

Financial Institution Soundness and Resilience

THE BANKING SECTOR

The Capitalisation of the Banking Sector Remains Strong,¹ Bolstering Banks' Resilience against Potential Stress Arising from Adverse Financial and Macroeconomic Shocks

All banks continue to maintain capital ratios well in excess of the regulatory minimum (Chart 2.1), underpinned by continued profitability and sound asset quality. The overall risk profile of banks has also been broadly stable, with the ratio of risk-weighted assets to total assets² remaining largely unchanged in recent periods at around 58%.

Sustained profitability and sound asset quality strengthened the solvency position of the banking system

In the second half of 2019, banking system profitability was sustained above the estimated average cost of capital (Chart 2.2),³ further strengthening banks' solvency positions. Pre-tax profits recorded an annual growth of 15.4%, supported by strong growth in non-interest income (Chart 2.3). Profit-taking by banks in the government

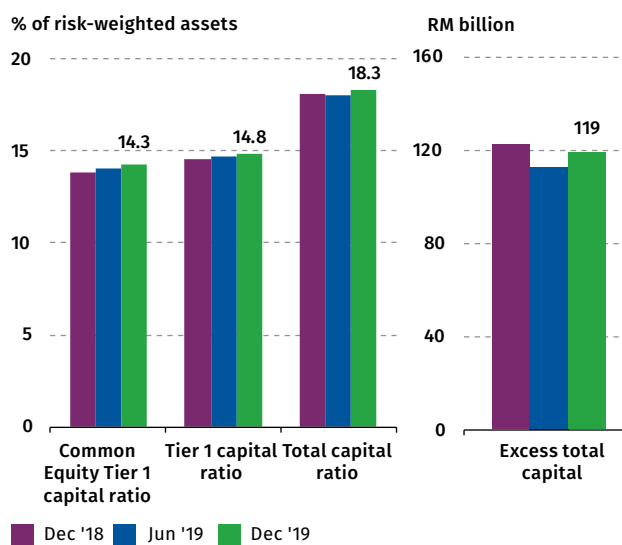
¹ Most of banks' capital (78%) are held in the form of Common Equity Tier 1 capital instruments such as ordinary shares and retained earnings, which are regarded as the most reliable and highest quality form of capital available to absorb losses.

² The ratio measures the relative riskiness of banks' assets. A higher ratio (or risk-weight density) generally indicates higher risk-taking by banks. Malaysian banking system risk-weight density has remained broadly stable in recent periods (December 2019: 57.6%; June 2019: 58.3%; December 2018: 58.2%).

³ The average cost of capital for Malaysian banks is estimated using the Capital Asset Pricing Model.

Chart 2.1: Banking System – Capitalisation

Banks maintained strong capitalisation



Note: Excess total capital refers to total capital above the regulatory minimum, which includes the capital conservation buffer requirement for 2018 (1.875%) and 2019 (2.5%) and bank-specific higher minimum requirements

Source: Bank Negara Malaysia

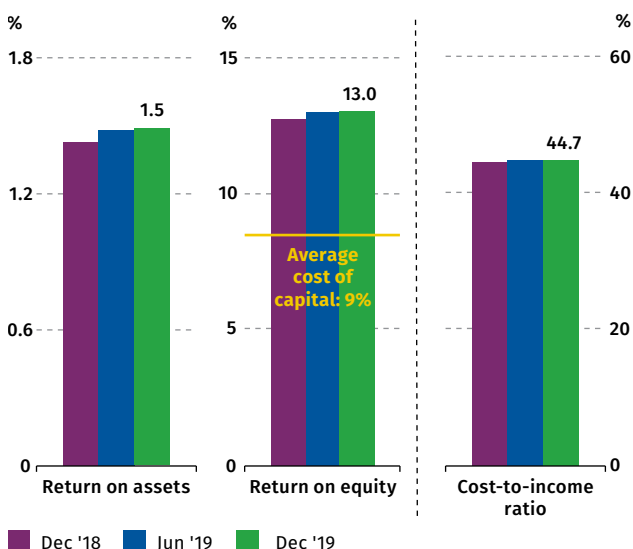
bond market amid declining yields in the second half of 2019 drove higher trading and investment income. The growth in fee and commission income has also been consistent with recent strides by banks to diversify revenue sources through the cross-selling of wealth management and insurance products.

In contrast, growth in net interest income from financing activities, which contributes the bulk (about two-thirds) of banks' gross income, moderated amid slower credit growth and further compression in banks' interest margins.⁴ Following the cuts in the Overnight Policy Rate (OPR) in May 2019 and the first quarter of 2020, slower adjustments to banks' funding costs (compared to the repricing of floating-rate loans)

⁴ For a broader discussion on trends affecting banks' interest margin, refer to the Financial Stability Review 1H 2019 Box Article 'Malaysian Banks' Profitability - Past Trends and Future Prospects'.

Chart 2.2: Banking System – Profitability

Banks sustained healthy profitability



Note: The average cost of capital for Malaysian banks refers to the average expected annual stock returns for all listed banks estimated using a Capital Asset Pricing Model

Source: Bank Negara Malaysia

will weigh on interest margins.⁵ However, with banks remaining generally prudent in their risk-taking, the drag on banks' earnings is expected to be cushioned by higher non-interest income, continued loan growth and lower debt-servicing burdens of borrowers. The reduction in net interest income from the lower benchmark policy rate is therefore expected to be largely manageable for banks.

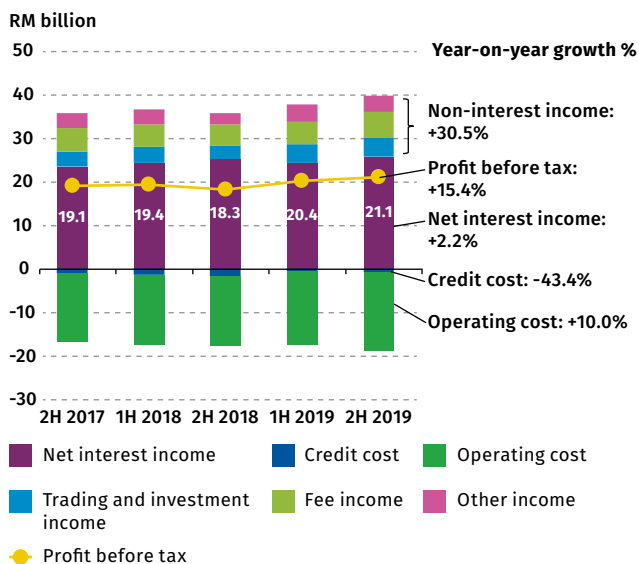
Interest rate risks in both the trading book and the banking book also remained low despite higher holdings of corporate bonds and negotiable instruments of deposit by several domestic banking groups. This reflects the active risk management and hedging strategies of banks, which have continued to contain exposures to levels well within prudent loss limits set individually by banks.

Banks continue to keep a firm lid on operational costs with sustained efforts to streamline and automate business processes as well as optimise their physical branch presence. On aggregate, the operating cost-to-income ratio remains stable at 44.7%.

⁵ This is also partly due to the increased stability of banks' funding profile in recent years. Banks now have a greater share of sticky and longer-tenure fixed deposits, following the implementation of the Bank's Liquidity Coverage Ratio and impending Net Stable Funding Ratio requirements.

Chart 2.3: Banking System – Income, Cost and Profit before Tax

Growth in banks' profits was driven by non-interest income



Note: Year-on-year growth computed based on figures for 2H 2019 and 2H 2018

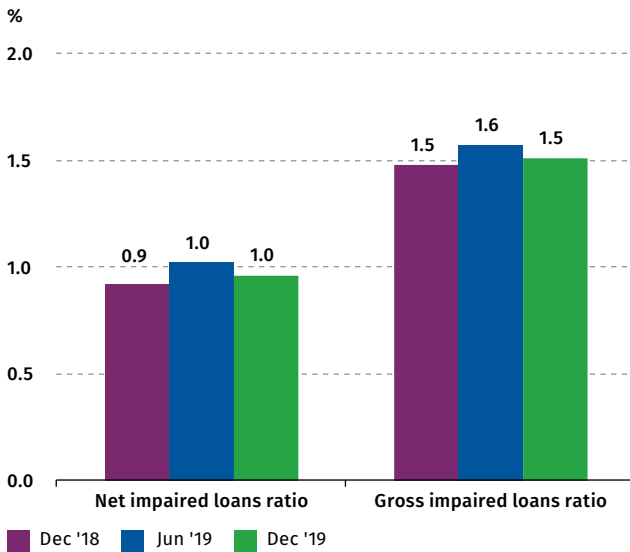
Source: Bank Negara Malaysia

Potential credit and market losses within financial buffers of banks

Impairments remain low across most credit portfolios and have been stable as a share of total banking system loans at 1.5% (Chart 2.4). As earlier noted, there has been some deterioration in loan performance in specific segments of the household and business sectors, but potential losses remain within the financial buffers of banks (for further details, refer to the credit risk section). In the wake of the COVID-19 pandemic, banks are expecting an increase in the share of restructured and rescheduled loans, particularly by borrowers in the business segments that have been most affected by the pandemic. This is likely to increase provisions over the short-term. Banks are well-positioned to absorb the potential impact on profitability, given the prudent provisioning buffers built up over the years. Total provisions including regulatory reserves held by banks against credit losses stood at RM33.9 billion or 126.4% of impaired loans as at end-2019 (Chart 2.5). Active monitoring and recovery efforts also saw several banks record impairment reversals on selected large credit accounts in December, thus sustaining overall asset quality.

Chart 2.4: Banking System – Asset Quality

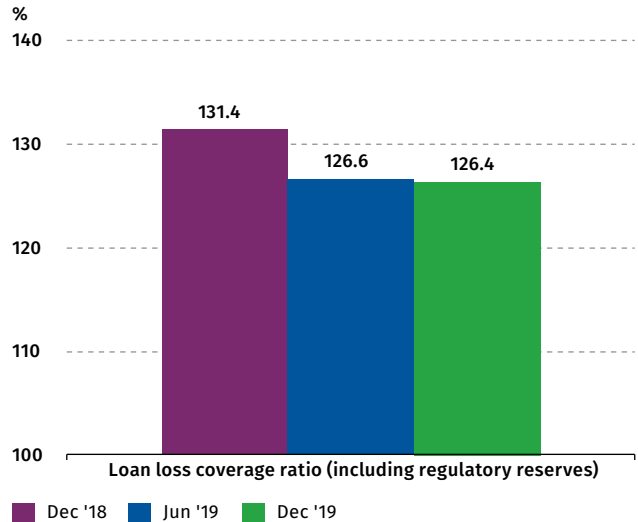
Impairment ratios remain low



Source: Bank Negara Malaysia

Chart 2.5: Banking System – Provisions

Banks continued to maintain strong buffers against potential credit losses



Source: Bank Negara Malaysia

Risks from DBGs’ overseas operations remained low despite the subdued regional economic environment

Weaker regional economic conditions affected the performance of domestic banking groups’ (DBGs) overseas operations⁶ in the second half of 2019 (Chart 2.6).

DBGs’ operations in Singapore, which account for almost half of total overseas assets (Chart 2.7), continued to face headwinds amid the challenging operating environment. The impairment ratio remained elevated at 3.8% (June 2019: 3.5%) due to higher new impairments relative to recoveries during the period. In Indonesia, DBGs recorded higher loan loss provisions amid the more moderate domestic growth performance with the impairment ratio rising to 4.1% (June 2019: 3.6%). Notwithstanding this, banking operations in Indonesia remained profitable as reflected by the weighted average return on equity of 9.8% (June 2019: 10.4%).

⁶ Refers to DBGs’ overseas offices (branches and subsidiaries) operating outside of Malaysia and Labuan International Business and Financial Centre (LIBFC). Cumulatively, DBGs have presence in 14 overseas jurisdictions, with major operations in Singapore, Indonesia, Thailand and Hong Kong SAR.

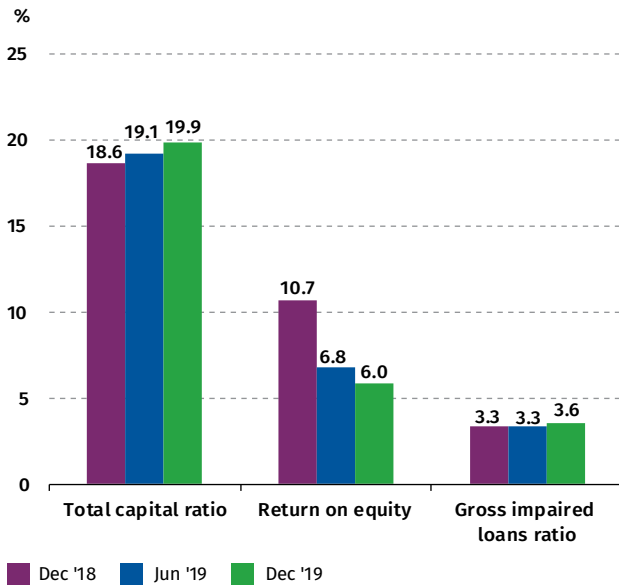
Meanwhile, the impact from heightened social unrest and political uncertainties in Hong Kong SAR has been limited as overseas operations in Hong Kong SAR remained small (7.5% share of total overseas assets) relative to other markets. Several DBGs have scaled back treasury and interbank activities, further reducing exposures in Hong Kong SAR (annual asset growth in 2019: -6.8%). DBGs recorded better earnings performance in Thailand (December 2019: 8.6%; June 2019: 7.3%), supported by relatively firm economic conditions, which contributed to higher interest income and improved asset quality.

The economic impact of the COVID-19 pandemic in the region will continue to weigh on the performance of DBGs’ overseas operations. In the first half of 2020, significant measures being taken by authorities to support affected businesses are however, expected to mitigate credit losses to banks. Based on banks’ internal stress tests, the potential impact of a further deterioration in the performance of DBGs’ overseas operations is expected to be manageable as their operations in Malaysia remain the largest contributor (84.5%) to overall profitability.

For 2020, banks are expecting weaker credit growth compared to 2019. This remains significantly dependent on the duration of the COVID-19 pandemic. While the impact of COVID-19

Chart 2.6: Banking System – Key Financial Indicators of Overseas Operations

Overseas operations remained profitable despite weaker economic conditions

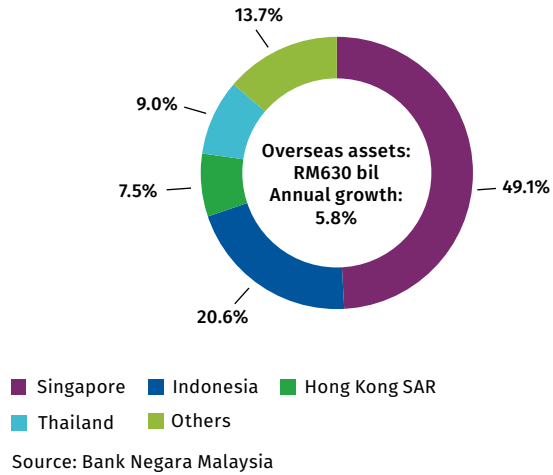


Note: The average key financial indicators are weighted by the asset size of selected overseas operations
 Source: Bank Negara Malaysia

on the economy is likely to be significant in the short-term, banks are entering this period from a position of strength, with significant capital and liquidity buffers. The prudent management of credit risks and diversified income sources will provide support to profitability. In addition, banks’ digitalisation strategies are expected to drive further operational efficiencies, lending additional support to long-term profitability and overall viability.

Chart 2.7: Banking System – Asset Composition of Overseas Operations

Overseas operations continue to be largely concentrated in Singapore and Indonesia



In response to the COVID-19 pandemic, the Bank also announced a series of regulatory measures in support of banks’ efforts to assist affected households and businesses. Banks have been allowed to draw down on capital and liquidity buffers, to support lending activities. These buffers, which have been built up over the years, along with liquidity management by the Bank, have placed banks in a strong position to support the economy during these challenging times. The sustained profitability of banks, underpinned by sound underwriting and risk management practices, will also help banks gradually restore their buffers once the flexibilities are lifted.