

Overview

Global financial vulnerabilities remained elevated in the second half of 2019 amid heightened uncertainties from trade and geopolitical tensions. During this period, prospects of weaker growth prompted several economies including those in Asia to reduce policy rates. Towards the end of 2019 and heading into 2020, improvements in the outlook for global growth which followed the Phase 1 trade deal between the United States and the People's Republic of China have since given way to widespread concerns over public health and the economic impact of the COVID-19 pandemic. The global economy is now projected to register negative growth in 2020. A reassessment of risk factors by investors and global policy responses to contain the pandemic and the consequent economic impact have renewed volatility in the financial markets. Since early March 2020, prospects of lower oil prices have also risen sharply after the collapse of an expected agreement on oil production cuts, further adding to market volatility. These headwinds are expected to weigh on the domestic economy and financial markets in 2020.

Amid these developments, domestic financial stability in Malaysia continues to be preserved. Financial market conditions have remained orderly despite portfolio outflows from both the bond and equity markets, supported by the presence of strong domestic institutional investors. The Financial Stability Committee of the Bank remains vigilant over elevated levels of private sector debt and imbalances in the property market which have continued to persist. While recent developments surrounding COVID-19 have increased risks to financial stability, the financial system is also more resilient to these risks. Crucially, financial institutions in Malaysia are well-positioned to support households and businesses through these exceptional circumstances. This will enhance prospects for a stronger recovery when the virus is contained and reduce longer-term risks to financial stability.

Businesses are facing more challenging conditions

The performance of businesses will remain highly challenging in the immediate period ahead. Businesses affected by the COVID-19 pandemic are facing tighter cash flows and slower demand. The sustainability of financial improvements earlier observed among firms in the oil and gas sector has become more uncertain. These developments have also clouded signs of improving conditions in the construction sector. While the developments could increase future credit risks for banks, measures announced by the Bank and the Government to support credit conditions for businesses and provide temporary financial relief will mitigate these risks.

As at end-2019, the overall debt-servicing capacity of businesses continued to be supported by broadly stable profitability and prudent leverage levels, although this has weakened in some sectors from earlier years. While banks' exposures to firms and sectors facing higher risks are expected to increase, potential losses to banks are expected to remain manageable. Sound provisioning practices by banks have also significantly strengthened the financial buffers that banks hold against potential losses. This will continue to support bank intermediation activities.

Household debt remains elevated

Overall household debt remains elevated and has recently edged higher, driven by loans for the purchase of residential properties. While housing loan impairments have increased in recent quarters, it has been from a low level with limited risks to banks due to improved assessments of loan affordability. Most households are able to comfortably service their debt, with growth in household financial assets continuing to outpace

that of debt. The vast majority of household borrowers are also expected to be resilient to a significant decline in house prices and income shocks as shown in this Review. Risks from household debt exposures remain concentrated among borrowers with monthly earnings of less than RM3,000 and housing loan borrowers with variable income who are more vulnerable to financial stress. The share of borrowers from the vulnerable income group has continued to decline to 17.6% of total household debt, while the exposure-at-risk for housing loan borrowers with variable income remained low at 2% of total banking system loans. The six-month moratorium on loan repayments and cash transfers by the Government to support households affected by COVID-19 should help households in managing their debt in the current environment. Some signs of easing in underwriting standards continued to be observed in 2019 but this has been mostly confined to lower risk-borrowers. Banks are well-positioned to continue supporting household lending activities which in turn will mitigate current macroeconomic risks. However, appropriate vigilance over lending standards will continue to be important to avert excessive debt burdens on households which could hurt future consumption.

Oversupply in some segments of the property market continues to persist

Initiatives to support home ownership have led to improvements in housing market activity and lowered the stock of unsold properties. Still, the number of unsold housing units remains elevated with house prices remaining seriously unaffordable and demand for affordable housing units continuing to outstrip supply by a wide margin. While placing a floor on corrections in house prices (and hence potential losses to banks), the underwhelming addition of affordable housing stock to the market will continue to exert upward pressure on the already high level of household debt. In the non-residential property market, oversupply conditions in the office space and shopping complex (OSSC) segment have not improved. This has led to elevated vacancy rates and depressed effective rental rates for

office and retail spaces. While conditions are likely to have deteriorated further in the wake of recent developments, the amount of debt-at-risk from bank exposures to the property sector is expected to be manageable with potential losses comfortably within banks' excess capital buffers.

Financial institutions remain profitable and well-capitalised

Banks, insurers and takaful operators remained profitable in 2019 despite the more challenging operating environment. Prudent risk-taking has cushioned the impact of cuts in the overnight policy rate since May 2019 on bank margins, with higher non-interest income, sustained lending activity and lower debt-servicing burdens of borrowers continuing to lend support to profitability. In the insurance and takaful sectors, overall performance has been supported by sustained business growth as ongoing reforms continued to contribute to improvements in pricing and persistency. Sustaining the momentum of insurance reforms, including in the motor insurance sector, will remain critical to preserve affordable access to insurance and takaful protection.

The continuing profitability of financial institutions is crucial to the essential roles that they play in the economy. Sustained profits have continued to underpin the strong capitalisation of financial institutions and a sound financial system in Malaysia. Capital buffers held by banks, insurers and takaful operators remain high. Along with the implementation of enhanced capital adequacy, liquidity and risk management standards for financial institutions, this has strengthened the overall resilience of the financial system. While the impact of COVID-19 on the economy is expected to be significant in the short-term, banks are entering this period from a position of strength. Updated stress tests conducted by the Bank continue to affirm that financial institutions remain resilient under severe market, credit, and funding and liquidity shocks. Further supporting this resilience is an increased supervisory emphasis by the Bank on strengthening financial institutions' response and recovery capabilities in the event of financial difficulty or operational disruptions. This underscores the ability of the financial system to

support economic activity under varying economic and financial conditions.

Looking ahead, a prolonged and severe impact from the COVID-19 pandemic remains a key downside risk to the economy and financial stability. A significant weakening of economic conditions could increase household, business

and financial market stress, and test the resilience of the financial system. As noted earlier, the financial system is on a strong footing to withstand such stress. Nevertheless, the Financial Stability Committee will continue to closely monitor developments to ensure continued support for the credit intermediation and risk protection needs of households and businesses.