

# Risk Developments and Assessment of Financial Stability

## CREDIT RISK

### Risks from the Household Sector are Largely Contained, but Some Household Segments Remain Vulnerable to Income Shocks

The annual growth of household debt<sup>1</sup> increased<sup>2</sup> at a faster rate of 5.1% in the first half of 2019 (Chart 1). The ratio of overall household debt-to-gross domestic product (GDP) correspondingly edged higher to 82.2% as at end-June 2019 (2018: 82%) (Chart 2). Loans for the purchase of residential properties remained the key driver of growth. Household borrowings were also bolstered by strong demand for loans for the purchase of securities, primarily fixed-priced unit trust funds such as *Amanah Saham Bumiputera*. In contrast, growth in household loans for consumption<sup>3</sup> has remained modest, mainly driven by personal financing extended to civil servants by development financial institutions (DFIs).

The debt-servicing capacity of households generally remained intact, as reflected in the low and stable impairment and delinquency ratios. For several years now, households' holdings of financial assets have expanded at a faster pace than that of debt (Chart 3). This continued into 2019 with household savings in deposits and deposit-like instruments increasing more than the decline in households' equity investments following the weak equity market performance. At the aggregate level, total household assets exceeded debt by 4.1 times (2018: 4.1 times). Excluding housing wealth, household financial assets stood at 2.2 times of debt. Two-thirds of these financial assets are in the form of liquid financial assets (LFA) such as deposits and unit trust funds which can be drawn upon to meet households' debt obligations and other financial commitments, if the need arises.

Risks to financial stability from the household sector continue to be largely contained, with debt-at-risk (DAR)<sup>4</sup> sustained at a low level of 5.2% of total household debt. The share of newly-approved household loans with debt service ratios (DSR)<sup>5</sup> exceeding 60% has increased (Chart 4) compared to levels in 2013, suggesting some easing of lending standards. However, this has been mainly evident among higher income households earning more than RM5,000 per month who are more likely to be able to adjust to adverse developments in their financial circumstances.

Exposures of banks and non-bank financial institutions (NBFIs) to the more vulnerable segment (borrowers earning less than RM3,000 per month) have continued to decline (Chart 5). Nonetheless, risks remain elevated among these borrowers. Despite greater constraints on their ability to borrow, the leverage<sup>6</sup> of households earning less than RM3,000 per month has continued to rise (1H 2019: 8.9 times; 2018: 8.8 times; 2015: 7.7 times) due to housing loans which have been made more accessible under various loan assistance schemes introduced in recent years. This borrower group remains susceptible to financial distress given their limited financial buffers to weather potential shocks.

<sup>1</sup> Extended by banks, development financial institutions and major non-bank financial institutions.

<sup>2</sup> The increase was partly due to higher housing loans reported by *Lembaga Pembiayaan Perumahan Sektor Awam* (LPPSA). Beginning January 2019, LPPSA moved from cash accounting to accrual accounting in line with the change in the Government's accounting practice for fiscal accounts. This led to a one-off upward revision in the value of LPPSA housing loans reported in 2019.

<sup>3</sup> Primarily motor vehicles, personal financing and credit cards.

<sup>4</sup> The proportion of debt of borrowers with negative financial margin to total household debt, after taking into account the potential losses given default (refer to Information Box on 'An Enhanced Financial Margin Framework for the Household Sector' on page 14).

<sup>5</sup> The ratio of total monthly bank and non-bank debt obligations to monthly disposable income (net of statutory deductions).

<sup>6</sup> Measured as a ratio of outstanding debt to annual income.

Default incidents by housing loan borrowers have also increased in recent periods, indicating that more households may be experiencing financial stress. This has been more prevalent among borrowers who (i) obtained housing loans for properties priced above RM500,000 and/or (ii) experience greater variability in their monthly income. Risks to the financial system however remain low as exposures at risk<sup>7</sup> of these borrowers accounted for only 6.2% of total household lending with only 0.9% of such loans being classified by banks and DFIs as impaired as at end-June 2019. Based on enrolments into the Credit Counselling and Debt Management Agency's (*Agensi Kaunseling dan Pengurusan Kredit*, AKPK) Debt Management Programme, the number of individuals seeking help also increased at a slower pace. Strengthened underwriting and risk management practices of financial institutions further mitigate financial stability risks. Given the significance of household lending as a share of total lending by banks (58.1%), preserving responsible lending standards in the banking system remains important going forward to promote both household resilience and financial stability.

As part of continued efforts to strengthen household resilience, the Bank is also working

with its partners<sup>8</sup> under the Financial Education Network (FE Network) to elevate financial literacy levels such that all Malaysians have the capability and confidence to make sound financial decisions. The National Strategy for Financial Literacy 2019 - 2023, which was launched in July 2019, outlines the priorities and actionable plans to equip Malaysians at all levels with the knowledge to manage their financial health in a prudent and responsible manner, in line with their financial goals and circumstances.

The proposed formulation of the Consumer Credit Act (CCA) will further support household resilience through consistent and proportionate standards of protection afforded to borrowers who obtain financing for personal, domestic or household purposes from both banks and non-bank credit providers. This includes requirements to comply with minimum standards relating to unsolicited financing, financing charges, credit assessments, debt collection practices and dispute settlements. Aside from promoting a healthy consumer credit market and ensuring the fair treatment of borrowers, the CCA will also provide for improved coordination arrangements among relevant authorities that are responsible for the oversight of consumer credit activities.

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<sup>7</sup> Taking into account the potential loss given default (LGD) for these borrowers.

<sup>8</sup> FE Network members comprise Bank Negara Malaysia, Securities Commission Malaysia, Ministry of Education Malaysia, Employees Provident Fund, Malaysian Deposit Insurance Corporation, AKPK and Permodalan Nasional Berhad. For more information, refer to <https://www.fenetwork.my/>.

Chart 1: Household Sector – Annual Growth of Debt

**Growth of household debt increased**

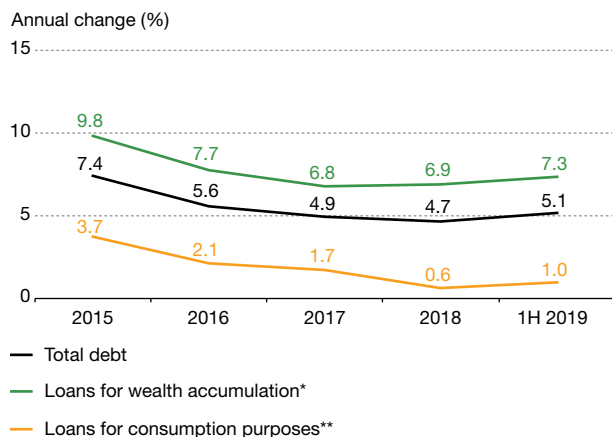


Chart 2: Household Sector – Key Ratios

**Higher debt- and financial asset-to-GDP ratios amid slower nominal GDP growth**

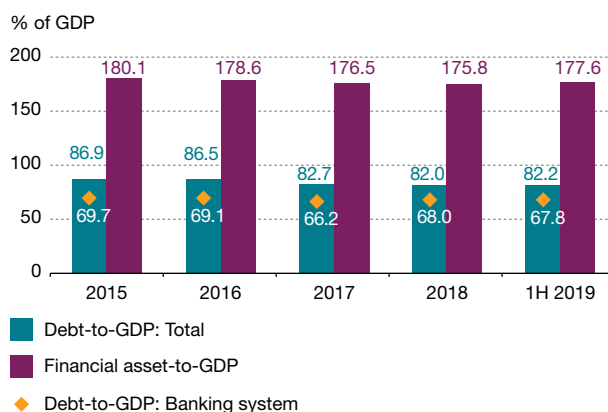


Chart 3: Household Sector – Debt and Financial Assets

**Household financial assets continued to expand faster than debt**

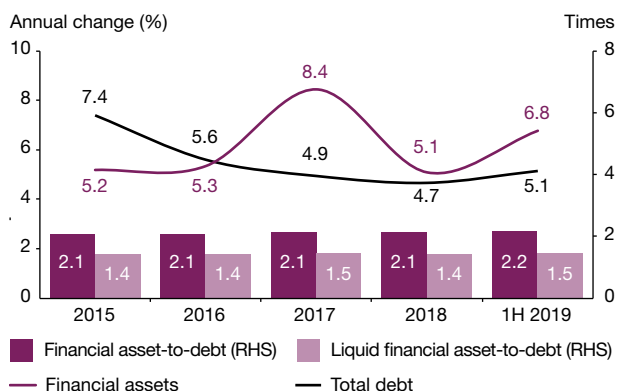


Chart 4: Household Sector – Borrowers with Newly-Approved Loans by DSR

**Share of borrowers with DSR exceeding 60% has increased since 2013**

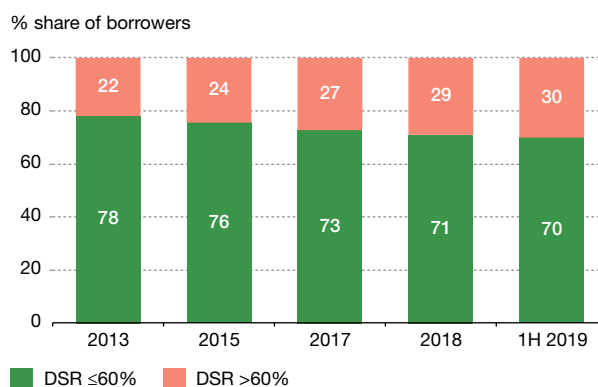
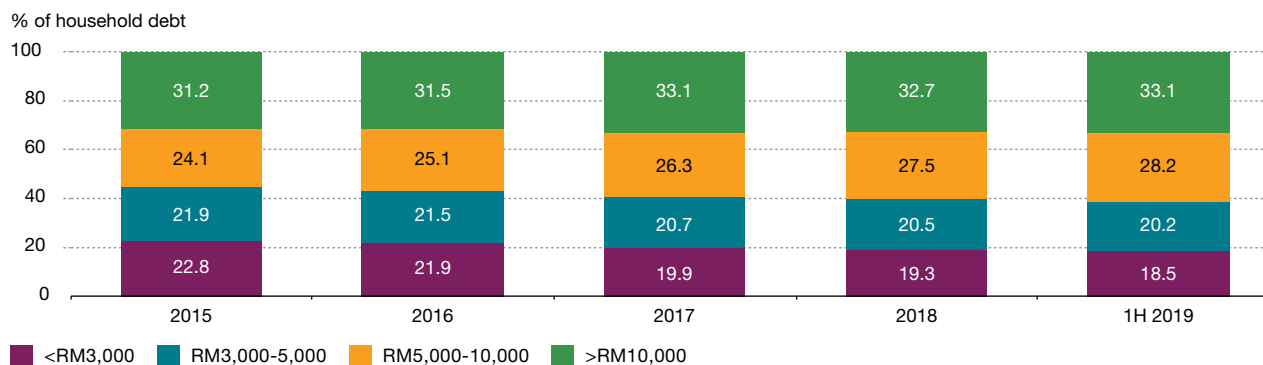


Chart 5: Household Sector – Debt by Monthly Income Group

**Exposures to vulnerable borrowers continued to decline**



\* Residential properties, non-residential properties and securities  
 \*\* Primarily motor vehicles, personal financing and credit cards

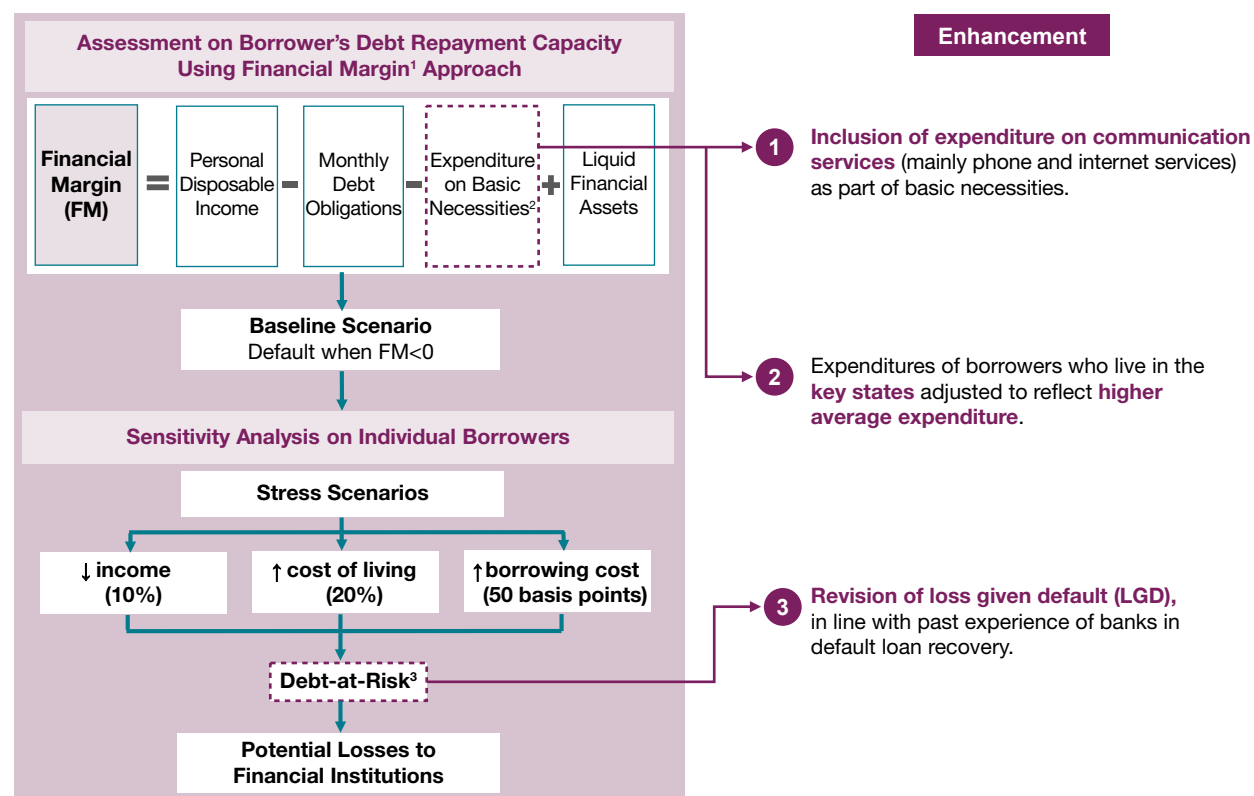
Source: Bank Negara Malaysia, Bloomberg, Securities Commission Malaysia and Department of Statistics, Malaysia

## An Enhanced Financial Margin Framework for the Household Sector

This info box summarises recent enhancements to the financial margin (FM) framework,<sup>9</sup> which uses individual-level income and credit information to identify and assess risks to financial stability from the household sector. The motivation for these refinements is twofold – first, to ensure that the components of borrowers’ FM continue to be reflective of their monthly spending and financial obligations, and second, to derive a more plausible estimation of DAR and potential losses to banks.

As evidenced by the high internet penetration rate of 87%<sup>10</sup> in 2018, expenditure by households in Malaysia on communication services has become much more of a necessity than a luxury. Therefore, in calculating the FM of an individual borrower, expenditure on communication services, which accounts for about 3% of monthly income, is now included under basic necessities (Diagram 2). Further, recognising the higher living costs in Kuala Lumpur, Selangor, Penang and Johor, the enhanced framework also incorporates higher relative expenditure levels for borrowers in these key states.

Diagram 2: Enhancement to the Financial Margin Framework



<sup>1</sup> Residual monthly disposable income and liquid financial assets, after deducting debt repayments and expenditure on basic necessities

<sup>2</sup> For this study, basic necessities are defined as: (i) food and non-alcoholic beverages; (ii) housing rental and maintenance; (iii) water, electricity, gas and other fuels; (iv) transportation; (v) education; (vi) healthcare; and (vii) communication services

<sup>3</sup> The proportion of debt of borrowers with negative FM to total household debt after taking into account the potential LGD

Source: Bank Negara Malaysia

<sup>9</sup> Financial Stability and Payment Systems Report (2016). 'Looking Beyond Headline Household Debt Statistics'. Bank Negara Malaysia, page 41-46 and Financial Stability and Payment Systems Report (2017). 'Indebted to Debt: An Assessment of Debt Levels and Financial Buffers of Households'. Bank Negara Malaysia, page 39-48.

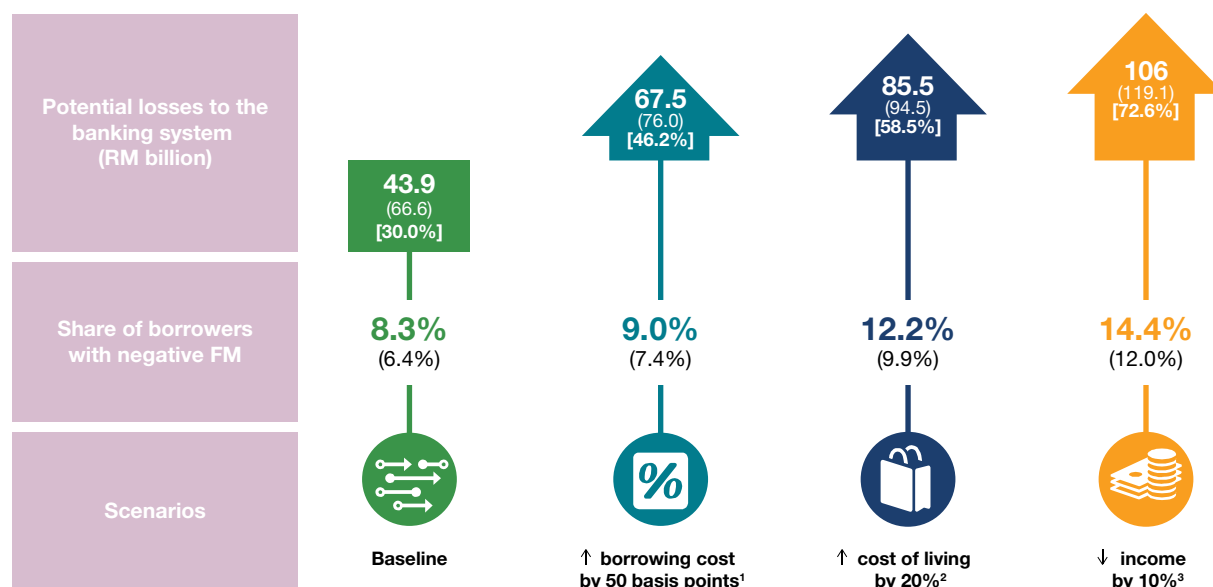
<sup>10</sup> Department of Statistics, Malaysia (2018). 'ICT Use and Access by Individuals and Households Survey Report', Putrajaya.

The DAR under the baseline and stress scenarios have also been re-estimated with a more plausible set of LGD data derived from the historical experience of domestic banks (Baseline scenario: 17% – 66%; stress scenarios: 23% - 76%).<sup>11</sup> Notable differences are mainly in LGDs for loans for the purchase of non-residential properties and securities which are significantly lower given the availability of collateral.<sup>12</sup> These LGDs are also in line with that assumed under the Bank’s multi-year solvency stress test.

With these refinements, the share of borrowers with negative FM is higher at 8.3% (pre-enhancement: 6.4%) (Diagram 3), driven mainly by the inclusion of expenditure on communication services. While the number of distressed borrowers has increased, overall DAR has declined to 5.2% of total household debt (pre-enhancement: 7.8%) given the lower LGDs (DAR for the banking system: 4.4%; pre-enhancement: 6.6%). The distributions of DAR by loan purpose and income group remain broadly unchanged with the refinements. Personal financing accounted for the largest share of DAR (42%), the bulk of which was attributed to borrowers earning less than RM5,000 per month. While residential property loans comprised more than half of total household debt, this segment accounted for only about a quarter of DAR as risks are largely mitigated by collateral values that exceeded balances on outstanding loans. Potential losses to the banking system under the baseline scenario stood at RM43.9 billion, or 30% of banks’ excess capital buffers.<sup>13</sup>

In assessing borrowers’ debt repayment capacity under stress scenarios, borrowers continued to be most susceptible to income and cost of living shocks, with a smaller impact from an increase in borrowing costs. The corresponding increase in potential losses to the banking system under stress scenarios remains within banks’ excess capital buffers of RM146.1 billion as at end-June 2019.

Diagram 3: Results of Sensitivity Analysis on Potential Losses to the Banking System



(..) denotes estimate based on the pre-enhancement framework  
 [..%] denotes ratio of potential losses to banks’ excess capital buffers

<sup>1</sup> Based on the increase in the average lending rate following two consecutive increases in the Overnight Policy Rate in 2006

<sup>2</sup> Close to triple that of 2009 - 2016 compounded annual growth rate (CAGR) of 7.3% for expenditures on basic necessities

<sup>3</sup> Larger than the decline in aggregate household disposable income of 8.7% during the Asian Financial Crisis in 1998

Source: Bank Negara Malaysia, Department of Statistics, Malaysia

<sup>11</sup> Previously, the estimation of LGDs only considers housing loans as having underlying collateral and imposes a 40% haircut on the collateral value in the event of a default. Other loans were assumed to have an LGD of 100%.

<sup>12</sup> Bulk of loans for the purchase of securities is invested in fixed-price unit trust funds.

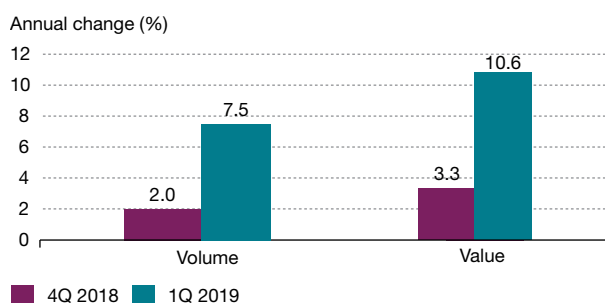
<sup>13</sup> Above the regulatory minimum of 8%.

## Demand for Affordable Housing Remains Strong, Amid Continued Imbalances in Some Segments of the Property Market

Malaysian house prices<sup>14</sup> continued to increase at a more moderate pace, especially in Kuala Lumpur, Selangor, Johor and Penang. House price growth was supported mainly by sustained demand for more affordable properties,<sup>15</sup> while activity in the higher-priced condominiums and apartments remained weak. Some signs of market recovery were observed in the first quarter of 2019 as housing transactions both in terms of volume and value recorded sharp increases (Chart 6). Housing transactions were largely driven by houses priced below RM300,000, reflecting continued demand for affordable housing across most states. Demand for housing was also boosted by various public and private sector initiatives to lower housing costs (Table 1).

Chart 6: Property Market – Housing Transactions

Some signs of market recovery were observed in the first quarter of 2019



Source: National Property Information Centre (NAPIC)

Table 1

### Collective Initiatives to Assist Home Buyers

Targeted to first-time home buyers	Stamp Duty Exemption	<ul style="list-style-type: none"> <li>Stamp duty exemption on memorandum of transfer and loan agreement for the first RM300,000. Applicable for properties priced up to RM500,000 (primary and secondary market).</li> <li>The exemption is valid for a period of two years until December 2020.</li> </ul>
	BNM Fund for Affordable Homes	<ul style="list-style-type: none"> <li>Eligible first-time home buyers with monthly household income of up to RM4,360 will be able to access home financing at a concessionary financing rate of up to 3.5% per annum to purchase houses priced up to RM300,000.</li> </ul>
	Mortgage Guarantees	<ul style="list-style-type: none"> <li>Higher margin of financing supported by guarantees from Cagamas Berhad and Syarikat Jaminan Kredit Perumahan Berhad under various schemes:                             <ul style="list-style-type: none"> <li>- <i>Skim Rumah Pertamaku</i>: For purchase of a first house priced up to RM300,000 (single borrower) and RM500,000 (joint borrower).</li> <li>- <i>Skim Perumahan Belia</i>: For purchase of a first house priced up to RM500,000.</li> <li>- <i>Skim Jaminan Kredit Perumahan</i>: For purchase of a first house priced up to RM300,000.</li> </ul> </li> </ul>
Targeted to all buyers	Home Ownership Campaign	<ul style="list-style-type: none"> <li>Stamp duty exemption on memorandum of transfer for residential properties priced up to RM1 million and for loan agreement of up to RM2.5 million.</li> <li>Price discounts (minimum of 10%) from developers (for properties priced above RM300,000).</li> <li>Campaign extended until December 2019 following strong interest from home buyers.</li> </ul>
	Advisory Assistance	<ul style="list-style-type: none"> <li><i>Khidmat Nasihat Pembiayaan</i> (MyKNP) has been established to assist applicants who have been unsuccessful in securing home financing to have greater understanding of the factors affecting their financing application, as well as to provide advice to help raise their eligibility for future financing. MyKNP is a joint collaboration between the Bank, Credit Guarantee Corporation Malaysia Berhad (CGC) and AKPK.</li> <li>RUMAHKU Financial Education programme by AKPK to help potential borrowers understand their financial commitments prior to purchasing a home.</li> </ul>

Source: Bank Negara Malaysia, Cagamas Berhad, AKPK, CGC, Ministry of Finance and news flows

<sup>14</sup> Measured by the Malaysian House Price Index (MHPI).

<sup>15</sup> Notably, terraced houses priced below RM500,000.

Importantly, prospective homebuyers are receiving financial advice and assistance through AKPK's RUMAHKU online financial education programme. The aim is to help them evaluate their financial commitments and ability to undertake new financial obligations prior to purchasing their first home. In the first six months of 2019, more than 12,000 participants have completed the programme. One in seven participants who completed the programme decided not to proceed with immediate plans to buy a house after considering their capacity to afford the long-term financial commitment. Home purchasing decisions that are better informed, in turn, will provide stronger underpinnings for a sustainable housing market.

Despite evidence of genuine demand, official data and engagements with industry players suggest a continued mismatch between supply and demand for housing. This is expected to persist at least in the near- to medium-term given generally inelastic housing supply conditions, especially in urban centres. As at end-March 2019, total unsold housing units<sup>16</sup> rose further to 177,200 units (2018: 168,261 units), with 73% of the unsold properties priced above the maximum affordable house price.<sup>17</sup> Housing units priced above RM300,000 continued to form the bulk of new launches, adding to the supply and demand mismatch. Continued strong demand for properties in the affordable segment and the gradual rebalancing of new launches by property developers towards properties priced below RM500,000 should however mitigate risks of a sharp and broad-based decline in house prices. Banks' exposures to property developers with unsold housing units remained small at 2.0% of total banking system loans and 2.9% of holdings of corporate bonds and sukuk. Of this, exposures to loans classified as underperforming or impaired<sup>18</sup> remain insignificant at 0.1% of total banking system loans.

In the non-residential segment, market activity picked up further in the first quarter. The number of commercial properties transacted increased by 25.1% (4Q 2018: 16.3%), attributed to higher transactions for shops especially in non-key

states. Overall transaction value, however, declined by 25.9% (4Q 2018: 6.7%), reflecting lower average transacted prices for leisure and other commercial properties.<sup>19</sup>

## Oversupply conditions in the OSSC segment have continued to persist

Oversupply conditions in the OSSC segment have continued to persist. The incoming supply of office space in the Klang Valley remained sizeable at 36.3 million square feet. On average, 4.4 million square feet per annum is expected to be added to the market between 2019 and 2021. This is significantly higher than the average annual demand of 2.3 million square feet per annum over the past three years. Generous incentives, including longer rent holidays and rental discounts, remained a prominent feature of tenancy negotiations and will likely depress effective rental rates further. Meanwhile, the number of incoming shopping complexes in key states stood at 140 units, amounting to 67.8 million square feet of new retail space. With vacancy rates for OSSC and retail space per capita in major cities in Malaysia already much higher than regional peers (Chart 7), the risk of a downward adjustment to prices of retail and office space remains elevated despite observations of higher transacted prices in the first quarter. Banks' exposures to the OSSC segment account for only 3.4% of total outstanding loans and 4.6% of holdings of corporate bonds and sukuk, and continue to be largely performing. However, broader spillovers to the economy from a prolonged weakness in the commercial property market could transmit higher risks to the financial system.

<sup>16</sup> Refers to unsold properties that have been completed (overhang) and unsold properties currently under construction. These properties encompass all residential properties as well as serviced apartments and small office home office (SOHO).

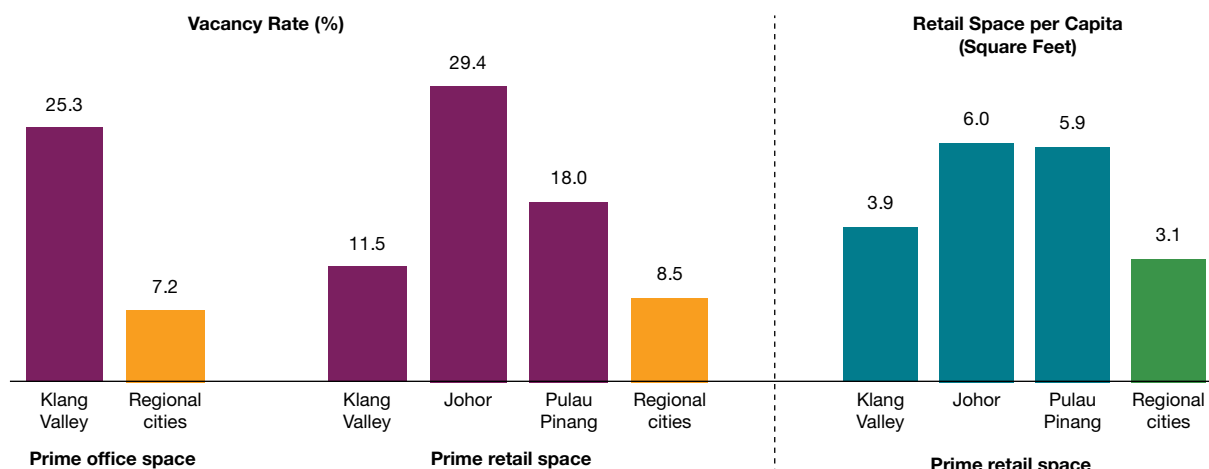
<sup>17</sup> Derived using the Housing Cost Burden Approach, in which a house is deemed affordable if the monthly housing repayment cost does not exceed 30% of household income. Estimates are based on unsold units considered not affordable to households of the respective states given their prevailing household income. Excludes Putrajaya and Labuan.

<sup>18</sup> Based on Malaysian Financial Reporting Standards (MFRS) 9 classification.

<sup>19</sup> Other commercial properties include land.

Chart 7: Property Market – Vacancy Rates for Prime Office and Retail Space, and Prime Retail Space per Capita in Key States

**Higher vacancy rates and prime retail space per capita for key states compared to regional cities**



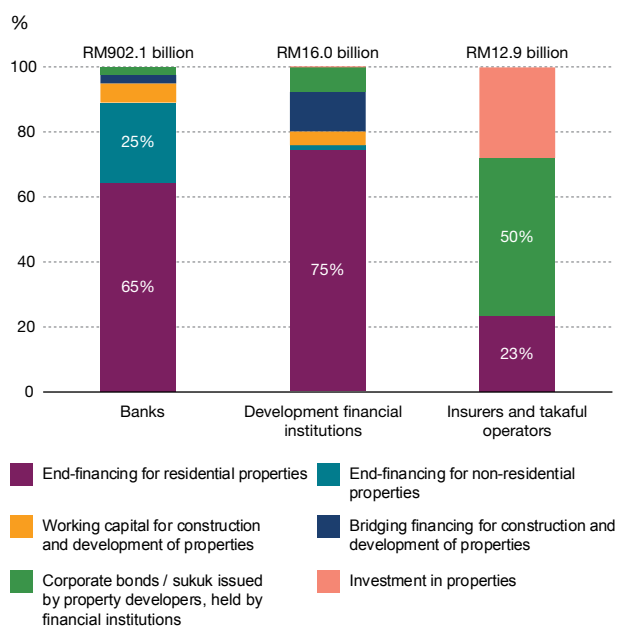
Notes:  
 i. Data are as at 1Q 2019  
 ii. Retail space refers to shopping complexes  
 iii. Regional cities for prime office space data refer to Bangkok, Beijing, Hong Kong, Manila, Seoul, Shanghai and Singapore  
 iv. Regional cities for prime retail space data refer to Bangkok, Hanoi, Ho Chi Minh, Jakarta, New Delhi, Shanghai and Singapore  
 v. Regional cities' and Malaysia's key cities' population estimates are as of 2018

Source: Colliers, Cushman and Wakefield, Jones Lang LaSalle, Jones Lang Wootton, Knight Frank, Savills, United Nations, Department of Statistics, Malaysia and Bank Negara Malaysia estimates

As at end-June 2019, financial institutions' total exposures to property expanded at a slower rate of 5.7% (2018: 6.6%), in line with softer conditions in the property market (Chart 8). Demand for home financing continued to support overall credit growth, with significantly stronger growth recorded in financing applications for residential properties priced below RM1 million (1H 2019: 12.7%; 2018: 1.3%). In the first six months of 2019, a total of RM78.5 billion of new housing loans were approved to more than 180,000 borrowers. Of this, 44% were to first-time home buyers. The growth of bank financing in the non-residential property segment meanwhile increased by 2.7% as at end-June 2019 (2018: 2.3%), driven largely by end-financing for the purchase of shops and shopping complexes. Banks however have continued to remain cautious in lending to the OSSC segment, as reflected in declining loan approval rates.

Chart 8: Property Market – Financial Institutions' Exposures to the Property Market

**Financial institutions' exposures are mostly related to end-financing for the purchase of residential and non-residential properties**



Source: Bank Negara Malaysia

## Risks from property sector remain contained, underpinned by sound lending practices

Sound lending practices of banks continue to mitigate risks from potential adverse developments in the property market. Overall, the loan impairment ratio for the purchase of residential and non-residential properties remained low (Chart 9). Of note, a significant share (83%) of residential property loans is extended to owner-occupiers who have a stronger incentive to maintain loan repayments compared to investors. This further reduces financial stability risks in the unlikely event of a generalised downward correction in house prices. Furthermore, 69% of outstanding housing loans have a loan-to-value ratio of less than 80%, thus providing a buffer against potential losses from defaults in the event of an adverse price correction. While risks remain elevated in the non-residential property segment, banks have similarly strengthened credit risk management standards which include, among others, more robust assessments on the viability of property development projects and the financial strength of property developers. Based on the Bank's sensitivity analysis, banks continue to maintain sufficient capital buffers to absorb 1.5 times the potential losses under severe stress scenarios<sup>20</sup> which also incorporate potential spillovers to other economic sectors that are highly dependent on the performance of the property sector.

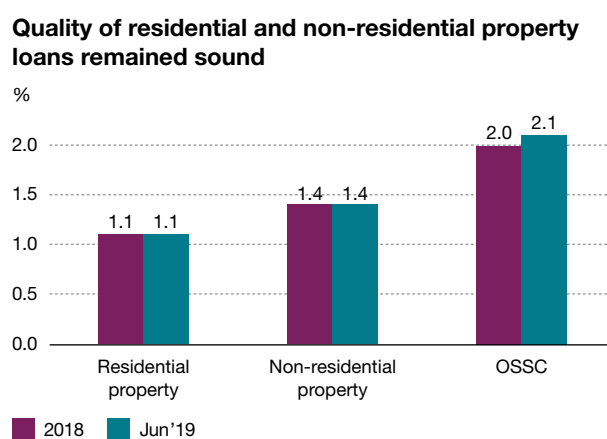
## Risks from Corporate Sector Contained, Despite More Challenging Business Conditions

As at end-June 2019, aggregate non-financial corporate (NFC) debt expanded at a more moderate annual growth rate of 3.6% to RM1,508.8 billion or 102% of GDP (Chart 10). This reflected higher business loan repayments amid more uncertain economic conditions and lower bond issuances following the rationalisation of public infrastructure projects by the Government. Financing growth was largely underpinned by sustained business activity in the construction, manufacturing, and wholesale and retail trade sectors.

Total loan repayments by businesses grew by 2.6% year-on-year to RM393.6 billion in the first half of 2019 (1H 2018: 3.9%; RM383.7 billion), outpacing overall loans disbursed which increased by 0.3% year-on-year to RM391.1 billion (1H 2018: 5.4%; RM390 billion). The slower growth in loans disbursed also reflected

lower demand for financing corroborated by the lower applications received, including from SMEs. Looking ahead, banks remain reasonably optimistic on their growth in business loans for 2019, although they are expecting growth to be slightly slower than initially projected. The overall business loan approval rate has remained stable at around 83%, trending close to its five-year average. A modest tightening of credit conditions has been observed in recent quarters, but this has been mostly limited to sectors with relatively weak credit risk outlook, such as the real estate and O&G sectors.

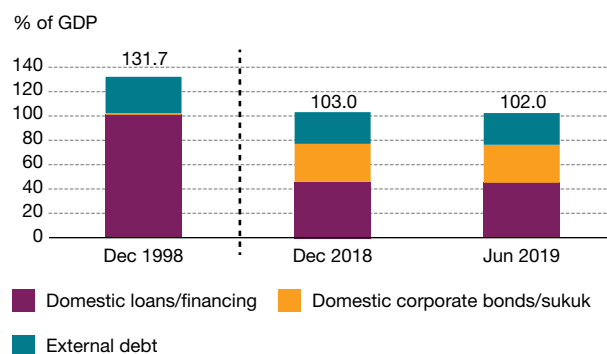
Chart 9: Property Market – Loan Impairment Ratios for End-Financing by Segment



Source: Bank Negara Malaysia

Chart 10: Business Sector – Non-Financial Corporate Debt-to-GDP Ratio

### Debt growth was sustained by domestic borrowings



Note: Reflects a higher nominal GDP, following the rebasing of GDP from 2010=100 to 2015=100; NFC debt-to-GDP ratio for December 2018 was 103.7% as reported in the FSPSR 2018

Source: Bank Negara Malaysia

<sup>20</sup> Refers to 50% earnings shock on large corporate borrowers in the property sector and 50% decline in property prices.

NFC external debt, which accounted for a quarter of total NFC debt and GDP, respectively grew at a slower pace of 2.9% in the first half of the year (2018: 7.5%) primarily driven by intercompany loans taken by multinational corporations in the services and O&G-related sectors. Risks from NFC external debt remained largely contained, given

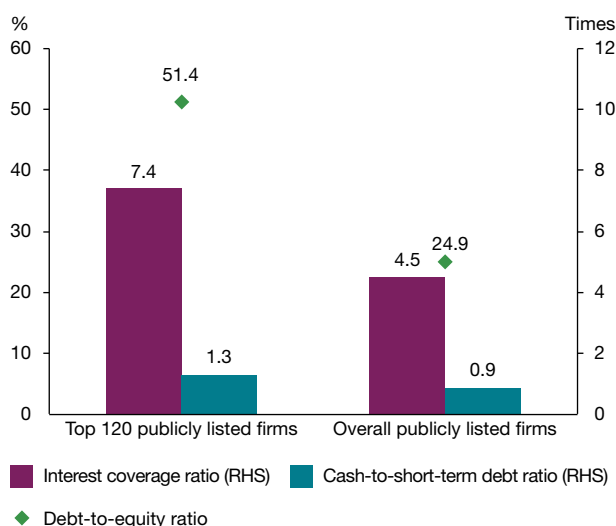
that three-quarters of external borrowings are of medium- to longer-term tenures and largely hedged against currency exposures. In addition, about half of the exposures are in the form of intercompany loans which are typically accorded flexible or concessionary terms, and trade credit facilities which are backed by export receivables, further mitigating repayment and rollover risks.

## Expansion of Financial Performance Data Coverage of NFCs

The Bank's coverage of the financial performance of NFCs has been expanded in this update to include all listed firms on Bursa Malaysia (Bursa). Previously, the coverage only encompassed the top 120 companies (excluding financial institutions) which accounted for about 85% of Bursa's market capitalisation. The inclusion of smaller firms in the dataset has resulted in a lower aggregate debt-servicing capacity of businesses as these smaller firms typically have lower earnings, although they are also less leveraged. The aggregate liquidity position of businesses (as measured by the median cash-to-short-term debt ratio, CASTD) was also lower under the expanded dataset, reflecting the higher dependency of smaller firms on shorter-term financing (Chart 11). The median CASTD of firms under the expanded dataset has however remained in line with its five-year average.

Chart 11: Business Sector – Comparison of Leverage, Debt-Servicing Capacity and Liquidity Indicators with Expanded Dataset

**Larger publicly listed firms typically have relatively higher leverage but stronger debt-servicing capacity and liquidity positions**



Note: Prudent thresholds for ICR and CASTD are two times and one time, respectively

Source: S&P Capital IQ and Bank Negara Malaysia estimates

On aggregate, the financial position of NFCs weakened slightly during the first half of 2019 (Chart 12) amid more challenging business conditions. Financial indicators of business health saw some deterioration, partly due to adjustments under new financial reporting standards.<sup>21</sup> This largely affected firms in the telecommunication, aviation and utilities sectors. Although overall operating margin improved slightly, lower earnings were observed in a few sectors. Firms in the plantation sector were affected by the decline in crude palm oil prices. Meanwhile, those in the transportation, and building and construction materials sectors reported lower earnings due to higher operating costs and weaker demand for raw materials amid soft property market conditions, respectively.

The debt-servicing capacity of most firms remained intact, supported by prudent leverage and interest coverage ratios (ICR).<sup>22</sup> The median CASTD remained at its five-year average of 0.9 times, largely reflecting the shorter-term debt profile of smaller firms. The majority of the small firms recorded ICR levels comfortably above the prudent threshold, with the median ICR at four times. Nevertheless, the Bank’s research<sup>23</sup> shows that changes in liquidity ratios are a predictive indicator of future business loan quality and hence, warrant continued monitoring of firm-level developments going forward. Excluding the smaller firms, the median CASTD of the top 120 firms stood at 1.3 times.

### Sustained overall quality of business borrowings, despite vulnerabilities in certain sectors

In the first half of 2019, the impaired loans ratio of the overall business sector increased marginally but remained in line with its five-year average (Chart 13). The increase largely reflected operational and financial challenges faced by specific firms in the manufacturing and palm oil sectors and was not broad-based. Firms in the O&G-related, construction and real estate sectors continued to face headwinds but some signs of improvement have recently emerged.

In the O&G sector, volatility in global oil prices continued to exert pressure on firms. However, potential risks to the financial system are expected to recede going forward given that these firms have been deleveraging or successfully restructured their debt. This is reflected in the notably lower median leverage ratio of 37.7% as at end-June 2019 (2018: 51.4%). The median ICR of the sector has also risen above the prudent threshold

Chart 12: Business Sector – Leverage, Debt-Servicing Capacity and Liquidity Indicators

#### Sustained debt-servicing capacity despite a marginal weakening in NFC financial standing

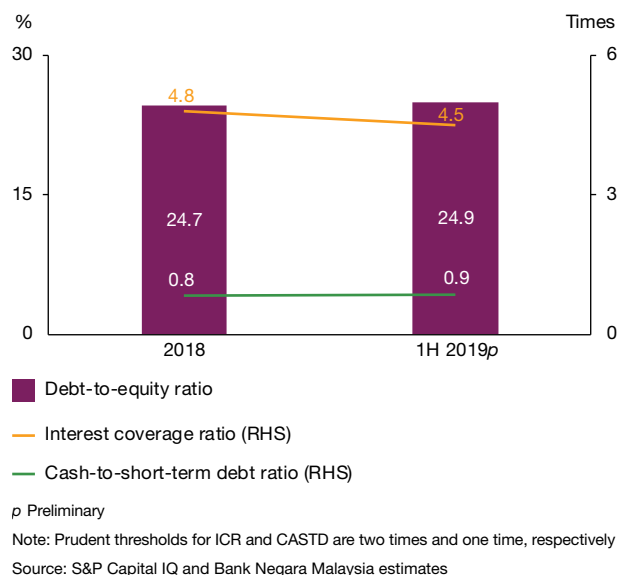
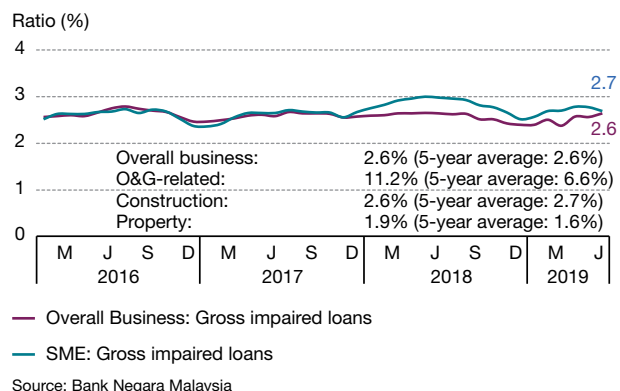


Chart 13: Business Sector – Gross Impaired Loans

#### Overall quality of lending remained sound



<sup>21</sup> MFRS 16 requires firms to recognise their longer-term (i.e. more than 12 months) off-balance sheet operating leases under an on-balance sheet accounting model. This typically increases the gearing ratio and interest expense, as firms would now need to recognise lease payments as an on-balance sheet liability.

<sup>22</sup> Prudent threshold for ICR is two times.

<sup>23</sup> The Bank recently conducted a study to establish the relationship between macroeconomic conditions, financial performance and loan impairments of businesses using multivariate ordinary least squares regressions modelling. The study suggests that movements in three statistically-significant financial ratios (leverage, solvency and liquidity) could predict future impairment ratios.

on the back of better earnings given increased activities in the offshore segment, which resulted in higher asset utilisation rates. The debt-servicing capacity of these firms is expected to improve further as most O&G players, particularly those in the upstream segment, continue to reduce their debt levels (Chart 14). While the impaired loans ratio for the O&G sector remained elevated, the bulk of potential losses arising from this segment has already been provided for by banks.

Despite some clarity from the Government on the review of major infrastructure projects, lower contracted values of such projects are expected to compress profit margins of firms in the construction sector. For smaller firms, conditions are further challenged by increased competition from larger firms for smaller-scale projects, hence potentially crowding out SMEs. Some firms also continued to face cash flow disruptions caused by delays in payments for services rendered. Although the debt-at-risk (measured as the share of debt borne by firms with an ICR of less than two times) of construction firms remained elevated, large firms mostly continued to maintain healthy order books that should support their ability to service debt.

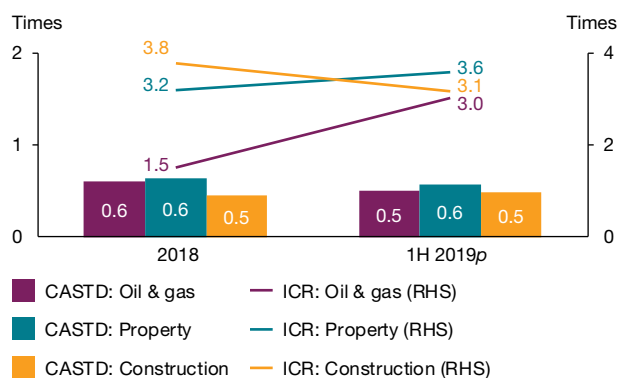
At the aggregate level, total corporate debt-at-risk increased to 23.6% (2018: 19%) of total debt of listed firms. This mainly reflected changes in how firms with significant operating leases account for interest expenses under lease arrangements following the implementation of the Malaysian Financial Reporting Standards (MFRS) 16. Despite the changes, the impairment ratios for sectors that were most affected by this development were observed to remain low and stable.

Financial institutions' exposures to large borrower groups<sup>24</sup> decreased slightly to 42.1% (2018: 42.7%) as at end-June 2019. Based on the Bank's sensitivity analysis, large borrower groups may face short-term liquidity issues under simulated stress conditions. Under a stress scenario of significant pressure on earnings – which would have the greatest impact on debt-servicing capacity – the median ICR of large borrower groups would stand at the prudent threshold of two times (2018: 2.2 times). In the unlikely event that all simulated shocks<sup>25</sup> occur concurrently, the ICR of these borrowers falls marginally below the prudent threshold to 1.8 times. Notwithstanding this, banks' excess capital buffers are sufficient to cover 2.3 times the potential credit losses arising from large borrower groups that are more likely to default under the assumed stressed conditions.

For the rest of the year, escalating trade tensions and geopolitical risks will continue to weigh on business performance. In addition, the performance of firms in the commodity sector may continue to be affected by volatile global commodity prices. As part of pre-emptive risk management, banks have been proactively engaging borrowers, particularly SMEs, that may be affected by the more challenging business conditions to assist them in ensuring that they can continue to meet their repayment obligations. This includes rescheduling and restructuring (R&R) credit facilities of eligible SMEs, with greater flexibility<sup>26</sup> provided under the Bank's guidelines on regulatory reporting to aid these efforts. Banks are nonetheless required to separately monitor the performance of these SMEs and maintain adequate provisions against potential credit losses. An additional measure to assist SMEs was the establishment of *Khidmat Nasihat Pembiayaan* (MyKNP) in collaboration with Credit Guarantee Corporation Malaysia Berhad. MyKNP provides SMEs with advice on how they can improve their eligibility for financing and alternative financing sources better suited to their specific needs and circumstances. These initiatives aim to alleviate a potential tightening in credit conditions and support continued access to financing for SMEs.

Chart 14: Business Sector – Liquidity and Debt-Servicing Capacity Indicators for Selected Sectors

**ICR above prudent threshold for firms in sectors with relatively weak credit risk outlook**



p Preliminary

Note: Prudent thresholds for ICR and CASTD are two times and one time, respectively

Source: S&P Capital IQ and Bank Negara Malaysia estimates

<sup>24</sup> Large NFC borrower groups represent corporations with aggregate credit exposures (includes direct financing and holdings of corporate bonds and sukuk) exceeding RM1 billion with Malaysian financial institutions.

<sup>25</sup> Up to 30% depreciation in ringgit, a 50% decline in operating profit, and a 50 and 100 basis points increase in borrowing costs for ringgit and foreign currency (FCY) borrowings, respectively.

<sup>26</sup> An R&R SME loan/financing need not be classified as an R&R facility in the Central Credit Reference Information System (CCRIS), provided that the principal and interest/profit on the loan/financing are not past due for more than 90 days or three months at the date of the application. The flexibility accorded to such facilities is for a period of two years up to 30 June 2021.

## MARKET RISK

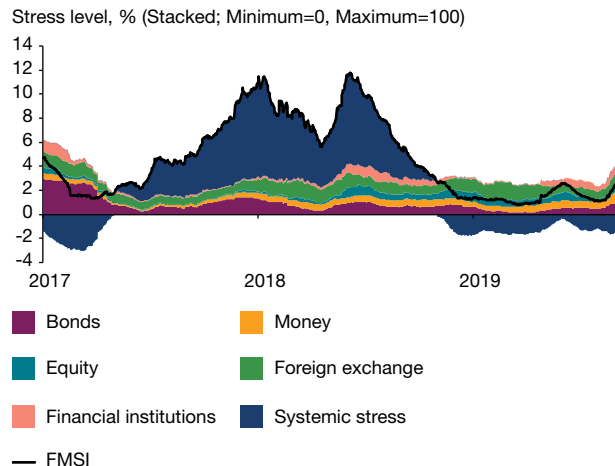
### Domestic Financial Markets Remained Orderly Despite Domestic and External Headwinds

Domestic financial markets continued to experience bouts of volatility in 2019 due to both domestic and external developments. On the external front, the US FOMC cut its policy rate for the first time in more than a decade in July. Although the July rate cut was broadly anticipated by the market, the unexpected escalation of trade tensions between the US and People's Republic of China (PR China) in August led to heightened uncertainty in the prospective path of monetary policy globally. Domestically, from mid-April to end-May, idiosyncratic factors following the news on Norges Bank's removal of emerging market bonds from the benchmark index it tracks and the possible removal of Malaysian Government Securities (MGS) from the FTSE Russell WGBI triggered non-resident (NR) outflows from both the bond and equity markets. NR holdings of Malaysian government bonds fell to 20.9% of total outstanding government bonds as at end-May, the lowest level observed since 2010 (peak in November 2016: 34%). As at end-August, NR holdings stood at 22% of total outstanding government bonds. Despite these developments, market conditions remained orderly as strong demand from domestic institutional investors (DII), including financial institutions, continued to support valuations.

Overall market stress as measured by the Financial Market Stress Index (FMSI) increased since the second quarter of 2019, but remained well below levels observed in 2018 (Chart 15). For the period January to August 2019, NR investors recorded a net inflow of RM7 billion into the government bond market following expectations of a US rate cut and resumption of the US-PR China trade talks in June which reversed earlier outflows (Chart 16). However, the equity market continued to record a net outflow position of RM7.4 billion on the back of growing concerns over weaker corporate earnings and the vacillation of trade developments during the year.

Chart 15: Financial Market – Financial Market Stress Index (FMSI)

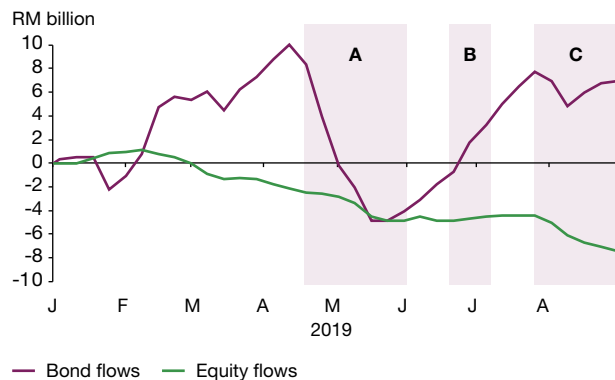
**Escalating trade tensions and unexpected monetary policy shifts will continue to drive market stress for the remainder of 2019**



Source: Bloomberg, Reuters and Bank Negara Malaysia estimates

Chart 16: Financial Market – Cumulative Non-resident Portfolio Flows

**Net non-resident inflows observed in the government bond market but persistent outflows from the equity market**



A: - News on potential removal of MGS from benchmark indices  
 - US increases tariffs on Chinese goods  
 B: - Resumption of trade talks and relaxation of ban on Huawei  
 C: - US rate cut amid vacillation of trade developments

Source: Bloomberg and Bank Negara Malaysia

Financial institutions continued to actively manage their market risk exposures while maintaining prudent risk-taking behaviour

## Banks

Banks' treasury portfolios expanded during the year, mainly attributed to higher holdings of government bonds in the banking book following the sell-off by NR investors in April and May. Interest rate risk in the banking book correspondingly increased slightly to 4.5% of total capital in the second quarter from 4.3% at the start of the year. Although the size of banks' trading book has also increased, it continued to remain relatively small at 18.5% of total securities (2018: 17.4%). Banks' foreign exchange (FX) net open position (NOP) declined to 4.9% of total capital (2018: 5.8%), reflecting greater caution among banks given the uncertain market conditions that prevailed during the first half of the year. FX NOP exposures continued to be dominated by exposures to the US dollar. The contribution of net trading and investment gains to banks' profit before tax rose to 20.2% (2018: 17.8%) on improved bond valuations due to lower interest rates. Active risk management and hedging strategies by banks continued to contain market risk exposures at manageable levels, well within prudent value-at-risk and loss limits set by individual banks.

## Insurers and takaful operators

Holdings of financial assets by insurers and takaful operators expanded in the first six months of 2019 in tandem with the growth of insurance funds. For life insurers and family takaful operators, a significant portion of their investment holdings remained in medium- to long-term corporate bonds and sukuk in order to match their longer-term liability structure. In contrast, general insurers and takaful operators continued to hold largely cash, deposits and liquid structured products given the shorter-term liability structure.

Equity holdings increased in the first half of 2019 as insurers and takaful operators took advantage of attractive valuations. Correspondingly, capital held against equity risk increased slightly to 7.8% (2018: 7.7%) of total capital available. Equity holdings continued to be mostly in blue-chip stocks and well-diversified across different economic sectors. Interest rate risk exposures increased to 4.4% (2018: 2.9%) of total capital available as bond yields decreased during the period. Overall, insurers and takaful operators delivered a stronger investment performance compared to the corresponding period in 2018. This was largely driven by improved valuations in the domestic bond market.

## LIQUIDITY AND FUNDING RISK

### Banks Maintained Sufficient Liquid Assets Amid Stable Funding Conditions

During the first half of 2019, banks continued to actively manage their liquidity positions in anticipation of maturing business deposits and opportunities to shore up liquid assets. Liquidity in the banking system remained sufficient to support domestic financial intermediation. The Liquidity Coverage Ratio (LCR) of the banking system, which measures the amount of high quality liquid assets (HQLA) held by banks to meet liquidity needs over a 30-day stress period (Chart 17), strengthened further over the past six months indicating greater resilience against potential shocks. All banks continued to record LCR levels above the regulatory minimum requirement of 100%, which came into full effect on 1 January 2019. Given the position of strength, banks also continued to provide support to the market during the period of heavy NR portfolio outflows, particularly in April and May.

Domestic funding conditions remained broadly stable. Banks' credit intermediation activities continued to be funded primarily by deposits and long-term funding, which

collectively grew by 4.9%. A moderation in overall deposit growth was observed in more recent months, partly driven by NBFIs which previously contributed to the strong deposit growth towards the end of 2018, as these institutions reallocated their cash holdings to other investments. Business deposits also moderated in line with the increasing trend in loan repayments observed since the start of the year. Notwithstanding that, overall deposit growth remained above its five-year average (Chart 18). Debt issuances by banks increased by 6.2% during the period as banks continued to enhance the stability of their funding structures in anticipation of new regulatory requirements on stable funding. Correspondingly, the banking system's loan-to-fund (LTF) and loan-to-fund-and-equity (LTFE) ratios remained stable at 83% and 72%, respectively (Chart 19). In the interbank market, interest rates across all maturities remained largely unchanged for most of the first half of 2019. Interbank rates however, declined in May, reflecting the pass-through from the adjustment in the Overnight Policy Rate (OPR). Banks' cost of funds (including interest expense paid on deposits and other funding instruments) have since stabilised, breaking an upward trend observed since the end of 2018.

Risks posed by banks' foreign currency (FCY) funding exposures remained manageable, given their limited reliance on external and cross-currency funding. External funding sourced by banks constituted less than 10% of total banking system funding liabilities, while NR deposits accounted for 5% of total banking system deposits. The bulk of banks' FCY funding remained in deposits and long-

term funds (56%), which are typically more stable in nature. Meanwhile, banks' external debt expanded in the second quarter of 2019 by RM25.2 billion to RM348.4 billion, offsetting the decline in the first quarter (Chart 20). The increase was driven by higher interbank borrowings, in line with lending and investment activities of foreign banks in Malaysia (including Labuan) and centralised funding and liquidity management by DBGs. Correspondingly, banks' external assets grew at a similar pace during the second quarter (+RM22.8 billion) in tandem with the higher external debt position. Both currency and maturity mismatches remained low as external borrowings continued to be broadly matched with corresponding financing exposures in terms of currency and tenure. Risks are further mitigated by the lower FX NOP of banks (Chart 21) and their holdings of liquid FCY assets, which are sufficient to cover more than double the level of external debt-at-risk<sup>27</sup> (Chart 22). Banks are also required to comply with local LCR requirements consistent with Basel III standards in the major jurisdictions in which Malaysian banks have operations.

As part of efforts to ensure that banks maintain a stable funding profile to support their activities, the Bank issued the finalised Net Stable Funding Ratio (NSFR)<sup>28</sup> requirements in July 2019. The standard, which is part of the Basel III reform package, will come into effect on 1 July 2020. Based on data gathered during the observation period, most banks are well-positioned to meet the requirements, with more than 85% of banks already above the 100% requirement. The banking system NSFR stood at 108.5% as at end-June 2019.

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<sup>27</sup> Refers to the proportion of banks' external debt that is more susceptible to sudden withdrawal shocks. This comprises financial institutions' deposits, interbank borrowings and short-term loans from unrelated NR counterparties.

<sup>28</sup> The NSFR complements the LCR, which has been in effect in Malaysia since 1 June 2015. While the LCR encourages the short-term resilience (30 days) of a banking institution's liquidity risk profile, the NSFR aims to reduce funding risk over a time horizon of up to one year.

Chart 17: Banking System – Liquidity Coverage Ratio and High Quality Liquid Assets

**Banks maintained sufficient liquidity**

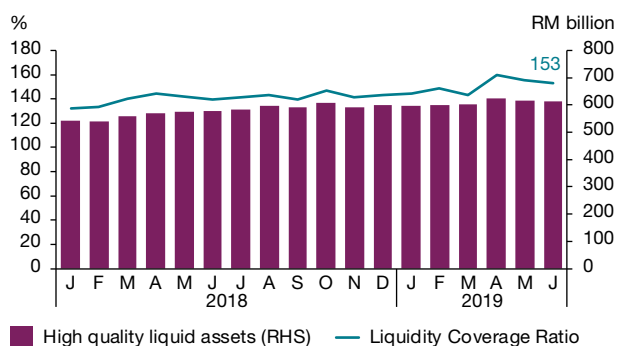


Chart 18: Banking System – Contribution to Growth in Deposits Accepted

**Growth in deposits remained above long-term average**

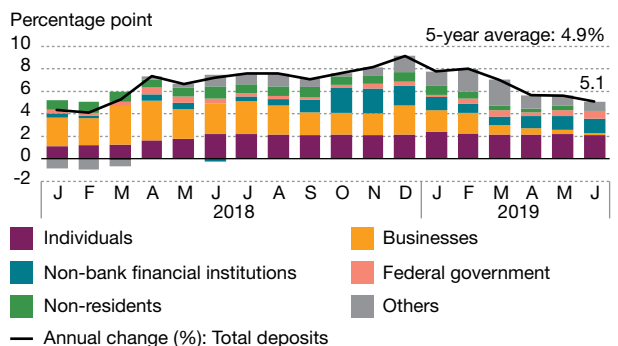


Chart 19: Banking System – Loan-to-Fund Ratio and Loan-to-Fund-and-Equity Ratio

**Banks' intermediation activities continued to be supported by growth in deposits and long-term funds**

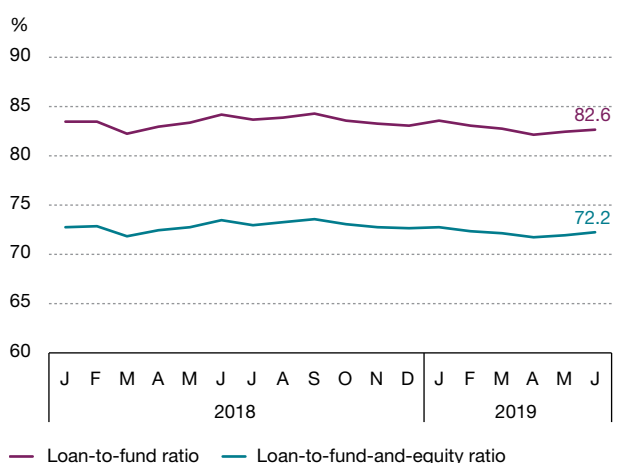


Chart 20: Banks' External Debt – by Instrument

**External funding remained small relative to total banking system funding**

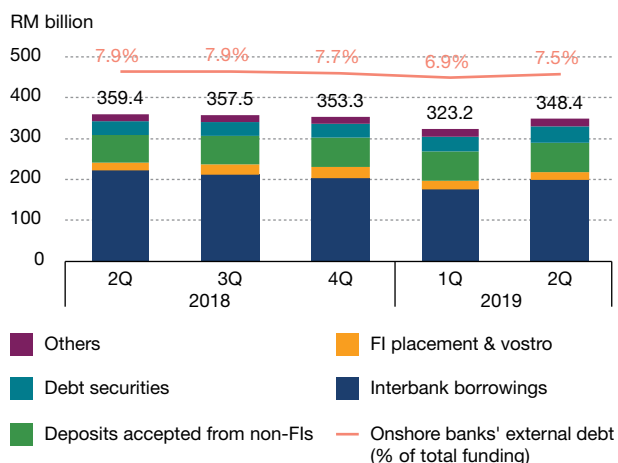


Chart 21: Banking System – FX and USD Net Open Position as Percentage of Capital

**FX and USD net open positions remained low**

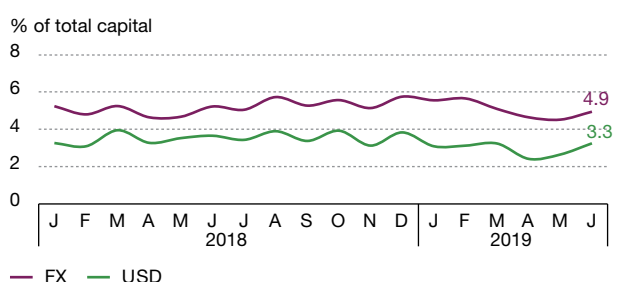
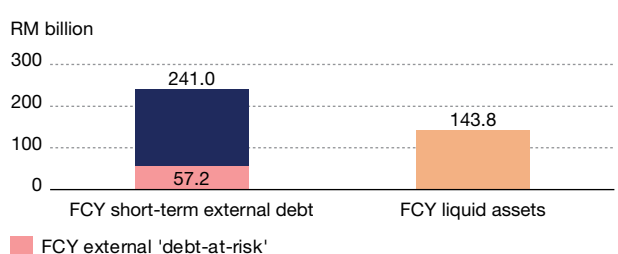


Chart 22: Banking System – FCY External 'Debt-at-Risk' and Liquid Assets

**Banks maintained FCY liquid assets of more than two times the FCY external 'debt-at-risk'**



Note:  
 1 Banks' external debt in this context refers to external debt of DBGs, 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

## CONTAGION RISK

### Contagion Risk Remained Contained

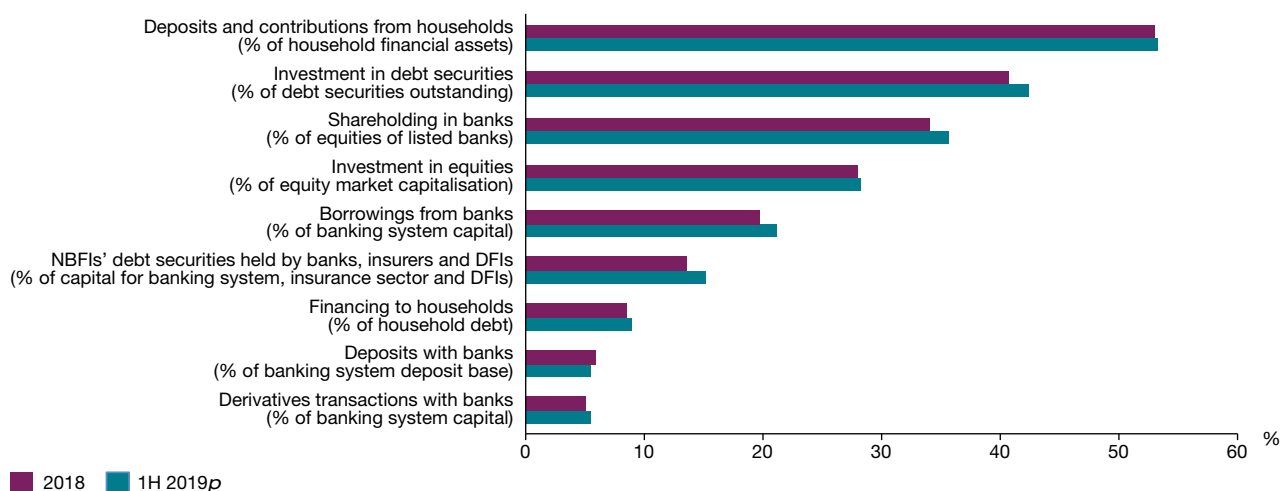
In the first half of the year, contagion risk arising from the financial activities of NBFIs to the financial system remained broadly contained. The provident and pension funds, and fund management industry continued to form the largest share of NBFIs' assets. NBFIs' participation in the financial markets remained significant, with investments in equities and debt securities accounting for 28.3% of total market capitalisation and 42.4% of total outstanding debt issuances, respectively (Chart 23). NBFIs' holdings of financial assets in common with financial institutions as well as their equity interests in several domestic banks remained the key risk transmission channel to the financial system. NBFIs increased their investment in equities in the first half of 2019, including shareholdings in domestic banks, as they took advantage of attractive valuations to augment their investment portfolios. Risks from rapid disposals of these financial assets resulting in sharp price adjustments remain limited, given NBFIs' medium- to long-term investment horizon, and the largely strategic nature of their investments. On the contrary, large NBFIs have continued to provide liquidity support to the domestic financial markets, particularly during periods of outflows in the first half of the year.

Direct credit exposures to NBFIs and the subscription of NBFIs-issued debt securities by banks, insurance companies (including takaful operators) and DFIs<sup>29</sup> increased by 5.2% and 5.4%, respectively. These exposures remained small, accounting for less than 3.5% of total loans and 7.7% of debt securities held by financial institutions. NBFIs continued to hold more than half of households' financial assets, mainly in the form of long-term savings in provident and pension funds. The withdrawals of such savings are subject to strict requirements to ensure that households have sufficient buffers for retirement. This, in effect, mitigates the liquidity risk faced by NBFIs. Nevertheless, a few NBFIs remain exposed to relatively higher withdrawal risk due to demand deposit-like liabilities. These NBFIs generally continue to hold sufficient liquid assets in the form of cash, deposit placements as well as government and government-guaranteed securities to meet liquidity needs, including from sustained heavy withdrawals.

Heightened public expectations for NBFIs to adopt good governance and sound risk management practices have been a positive development for the sector. Renewed efforts by NBFIs to increase transparency and strengthen risk management capabilities have been observed and will contribute towards promoting the long-term sustainability of NBFIs. This in turn will serve to mitigate contagion risk to the financial system.

Chart 23: Interlinkages of NBFIs with the Financial System

#### Higher magnitude of NBFIs' interlinkages with the financial system mainly due to NBFIs' participation in the financial market



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Source: Bank Negara Malaysia, Securities Commission Malaysia, Malaysia Co-operative Societies Commission and published financial statements

<sup>29</sup> DFIs that are regulated by the Bank under the Development Financial Institutions Act 2002.