ASSESSING THE RESILIENCE OF FINANCIAL INSTITUTIONS

Stress testing is an integral component of the Bank's financial stability framework. In the previous publication,[25] 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	• No R&R of business loans after the second quarter of 2021 • Repayment assistance for household borrowers to end after the first quarter of 2021
Cures	• No reversion in loan staging of households and businesses, even if subsequent improvements are observed
Policy support measures	• Effects from policy initiatives such as flexibilities to withdraw from retirement savings, wage subsidy programmes, or cash transfers from the Government are not considered
Maturing bullet repayment loans	• 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[1] observed thus far

Note:
[1] 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

[25] 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,[26] 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[27] 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.

[26] 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.

[27] The inter-quartile range indicates the difference between the total capital ratio decline reported by the 75th percentile bank and the 25th 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.