Banking in Singapore and Malaysia

August 2016 by Richard Perry, Market Analyst

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Singapore and Malaysia are two of the most important economies in South East Asia. Measured by Gross Domestic Product (GDP), Malaysia is the 36th largest economy in the world, whilst Singapore is the 39th largest. But what is the current outlook for the economies and their banking sectors?

We take a brief look at their economic outlook and consider what is driving the performance of the banking sectors in both countries. We consider the impact of important macroeconomic factors including global issues and compare the two countries on economic fundamentals. We also delve into more country specific issues, such as the impact of Shariah law, the outlook of credit ratings agencies and how these are affecting economic performance.

MACROECONOMIC IMPACT - Slowdown in China

The economic restructuring and subsequent slowdown in China has been impacting significantly on global market, with Emerging Asian economies so closely tied to the prospects of Chinese growth, this has created some significant issues. The prospect of a "hard landing" in China is still a major concern for economic growth in the region and one which could have a negative impact on its banks.

China is currently undergoing a massive economic re-structuring away from the high growth, high investment, export driven, capital intensive economy; towards a lower growth, more sustainable, consumption driven economic model. Having seen several years of double digit economic growth, GDP expansion is slowing. As recently as 2010, Chinese growth was up around 12%, however, annual GDP growth is set to fall below 7% this year and in Q2 was back to 6.7%.

Current expectations are that China will manage to avoid a hard landing (seen as a drop back to near zero growth). As a comparison, Japan and South Korea have previously been on similar paths of rapid growth and subsequent slowdown. Both were achieving almost double digit growth during highly industrialized periods before slowing to a more manageable 3% to 4% as economic restructuring took hold. Subsequently, if these examples are anything to go by then the slowdown is likely to continue in China. **As yet, China's slowdown has been reasonably steady and seems to have been relative well contained for now. Despite this though, the economic impact remains sizeable.**

However, if the slowdown in China does continue (and there is little evidence to suggest that it will bottom out any time soon) then the negative economic contagion will continue in the region. This will mean that the economic restructuring of China will remain an issue for both Singapore and Malaysia.

MACROECONOMIC IMPACT - Interest rate policy by the Federal Reserve

Emerging Asian banking came under pressure as the market priced in monetary tightening by the Federal Reserve las year. The stronger US dollar hit exchange rates and the repayments of dollar denominated debt became a real issue in the region.

In 2016, as the Fed has dialled back on its tightening, the concerns of Emerging Asian economies have dissipated somewhat. In December 2015 it was feared that the Fed could hike four times in 2016, however, the current market pricing is for possibly just one and maybe even none. **The Fed pushing back on its tightening program subsequently increases the attractiveness of debt from relatively higher interest rate countries. The "carry trade" (borrowing in a lower yield currency to buy assets in a higher yielding currency) is working again** and this has certainly helped the issuance of dollar denominated debt in Malaysia. The spread of the dollar denominated Malaysian 10 year Sukuk (i.e. the Sharia compliant Islamic Bond) over the US 10 year Treasury is currently around 200 basis points and clearly the fall in the yields of US Treasuries has helped.

The fact that the Federal Reserve has been steadily pushing back on its tightening of interest rates will have certainly played a role in why currencies of South East Asia have strengthened against the dollar this year. Both the Singapore dollar (appreciated by over 5%) and Malaysian ringgit (appreciated by around 7%) have strengthened significantly since the beginning of 2016. The search for yield is certainly one key factor.

FUNDAMENTALS - Overview of key economic indicators

	SINGAPORE	MALAYSIA
GDP growth	**+2.1%** in Q2 (was 2.1% in Q1)	**+4.0%** in Q2 (was 4.2% in Q1)
Interest rate*	**+0.37%** (down from 0.44%)	**+3.0%** (down from 3.25%)
10 year Govt bond yield	**+1.7%**	**+3.5%**
Inflation	**-0.7%** in June (up from -1.7%)	**+1.6%** in June (down from 2.0%)
Debt to GDP	**105%** (Dec 2015)	**54%** (Dec 2015)
Budget deficit	**-1.2%**	**-3.4%** (improved from -3.5%)
Current account deficit	**+19.6%**	**+2.8%**
Corruption rank **	Score: **85** Rank: **8**/167	Score: **50** Rank: **54**/167
Currency performance vs USD year to date***	Singapore dollar **+5.5%**	Malaysian ringgit **+7.1%**

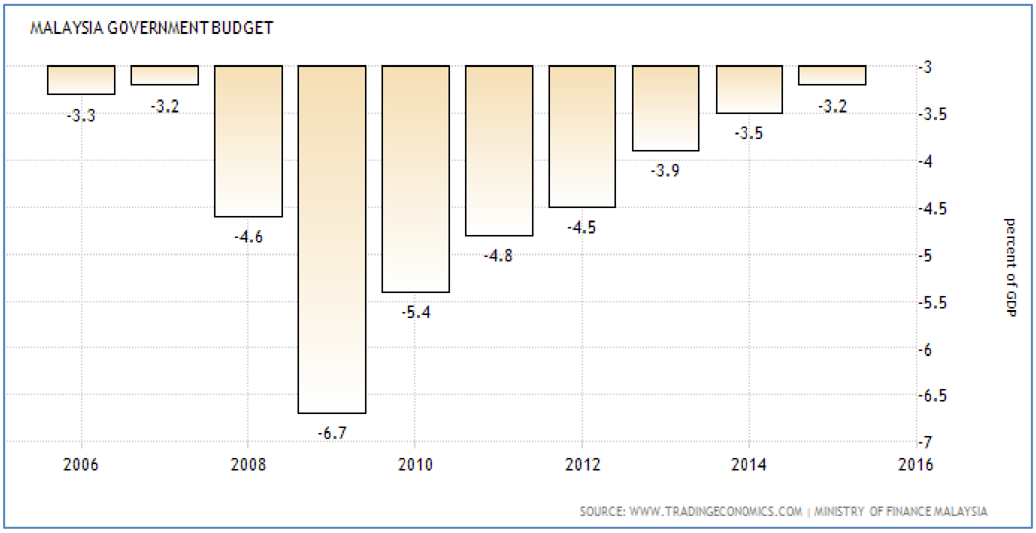
**Interest rates in Singapore are taken as the Singapore Average Overnight Interest Rate – the Monetary Authority of Singapore does not control monetary system via interest rates, instead managing the exchange rate policy*
***as per the Corruption Perceptions Index as at December 2015*
****as at 15th August*

Both Singapore and Malaysia are achieving decent levels of growth (certainly relative to other countries in this low global growth environment), and both run current account surpluses (a big positive for currency protection). **Furthermore, the higher interest rate amidst relative economic stability is likely to be one of the reasons behind the improvement in demand for Malaysian bonds.**

The recent Malaysian interest rate cut may conventionally be seen as a negative for the ringgit, but with US monetary policy not tightening as fast as previously anticipated (see later), the carry trade is attractive once more. The negative inflation in Singapore means that monetary policy from the Monetary Authority of Singapore looks set to remain loose, with core inflation around 1.1%. Perhaps this is one of the reasons behind the outperformance of the ringgit relative to the Singapore dollar.

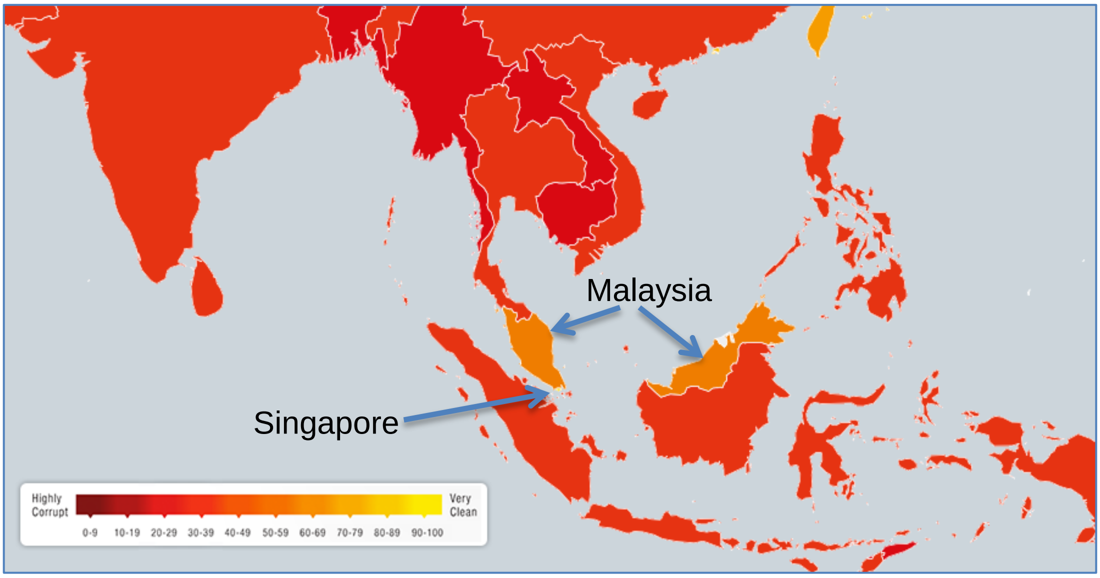
The 3.2% budget deficit for Malaysia is worse than Singapore's deficit of 1.2%, but continues to improve and is less of a concern considering the fiscal stability the Malaysian government is exhibiting and a comparative low debt to GDP at 54% (versus a relatively high 105% for Singapore). Furthermore, Singapore's budget deficit seems to be on a path of deterioration and is at its worst level for over 25 years, whilst Malaysia's budget deficit has been improving for the past six years.

The graphs below show the track of government budget deficits in Singapore and Malaysia in the past ten years. You can see tat they are currently on divergent paths.



However, **one of the main differences is in the comparison between the perception of corruption in the two countries.** This is certainly an issue that could impact on the business of banking. Singapore does very well with combating corruption with a score of 85 out of 100 and lies an impressive 8th on the Corruption Perceptions Index. Malaysia on the other hand is struggling with corruption with a score of just 50 out of 100 and ranks a lowly 54th out of 167 countries.

The map below shows the scale of corruption in South East Asia. Whilst Malaysia (in orange) may seem corrupt against Singapore (in yellow), when compared with the rest of the South East Asian economies, Malaysia is actually positioned relatively well. However, as I discuss below, **corruption in Malaysian is still a significant problem and recent issues could have a lasting legacy on investor perceptions. In stark contrast, Singapore is one of the least corrupt countries in the world.**



MALAYSIA

There are different aspects to consider here when it comes to economic performance:

- Corruption
- The impact of falling resources prices
- Credit rating agencies
- Interest rates
- Sharia Law

Corruption – Ignoring the 1MBD scandal?

The 1MDB scandal may have rocked Malaysia but the political impact on Prime Minister Nijab Razak seems to be fairly limited, so far. More than $1bn has been embezzled from the 1 Malaysia Development Berhad fund (1MDB), around $681m of which apparently found its way into the bank account of PM Najib.

Although the story is even now still unfolding, the Prime Minister appears to have come out of the scandal relatively unscathed. Nijab became chairman of the 1MDB advisory board in 2009 but the fund rang up huge debts amid a string of suspicious business dealings. The scandal has drawn in Middle Eastern royalty (the money into Nijab's bank account was said to be a "gift" from the Saudi royal family), investment bank Goldman Sachs and the use of offshore tax havens. However, as yet the whole picture remains unclear and Nijab has resisted calls to resign as prime minister.

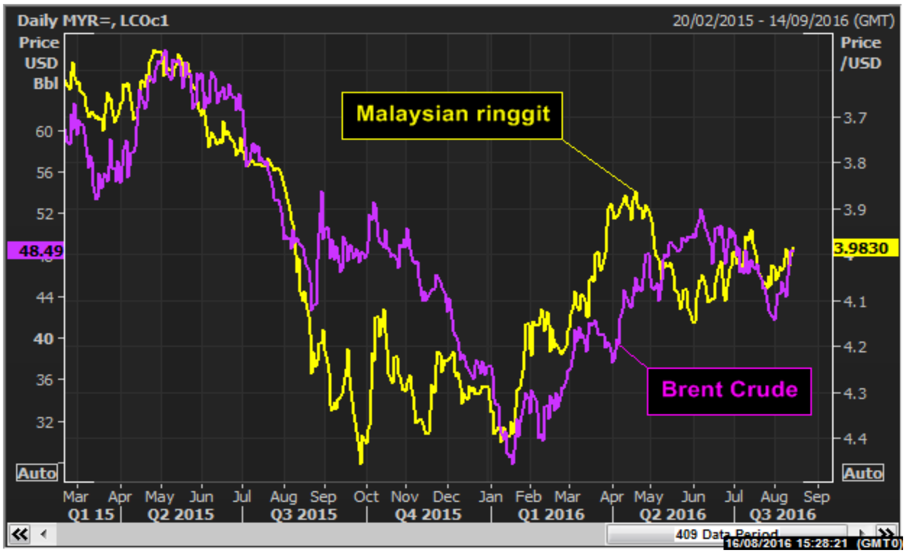
The ruling party in Malaysia has been in power since 1957 and there is a high level of corruption amongst the ruling elite that has allegedly resulted in the embezzling of the country's natural resources (mostly oil and palm oil). However, in the wake of the 1MDB scandal, Nijab's attempt to consolidate power has reportedly resulted in even more corruptive practices which have looked to neutralise the investigation, with constant pressuring of the independent media outlets and the incarceration of protestors.

Subsequently, even in the face of such significant accusations, **the political scandal has done little to impact the ruling party's power**. The ruling coalition Barison Nasional won 72 out of 82 seats in the Sarawak regional elections in May.

The Corruption Perceptions Index for Malaysia is low at 50, suggesting a high level of corruption, however, it would appear that the country is managing to look past this, whilst the international financial markets also do not seem to be too bothered either at the moment. The 10 year Malaysian Government bond yield has dropped from around 4.2% at the beginning of 2016 to now stand at below 3.5%. This is less than 200 basis points above the yield on 10 year Treasuries.

The impact of falling resources prices

The sell-off in the oil price has hit the Malaysian Government's finances, however the economic dependency on oil in Malaysia has dropped. **Having previously accounted for around 40% of the national budget, the government has now reduced the dependency on oil to just 15% to 20%.** With the oil price falling so significantly in recent years, this seems to be a good move. However, even then, oil is the country's chief resource and Malaysia is still a net oil exporter, subsequently there is still a positive correlation between the performance of the oil and the performance of the Malaysian ringgit.



The government budget for 2016 assumed an oil price of $48 per barrel. The average price of Brent Crude for 2016 to date has been just a shade above $42 per barrel so the low price of oil would have continued to have a negative impact.

The government had been targeting a budget deficit of 3.1% which it is marginally missing (currently the budget deficit is around -3.4%). This gives the government little room for increased spending through fiscal stimulus, however, the self-imposed ceiling of 55% of Debt to GDP remains in check (currently around 54%). Despite these minor discrepancies, the government's commitment to fiscal discipline and the international financial markets have been relatively kind.

A more stable Malaysian economy is helping

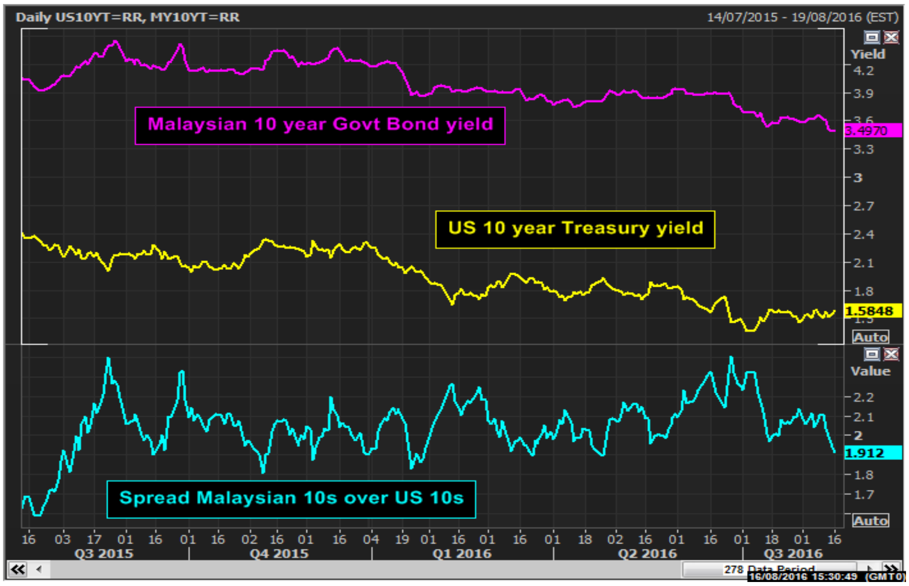
After a period of instability both financially (volatility/weakness of the ringgit through previous pressure of a stronger dollar) and politically (the scandal of 1MDB) there is now an increased confidence in Malaysia as the economy looks to stabilizing along with that of the political position. **Markets tend to be more confident during time of stability.**

This stability is reflected in the views of the ratings agencies such as RAM Ratings which have had a far more settled outlook for Malaysia this year. Positives are seen to come from the government's commitment to fiscal consolidation and the stability of the ringgit which helps to play down the foreign exchange risk.

Interest rate cut in Malaysia

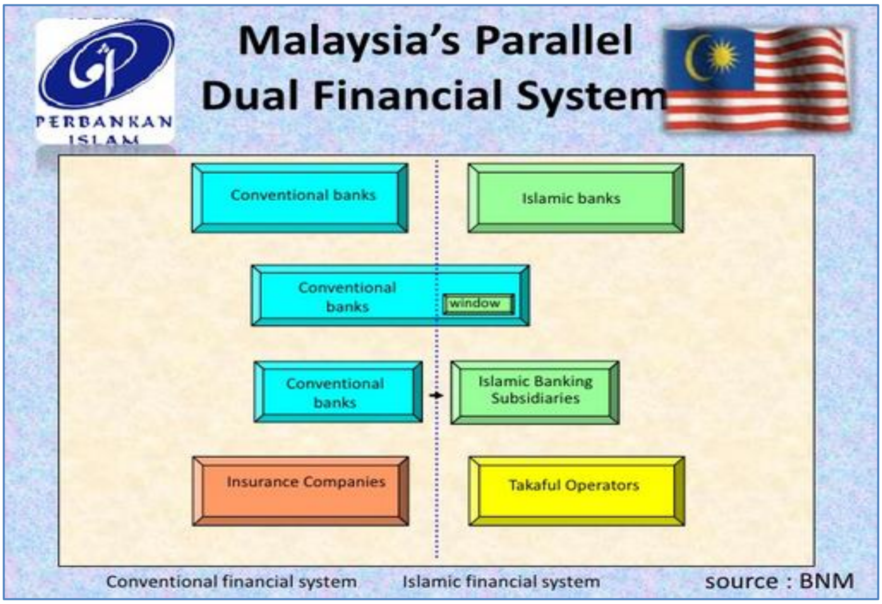
Faced with a slowing economy, amidst falling oil revenues and slowing exports there was a 25 basis points rate cut in early July, to 3.0%. The central bank also suggested that it is unlikely to be the end of the monetary easing. This may not be great for investors, however bond issuance by Malaysian companies looking to refinance is really strong. Malaysia is the world's largest sukuk market (Islamic bonds) and according to Bloomberg growth in issuance is supposed to be around 19% in 2016.

The Malaysian 10 year bond yields around 3.5%, which on the spread over US 10 year Treasuries is back close towards the 12 month lows around 190 basis points.



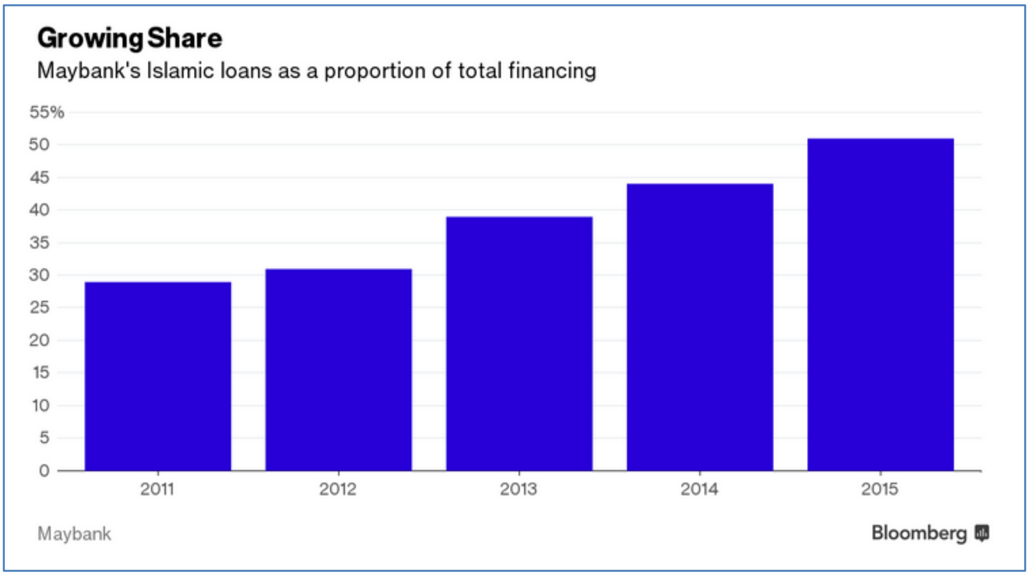
Malaysian banking - Sharia Law

Malaysian banking runs through a parallel dual financial system, done through both conventional banking and also through Shariah compliant processes. According to Bloomberg, the Shariah compliant sector provided around 26% of banking in Malaysia in 2015, however the contribution is growing. **Around 60% of the population of Malaysia is Muslim and the government has a goal of increasing the proportion of Malaysian banking that is Shariah compliant to 40% by 2020.**



Shariah law forbids the payment of interest and Islamic loans are structured using discounts, sale or lease, profit participation or repurchase agreements. Shariah compliant finance has a reputation of not being as profitable as conventional banking. However, looking at the performance of Malayan Banking, the country's biggest lender, this may not be entirely the case in Malaysia.

In March, Malayan Banking, announced that for the first time it was issuing more Islamic loans than non-Shariah compliant loans as it has been looking to grow the sector. With the group's subsidiary MayBank Islamic providing a total of 51% of financings, apparently this total is set to continue to grow, perhaps even to 60% or even 70% in the coming years. However**, interestingly, Maybank Islamic also achieved an average 16% return on equity in the last four years, compared with 14% for the parent group. If the performance of Maybank is not an isolated case, this could bode well for the country as a whole.**



Maybank Islamic is the world's third-biggest Shariah lender outside of Iran (after Saudi Arabia's Al Rajhi Bank and Kuwait Finance House). With regards to financial performance, Maybank's profit before tax has grown at an average of over 18% for the past five years (to 1.64bn ringgit in 2015). It is also the domestic market leader for loans and deposits with respective market shares of 33.5% and 26.3%.

Furthermore, the Islamic finance industry itself is growing, so Maybank is well placed to take advantage of this as the market leader. Global Islamic population is expanding faster than non-Muslims and increasing wealth is driving growth in Shariah-compliant finance. According to an estimate by Ernst & Young, the industry's worldwide assets will double to $3.4 trillion by 2018 in the five years from 2013.

SINGAPORE

The outlook for Singaporean economic growth suggests that the country continues to chug along at a relatively slow pace. According to the forecasts from the Ministry of Trade & Industry, GDP projections for 2016 have recently been narrowed to between 1% and 2% (from a previous range of between 1% and 3%), whilst this year is set to show the slowest economic growth since 2009.

The impact of a weakening outlook for global growth and the potential knock on impact of Brexit have contributed to the narrowing of GDP expectations. The ongoing slowdown in China with increased levels of debt defaults are also having a part to play, with GDP in the second half of 2016 expected to be weaker than the 2.1% GDP seen in H1. The slowdown is being seen across the economy, with the service sector (which accounts for around two thirds of the economy) slowing to 1.4% in Q2 (from 1.7% in Q1), whilst export oriented sectors remain at the mercy at the mercy of slowing global fundamentals and the strengthening of the Singaporean dollar in the past few months.

The Monetary Authority of Singapore (MAS) manages monetary policy by allowing the Singapore dollar to appreciate or depreciate against an undisclosed basket of currencies from its major trading partners. **The Singaporean authorities have therefore been looking to ease monetary policy through not allowing the Singapore dollar to appreciate against the dollar.**

In 2016 growth has been subdued whilst core inflation has also been slowing, now closer to 1% and is likely to be below 2% for the medium term now. As is typical with many of the SE Asian economies though, attention need to be given to Federal Reserve monetary policy and the slowdown in China with the economy so closely associated.

Singaporean Banking and Credit Rating Agencies

Singaporean banks are going to be less profitable in 2016 as there has been slower economic and trade growth in the country and across Emerging Asia. This has been led by the slowdown in key trading partners, China and Malaysia. This comes with the economic growth projections from ratings agency Moody's falling to 1.6% in 2016 and 1.5% in 2017, which is well down from the average growth of 4.5% that was achieved between 2011 and 2014. The perception is also that banks are likely to see asset quality negatively impacted whilst problem loans could also rise.

Despite this though, broadly speaking, the banking sector in Singapore is well capitalised with strong capital buffers and government support.

However, this did not stop ratings agency Moody's cutting the credit rating for the Singapore banks sector to negative (from stable) in March 2016. This was apparently due to the fact that bank lending had fallen for five months in a row from a year ago, something that had not been seen since 1999. The downgrade reflects the likely direction of the rating over the next 12 to 18 months. The move also reflects the more challenging environment for Singaporean banks in 2016 that could impact on asset quality and profitability moving forward.

Despite the decline in economic growth and the impact on banking, the issues today are different to those faced during the financial crisis of 1998. This time around there are no systemic issues such as high corporate leverage significant currency exposure or a global liquidity crunch.

Ultimately though, the banking sector in Singapore is still deemed to have strong balance sheets with strong capital buffers, loan loss provisions and more robust funding and liquidity profiles. This should certainly help to contain the impact of a slowdown, and once the bottom is found, the sector could be well positioned to take advantage of any upswing.

S&P holds its rating

However, the views of the ratings agencies do differ. **In March, S&P maintained a "stable" outlook for the Singaporean banking sector (its coverage is for the three largest banks, DBS, OCBC and UOB).** S&P said that the banks all had "sufficiently solid financial profiles to endure the difficulties… supporting our AA- long term issuer credit rating".

S&P noted that the loan-loss reserve was more than 100% of problem loans, whilst the lower credit growth that was being seen in the industry would also put less pressure on capital. For example, there have been macro-prudential measures taken to try to cool the housing market and this seems to have had an impact with loan growth expected to be between 3% and 5% in 2016.

However, there is a flip-side to this. Whilst lower loan growth may make the banks less susceptible during an economic downturn, there is an impact on banking profitability. Around 60% of revenue for Singaporean banks comes from interest income from loans.

Moody's assessment of the "Big 3" in Singaporean banking

Moody's also gave an assessment of the individual Singaporean banks in May, where it said that of the **"Big Three" banks (DBS Bank, Overseas-Chinese Banking Corp and United Overseas Bank)** individual performance could vary according to geography, risk appetite in capital markets, funding structures and the introduction of Basel III rules.

Here is Moody's appraisal of each of the factors:

- **Geography** – UOB would be expected to outperform due to its larger exposure to Singapore. OCBC and DBS have larger exposure to risker banking markets such as China, Thailand and Indonesia. DBS for example has around 17% of gross loans exposure to greater China.
- **Capital Market Activities** – Whilst all three are generally low risk appetite, DBS has the relatively larger market risk appetite and has a higher share of trading gains in its earnings than OCBC or UOB.
- **Funding Structures** –DBS has the lowest cost of capital with a higher share of lower yielding customer deposits. Whereas, OCBC profits are more dependent on volatile earnings from its insurance division (Great Eastern Holdings).
- **Basel III rules** – Under Basel III, non-consolidated insurance subsidiaries will need to be fully deducted from their CET1 capital base. Therefore, OCBC will be impacted by deducting Great Eastern from its CET1 capital, whereas DBS and UOB will have less deductions to make

Singaporean banking sector exposure to the Oil & Gas slowdown

There have been concerns over the exposure of the local banks to the Oil & Gas sector. However **there is an expectation that the contagion to the financial sector would be contained due to a relatively limited exposure.**

In early August, the MAS Deputy Director Jacqueline Loh announced that the MAD saw the exposure of the banks to the oil and gas sector was only around 6% of total loans, whilst also reiterating the banks had "robust capital buffers and prudent provision".

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