Chapter

New Malaysia, Brexit and US-China Trade War: Credit Risk to Malaysian Banks

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Abstract

A country's economic prosperity is intimately linked to the external and internal forces that exert influences on its economy. While some of these forces may not be under the overt control of the country's economic planners, any disruption to the economy by these forces may just tip the balance that causes financial hardship to millions of people. Certainly, national governments through fiscal and monetary policy measures may attempt to prevent such a catastrophe, but what happens if at such a critical time, the needed government leadership is suddenly not available? In such a situation, what will be the most appropriate reaction from the central bank and what is the likely effect to the country's banking industry? While this scenario might sound like an interesting thought experiment in a banking classroom, a similar situation is in fact unfolding in real life at this very moment in Malaysia.

Keywords: Malaysian banking, Malaysian economy, Bank Negara Malaysia, Brexit, trade wars, China, USA, New Malaysia, economic uncertainties, recession, credit risk, repayment risk, Corona virus, Malaysian politics

1. Introduction

2018 was a period of interesting change in Malaysia. The General Election held on May 9 resulted in the ruling Barisan Nasional (BN) coalition, which has held power in the country ever since Malaysia's independence in 1957, being voted out of power. In its place, the Pakatan Harapan (PH) coalition formed the new Malaysian government. It seemed that the unprecedented change of government also brought a new wave of hope for the Malaysian people. The Malaysian economy grew above market expectations in the fourth quarter of 2018, buoyed by strong domestic activities which grew 5.6% along with total external trade that grew at 6.9% [1].

This was excellent news for the people, as earlier in the year in March 2018, there appeared to be a looming threat of a full-on trade war between the United States and China. China is Malaysia's second largest trade partner at 13%, and 9% of Malaysian trade is with the United States, its third largest trade partner, respectively [2]. Worries about the trade war between these two countries had already caused Asian markets in general to trade lower—the KLCI (Kuala Lumpur Composite Index) dropped 0.6% to 1865.22 points, and Hong Kong's Hang Seng Index dropped 2.5% to 30, 309.29 points after US and China announced tariffs on each other on 26 March 2018 [3]. Despite the threat of a trade war, there were potential benefits for Malaysia. It was thought that China may scale back purchases of US Treasury bonds, and divert capital flows to Ringgit assets, which will be beneficial to Malaysian Government Securities' yields [2]. There is even the possibility that the price of oil, a key Malaysian export, will increase as a result of the trade war [2]. Indeed, by the fourth quarter of 2018, most Malaysians had a positive outlook on their personal finances and job prospects, with 70% of Malaysians believing that the state of personal finances in the next year would be excellent or good, and 71% had a positive view of their job prospects [4].

However, this positive mood had declined by the second quarter of 2019, with only 63% of Malaysians believing that the state of personal finances in the next year would be excellent or good, and 63% had a positive view of their job prospects [5]. In Ref., [5] also found that 70% of the Malaysian consumers already believed that the country was already in economic recession. In response, the central bank of Malaysia, Bank Negara Malaysia (BNM) signaled the banking industry that they should continue to give out more loans by reducing the Statutory Reserve Requirement (SRR) Ratio to 3% from 16 November 2019 [6]. This is the latest series of SRR ratio reduction by BNM, which started in 2016, when the central bank reduced the SRR from 4 to 3.5% [7]. This message was reinforced by BNM on 22 January 2020, when the Monetary Policy Committee of Bank Negara announced the reduction of the Overnight Policy Rate (OPR) to 2.75%, and considered the adjustment to the OPR as a pre-emptive measure to secure economic growth with price stability [8].

What had happened to Malaysia between 2018 and 2019 timeframe that had caused such a drastic change in its perceived economic fortunes is a point of conjecture at this time, but several external forces will be discussed here, which cumulatively, may explain the present situation that Malaysia has found herself in. Further, the recent shocking developments in the political scene in Malaysia on 24 February 2020 also add turmoil to the present situation of economic uncertainty. Through it all stands the Malaysian banker, duty bound to protect the interests of their respective employers, and at the same time fully aware that should they be too careful, they may just doom the country to another economic recession that they have tried so hard to avoid. Conversely, BNM is counting on the banking industry to continue to provide the necessary funds for economic activities despite the heightened risk of non-performing loans and the negative impacts this will have on the banking industry. It would almost seem that the BNM appears to be willing to expose the banking industry to more risks in order to protect the Malaysian economy.

2. Capital and lending

Giving loans has always been an integral part of banking operations [9]. In 2018, CIMB Group, Malaysia's second largest commercial bank by assets, recorded that its gross loans account for 63% of its total assets and Maybank, Malaysia's largest commercial bank with over 20 million customers, recorded that its gross loans in 2018 is 62.8% over its total assets [10]. This shows the importance of lending to banks, as it is the most important income generating activity to banks [11]. Banks would evaluate potential customers, and then decide the level of risk such a loan would impose, charge the appropriate interest and disburse the amount requested, while ensuring that the capital borrowed is returned over the agreed time-frame of the loan. The interest charged will then yield interest income to the banks. However, there are instances when the borrower defaults on paying back the loan, and this causes the lending bank to suffer financial loss, as their income will be affected and potentially there is a danger that the capital loaned may be lost as well.

This was the case in Malaysia during the Asian Financial Crisis of 1997–1998, when cases of Non-Performing Loans (NPLs)/Impared Loans (as expressed as the ratio of net impaired loans to net total loans in percentage) reached 8–9% [12]. Because of the Asian Financial Crisis of 1997, growth and innovation in Malaysia are constrained by banks whose capital has been eroded by accumulating non-performing loans [13]. This leads to the mergers of several banks that shaped the banking industry to the one that we see in Malaysia today [14].

Therefore, it is clear that anything that affects the banking sector's lending activity will adversely affect the income of the banks. The factors that may affect such activities may be divided into two types of factors, internal factors (bank specific factors), and external factors like the economic climate or political climate. By its nature, external factors may not be readily controlled by the bank [14]. This makes it harder for banks to maintain profitable lending. Malaysian banks loan growth remained low at 5% as of June 2018, due to the poor performance of working capital loans [15] and loan growth was projected to remain flat at 5–6% level in 2019 [16]. The external factors are discussed next.

2.1 Brexit and Malaysia

Brexit is a portmanteau for 'Britain' and 'Exit', following a referendum in the United Kingdom (UK) that resulted in London, Scotland and Northern Ireland electing to remain in the European Union (EU) while the rest of England and Wales deciding to leave the EU [17]. Following [18], there is little short-term impact of Brexit to Malaysia. The UK is not a large trading partner of Malaysia, and despite UK's status as the financial center of Europe, any impact of Brexit will not have a big effect to Malaysian financial markets [18]. In fact, the weakened British Pound (GBP) will even make the UK a favourable destination for Malaysian students, and well-to-do Malaysians may even find it a good time to holiday there or to buy properties in the UK. This view is echoed by [19], despite the UK contributing RM 1.9 billion worth of Foreign Direct Investment (FDI) while the EU invested RM 30.3 billion in the same period in 2016, and estimated that Brexit will not affect FDI to Malaysia.

However, Brexit's effect on the UK economy is expected to be not so benign. Following [20], a recession in the UK is a strong possibility. The Organization for Economic Cooperation and Development (OECD) has already predicted the UK economy to grow at only 1% in 2020. An impending economic recession in the UK will have a negative impact on the EU, since half of the UK's imports come from the EU. In addition, with a general slowdown in the global economy caused by instability in global trade due to trade spats, the OEDC concludes that it is likely to dampen the EU's growth rate to about 1% as well in 2020 [20].

Given that Malaysian trade with the EU is about 10%, a weaker EU economy will impact the Malaysian economy in general. Further, with the expected weakening of the GBP against the Ringgit, Malaysian exports to the UK, already at a tiny 0.2% of total exports, will increasingly become less competitive in the UK market [20]. These events do not bode well for the Malaysian economy.

2.2 US-China trade war

Malaysia has always been a trading nation, and international trade has consistently contributed to the Malaysian gross domestic product (GDP), and since 2017 its share of contribution to the GDP was higher than 130% [21]. Following [21], there is concern that the Malaysian economy will shift into lower gear on fears of a gloomier global economic outlook. The International Monetary Fund (IMF) had already reduced its 2019 forecast for the ASEAN region from 3.9 to 3.7%. Echoing a similar sentiment, the Asian Development Bank has put the region's growth rate expectation at 5.8%. The sole underlying cause that contributed to these downward revisions is the US-China trade war.

As discussed earlier, the US and China are two of Malaysia's largest trade partners. Therefore, any trade policies that harm trade between these countries could affect Malaysia's trade position, especially when Malaysia's intermediate goods exports to China are significant [21]. Further, the weakening global markets will impact demand for electronics, one of the key Malaysian exports. Palm oil demand is also expected to fall, as does the price of oil [21].

The slowdown in exports will result in the narrowing of the Malaysian current account surpluses [21] as well, giving the Malaysian government less money to spend on fiscal measures to stimulate the economy. Indeed, the 2020 Malaysian economic growth forecast had been continually downgraded, with Finch Solutions predicting only 3.7% expansion, down from an earlier projection of 4.7% [22]. To navigate the difficult economic situation, it is vital for the Malaysian government to establish forward-looking policies. Thus far, it appears to be contented to rely on BNM to apply monetary policies to shore up the economy. This may soon be insufficient.

2.3 New Malaysia

When the Pakatan Harapan (PH) party took over the reins of power after the 2018 General Election, Tun Dr. Mahathir Mohamad was made Prime Minister with an understanding that there will be a transition plan for Datuk Seri Anwar Ibrahim to succeed him mid-term [23]. However, the PH government collapsed on Monday 24 February 2020 by Tun Dr. Mahathir's shock resignation as Prime Minister. Tun Dr. Mahathir's resignation was speculated to be caused by a power struggle between the Prime Minister and his planned successor [22]. Economists quickly opined that the political uncertainty this has caused is harmful to the Malaysian economy [22].

The resignation by a country's Prime Minister at any time during the tenure of a government has the effect of causing the entire cabinet to be dissolved [24]. Effectively, Malaysia does not have a government anymore. Unfortunately, the dissolution of the Malaysian government cannot come at a worse time, as in the past few months, an additional threat to the Malaysian economy had emerged in the form of a novel corona virus, called Covid-19 [25]. While Covid-19 is currently under control, the disease has already caused a huge impact on the global economy, and Malaysia's economy has not been spared [25]. Accordingly, the Malaysian government was scheduled to announce an economic stimulus package to stimulate the economy on 27 February 2020. Unfortunately, the sudden resignation of the Prime Minister on 24 February 2020 has caused fears that the stimulus package has been put on hold [22, 25]. Indeed, this was stated by the former Finance Minister Lim Guan Eng on 25 February 2020 that Tun Dr. Mahathir will announce the economic stimulus at a later date [26].

Unease about the political uncertainty arising from a suddenly-defunct government and its possible effect on the Malaysian economy prompted BNM to announce on 25 February 2020 that it was closely monitoring the financial markets, and stated that there was sufficient liquidity in the financial markets [27]. The political situation had settled down somewhat by the 27th of February 2020, with Tun Dr. Mahathir appointed Interim Prime Minister. The irony of his actions now fully realized, Tun Dr. Mahathir had stated that he had intended to resign from his job, but now only he among his cabinet colleagues still had one.

As such, Tun Dr. Mahathir was able to announce the anxiously awaited economic stimulus on 27 February 2020. The economic stimulus package has three strategies—to manage the impact of Covid-19, spur a people-centric growth and encourage quality investment. With immediate effect, government employees who are in medical profession will receive an extra allowance of RM 400 a month, while Immigration and other civil servants involved with the fight against Covid-19 will receive RM 200 extra monthly, until the outbreak is over [25].

The effectiveness of the stimulus package to counter the effects of Covid-19 remains to be seen. Goldman Sachs warned that it does not expect US companies to generate earnings growth in 2020 due to the Covid-19 virus [28]. It also expected that a more severe pandemic would lead to a more prolonged disruption and even a US recession. Goldman Sachs also expected a severe decline in the Chinese economic activities as well [28]. Indeed, blue chip US companies like Microsoft, Apple, Booking Holdings and Anheuser-Busch InBev are already reporting that they no longer expect to meet revenue targets due to Covid-19 [28, 29].

With Malaysia's major trading partners expected to experience economic troubles, the Malaysian economy is expected to experience significant challenges going forward. Following [30], the Malaysian economic growth rate is expected to be 2.5% at the end of the first quarter of 2020. It is expected to slowly recover to 4.4% by the same time period next year [30]. How does this data on economic performance affect Malaysian bankers?

2.4 Malaysian banking

Following [11], economic and political factors have the potential to adversely affect the banking sector's lending activity and this will adversely affect the income of the banks. Consumer lending risks can be moderated by banks using computerized credit reporting as provided by CTOS Data Systems Sdn Bhd and BNM. CTOS produces the MyCTOS Basic Report and MyCTOS Score Report by using information sourced from various public sources such as the National Registration Department, Registrar of Societies, the Malaysian Insolvency Department, Companies Commission of Malaysia and publication of legal proceedings or litigation records [31]. BNM also provides credit reports and this is managed by the Credit Bureau of BNM, known as the Central Credit Reference Information System (CCRIS). CCRIS gathers credit related information from all borrowers of participating financial institutions in Malaysia, and this includes all licensed commercial banks, Islamic banks, investment banks, development financial institutions, insurance companies, payment instrument issuers, rehabilitation companies, building societies, credit leasing companies and government agencies. These financial institutions are required to report on a regular basis information like profiles of borrowers (name, business or personal identification number, date of birth/registration, and address, among others) credit application details (amount of borrowing applied, date of application, type of facility) and credit account details (type of credit facilities, credit limit, outstanding balance, instalment amount, conduct of account and legal action status, if any) [31].

Therefore, it is possible for financial institutions in Malaysia to access up-to-date financial records for any potential individual borrower and assess the suitability of lending risk by obtaining CCRIS or CTOS financial data. Even so, despite such a system in place, banks continue to suffer cases of Non-Performing Loans (NPLs)/Impaired Loans. Data from BNM show the ratio of net impaired loans to net total loans in percentage [32] of a high of 9% in November 1998 to a low of 1.2% in January 2016, with this figure hovering around 1.2% throughout 2015. While the reduction of impaired loans since 1998 has been significant, the banking industry has seemingly been unable to completely eradicate impaired loans/NPLs. As a result of this inability, the collective impairment provisions that has to be made to account

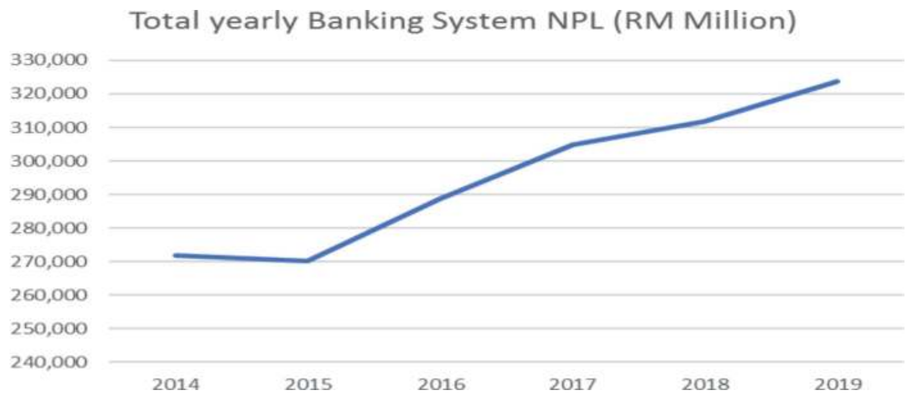

Figure 1.
Malaysian banking NPL. source: BNM.

for the impaired loans totaled in the region of RM 16,354 million in January 2016 alone, and this figure increased to RM 23, 914.4 million in February 2019, even though the ratio of net impaired loans to net total loans in percentage has been reduced to 0.93% by February 2019. Credit scoring methods are by nature quantitative methods of evaluating credit and are only as good as the scoring algorithms that predict consumer behavior. If it is implemented properly, then cases of impaired loans should not have happened at all.

More worryingly for bankers, such a system does not exist for another important consumer group of lending, small to medium sized Industries (SMEs). SMEs contribute one third of the country's Gross Domestic Product (GDP). This has increased to 37.1% in 2018 [11] and comprises 97% of all formal business establishments in Malaysia. SMEs employ 66% of the Malaysian workforce as of 2018 and BNM also believes that SMEs have the potential to contribute more to the Malaysian economy. It is expected that by the year 2020, SMEs contribution to the Malaysian GDP will increase to 41% [11]. Also, financial institutions like banks are the main source of financing for SMEs, and lending to SMEs constitute almost half of the total sum of the financial institutions lending to the business sector [11]. The financing approval rate from financial institutions has exceeded 80%, with the financing approval rate reaching 91% in 2019. As of February 2018, there was still RM 3.3 billion still available to SMEs to use for working capital and for buying machinery [11]. However, the higher loan approval rates to SMEs have also had some unintended consequences to financial institutions, which showed an increase in NPLs from the business sector in 2019 [11] (**Figure 1**).

Following [33], an increase in NPLs will affect the bank's profitability and liquidity which are the main components for the efficiency of the bank. There has been some research to find methods to mitigate this by using non-quantitative methods by analyzing the SME sales officers' psychological factors [11–14] as well as their past experiences [34]. Indeed, since there is no computerized credit analysis available for SMEs, banks have been forced to approach loan applications by SMEs using a case-by-case approach, where a personalized banking style is adopted. This makes the case for understanding how an individual bank sales officer approaches a lending case very relevant in order to minimize NPLs.

3. Conclusion

The global economic events of Brexit and the US-China Trade War in the last few years along with the unanticipated Covid-19 pandemic are still influencing the

Malaysian economy, and as a result, it poses great credit risks to Malaysian banks. One might even be tempted to call this a "perfect storm" for the banking industry. The surprise political events of 24 February 2020 had just magnified those risks. Faced with a lack of governmental fiscal policy, BNM must rely on the tools it has on hand to get on with the task of protecting the Malaysian economy. It is expected that BNM will soon be forced to further reduce the OPR yet again [35]. This will mean that Malaysian banks' interest income, already under strain, will be further reduced. Even so, the BNM is fast running out of options. As an analogy, if BNM was an archer, its two quivers of OPR and SRR is running out of arrows. It is clear that BNM cannot prevent an economic disaster on its own. However, for Malaysian bankers, a time of hardship is just beginning.

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