MANAGING RISKS TO FINANCIAL STABILITY

Financial stability continued to be preserved

A resilient financial sector and the orderly functioning of the financial markets continued to support financial intermediation activities in the domestic economy. To ensure continued soundness of the household sector and the stability of the financial system, the Bank introduced a number of policy measures during the quarter. These pre-emptive measures include the issuance of a new Credit Card Guideline, proposals to promote responsible lending practices by financial institutions for retail financing and raising the capital charges on housing loans where the loan-to-value (LTV) ratio exceeds 90% and for longer-tenured personal financing. These initiatives are also complemented with a targeted financial education programme introduced for young and first time borrowers on financial management.

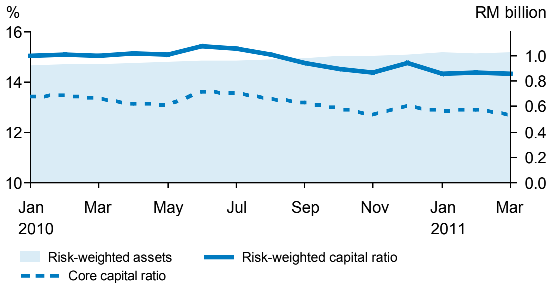
Risks to financial stability remained low. Overall credit risk exposures of the financial sector remained manageable. Both loan impairment and loans that are in arrears remained stable at 2.2% of net loans (4Q 10: 2.3%) and 3.2% of gross loans (4Q 10: 3.4%) respectively. Households' debt servicing capacity remained intact with the household debt-to-GDP at 76.4%. Impairment levels registered a slight improvement to 2.2% of household loans (4Q 10: 2.3%). The level of debt repayments of households was 53% (4Q 10: 47.8%) of income.

Improved business conditions during the quarter had spurred further expansion in credit as businesses gradually increased capital expenditures to improve their productive capacity. Despite a slight increase in the median Expected Default Frequency from 0.61% to 0.64% in the first quarter due mainly to higher cost of production, the debt-servicing capacity of businesses remained strong supported by steady growth in business revenue. The ratio of repayment-to-disbursement remained stable at 90%, whilst the gross impaired loans ratio improved to 4.9% (4Q 10: 5.2%). The credit risk outlook for businesses is expected to be positive underpinned primarily by the continued robust domestic demand.

Higher volatility in equity market arising from external developments and the rise in MGS yields on inflationary concerns has had negligible effects on the financial sector. Despite these uncertainties, the domestic financial markets have remained orderly with sustained capacity to intermediate the increased volume and volatility of financial flows.

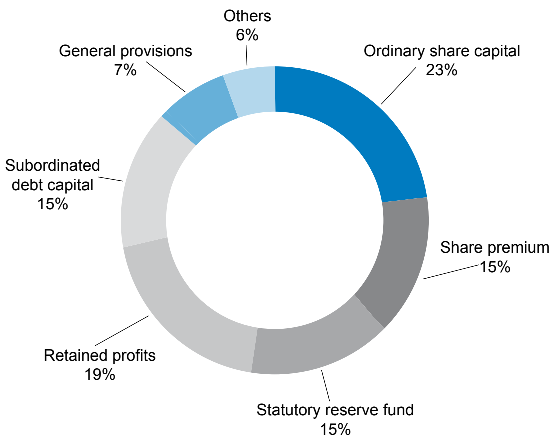
While the financial system continued to be the recipient of net inflows of portfolio investments, further magnifying the ample liquidity environment, there has not been evidence of material changes in the risk-taking behaviours of financial institutions. The banking system's exposure to equity risk remained small at 1.3% of capital base as at end-March (4Q 10: 1.2%), whilst insurance and takaful sector's exposures to equity risk remained at 7.3% of capital base. Meanwhile, interest rate risk remained small at 4.3% of capital base (4Q 10: 4.9%) for the banks and 3.3% (4Q 10: 3.3%) for the insurance and takaful sector. Given the expectation of continued inflows of portfolio funds into the country, the consequent build-up of liquidity in the domestic financial system, if not managed carefully, could create risks to macroeconomic and financial stability. The Bank, as a pre-emptive measure, raised the Statutory Reserve Requirement (SRR) ratio by 100 basis points in March and a further 100 basis points to 3 percent in May 2011 to manage the build-up of liquidity, which may result in financial imbalances and create risks to financial stability.

Banking System: Capitalisation



Source: Bank Negara Malaysia

Banking System: Quality of Capital

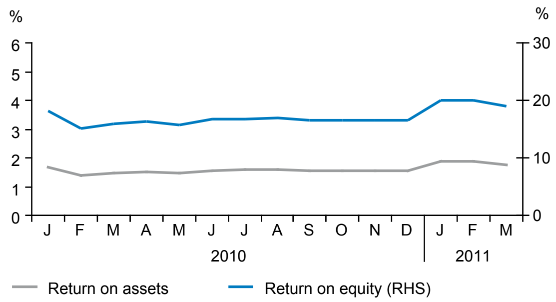


Source: Bank Negara Malaysia

The financial sector remained resilient, providing firm support for financial intermediation of domestic economic activities

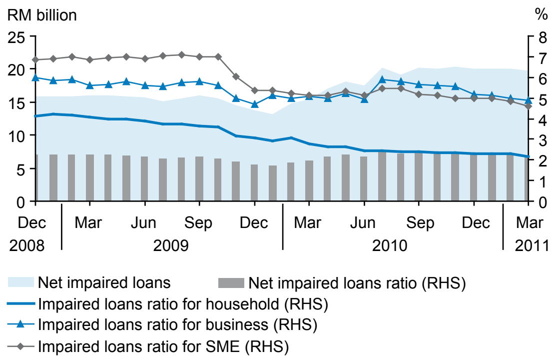
Banking sector capitalisation remained at a very comfortable level. Common equity and reserves continued to account for the bulk of banking sector capital funds. Core capital ratio and risk-weighted capital ratio remained strong at 12.7% and 14.3% respectively. Capital buffers were sustained in excess of RM60 billion. The insurance and takaful sector demonstrated similar resilience. Capitalisation was strong as reflected by the capital adequacy ratio of 225.7% and excess capital of RM19.1 billion. About 91% of capital comprised high quality Tier-1 capital.

Banking System: Profitability



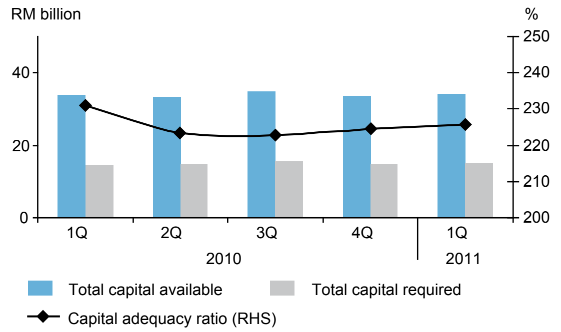
Source: Bank Negara Malaysia

Banking System: Loan Quality



Source: Bank Negara Malaysia

Insurance Sector: Capital Adequacy Ratio

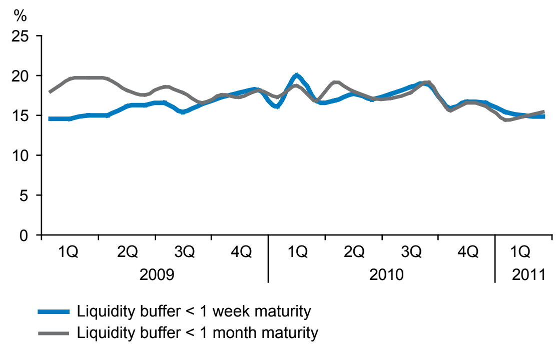


Source: Bank Negara Malaysia

Banks' pre-tax profits for the quarter amounted to RM6.9 billion (4Q 10: RM5.7 billion) on lower loan loss provisions and substantially higher gains on trading and investment portfolios. Consequently, average returns on assets and equity improved to 1.8% (4Q 10: 1.5%) and 18.9% (4Q 10: 16.6%) respectively. Underwriting profit for insurers decreased marginally by 6.3% to RM280.9 million, due to lower investment income and moderating overall claims incurred. Claims for the motor segment nonetheless continued to remain high at 73% in the first quarter. Operating profit for general insurance and general takaful moderated due to higher motor claims. The strong equity market performance continuing from 2010 spurred further growth in the investment-linked products of both life and family takaful businesses. Coupled with moderating investment income and investment gains, excess of income over outgo for life insurance and family takaful rose to RM3.2 billion (1Q 10: RM2.9 billion).

Liquidity remained ample to meet demands for deposit withdrawals and other liquidity obligations.

Banking System: Liquidity Buffer to Total Deposit Ratio



Source: Bank Negara Malaysia

Insurance and Takaful Sector: Indicators

	2010			2011
	1Q	4Q	Year	1Q
	RM million			
Life insurance & family takaful				
Excess of income over outgo	2,903.5	3,155.3	14,099.5	3,140.8
General insurance & general takaful				
Operating profit	524.9	559.9	2,167.9	516.6
Claims ratio (%)	62.8	62.2	62.2	61.4

Source: Bank Negara Malaysia