Overview

The COVID-19 pandemic continued to present significant challenges to global economic activity in the second half of 2020, although prospects for a firmer recovery in the global economy have improved in recent months. While the rapid roll-out of fiscal and monetary policy responses on an unprecedented scale helped to avert a deeper economic downturn, risks to financial stability remain elevated. Global financial conditions remain susceptible to bouts of heightened volatility, despite having eased significantly since March 2020. Credit risk remains a key risk for the global financial system going forward, as policymakers weigh the trade-off between sustaining short-term support and averting medium-term macro-financial stability risks.

Domestically, significant efforts to strengthen the resilience of the Malaysian financial system over the years have afforded banks the capacity to help households and businesses through this difficult period by deferring loan repayments. Despite the unprecedented scale of debt assistance provided, banks have also continued to extend new financing in an environment of heightened credit risks. So far, this underlying strength of banks is enabling them to play an important countercyclical role to support the economy, both in the initial and subsequent recovery phases of this crisis. Insurers and takaful operators, backed by healthy financial buffers, have also been able to extend financial relief to affected policyholders to preserve their coverage. In the domestic financial markets, conditions stabilised over the second half of 2020, amid a reversal of non-resident bond outflows, a sharp increase in retail investor participation in the equity market, and sustained demand by domestic institutional investors.

While the second half of 2020 saw some improvements in the operating environment for businesses, recovery has remained uneven across different business sectors. Improvements observed were mainly in sectors that have returned to near-full operational capacity such as manufacturing. Meanwhile, companies in more severely affected industries such as hotels and restaurants have experienced further depletion of their financial buffers amid a persistent decline in revenue. Small and medium enterprises (SMEs), in particular, were significantly affected given more limited financial buffers and narrower profit margins. Repayment assistance, along with support measures introduced by the Government and the Bank, have helped businesses to sustain financing repayments and contained any notable increase in defaults. While defaults are expected to rise from current levels, loan repayment data suggests that most firms are able to service their debt as business activities resume. The easing of containment measures, vaccine roll-out and more targeted policy support going forward are expected to further support debt-servicing capacity and mitigate any material increase in defaults.

For households, financial asset growth continued to outpace that of debt, indicating that in aggregate, households have managed to increase their financial wealth during this period. Nonetheless, lower-income segments remain stretched financially. These borrowers are likely to face continued challenges in 2021 given an uneven recovery in the labour market. Similar to businesses, repayment assistance programmes and support measures are helping to ease cashflows of financially-stretched households. However, a sustained recovery in income will be key to maintain their debt-servicing capacity over the longer term. Outside this segment of household borrowers, most households are in reasonably good shape, with repayment levels by households in the banking system reaching over 90 percent of levels seen prior to the automatic moratorium.

In the Malaysian property market, housing market activity saw a slight rebound in the third quarter of the year amid the low interest rate environment and ongoing measures to support demand. Average housing transaction values rose for a second consecutive quarter, lending support to house prices. Softer market conditions have also prompted supply shifts towards more affordable housing segments, a welcome adjustment in reducing the demand-supply mismatches weighing on housing affordability. This also helps to mitigate risks of future disorderly price corrections. The non-residential property segment, however, continued to face considerable challenges. The hotel segment remains severely affected by travel restrictions, while the recovery in footfall in shopping malls also faced headwinds from lingering concerns over the resurgence of COVID-19. Some businesses have started downsizing office space amid the prevalence of flexible working arrangements, weighing on occupancy and rental growth of office space. Taken together, risks of potential losses to financial institutions from prospects of weaker debt-servicing ability and valuations in the non-residential property market are judged to have increased due to COVID-19. Nonetheless, banks have built up adequate provisions against potential credit losses, which are expected to remain manageable given the low and declining share of bank exposures to segments of the property market exhibiting higher risks.

Overall credit costs of banks remained at an elevated level as banks continued to build up provisions in anticipation of higher credit losses. The various measures introduced since the onset of the crisis, including repayment assistance programmes by banks, targeted financing schemes and government relief programmes, have helped to stave off more severe scarring effects on the economy and the subsequent spillovers to the financial system. Nonetheless, banks face considerable challenges in assessing loan performance, in part due to reduced visibility around the debt-servicing capacity of borrowers, particularly those that remain under loan moratoriums.

While downward pressure on earnings is likely to persist going into 2021, the impact is expected to be less severe than in 2020 partly owing to the front-loading of provisions by banks. Improvements in the domestic and global economy, coupled with continued support measures and the operational capacity of banks to engage and assist borrowers in distress, will further help sustain debt serviceability and support bank earnings. In the insurance and takaful sector, the impact of temporary relief measures and recent floods on the profitability of insurers and takaful operators has also remained limited to date. Going forward, the low interest rate environment will continue to pose challenges for life insurers and family takaful operators, while general insurers may face prospects of rising reinsurance costs following pandemic-related and natural catastrophe losses.

Overall, the financial system remains in a strong position to continue supporting the economic recovery, with strong capitalisation levels to absorb any potential losses and ample liquidity to facilitate financial intermediation activity. The Bank's updated stress tests affirm the resilience of the financial system, with the banking system and insurance sector expected to maintain capital ratios above the regulatory minimum even under simulated scenarios of significantly weaker economic conditions. Financial institutions also remain operationally resilient and will continue to take steps to further strengthen their crisis response arrangements in light of operational challenges presented by the pandemic. This in turn will provide greater assurance of their ability to maintain critical operations and increase the speed with which financial institutions are able to adapt to changing operating conditions going forward.