

Overview

Global financial vulnerabilities remained elevated in the first half of 2019, on concerns of slower global growth and rising geopolitical tensions which contributed to increased volatility in financial asset and commodity prices. Concerns on high corporate debt, particularly in advanced economies, have increased amid continued expansion in leveraged loans. On the back of these developments, major central banks have signalled a more dovish monetary policy stance. The US Federal Open Market Committee (FOMC) cut its policy rate for the first time since the global financial crisis citing concerns over the global economy, while the European Central Bank announced that it stands ready to deliver further monetary stimulus to the euro area. Central banks in emerging market economies, including those in the region, have also reduced policy rates as the effect of escalating trade tensions weighed on growth prospects.

Domestic financial stability continued to be supported by relatively resilient economic growth in the first half of 2019. Despite some volatility in financial markets due to both global and domestic developments, including concerns over the possible removal of Malaysian Government Securities (MGS) from the FTSE Russell World Government Bond Index (WGBI), orderly conditions were preserved. Strong domestic institutional investors, including financial institutions, have continued to be an important source of stability to the domestic markets during periods of heavy portfolio outflows. This in turn has supported stable domestic funding conditions for financial intermediation activities.

The Financial Stability Committee of the Bank remained vigilant over risks from rising private sector debt levels and imbalances in the property market. Aggregate household debt levels remain elevated. However, most households continue to be able to comfortably service their debt with aggregate households' holdings of financial assets continuing to expand faster than that of debt. Although risks have somewhat increased among housing loan borrowers that are more exposed to income variability, these remain contained given the low exposures of banks to higher-risk borrowers as a result of sound lending practices.

Some signs of recovery have been observed in the property market, with higher transactions recorded in both the residential and non-residential segments. House prices continued to expand at a more moderate pace amid sustained demand for affordable properties. Ongoing adjustments to business strategies by property developers should help to reduce housing demand and supply mismatches, thereby mitigating risks of a broad-based decline in house prices. The oversupply of office space and shopping complexes (OSSC) has however continued to persist.

The financial performance of businesses weakened slightly on lower earnings in the plantation, transportation, and building and construction materials sectors. Notwithstanding this, the overall debt-servicing capacity of firms remains reasonably healthy with corporate leverage generally within prudent levels. Some positive signs were observed for firms in the oil and gas (O&G), construction and real estate

sectors despite business conditions that continue to be challenging. While oil prices remained volatile, further deleveraging by firms in the O&G sector has improved their financial positions. Announcements on the resumption of major infrastructure projects and various Government incentives to lower housing costs have also improved the outlook for firms in the construction and real estate sectors. Greater flexibility provided under the Bank's guidelines on regulatory reporting of rescheduled and restructured (R&R) loans to small and medium enterprises (SMEs) has further supported continued credit supply to viable businesses in a more challenging environment.

The financial sector remained resilient, underpinned by sustained profits and strong capitalisation of the banking, and insurance and takaful sectors. The weaker regional economic environment has put some downward pressure on performance in the overseas operations of domestic banking groups (DBGs). In the insurance and takaful sector, ongoing reforms are contributing to improvements in pricing and persistency. Based on stress tests conducted by the Bank, financial institutions continue to be well-positioned to withstand potential losses even under extreme conditions.

Going forward, several potential sources of risk warrant continued vigilance:

- **Weaker global growth and volatile capital flows**

Weaker growth prospects compounded by unexpected changes in the US monetary policy stance, further escalation of trade tensions and a disorderly unfolding of Brexit could heighten global financial volatilities, with implications for the domestic economy and financial conditions. A tightening of market liquidity could increase market fragmentation and drive funding costs higher. Weaker global demand could also further weigh on corporate earnings and investment decisions, although most businesses appear well-placed to adjust to adverse developments given their prudent leverage and healthy buffers.

- **Soft property market conditions**

Unsold housing units are expected to remain elevated, particularly in the high-rise and higher-priced segments. While risks of a large and broad-based decline in house prices are mitigated by firm demand for affordable housing, a prolonged weakness in the residential property market could reduce further investments in this sector. In the non-residential property segment, the large incoming supply of OSSC could continue to pose challenges for investors and developers. While direct exposures of financial institutions are contained, these risks could indirectly impact financial stability.

- **Elevated level of household debt**

Although growth in household debt has moderated in recent years, some households could continue to face increasing stress, particularly if they are over-extended from easier lending conditions in the past. Overall household resilience continues to be firmly supported by stable labour market conditions. However, unexpected severe income shocks could erode household financial buffers and impact spending and future borrowings. This in turn could hurt the financial performance of banks and the economy more broadly.

- **Exposure to cyber risks**

The rapid digitalisation of the financial sector inherently increases financial institutions' exposure to cyber-attacks. Such attacks have the potential to cause material disruptions to financial services that can impact the stability and integrity of the financial system. The increasing sophistication of attacks calls for corresponding measures, both at an institution and system-wide levels, to support a financial sector that is both technologically innovative and resilient to cyber threats. These measures will continue to be a key focus of the Bank's regulatory and supervisory priorities going forward.

Diagram 1: An Overview of External Developments and Domestic Financial Stability Risks

