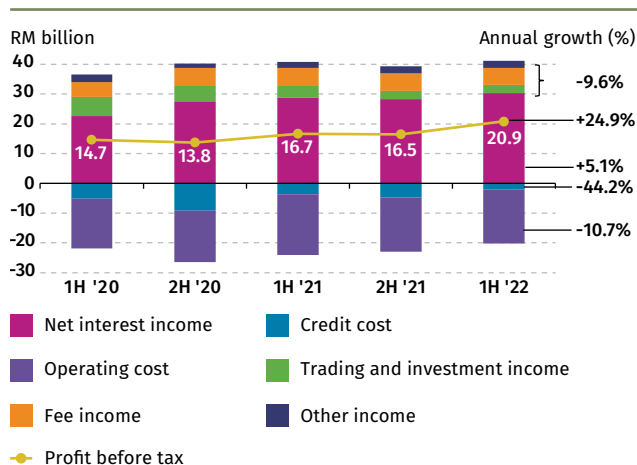


rose to 1.3% and 11.8% (December 2021: 1.1% and 9.5%), respectively. Market valuations of listed banks, as measured by the price-to-book (P/B) and price-to-earnings (P/E) ratios, however, have trended slightly lower (Chart 2.14). This reflected the weaker overall sentiment in the domestic equity market despite a more favourable outlook for the performance of banks. Looking ahead, some downside risks remain for the performance of banks. Increased competition

from existing players as well as emergence of new products and players (e.g., digital banks, e-wallets and BNPL lenders) in the market, may dampen potential upsides to banks' profits. Continued monetary policy tightening in major economies and heightened global bond market volatility could also have spillover effects to Malaysia's bond markets. This in turn could weigh on banks' trading and investment income (June 2022: 6.9% of banking system's total income).

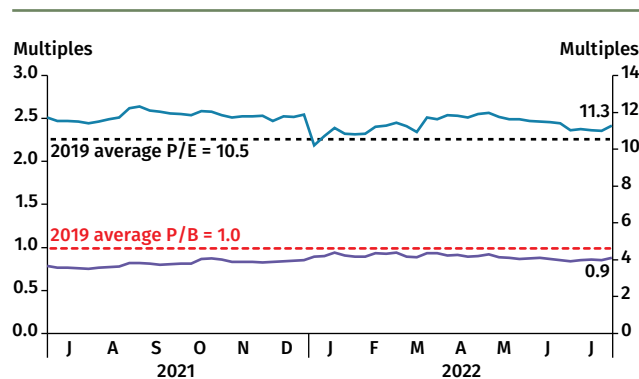
Chart 2.13: Banking System – Income, Cost and Profit before Tax



Note: 1. Annual growth computed based on figures for 1H 2021 and 1H 2022.
2. Figures may not add up due to rounding.

Source: Bank Negara Malaysia

Chart 2.14: Banking System – Price-to-Book and Price-to-Earnings Ratios of Publicly Listed Banks in Malaysia



Note: Refers to the median ratio of all publicly listed banks in Malaysia.

Source: Bloomberg

Despite a Significant Decline in Profitability During the Pandemic, Banks Continued to Support the Economic Recovery

Introduction

Banks' profitability matters for financial stability. Well-capitalised banks with healthy levels of profitability can insulate the real economy from financial downturns while loss-making banks amplify and worsen negative shocks to the economy. Capital buffers allow banks to absorb unexpected losses and sustain financial intermediation during periods of economic uncertainty. These buffers are primarily replenished through retained earnings, which are mainly driven by profits. Banks with a track record of healthy profitability will also find it easier to raise fresh capital and funding from financial markets. Conversely, banks experiencing falling profitability may struggle to replenish capital buffers, affecting their willingness and capacity to lend. Some may instead choose to adopt riskier strategies to boost profits, increasing the risks to financial stability.

A profitable banking system also sustains a broader ecosystem. In Malaysia, large non-bank financial institutions¹ (NBFIs) are substantial shareholders in the banking sector (NBFIs' holdings of bank shares, as % of listed equity of banks: 37.8%). Stable banking system profitability translates into steadier dividend pay-outs, which ultimately benefit households that save with NBFIs.

This article reviews the performance of the banking sector during the COVID-19 pandemic and related observations on banks' risk-taking behaviour.

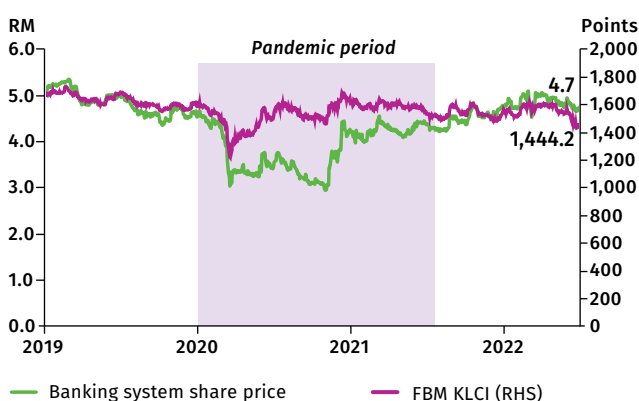
¹ Refers to entities undertaking investment activities through the management of public funds, collective investment schemes and retirement funds, that are not under the purview of the Bank.

Banks underwent significant stress during the pandemic

Malaysian banks entered the pandemic with strong capital buffers and healthy profitability. Nevertheless, all banks experienced a significant adverse impact on their profits at the onset of the pandemic as economic activity came to a halt. Market confidence in the banking sector, as reflected by the median share price of publicly listed banks also plunged to its lowest levels since the Global Financial Crisis due to the uncertain credit risk environment (Chart 1).

At the end of the first year of the pandemic, the return on equity (ROE) of the banking system fell to 8.3% in March 2021, a record low, from 12.2% at end of December 2019 (Chart 2). This decline in profitability was observed in all banks. The repeated lockdown of the economy affected banks' lending activity and hence reduced banks' net interest income significantly, which is a key source of earnings for banks. Of note, the contribution of net interest income to banks' gross income increased during the pandemic (net interest income as % of banking system income, June 2022: 73.6%; 2019: 71.4%), driven by falling non-interest income. As noted in our 2019 review,² a significant proportion of fee-based revenue is from the provision of ancillary services linked to loan disbursement. This dropped in line with reduced credit demand during the pandemic. At the same time, banks set aside more loan loss provisions to account for the uncertain credit risk environment during the implementation of loan moratorium, leading to further declines in banks' profitability. This was further compounded by modification losses³ associated with broad-based repayment assistance measures introduced to ease cash flows of households and SMEs during the earlier phases of the COVID-19 pandemic.

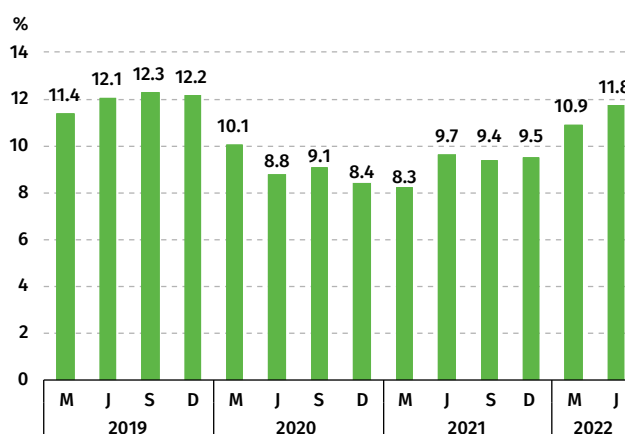
Chart 1: Banking System – Share Price of Publicly Listed Banks in Malaysia and FBM KLCI



Note: Refers to the median ratio of all publicly listed banks in Malaysia.

Source: Bloomberg

Chart 2: Banking System – Quarterly Return on Equity



Source: Bank Negara Malaysia

Investor appetite for banking sector stocks also suffered significantly in 2020

Before the pandemic, the industry's median price-to-book (P/B)⁴ ratio of publicly listed banks was already on a gradually declining trend, driven by falling profitability and higher capital requirements. The uncertain credit risk outlook and the challenging operating environment during the pandemic exacerbated this long-term decline, commensurate with the sharp fall in banks' profitability ratios. Listed banks' median P/B ratio fell to its all-time low at 0.59 times in October 2020 before rebounding to 0.78 times by the end of 2020 (December 2019: 0.91 times) (Chart 3). More recently in 2022, the median P/B ratio moderated, reflecting increased investors' uncertainties over the impact of volatile markets on banks' trading income.

² Refer to the Information Box on 'Malaysian Banks' Profitability – Past Trends and Future Prospects' in the BNM Financial Stability Review for First Half 2019 for further details.

³ Modification losses refer to the one-off adjustment cost arising from the loan moratorium due to changes in the carrying amount and interest income post-modification. Based on MRFS 9, the gross carrying amount must be recalculated at the present value of the modified contractual cash flow, resulting in the recognition of modification losses.

⁴ Price-to-book (P/B) ratio is a market measure of bank equity relative to book values and offers a measure of banks' franchise value. A P/B ratio greater than one signals investor confidence in a company's earnings capacity and that the market is willing to pay more per share than the value of the company's net assets. Conversely, a P/B ratio below one suggests investor concerns about shareholder value.

The lower median P/B ratio during the pandemic reflected investor concerns on banks' earnings capacity and potential for unrecognised losses, given repeated repayment assistance measures along with a lack of visibility over asset quality. P/B ratios rose in 2021, as greater visibility started to emerge on banks' credit risk exposures with the transition to more targeted repayment assistance. Prudent provisioning practices of banks together with various regulatory support measures provided further confidence in banks' capacity to 'weather the storm'.

Banks' risk-taking behaviour remained relatively consistent throughout the pandemic

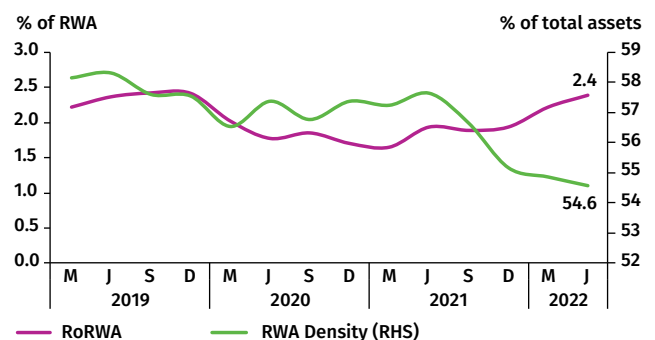
Despite the challenging operating conditions during the pandemic, banks did not dramatically change their risk-taking behaviour. Similar to ROE, banks' return on risk-weighted assets (RoRWA)⁵ also declined throughout 2020, falling from the pre-pandemic level of 2.42% to 1.71% by the end of 2020 (Chart 4). RWA density,⁶ a proxy for absolute risk-taking levels, did not change significantly throughout 2020, although it did exhibit some increased volatility. This suggests that the lower earnings during the pandemic played a more decisive role in the decline of RoRWA rather than any significant changes in banks' risk-taking behaviour. This is consistent with the countercyclical role that banks were able to play during the pandemic due to their strong buffers (further elaborated below). RWA density did, however, fall in the second half of 2021, driven by lower risk-weighted assets. In an environment of ample liquidity and low credit demand, banks placed excess funds in government securities which are prescribed a low-risk weight. At the same time, management judgments applied under existing regulatory capital and accounting standards helped to prevent undue stress on banks' capital reserves.

Chart 3: Banking System – Median Price-to-Book Ratio of Publicly Listed Banks in Malaysia



Source: Bloomberg

Chart 4: Banking System – Return on Risk-Weighted Assets (RWA) and RWA Density



Source: Bank Negara Malaysia

The strong pre-crisis capital positions of banks was an important factor behind the relative stability observed in banks' risk-taking behaviour during the challenging operating environment of the pandemic. Most banks entered the crisis with significant capital headroom above regulatory requirements. This enabled banks to take short-term hits to profitability, while still preserving their capacity to lend and support the economy once the economic recovery began, without compromising their long-term risk profiles. While banks were more cautious in lending to new borrowers, there was no broad-based pullback of credit lines to existing borrowers. During this period, most banks also lowered dividend distributions and implemented dividend reinvestment programmes to preserve capital buffers. The prudent management of risks by banks during the pandemic and improvement in the outlook for banks along with the broader economy are expected to shore up the long-term franchise values of banks. This is despite continued downside risks noted in this chapter. Importantly, the continued resilience of banks will preserve their countercyclical role during times of stress.

⁵ RoRWA, where the denominator is the risk-adjusted measure of total banking system assets, reveals the cost efficiency per unit of risk a bank is currently generating, where low values may signal higher risk-taking levels amongst banks through higher RWA.

⁶ Risk-weighted assets density is defined as the ratio of total RWA over total assets, as a proxy for banks' absolute risk-taking levels. A higher density suggests higher risk-taking activity.