

Overview

Global financial market conditions tightened in the first half of 2022 amid concerns over global economic growth, rising inflation and volatile commodity prices. Financial market volatility has continued to be fuelled by a quicker-than-anticipated normalisation of monetary policy in major economies to control inflation, as well as the prospects of a longer war in Ukraine and ongoing risks of global economic disruptions brought on by COVID-19 restrictions in some parts of the world. Domestically, market stress levels have remained elevated since the second quarter of 2022, reflecting a global risk-off sentiment in response to rising global bond yields. Despite continued heightened volatility in the domestic financial markets, market conditions have remained orderly with the smooth intermediation of two-way flows in the bond and equity markets. The US dollar has strengthened significantly and remained at a two-decade high, due to aggressive policy rate hikes in the US and flight to perceived safe US dollar assets. Continued liquidity in the onshore foreign exchange market is enabling orderly adjustments to external developments. This, in turn, will support businesses and market participants in managing their foreign exchange exposures.

Businesses continued to show improvement in their financial performance in the first half of 2022 in line with the full resumption of economic activities and reopening of international borders. Measures of financial performance at the aggregate level have recovered above pre-pandemic levels, with the median interest coverage ratio and operating margin at 7.1 times and 7.3%, respectively. However, recovery remains uneven and has been slower in certain economic sub-sectors. Reflecting this, the overall share of firms-at-risk has been stable, but it remains elevated in the hotels and restaurants, construction, and real estate sectors. Overall

business loan impairments remain low at 1.1% of total banking system loans, with leading indicators also pointing to manageable risks that will be well within the capacity of banks to absorb. Of note, the share of business loans with higher credit risk has continued to decline to 14.4% of total business loans in line with the gradual improvement in business conditions. The share of small and medium enterprise (SME) loans under repayment assistance meanwhile has halved to 13.1% of total SME loans (or 2.3% of total loans from the banking system and development financial institutions). SMEs that have exited the repayment assistance programme have largely been able to resume their loan repayments. SMEs falling behind in repayments account for less than 1% of total SME loans. Corporate default risk indicators have also continued to improve. While businesses are expected to face continuing headwinds in the period ahead – including from effects of tightening global financial conditions and exchange rate developments – additional business defaults are expected to remain manageable under simulated severe stress scenarios. Importantly, various targeted debt management programmes with the support of banks remain available for SMEs that continue to experience temporary financial challenges.

Household resilience has continued to be supported by improving economic and labour market conditions. The ratio of household debt-to-GDP has reverted closer to pre-pandemic levels at 84.5% as banks continue to maintain prudent lending standards amid a sustained recovery in household lending. This is helping to preserve healthy loan servicing buffers among households and their ability to manage the impact of higher borrowing and other costs. The median debt-to-income (DTI) ratio for overall households has increased only marginally to 1.5 times over the period of the pandemic despite income shocks and large-scale repayment assistance extended by banks. Other measures of debt servicing capacity, including for housing debt, also remain stable.

The share of household debt under repayment assistance has declined significantly from 18.8% in December 2021 to 2.4% as at June 2022, along with a lower share of household debt reported by banks to be of higher risk. Some segments of household borrowers that are more highly leveraged with low financial buffers could come under financial stress from rising costs of living and higher repayments on floating-rate loans. Borrowers who are still under an extended period of repayment assistance are also likely to present higher risks. Banks have set aside sufficient provisioning buffers against these risks and continue to extend appropriate support – including through the Credit Counseling and Debt Management Agency (Agensi Kaunseling dan Pengurusan Kredit, AKPK) – to household borrowers who still face financial challenges. Bankruptcy action continues to be the last resort for banks, after exhausting all other debt rehabilitation and recovery efforts. Under a stressed scenario incorporating additional borrowing costs and basic expenditure shocks, household impairments could rise a little more from previous stress tests conducted. However, most households would remain resilient as would the banking system.

Banking system profitability continued to recover in the first half of 2022 on the back of a pick-up in lending and lower credit costs. Strong liquidity positions of banks, as reflected in the Liquidity Coverage Ratio of 148.3% and Net Stable Funding Ratio of 118.5%, are also helping to keep funding costs low. This is sustaining net interest margins despite prospects of greater competition for higher-cost fixed deposits and repricing of deposits due to OPR hikes. Credit costs have fallen by 24 bps since December 2021, but remain above pre-pandemic levels as banks continue to be vigilant over the emergence of credit losses from borrowers who have been more severely affected by the pandemic. The share of loans under repayment assistance has correspondingly declined from pandemic-level highs to just 7.2% of total banking system loans. The ratio of impaired loans in the banking system also remains low at 1.8%. While higher interest rates and costs of living could see defaults rise further for some borrowers in the second half of 2022, the increase in overall impairments is expected to be modest given normalisation of economic activities and improving labour market conditions. Provisions by banks for potential credit losses are nevertheless

likely to remain elevated throughout the year as banks continue to observe repayment trends for borrowers who have exited the repayment assistance programmes before unwinding provisions. Importantly, banks' capital buffers remain strong, with the total capital ratio of the banking system at 18.0% as at end-June 2022 and excess capital buffers above the regulatory minimum amounting to RM122.9 billion.

Overall profitability for insurance and takaful funds declined in the first half of 2022 driven by weaker investment performance of life insurance and family takaful funds. In contrast, income from underwriting activity in the life and family takaful funds improved on the back of stronger new business growth which has seen premiums mostly recover to pre-pandemic levels. For the general insurance and takaful funds, operating results were adversely affected by the major flood events in the beginning of the year and higher motor claims as mobility returned to normal conditions. Despite their sizeable exposures to market risks from their bond and equity holdings, insurers and takaful operators (ITOs) remain resilient to the potential adverse impacts from heightened financial market volatility. The performance of ITOs going forward is also expected to reflect the continued normalisation of claims experience, rising medical and motor claim costs, and more frequent and severe physical events such as floods which could weigh on profitability. ITOs are expected to remain resilient against these risks, supported by strong capital positions. The aggregate capital adequacy ratio of ITOs stood at 224% with excess capital buffers above the regulatory minimum at RM35.8 billion as at June 2022. As part of ongoing efforts to preserve a sound capital framework for ITOs, the Bank has embarked on a multiphase review of the capital adequacy requirements for ITOs.

The strong buffers of banks and ITOs will continue to preserve the resilience of financial institutions against potential unexpected losses, enabling them to support households' and businesses' financing and protection needs as economic activities resume. This is further affirmed by the Bank's stress tests that have incorporated additional shocks from a further tightening in global and domestic financial conditions and ringgit depreciation. Post-shock aggregate capital ratios as at end-2023 remain comfortably above

regulatory minimum levels at 15.4% for banks and 209% for ITOs.

Ensuring operational and cyber resilience of financial institutions continues to be a high priority for the Bank and financial institutions. Financial institutions are directing significant resources to maintaining strong cyber defences and technology risk controls. Given the evolving nature of these risks, the Bank continues to work closely with the industry, key agencies and law enforcement authorities to address emerging threats and enhance the financial industry's capacity to recover from a

range of operational incidents. This includes ensuring the practical ability of financial institutions and payment system operators to effectively execute cyber incident response plans under simulated live tests. Financial institutions have also been required to implement additional countermeasures against online banking fraud. In parallel, the Bank is coordinating efforts with the industry, Royal Malaysia Police (RMP) and Malaysian Communications and Multimedia Commission (MCMC) to further improve fraud incident response and recovery efforts, as well as to educate the public on using digital financial services safely.