

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).¹ Meanwhile, deposits from non-bank financial institutions (NBFIs) moderated slightly, reflecting withdrawals by these institutions, partly to facilitate the implementation of Government relief measures.

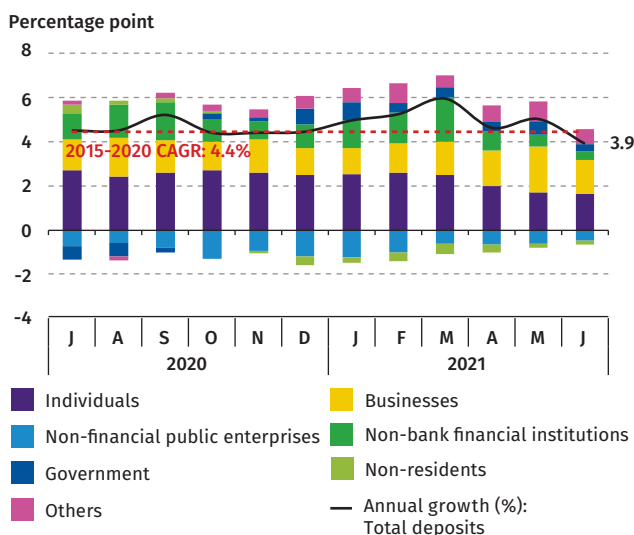
Given the uncertain operating environment, households, businesses, and fund managers have continued to maintain a preference for more liquid deposits (Chart 2.2). This has led to lower funding costs and consequently improved net interest income for banks (Chart 2.3). At the institution level, the shift towards shorter-term funding has led to larger movements in the Liquidity Coverage Ratio (LCR) positions² 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).

¹ 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.

² 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.

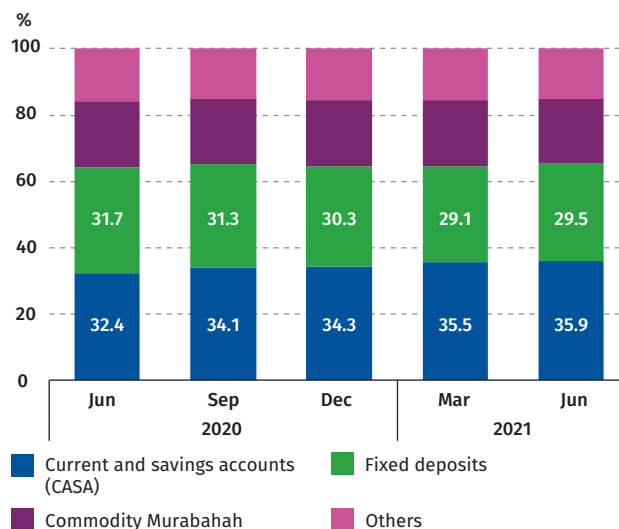
Notably, banks' holdings of government bonds rose by RM22 billion from December 2020 (2H 2020: -RM1 billion), helping to support interest income amid the subdued loan growth.

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



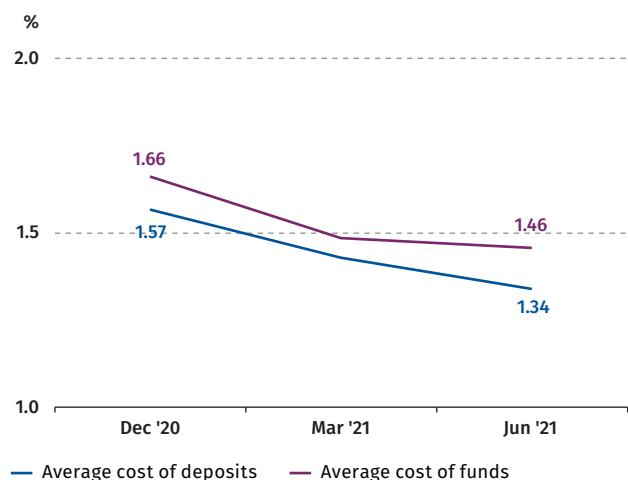
Source: Bank Negara Malaysia

Chart 2.2: Banking System – Composition of Deposits by Type



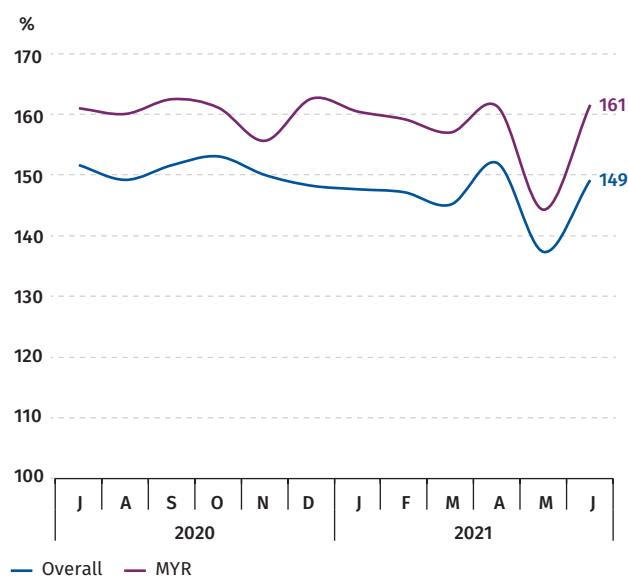
Source: Bank Negara Malaysia

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).³ 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

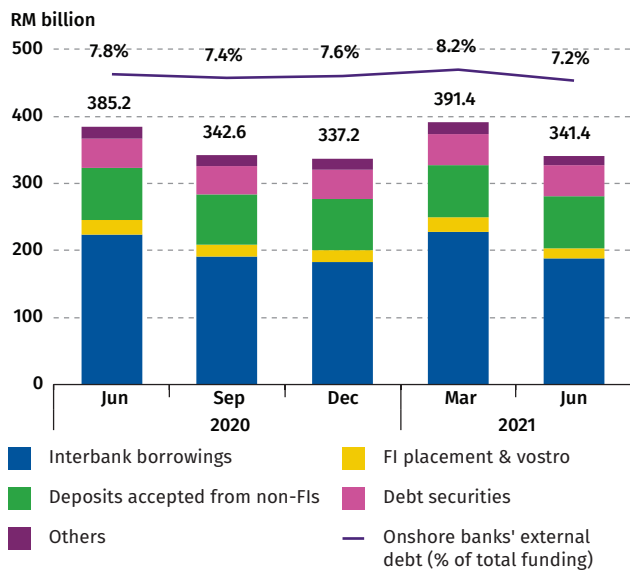


Chart 2.6: Banks' External Debt – by Type of Exposure and Instrument

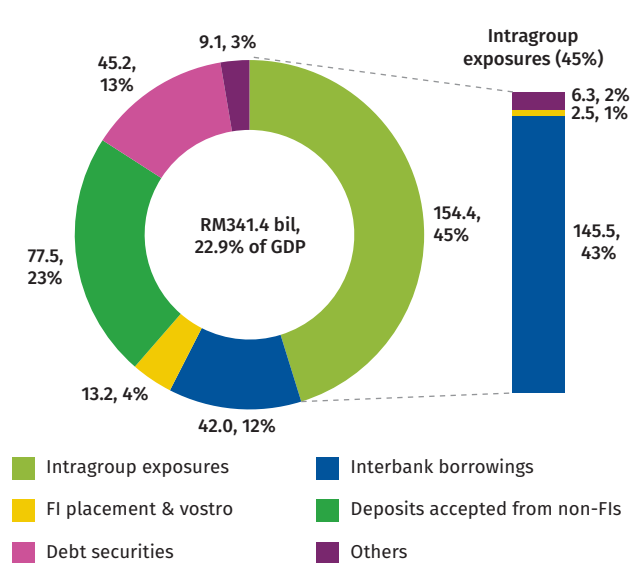


Chart 2.7: Banking System – FCY External 'Debt-at-Risk' and Liquid Assets

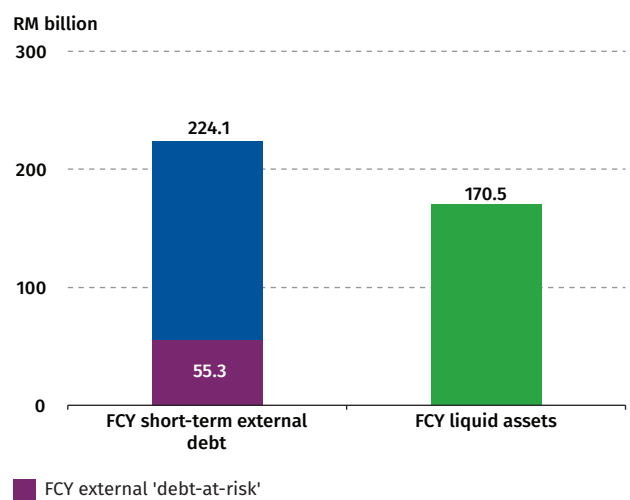
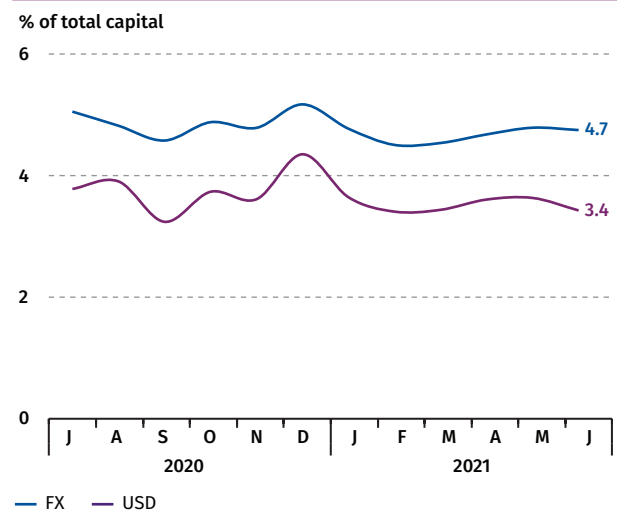


Chart 2.8: Banking System – FX and USD Net Open Positions



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

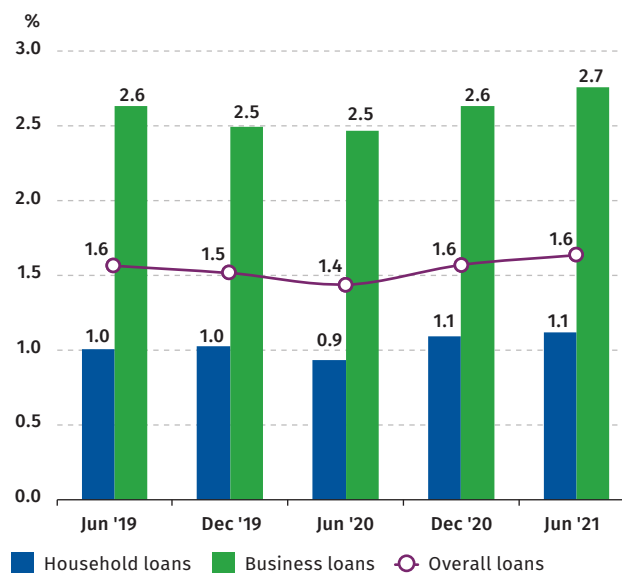
³ Banks' external 'debt-at-risk' comprises financial institutions' deposits, interbank borrowings, and short-term loans from unrelated non-resident counterparties, which are considered more susceptible to sudden withdrawal shocks.

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%)⁴ (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

⁴ 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.

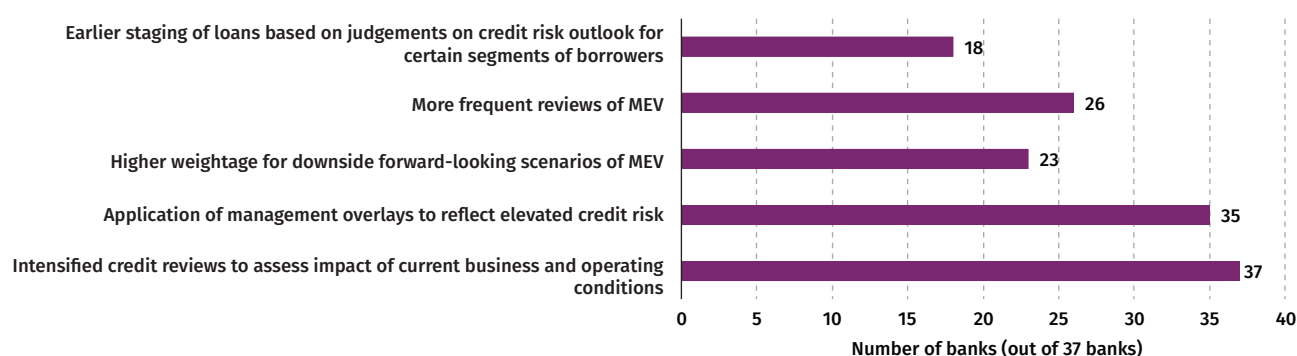
Reflecting these challenges, the Bank formally communicated its expectations of banks to exercise appropriate discretion in the application of accounting and regulatory capital standards in relation to ECL and the definition of default respectively. This took into account the exceptional nature of the 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

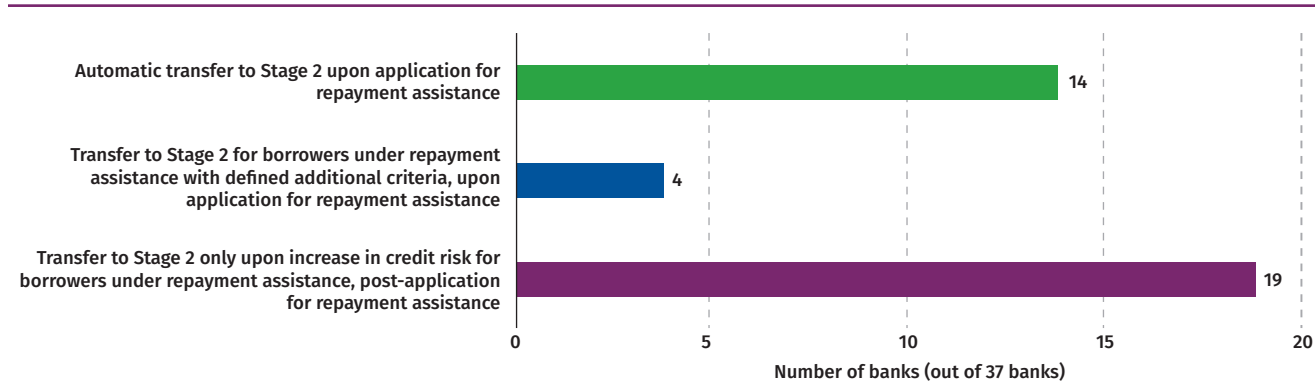


Source: BNM Survey to Banks

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



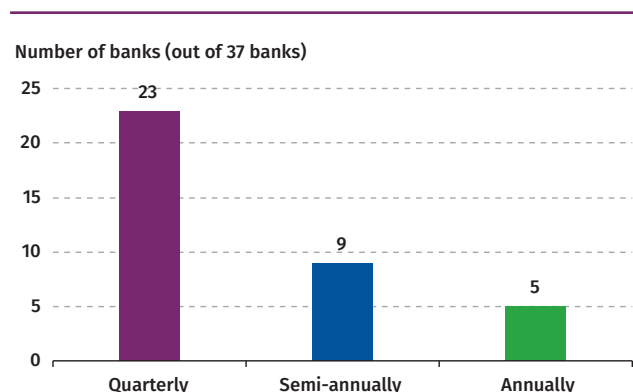
Source: BNM Survey to Banks

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

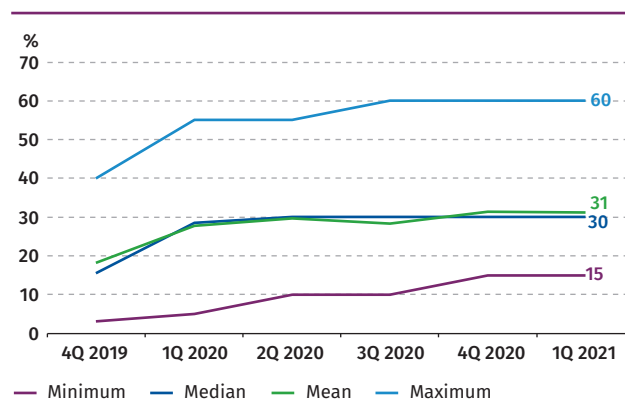
The majority of banks increased the frequency of revisions to MEV used in their ECL models, specifically GDP growth and unemployment forecasts, given the high and persisting degree of economic uncertainty experienced throughout the pandemic (Chart 2.12). Most banks also incorporated a higher degree of 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 overlays⁵ 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.

⁵ 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 profits⁶ 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

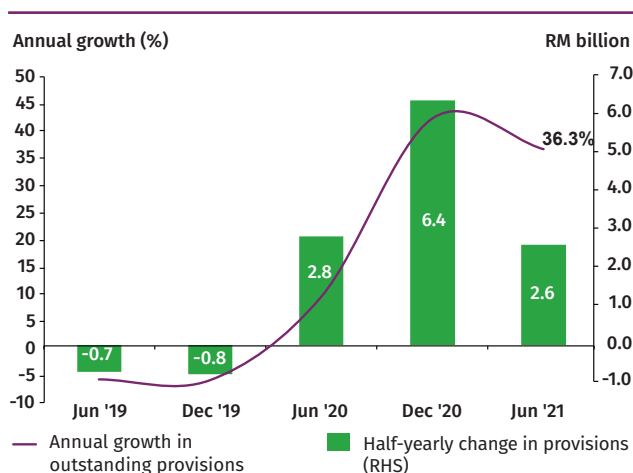


Chart 2.15: Banking System – Annualised Credit Cost Ratio

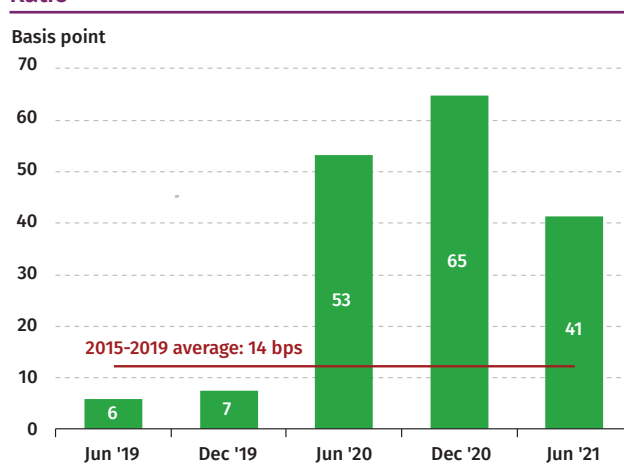


Chart 2.16: Banking System – Income, Cost and Profit before Tax

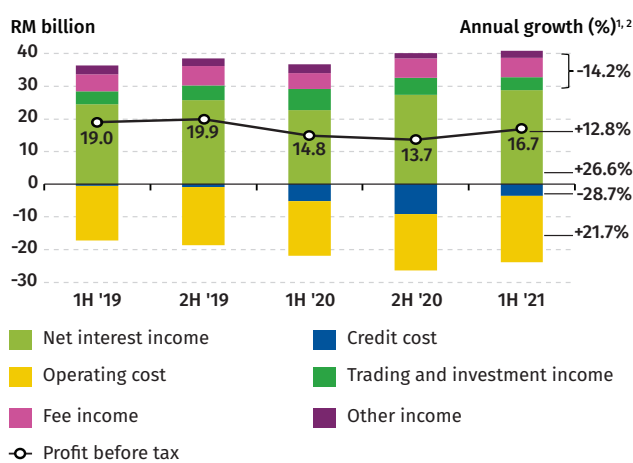
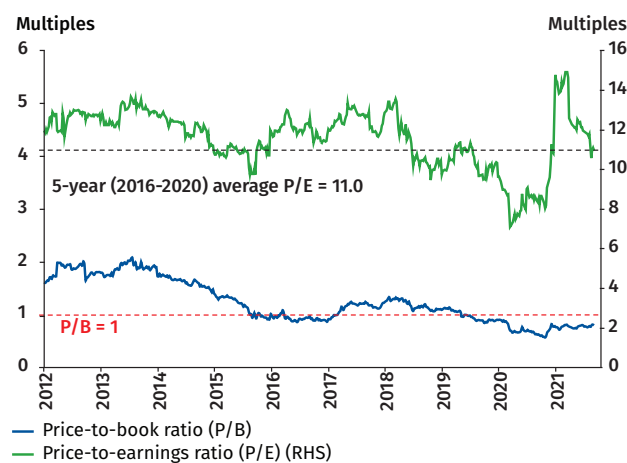


Chart 2.17: Banking System – Price-to-Book and Price-to-Earnings Ratios³ of Publicly Listed Banks in Malaysia



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

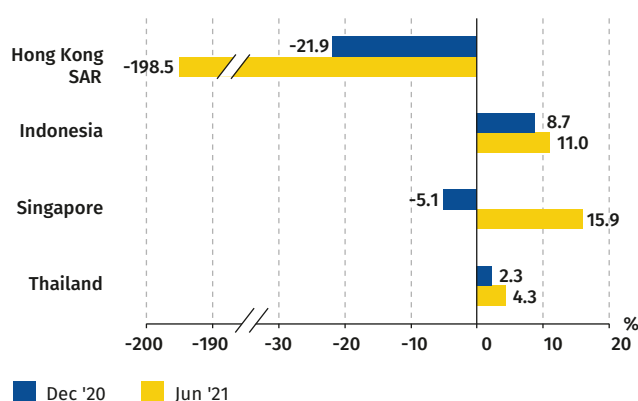
⁶ Banking system profits are aggregated at the entity level. The aggregated results are subsequently adjusted for dividend income received from domestic banking subsidiaries (previously added at both the parent and subsidiary levels). Differences in comparative pre-tax figures reported in previous Financial 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 operations⁷ 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

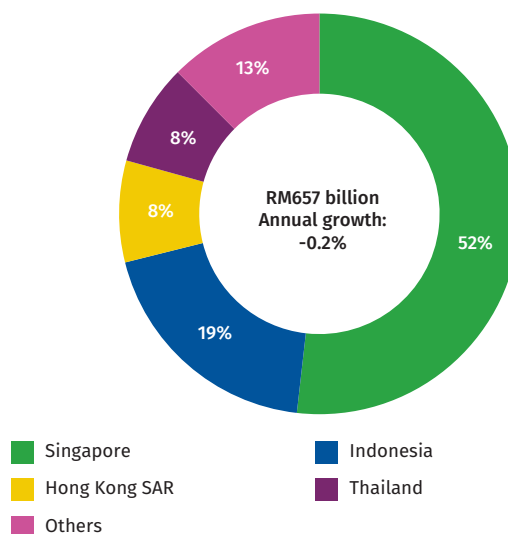


Note: Average ROE is weighted by the asset size of each domestic banking groups' overseas operations in respective jurisdictions

Source: Bank Negara Malaysia

⁷ 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



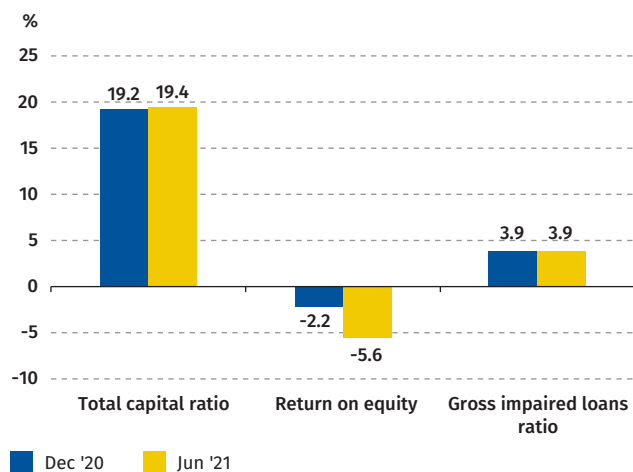
Source: Bank Negara Malaysia

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).⁸ 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.

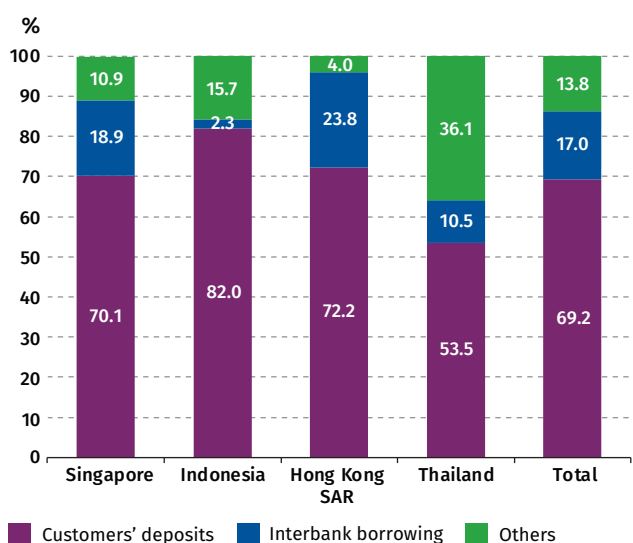
⁸ Impairment ratio is weighted by the asset size of operations of each DBG in respective jurisdictions.

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

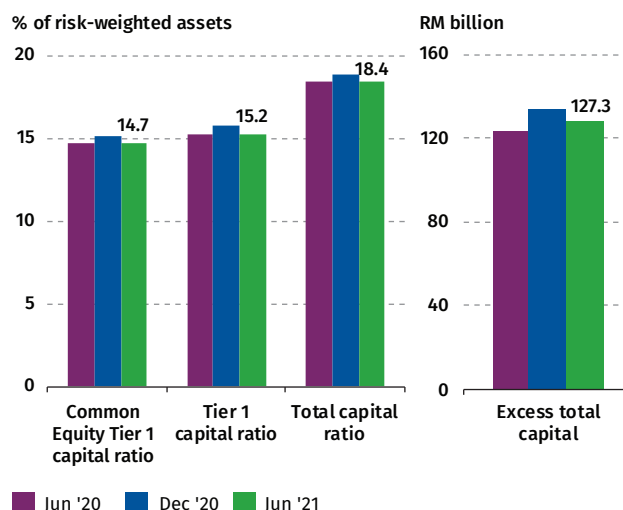


Note: Figures may not add up due to rounding
 Source: Bank Negara Malaysia

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 buffers⁹ 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,¹⁰ 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	1.0
Public Bank Berhad	0.5

Source: Bank Negara Malaysia

⁹ Refers to capital held in excess of regulatory minimum, which includes the capital conservation buffer (2.5%) and bank-specific requirements.

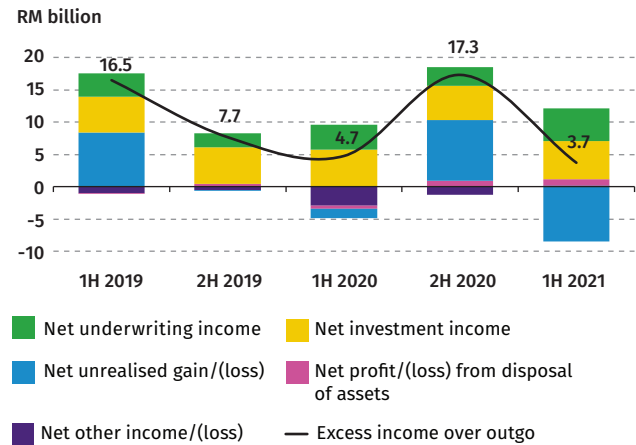
¹⁰ The D-SIBs assessment is bounded for banks with total consolidated assets equal to or more than RM30 billion. Please refer to <https://www.bnm.gov.my/-/domestic-systemically-important-banks-d-sib-framework>.

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 premiums¹¹ 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.

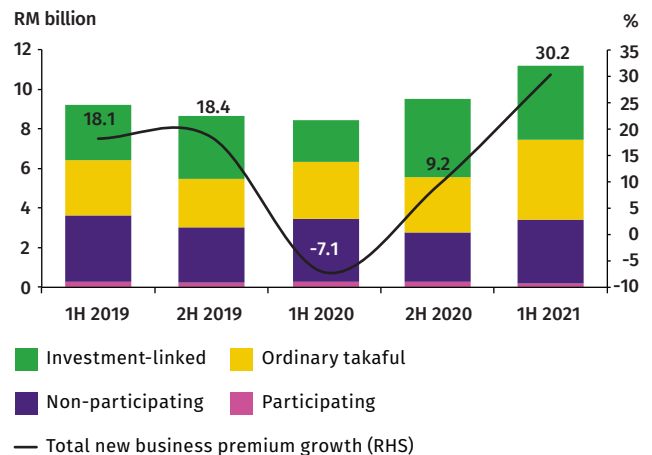
Chart 2.23: Life Insurance and Family Takaful Fund – Composition of Income and Outgo



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

¹¹ Refers to both insurance premiums and takaful contributions, unless stated otherwise.