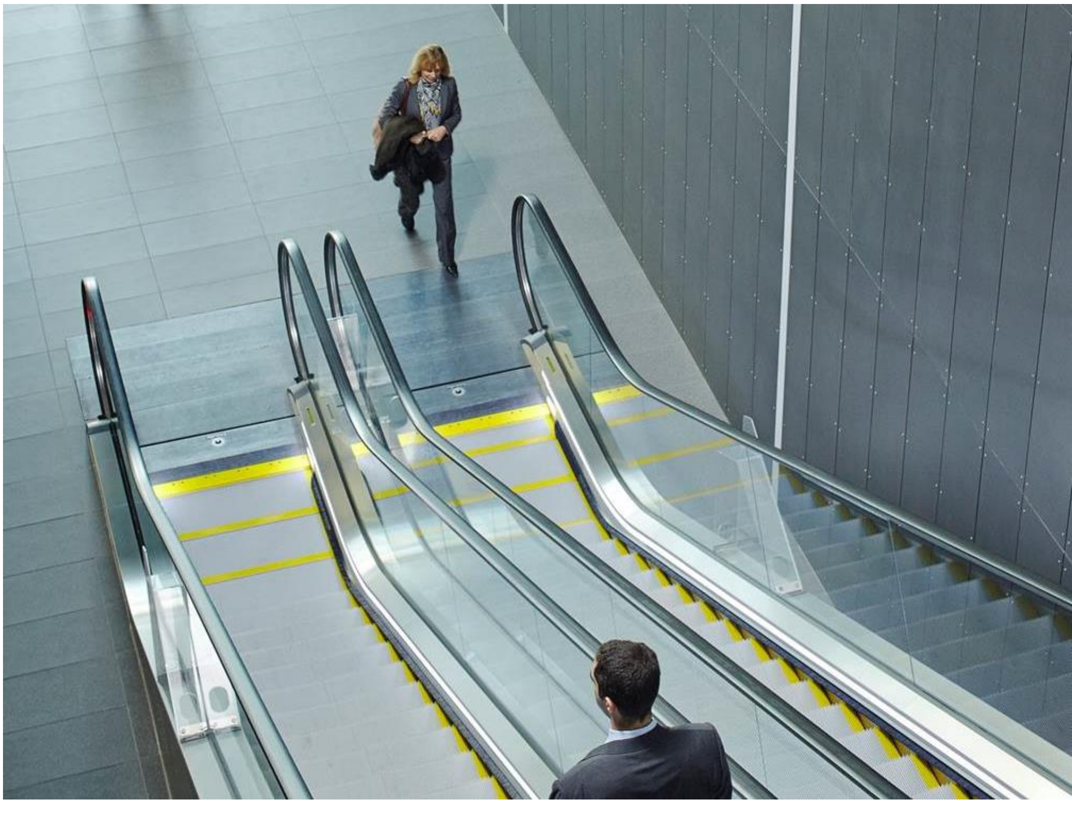
Banking Banana Skins 2014

Risks and opportunities: What's keeping Malaysian bankers on their toes



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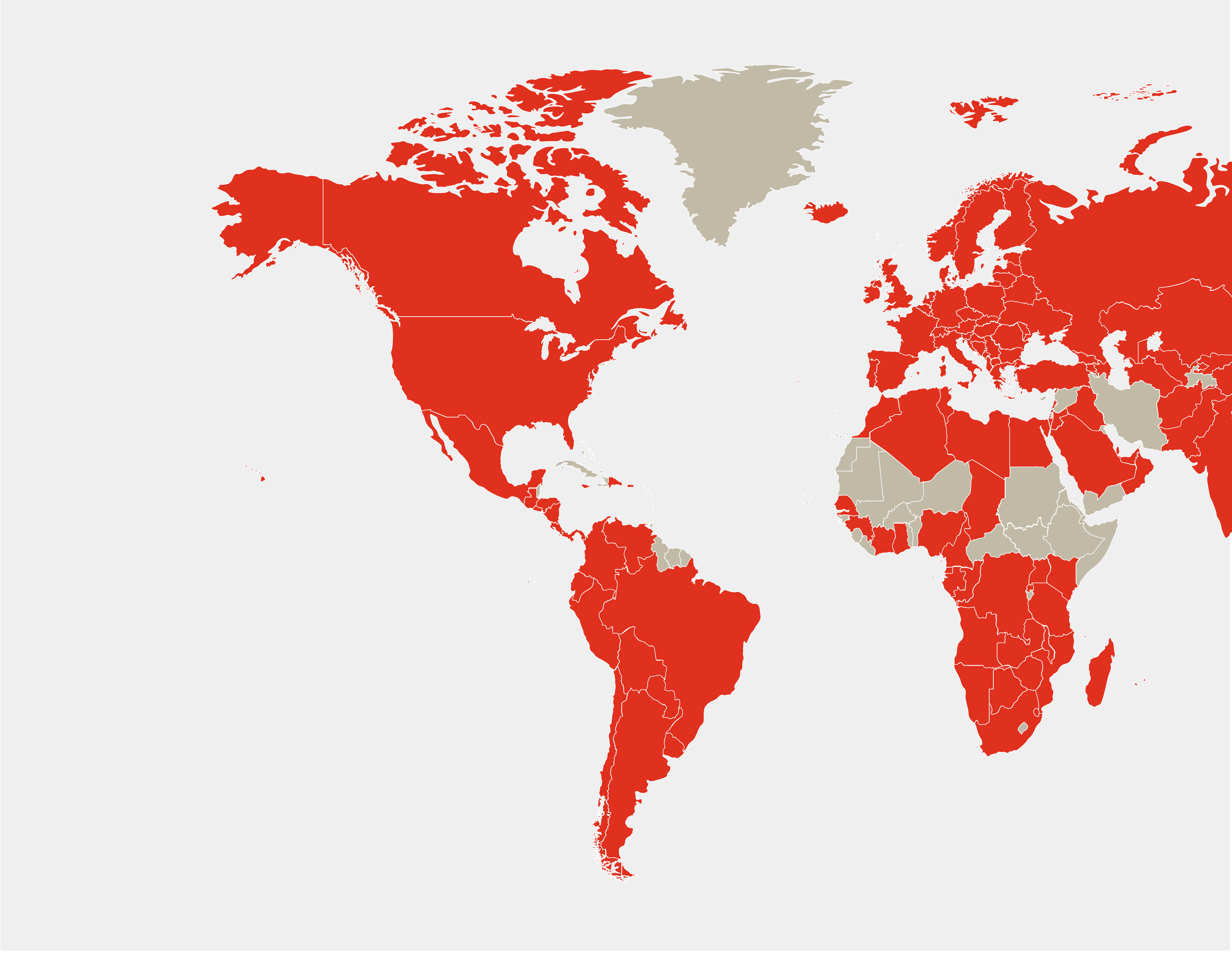


World		Malaysia	
1	Regulation	1	Macro-economic environment
2	Political interference	2	Interest rates
3	Macro-economic environment	3	Quality of risk management
4	Technology risk	4	Derivatives
5	Profitability	5	Human resources
6	Pricing of risk	6	Corporate governance
7	Credit risk	7	Credit risk
8	Corporate governance	8	Criminality
9	Criminality	9	Management incentives
10	Capital availability	10	Pricing of risk
11	Quality of risk management	11	Technology risk
12	Interest rates	12	Social sustainability
13	Back office	13	Back office
14	Change management	14	Emerging markets
15	Liquidity	15	Liquidity
16	Sales and business practices	16	Currency
17	Emerging markets	17	Profitability
18	Derivatives	18	Shadow banking
19	Social media	19	Capital availability
20	Shadow banking	20	Social media
21	Management incentives	21	Equity markets
22	Currency	22	Regulation
23	Human resources	23	Reliance on third parties
24	Reliance on third parties	24	Sales and business practices
25	Social sustainability	25	Change management
26	Equity markets	26	Business continuation
27	Commodity markets	27	Political interference
28	Business continuation	28	Commodity markets

Survey highlights

- **Macro-economic concerns**

  The Malaysian response was dominated by concerns about the macro-economic environment and the impact of expected interest rate hikes. In the domestic economy, there was particular unease about high levels of household debt and excessive property valuations.

  "Economic growth is not improving as expected", said a respondent from Malaysia.

  Looking internationally, one observer said: "The future of the financial institutions looks precarious and it will only take a crack in a neighbouring economy to create a downturn chain reaction in the local scene".

  Also notable was the relatively high ranking of risks related to the individual banks' conduct: the quality of risk management, corporate governance and management incentives.

  These risks are closely related to retention of talent issues we face in Malaysia.

- **Regulations – high compliance costs and ease of implementation**

  On the other hand, Malaysia was one of the few countries in which regulation and political interference were not among the higher rated concerns.

  Having said that, the Malaysian participants felt that there is tremendous pressure to comply with regulations which are very costly to implement.

  However, these risks are still manageable as they are in line with international practices. For example, the Financial Services Act (FSA) and the Islamic Financial Services Act (IFSA), which came into effect in 2013, are based on a similar framework to that of the United Kingdom Financial Services Act 2012 and the Australian Financial Services Reform Act 2001.

- **Talent, a persistent challenge**

  Other concerns such as retaining the right talent may prove to be a greater challenge to the industry in these volatile economic times.

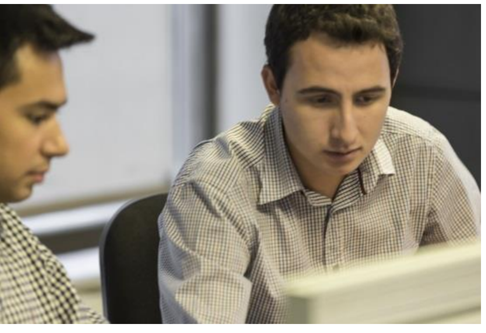
  The limited pool of skilled and experienced talent are the key reasons for this talent shortage. This seems to be a persistent challenge across the board.

Note:

Bankers – Commercial and Investment banks

Observers – Non-bankers, mainly comprises academicians, analysts and service providers

Risk managers – Those working in risk management divisions of banks, including regulators



The higher concerns

Interest rates (No. 2): Increase in interest rates will be a big challenge, especially given high household debts in Malaysia. This may result in higher impaired loans ratio in household debts.

Quality of risk management (No. 3): "Risk managers are often ineffective because they lack influence and authority. Most risk managers give management the benefit of the doubt because management pays the salary", said one banker.

Also, given the brain drain situation in Malaysia, it is difficult to attract and retain the right talent.

Derivatives (No. 4): One chief operating officer expressed concerns about the "relentless pursuit of new and exotic treasury products by financial institutions". Having said that, many banks still worry about the appropriate risk appetite on derivatives. Risk Management teams are also expected to "catch up" with the latest innovations in the capital market in finding alternative sources of investment as the risks associated with derivative products can be high.

Human resources (No. 5): Talent attraction and retention risk has moved up a few places although it may be a low order priority risk in other jurisdictions. (Global ranking – 23)

The lower concerns

Political interference (No. 27); Regulation (No. 22) – as in the Far East/Pacific region more widely, not top-order risks. One respondent described political interference as a "fact of life", but bemoaned the heavy compliance costs of new regulation. Bank Negara Malaysia has helped banks to manage risks better by rolling out various regulations in stages (e.g. Basel III).

Anxiety level

The "anxiety level" of Malaysia's response was 3.66 on a scale of 1-5, i.e. well above the global level of 3.12.

Malaysian banks generally have a low risk appetite as they have to rein in various structural challenges including managing the rising inflation, and the recent Fitch Ratings downgrade of Malaysia's sovereign credit rating outlook.

Banks in Malaysia are in a somewhat precarious position. Growth can quickly turn into a downturn. Take the turn of events for the world's emerging economies in 2013, for example. Tapering growth is expected for the BRIC countries (Brazil, Russia, India and China).

Adding to banks' anxiety is the relatively weak consumer and business confidence, hovering around 100 points (the threshold of confidence) in the 1st quarter of 2014.[1]

Preparedness

We asked the respondents *how well prepared they thought banks were to handle the risks they had identified, on a scale where 5=well and 1=poorly?"*.

Malaysia scored 3.20 (out of a possible 5), indicating a higher level of perceived preparedness than the world average of 3.04.

For example, the effects of Malaysia's central bank, Bank Negara Malaysia's measures to tighten consumer lending and the government's moves to cool property prices in 2013 have been manageable, with loans still growing but at a slightly slower pace.

Banks also continue to maintain strong capital positions under Basel III, with prudent earnings retention and issuance of new Basel III compliant capital instruments.

As at end 2013, the banking system capital buffers in excess of regulatory minimum reached RM79 billion and can absorb up to 3 times the probability of default of household loans in 2013.[2]

1 *Malaysia's Consumer and Business Confidence Index (www.mier.org.my)*

2 *Bank Negara Governor's presentation: Taklimat Laporan Tahunan 2013 dan Laporan Kestabilan Kewangan dan Sistem Pembayaran 2013 (http://www.bnm.gov.my/files/publication/ar/en/2013/slides/AR2013_FSPSR2013_slides.pdf) (19 March 2014)*

In summary

At the end of the day, each bank's unique response is very much dependent on its current market position and its aspirations for the future in line with organisational capabilities, the regulatory situation and capital constraints.

The challenge is for banks to constantly consider which posture they wish to adopt in the marketplace. Do they want to differentiate themselves by innovating and shaping the future, or rapidly follow their competitors, or in some cases, manage reactively in line with market trends and economic developments? What's certain however is that maintaining the status quo is not an option.

Banks need to have clear strategies and priorities for growth. They need to make the tough choices about which customers to serve, which technologies to invest in, how to stay ahead and where to dip their feet in.

Global indexes

Anxiety index

In the survey we also calculated the Banana Skins Index which shows the level of "anxiety" conveyed by the scores given to individual risks.

The Banana Skins Index tracks survey responses over time and can be read as an indicator of changing anxiety levels. In our survey, respondents rate each risk from 1-5, where 5 is the most severe. The Anxiety index in the table on the right is the average score of all the risks.

This table shows the ranking on a scale of 1-5 where 1=low anxiety and 5=high anxiety. The ranking consists of countries which provided ten or more responses.

There is no clear pattern to the result since individual country scores depend very much on local conditions. It is notable, however, that China, a country whose banking system is causing much concern abroad, has the lowest anxiety level.

The relatively high anxiety level of Malaysian banks can be attributed to several factors – increased competition, costs and compliance (the 3Cs).

Slow economic and loans growth may well be the key concerns. There is also the increased cost of doing business contributed by the rationalisation of government subsidies and the implementation of GST which are part of the government's efforts to ensure fiscal sustainability.

The responsible lending guidelines introduced by Bank Negara have put increasing pressure on banks to increase their loan growth, while continuing to be prudent in their lending policy. Banks are also facing a squeeze on profit margins due to stiff market competition on most of the banking products.

Anxiety index		
1	Malaysia	3.66
2	Turkey	3.28
3	Singapore	3.25
4	Romania	3.23
5	USA	3.21
6	Belgium	3.21
7	UK	3.20
8	Netherlands	3.17
9	Mexico	3.14
10	**Global average**	**3.12**
11	Luxembourg	3.10
12	Canada	3.08
13	Switzerland	3.05
14	South Africa	3.03
15	Australia	3.02
16	Slovakia	3.00
17	Philippines	2.99
18	India	2.97
19	Russia	2.96
20	Poland	2.88
21	Latvia	2.85
22	China	2.19

Preparedness index

In the survey we asked respondents how well prepared they thought banks were to deal with the risks they had identified on a scale of 1-5 where 1=poorly and 5=well.

This table shows the ranking for countries which produced ten or more responses. Interestingly, the two countries at the top, Canada and Australia, are the two most widely thought to have weathered the financial crisis reasonably well. By contrast, the two countries at the bottom, the UK and the US, were particularly hard hit.

While Malaysian bankers are optimistic about their level of preparedness, this is a sentiment of cautious optimism. As with other emerging markets in the region, Malaysia needs to grapple with challenges like addressing the fiscal deficit and finding new sources of FDI on the back of sluggish growth in both emerging and advanced economies.

However, due to the environment of increased competition, Malaysian banks are pushing to do more with less to address slower growth and profit trends. This may contribute to the higher level of perceived preparedness among bankers in Malaysia.

Preparedness index		
1	Canada	3.52
2	Australia	3.50
3	Poland	3.50
4	China	3.50
5	Singapore	3.43
6	South Africa	3.31
7	Philippines	3.25
8	Latvia	3.23
9	Malaysia	3.20
10	Switzerland	3.18
11	Turkey	3.17
12	India	3.11
13	Mexico	3.08
14	**Global average**	**3.04**
15	Romania	3.00
16	Netherlands	3.00
17	Slovakia	3.00
18	Belgium	2.93
19	Luxembourg	2.81
20	Russia	2.81
21	UK	2.70
22	USA	2.48

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