

Financial Institution Soundness and Resilience

RESILIENCE AND PERFORMANCE OF THE BANKING SECTOR

Banks' Capitalisation and Profitability Remained Strong

Banks maintained strong capitalisation levels throughout the first half of 2019 (Chart 24). During this period, redemptions of Additional Tier 1 and Tier 2 capital instruments that are being phased-out from qualifying as regulatory capital under the Basel III transitional arrangements resulted in marginally lower capital ratios. Notwithstanding this, 77% of banks' capital continued to be held in the form of high-quality loss-absorbing capital comprising paid up capital, retained earnings and reserves. Banking system profitability remained healthy (Chart 25), supported by financing activities which continue to account for the bulk of banks' gross income. Pre-tax profits which recorded an annual growth of 5.2% (1H 2019: RM20.4 billion; 1H 2018: RM19.4 billion) were also bolstered by dividend income from subsidiaries and lower loan loss provisions as banks continued to refine their credit risk estimations under MFRS 9. Despite a narrowing of interest margins following the 25 basis points reduction in the OPR in May, sustained improvements in cost-efficiency over the past few years have supported relatively stable bank profits (refer to Box Article on 'Malaysian Banks' Profitability – Past Trends and Future Prospects' on page 35).

The resilience of banks' capital and profits continued to be underpinned by sound asset quality (Chart 26). This is supported by the sustained debt-servicing capacity of the household sector. Despite slightly higher impairments from business loans given challenges faced by specific firms in selected sectors, banks continued to maintain strong buffers against potential future losses. In addition to loan loss provisions,

regulatory reserves held by banks further mitigate the impact of any potential deterioration in asset quality (Chart 27). Furthermore, most banks remained resilient to extreme macroeconomic and financial shocks under multi-year stress tests³⁰ conducted by the Bank, with sufficient capital and earnings buffers to absorb potential losses (Chart 28).

Risks from DBGs' overseas operations to the Malaysian banking system remain contained despite weaker economic conditions

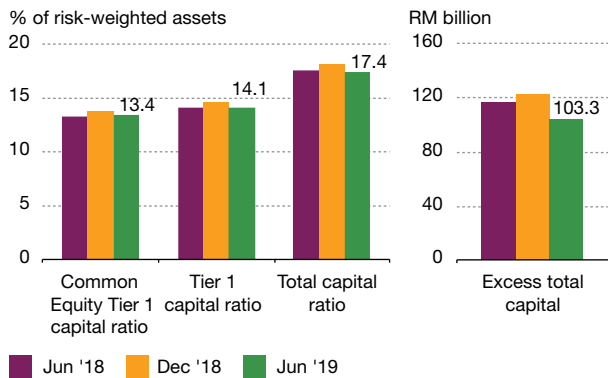
In the first half of 2019, growth in the total assets of DBGs' overseas operations was broadly sustained (1H 2019: 9%; 2018: 8%) (Chart 29). The performance of overseas operations deteriorated slightly, reflecting weaker economic conditions in the region. Notwithstanding this, overall capitalisation of DBGs' overseas operations remained strong (Chart 30), with earnings continuing to be well supported by contributions from interest income and enhanced operational efficiency. DBGs have also increased their vigilance over the more vulnerable segments in their lending portfolios, with a particular focus on the manufacturing, O&G, real estate and construction sectors.

The Bank monitors developments in the overseas operations of individual DBGs as part of its consolidated supervision framework. This is supported by regular engagements with host regulators through supervisory colleges and periodic bilateral meetings. Such engagements continue to provide an important platform for the timely exchange of information and identification of emerging risks, as well as coordination of supervisory responses where relevant.

³⁰ Please refer to the information box in the Financial Stability and Payment Systems Report 2018 titled 'Solvency Stress Test Scenarios, Key Assumptions and Shock Parameters' for details of the multi-year solvency stress test.

Chart 24: Banking System – Capital Ratios

Banks maintained strong capitalisation



Note: Excess total capital refers to total capital above the regulatory minimum, which includes the capital conservation buffer requirement for 2018 (1.875%) and 2019 (2.5%) and bank-specific higher minimum requirements

Chart 25: Banking System – Profitability

Banking profitability remained healthy

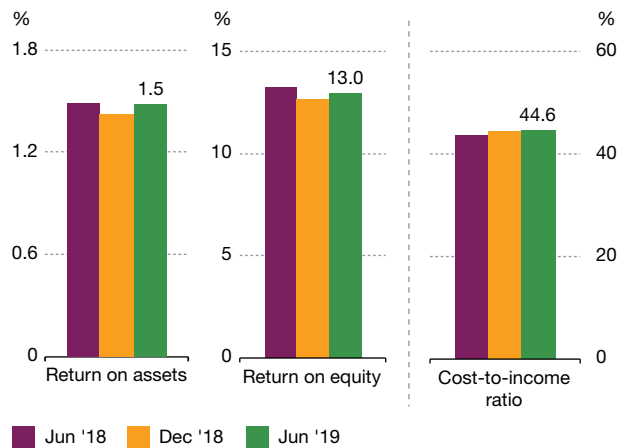


Chart 26: Banking System – Asset Quality

Impairment ratios increased slightly

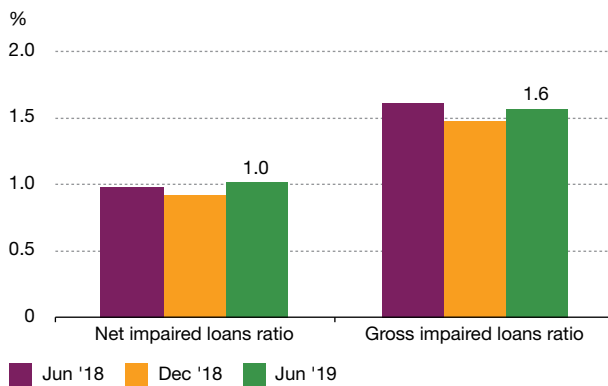


Chart 27: Banking System – Loan Loss Provisions

Banks maintained strong buffers against potential losses

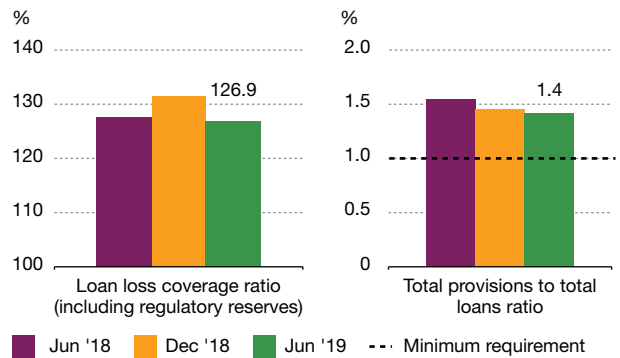


Chart 28: Banking System – Post-Shock Common Equity Tier 1 (CET1) Capital Ratios

Post-stress capital ratios are well above regulatory minima

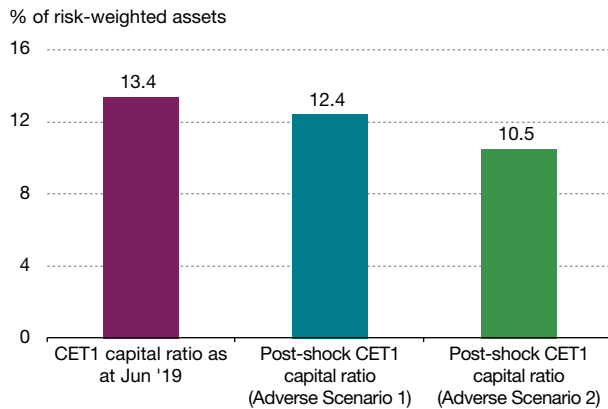
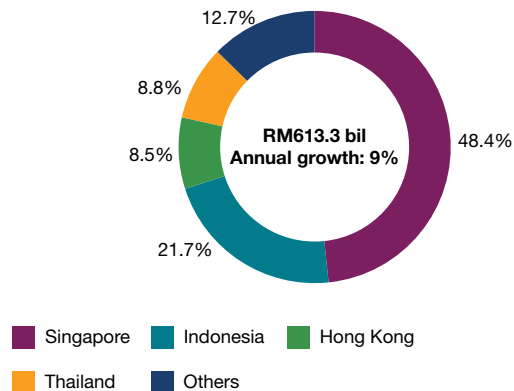


Chart 29: Banking System – Asset Profile of Major Overseas Operations

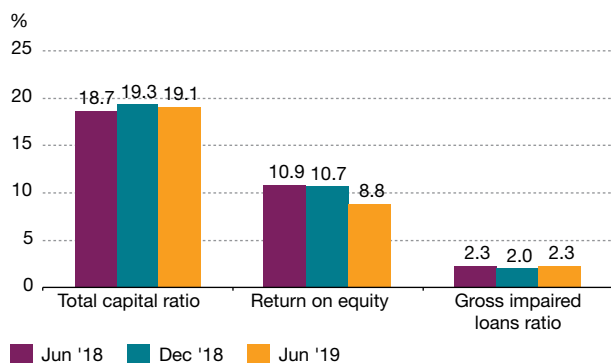
Bulk of overseas assets continued to be largely concentrated in Singapore and Indonesia



Source: Bank Negara Malaysia

Chart 30: Banking System – Key Financial Indicators of Overseas Operations

Financial performance of overseas operations remained sound



Note: Refers to median key financial soundness indicators of selected overseas operations
Source: Bank Negara Malaysia

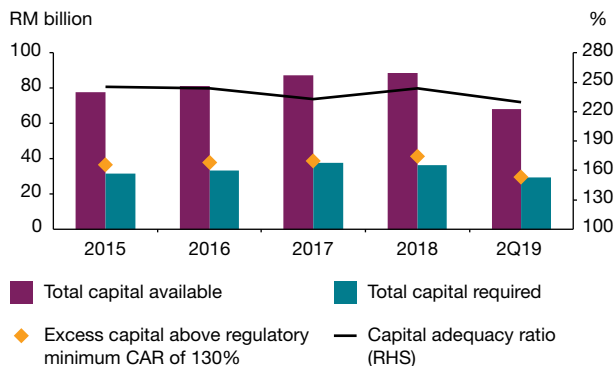
RESILIENCE AND PERFORMANCE OF THE INSURANCE AND TAKAFUL SECTOR

Insurance and Takaful Sector Remained Resilient

The insurance and takaful sector recorded an aggregate capital adequacy ratio (CAR) of 230% as at end-June 2019 (Chart 31), well above the regulatory minimum and higher than insurers and takaful operators' (ITOs) internal target capital levels. Capital held against insurance and takaful risk – which continued to form the largest component (43%) of total capital required – remained broadly unchanged, reflecting the relatively stable overall product mix.

Chart 31: Insurance and Takaful Sector – Capital Adequacy Ratio

Aggregate capital adequacy ratio (CAR) remained well above the regulatory minimum of 130%



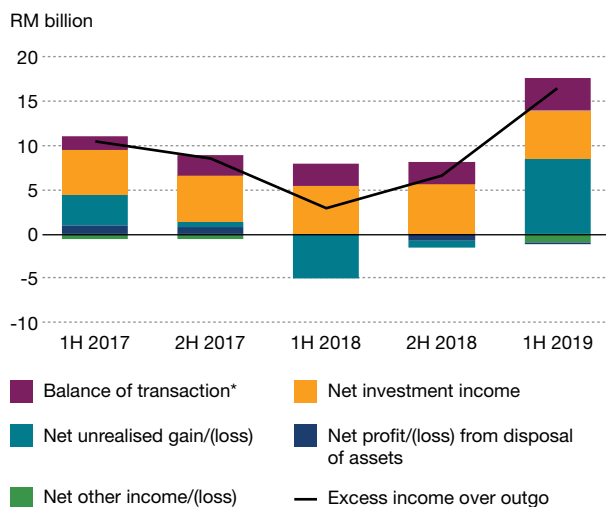
Source: Bank Negara Malaysia

Insurance and takaful sector recorded higher profitability amidst better investment performance

Overall profitability for the insurance and takaful sector in the first half of 2019 improved compared to the corresponding period last year. This was largely supported by the life insurance and family takaful segment on the back of unrealised gains from bond holdings and higher growth in net premiums (Chart 32).

Chart 32: Life Insurance and Family Takaful Sector – Composition of Income and Outgo

Higher excess income over outgo driven by net unrealised gains



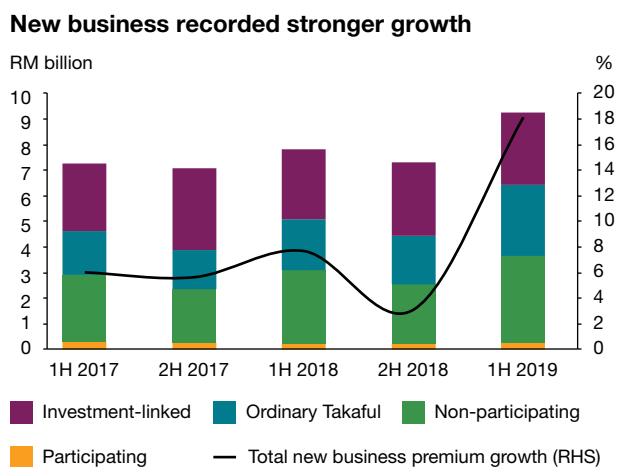
* Excess of net premium after deducting benefit payouts, agency remuneration and management expenses

Source: Bank Negara Malaysia

New business premiums in the life insurance and family takaful sector recorded significantly stronger growth due to improved sales of non-participating endowment policies via bancassurance arrangements, and higher contributions from medical and health takaful products for the lower income segment (Chart 33). The implementation of the Balanced Scorecard (BSC) framework,³¹ which entered its second year of implementation, has seen measurable improvements in the quality of advice provided by agents as reflected in the markedly higher number of agents meeting the 90% first-year and 80% second-year persistency rates. This is expected to further support the sustainability of premium growth going forward.

³¹ The BSC framework aims to align sales incentives with better quality sales and policy servicing by insurance and takaful intermediaries.

Chart 33: Life Insurance and Family Takaful Sector – New Business Premium Growth and Product Composition

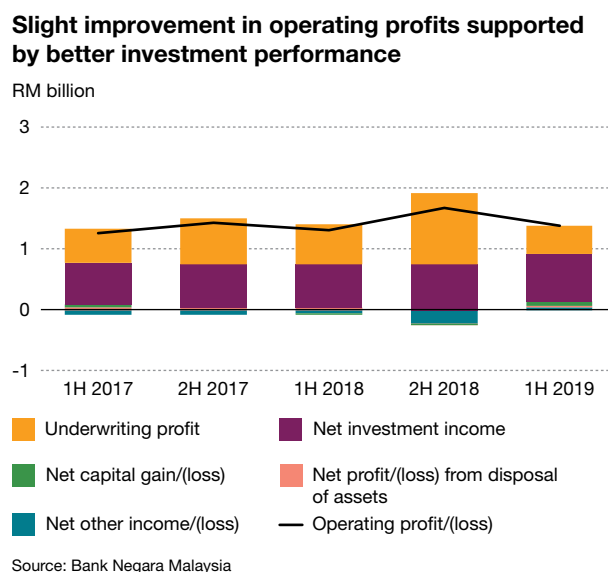


Despite sustained renewals, growth in new premiums for investment-linked policies on the other hand was largely flat amid weaker equity markets and the diversification of some ITOs into other product lines. In response to revised regulatory requirements on investment-linked products, including the Minimum Allocation Rate (MAR)³² which came into effect on 1 July 2019, ITOs are in the process of implementing changes to their product designs and business strategies. While delivering better value to policyholders, these adjustments could potentially affect new business growth and profitability of investment-linked products in the near term.

Operating profits in the general insurance and takaful sector were similarly bolstered by better investment performance (Chart 34). Underwriting profits however declined, largely due to several large claims from fire and explosion incidents. In the motor segment, underwriting performance remains under pressure amid greater competition and rising claims costs. Nonetheless, the improved pricing flexibility under the phased liberalisation

of the Motor Tariff³³ has sustained positive overall operating results. Out of the 8.2 million in-force private car policies as at end-June 2019, premium rates were either lower or maintained for 43% of policies, while 57% were subject to higher rates. The quantum of the rate changes was however modest, with changes mostly falling within 10% of tariff rates. Consistent with pricing that is more aligned with risks, larger rate increases were observed for higher risk vehicles or risk owners, while certain covers and risk segments which were previously overpriced under the tariff saw significant reductions.

Chart 34: General Insurance and Takaful Sector – Composition of Operating Profits

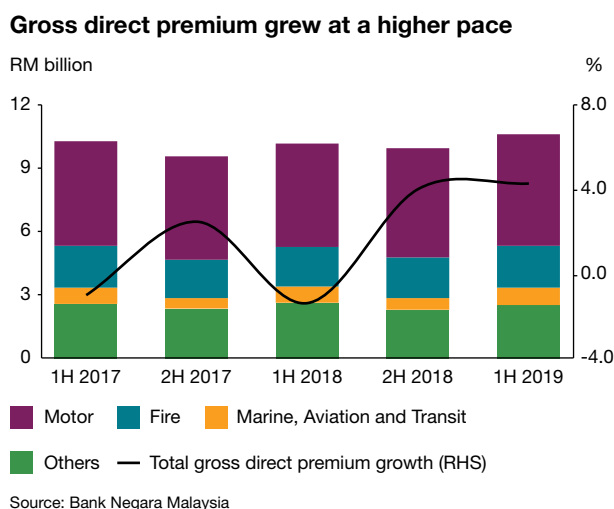


³² MAR specifies minimum proportion of premiums or takaful contributions for investment-linked policies or takaful certificates to be allocated to a unit fund(s). MAR is being implemented in a phased manner over the period from 1 July 2019 to 1 July 2020.

³³ The liberalisation of the Motor Tariff for 'Comprehensive' and 'Third Party, Fire and Theft' products commenced on 1 July 2017 as part of Phase II of the overall pricing reform. The Bank is currently developing proposals for the next phase of liberalisation.

During the period, gross direct premiums grew at a faster pace (Chart 35). Growth was largely supported by the motor segment, which continued to form the largest line of business, contributing to about half of total gross premiums. General ITOs benefitted from a boost in car sales in the first half of 2019 as well as improved pricing of risks. Premium growth was also supported by the fire segment and a marginal recovery in the O&G

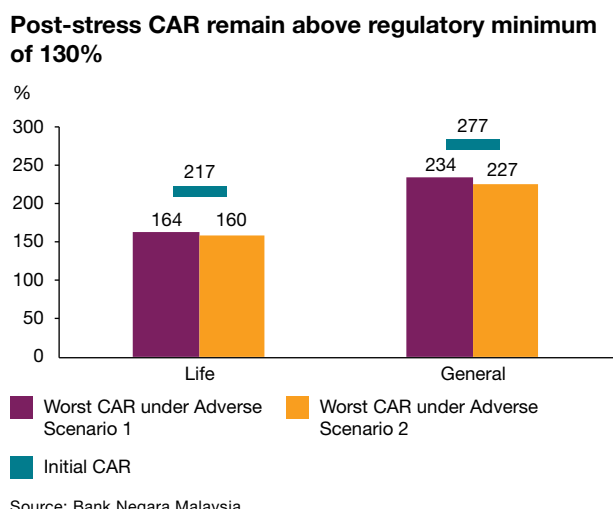
Chart 35: General Insurance and Takaful Sector – Gross Direct Premium Growth and Product Composition



sector, which saw higher premiums booked in the offshore oil-related segments.

Similar to banks, insurers continued to demonstrate resilience even under simulated scenarios of severe multi-year macroeconomic and financial shocks.³⁴ The aggregate CAR of both life and general insurance sectors remained above the regulatory minimum throughout the stress test horizon (Chart 36).

Chart 36: Insurance Sector – Post-Shock Capital Adequacy Ratio



³⁴ Please refer to the information box in the Financial Stability and Payment Systems Report 2018 titled ‘Solvency Stress Test Scenarios, Key Assumptions and Shock Parameters’ for details of the multi-year solvency stress test.