

Overview

Global financial markets experienced increased volatility in the second half of 2021 which continued into 2022. This was largely driven by expectations of monetary policy normalisation in the United States, tensions from the military conflict in Ukraine and continued challenges from the COVID-19 pandemic. Domestically, a surge in COVID-19 cases and the rise in global bond yields also led to some market stress. Domestic bond yields could experience further upward pressure amid market expectations of larger incoming government bond supply. Conditions in domestic financial markets are, however, expected to remain orderly. This will continue to be supported by Malaysia's deep and liquid bond market, diverse investor base, as well as positive real yields.

Credit risk remained a key focus for banks as they continued to build up provisions to buffer against a potential rise in impairments. This ensured the continued resilience of banks to support financing activities necessary for a sustained economic recovery. Similarly, insurers and takaful operators (ITOs) remained resilient and well-positioned to continue supporting the protection needs of households and businesses. Financial institutions have remained vigilant in managing their risks given continued uncertainty posed by domestic and global developments. This, coupled with their strong capital and liquidity buffers, has helped preserve domestic financial stability during the year. Updated stress tests conducted by the Bank continue to affirm the resilience of capital buffers of banks and insurers to withstand potential losses under severe macroeconomic and financial shocks, while sustaining support for economic recovery.

The financial performance of businesses continued to improve in the second half of 2021, although recovery remains uneven. The share of firms-at-risk declined further to 20.9% (3Q 2020 (peak): 31.9%). Lower leverage, more prudent controls over expenses, and a gradual recovery of economic activities

were major contributing factors to improvements in business performance. In addition, firms that successfully pivoted towards digitalisation and greater automation of their operations have also been observed to fare better during the more recent episodes of operating and mobility restrictions. The quality of business borrowings has not, so far, shown significant deterioration, owing to support measures that remain in place, particularly for SMEs. Leading indicators from banks, while elevated, point to a recovery in the operating environment as business loans with increased credit risk grew at a slower pace. Average monthly repayments have also surpassed pre-pandemic levels.

With the prolonged pandemic, SMEs remained more vulnerable given their smaller cash buffers and generally thinner profit margins. SMEs, therefore, continued to make up the bulk of firms benefitting from repayment assistance. The share of SME loans under repayment assistance also remained high. It should be noted, however, that new rescheduling and restructuring (R&R) applications by SMEs have decelerated from its peak in July 2021. This indicates greater confidence among SMEs of their ability to service their debt. Further improvements in business resilience amid a steady recovery in earnings will lift firms' debt-servicing capacity. Measures supporting the economy under Budget 2022, existing credit guarantee schemes and on-going R&R by banks will also support business recovery and mitigate risks of a significant rise in impairments.

The debt-servicing capacity of household borrowers continued to be supported by positive growth in household financial assets, available assistance for borrowers facing temporary repayment difficulties, and improving economic and labour market conditions. Although repayment assistance under the PEMULIH package saw a higher take-up across all income groups, this partly reflected the flexible enrolment criteria which also covered borrowers

whose incomes have not been affected and are therefore more likely to be able to continue servicing their loans. Concerns, however, remain over some segments of household borrowers that are highly leveraged or have low financial buffers. This includes household borrowers under repeat repayment assistance with debt service ratios above 60% and employed in sectors most impacted by the pandemic – they account for around 1.7% of total banking system loans. As support measures are gradually unwound, these borrowers could face difficulties servicing their loans. However, risks to the banking system remained contained. For borrowers who are still unable to service their loans, more targeted repayment assistance provided through the Financial Management and Resilience Programme (URUS) and other programmes remain in place. Banks also continue to offer repayment assistance packages to distressed borrowers which are tailored to their financial circumstances. Over the longer term, the depletion of household retirement savings poses considerable risks to households. As the economy recovers, it is important for households impacted by the pandemic to gradually re-build their financial buffers. Labour market and social protection reforms will be key towards raising income levels and securing household resilience in the long run.

Some improvements in housing market activity were visible heading into 2022, although the number of unsold houses remained high. Disruptions caused by the pandemic partly contributed to the slower clearance of unsold housing stock. Nonetheless, the high number of unsold houses continues to reflect pre-existing affordability issues. This has worsened since the onset of the pandemic amid some weakening in income. Supply-side adjustments have continued with more housing launches shifting towards lower- and mid-price market segments. However, broader reforms to improve housing affordability remain critical to contain the debt burden of households and mitigate risks of future financial hardship. In the commercial real estate (CRE) sector, the shift towards flexible working arrangements and accelerated pace of digitalisation arising from the pandemic will continue to transform how physical spaces are utilised. These trends could exacerbate existing oversupply concerns in selected CRE segments such as office and retail spaces. Direct linkages between the CRE sector and financial system are largely contained, thereby substantially mitigating risks to financial stability. However,

further progress in resolving excess supply remains important given the high multiplier effects of the construction sector to the broader economy. Large planned incoming supply of office and retail spaces continues to pose risks.

Banking system profitability was sustained in the second half of 2021 on the back of a pick-up in lending and low funding costs. Gradual improvements in the financial condition of borrowers as the economy recovers will further support banks' earnings going forward. Credit costs are expected to remain elevated due to the emergence of defaults/delinquencies once support measures are withdrawn. However, further additions to provisions are likely to be more modest given the sizeable buffers already built up and continued support for more vulnerable borrowers. This is reflected in banks' aggregate loan loss coverage ratio which remains close to its recent historical high. Banks' capital positions also remained strong. These buffers crucially preserve the capacity of banks to absorb potential unexpected losses amid a still challenging operating environment, and enable them to support households and businesses' financing needs through the cycle.

Aggregate profitability declined for insurance and takaful funds, mainly driven by weaker investment performance. The impact of COVID-19 claims and the December floods on the profitability of ITOs remained manageable. Claims arising from the recent floods were the largest payout by the industry for a flood event over the past decade. Notwithstanding this, economic losses were substantially higher, reflecting the underinsurance of flood risks by households and businesses. Looking ahead, the recovery in insurance and takaful business growth remains contingent upon the economic outlook. Higher revaluation losses from investments could potentially materialise given expectations of further increases in yields in 2022. ITOs are expected to remain resilient, supported by pre-existing financial buffers. The impact of further planned liberalisation of motor and fire tariffs on general ITOs' profitability is also expected to be manageable given the gradual approach towards implementation. Further progress on this front aims to encourage more competitive and risk-based pricing, increased product options for consumers, and investments in technology to improve the claims process.

Ensuring operational and cyber resilience remains a key focus of the Bank and financial institutions. This comes amid an increasing reliance by financial institutions on third party service providers, higher cloud adoption and rising ransomware threats. Operational incidents and losses remained small and isolated, reflecting significant investments and measures by financial institutions to strengthen cyber defences and recovery capabilities. However, risks of reputational damage are likely to have increased, with closer attention needed to manage such risks as part of financial institutions' incident response plans.

Effectively managing the effects from climate risks will also be an area of focus for the Bank and the industry in the coming years. Beginning July 2022, financial institutions will start to report exposures in line with the Climate Change and Principle-based Taxonomy (CCPT) to the Bank, in turn paving the way for financial institutions to make TCFD-aligned¹ climate-related financial risk disclosures from 2024. Financial institutions remain committed to support the transition to lower carbon activities by their customers and are actively taking steps to increase engagements to better understand the transition plans and financing needs of these customers.

¹ Refers to recommendations by the Task Force on Climate-related Financial Disclosures.