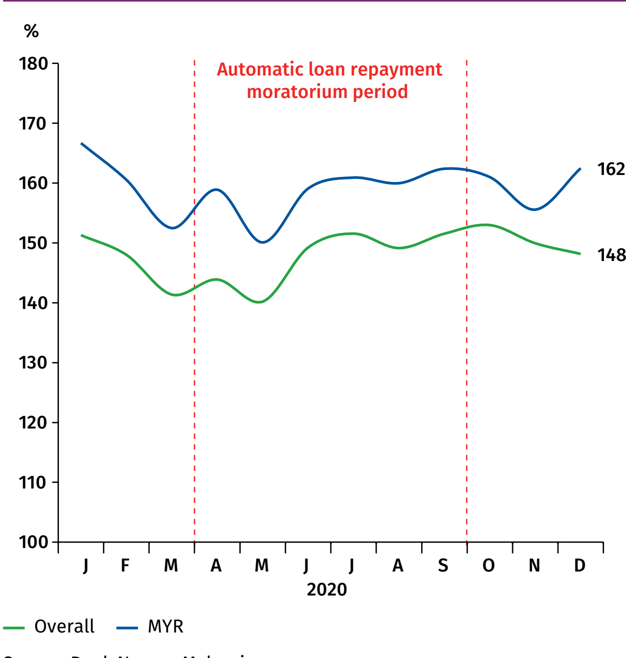
Financial Institution Soundness and Resilience

THE BANKING SECTOR

Banking system liquidity conditions remained supportive of financial intermediation activities amid sustained growth in deposits and improvement in loan repayments

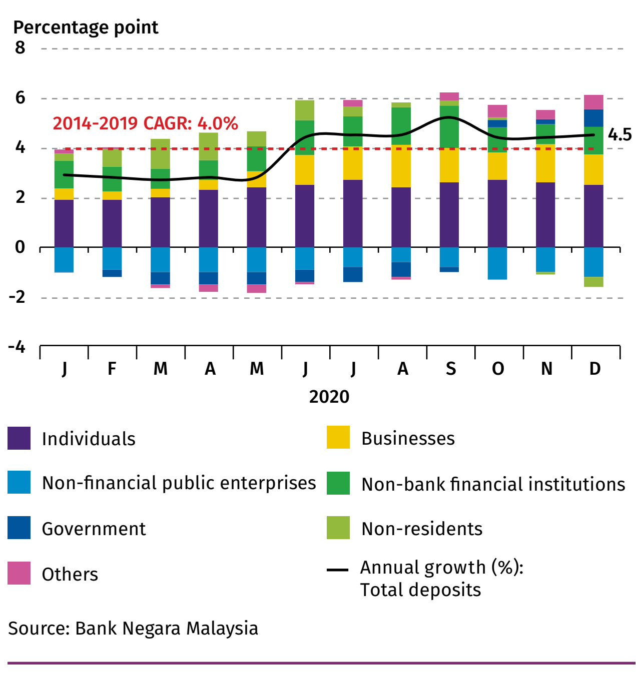
Banks continued to record healthy liquidity positions throughout the second half of 2020, with the aggregate banking system Liquidity Coverage Ratio (LCR) at 148.2% (Chart 2.1). This was supported by the resumption in loan repayments by most household and SME borrowers since October following the end of the automatic moratorium on these loans, with overall repayments almost returning to levels prior to the automatic moratorium. Banking institutions' placements with the Bank also increased significantly (+RM14.7 billion) as some banks shored up cash buffers in anticipation of potential withdrawals by the Government and/or non-bank financial institutions (NBFIs) to support various relief measures. Banks' operations continued to be supported by stable funding sources, with the aggregate Net Stable Funding Ratio (NSFR)[1] at 116%. Growth in banking system deposits remained firm, above the 5-year compounded annual growth rate (CAGR) of 4%, as households and businesses continued to hold precautionary cash buffers amid the challenging operating environment (Chart 2.2). Deposits from NBFIs also grew further, especially during the third quarter, as some of these institutions rebalanced

Chart 2.1: Banking System – Liquidity Coverage Ratio



Source: Bank Negara Malaysia

Chart 2.2: Banking System – Contribution to Growth in Deposits Accepted



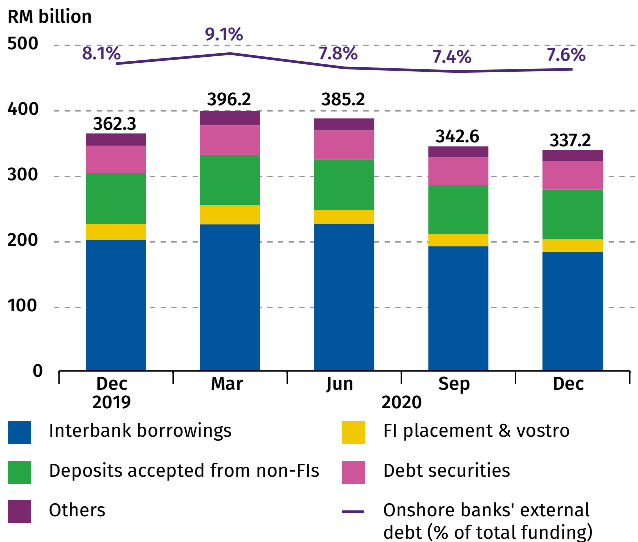
Source: Bank Negara Malaysia

[1] Banks' funding profile is assessed using the NSFR, replacing the loan-to-fund (LTF) and loan-to-fund-and-equity (LTFE) ratios which were previously developed as interim funding indicators prior to the NSFR implementation. The LTF and LTFE ratios stood at 82.5% and 72%, respectively, as at December 2020 (June 2020: 82% and 71.5%).

their portfolios amid market developments and to accommodate the implementation of relief measures. Some banks have used the regulatory flexibilities accorded earlier by the Bank, which enables them to draw down on liquidity buffers and correspondingly, lower their internal LCR and/or NSFR limits. This has helped to support earnings while enabling these banks to continue lending to the economy and facilitate repayment assistance to borrowers facing temporary financial difficulties. Banks that have reduced available liquidity buffers are expected to be able to restore these buffers with relative ease. All banks are also well-positioned to meet the minimum NSFR requirement of 100% by 30 September 2021.

Banks' reliance on external funding continued to be limited (Chart 2.3). During the second half of 2020, overall banking system external debt declined by RM48 billion, primarily due to maturing intragroup borrowings by banks in the Labuan International Business and Financial Centre (LIBFC). At the same time, lower demand for foreign currency (FCY) financing domestically reduced banks' need for external FCY borrowings. The decline in external debt in the third quarter was partially offset by higher precautionary buffers accumulated by domestic banking groups (DBGs) in the fourth quarter. This was in anticipation of a potential tightening in domestic USD liquidity conditions towards year end, particularly amid uncertainty ahead of the US Presidential election in November. Valuation effects following the stronger ringgit against selected major and regional foreign currencies during the period further reduced the amount of external debt.

Chart 2.3: Banks' External Debt – by Instrument



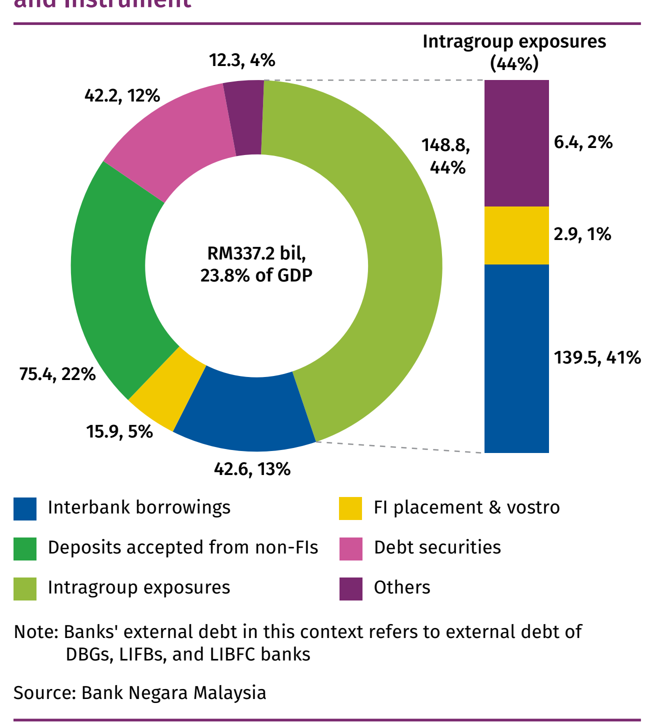
Note: 1. Banking system or onshore banks refer to only DBGs and locally-incorporated foreign banks (LIFBs)
2. Banks' external debt in this context refers to external debt of DBGs, LIFBs, and LIBFC banks

Source: Bank Negara Malaysia

Funding and currency risks from banks' external debt exposures remained manageable

Risks from external debt exposures remained low. A large proportion (almost 60%) of external debt comprises intragroup placements and long-term debt securities that are generally more stable, thereby reducing withdrawal or rollover risks (Chart 2.4). 18% of external debt are also ringgit-denominated, which are not subject to valuation changes from fluctuations in the exchange rate. Risks associated with cross-currency mismatches are contained, with the foreign exchange net open position (FX NOP) remaining well within levels recorded in recent periods (December 2020: 5.3%; June 2020: 4.9%; 5-year average: 5.7%) (Chart 2.5). Banks also continued to maintain sufficient FCY liquid assets to cover almost three times the level of FCY external debt-at-risk (Chart 2.6).[2]

Chart 2.4: Banks' External Debt – by Type of Exposure and Instrument

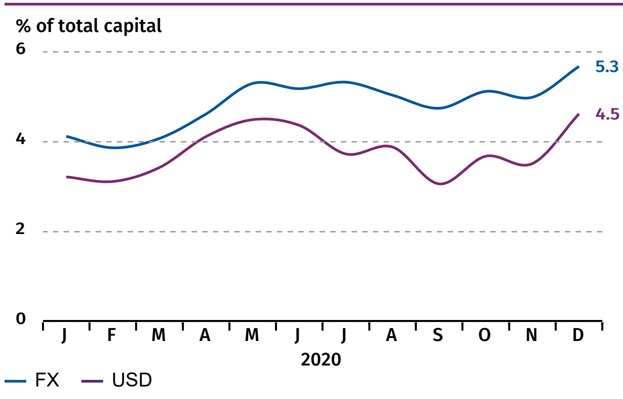


Note: Banks' external debt in this context refers to external debt of DBGs, LIFBs, and LIBFC banks

Source: Bank Negara Malaysia

[2] Banks' external 'debt-at-risk' comprises financial institutions' deposits, interbank borrowings and short-term loans from unrelated non-resident counterparties which are considered more susceptible to sudden withdrawal shocks.

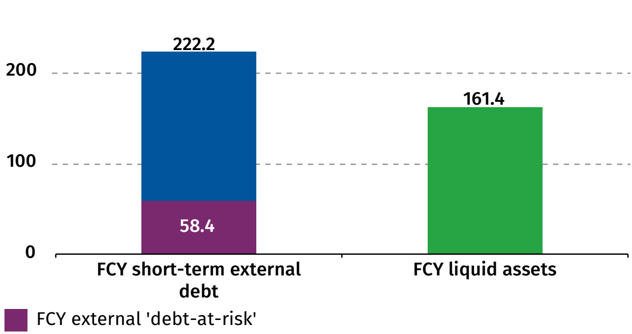
Chart 2.5: Banking System – FX and USD Net Open Positions



Note: Banking system or onshore banks refer to only DBGs and LIFBs

Source: Bank Negara Malaysia

Chart 2.6: Banking System – FCY External 'Debt-at-Risk' and Liquid Assets

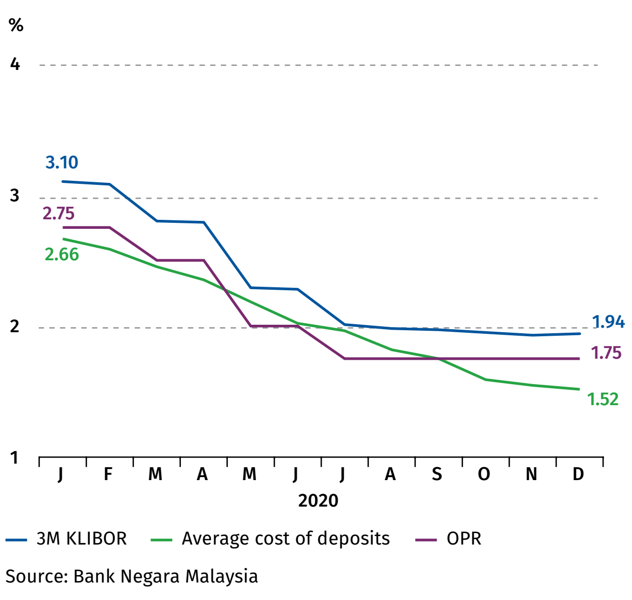


Note: 1. Banking system or onshore banks refer to only DBGs and LIFBs
2. Liquid assets comprise cash and cash equivalents, unencumbered debt securities held and interbank placements

Source: Bank Negara Malaysia

Overall, banks' funding costs continued to be on a declining trend amid strong pass-through of the earlier Overnight Policy Rate (OPR) cuts and ample liquidity conditions (Chart 2.7). While funding conditions are expected to remain broadly favourable in the near term, adverse changes in global market sentiment could lead to capital

Chart 2.7: Banking System – Average Cost of Deposits, Kuala Lumpur Interbank Offered Rate (KLIBOR) and Overnight Policy Rate (OPR)



Source: Bank Negara Malaysia

outflows and drive funding costs higher. Chunky withdrawals by the Government and/or NBFIs to support the implementation of further relief measures, as well as sizeable deposit drawdowns by distressed individuals and businesses following the implementation of MCO 2.0, could also put pressure on the liquidity position of some banks. Despite these challenges, banks are expected to remain resilient on account of their sizeable liquidity buffers and sound liquidity risk management practices, as well as continued progress in accumulating stable sources of longer-term funding. The extension of the flexibility for banking institutions to use Malaysian Government Securities (MGS) and Malaysian Government Investment Issues (MGII) to meet the Statutory Reserve Requirement (SRR) until 31 December 2022 will also augment liquidity in the banking system to support financial intermediation activity.

Developments of the Benchmark Rate Reform in Malaysia

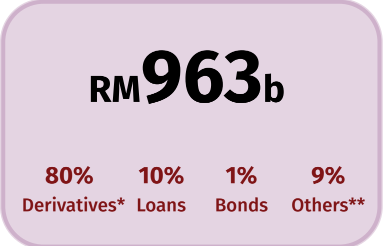
London Interbank Offered Rate (LIBOR) Transition: Recalibration of Malaysia's Transition Signposts

There has been considerable progress since the first publication of the Bank's LIBOR transition[3] signposts in 2020.[4] Banks in Malaysia have been proactively engaging borrowers to renegotiate benchmark replacements and to develop fallback provisions in existing LIBOR-based loan contracts in an effort to manage tough legacy[5] contracts and reduce the consequential legal risk. Banks are also working through system enhancements needed to ensure their operational readiness to support products priced off alternative risk-free rates (RFR). These efforts were interrupted by COVID-19 in some banks, but are expected to pick up pace again in 2021. Malaysian banks with significant derivative exposures have also adhered to the International Swaps and Derivatives Association (ISDA) 2020 Interbank Offered Rate (IBOR) Fallbacks Protocol, which enables market participants to amend the terms of their derivative contracts. The Malaysian banking industry's LIBOR exposures[6] stood at RM963 billion as of 31 December 2020 (Diagram 2.1).

Cash products present a different hurdle in transitioning to RFRs due to the lack of a forward-looking term structure. While borrowers prefer certainty in their future monthly cashflows, the actual rate under the compounded-in-arrears convention of term RFRs is known only at the end of the interest period. Hence, there is a mismatch between the demand and supply of RFR-referenced products without a forward-looking term structure. In order to address the lagging demand, the Alternative Reference Rate Committee (ARRC)[7] in the United States of America (US) is working towards identifying a potential administrator to publish the forward-looking term Secured Overnight Financing Rate (SOFR) by the end of 2021. The success of this hinges upon liquidity conditions of the SOFR derivatives markets, from which the forward rate is derived.

Recently, the ICE Benchmark Administration (IBA), the global administrator of LIBOR, announced a delay to the cessation of the publication of USD LIBOR for the overnight, 1, 3, 6, and 12-month tenures by 18 months to 30 June 2023. The publication of all other USD LIBOR tenures and LIBOR currencies will, however, cease on 31 December 2021 as planned.

Diagram 2.1: Malaysian Banks' LIBOR Exposures as of 31 December 2020



* Refers to notional amount
** Mainly interbank lending/borrowing and customer deposits

Note: At consolidated banking group level

Source: Bank Negara Malaysia

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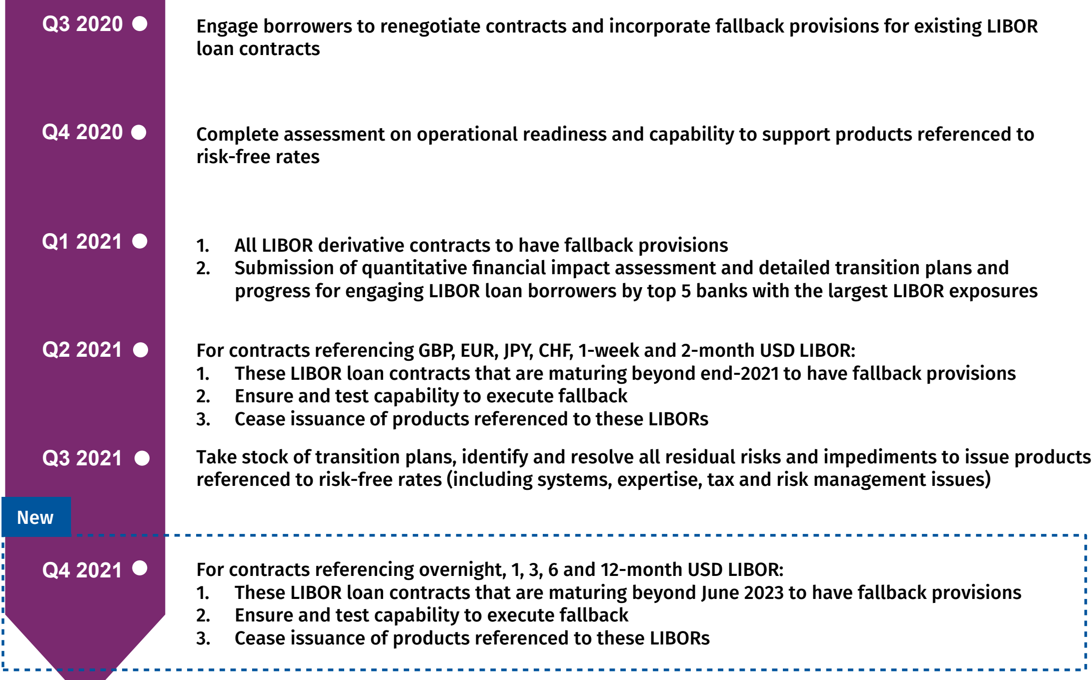
3 As part of the global reform of benchmark interest rates, LIBOR will be discontinued and replaced with alternative risk-free rates (RFR).
4 Refer to the Information Box on 'Benchmark Rate Reform: LIBOR Transition' in the BNM Financial Stability Review for Second Half 2019 for further details.
5 Existing LIBOR referencing contracts that are unable to be converted into non-LIBOR rates or amended to include fallback provisions when LIBOR is discontinued.
6 Refer to the outstanding amount of on-balance sheet exposures and notional amount of derivatives at the consolidated banking group level.
7 ARRC consists of a group of private-market participants, convened by the Federal Reserve Board and the New York Fed, to help ensure a successful transition from the USD LIBOR to the Secured Overnight Financing Rate.

In line with this development, the Bank is recalibrating key signposts to facilitate renegotiations and provide sufficient time for the demand of SOFR-based cash products to grow, as the forward-looking term SOFR is expected to be published before end-2021. Two signposts will be shifted from the original target of the second quarter of 2021 to the fourth quarter of 2021. First, the cessation of new products referencing the overnight, 1, 3, 6, and 12-month USD LIBOR, and second, the incorporation of fallback provisions in existing USD LIBOR-referenced contracts maturing beyond June 2023 (Diagram 2.2).

Diagram 2.2: Recalibrated Key Transition Signposts



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

Development of an Alternative Reference Rate (ARR) and Refinements to the Kuala Lumpur Interbank Offered Rate (KLIBOR)

As for domestic benchmark rates, in line with global benchmark reform efforts recommended by the Financial Stability Board (FSB), the Financial Markets Committee (FMC) will oversee efforts in developing an ARR, which adheres to the Principles for Financial Benchmarks by the International Organization of Securities Commissions (IOSCO). The ARR will run parallel to the existing KLIBOR, providing sufficient time for market participants to prepare for its adoption.

In the first half of 2021, the FMC will conduct a public consultation to gather feedback on the proposed ARR and methodology. This is to ensure that the development of the ARR will take into account views from key stakeholders, including both the sell and buy side (e.g. banks and institutional clients), and will serve as an effective reference rate for all products including derivatives, loans and securities. Upon its finalisation, the Bank intends to commence publication of the ARR in the second half of 2021, which will allow market participants to start designing and pricing financial products based on the ARR.

Alongside this exercise, the Bank also intends to introduce additional refinements to the KLIBOR framework, including the incorporation of fallbacks, to further enhance its integrity and reliability as a financial benchmark.

Weaker credit risk outlook and uncertain economic recovery prospects raised credit costs and weighed down earnings

The impact of the pandemic on bank impairment levels remained largely contained in the second half of 2020 due to repayment assistance programmes offered by banks to help household and business borrowers manage temporary cashflow constraints. Gross impairment ratio of the banking system edged slightly higher to 1.6% (June 2020: 1.4%; 2019 average: 1.5%) (Chart 2.8) following the end of the blanket automatic moratorium, mainly driven by a slight increase in household impairments. However, with uncertainty around the ongoing pandemic and uneven economic recovery, the credit risk outlook remains challenging. The overall proportion of loans classified as Stage 2[8] under MFRS 9 rose to 10% of total banking system loans (June 2020: 8.4%), given expectations of rising impairments from households and a further deterioration in the financial performance of some businesses. In light of that, banks continued to build up provisions in anticipation of higher credit losses. On a year-on-year basis, provisions grew by 40.6% (June 2020: +9%) (Chart 2.9). Higher overall provisions set aside by banks in the second half of 2020 (+RM6.1 billion to RM30.9 billion as at end-December 2020) reflected adjustments to banks' provisioning model parameters to account for the downside risks to domestic economic growth. In addition, around 40% of additional provisions for the year were from the application of management overlays by banks over and above the expected credit loss (ECL) model provisions. This reflects continued challenges faced by banks in incorporating forward-looking information in the measurement of ECL given prevailing uncertainties in the economic recovery path, and reduced visibility on the debt-servicing capacity of borrowers under loan moratoriums.

Overall credit costs[9] remained at an elevated level, rising further to 78 basis points (bps) for the full year of 2020 (June 2020: 57 bps; 5-year average: 15 bps) (Chart 2.10). Correspondingly, banks' profit before tax fell the most since the Asian Financial Crisis (AFC) (2020: -24.8%; 2H 2020: -31%), despite improvements in other sources of profits in the second half of the year (Chart 2.11). Net interest income recovered, supported by stabilising interest margins given the repricing of deposits from earlier OPR cuts (Chart 2.12). In addition, banks' trading and investment income was boosted by the sale of debt securities and fair value changes amid declining yields. Fee income also improved, mainly from equity brokerage and credit-related fees, amid a resumption in economic activity and higher retail participation in the equity market.

In line with weaker bank earnings throughout 2020, returns on equity and assets of the banking system declined to 9.2% and 1.1% (June 2020: 10% and 1.2%), respectively (Chart 2.13). Market valuations for listed banks, as measured by the median price-to-book (P/B) and price-to-earnings (P/E) ratios, however, improved towards the end of 2020 and into 2021, partly lifted by prospects of earnings support from pre-emptive provisions made by banks in 2020 and lower pressure on banks' interest margins moving forward. Notwithstanding this, the cautious credit risk outlook will continue to weigh on banks' profitability.

While downside pressure on earnings is likely to persist in the first half of 2021, the impact is expected to be less severe than that experienced in 2020. Banks are operationally better prepared to support borrowers affected by MCO 2.0 who are in need of temporary repayment assistance. The number of affected borrowers requiring assistance is also expected to be lower, with most household and SME borrowers resuming their loan repayments since the fourth quarter of 2020. The additional relief measures introduced by the Government under the 2021 Budget and fiscal stimulus packages will further help sustain debt serviceability. Credit costs are expected to begin normalising in the second half of 2021 following banks' pre-emptive provisioning in 2020.

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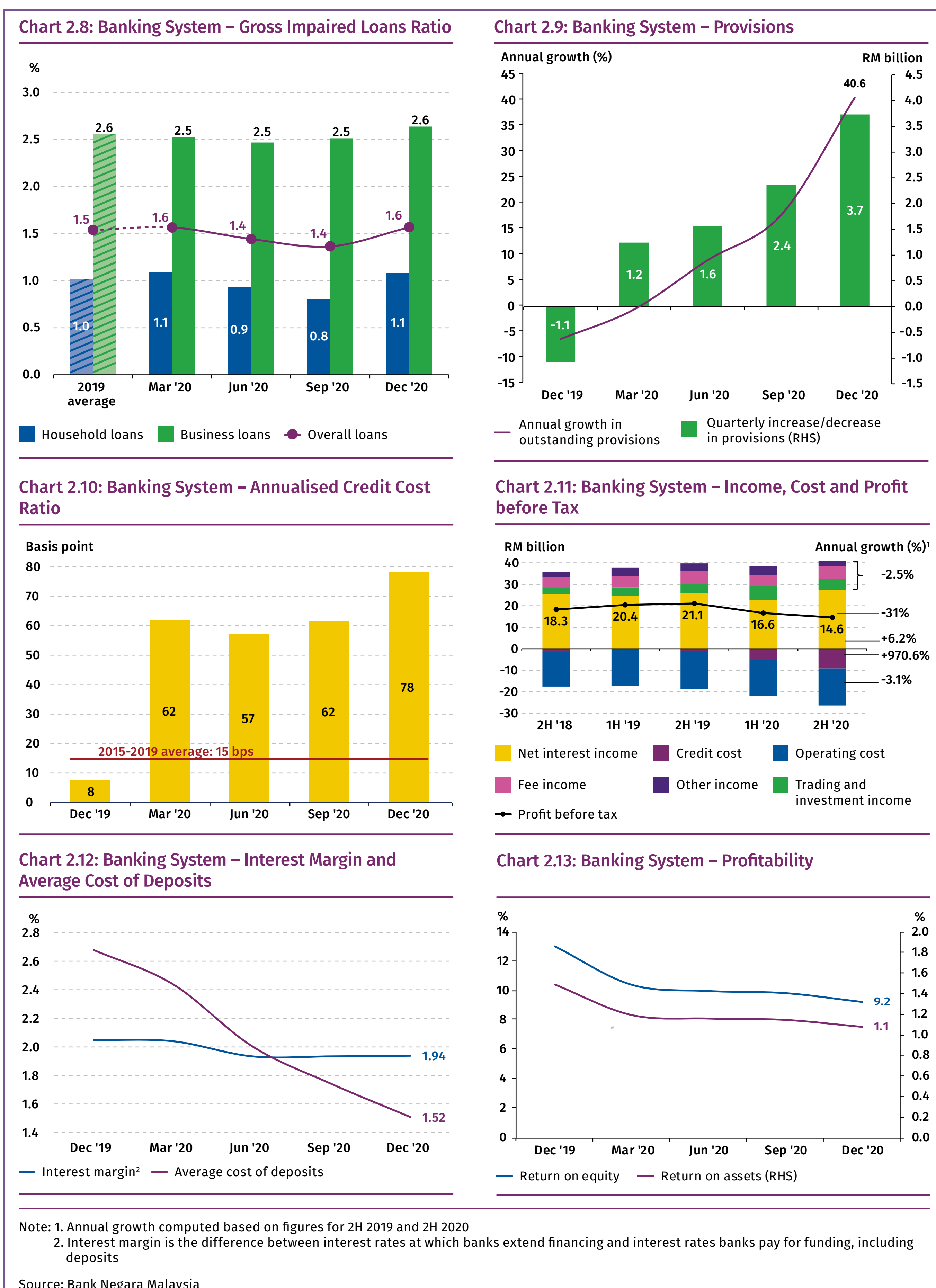
[8] Stage 2 loans refer to loans that have exhibited deterioration in credit risk, for which banks are required to set aside provisions based on lifetime expected credit losses.

[9] Refers to annualised year-to-date loan loss impairment and other provisions charged to the income statement over outstanding loans. Excludes loans from DBGs' overseas operations.



Note: 1. Annual growth computed based on figures for 2H 2019 and 2H 2020
2. Interest margin is the difference between interest rates at which banks extend financing and interest rates banks pay for funding, including deposits

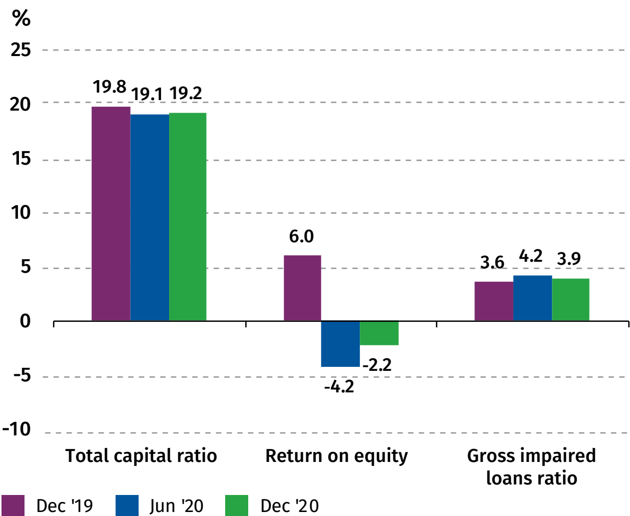
Source: Bank Negara Malaysia

The financial performance of the overseas operations of DBGs[10] remained subdued over the past year amid the COVID-19 pandemic and contraction in economic activities across most countries. Nevertheless, improvements in the performance of selected DBGs' overseas operations in Singapore (51% share of total overseas operations' assets) during the fourth quarter of 2020 lifted the overall average[11] return on equity (ROE) to -2.2% (1H 2020: -4.2%). Operations in Singapore recorded lower losses (average ROE of -5.1%; 1H 2020: -14.5%),[12] mainly due to lower provisions compared to the first half of 2020, but remained under pressure amid lower earnings from interest-related activities. On the other hand, operations' in Indonesia and Thailand continued to record profits, albeit at a lower ROE of 8.7% and 2.3% (1H 2020: 11.9% and 5.3%), respectively due to higher impairment allowances. Meanwhile, operations in Hong Kong SAR were impacted by higher provisions by some DBGs for exposures to large corporates affected by the pandemic, as well as lower trading and investment income. Collectively, overall asset quality of the DBGs' overseas operations improved slightly, with the gross impaired loans ratio[13] at 3.9% (June 2020: 4.2%), supported by ongoing moratorium and debt relief measures (Chart 2.14)

Challenging credit conditions amid COVID-19 pressures continue to weigh on financial performance of banks' overseas operations

Risks posed by the overseas operations of DBGs are assessed to be limited as exposures to sectors directly and indirectly affected by the pandemic are small relative to DBGs' total gross loans. Moreover, funding of DBGs' overseas operations, mainly from local currency deposits (Chart 2.15), remained stable. Although pressure on asset quality remains elevated given continued uncertainty on regional growth prospects, major overseas subsidiaries continue to maintain relatively high levels of capital, which serve to buffer against potential credit losses without having to draw on parental support. Based on stress tests conducted by DBGs on their overseas operations, all major foreign subsidiaries continued to maintain sufficient capital to withstand severe shocks associated with higher

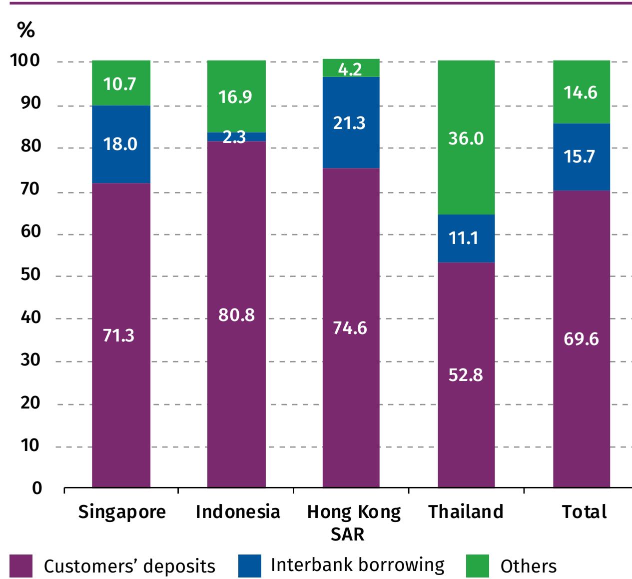
Chart 2.14: Banking System – Key Financial Indicators of Overseas Operations



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

Source: Bank Negara Malaysia

Chart 2.15: Banking System – Funding Profile of Major Overseas Operations



Note: Figures may not add up due to rounding

Source: Bank Negara Malaysia

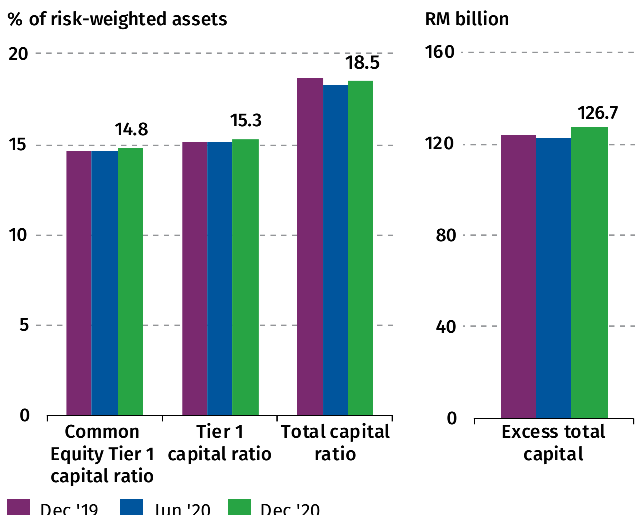
[10] Refers to DBGs' overseas offices (branches and subsidiaries) operating outside of Malaysia and LIBFC. Cumulatively, DBGs have presence in 14 overseas jurisdictions, with major operations in Singapore, Indonesia, Thailand and Hong Kong SAR.
[11] Average figures are weighted by asset size of operations of each DBG in respective jurisdictions.
[12] Higher provisions made during the first half of the year were driven primarily by sizeable exposures to impaired borrowers from the oil and gas sector.
[13] Ratio is weighted by asset size of operations of each DBG in respective jurisdictions.

credit risks arising from the pandemic, weaker oil prices and a delayed recovery in global growth. Post-shock total capital ratios of these subsidiaries remained well above the regulatory minimum, ranging between 17% and 27%.

The capitalisation of the banking system remains strong, bolstering banks' capacity to absorb potential shocks and support economic recovery

Despite lower profits during the period, banks continued to maintain strong capitalisation levels throughout the second half of 2020 (December 2020: 18.5%; 2019 average: 17.9%), with aggregate excess capital buffers[14] amounting to RM126.7 billion (Chart 2.16). Banks have sought to preserve their buffers in anticipation of higher credit losses going into 2021, by lowering dividends to shareholders, implementing dividend reinvestment programmes, and raising new equity. Some banks also issued Additional Tier 1 and Tier 2 capital instruments, replacing Tier 2 capital instruments that were being phased out as regulatory capital under the Basel III transitional arrangements. The stable capital buffers of banks have been maintained, as the ratio of risk-weighted assets to total assets returned to pre-COVID-19 levels (December 2020: 57.4%; March 2020: 56.5%; December 2019: 57.5%), indicating that banks continued to support credit flows to the economy.

Chart 2.16: Banking System – Capital Ratios



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

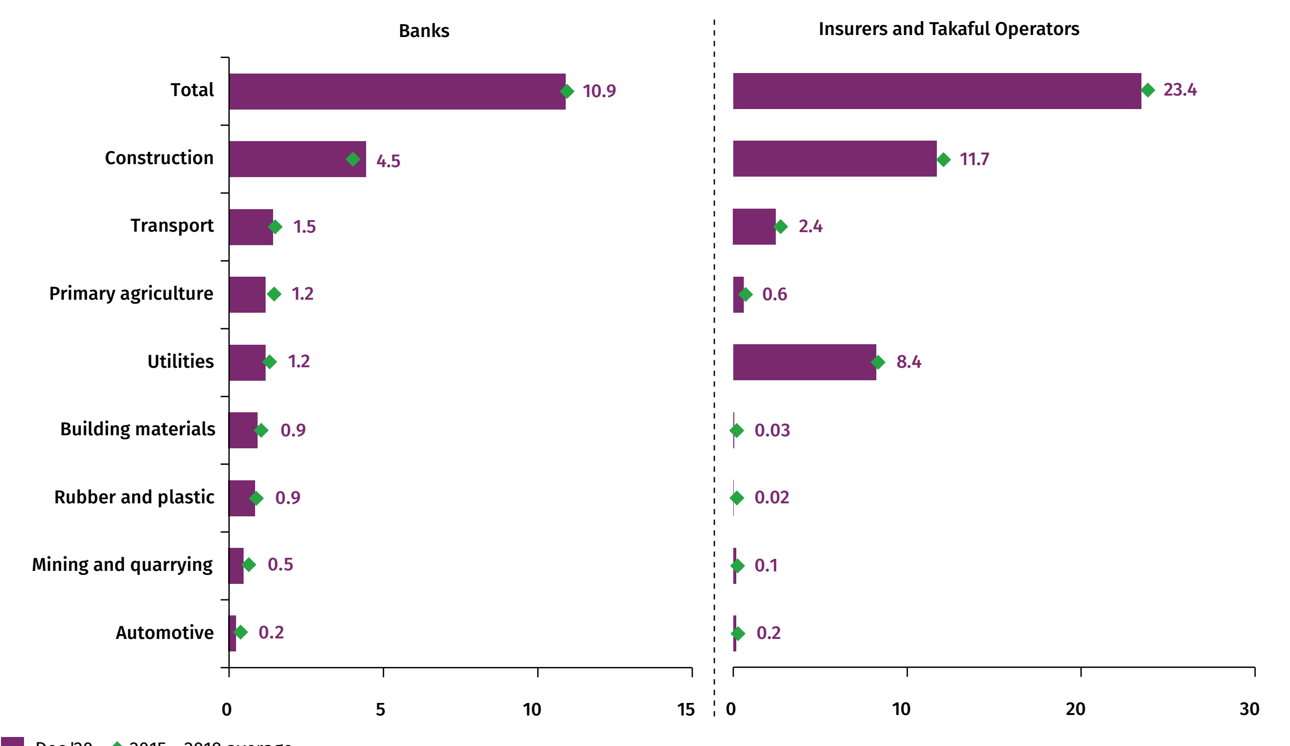
Source: Bank Negara Malaysia

[14] Refers to capital held in excess of regulatory minimum, which includes the capital conservation buffer (2.5%) and bank-specific requirements.

Climate Risk Management by Financial Institutions

Financial institutions have made progress in responding to climate-related risks. More financial institutions have begun to formulate their long-term strategies towards sustainability. These include rebalancing their portfolios, given the implications of potential climate risk exposures on their core lending, insurance businesses, deposit taking, and derivatives as well as investment activities (Chart 2.17). Increasingly, financial institutions are also promoting and helping their customers to adopt sustainable practices through their lending, advisory and/or investment activities.

Chart 2.17: Exposures of Malaysian Financial Institutions in Sectors Potentially Exposed to Climate Change (as % of Total Assets)



Note: 1. Construction includes civil engineering works and construction of residential and non-residential properties; utilities includes power and water; transport includes land, water and air transport; primary agriculture includes mainly palm oil
2. Figures refer to exposures as at end-December 2020. Exposures are based on existing reporting requirements and will be refined upon full implementation of the Climate Change and Principle-based Taxonomy

Source: Bank Negara Malaysia estimates

Following increased supervisory engagements with financial institutions since early 2020, positive developments have been observed in efforts by financial institutions to incorporate climate risk considerations in their strategies and operations. This included aligning governance arrangements, customer onboarding practices, disclosures and product solutioning (Diagram 2.3).

In 2021, the Bank will continue to work with the industry to further support strengthened climate risk management and disclosure practices. A key priority will be the implementation of the Climate Change and Principle-based Taxonomy (CCPT), and ongoing development of sectoral guides for the manufacturing, oil and gas, infrastructure and construction sectors. Work will also continue on producing additional practical resources to help financial institutions better evaluate and manage climate-related risks (Diagram 2.4). With finalisation of the taxonomy, financial institutions will begin capturing exposures based on the CCPT for internal risk management and supervisory purposes. This will help support risk management, scenario analysis, stress testing and disclosures. Initiatives to encourage greater adoption of climate-related disclosure by financial

Diagram 2.3: Key Developments Observed in Financial Institutions

Climate-related risk management is gaining traction but at an uneven pace across the industry

	Key observations	Leading initiatives
Governance & strategy	• Stronger leadership by Board and senior management on the need to integrate climate-related considerations in business strategies and decisions, and risk management practices	• Established dedicated teams and senior management sponsors for climate-related initiatives • Specific focus on climate risks as permanent agenda in Board and management committee meetings
Policy & framework	• Increasing integration of climate-related considerations into risk management framework and practices	• Established group climate risk framework and policies, and risk appetite • Subjecting segments of customers to climate risk assessments including in underwriting practices • Climate risks embedded in enterprise wide risk management. Developed transition risk management framework for effective monitoring and management of credit risk
Capacity building	• Greater focus on enhancing staff awareness and technical capabilities	• Established structured training roadmap for staff • Hired subject matter experts to provide technical support and expedite knowledge development
Product development & solutions	• Introduction of new products such as sustainability-linked loans, insurance/takaful cover for weather and climate risks, and preferential rates for purchase of green products and solutions	• Preferential rates for renewable energy technology • Invested in alternative technologies and relevant infrastructure projects to support climate risk mitigation and adaptation
Reporting & disclosure	• More financial institutions committing and taking active steps to adopt the TCFD recommendations and better quality disclosures	• Embarked on data collection initiative • Developed Malaysia Flood Catastrophe Modeling to enhance risk monitoring and reporting

More financial institutions have become signatories to the United Nations Environment Programme Finance Initiative Principles for Responsible Banking as well as Principles for Sustainable Insurance

Source: Bank Negara Malaysia

institutions in line with the Task Force on Climate-related Financial Disclosures (TCFD) recommendations, as well as to expand the range of financial products, solutions and activities that support sustainable activities, will be pursued as part of the work of the Joint Committee on Climate Change (JC3). The JC3 will also establish a dedicated workstream to identify and bridge gaps in climate- and environmental-related data required by financial institutions to support risk assessments. In addition, efforts to scale up capacity building programmes for industry players to accelerate their knowledge and skill sets in climate risk management will continue (refer to the BNM Annual Report 2020 for further information on the role and initiatives of the Bank in addressing climate-related financial risks).

Diagram 2.4: Key Achievements in 2020 and Priorities in 2021

Supported by collaboration with industry and partners through the Joint Committee on Climate Change and Value-Based Intermediation Community of Practitioners to promote an orderly transition

2020 Key Achievements

Pilot implementation of Climate Change and Principle-based Taxonomy

Conducted assessment on disclosure practices of financial institutions and gaps against the TCFD recommendations

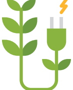
Increased awareness on climate risk-related areas among the public and industry through awareness and education programmes

Consultation on Value-Based Intermediation Financing and Investment Impact Assessment Framework (VBIAF) sectoral guides on renewable energy, energy efficiency and palm oil

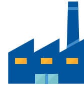
2021 Key Priorities

Finalisation and implementation of Climate Change and Principle-based Taxonomy

Issuance of industry consultative paper on Guides for Climate Risk Management and Scenario Analysis, and TCFD Application Guide



Finalisation of VBIAF sectoral guides on renewable energy, energy efficiency and palm oil



Issuance of VBIAF sectoral guides consultative documents on manufacturing, oil & gas and construction & infrastructure

Scale-up capacity building programmes

Source: Bank Negara Malaysia