

# Financial Institution Soundness and Resilience

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# Financial Institution Soundness and Resilience

## THE BANKING SECTOR

### Liquidity and funding conditions in the banking system remained supportive of credit intermediation activities

Funding conditions in the banking system remained stable. The aggregate Net Stable Funding Ratio (NSFR) stood at 116.4% (December 2020: 116%), with all banks meeting the minimum NSFR requirement of 100% ahead of the 30 September 2021 full compliance deadline. Banking system deposits continued to grow, supported by precautionary savings by households and businesses (Chart 2.1).<sup>1</sup> Meanwhile, deposits from non-bank financial institutions (NBFIs) moderated slightly, reflecting withdrawals by these institutions, partly to facilitate the implementation of Government relief measures.

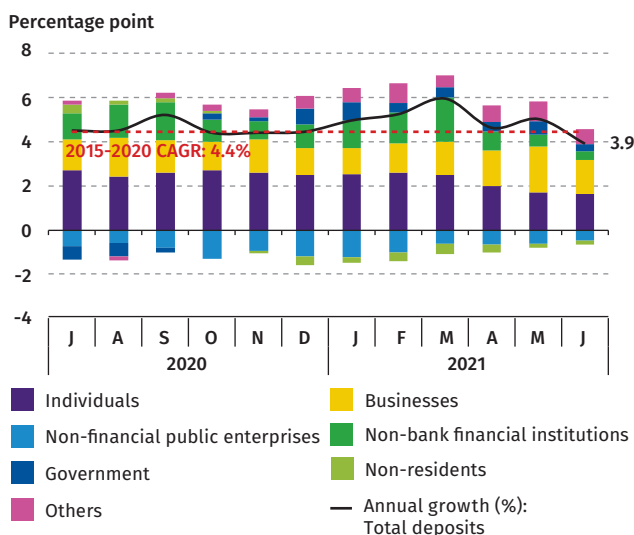
Given the uncertain operating environment, households, businesses, and fund managers have continued to maintain a preference for more liquid deposits (Chart 2.2). This has led to lower funding costs and consequently improved net interest income for banks (Chart 2.3). At the institution level, the shift towards shorter-term funding has led to larger movements in the Liquidity Coverage Ratio (LCR) positions<sup>2</sup> for some banks. However, this is unlikely to have a material impact on liquidity risks given ample liquidity buffers maintained by banks (Chart 2.4). Banks have also continued to more efficiently manage excess liquidity buffers above internal LCR targets in an effort to lift earnings amid slower expected loan growth. All banks continue to record LCR above 100%, with increased holdings of high-quality liquid assets (HQLA).

<sup>1</sup> The moderation in household and business deposit growth since April 2021 was predominantly due to base effects, as the blanket automatic loan moratorium led to a surge in deposit growth from precautionary cash holdings in the second quarter of 2020.

<sup>2</sup> The notable LCR decline in May 2021 was driven mainly by maturing deposits from fund managers due to the expected expiry of an existing income tax exemption for corporate investors on interest or profit earned from money market funds. The tax exemption has been extended to January 2022, which resulted in a rollover of the bulk of the deposits and the corresponding LCR improvement in June 2021.

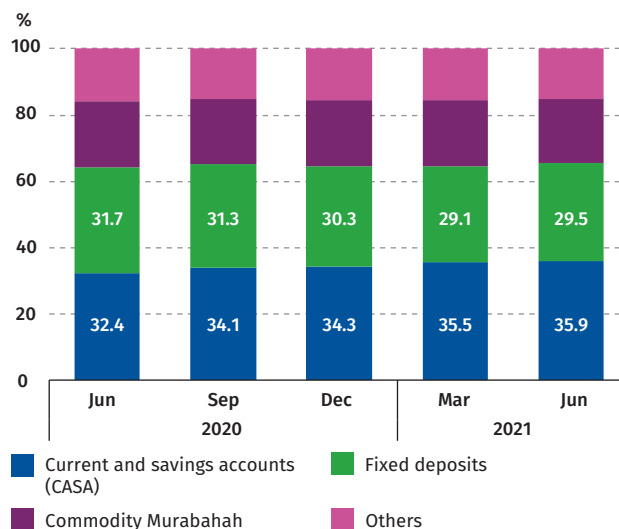
Notably, banks' holdings of government bonds rose by RM22 billion from December 2020 (2H 2020: -RM1 billion), helping to support interest income amid the subdued loan growth.

Chart 2.1: Banking System – Contribution to Growth in Deposits Accepted



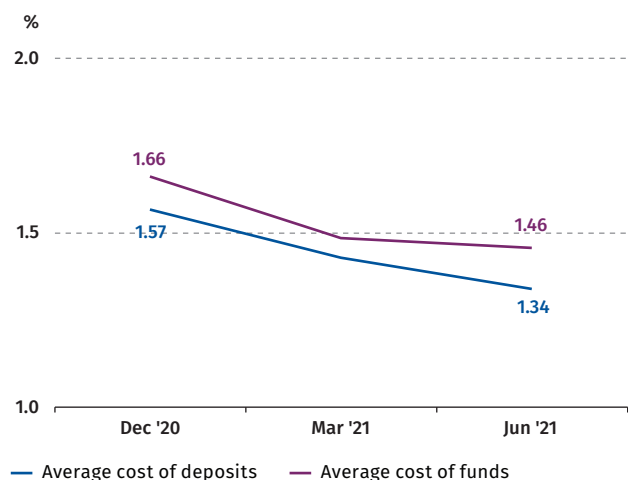
Source: Bank Negara Malaysia

Chart 2.2: Banking System – Composition of Deposits by Type



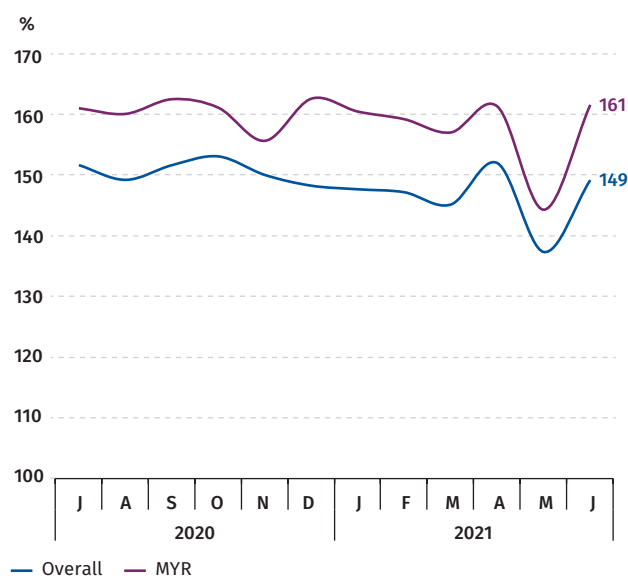
Source: Bank Negara Malaysia

**Chart 2.3: Banking System – Average Cost of Deposits and Average Cost of Funds**



Source: Bank Negara Malaysia

**Chart 2.4: Banking System – Liquidity Coverage Ratio**



Source: Bank Negara Malaysia

Moving forward, overall funding conditions are expected to remain supportive of intermediation activity. Some banks could face higher deposit withdrawals by individuals and firms that have been more severely affected by the implementation of the FMCO. The sharply higher take-up of repayment assistance under the PEMULIH package, along with withdrawals by non-bank public enterprises to support additional relief measures could also increase liquidity pressures for certain banks. Heavy outflows by non-residents could further exacerbate these risks. However, as noted earlier, banks’ liquidity

positions are expected to remain resilient to these pressures. Based on a conservative simulation exercise conducted by the Bank which incorporates the simultaneous materialisation of these downside risks, coupled with the drawdown of unutilised credit lines by businesses, banks’ liquidity positions remained resilient. Banks also continue to observe sound liquidity risk management practices, and have additional flexibility to draw on their liquidity buffers, if needed, to preserve support for lending activities. The availability of the Statutory Reserve Requirement (SRR) flexibility until end-2022 will further support banks’ ability to respond to potential liquidity stress.

### Risks posed by banks’ external debt exposures remain manageable

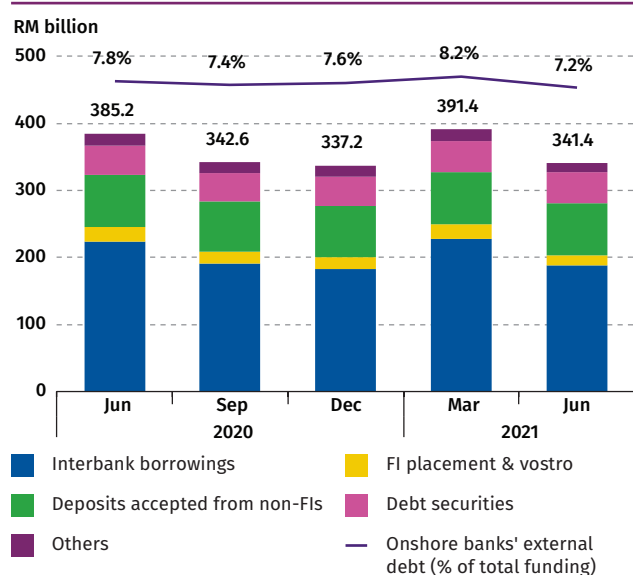
Banking system external debt increased marginally in the first half of the year (RM341.4 billion; December 2020: RM337.2 billion) (Chart 2.5). The weaker ringgit against selected major and regional foreign currencies (FCY) during this period partly contributed to the higher external debt. The level of external debt was notably higher in the first quarter of 2021, driven mainly by higher intragroup transactions by banks in the Labuan International Business and Financial Centre (LIBFC). The bulk of these borrowings are channelled to support financing transactions with non-resident clients, consistent with their active role in facilitating FCY transactions arranged and managed by the head office. Risks associated with these exposures are assessed to be low, with intragroup funding observed to closely match the financing extended in terms of amount, currency, and tenure. Higher interbank borrowings by a few domestic banking groups (DBGs) as part of their centralised liquidity management operations also contributed to the increase in the aggregate external debt of banks. These trends reversed in the second quarter of 2021 with total external debt of banks as a share of total funding remaining low and in line with historical averages of 7.7%.

Overall risks from the external debt exposures of banks continue to be mitigated by a number of factors that remain consistent. Almost 60% of total banking system external debt can be attributed to stable intragroup exposures and long-term debt securities, which are less susceptible to sudden

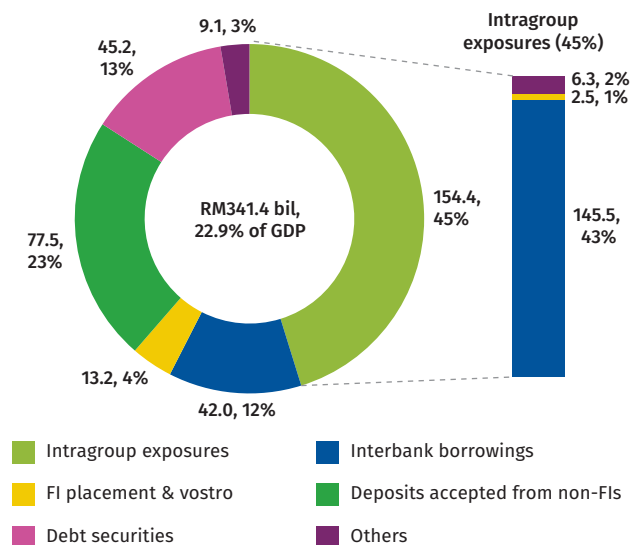
withdrawal shocks and rollover risks (Chart 2.6). Around 20% of the external debt are ringgit-denominated, which are unaffected by valuation changes from currency movements. Additionally, banks continued to maintain sizeable FCY liquid assets of RM170.5 billion, sufficient to cover up to 3.1 times the current level of FCY external debt-

at-risk (Chart 2.7).<sup>3</sup> Banks' foreign exchange net open position (FX NOP) has also trended lower to 4.7% (December 2020: 5.2%) of banks' total capital (Chart 2.8). This reflects banks' reduced risk appetite amid renewed uncertainties surrounding the economic and market outlook during the period.

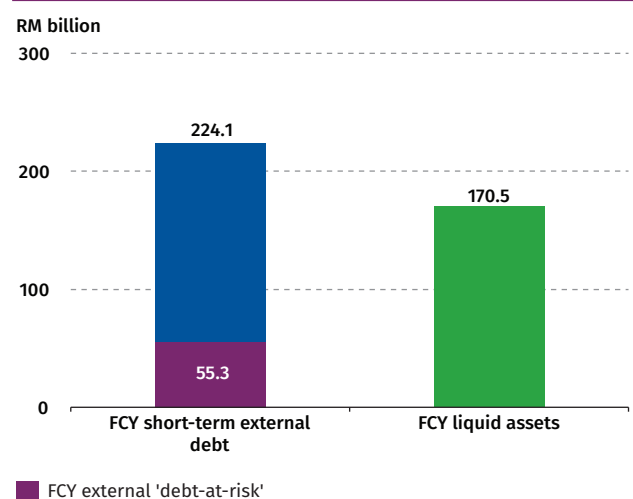
**Chart 2.5: Banks' External Debt – by Instrument**



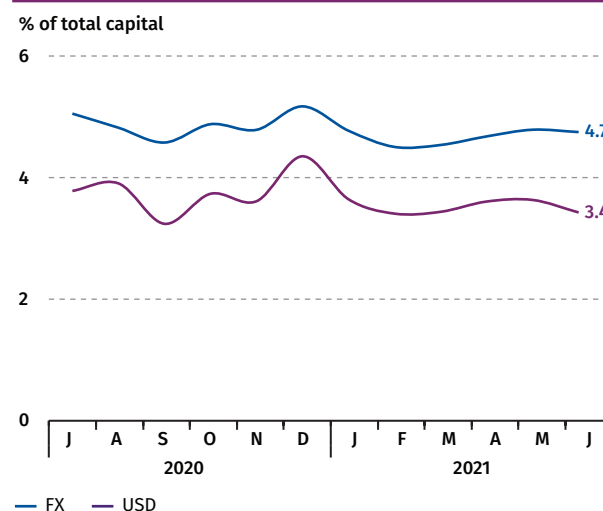
**Chart 2.6: Banks' External Debt – by Type of Exposure and Instrument**



**Chart 2.7: Banking System – FCY External 'Debt-at-Risk' and Liquid Assets**



**Chart 2.8: Banking System – FX and USD Net Open Positions**



Note: 1. Banks' external debt in this context refers to external debt of DBGs, locally-incorporated foreign banks (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

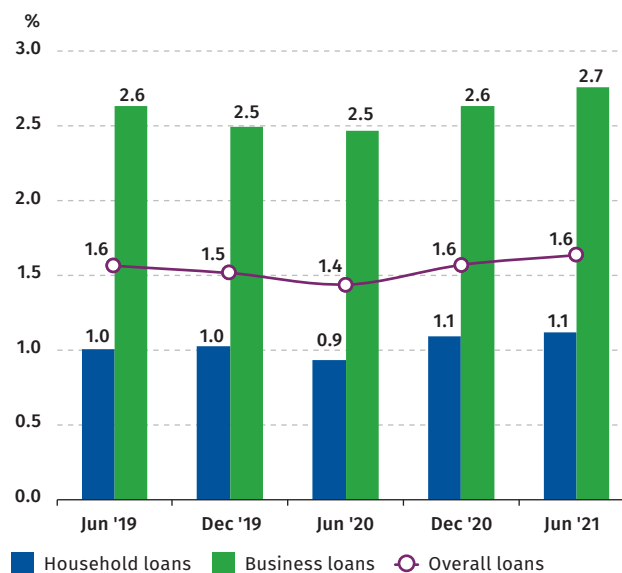
<sup>3</sup> Banks' external 'debt-at-risk' comprises financial institutions' deposits, interbank borrowings, and short-term loans from unrelated non-resident counterparties, which are considered more susceptible to sudden withdrawal shocks.

## Banks continued to be resilient despite the challenging credit risk outlook

The expansion of repayment assistance – in November 2020 and again in June and July 2021 – has kept banking system impairments at low levels, with gross and net impaired loan ratios remaining stable at 1.6% and 1% of total loans, respectively (Chart 2.9). Notwithstanding this, banks have continued to increase provisions for credit losses throughout the first half of 2021 in anticipation of a deterioration in asset quality as repayment assistance programmes are gradually unwound. Total provisions are now about 54% higher than the pre-pandemic level at the end of 2019, and have risen further to 1.8% as a share of total loans as at end-June 2021 (2020: 1.7%; 5-year average: 1.3%). The loan loss coverage ratio (including regulatory reserves) has remained around historically high levels at 129.2%. Banks continue to be prudent in setting aside buffers for credit losses from loans assessed to be of higher risk, as observed from the sustained increase in provisions for Stage 2 loans despite impairments remaining low. Provisions for Stage 2 loans represented 40% of total provisions (2020: 36.8%; 2019: 29.2%), in line with the elevated

share of loans under Stage 2 which stood at 9.7% of total loans as at end-June (December 2020: 9.9%; 2019 average: 7.5%)<sup>4</sup> (refer to the Information Box on ‘Banking Institutions’ Provisioning Practices to Mitigate Elevated Credit Risk from the Pandemic’ for further details on banks’ provisioning practices).

**Chart 2.9: Banking System – Gross Impaired Loans Ratio**



Source: Bank Negara Malaysia

<sup>4</sup> Refer to the section on Credit Risk for further assessment on credit risk.

## Banking Institutions' Provisioning Practices to Mitigate Elevated Credit Risk from the Pandemic

Banks faced considerable challenges in updating their assessments of credit risks and determining the appropriate level of provisions against expected credit losses (ECL) during the COVID-19 pandemic. Elevated levels of uncertainty have required banks to continuously reassess the reasonableness of forward-looking economic indicators embedded in ECL models. This has been further compounded by difficulties faced to ascertain the actual deterioration in borrowers' repayment capabilities, particularly among borrowers enrolled under the various repayment assistance programmes, due to the absence of more current repayment data.

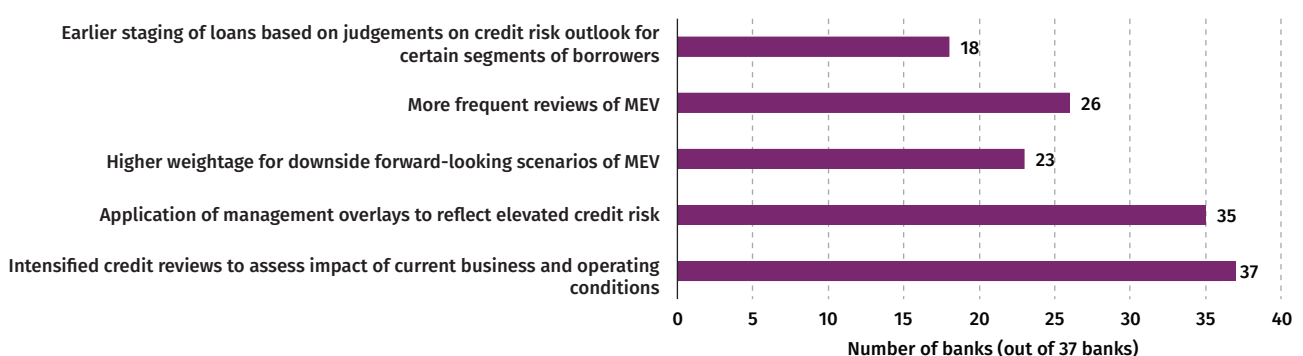
Reflecting these challenges, the Bank formally communicated its expectations of banks to exercise appropriate discretion in the application of accounting and regulatory capital standards in relation to ECL and the definition of default respectively. This took into account the exceptional nature of the COVID-19 shock, and the mitigating effects of substantial policy support measures, including repayment assistance, aimed at helping borrowers bridge temporary repayment difficulties and thus, preserve their debt-servicing capacity over the life of the financing. Consistent with this, the Bank clarified that in the absence of other factors indicating a significant increase in credit risk, the extension of repayment assistance to borrowers affected by the pandemic should not result in an automatic transfer of their financing to Stage 2 or Stage 3 that would, in turn, require banks to make provisions for lifetime losses under MFRS 9. Similarly, the assessment of 'unlikeliness to repay' under the definition of default for regulatory capital purposes should not be based solely on borrowers taking up repayment assistance but should instead be based on a more holistic assessment of relevant indicators and information available on the borrowers.

Against this backdrop, this box elaborates how banks have adapted to the challenges faced in the assessment of credit risks, while ensuring the adequacy of provisions against elevated credit risks due to the pandemic. It draws insights from a thematic review conducted by the Bank in the second quarter of 2021 involving 37 banking institutions.

### Banks have adjusted their provisioning and credit monitoring practices to account for the potential increase in credit risk amid lower borrower visibility

All banks have incorporated a higher degree of stringency in their provisioning practices (Chart 2.10). This has taken various forms, including the earlier staging of loans based on judgements about the credit risk outlook for certain borrower segments; subjecting management judgements to stronger oversight; more frequent reviews of macroeconomic variables (MEV) with higher weightages assigned to downside forward-looking scenarios; and adopting greater conservatism in the determination of management overlays to reflect the continued economic uncertainty. Credit monitoring processes were also enhanced by harnessing alternative data, such as data on payment transactions to compensate for the inability or delays in obtaining updated financial information on borrowers. All banks also intensified credit reviews of vulnerable corporate borrowers through frequent virtual engagements, focusing on changes in business and operating conditions to obtain a better understanding of the pandemic's impact on borrowers' profiles.

**Chart 2.10: Banks' Provisioning and Credit Monitoring Practices to Account for Potential Increase in Credit Risk**

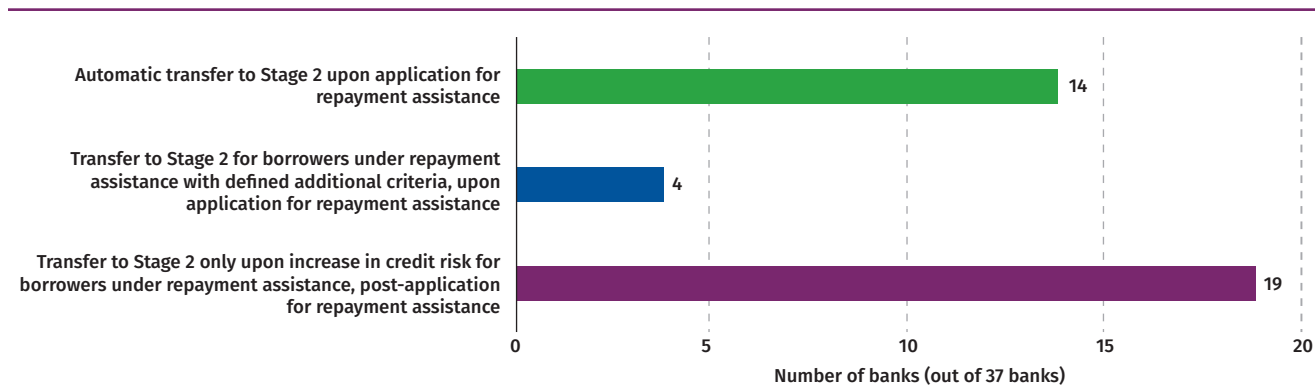


Source: BNM Survey to Banks

## Staging classifications

For the retail portfolio, triggers used by banks to indicate a significant increase in credit risk remained reasonably prudent (Chart 2.11). Despite flexibilities provided for banks to make informed judgements on the relative importance attached to criteria normally used to indicate changes in credit risk, almost half (18) of banks covered under the review continue to consider repayment assistance as a key trigger for assessments of a significant increase in credit risk. For most of these banks, the approval of an application for repayment assistance automatically results in the transfer of the financing to Stage 2. In four banks reviewed, an application for repayment assistance would trigger a stage transfer for financing if it also met other indicators of heightened credit risks, such as pre-pandemic records of payment arrears, lower income levels and higher debt service ratios. In the remaining 19 banks, the assessment of a significant increase in credit risk for financing under repayment assistance is based on evidence of repayment behaviour during the repayment assistance period. However, in these cases, banks also consider the extent of a borrower's reliance on repayment assistance programmes to support debt servicing, for example, where requests are made by borrowers to further extend repayment assistance.

**Chart 2.11: Banks' Staging Practices for Retail Borrowers under Repayment Assistance**



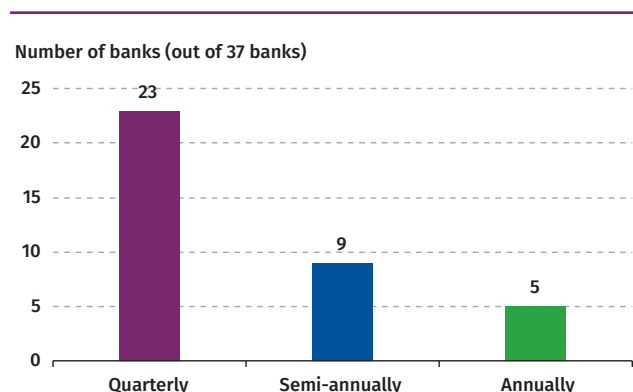
Source: BNM Survey to Banks

For the non-retail portfolio, staging classification practices remain largely unchanged from the pre-pandemic period. Borrowers continue to be assessed at the account level and are moved to Stage 2 or Stage 3 only upon observed evidence of a significant increase in credit risk. Banks with pre-existing policies that require the automatic transfer of rescheduled and restructured loans to Stage 2 have maintained practices consistent with these policies. Several banks were also more pre-emptive in classifying loans under Stage 3, resulting in higher provisions made for selected vulnerable corporates in economic sectors that were most impacted by the pandemic. Most banks have continued to observe the minimum period of sustained debt servicing by borrowers of no less than six months before allowing staging upgrades from Stage 2 to Stage 1 to take place. In all cases, staging upgrades are further subjected to additional reviews at the account-level to affirm that the borrower's debt-servicing capacity is likely to be sustained.

## ECL models

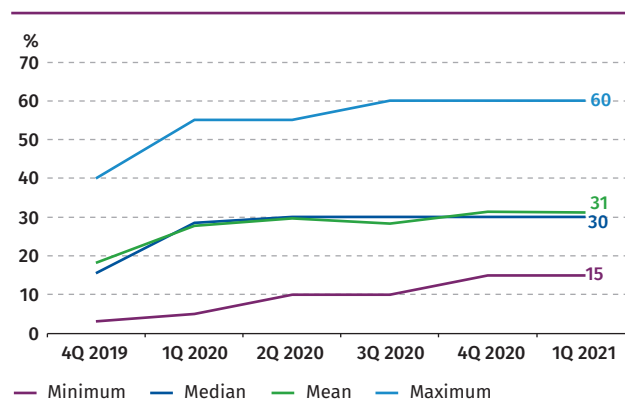
The majority of banks increased the frequency of revisions to MEV used in their ECL models, specifically GDP growth and unemployment forecasts, given the high and persisting degree of economic uncertainty experienced throughout the pandemic (Chart 2.12). Most banks also incorporated a higher degree of conservatism in their MEV forecasts relative to the pre-pandemic period, with a higher weightage (ranging between 15% and 60% across banks) applied to downside forward-looking scenarios (Chart 2.13). 14 banks further excluded probability of default data points in 2020 to mitigate data distortions caused by repayment assistance programmes. During this period, several banks have suspended any write-back of provisions based on ECL model outputs in order to preserve provisioning buffers against higher future expected losses.

**Chart 2.12: Frequency of Revisions to MEV**



Source: BNM Survey to Banks

**Chart 2.13: Weightage for Downside Forward-looking Scenarios**



Source: BNM Survey to Banks

### Management overlays

The majority of banks have pre-emptively applied management overlays<sup>5</sup> to bolster provisions for borrower segments judged to be of higher credit risk. This includes borrowers under repayment assistance and in economic sectors that have been more affected by the pandemic. The increased application of management overlays by banks reflects the higher uncertainties surrounding the determination of ECL estimates, as well as to provide additional buffers for borrowers under repayment assistance that could see a deterioration in credit risk going forward (including borrowers that remain in Stage 1). Cumulative management overlays set aside by banks currently represent about 40% of total provisions – the highest level since the implementation of MFRS 9. In the second quarter of 2021, management overlays provided by banks with significant retail exposures notably increased by an average of 34% in response to the successive expansion of repayment assistance programmes. In determining the quantum of management overlays, most banks apply higher probabilities of default and/or Stage 2-equivalent default probability assumptions for identified segments of borrowers under repayment assistance.

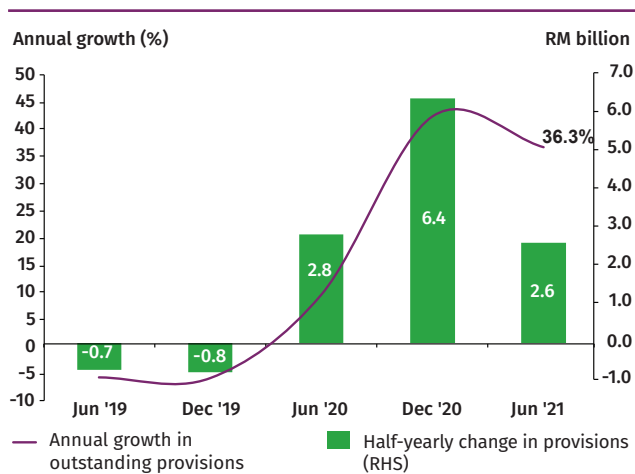
The pre-existing prudent provisioning practices of banks and adjustments made during the pandemic to account for the heightened level of uncertainty are expected to support the resilience of banks against potential risks of a significant deterioration in asset quality. Loan loss provisions are currently assessed to be adequate to buffer against conservative estimates of projected losses, including losses from exposures to sectors that have been more affected by the pandemic and more vulnerable borrowers that may continue to face difficulties servicing their debt when repayment support measures are gradually unwound. Banks are expecting to further increase provisions in the second half of the year following updated assessments of the impact of the FMCO and the extended duration of repayment assistance programmes. However, current buffers as well as projected earnings should enable banks to absorb such additional provisions. The conservative provisioning practices observed across banks provide further assurance that banks are reasonably well-positioned to withstand higher-than-expected credit losses in the event of more adverse credit developments.

<sup>5</sup> Management overlays are additional provisions set aside on top of provisions derived from ECL models. It reflects adjustments to account for data deficiencies or uncertainties not adequately captured by the ECL models.

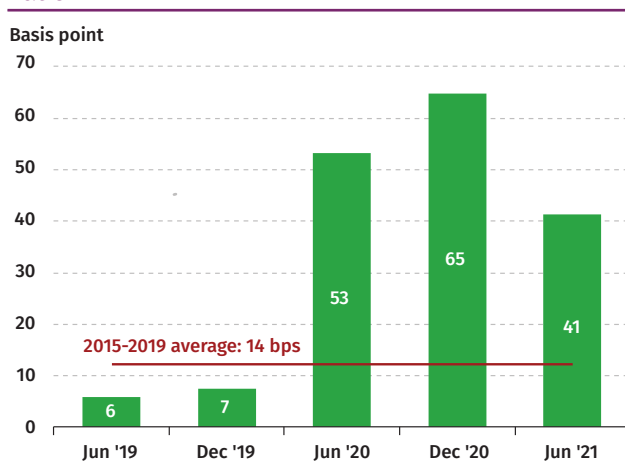
The ramp up of provisions in 2020 has provided banks with some headroom this year to moderate the amount of additional provisions set aside for credit losses (Chart 2.14). The resulting decline in annualised credit costs (Chart 2.15), coupled with lower modification losses from the transition to more targeted repayment assistance programmes, supported improvements in banks' profitability in the first half of 2021. Net interest margins also improved (2.1%; December 2020: 1.9%) due to lower funding costs and higher loan growth particularly in the household

segment. This partially offset a marked decline in net trading income amid rising bond yields, after significant gains recorded in 2020. Overall, pre-tax profits<sup>6</sup> of the domestic banking system improved slightly (Chart 2.16), translating into higher returns on asset and equity of 1.1% and 9.7% (December 2020: 1.0% and 8.4%), respectively. However, market valuations of listed banks remained volatile and continue to reflect cautious investor sentiment amid prospects of weaker future earnings due to the delayed economic recovery (Chart 2.17).

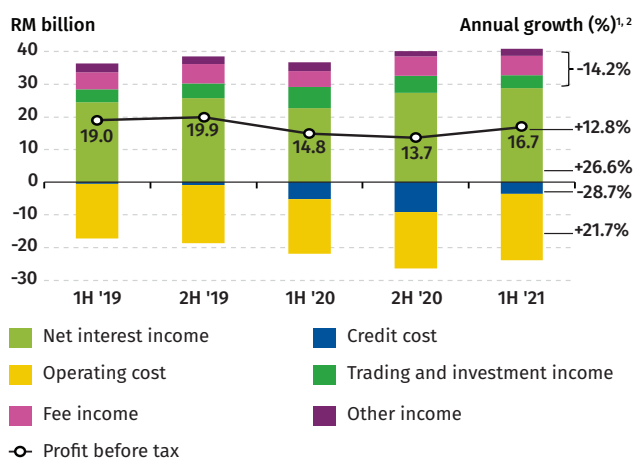
**Chart 2.14: Banking System – Provisions**



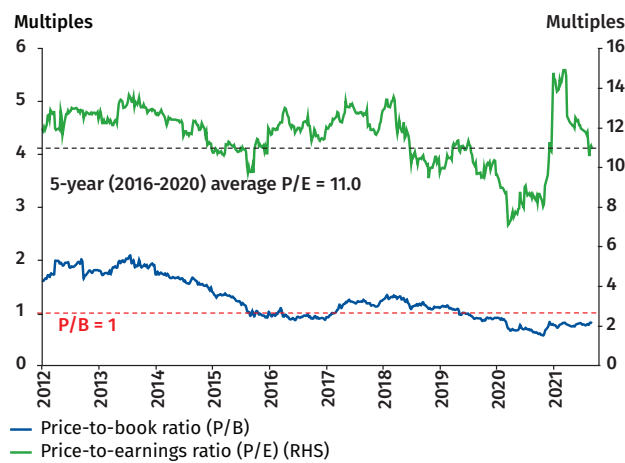
**Chart 2.15: Banking System – Annualised Credit Cost Ratio**



**Chart 2.16: Banking System – Income, Cost and Profit before Tax**



**Chart 2.17: Banking System – Price-to-Book and Price-to-Earnings Ratios<sup>3</sup> of Publicly Listed Banks in Malaysia**



Note: 1. Annual growth computed based on figures for 1H 2020 and 1H 2021  
 2. Figures may not add up due to rounding  
 3. Refers to median ratio of all publicly listed banks in Malaysia

Source: Bank Negara Malaysia and Bloomberg

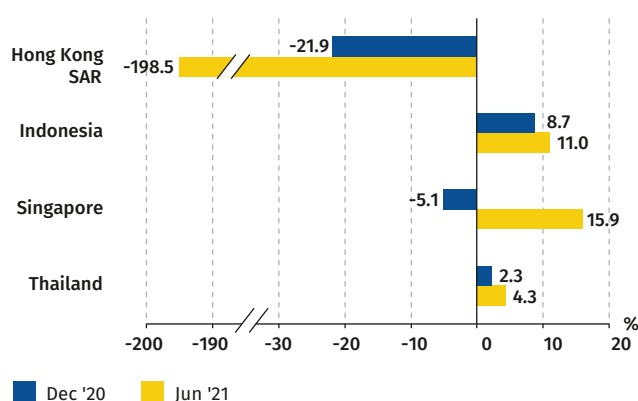
<sup>6</sup> Banking system profits are aggregated at the entity level. The aggregated results are subsequently adjusted for dividend income received from domestic banking subsidiaries (previously added at both the parent and subsidiary levels). Differences in comparative pre-tax figures reported in previous Financial Stability Reviews are estimated to range between 5.5% and 10.7%.

Banks expect to continue bolstering provisions in the second half of 2021 given renewed stress faced by some borrowers. However, this is likely to taper off with the return to more targeted repayment assistance along with greater ability of banks to differentiate borrowers' repayment capacity as broad-based repayment assistance measures are gradually retired. Loan growth is also expected to improve as containment measures are eased in tandem with the progress of the domestic vaccination programme. This will provide further support to earnings.

### DBGs' overseas operations continue to remain resilient, with a recovery in profitability in most jurisdictions

Most of the DBGs' overseas operations<sup>7</sup> recorded an improvement in profitability, mainly due to lower provisions made this year compared to 2020 (Chart 2.18). In particular, operations in Singapore, which are the most significant (Chart 2.19), registered a strong turnaround in tandem with the recovery in economic activities as COVID-19 infections were effectively contained. Earnings from operations in Indonesia and Thailand were also lifted by a lower increase in impairment allowances. The overall performance of overseas operations was, however, weighed down by operations in Hong Kong SAR mainly due to higher provisions from additional management overlays allocated for borrowers with elevated credit risk.

**Chart 2.18: Banking System - Return on Equity of Overseas Operations by Jurisdiction**

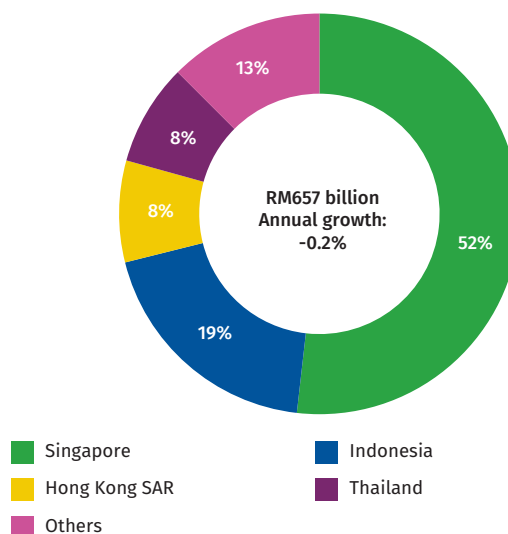


Note: Average ROE is weighted by the asset size of each domestic banking groups' overseas operations in respective jurisdictions

Source: Bank Negara Malaysia

<sup>7</sup> Refers to DBGs' overseas offices (branches and subsidiaries) operating outside of Malaysia and LIBFC. DBGs have presence in 14 overseas jurisdictions, with major operations in Singapore, Indonesia, Thailand and Hong Kong SAR.

**Chart 2.19: Banking System - Asset Profile of Major Overseas Operations**



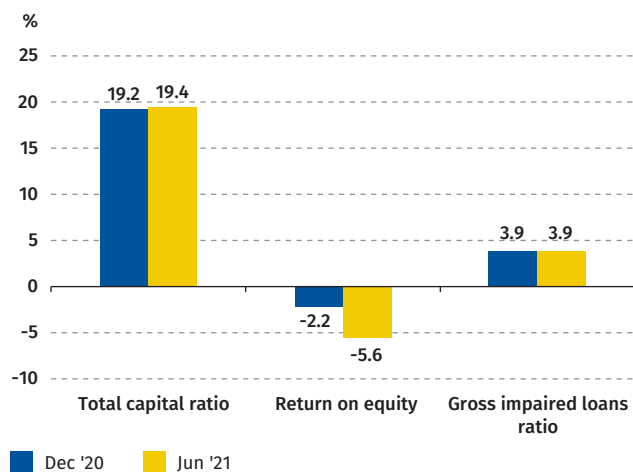
Source: Bank Negara Malaysia

Relief measures implemented throughout the first half of 2021 have continued to support the asset quality of DBGs' overseas operations which remained broadly stable (Chart 2.20).<sup>8</sup> Overseas exposures to sectors directly and indirectly affected by the pandemic are also relatively small, ranging between 0.02% and 7.2% of gross loans of individual DBGs. Further, liquidity and funding risk in key jurisdictions continue to be manageable as activities are largely funded by customer deposits (Chart 2.21).

During this period, most overseas operations of DBGs have observed an increase in short-term deposits arising from relief measures implemented in the respective jurisdictions. Capital buffers held against overseas operations remain strong and are expected to reduce the need for any recourse to parental support. While the resurgence in COVID-19 cases in some jurisdictions continues to cloud the credit risk outlook, stress tests conducted by the Bank on overseas operations affirm that all major foreign subsidiaries of DBGs are expected to have sufficient capital buffers to withstand potential shocks under extreme stress scenarios, without additional support from their respective parent DBGs.

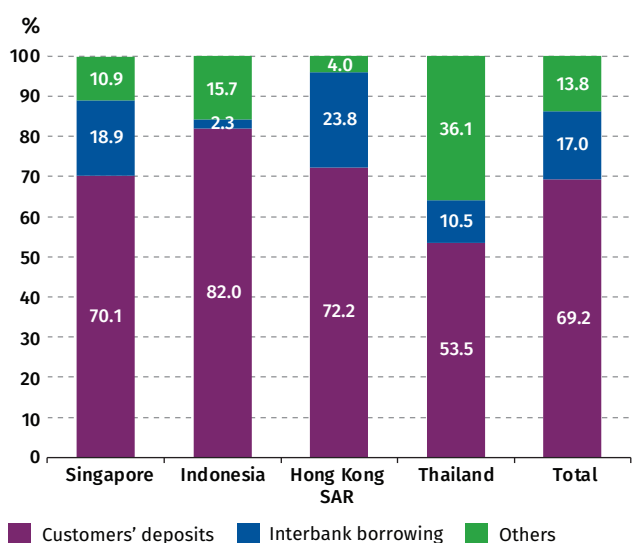
<sup>8</sup> Impairment ratio is weighted by the asset size of operations of each DBG in respective jurisdictions.

**Chart 2.20: 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 2.21: Banking System – Funding Profile of Major Overseas Operations**

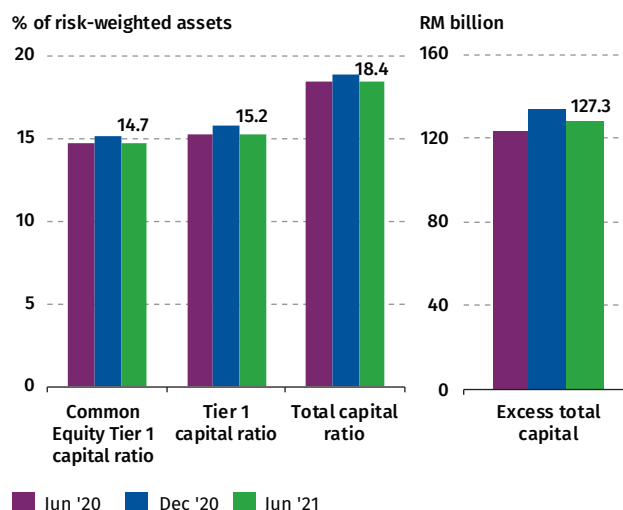


Note: Figures may not add up due to rounding  
 Source: Bank Negara Malaysia

The improvement in earnings from both their domestic and overseas operations has enabled banks to preserve healthy capital buffers. This allowed some banks to cautiously resume dividend payments that were previously halted or reduced to conserve capital, although a number of banks have kept in place dividend reinvestment programmes to protect their capital buffers given lingering uncertainties over the outlook of the economy. Banks continued to maintain strong capital

positions, with excess capital buffers<sup>9</sup> above the regulatory minimum that remain high (Chart 2.22). This remains critical to promote supportive conditions for bank lending amid higher expected levels of credit losses.

**Chart 2.22: 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

All domestic systemically important banks (D-SIB) continued to maintain CET1 capital comfortably above the regulatory minima, including the higher loss absorbency (HLA) requirements which came into effect on 31 January 2021, and internal capital targets. Based on the Bank's latest assessment using end-2020 data submissions,<sup>10</sup> the list of banks subjected to the higher capital buffer requirements to reflect their systemic importance remains unchanged (Table 2.1).

**Table 2.1: D-SIBs HLA Requirement**

D-SIBs	HLA Requirement (% of risk-weighted assets)
Malayan Banking Berhad	1.0
CIMB Group Holdings Berhad	
Public Bank Berhad	0.5

Source: Bank Negara Malaysia

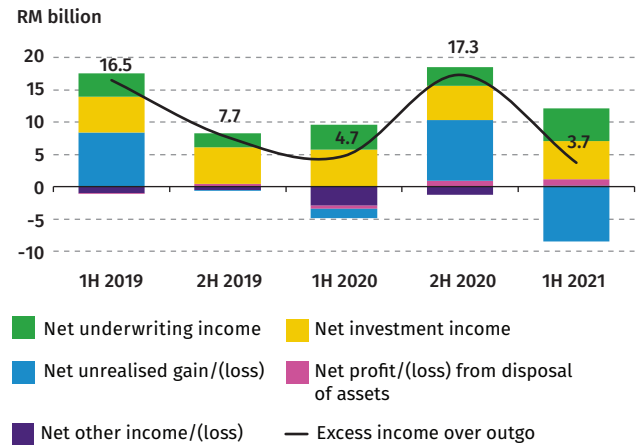
<sup>9</sup> Refers to capital held in excess of regulatory minimum, which includes the capital conservation buffer (2.5%) and bank-specific requirements.  
<sup>10</sup> The D-SIBs assessment is bounded for banks with total consolidated assets equal to or more than RM30 billion. Please refer to <https://www.bnm.gov.my/-/domestic-systemically-important-banks-d-sib-framework>.

## THE INSURANCE AND TAKAFUL SECTOR

### The insurance and takaful sector recorded lower profitability, driven by weaker investment performance

The overall profitability of insurance and takaful funds was lower in the first half of 2021 compared to the same period in 2020. For the life insurance and family takaful funds, excess income over outgo declined to RM3.7 billion (1H 2020: RM4.7 billion) (Chart 2.23). This was driven by net unrealised losses from bond investments in line with the weaker bond market performance and, to a lesser extent, mark-to-market equity investment losses. Income from underwriting activities provided some support to profitability. Growth of new business premiums<sup>11</sup> recovered strongly at 30.2% (1H 2020: -7.1%), primarily driven by the investment-linked, Mortgage Reducing Term Assurance/Takaful (MRTA/MRTT), and medical and health business segments (Chart 2.24). This reflected the resumption of face-to-face product sales and property market activity as a result of less restrictive containment measures up until end-May. As noted in the previous publication of the Financial Stability Review, ITOs have also observed an increasing awareness among Malaysians on the important role that insurance and takaful can have in providing a financial safety net in times of uncertainty. This is expected to provide some lift to demand for insurance and takaful despite near term pressures on household incomes.

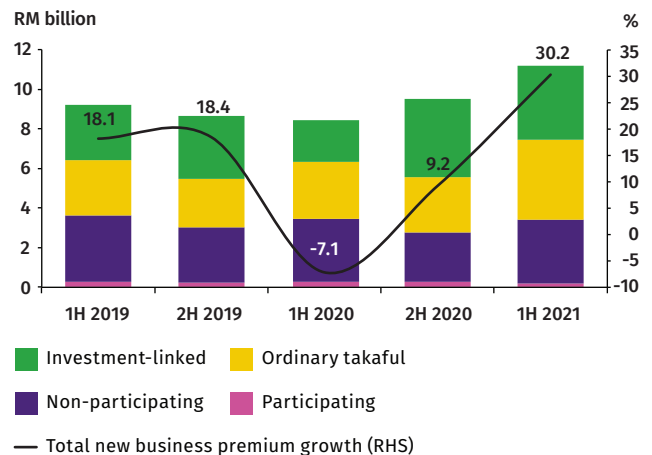
Chart 2.23: Life Insurance and Family Takaful Fund – Composition of Income and Outgo



Note: Net underwriting income refers to excess of net premium after deducting benefit payouts, agency remuneration and management expenses

Source: Bank Negara Malaysia

Chart 2.24: Life Insurance and Family Takaful Sector – New Business Premium Growth and Product Composition



Source: Bank Negara Malaysia

<sup>11</sup> Refers to both insurance premiums and takaful contributions, unless stated otherwise.

The impact on life and family ITOs from the temporary relief measures granted to policyholders<sup>12</sup> remained limited. Affected policyholders have been afforded the option to defer premiums due under life insurance policies and family takaful certificates for three months, without interruption in their coverage. This option, previously slated to expire by June 2021, has been extended until December 2021. Policyholders that have availed of the premium deferment option have continued to increase, although the amount of premiums deferred and covered by premium holidays<sup>13</sup> remained relatively small at 8.3% of premiums in force (June 2021: 7.7%; March 2021: 6.5%).<sup>14</sup> To account for heightened risks arising from the pandemic, some life and family ITOs have introduced additional underwriting measures, including questionnaires to assess the COVID-19 medical history and risk exposure of prospective policyholders. In selected

cases, affected policyholders could be subjected to additional underwriting conditions such as longer waiting periods. Higher premium loadings could also be imposed on policyholders with indications of higher risk to develop serious health conditions, although this would be largely dependent on further medical assessments undertaken on a case-by-case basis. Overall, such practices have so far not been widely observed to suggest a broader tightening of underwriting conditions across ITOs due to COVID-19.

The impact on ITOs' earnings from the premium deferrals as well as COVID-19 claims is expected to remain manageable, with ITOs assessed to be resilient against stressed scenarios assuming higher claims<sup>15</sup> than observed thus far. Consistent with this, ITOs have not to date been dependent on the regulatory flexibilities accorded to them throughout the course of the pandemic.

<sup>12</sup> Refers to both insurance policyholders and takaful participants, unless stated otherwise.

<sup>13</sup> A premium holiday refers to continued insurance/takaful coverage despite an absence of premium payments and applies to products with the premium holiday feature already in place such as investment-linked products. This flexibility is available to policyholders as long as the investment value in the unit fund remains sufficient to meet the necessary insurance cost during the premium holiday period.

<sup>14</sup> Based on a cumulative amount from 27 March 2020 until 3 September 2021.

<sup>15</sup> Assumptions under the stressed scenarios include: (i) COVID-19-related ex-gratia payments to policyholders and higher claims for policies without a pandemic clause; and (ii) a conservative increase in the general insurance claims ratio by up to 17%. Refer to the section on 'Assessing the Resilience of Financial Institutions' in the BNM Financial Stability Review for Second Half 2020 for further details.







## Evaluating the Impact of Medical Re-pricing Deferrals on Life Insurers and Family Takaful Operators

Medical reimbursement insurance/takaful cover in Malaysia is typically designed to cover or reimburse, either fully or partially, the expenses arising from inpatient and certain outpatient medical treatments. In 2020, close to 7 million individual medical reimbursement policies/certificates were written by life insurers and family takaful operators. This represents a significant portion of life insurance and family takaful business, accounting for 68% of total protection insurance and takaful claims<sup>16</sup> in 2020. This box examines trends in the claims experience of medical reimbursement insurance/takaful products, the effect of the pandemic, and the consequential impact on the re-pricing cycles of these products.

### How are medical reimbursement insurance/takaful covers managed?

Medical reimbursement covers are typically designed with annually reviewable premium rates to reflect changes in the cost of treatment and propensity to utilise healthcare services. As these factors are difficult to predict in the long term, regular re-pricing is a standard feature of these products to ensure the sustainability of the medical insurance/takaful portfolios. Medical insurance/takaful portfolios become unsustainable when the premiums collected are insufficient to cover the expected claims cost, expenses, and profit margin of the ITOs. Key assumptions used to estimate the expected claims cost are the rate of medical claims inflation and the average cost per treatment or claim event. Similar to other countries, the cost of medical services in Malaysia has been increasing at a much faster pace than general price inflation (Table 2.2). The claims cost is also affected by changes in utilisation of healthcare services by policyholders, which may arise from demographic shifts and changes in lifestyle and behaviours. All these assumptions are combined to derive the expected claims cost which determines the required level of premiums.

Table 2.2: Comparison of Net Medical Trend Rates

	Net Medical Trend Rate* (%)		
	2019	2020	2021 (Projected)
Malaysia 	10.0	10.7	9.8
Singapore 	7.1	7.8	7.7
Global 	5.1	4.6	6.2
United States 	6.1	6.6	5.1
United Kingdom 	3.9	5.2	5.0
Australia 	4.9	4.6	4.2

\*Medical trend rate net of general inflation

Source: 2021 Global Medical Trends Survey Report, Willis Towers Watson

<sup>16</sup> Total protection claims are claims which arise from medical, death, and disability coverages, excluding surrender and maturity claims. This proportion includes medical claims from group and employer-based schemes.

The claims experience of medical reimbursement covers varies across ITOs, and even across the various products of the same ITO, on account of:

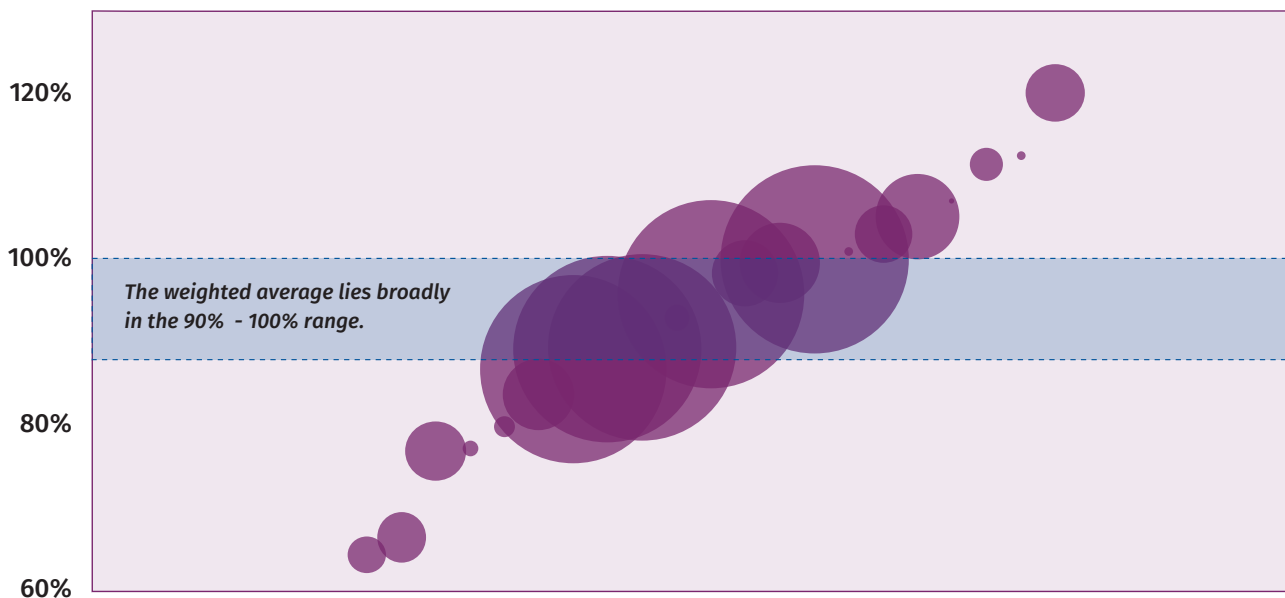
- (1) The risk profiles of individuals covered, such as age groups, which in turn affect the type of medical services utilised. For example, products covering individuals with older age profiles will likely exhibit higher medical claims inflation since the likelihood of requiring medical services and encountering surgical complications increases with age; and
- (2) Product features, which affect policyholders' tendency (and ability) to make a claim. For example, products with cost-sharing features often have lower claims payout compared to those without. In some countries, cost-sharing via deductibles or co-payments is mandated in their healthcare systems to contain the cost of medical services.

To maintain fair outcomes across policyholders, premiums are typically differentiated to take into account differences in claims experience between risks that are pooled together. For example, the premium levels for risk groups with higher tendency to claim and/or require more expensive treatments are generally set higher than those with lower risk profiles.

### How has COVID-19 impacted the claims trend and what can be expected post-pandemic?

Over the period from 2015 to 2019, the combined ratio of life insurance and family takaful industry's individual medical portfolio lay broadly in the range between 90% and 100% (Diagram 2.1). It is observed that the combined ratio, which is the ratio of total claims paid and expenses to total premiums collected,<sup>17</sup> displays a cyclical pattern of peaks and troughs that coincides with a three- to five-year re-pricing cycle commonly practised by ITOs.

**Diagram 2.1: Distribution of Life Insurers and Family Takaful Operators' Total Medical Combined Ratios for the Period 2015 - 2019**



Note: The size of the bubbles generally denotes the size of medical business by claims, averaged for the top 5 writers

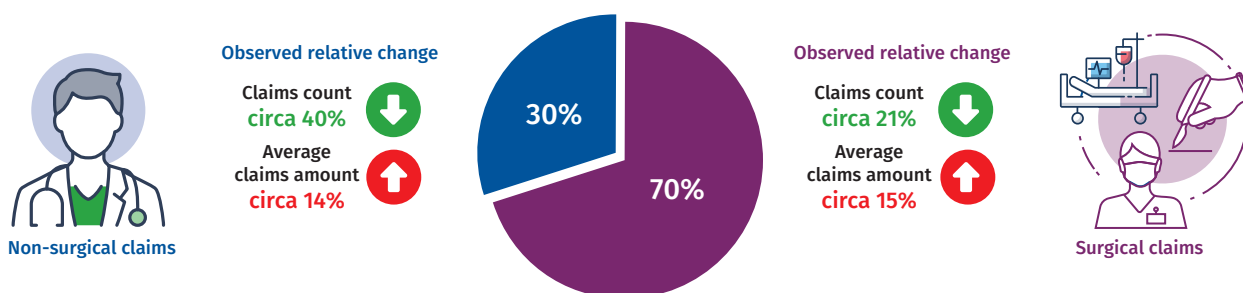
Source: Bank Negara Malaysia estimates

<sup>17</sup> A combined ratio of 100% indicates that the premiums collected are fully depleted by claims and expenses, with no profit left for the ITO as a return for underwriting the portfolio.

In 2020, the combined ratios of the medical portfolios of ITOs decreased. It was observed that the lower claims were driven primarily by temporary factors, such as movement restrictions, reduced social contact due to the implementation of remote working and learning, and hesitation to seek non-critical medical treatment at hospitals during the pandemic. The number of claims in 2020 decreased compared with 2019, with most claims coming from critical treatments that could not be deferred. However, the reduction in the number of claims during the pandemic period was partially offset by the increase in the average cost per treatment of 14% for non-surgical treatments and 15% for surgical treatments (Diagram 2.2), which exceeded the respective long-term trends of 8% and 9% per annum.<sup>18</sup> This was partly attributable to the more severe and urgent nature of illnesses being treated and claimed for, as well as additional costs arising from pandemic-related protocols such as lab tests for COVID-19 and higher utilisation of disposable medical supplies (including personal protective equipment).

**Diagram 2.2: Claims Experience Over the Pandemic Period by Claims Type**

Lower medical claims incidence but average medical claims inflation continued to rise during the pandemic period



Note: The annualised relative change in claims count and average claims amount is based on a comparison between 2019 experience to that over the pandemic period (2020 up to 1H 2021). The annualised relative change experienced by each individual life insurer and family takaful operator may differ from the above aggregate statistics

Source: Bank Negara Malaysia estimates using data from life insurers and family takaful operators with significant medical business

The number of claims is expected to normalise once the pandemic abates and movement restrictions are gradually lifted. Incidences of hospitalisation from common non-surgical treatments such as stomach flu and dengue fever are expected to return to past trends. Although the extent of the rebound in medical claims post-pandemic is uncertain, observations from other markets suggest the possibility of a temporary increase in utilisation of healthcare services. This can be contributed by a sharp increase in the number of claims compared to the pandemic period due to delayed non-critical treatments, and diagnoses from postponed medical visits by individuals who had earlier avoided going to hospitals due to COVID-19 concerns (Gardner and Fraser, 2021; Berlin et. al, 2020).

In the short term, the average treatment cost could also increase due to poorer health conditions worsened by delays in seeking treatment (Mathews and Cherney, 2020). Demand-supply dynamics may also push costs higher, particularly for hospital supplies and services that may increase due to higher demand. Based on 2018 claims data, hospital supplies and services accounted for 60% and 70% of claimable surgical and non-surgical treatment costs respectively in Malaysia.<sup>19</sup> Further, higher charges from pandemic-related protocols are likely to persist in the foreseeable future.

Over the longer term, it is uncertain how the pandemic will affect underlying medical trends. The accelerated adoption of telehealth services by international insurers during the pandemic has been a notable development that could improve the efficiency of providing healthcare and reduce cost. However, balanced against this is the yet unknown effects of long COVID<sup>20</sup> in the insured population which could increase the utilisation of healthcare services (Aon, 2021; Willis Towers Watson, 2020).

<sup>18</sup> The compounded annual growth rate from 2013 – 2018 of average billed amount based on an independent study commissioned by the industry through the Medical Cost Containment Task Force.

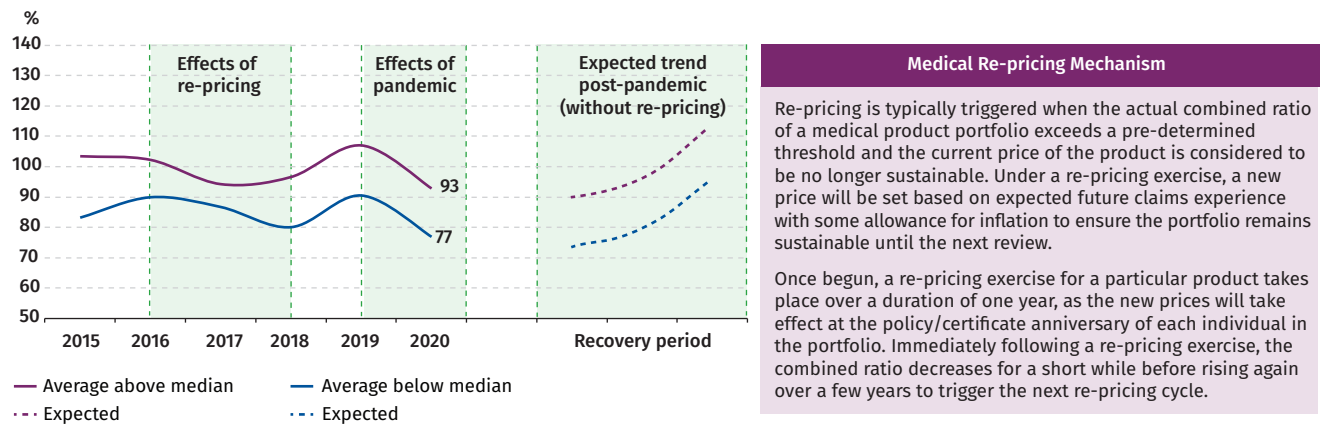
<sup>19</sup> Based on the independent study commissioned by the industry through the Medical Cost Containment Task Force.

<sup>20</sup> Longer-term health conditions that may affect some patients after contracting COVID-19.

### What is the impact of delaying the re-pricing cycle?

Notwithstanding these expected trends (Chart 2.25), most ITOs agreed to defer any earlier planned re-pricing exercises in 2020 to preserve the affordability of medical covers. ITOs will be carefully evaluating the risks of continuing to delay the re-pricing cycle, especially for portfolios with the highest combined ratios prior to the pandemic (Chart 2.26). For such portfolios, there is considerable risk that a sharp rebound in claims once the pandemic fears subside could lead to steeper or more frequent price increases in the near term. This could have a disproportionate impact on some individual policyholders given the larger adjustments made over a shorter period of time. In the takaful business, which is based on risk sharing between takaful participants, there could be additional concerns relating to fairness and equity if the medical tabarru' charges are not increased in line with risk expectations, as other takaful participants will be subsidising the losses attributed to medical claims to a greater extent than originally represented to participants.

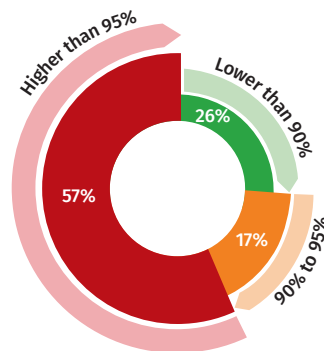
**Chart 2.25: Medical Combined Ratios from 2015 to 2020 and the Expected Impact of Delaying Re-pricing**



Note: Data represents yearly renewable individual medical insurance policies. The average combined ratio is aggregated for all life insurers that are higher or lower than the median life insurer for each calendar year. Data has been adjusted to address any data issues

Source: Bank Negara Malaysia estimates using data from life insurers

**Chart 2.26: Distribution of Life Insurers and Family Takaful Operators by Pre-pandemic Medical Combined Ratios**



Note: Data represents 2019 medical claims experience

Source: Bank Negara Malaysia estimates

### What can be done to better manage the re-pricing of medical insurance/takaful business?

While re-pricing enables ITOs to manage the sustainability of their business, the Bank requires ITOs to implement re-pricing exercises in an objective and fair manner, based on actual past claims experience and expectations of future claims experience that are reasonable and supportable. Prior to the pandemic, the Bank was also concerned when ITOs delayed re-pricing exercises for too long as a competitive strategy. Lengthy delays are likely to result in sharp and unexpected premium adjustments subsequently to catch up with claims inflation. This may leave policyholders who are unable to afford the higher premiums with limited options to obtain replacement coverage due to advancement in age or changes in their health status. To promote fairer outcomes for policyholders, ITOs are required to establish an internal policy to govern the medical re-pricing exercise, which includes setting out objective indicators and thresholds used by ITOs to trigger re-pricing, as well as the methodology used to determine the new price. The implementation of these policies must be monitored and reviewed to ensure that it is applied consistently and with due regard to the fair treatment of policyholders. The Bank is also reviewing existing regulations to allow more flexibility for ITOs to moderate the extent of re-pricing required for smaller product portfolios that may be more likely to experience greater volatility in claims experience.

Following earlier signs of improvements in the economy in 2021, some ITOs have resumed re-pricing recently. However, these ITOs have also put in place measures to support medical policyholders who may have difficulties maintaining higher premium payments given the current exceptional circumstances. The measures aim to ease cashflows of policyholders without forgoing protection, allowing them time to financially recover. Options made available to policyholders include enabling them to maintain premiums at the original amount before re-pricing, by temporarily switching to a cheaper plan or product. Policyholders exercising this option would be able to revert to their original coverage within a specified period without new or additional underwriting. This is in addition to the existing option for affected policyholders to temporarily defer premium payments.

Over the longer term, containing medical claims inflation, which is a major driver of re-pricing, remains a key priority to preserve sustainable access to medical reimbursement coverage from private ITOs. This requires a concerted effort from multiple stakeholders – including healthcare providers, regulators, ITOs, support service providers, and end consumers – to deliver longer-term reforms in the delivery and consumption of private healthcare services. Such reforms are further discussed in the article on ‘Managing Medical Claims Inflation’ published in the Bank’s Annual Report 2019.

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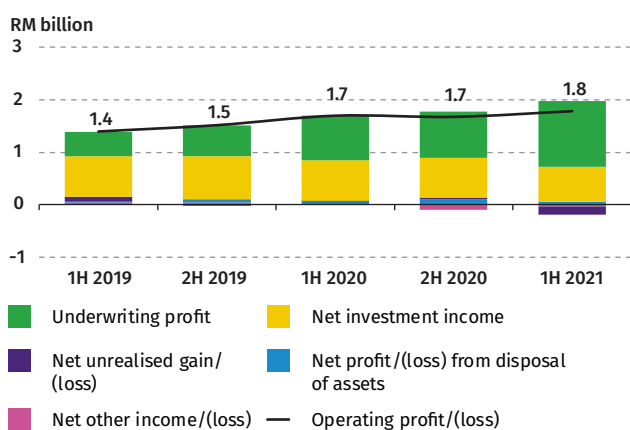
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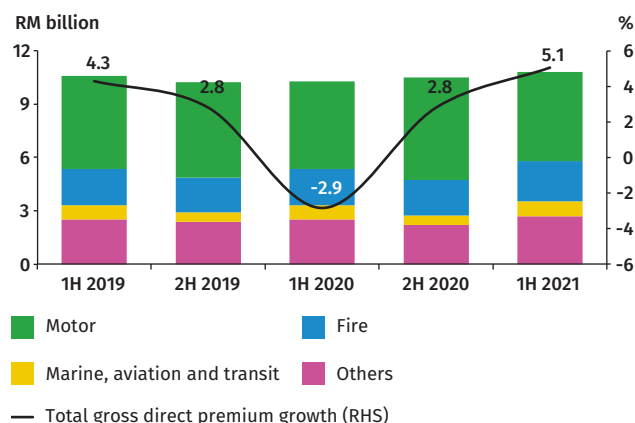
General insurance and takaful funds recorded a slight increase in operating profits to RM1.8 billion (1H 2020: RM1.7 billion), driven by better underwriting performance (Chart 2.27). Gross direct premiums were bolstered by revised premium rates in the fire, and contractors' all risks and engineering segments (1H 2021: +14%; 1H 2020: +4%) following higher claims from several large fire and explosion incidents in the last two years (Chart 2.28). Higher premiums were also supported, to a lesser extent, by a recovery in the motor segment amid a rebound in car sales following the extension of the vehicle sales tax exemption, which is in place until December 2021, and the easing of containment measures prior to the FMCO. A modest increase in general reinsurance rates was observed amid a hardening of the global reinsurance market, mainly affecting the commercial and specialised lines of business. Reinsurance support for the coverage of business interruption losses arising from infectious and contagious diseases – already limited in terms of global capacity and take-up – may also be further reduced in the wake of the pandemic. However, this had little impact on the overall profitability of ITOs. Some smaller ITOs continued to experience considerable earnings volatility due to a higher reliance on investment income to support overall profitability. Risks of heightened volatility in the financial markets therefore remain significant for these ITOs.

**Chart 2.27: General Insurance and Takaful Fund – Composition of Operating Profits**



Source: Bank Negara Malaysia

**Chart 2.28: General Insurance and Takaful Sector – Gross Direct Premium Growth and Product Composition**



Note: Others include contractors' all risks and engineering

Source: Bank Negara Malaysia

Despite the lower interest rate environment, the long-term asset allocation and investment strategies of life and family ITOs have remained largely stable. The life insurance industry is also expected to remain resilient in an environment of prolonged low interest rates.<sup>21</sup> In comparison, general ITOs have been observed to shift more of their cash holdings into Collective Investment Schemes (CIS)<sup>22</sup> over the past few years to generate higher returns, while still maintaining sufficient liquidity to meet short-term obligations. General ITOs' cash and deposit holdings declined further to 15.1% of total assets (December 2020: 18.4%), while their bond holdings have also increased in tandem over the recent period to 28.9% of total assets (December 2020: 27.6%). Additionally, general ITOs were also observed to have increased their investments in equities during this period, taking advantage of attractive equity prices. ITOs' investment risk management practices remain generally sound. Investment strategies continue to be largely driven by ITOs' board-approved strategic asset allocation and tactical asset allocation plans that have not changed significantly in response to market developments in recent periods. This continues to be supported by satisfactory monitoring and governance arrangements that serve to contain risk exposures in asset classes that have experienced greater volatility.

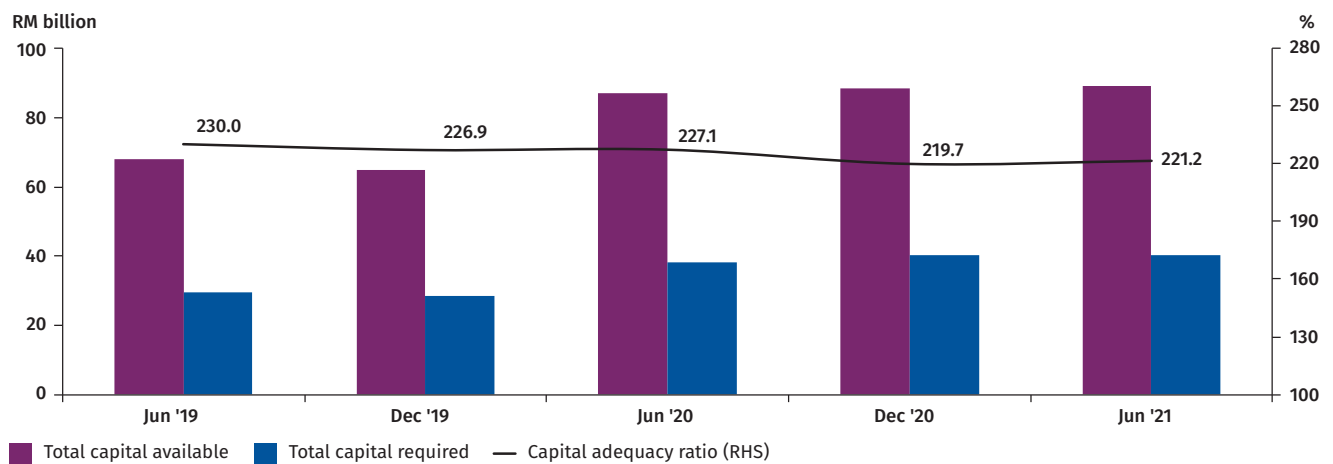
<sup>21</sup> Refer to the Information Box on 'Assessing the Impact of Declining Interest Rates on Life Insurers' Solvency Positions' in the BNM Financial Stability Review for Second Half 2019.

<sup>22</sup> Largely comprise investments in unit trust funds with fixed income investments as the underlying assets.

Going forward, financial market volatility and prospects of rising bond yields will continue to weigh on earnings of ITOs given their sizeable financial investments. Nonetheless, the insurance and takaful sector is expected to remain resilient. A sensitivity analysis conducted<sup>23</sup> on the balance sheet of ITOs shows limited impact to their solvency positions in the event of a sharp rise in bond yields. This is underpinned by the strong capitalisation of ITOs.

The aggregate industry capital adequacy ratio (CAR) of 221.2% remains well above the regulatory minimum of 130% (Chart 2.29). All ITOs also continue to maintain capital ratios above their internal capital target levels that range between 150% and 250%. As at end-June 2021, aggregate excess capital buffers above the regulatory minimum stood at RM36.8 billion. Stress tests conducted on insurers<sup>24</sup> also affirmed their ability to withstand severe potential shocks.

**Chart 2.29: Insurance and Takaful Sector – Capital Adequacy Ratio**



Source: Bank Negara Malaysia

<sup>23</sup> Refer to the section on Market Risk in the chapter 'Coping with an Uneven Recovery: Key Developments in the First Half of 2021' for details of a sensitivity analysis conducted on the balance sheet of ITOs to bond yield movements.

<sup>24</sup> Refer to the section on 'Assessing the Resilience of Financial Institutions' in the BNM Financial Stability Review for Second Half 2020 for further details.

## ASSESSING THE RESILIENCE OF FINANCIAL INSTITUTIONS

Stress testing is an integral component of the Bank's financial stability framework. In the previous publication,<sup>25</sup> the Bank presented the results of its most recent multi-year, top-down solvency stress test. In that exercise, two hypothetical adverse scenarios were designed to augment our assessment of the resilience of individual financial institutions and the broader financial system against an economic recovery path that was significantly weaker than anticipated. Results of the exercise affirmed that financial institutions are adequately buffered against potential losses that may arise should these adverse scenarios materialise.

Taking into account developments since the publication of those results, including the implementation of the FMCO, the top-down stress test performed earlier this year continues to capture the range of possible severe economic and financial shocks that sufficiently tests the resilience of financial institutions. This, in part, reflects the significant degree of conservatism around repayment assumptions that has been built into the stress test when translating the applied shocks into potential losses of financial institutions (Table 2.3).

Therefore, an update of the multi-year, top-down stress test will be published in the Financial Stability Review for the Second Half of 2021, in line with past annual stress test cycles. Notwithstanding this, as part of the Bank's ongoing supervisory assessments, individual banks were required to submit their stress test results based on a hypothetical stressed scenario of a weaker-than-expected economic recovery path, extending to the end of 2022. The scenario assumes that recovery in the domestic economy will be gradual and only expected towards the second half of 2022. Given prolonged movement restrictions, economic scarring is assumed to be deep and widespread with elevated unemployment levels, depressed asset prices, high business closures, and weak consumer and business sentiments. In addition, no further extension of support measures and introduction of new relief measures are assumed. Banks were also asked to consider the impact of potential sovereign rating downgrades. As with the top-down, macro-solvency stress test, the economic scenario used in this bottom-up exercise does not represent the Bank's actual expectations for the trajectory of the economy. The scenario is constructed solely for the benefit of testing the resilience of banks against severe and prolonged economic shocks, and serves to complement the Bank's assessments under its top-down stress test.

**Table 2.3: Repayment Assumptions in the Top-down Stress Test**

	Assumption
Repayment assistance	<ul style="list-style-type: none"> <li>No R&amp;R of business loans after the second quarter of 2021</li> <li>Repayment assistance for household borrowers to end after the first quarter of 2021</li> </ul>
Cures	<ul style="list-style-type: none"> <li>No reversion in loan staging of households and businesses, even if subsequent improvements are observed</li> </ul>
Policy support measures	<ul style="list-style-type: none"> <li>Effects from policy initiatives such as flexibilities to withdraw from retirement savings, wage subsidy programmes, or cash transfers from the Government are not considered</li> </ul>
Maturing bullet repayment loans	<ul style="list-style-type: none"> <li>Up to 50% of maturing bullet repayment loans of non-listed firms in the vulnerable sectors were assumed to turn impaired, which is markedly higher compared to the actual impairments<sup>1</sup> observed thus far</li> </ul>

Note:

<sup>1</sup> As of June 2021, only 17% of the total original maturing bullet repayments were assessed by banks (and reviewed by auditors) to exhibit signs of a significant increase in credit risk, while a very small portion (0.4%) of maturing bullet loans have turned impaired

Source: Bank Negara Malaysia

<sup>25</sup> Refer to the section on 'Assessing the Resilience of Financial Institutions' in the BNM Financial Stability Review for Second Half 2020 for further details.

In this exercise, individual banks independently modelled the expected macroeconomic and financial shocks to be applied and the corresponding potential losses they may incur. The degree of shocks and corresponding assumptions applied were observed to be generally conservative across all banks. For instance, some banks applied additional stress factors to selected segments of their portfolios, including significantly higher probabilities of default. DBGs also included the impact of shocks to the operations of their overseas branches in the stress test. In addition, most banks assumed a rise in bond yields,<sup>26</sup> reflecting expectations of higher non-resident outflows amid renewed policy uncertainty and a resurgence in COVID-19 cases domestically. This was despite their expectations of further overnight policy rate (OPR) cuts. Banks were further observed to assume that loans under repayment assistance would continue to spike in 2021 before tapering by end-2022 in line with the assumed economic recovery path.

The results of the bottom-up stress test performed by individual banks affirm the aggregate resilience of the banking system against severe economic and financial shocks. Credit risk remains the key driver of potential losses faced by banks, with both the top-down and bottom-up stress tests showing a larger share of losses coming from the business sector. Credit costs

under the bottom-up exercise are close to four times the credit costs observed in 2020, higher than that derived under the top-down stress test of about two times. This was skewed by significantly more conservative economic parameters employed by a few banks. These banks account for about a fifth of total banking system assets and are supported by strong starting capital positions at the entity and group levels.

Overall, under the bottom-up exercise, the median decline in the total capital ratio by end-2022 is 4.4 percentage points (ppts), with an inter-quartile range<sup>27</sup> of 5.9 ppts (first quartile: 2.1 ppts, third quartile: 8 ppts). These results, while showing a larger aggregate impact on the banking system due to large variations in assumptions across banks, do not change the overall assessment of the resilience of the banking system under the Bank's top-down stress test.

Importantly, the continued resilience of banks remains a key mitigant against excessive risk aversion which often typifies banks' behaviour following an economic downturn. The stress test results affirm that banks remain in a sound position to support lending to viable businesses and households, thus promoting conditions for the economy to stage a stronger recovery.

<sup>26</sup> Refer to the section on Market Risk in the chapter 'Coping with an Uneven Recovery: Key Developments in the First Half of 2021' for details of a complementary sensitivity analysis conducted on the balance sheet of financial institutions to bond yield movements.

<sup>27</sup> The inter-quartile range indicates the difference between the total capital ratio decline reported by the 75<sup>th</sup> percentile bank and the 25<sup>th</sup> percentile bank. Given the approach taken in the bottom-up stress test which may result in exceptional variations in economic parameters used by some banks, the inter-quartile range offers a more representative measure of the dispersion between the results of individual banks.

