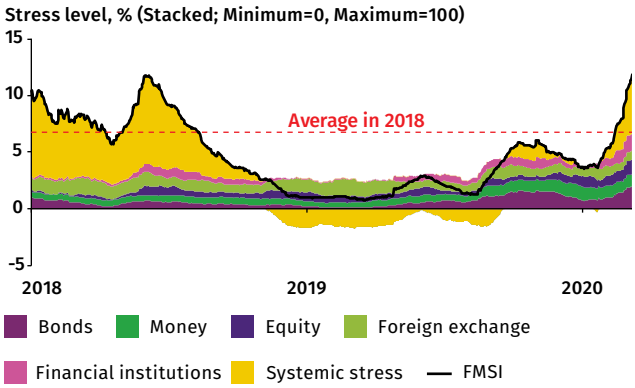
Net non-resident portfolio outflows observed since the beginning of 2020



Source: Bank Negara Malaysia and Bloomberg

Chart 1.21: Financial Market – Financial Market Stress Index (FMSI)

Market stress rose to levels observed in 2018



Source: Bloomberg, Reuters and Bank Negara Malaysia estimates

the bond and equity markets. These developments contributed to the higher broad-based stress levels in domestic financial markets (Chart 1.21). In recent weeks, market volatility has surpassed stress levels observed over the past decade and is expected to remain heightened at least in the near term. However, the continued presence of domestic institutional investors as well as the deep and liquid financial markets is expected to continue to support the intermediation of portfolio flows, thus preserving orderly market conditions.

Banking System Funding and Liquidity Conditions Remain Supportive of Intermediation Activity

Despite continued volatility in domestic financial markets, liquidity and funding conditions in the banking system remain supportive of credit intermediation activities. Stable deposits and long-term funding, collectively, grew at a slower pace by 2.7% in the second half of 2019. While the growth in deposit placements by households and non-bank financial institutions was sustained, public sector deposits declined amid withdrawals by the Government for repayment of maturing bonds and payment of remaining expenses for the year (Chart 1.22). Notwithstanding this, overall funding conditions remained stable. Banks' loan-to-fund (LTF) and loan-to-fund-and-equity (LTFE) ratios were little changed (Chart 1.23), while

banks' median cost of funds declined to 2.8% (1H 2019: 3.0%) as deposits were gradually repriced following the Overnight Policy Rate (OPR) cut in May and the reduction in the Statutory Reserve Requirement (SRR) Ratio in November.

The Liquidity Coverage Ratio (LCR) of the banking system, which indicates banks' ability to meet liquidity needs over a 30-day stress period, stood at 149.1% as at end-2019 (Chart 1.24), with all banks recording LCR levels above the regulatory minimum of 100%. These liquid assets are available for banks to draw upon during periods of stress. As part of measures recently introduced by the Bank to preserve stability in funding markets and support bank lending activity, the implementation of the Net Stable Funding Ratio (NSFR) requirement will be phased-in with a minimum compliance ratio of 80% in July 2020 and 100% in September 2021. Banks remain well-positioned to meet the revised requirements.

Risks posed by banks' external debt[36] exposures remained manageable

Banks' reliance on external debt continued to be limited, accounting for less than 10% of total banking system funding liabilities (Chart 1.25). In the second half of 2019, banks' external debt expanded by RM14.2 billion to RM362.6 billion, largely attributable to higher FCY deposits and FCY interbank borrowings as some domestic banking groups (DBGs) took pre-emptive measures to accumulate additional US dollar liquidity buffers in anticipation of a potential tightening in US dollar liquidity conditions towards the year end.[37] Correspondingly, banks' external assets also increased as a result of higher intragroup placements as part of DBGs' centralised liquidity management. Some DBGs increased carry trade activities to take advantage of interest rate differentials. Risks from external debt exposures associated with such activities remain low as investments funded by offshore borrowings are typically in government bonds or central bank securities and are closely matched in terms of duration. Higher placements from the parent banks of locally-incorporated foreign banks (LIFBs) to fund domestic FCY loans and short-term investment activities were also observed.

Risks posed by currency and maturity mismatches arising from banks' external debt exposures remain low based on several factors. A high proportion (58%) of external debt exposures comprises intragroup placements and long-term debt securities which are generally more stable, thereby reducing withdrawal or rollover risks faced by banks. 17% of the external debt was ringgit-denominated, mainly in the form of non-resident deposits. These exposures are not subject to valuation changes from fluctuations in the exchange rate. As at end-2019, banks' liquid FCY assets were more than adequate to cover two times the FCY external debt-at-risk[38] (Chart 1.26). Risks associated with cross-currency mismatches are further mitigated by the low foreign exchange net open position (FX NOP) of banks in line with active hedging activities by banks (Chart 1.27), and DBGs' continued compliance with the local LCR requirements in the major jurisdictions in which they operate.

The discontinuation of London Interbank Offer Rate (LIBOR) by end-2021 and the transition to alternative risk-free rates (RFRs) however poses some challenges for banks globally including those in Malaysia (for further analyses on the challenges and transition strategy, refer to the Information Box on 'Benchmark Rate Reform: LIBOR Transition').

[36] Refers to all liabilities that require payment of principal and/or interest at some point in the future, and are owed to non-residents by residents of an economy. This is in accordance with the External Debt Statistics guide provided by the International Monetary Fund.

[37] This was largely driven by concerns over the removal of Malaysian Government Securities (MGS) from the FTSE Russell WGBI in September and stress in the US money market.

[38] Refers to the proportion of banks' external debt that is more susceptible to sudden withdrawal shocks. This comprises financial institutions' deposits, interbank borrowings and short-term loans from unrelated non-resident counterparties.

Chart 1.22: Banking System – Contribution to Growth in Deposits Accepted

Growth in deposits largely driven by households and non-bank financial institutions

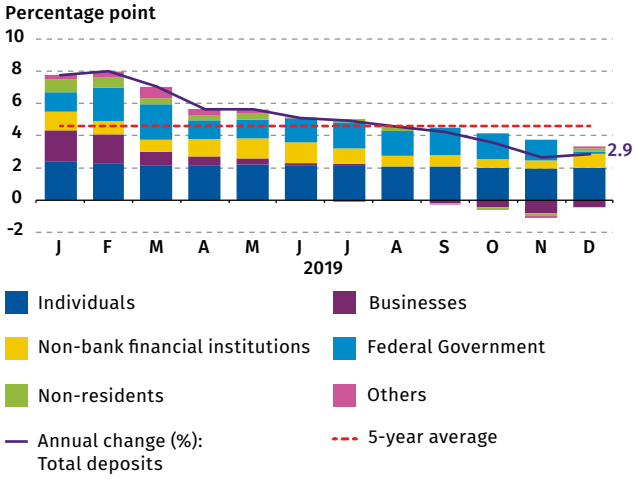


Chart 1.23: Banking System – Loan-to-Fund Ratio and Loan-to-Fund-and-Equity Ratio

Banks' funding remained stable to support intermediation activities

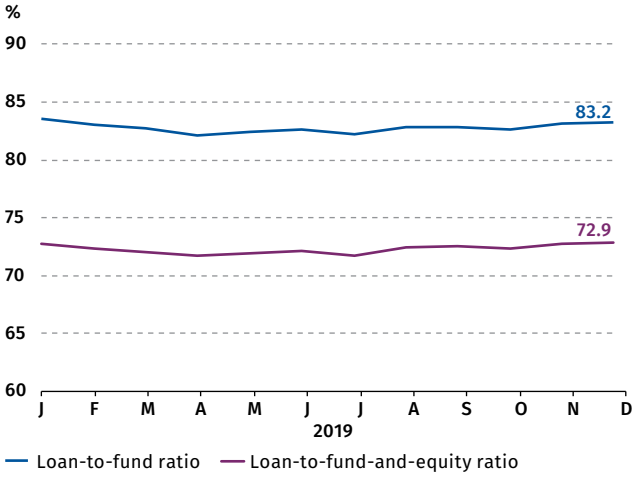


Chart 1.24: Banking System – Liquidity Coverage Ratio, High Quality Liquid Assets and Net Cash Outflows

Decline in LCR reflective of banks' disposal of government bonds to capitalise on declining yields

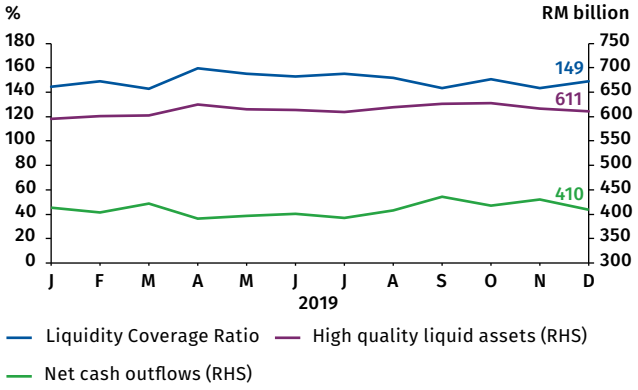


Chart 1.25: Banks' External Debt – by Instrument

Higher external funding reflects higher deposits accepted from financial institutions and customers, and interbank borrowings

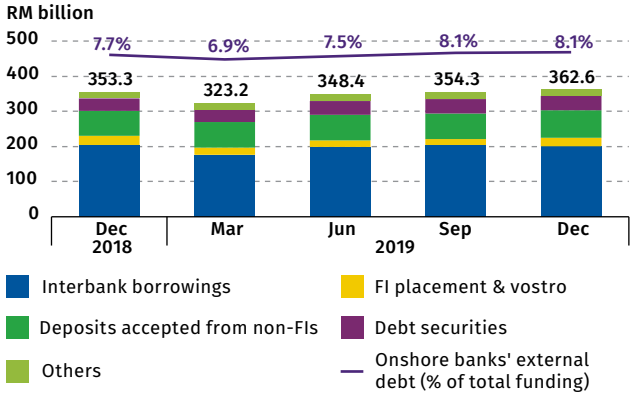


Chart 1.26: Banking System – FCY External 'Debt-at-Risk' and Liquid Assets

Banks maintained FCY liquid assets of more than two times the FCY external 'debt-at-risk'

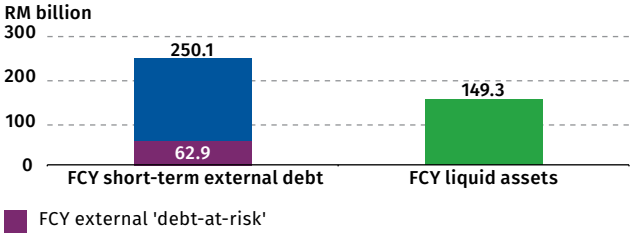
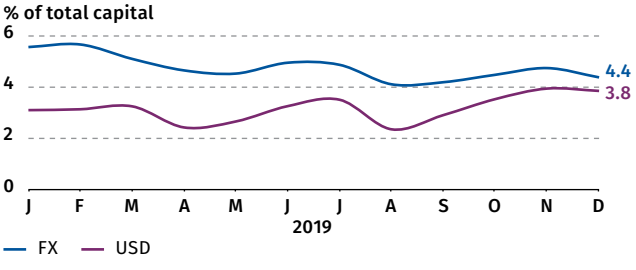


Chart 1.27: Banking System – FX and USD Net Open Positions as Percentage of Capital

FX and USD net open positions remained low



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

Source: Bank Negara Malaysia

Benchmark Rate Reform: LIBOR Transition

London Interbank Offer Rate (LIBOR) has been a dominant reference rate used in financial transactions globally, with more than USD300 trillion in outstanding financial contracts that reference LIBOR. As part of the global reform of benchmark interest rates, LIBOR will be discontinued by end-2021[39] and replaced by alternative risk-free rates (RFRs).[40] As existing LIBOR panel banks will also gradually cease to support this benchmark rate, it is likely that LIBOR will no longer represent accurately and reliably the market or economic reality that the benchmark is intended to measure. The transition away from LIBOR could have significant legal, valuation, accounting, risk management, and system implications for banks globally. Therefore, there is a need for the financial industry to strategise and accelerate the preparation for the transition away from LIBOR.

The Malaysian banking industry's LIBOR exposures[41] are considerable at RM857 billion as of 30 June 2019 (Diagram 1.5). Derivative contracts account for 79% of the LIBOR exposures but pose lower transition risk as these contracts are largely standardised with concerted global efforts[42] to develop fallback provisions well in progress. Existing LIBOR loans maturing beyond 2021 pose greater concern, as these loans require banks and borrowers to renegotiate existing contracts individually and incorporate fallback provisions. The spread between the existing LIBOR and the RFR can result in potential gains to one party of the transaction and losses to the other. For example, if the RFR is lower than the existing LIBOR, the borrower may gain from the lower rate at the expense of the bank. Any potential transfer of value between parties of the transaction arising from the transition to the RFR could complicate contract modifications and pose legal, tax, reputational and economic risks to banking institutions.

Diagram 1.5: LIBOR Exposures as of 30 June 2019

*Mainly interbank lending/borrowing and customer deposits

Note: At consolidated banking group level

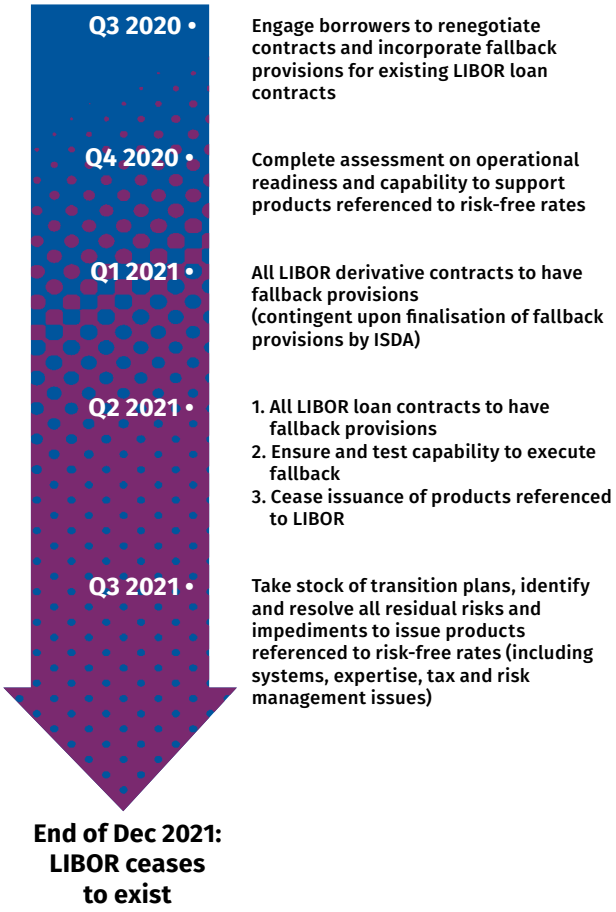
Source: Bank Negara Malaysia

The unavailability of a reliable term structure for RFRs presents a further challenge as under the new RFRs, the actual term rate will only be known at the end of the compounding period.[43] Given this constraint, borrowers are reluctant to adopt the new RFRs as they prefer more certainty in their expected monthly cash flows. In response, industry and regulatory efforts to offer new RFR term rates have recently intensified. The Federal Reserve Bank of New York, administrator of the US Dollar Secured Overnight Financing Rate (SOFR), for example, has begun to publish SOFR term rates[44] beginning 2 March 2020. This move will facilitate the renegotiation of LIBOR loan contracts.

For the Malaysian banking industry, the Bank has established key signposts to ensure that banks adequately prepare for and manage a smooth transition away from LIBOR (Diagram 1.6).

[39] Financial Conduct Authority (FCA) UK indicated that by end-2021, the FCA would no longer compel panel banks to submit quotes for LIBOR.
[40] Based on overnight trades in markets, whether unsecured or secured, where liquidity is deep enough to allow the rate to be strongly anchored in transactions, including in more adverse market conditions. The RFRs, by largely excluding bank credit risk, also closely track central bank policy rates, offering a more efficient and transparent way of measuring, managing, and hedging movements in those rates.
[41] On balance sheet outstanding amount and derivatives notional amount at consolidated banking group level.
[42] Developments in derivative contracts' fallback provisions are driven by International Swaps and Derivatives Association (ISDA).
[43] At present, only the overnight RFR is available. In the absence of published term rates for RFRs, the interest chargeable for RFR loans is calculated by compounding the overnight rate over the loan interest payment period (e.g. monthly). As a consequence, the actual rate of the loan will only be known at the end of the interest payment period.
[44] 30 days, 90 days and 180 days.

Diagram 1.6: LIBOR Transition Signposts



Note: Signposts may be reviewed if there is any change in the global transition timeline

Source: Bank Negara Malaysia

All banks have since established dedicated transition teams to oversee the process but actual progress remains uneven across institutions. There is an urgent need for banks to ensure a robust process for identifying and evaluating the range of possible transition risks and accelerate efforts to prepare for the transition. Aside from the potential challenges in renegotiating existing contracts with borrowers, other risks should also be given due consideration. These include banks' operational readiness and system capability to support products referenced to alternative RFRs, potential tax implications and the impact of changes to banks' risk management models that rely on LIBOR-based parameters. Banks should also undertake adequate measures to mitigate consumer conduct risks arising from the issuance of new LIBOR-based financial contracts maturing beyond 2021. If not managed well, banks could face significant reputational risks arising from the failure to properly disclose and educate borrowers on the transition to an RFR.