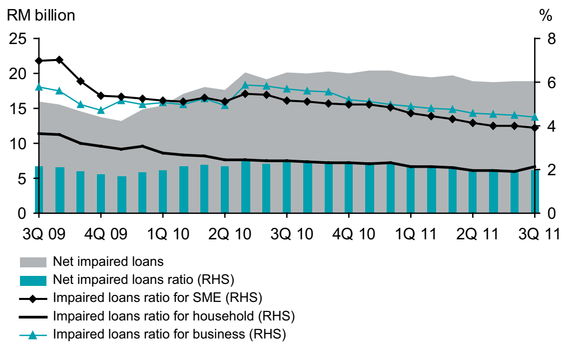
## MANAGING RISKS TO FINANCIAL STABILITY

### Financial stability remained intact

Financial stability remained intact throughout the third quarter amid more challenging external conditions and greater domestic competition. This was underpinned by well-capitalised financial institutions which provided continued support for financial intermediation activities in the domestic economy. Public confidence in the financial system was also preserved. The financial market demonstrated the capacity to absorb the increased volatility arising from concerns on sovereign risk in the US and Euro area.

Overall risks to financial stability remained low, supported by the stable credit risk outlook for the banking system. Loan (includes Islamic financing) quality was preserved with the total impaired loans ratio (net of impairment provisions) remaining stable at 2.0% of net loans (2Q 11: 2.0%) and total loans-in-arrears (for duration of one to less than three months) accounting for 3.8% of gross loans (2Q 11: 3.7%). Outstanding household debts grew by 2.4% during the quarter, while overall household indebtedness to GDP ratio was relatively stable at 77.6% (2Q 11: 77.2%). The bulk of household debts continued to be directed towards asset accumulation through the purchase of residential properties and vehicles. Banks' credit to households through personal financing and credit cards increased at a faster pace but continued to represent less than 10% of overall banking system loans, unchanged from 2010. On aggregate, the debt servicing capacity of households continued to be well-supported by financial assets that amounted to 2.3 times of total household debts (2Q 11: 2.4 times). There are, however, certain segments of households who are facing challenges from the rising cost of living. Recognising this, the Government has introduced a number of measures to ease the financial burden of this group to enable them to manage the situation. These measures should contribute favourably to overall financial and economic stability. Total impaired household loans improved slightly to account for 1.9% of gross household loans (2Q 11: 2.0%), attributed to the sound quality of loans for the purchase of residential properties.

**Banking System: Loan Quality**




Source: Bank Negara Malaysia

Credit growth in the business sector expanded by 2.4% q-o-q during the quarter amid steady growth in business revenue, in tandem with expansion in real sector activities. The risk of delinquency, as measured by the expected default frequency, for businesses remained very low at 0.8% (2Q 11: 0.6%), supported further by a sound debt servicing capacity of businesses. Repayment-to-disbursement ratio improved further to 96% (2Q 11: 87%) while total impaired loans improved to account for 4.4% of gross business loans (2Q 11: 4.6%). Despite higher uncertainty in global growth and continued elevated commodity prices, the credit risk outlook for businesses remains neutral.

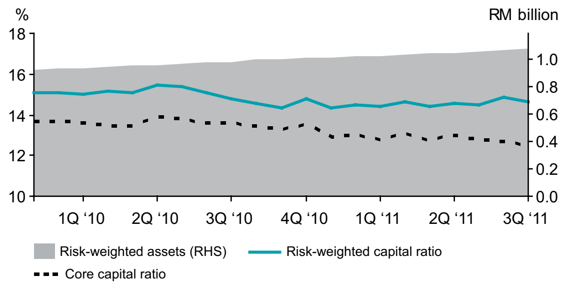
The domestic financial markets experienced higher volatility and some outflows during the quarter, but remained orderly with the capacity to absorb the changes in volume. The persistent sovereign debt concerns in Europe and ratings downgrade of some US financial institutions had a very limited impact on the Malaysian financial system owing to its minimal holdings of foreign currency denominated exposures to counterparts in these jurisdictions. The financial system also remained resilient to indirect spillovers through the trade and economic channels based on results of stress tests under severe economic scenarios. The banking system's exposures to equity risk remained small at 0.7% of capital base (2Q 11: 1.3%), while the insurance and takaful sector's exposures to equity risk was lower at 6.6% of capital base (2Q 11: 7.3%) following measures by insurers and takaful operators to reduce equity holdings amid more uncertain market conditions. Interest rate risk remained manageable at 4.9% of capital base (2Q 11: 6.0%) for the banking system and 3.4% of capital base (2Q 11: 3.3%) for the insurance and takaful sector.

## The financial sector remained resilient

The banking system continued to maintain a high level of capitalisation with the core capital ratio and risk-weighted capital ratio remaining strong at 12.5% (2Q 11: 13.0%) and 14.6% (2Q 11: 14.6%) respectively. Approximately 85% of total capital comprised high quality Tier-1 capital primarily in the form of paid-up capital and reserves. Capital in excess of the minimum 8.0% regulatory requirement remained high at RM67.8 billion, hence providing the banking system with the strong capacity to absorb any unexpected losses from adverse market and economic conditions. Similarly, capitalisation of the insurance and takaful sector remained strong with a capital adequacy ratio of 221.1% (2Q 11: 223.2%) and excess capital of RM18.6 billion.

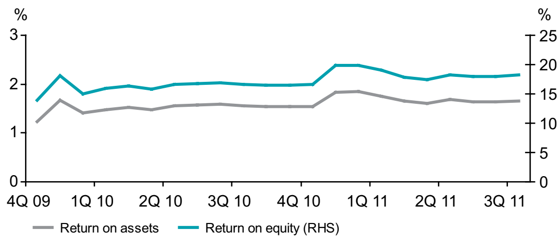
The banking system recorded pre-tax profits totalling RM6.7 billion for the quarter (2Q 11: RM6.6 billion) attributable mainly to sustained revenue from financing activities, and lower staff expenses (-22.8% q-o-q) and loan loss provisions (net of recoveries) (-1.4% q-o-q). As a result, returns on assets and equity remained stable at 1.6% (2Q 11: 1.7%) and 18.2% (2Q 11: 18.2%) respectively. The life insurance and family takaful businesses recorded an excess of income over outgo of RM1.3 billion (2Q 11: RM3.8 billion), while the general insurers and general takaful operators registered lower operating profits of RM476.0 million (2Q 11: RM557.2 million) during the quarter. The decline in life insurance and family takaful profitability was due mainly to higher market valuation losses in the equity investment portfolio, in tandem with heightened volatility in the capital market. The lower operating profits recorded by the general business sector was attributed mainly to higher claims incurred in the third quarter with an overall claims ratio at 62.1% (2Q 11: 61.3%). The motor 'act' business segment continued to pose significant losses with a recorded claims ratio of 286.9% (2Q 11: 284.3%).

**Banking System: Capitalisation**



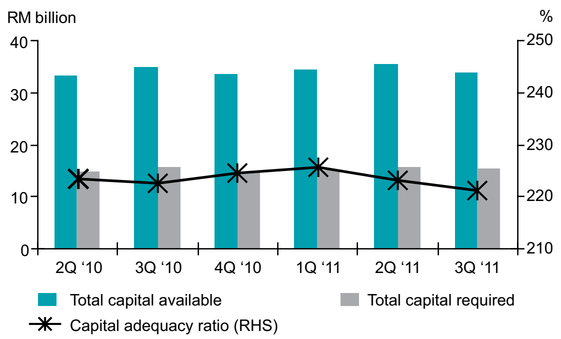

Source: Bank Negara Malaysia

**Banking System: Profitability**



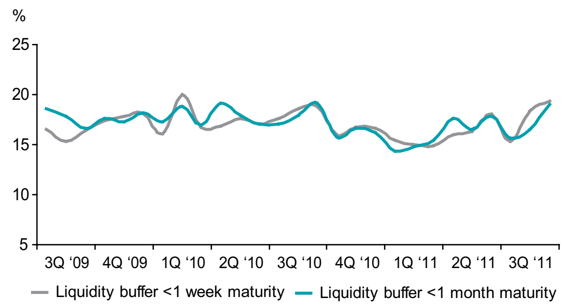

Source: Bank Negara Malaysia

**Insurance Sector: Capitalisation**




Source: Bank Negara Malaysia

**Banking System: Liquidity Buffer to Total Deposit Ratio**




Source: Bank Negara Malaysia

Overall liquidity in the banking system remained ample and more than sufficient to meet demand for deposit withdrawals and other liquidity obligations. The liquidity buffer remained well above the minimum regulatory requirements, accounting for 19.0% of total deposits for liquidity needs maturing within one month.

**Insurance and Takaful Sector: Indicators**

| | 2010 | | 2011 | | |
|---|---|---|---|---|---|
| | 3Q | 4Q | 1Q | 2Q | 3Q |
| | RM million | | | | |
| **Life insurance & family takaful** | | | | | |
| Excess of income over outgo | 5,062.8 | 3,151.3 | 3,238.5 | 3,775.3 | 1,315.0 |
| **General insurance & general takaful** | | | | | |
| Operating profit | 480.9 | 563.7 | 562.9 | 557.2 | 476.0 |
| Claims ratio (%) | 62.2 | 62.1 | 61.2 | 61.3 | 62.1 |

Source: Bank Negara Malaysia