20 March 2014 | Sector update

BANKING: 2013 Financial Stability and System Payment Report - *Financial Sector remained resilient*

***Maintain* NEUTRAL**

KEY HIGHLIGHTS

We attended BNM's briefing for its 2013 Annual Report and Financial Stability and System Payment Report. Below are the key highlights from the briefing.

- **BNM expects domestic financial stability to be maintained despite of a rise in household debt to 86.8% of GDP in 2013 (2012: 80.5%) as substantial portion of the financing were for purchase of assets.** Risk to domestic financial stability has been well contained. Fundamentals of households and financial sector have been strong while prudential measures are already in place to rein in household debts. Of the total lending to households, in circa 60.0% of the financings were for purchase of assets (purchase of residential properties, investment in equities and unit trust). In 2013, household financial assets grew 11.2%yoy, close that of household borrowings of 11.7%yoy. Ratio of households' financial asset to debt was stable at 2.2x in 2013 as in the case of 2012.
- **Growth of household debt moderated in 2013 and was the slowest since 2010.** Household loans grew at a slower pace of 11.7%yoy as compared to 13.5%yoy in 2012. This was contributed by slower loan growth of Non Bank Financial Institutions' (NBFIs) loans in 2H2013 after measures have been implemented to limit the maximum tenure for housing loans and personal financing to 35 years and 10 years respectively. Growth of loans extended by NBFIs to the household sector declined significantly to 9.6%yoy in 2013 as compared to 22.1%yoy in 2012. NBFIs' personal financing growth decelerated to 13.9% as at end 2013 vs. 25.0% in 1H2013. Average leverage of low income borrowers with monthly earnings of up to RM3,000 remained stable at 7x.
- **BNM comfortable with the quality of loans underwritten and on the affordability assessments by Banks.** We gather that the average debt servicing ratio (DSR) for new loans approved has been prudent at less than 40.0%. Banks have been more prudent in loan documentation to verify income eligibility for loans. Also, Banks were found to have applied conservative assumptions in assessing the the variable income of borrowers. To improve risk profiling, we understand that work is in progress to integrate the datas of Central Credit Reference Information System (CCRIS) with that of Inland Revenue and EPF.
  BNM has increased its scrutiny of valuation practices due to the rise in property prices. It found that valuation standards on the overall have been sound. Formal valuations continue to be required by Banks to support approved loan amounts in line with their internal Loan-to-Value (LTV) ratio policies. It was also found by BNM that lower LTV ratios have applied by Banks for financing the purchase of properties in locations where prices have risen substantially and for higher credit risk profile borrowers.

  To increase buffers against future losses, BNM has required Banks to maintain collective impairment provisions and regulatory reserves of a minimum 1.2% against outstanding loans (net of individual impairment provisions) by end 2015 as well as adopt risk based pricing in line with the Risk Informed Pricing Standards. BNM has stressed tested for expected losses in financing to the household sector. This included the most vulnerable group of borrowers with monthly income of up to RM3,000. It found that the Banking System has the ability to absorb losses (if any) comfortably.

Capital buffers of banks sufficient to absorb losses if a contraction in house prices by 40% occurs. BNM views that the high property prices has been contributed by structural mismatch with demand outstripping supply of new houses. Demographic factors and increased urbanization have led to the increase in demand for houses. Meanwhile, availability of affordable homes has been slow in materializing and house prices continue to remain high due to higher land and construction cost with the launch of higher end properties by developers. We gather that financing driven speculative purchases of properties have remained subdued. With prudential measures introduced by BNM and property measures implemented to cool down property prices, we expect property prices to remain at high levels but the growth of the prices will at a much slower pace than in the previous years.
Based on the findings of BNM, 84.0% of the housing loan borrowers only have one outstanding housing loan while the proportion of outstanding housing loans with LTV of more than 70.0% reduced to 46.6% in 2013 (2012: 50.1%). Also, the Banking System has capital buffer of more than 5x the estimated losses by Banks should there be a 40% contraction in property prices.

- **Credit risk from Business Sector borrowings remains unchanged**. Despite of the expansion of lending to the business sector albeit at slower rate of 10.4% in 2013 (2012: 12.7%), credit risk to the sector remain unchanged. Leverage position of businesses trended lower as attested by a lower debt/equity ratio of 39.7% in 2013 (2012: 41.3%). Debt servicing ability of businesses improved with an interest coverage ratio of 7.7x in 2013 (2012: 5.4x).

- **Volatility in domestic financial markets caused by capital outflows absorbed by domestic institutional investors.** The deeper financial markets and presence of domestic institutional investors (banks, pension and provident funds as well as insurance companies) have supported and absorbed the outflow of foreign funds from the sell-off of securities thus far.

- **Limited contagion risk from external development on Malaysia banking system.** As at end of 2013, the Banking System's CET1 ratio, CCR and RWCR was 12.1%, 13.0% and 14.4% respectively. Excess capital above the minimum required capital was RM79.3b. This represented a substantial loss absorption capacity of Banks. BNM views the potential impacts on Malaysia Banking System from the deleveraging activities by European financial institutions as low. It views Banks as well capitalized to weather through various stress scenarios and that financial institutions have made smooth transition to higher capital requirements in line with the Basel III.

WHAT LIES AHEAD

- Concept Paper on Liquidity Coverage Ratio (LCR) will be rolled out in mid 2014. We understand the average LCR of Banks was 90.0%. Most Banks have LCRs of above 100.0%. Official implementation of LCR on Banks will be in 2015.
- We understand that frameworks will also be rolled out later for enhancement in risk management standards of banks, corporate governance and capital standards for Financial Holding Companies (FHCs).

NOTABLE IMPLEMENTATION DATES FOR CHANGES IN BANKING SYSTEM

Implementation Date	Changes	Details of changes and our comments
Effective 2nd Jan 2015	New reference rate for retail floating rate loans	In line with the new reference rate framework, effective 2nd Jan 2015, Base Rate (BR) will replace with BLR as the reference for retail floating rate loans. Hence, come 2015, new retail loans will be quoted as BR + Spread instead of BLR - Spread. BR will encompasses Bank's Cost of Funds (COF) and Statutory Reserve Requirement (SRR) while the Spread will include other components of loan pricing such as credit risk, liquidity risk, operating cost and profit margin. Existing retail loans will still be pegged to BLR. This new framework only impacts new retail loans (mortgage loans) and does not affect the pricing for corporate loans. While Banks will have their own BRs due to different COFs, we believe that pricing for the floating rate retail loans will be closely matched to each other and will be in line with the market rate by varying the other pricing components in the spread. There will be no changes to the effective lending rate on retail loan borrowers and that the changes in new reference rate framework do not reflect any adjustments in monetary policy stance.
Effective 2nd Jan 2015	Charge of 50 sen to be imposed on cheques	The charge of 50 sen imposed on cheques initially announced to be implemented on 1 Apr 2014 has been deferred to 2 Jan 2015. This is to ensure that devices are in place to facilitate the acceptance of e-payments at the Federal and State Agencies nationwide.
Effective 30th June 2015	Islamic Banking deposits to be reclassified into investment accounts and deposits under ISFA	BNM has granted 2 year transition period until 30 June 2015 for the reclassification and segregation of Islamic Banking deposits under the repealed Islamic Banking Act 1983 into Investment accounts and Islamic deposits under the Islamic Financial Services Act (ISFA). Non capital guaranteed Islamic Deposits will subsequently be treated as Investments. In the interim period, all Islamic Banking deposits will remain guaranteed by PIDM. We believe that Islamic Banks are already taking steps to convert their existing Mudarabah deposits into either Commodity Murabahah or Wadiah deposits to comply with ISFA. The conversion from Mudarabah into Commodity Murabahah will attract transaction cost. We expect competition for Commodity Murabahah deposits to be more intense moving forward. This will add pressure to Islamic Banks COF and hence impact their NIM.

CALL ON SECTOR & STOCK PICKS

- **Maintain NEUTRAL for sector**. We continue to expect NIM pressures, normalizing credit cost and the volatile markets contributing to tougher operating conditions for IB and hence resulting in more challenges for non interest income growth of banks.

  Our BUY calls are on Maybank (TP: RM11.00), RHB Cap (RM9.50) and Hong Leong Bank (TP: RM16.50). We are NEUTRAL on AFG (TP: RM4.80), Public Bank (RM18.60), CIMB (TP: RM8.10), AMMB (TP: RM8.00) and Affin (TP: RM3.80).

	Rec.	Price @ 19/3	Target Price	EPS (sen)		PER		Net DPS		Net DivYield	
				14	15	14	15	14	15	14	15
AMMB	NEUTRAL	7.12	8.00	60.0	66.0	11.9	10.8	24.0	26.0	3.4	3.7
Maybank	BUY	9.57	11.00	77.0	84.0	12.4	11.4	46.0	50.0	4.8	5.2
Public Bank	NEUTRAL	19.16	18.60	125.0	135.0	15.3	14.2	60.0	65.0	3.1	3.4
RHB Capital	BUY	7.98	9.50	83.0	91.0	9.6	8.8	25.0	27.0	3.1	3.4
Hong Leong	BUY	14.08	16.50	106.0	117.0	13.3	12.0	35.0	39.0	2.5	2.8
CIMB	NEUTRAL	7.07	8.10	60.0	69.0	11.8	10.2	24.0	28.0	3.4	4.0
AFG	NEUTRAL	4.26	4.80	36.0	39.0	11.8	10.9	19.0	20.0	4.5	4.7
Affin	NEUTRAL	3.95	3.80	32.0	37.0	12.3	10.7	16.0	19.0	4.1	4.8

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MIDF AMANAH INVESTMENT BANK : GUIDE TO RECOMMENDATIONS	
STOCK RECOMMENDATIONS	
BUY	Total return is expected to be >15% over the next 12 months.
TRADING BUY	Stock price is expected to *rise* by >15% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -15% and +15% over the next 12 months.
SELL	*Negative* total return is expected, by -15% or more, over the next 12 months.
TRADING SELL	Stock price is expected to *fall* by >15% within 3-months after a Trading Sell rating has been assigned due to negative newsflow.
SECTOR RECOMMENDATIONS	
POSITIVE	The sector is expected to outperform the overall market over the next 12 months.
NEUTRAL	The sector is to perform in line with the overall market over the next 12 months.
NEGATIVE	The sector is expected to underperform the overall market over the next 12 months.