

Solvency Stress Test Scenarios, Key Assumptions and Shock Parameters

The first adverse scenario (AS1) simulates a V-shaped GDP growth path, in which Malaysia is assumed to experience a sharp recession with a magnitude equivalent to 2.5 standard deviations from the baseline growth in the first year of stress. This simulates a recession more severe than that experienced during the 2008 Global Financial Crisis. Under this scenario, shocks to global growth spill into the domestic economy, leading to lower income for households and firms, weaker business and consumer sentiments and severe stress in financial markets. This is followed by a strong rebound in the following years, amid positive counter-cyclical policy responses and improving sentiments.

In the second adverse scenario (AS2), an L-shaped growth path is simulated with a cumulative decline of 6 standard deviations spread across over four years. This scenario assumes an environment of prolonged sluggish growth, which will adversely impact income, wealth and sentiments over an extended period, as policy responses are either minimal or significantly underwhelming. Again, there is a deliberate focus on conservatism in this stress scenario, as the Government is likely to roll out sizeable measures to address the weakness in the economy.

Table 2.3

Solvency Stress Test Scenarios, Key Assumptions and Shock Parameters

Key Assumptions	AS1 – V-shaped Recession	AS2 – L-shaped, Protracted Recession
Balance sheet and income projections <ul style="list-style-type: none"> ○ Weaker annual loan growth ○ Annual decline in banks' income growth, differentiated across segments ○ Annual decline in insurers' premium income 	<ul style="list-style-type: none"> ○ Drops to as low as +0.5% ○ Up to 48% ○ Up to 46% 	<ul style="list-style-type: none"> ○ Drops to as low as -2.1% ○ Up to 21% ○ Up to 33%
Credit risk shocks <ul style="list-style-type: none"> ○ Probability of default (PD) <ul style="list-style-type: none"> • Business loans • Household loans ○ Loss given default (LGD) <ul style="list-style-type: none"> • Business loans • Household loans ○ Default of selected non-financial corporates with large borrowings from the financial system 	<ul style="list-style-type: none"> • 5% to 10% • 1% to 14% • 45% to 54% • 18% to 90% ○ Corporations that have weak financial standings (below prudent thresholds) under simulated shocks 	<ul style="list-style-type: none"> • 6% to 12% • 1% to 13% • 46% to 58% • 17% to 89%
Market risk shocks <ul style="list-style-type: none"> ○ Annual increase in MGS yields ○ Annual increase in corporate bond yields ○ Annual decline in FBM KLCI ○ Annual depreciation against major currencies 	<ul style="list-style-type: none"> ○ Up to 86 bps ○ Up to 103 bps ○ Up to 34% ○ 10% to 19% 	<ul style="list-style-type: none"> ○ Up to 71 bps ○ Up to 79 bps ○ Up to 17% ○ 4% to 8%
External funding risk shock <ul style="list-style-type: none"> ○ Reversal of claims by non-resident banks 	<ul style="list-style-type: none"> ○ Up to 30% of borrowings and deposits 	<ul style="list-style-type: none"> ○ Up to 15% of borrowings and deposits
General insurance risk shock <ul style="list-style-type: none"> ○ Increase in claims ratio 	<ul style="list-style-type: none"> ○ Up to 30% 	<ul style="list-style-type: none"> ○ Up to 16%
Contagion risk shocks <ul style="list-style-type: none"> ○ Interbank ○ Banks to insurers 	<ul style="list-style-type: none"> ○ Deterioration in counterparty bank's solvency ○ Deterioration in value of bonds issued by banks that failed the stress test under the adverse scenarios 	

Source: Bank Negara Malaysia