Banking

BNM Financial Stability Review 1H19

OVERWEIGHT

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The Financial Stability Review highlighted the quality and resilience of the domestic banking system. Asset quality from both Households and Business looks contained with debt servicing and interest coverage ratio remaining prudent and comfortable. Capital Buffers are more than adequate with stress test showing that Capital Ratios will be well above the regulatory requirements in the event of adverse shocks. While we see moderate loans growth ahead, the resilient asset quality translates to stable credit cost, sustaining profitability. However, valuations are attractive and undemanding with most of the banking stocks under our coverage rated as OUTPERFORM with Top Picks are CIMB and ABMB.

BNM released its 1H19 Financial Stability Report yesterday emphasising again the soundness, stability and resilient of the domestic banking system. The financial sector remains resilient amid the moderation in loans growth with market conditions that remained orderly despite increased volatilities due to trade conflict and geo-political tensions. Funding condition was stable, supported by sound domestic institutional investors. However, vigilance continued on household and corporate debts due to the heightened volatility in global markets as housing market shows signs of recovery but with risks remaining elevated in commercial property segment.

Households' resilience remains intact with Household assets exceeding debt. Household debt-to-GDP rose 20bps (2018: 82%) to 82.2% as debt grows at 5.1% YoY (vs 2018: +4.7% YoY) but outpaced by growth in household financial assets at +6.8% (vs 2018: +5.1% YoY). Aggregate debt repayment capacity remained strong as aggregate level of household assets exceeded debt at 4.1x (2018: 4.1x) with household financial assets at 2.2x of debt. Two-third of these financial assets is in the form of liquid financial assets such as deposits and unit trust funds. Exposures of banks and NBFIs to the more vulnerable segment (borrowers whose earnings are <RM3k/month continued to decline (-80bps to 18.5% of household debt) but remained a concern as their outstanding debt to annual income rose 8.9x (vs 2018: 8.8x) due to ease of borrowing from various loan scheme introduced in recent years. These group remains susceptible to financial distress given their limited financial buffers to weather potential shocks.

Risks from household debt contained. Impairment ratio for Banks and NBFIs saw a 10bps uptick in 1H19 to 1.3% (2018: 1.2%) but still below its 5-year average of 1.5%. Default incidents by housing borrowers continued to increase, most prevalent among (i) loans >RM500k and (ii) borrowers with greater variability in their monthly income. However, risks to the financial system remained low as these borrowers accounted for only 6.2% of total household lending with only 0.9% of such loans being classified by banks and DFIs as impaired.

Housing transaction remained strong led by affordable housing. Recovery seemed to be in the cards for the housing market with transaction volume growth of +7.5% YoY (vs 4Q18: +2.0% YoY) and growth in value at +10.6% YoY (vs 4Q18: +3.3% YoY). Housing priced <RM300k led the growth in volume at 4.3% YoY in 1Q19 (vs 2018: 0.8% YoY) followed by the >RM300k to 500k range at +2.4% YoY (vs 2018: +1.1% YoY). However, market conditions remained soft with housing price index falling to +1.3% YoY in 1Q19 from +2.6% YoY in 4Q18. Unsold units rose 5.3% YTD with 68% of these unsold units coming from properties valued at >RM300k and with 67% coming from high rises.

Oversupply in the office and commercial space (OSSC) likely to persist but banks' exposure remained low. Incoming supply of office space in the Klang Valley remained at a sizeable 36.3m square feet with an average of 4.4m square feet/annum expected to add to the market supply between 2019 and 2021 (higher than the 3-year average of 2.3m square feet/annum. Incoming supply of shopping complexes in key states stood at 140 units amounting to 67.8m square feet of new retail space. Vacancy rates of OSSC and retail space in major cities in Malaysia are higher than peers' average; thus, risks of downward adjustment to prices of retail and office space remain elevated. However, banks' exposure to the OSSC segment accounts for 3.4% of total outstanding loans, and 4.6% of holdings of bonds and sukuk and continue to be largely performing.

Applications for higher-end financing increasing but overall loan impairment ratio remained stable. Financial Institutions exposure to the property sector in 1H19 moderated, at +5.7% YoY growth (vs 2018: +6.6%). Demand for home financing continued to support credit growth with stronger growth in financing applications for residential properties priced <RM1m (1H19: +12.7% YoY vs 2018: +1.3% YoY). Growth in non-residential properties was at +2.7% YoY for 1H19 (vs 2018: 2.3%) driven by end-financing for purchase of shops and shopping complexes. Sound lending practises continued to mitigate risks from potential adverse developments in the property market. Loan impairment ratio for purchase of residential, non-residential and OSSC remained low at 1.1%, 1.4% and 2.1% for 1H19 (vs 2018: 1.1%, 1.4% and 2.1%) respectively. 83% of residential property loans were for owner-occupiers who have stronger incentive to maintain loan repayments than speculators/investors. Furthermore 69% of outstanding loans have LTV of <80%, providing buffer against potential losses from defaults in the event of an adverse price correction. Based on the Bank's sensitivity analysis, banks continued to maintain sufficient capital buffers to absorb 1.5x potential losses under severe stress scenarios (*referring to 50% earnings shock on large corporate borrowers and 50% decline in property prices*).

Corporate sector risks contained. Non-financial corporate (NFC) debt expanded moderately at +3.6% YoY for 1H19 to RM1,509b or 102% of GDP reflecting higher business loan repayments amid uncertain economic conditions. Financing growth was largely underpinned by sustained activities in construction, manufacturing and wholesale & retail trade sectors amid rationalisation of public infra projects by the government. NFC external debt which accounted for a quarter of total NFC debt and GDP grew at a slower pace at +2.9% YoY (vs 2018: +7.5% YoY). Risks from external debt remained contained; (i) as 78% of external borrowings are of medium to longer term tenures, (ii) 51% are intercompany loans and trade credit facilities, and (iii) 75% of approved offshore borrowings are hedged. Overall Gross Impairment Ratio for Business remained unchanged at 2.6% (vs 5-year average of 2.6%) with SMEs at 2.7% (vs 5-year average of 2.7%). Debt servicing capacity remained intact with NFC's debt-to-equity ratio at 24.9% for 1H19 (vs 2018: 24.7%). While interest coverage ratio slipped to 4.5x in June 19 (vs 2018: 4.8x) cash-to-short-term debt ratio rose to 0.9x (vs 2018: 0.8x). Financial institutions' exposures to large borrower groups decreased slightly to 42.1% (vs 2018: 42.7%). Under a stress scenario of significant pressure on earnings, the median interest coverage ratio of large borrower groups would stand at a prudent threshold of 2.0x (vs 2018: 2.2x). In the event of all stimulated shocks (up to 30% of Ringgit depreciation, 50% decline in operating profit and 50 to 100 bps increase in borrowing costs) , ICR of these large borrowers would fell to 1.8x. Notwithstanding this, banks' excess capital buffers (RM103b) are sufficient to cover 2.3x the potential credit losses. Under BNM's adverse stress tests scenarios, banks will likely suffer a capital reduction of 300bps with CET1 slipping to 10.5% from the present 13.4%, thus well above the regulatory requirements of 4.5%

Resilient Financial Buffers. The system liquidity remained stable with Liquidity Coverage Ratio (LCR), Loan-to-Fund-ratio (LTF) and Loan-to-Fund-and-Equity Ratio (LTFE) at 153%, 83% and 72% (vs 2018: 143%, 83% and 73%) respectively. Loan loss coverage ratio remained resilient at 127% with 85% of the banks complied with the NSFR compliance by 1 July 2020. NSFR in the banking system stood at 108% as at June 2019.

No change to our views of moderate loans ahead with growth driven by the resilient household as income and employment outlook continues to be stable. In view of prevailing volatilities, banks will still maintain selective asset quality, with the stable system asset quality seeing continued resilient demand from households especially loan demand for residential property and personal financing (from quality borrowers). Affordable housing (<RM500k) will be the key driver of mortgage loans given the lower risks perceived from this segment. The stable asset quality supported by resilient employment and stable economic conditions will support higher approvals given the low interest rate environment with default risk likely mitigated. Given that risks are contained, we maintained our OVERWEIGHT call on the sector due to the undemanding valuations and the sector likely to benefit from a low interest rate environment that will spur fiscal stimulus/spending. We have an **OUTPERFORM** call for most of the banking stocks with the exception of HLBANK (TP: RM17.30) which we deemed at MARKET PERFORM. Among the **OUTPERFORM call, our Top Pick**s **are i) CIMB** – benefiting from fiscal/infra spending especially coming from Indonesia **and ii) ABMB** – cheap valuation and potential for a M&A.

Table 1: Solvency Stress Tests – Key Assumptions and Shock Parameters Applied under Assume Adverse Scenarios

Key assumptions	AS1 – V-shaped recession	AS2 – L-shaped, protracted recession
Balance sheet and income projections		
o Decline in loan growth (compounded annual growth rate)	o 3%	o 6%
o Annual decline in banks' income growth, differentiated across segments (interest income, fee-based and other income)	o Up to 21%	o Up to 17%
o Annual decline in insurers' premium income	o Up to 30%	o Up to 28%
Credit risk shocks		
o Probability of default (PD) shocks		
• Business loans	• 5% to 10%	• 5% to 12%
• Household loans	• 1% to 11%	• 2% to 13%
o Loss given default (LGD) shocks		
• Business loans	• 44% to 56%	• 44% to 61%
• Household loans	• 18% to 76%	• 19% to 76%
o Default of top corporate borrowers with large borrowings from the financial system	o Corporations that have weak financial standings (below prudent thresholds) under simulated shocks	
Market risk shocks		
o Annual increase in MGS yields	o Up to 56 bps	o Up to 62 bps
o Annual increase in corporate bond yields	o Up to 72 bps	o Up to 71 bps
o Annual decline in FBM KLCI	o Up to 34%	o Up to 23%
o Annual depreciation against major currencies	o 13% to 30%	o 6% to 15%
External funding risk shocks	o Up to 30% of interbank borrowing and deposits	o Up to 15% of interbank borrowing and deposits
o Reversal of claims by non-residents		
General insurance risk shocks		
o Increase in claims ratio	o Up to 30%	o Up to 16%
Contagion risk shocks		
o Interbank	o Deterioration in counterparty bank's solvency	
o Banks to insurers	o Deterioration in value of bonds issued by banks that fail the stress test under the adverse scenarios	

Source: BNM

Chart 1: Household Sector – Annual Growth of Debt

Growth of household debt increased

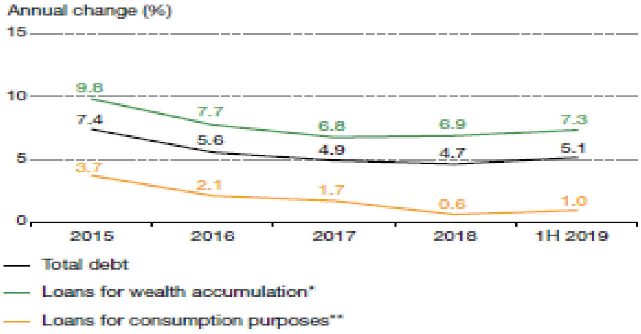


Chart 2: Household Sector – Key Ratios

Higher debt- and financial asset-to-GDP ratios amid slower nominal GDP growth

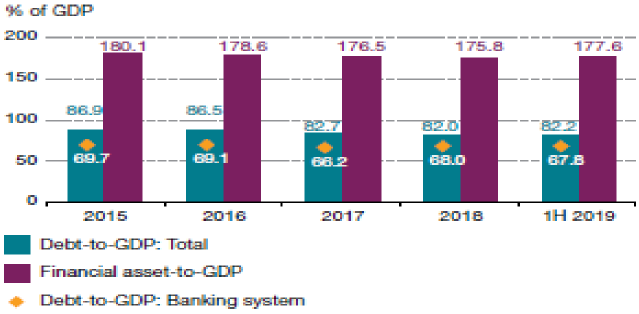


Chart 3: Household Sector – Debt and Financial Assets

Household financial assets continued to expand faster than debt

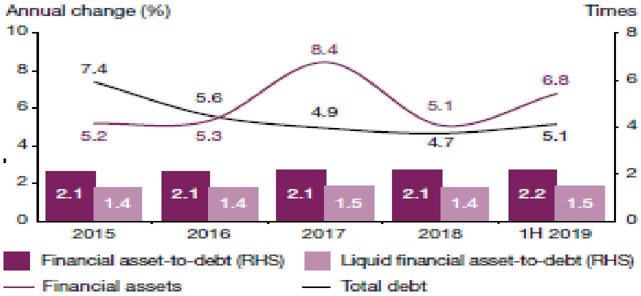
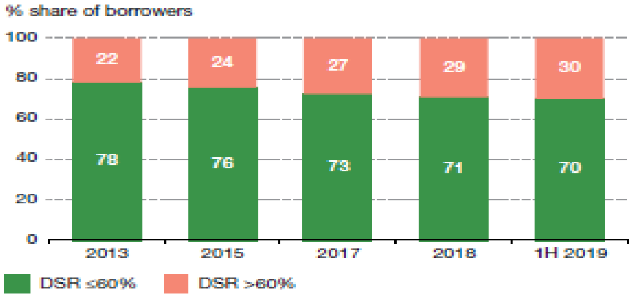


Chart 4: Household Sector – Borrowers with Newly-Approved Loans by DSR

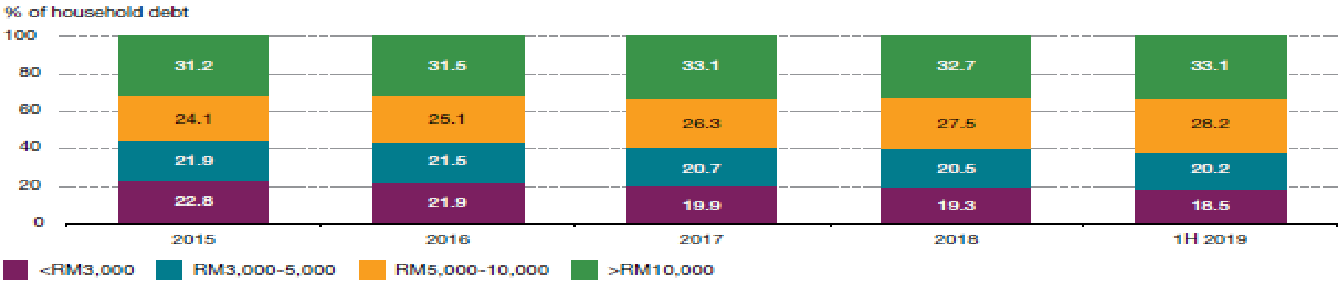
Share of borrowers with DSR exceeding 60% has increased since 2013



Source: BNM

Chart 5: Household Sector – Debt by Monthly Income Group

Exposures to vulnerable borrowers continued to decline



Source: BNM

Chart 6: Property Market – FIs exposure to the Property Market

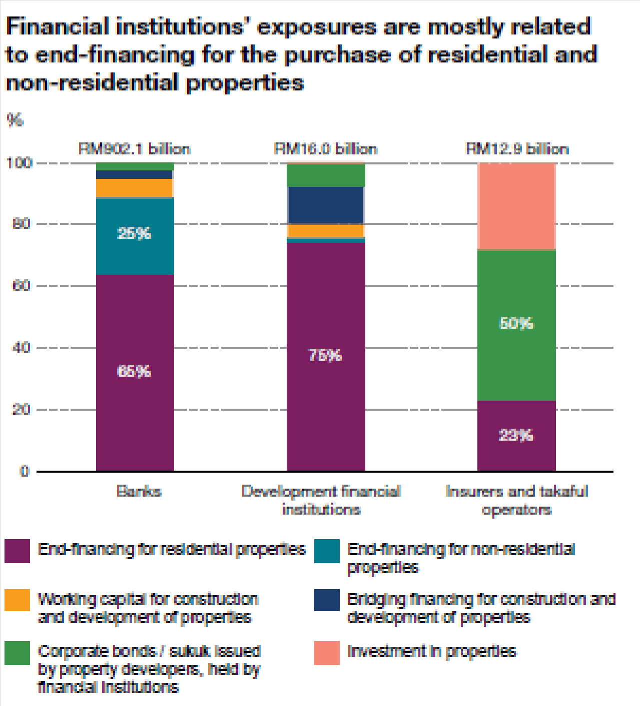
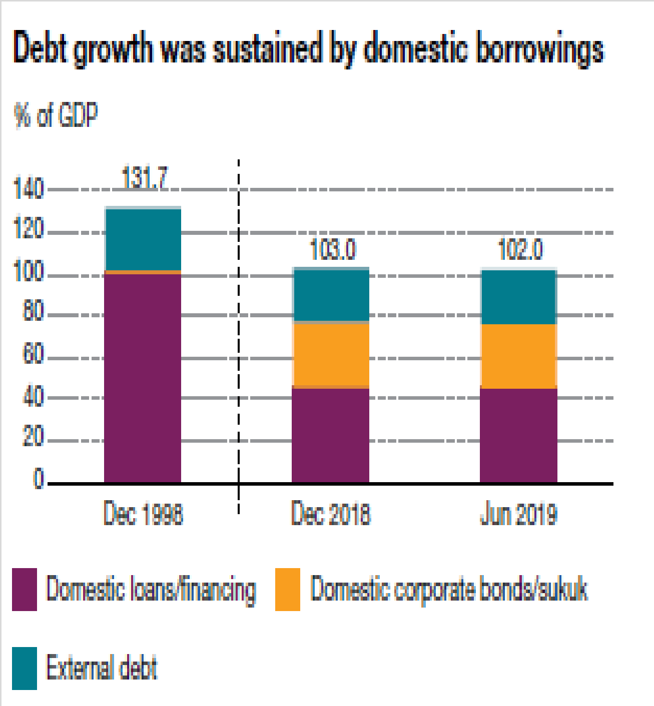


Chart 7: NFC Debt-to-GDP ratio



Source: BNM, Kenanga Research

Chart 8: Property Market – Housing Transactions

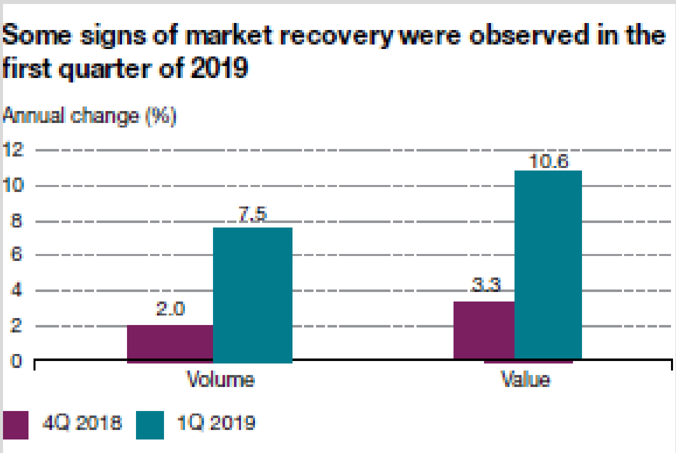
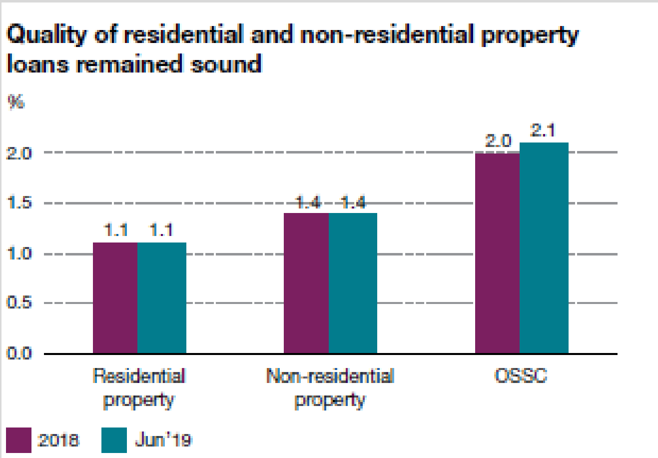


Chart 9: Property Market – Loan Impairment Ratios for End-Financing segment



Source: BNM

Peer Comparison

Name	Last Price (RM)	Market Cap (RM'm)	Shariah Compliant	Current FYE	Revenue Growth		Core Earnings Growth		PER (x) - Core Earnings			PBV (x)		ROE (%)	Net Div Yld (%)	Target Price (RM)	Rating
					1-Yr. Fwd.	2-Yr. Fwd.	1-Yr. Fwd.	2-Yr. Fwd.	Hist.	1-Yr. Fwd.	2-Yr. Fwd.	Hist.	1-Yr. Fwd.	1-Yr. Fwd.	1-Yr. Fwd.		
BANKING																	
AFFIN BANK BHD	1.99	3,952.2	N	12/2019	4.1%	2.9%	15.0%	15.8%	7.9	6.8	5.9	0.5	0.4	6.5%	2.8%	2.45	OP
ALLIANCE BANK MALAYSIA BHD	3.04	4,706.2	N	03/2020	5.9%	7.2%	-1.5%	10.9%	8.8	8.9	8.0	0.8	0.8	9.0%	5.4%	3.45	OP
AMMB HOLDINGS BHD	4.11	12,388.3	N	03/2020	10.4%	4.5%	-0.4%	2.8%	8.2	8.3	8.0	0.7	0.6	7.8%	4.9%	4.75	OP
BIMB HOLDINGS BHD	3.96	6,986.6	Y	12/2019	10.0%	6.6%	7.6%	13.6%	10.2	9.8	9.0	1.4	1.3	14.0%	4.1%	4.80	OP
CIMB GROUP HOLDINGS BHD	5.01	48,734.4	N	12/2019	4.6%	5.0%	-16.2%	2.6%	8.4	10.4	10.4	0.9	0.8	8.5%	4.5%	6.45	OP
HONG LEONG BANK BERHAD	16.50	35,767.3	N	06/2020	4.1%	5.1%	1.0%	0.5%	12.8	12.7	12.6	1.4	1.3	10.8%	3.0%	17.30	MP
MALAYAN BANKING BHD	8.70	97,799.8	N	12/2019	3.8%	4.3%	-2.2%	4.7%	11.8	12.1	11.6	1.2	1.1	9.7%	6.5%	9.70	OP
MALAYSIA BUILDING SOCIETY	0.85	5,706.4	N	12/2019	-4.2%	4.5%	-17.8%	8.6%	8.5	10.3	9.9	0.7	0.7	6.7%	5.9%	1.10	OP
PUBLIC BANK BERHAD	20.16	78,263.9	N	12/2019	3.9%	5.2%	-0.1%	3.5%	13.9	13.9	13.5	1.9	1.9	13.7%	3.4%	25.20	OP
RHB BANK BHD	5.62	22,536.5	N	12/2019	6.0%	4.8%	3.7%	5.7%	9.8	9.4	8.9	1.0	0.9	9.9%	3.7%	6.05	OP
Simple Average					**4.9%**	**5.0%**	**-1.1%**	**6.9%**	**10.0**	**10.3**	**9.8**	**1.0**	**1.0**	**9.7%**	**4.4%**		

Source: Bloomberg, Kenanga Research

Stock Ratings are defined as follows:

Stock Recommendations

OUTPERFORM	: A particular stock's Expected Total Return is MORE than 10%
MARKET PERFORM	: A particular stock's Expected Total Return is WITHIN the range of -5% to 10%
UNDERPERFORM	: A particular stock's Expected Total Return is LESS than -5%

Sector Recommendations***

OVERWEIGHT	: A particular sector's Expected Total Return is MORE than 10%
NEUTRAL	: A particular sector's Expected Total Return is WITHIN the range of -5% to 10%
UNDERWEIGHT	: A particular sector's Expected Total Return is LESS than -5%

******Sector recommendations are defined based on market capitalisation weighted average expected total return for stocks under our coverage.***

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