



Economic Briefing To the Penang State Government

Banking on New Products and Services to Improve Performance

The completion of bank mergers in June 2002, as marked by the completing of the merger between Arab-Malaysia Finance Berhad and MBf Finance Berhad sees Malaysia enter the second stage of the Financial Master Plan. The Financial Master Plan outlines a three-phase implementation programme. The first stage of the plan aims to build domestic capacity, the second phase focuses on increasing domestic competition, and the third phase on integration with the international market. This article seeks to examine some of the trends and issues currently faced by the banking sector as Malaysia enters this second phase of the Financial Master Plan.

In its recently released Annual Report for the year 2002, Bank Negara Malaysia (BNM) outlines a generally improving situation for Malaysia in general, with gross domestic product (GDP) expanding by 4.2% in 2002 compared to 0.4% for 2001 (Table 1). Recently released figures by BNM show a 4.0% growth for the first quarter of 2003. In line with efforts to strengthen the domestic sector, growth was broad based, driven by strong domestic demand as well as favorable export performance, in line with efforts to strengthen the domestic sector. Additionally continued fiscal and monetary stimulus, as well as the recent rise in commodity prices provided additional support to domestic demand.

Immediate concerns ahead for the Malaysian Economy include recent events, including the SARS outbreak, Middle East events, continued dependence on the US economy in the short term, and concern regarding the diminishing scope for policy stimulus in the US and other international economies.

War in Iraq

As recent events in the Middle East show, there remain considerable risks to the downside for the economy, the most obvious of which being the war in Iraq. Prior to the war, uncertainty regarding whether there was going to be a war was one of the greatest concerns to the economy. Indeed, while markets around the world rose briefly at the start of the war, concern has shifted now to the continued uncertainties with regards to US interests in the Middle East and the rebuilding of Iraq.

Continued Short-Term Dependence on the US

Despite efforts made to strengthen the domestic sector, Malaysia remains dependent on the US, especially in the short term. According to the latest data, the United States is still our largest and most important export market, with 20.2% of Malaysian exports destined for the US, compared to the next important trading partners Singapore at 17.1%, and Japan at



Table 1: Malaysia: Gross Domestic Product by Kind of Economic Activity RM Million, Constant 1987 Prices

	1998	1999	2000	2001	2002 ^p	2003 ^f
Agriculture	17,512	17,596	17,943	18,269	18,330	18,613
M&Q	14,357	15,344	15,641	15,892	16,603	17,354
Manufacturing	50,899	56,841	67,717	63,536	66,126	69,400
Construction	7,241	6,926	6,996	7,159	7,325	7,467
Services	101,753	106,293	122,372	118,764	124,083	129,545
Less: Imputed bank service charges	13,956	14,896	15,873	17,902	18,644	19,556
Plus: Import Duties	4,430	5,319	4,742	4,762	5,519	6,379
GDP at Purchasers' Prices ¹	182,237	193,422	209,538	210,480	219,342	229,202

Annual Change (%)

Agriculture	-2.8	0.5	2.0	1.8	0.3	1.5
M&Q	0.4	6.9	1.9	1.6	4.5	4.5
Manufacturing	-13.4	11.7	19.1	-6.2	4.1	5.0
Construction	-24.0	-4.4	1.0	2.3	2.3	1.9
Services	-0.4	-4.5	5.7	5.7	4.5	4.4
Less: Imputed bank service charges	1.4	6.7	6.6	12.8	4.1	4.9
Plus: Import Duties	-42.4	20.1	-10.8	0.4	15.9	15.6
GDP at Purchasers' Prices	-7.4	6.1	8.3	0.4	4.2	4.5

Source: Bank Negara Malaysia Annual Report 2002

¹ Slight discrepancies may occur due to rounding

^p Preliminary

^f Forecast

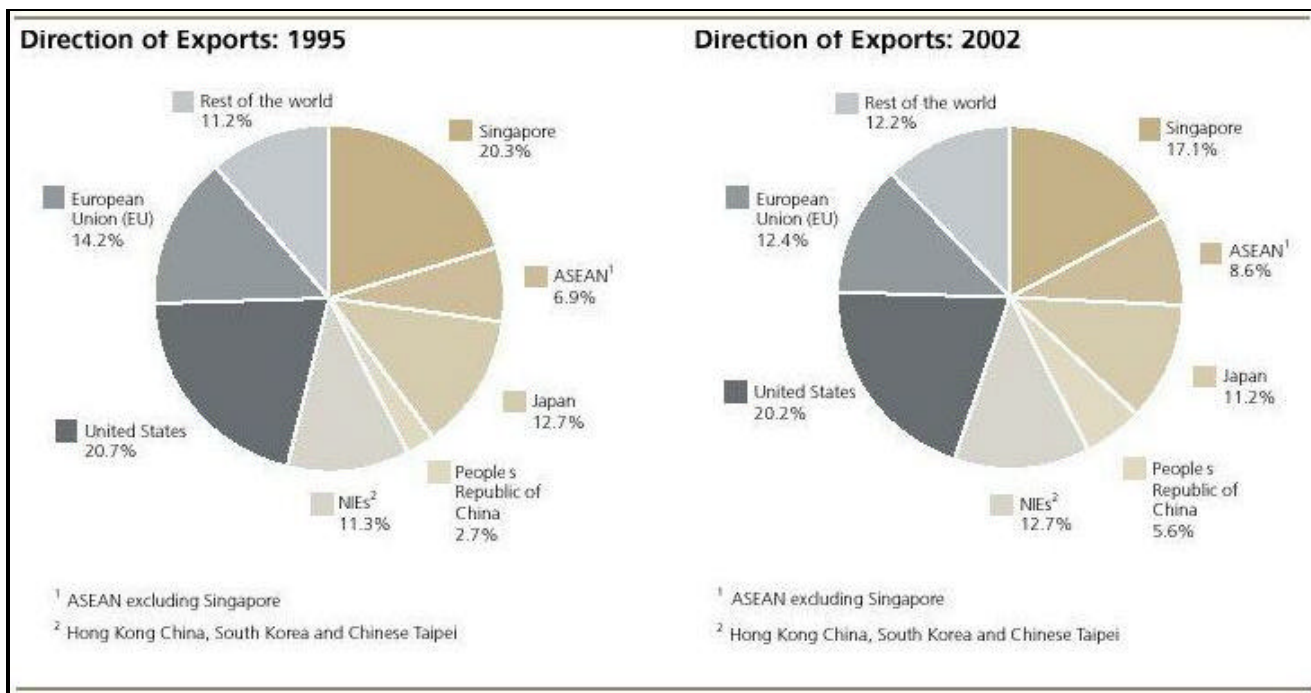
11.2%. Corresponding numbers for 1995 see 20.7% of Malaysian exports destined for the US, 20.3% to Singapore, and 12.7% to Japan. While Malaysia has made considerable progress thus far in strengthening our domestic sector and regional links, it will still take time to lessen the dependence we have on the US economy.

Diminishing scope for policy stimulus in export market economies

Related to the above and also to the openness of Malaysia's economy, another source of concern is that of the continued clout of the various governments around the world in maintaining policies that can support economic growth effectively. While Malaysia itself has ample room for continued policy stimulus, the lack of such for several of the major economies around the world was highlighted as the main threat to the global economy by Stephen King, Chief Economist of HSBC. In the Asian Economic Outlook 2003, he noted that the world is still in a post-bubble environment, with i) too much capacity, ii) not enough profit, and iii) downward pressure on pricing. He further asserts that such an environment is associated with stagnation, "whereby economies are unable to respond well to supportive policy measures."

In the case of the US, the Federal Funds Rate is at its lowest rate since 1950. With rate cuts taking about a

Figure 1: Malaysia: Direction of Exports 1995 and 2002



Source: Bank Negara Malaysia Annual Report 2002

year to affect the economy, the effects of the majority of rate cuts by the Fed would already have been felt in 2002. While the last rate cut was a 50 basis point cut to 1.25% in November 2002, there is increasingly little room for the Federal Reserve to maneuver should the latest cut have little effect. Similar problems of a lack of traditional policy stimulus clout exists in Japan and Europe.

Coupled with other aggressive policy stimulus, Mr. King notes that such policies have helped the larger economies such as the US and Europe post low growth rates over the past two years. He further notes that, according to their estimates, the US and European economies would have experienced deep recessions without such stimulus. However, with rates nearing the trough of a 0% interest rate, future rate cuts will not be as potent or come as frequently as before, signaling a limit to fiscal stimulus.

This is best reflected in consumer spending, which has been identified as one of the few positive aspects propping up economies such as the US and UK. Recent data show consumers an increasing level of indebtedness among consumers, as they take advantage of lower rates which make the cost of borrowing cheaper. With the scope for further rate cuts diminishing with every additional cut, it is unlikely that the consumer will be able to sustain their spending in these economies, thereby affecting Malaysian Exports to these economies.

Domestic Scenario

Liquidity

One of the immediate objectives of the bank mergers was to enhance the liquidity condition. According to the New Liquidity Framework Data, which was implemented for all banks beginning January 2001, we see that there is sufficient liquidity to meet unexpected withdrawals for a period up to one month. According to Bank Negara Malaysia in its *Annual Report 2002*, the banking system as a whole (excluding the two Islamic banks) projected a cumulative liquidity surplus of RM53.8 billion to meet demands of up to one week and a surplus of RM72.9 billion to meet demands of up to one month.



Table 2a: BNM Annual Report 2002: Liquidity Projection as at 31 December 2002

	Cumulative mismatch		Buffer as % of total deposits		Total Deposits (RM Bil) ^{1,2}
	1 week	1 month	1 week	1 month	
Commercial Banks	39.0	56.1	11.7	16.8	350
Finance Companies	9.1	12.9	10.9	15.6	83
Merchant Banks	5.7	3.9	39.0	26.5	14
Banking System	53.8	72.9	11.0	14.9	448

Source: Bank Negara Malaysia Annual Report 2002

¹Rough Estimates

²Derived from the *Monthly Statistical Bulletin*, various issues.

Asset structure & quality

Restructuring efforts coupled with a benevolent economic environment saw an improvement in asset quality in 2002. The favourable economy enhanced the capacity of borrowers to service their loan, which resulted in RM13.2 billion of non-performing loans (NPLs) reclassified to performing (an increase of 43%), and a RM5.8 billion decline in the amount of new NPLs. Additionally, 2002 saw higher recoveries of NPLs, with RM10.4 billion recovered compared with RM8.3 billion in 2001.

Most economic sectors recorded improvement in NPL positions. While the manufacturing sector continues to account for one of the largest shares of NPLs, NPLs in this sector increased only marginally by 0.7% in 2002, compared with an increase of 40.1% in 2001. Construction activities, on the other hand, has benefited through Government spending initiatives, recording a decline of -10.4% in 2002 to account for 15.1% of total NPLs in the banking system.

Two other sectors that recorded large declines in NPLs include the finance, insurance and business services sector, and the wholesale and retail trade, restaurants and hotel (WRHR) sector. The finance, insurance and business services sector saw a 33.7% decline in NPLs primarily due to the completion of debt restructuring exercises by several investment holding companies in 2002. The WRHR sector saw a decline in NPLs of 13.4% as a result of higher consumer spending.

The risk-weighted-capital-ratio (RWCR) and core capital ratio are two ratios used to measure asset quality. RWCR refers to the ratio of the capital base to the risk-weighted assets, while the core capital ratio refers to the ratio of tier-1 capital to risk-weighted assets. As can be seen in Table 4, asset quality as measured by the RWCR for the banking system as a whole increased from 11.8% in 1998, to 12.5% in 2000 after the first wave of merger and consolidation exercises, and to 13.0% in the latest figure recorded in February of 2003. Corresponding figures for the core capital ratio also show improvement, moving from 8.7% in 1998, to 10.7% in 2000, and peaking at 11.1% at 2001. However, the core capital ratio has since leveled off to 10.9% as of February 2003. These figures well exceed the minimum standards set at the international level, which recommends a level of at least 8% for the standard ratio, and at least 4% for the core capital ratio.

Table 3: Banking System¹: Non-performing Loans by Sector

as at end

	NPL by Sector		Change '01-'02	As Percentage of Total Loans to Sector	
	2001	2002		2001	2002
	RM Million		%		
Agriculture, Hunting, Forestry & Fishing	924.0	932.9	1.0	8.1	8.2
Mining & Quarrying	244.6	158.9	-35.0	19.4	16.1
Manufacturing	12,425.2	12,509.1	0.7	20.3	21.0
Electricity, Gas & Water	358.8	422.5	17.8	7.3	6.6
WRHR	4,984.5	4,316.7	-13.4	14.0	11.8
<i>Wholesale Trade</i>	2,127.6	1,851.8	-13.0	10.8	9.0
<i>Retail Trade</i>	1,364.5	1,202.5	-11.9	12.3	10.4
<i>Restaurants & Hotels</i>	1,492.4	1,262.4	-15.4	30.4	27.5
Broad Property Sector	27,347.5	26,816.3	-1.9	17.1	15.8
<i>Construction</i>	10,503.2	9,408.4	-10.4	31.7	30.3
<i>Purchase of Residential Property</i>	6,741.9	8,491.2	25.9	8.0	8.7
<i>Purchase of Non-Residential Property</i>	4,928.8	4,813.3	-2.3	18.3	18.0
<i>Real Estate</i>	5,173.7	4,103.4	-20.7	33.5	29.7
Transport, Storage & Communication	1,595.0	1,406.5	-11.8	15.9	14.6
Finance, Insurance & Business Services	4,680.7	3,105.3	-33.7	14.6	10.5
Consumption Credit	5,784.1	5,419.6	-6.3	10.5	9.5
<i>Personal Use</i>	1,873.8	1,867.6	-0.3	14.2	13.4
<i>Credit Cards</i>	409.4	434.2	6.1	4.6	4.1
<i>Purchase of consumer durables</i>	71.0	57.6	-18.8	15.0	15.9
<i>Purchase of transport vehicles²</i>	3,429.9	3,060.2	-10.8	7.0	5.3
Purchase of Securities	5,180.8	4,372.8	-15.6	24.5	20.4
Community, Social & Personal Services	1,238.1	1,225.7	-1.0	21.0	21.7
Others	1,827.1	1,629.3	-10.8	18.0	16.8
Total	66,590.4	62,315.8	-6.4		

Source: BNM Annual Report 2002

Note: Discrepancies may arise due to rounding

1 Excludes Islamic Banks

2 Includes commercial vehicles



Table 4: Banking System: Risk-Weighted Capital-Ratio And Core Capital Ratio

End of Period	RWCR (%)	Core Capital Ratio (%)
1998 Dec	11.8	8.7
1999 Dec	12.5	10.1
2000 Dec	12.5	10.7
2001 Dec	13.0	11.1
2002 Dec	12.8	10.7
2003 Feb	13.0	10.9

Source: Monthly Statistical Bulletin, March 2003
¹Starting June 2000, includes Islamic Banks

Efficiency

The past year saw the Banking System as a whole recording an increase in pre-tax profit of 34.8% from end December 2001 to end December 2002. Profits of Commercial Banks over the same period saw an increase of 41.3%, while corresponding numbers see Finance Companies rising 11.4%, and Merchant Banks jumping 99.91%.

	Commercial Banks		Finance Companies		Merchant Banks		Banking System	
	1-Dec	2-Dec	1-Dec	2-Dec	1-Dec	2-Dec	1-Dec	2-Dec
Pre-tax profit / Average Assets (%)	0.90%	1.20%	1.80%	1.90%	0.80%	1.40%	1.00%	1.30%
Pre-tax profit per employee (RM '000)	65.5	94.7	102.9	120.9	124.8	244.5	75.4	104.6
Number of Employees	67,398	65,866	20,488	19,430	2,402	2,451	90,288	87,747
Pre-tax Profit (RM Mil, Calculated)	4,414.60	6,237.50	2,108.20	2,349.10	299.8	599.3	6,807.70	9,178.30
Pre-tax Profit (RM Mil, BNM predicted)	4,507.10	6,307.10	2,120.80	2,412.90	294.8	591.3	6,922.70	9,311.30
% change	41.29%		11.43%		99.91%		34.82%	
Average Assets (RM Mil, calculated)	405,639.00	567,639.00	190,872.00	217,161.00	26,532.00	53,217.00	623,043.00	838,017.00
Net Interest Income (RM Mil)	12,131.00	12,258.80	4,917.70	4,941.00	582.1	530.9	17,630.80	17,730.70
% Change	1.10%		0.50%		-8.80%		0.60%	
Net Interest Income / Average Assets (%)	2.99%	2.16%	2.58%	2.28%	2.19%	1.00%	2.83%	2.12%

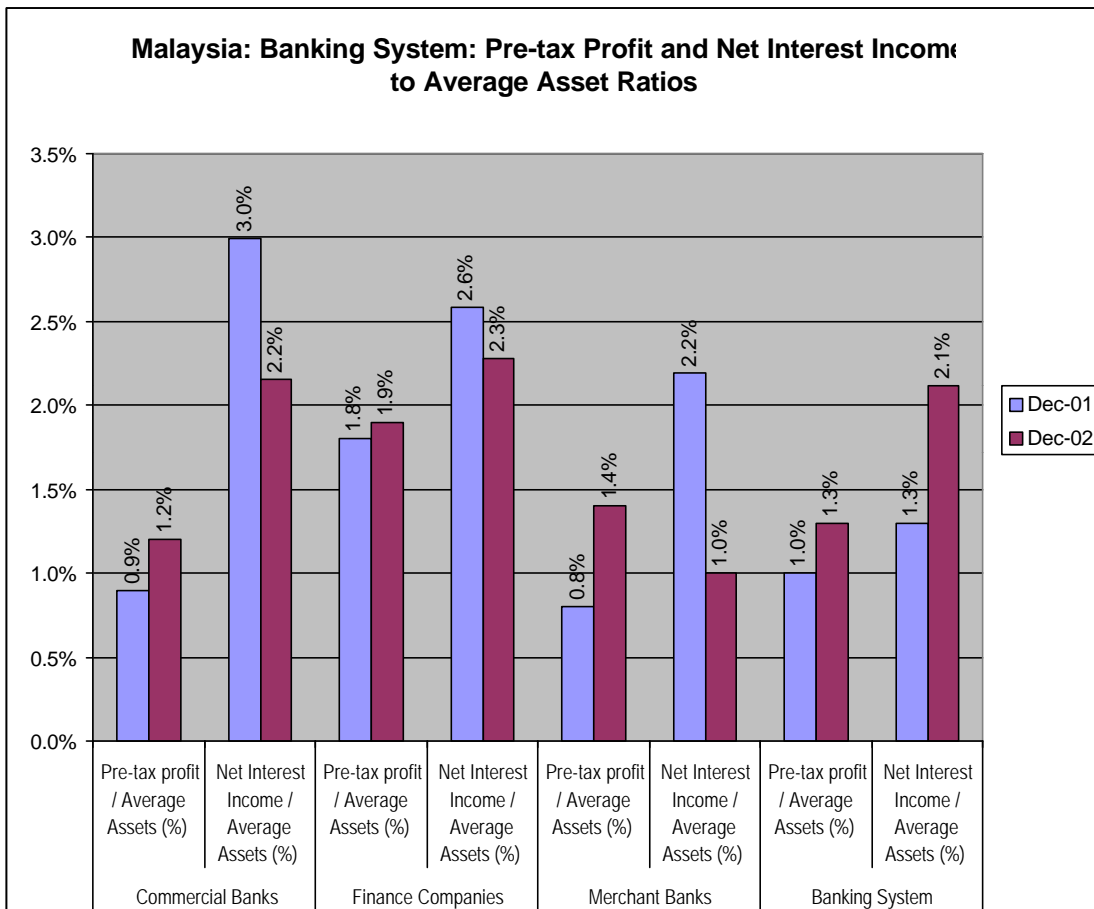
Note: Slight discrepancies may arise due to rounding
 Net Interest Income for 2002 are predicted figures
 Source: BNM Annual Report 2002

As measured by ratio of pre-tax profit to average assets, we find that banks have improved in efficiency over the past year, with the banking system as a whole seeing an increase from a ratio of 1.0% at end December 2001 to 1.3% at end December 2002. Merchant Banks recorded the largest increase, jumping from 0.8% to

1.4% for the same period, while Commercial Banks saw a change from 0.9% to 1.2% respectively. Finance Companies recorded the smallest improvement, up from 1.8% to 1.9% for the Dec 01 – Dec 02 period, but are the most efficient of the three banks as measured by this ratio. The banking system as a whole saw an improvement overall, moving from 1.0% to 1.3%.

Looking at Net Interest Income figures however, we see that the Banking System as a whole saw only a slight increase from RM17,630.8 million at end December 2001 to RM17,730.7 mil at end December 2002, an increase of 0.6%. Commercial Banks posted the largest increase in net interest income seeing an increase of 1.1% over 2002. Over the same period, Finance Companies saw a smaller increase of 0.5%, while Merchant Banks experienced a decrease of -8.8%.

The low or marginal increase in Net Interest Income despite an increase in overall profits indicates that much of these profits have come from cost cutting, restructuring, and other non-traditional income sources, such as fee-based income and so on. This can be seen in the ratio of Net Interest Income to Average Asset figures, an indicator used to measure the off-balance-sheet activities of banks, that is, the level of deviation of banks from their traditional activities. For the banking sector as a whole, we see this ratio declining from 2.83% at end 2001 to 2.12% at end 2002. Commercial Banks saw a similar decline, moving from 2.99% to 2.16% for the same period, while Finance Companies dropped from 2.58% to 2.28%. Reflecting the large jump in Pre-tax Profit, despite a decrease in Net Interest Income, corresponding figures for Merchant banks recorded the largest drop, from 2.19% to 1.00%.





Finding New Opportunities and Sources of Growth

Cost savings and restructuring will continue to be a prominent factor for 2003 and 2004 to a lesser degree, as local banks iron out the remaining redundancies caused by the in-market mergers. However, as both these strategies are neither cyclical drivers or viable strategies that may be carried out in the long run, it is in finding new opportunities and sources of growth that will prove more important in the long run.

Some of the areas in which we already see banks expanding into include that of private and priority banking, credit card services, personal finance planning and wealth management services. Additional fee-based services may include treasury-related products, access to debt capital markets and advisory services for large corporations; e-payment services, cash management and foreign exchange services for SMEs; and capital guaranteed funds, foreign exchange services, loyalty programmes, in addition to the wealth management and credit card products and services mentioned above, for individuals.

However, it is important to note that, banks must be able to provide these services efficiently if any significant improvement is to be made to their fee-based revenues. In order to do this, banks must acquire the necessary knowledge and abilities to provide these services, as well as take steps and implement measures to better understand the needs of their customers.

While the first part has largely been achieved by most banks in Malaysia, the second will require heavy initial investment in several areas. Some of these areas include cultivating a commitment to customer service, increasing customer contact points, feedback mechanisms, data-mining programs, and the upgrading and implementation of more sophisticated data management and processing technologies. As noted by the Daiwa Institute of Research,

The grim conclusion is that to increase fee-based income, banks have to invest heavily in their existing systems and IT. Short term underinvestment will impair long term competitiveness in this service-oriented industry.

Conclusion

Figures noted in this article serve only to emphasize that the overall economic climate, while improving, remains cautious. Thus far, the banking system in Malaysia has coped very well with these uncertain times. International standards of safety have been reached and exceeded, in areas of risk management, as reflected by the RWCR and core capital ratios. Pre-tax profit for all bank types and the banking system as a whole have also increased over the last year. While part of this increase has come from restructuring and cost cutting measures as is reflected by the pre-tax profit to average asset ratio, banks are also moving more towards non-traditional income sources, as the net interest income to average asset ratio would indicate.

The economic climate remains uncertain though, and many economic forecasts have been lowered due to the ongoing events in the Middle East and the severe acute respiratory syndrome (SARS) outbreak. The banking sector will have to redouble its efforts to improve efficiency and increase their competitiveness in line with the Financial Master Plan. To do this, banks will not only have to identify new products and services, and acquire the abilities to provide them, but also invest heavily in customer relations and related IT and data management technologies. §
Terence Too