Source: The StarBiz, 15 April 2023

Are there *increasing* cracks in banks?

First there was the Silicon Valley Bank collapse, then the bank run on Credit Suisse that resulted in investors of the lender's bonds losing their shirts. Now banks in the United States face another crisis related to commercial real estate. What are the implications for Malaysia?

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FINANCE

Banks in spotlight

Bankers and economists reckon that risk management frameworks of local lenders will keep sector sound for now

By YVONNE TAN
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ONCE thought of as a safe and secure bet, banks are increasingly looking vulnerable stemming from the recent crises that hit Western lenders such as Silicon Valley Bank (SVB) and Credit Suisse AG.

Now another crisis appears to be on the horizon for the global banking sector, no thanks to a US$1.5 trillion (RM6.61 trillion) wall of debt looming for US commercial properties, as reported by *Bloomberg* this week.

Borrowers whose payments for this debt will be due in the coming years, will find it increasingly challenging to find the funds to pay up amid higher interest rates, falling property valuations and tighter sources of credit.

There's a double whammy factor, as banks themselves are said to own a lot of the bonds that are supported by loans taken to finance the same properties.

While these issues seem to be only impacting banks in the West for now, there is concern that the effects could spill unto banks in this part of the world, considering the interconnectedness of financial institutions.

Consider the recent case of the Additional Tier-1 or AT1 bonds of Credit Suisse which were completely written down after the financially-troubled Credit Suisse got taken over by its rival, UBS AG.

The bonds which were valued at over US$17bil (RM74.9bil) are now worth nothing.

Some of the investors that were hurt in this debacle were Asian investors including Malaysian and Singaporean high-net-worth individuals who suffered losses from holding such bonds either directly or via other instruments that included these bonds.

"All top banks and asset managers with private wealth management businesses may have sold the AT1 products in one form or another. The losses have been painful for investors," says one private banker.

It is unclear whether these AT1 bonds, which ironically were supposed to be a safer investment choice compared to bank shares, were sold only to sophisticated investors, or were they also sold to the average investor via unit trusts.

But what is clear is that many banks and asset management houses, even here in Malaysia, had sold it and as a result, many fingers were burnt.

In Singapore, it has been said that one of its big banks had sold close to US$400mil (RM1.76bil) worth of these AT1 bonds to its clients.

AT1 bonds are supposed to be a compelling investment choice as the bond holders are considered higher in the hierarchy of equity investors and are supposed to be compensated first if a lender runs into financial issues.

In the case of the Credit Suisse AT1 bonds, these looked attractive as they also carried relatively high coupon rates at a time of very low interest rates.

Naturally, investors sitting on cash were attracted to such bonds, considering also that the underlying asset was a supposedly world renowned bank, namely Credit Suisse.

However, after a massive deposit flight and a buyout by UBS, regulators in Switzerland had decided to compensate shareholders of the lender, instead of the bond holders.

Elsewhere on a larger scale of things, Western banks, American ones at least, have been recently reported to see their customer deposits fall the most in at least a decade as jitters about the health of banks, coupled with high inflation which eats into savings, kept depositors away from traditional lenders.

This brings us back to the fact that financial institutions the world over are somewhat connected and so, the ripple effects of any banking industry gone wrong in most parts of the world, will be felt here.

Industry players weigh in with their views on this, commenting on how the current fragile banking sector overseas will impact Asia, specifically Malaysia.

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>
> Datuk Sulaiman Mohd Tahir

Relatively safer

AMMB Holdings Bhd group chief executive officer Datuk Sulaiman Mohd Tahir says when analysing the potential commercial real estate (CRE) crisis in the United States, it is important to note that any impact on banks will most likely be felt primarily within their operating territory.

"Unlike the 2008 global financial crisis, which had a more international impact, any contagion risk from the current situation may be limited to declining confidence rather than direct exposure to the US commercial property sector," Sulaiman tells *StarBizWeek*.

He says banks operating in the United States may face increased refinancing risk due to higher borrowing costs and tighter lending standards, which typically occur during periods of economic slowdown.

"Furthermore, the shift towards permanent work-from-home arrangements resulting from the pandemic may further impact the occupancy rates of commercial properties in the sector," he adds.

Within Malaysia, he says, risk management frameworks are firmly in place to ensure the safety and soundness of the banking sector.

"While there is always some degree of risk associated with any banking system, especially in times of economic uncertainty, the key to mitigating such risks lies in the ability of the banks to identify and manage these risks effectively, while maintaining adequate capital buffers."

He also notes that Malaysia's banking system has survived major crises such as the 2008 global financial crisis and the eurozone sovereign debt crisis.

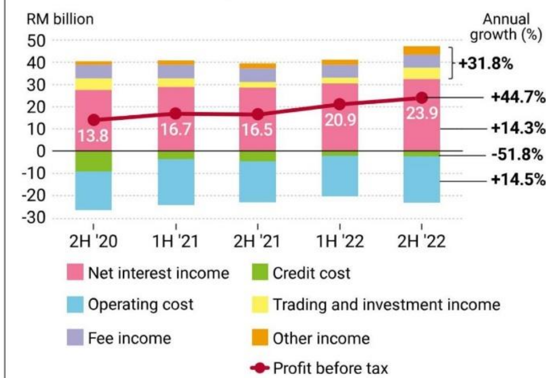
"Although the ride was bumpy, it is a testament to the resilience of Malaysia's banking sector."

Sunway University economics professor Yeah Kim Leng says being "profitable, well capitalised, strictly regulated and relatively liquid" with adequate provisioning for non-performing loans, Malaysian banks are "relatively safer" than those in most countries in the region as well as those in developed economies.

Loan delinquencies may rise

However, he cautions that the

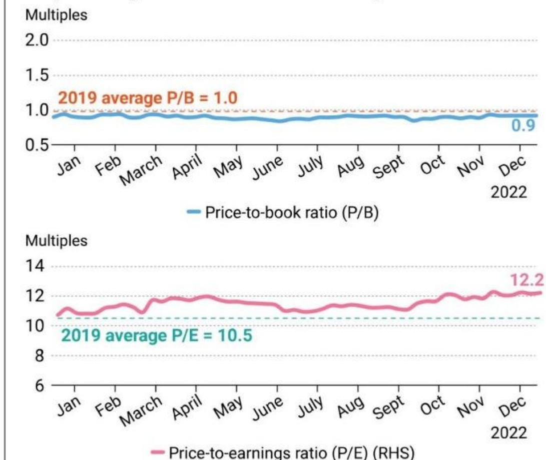
Income, cost and profit before tax



Note: 1. Annual growth computed based on figures for 2H 2021 and 2H 2022.
2. Figures may not add up due to rounding.

Source: Bank Negara

Price-to-book and price-to-earnings ratios of publicly listed banks in Malaysia



Note: Refers to median ratio of all publicly listed banks in Malaysia.

Source: Bloomberg

The Star graphics

Strict requirements: The Bank Negara logo is seen at its museum and art gallery in Kuala Lumpur. The central bank requires banks to maintain healthy capital and liquidity buffers, and to adopt robust risk management practices, including rigorous stress testing, to ensure that they remain resilient during extreme stress scenarios.

country's high household debt levels and relatively large exposure to the property market may elicit concerns over the potential rise in loan delinquencies.

"This is especially the case after the end of the loan moratoriums imposed during the pandemic. However, the adverse impact has yet to emerge in the balance sheets of banks and their quarterly performances," Yeah tells *StarBizWeek*.

He adds that most Asian banks are exposed to the property sector through direct lending in the more traditional way rather than having an additional risk through investment in mortgage-backed securities like the West.

"In Malaysia, the government-owned agency Cagamas Bhd tasked to enhance liquidity for banks to extend more loans to the housing sector, is rated *AAA*, the highest credit rating.

"This should allay any concern of a similar financial crisis emanating from the banking or housing sector," he adds.

Socio-Economic Research Centre executive director Lee Heng Guie says in the United States, higher interest rates, tighter credit conditions and tightened lending credit standards are expected to exacerbate the existing liquidity crunch in the trillion-dollar CRE debt market.

"It is estimated that more than US$2.4 trillion (RM10.6 trillion) of debt is expected to mature over the next five years," Lee says.

Within Asia, he reckons since the subprime-triggered Global Financial Crisis in 2008/2009, regulatory and central banks' intervention have curbed banks' risk appetite in real estate, comprising residential and commercial real estate.

"Macro-prudential measures such as targeted purchases of investment property and tightened lending criteria have been in place to strengthen the banking sector's resilience against any potential property stress and risks of overheating."

That said, Malaysian banks' exposure to non-residential properties has been increasing steadily from RM55bil or 8.5% of total banking system loans outstanding at end-December 2007 to RM240.4bil or 11.9% as at end-February 2023.

"In terms of growth, non-residential properties' loan portfolio moderated sharply from an average annual growth of 17.3% per annum in 2007-2015 to 2.6% per annum in 2016-2022, reflecting the continued consolidation as well as adjustment of the sector to over-building as developers add more supply amid stagnant demand."

While the CRE sector in Malaysia could see potential asset quality weakness as new supply of office buildings and shopping malls result in a likely overhang and correction in market valuations, Lee believes the banking system has strong financial buffers in terms of capital, liquidity coverage and provisioning to absorb deterioration in asset quality.

RAM Holdings Bhd rating specialist for financial institutions Amy Lo also reckons that domestic banks are well positioned to face headwinds from increasing financial market volatility and uncertainty amid the banking stress in some advanced economies.

"Robust loss absorption buffers, diversified funding and well-controlled asset quality risks continue to anchor the resilience of the Malaysian banking system."

Lo reckons despite some pockets of oversupply in the CRE sector in Malaysia, risks to financial stability remain low.

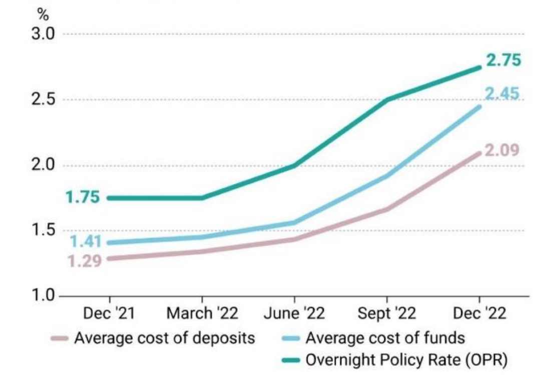
"Credit exposures to the CRE sector amounted to less than 8% of the banking system's assets while impairment ratio was low at below 2% as at end-2021, based on latest data from Bank Negara."

Lo also points out that part of the concern about the US commercial property market centres around the commercial- backed securities (CMBS) sector where these face significant refinancing risks.

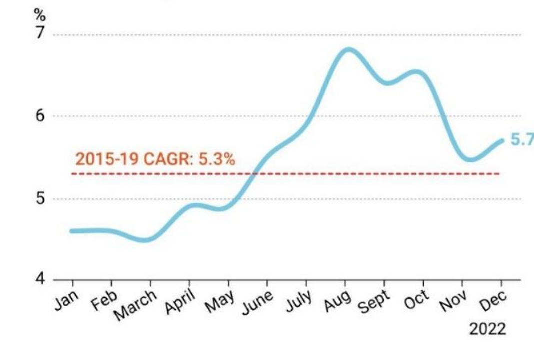
"Our CMBS market is smaller, mostly issued by real estate investment trusts and individual asset owners. In addition, valuations of domestic CMBS transactions valuations are less stretched and have lower property leverage, providing a cushion should values decline."

She reckons most of the underlying assets are still resilient, although recovery prospects of the office and hospitality asset sectors remain challenged by oversupply.

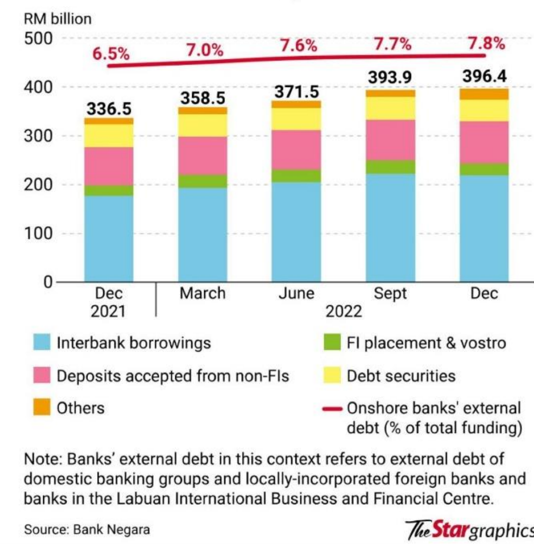
Average cost of deposits, average cost of funds and OPR



Annual loan growth



Banks' external debt – by instrument



Note: Banks' external debt in this context refers to external debt of domestic banking groups and locally-incorporated foreign banks and banks in the Labuan International Business and Financial Centre.

Source: Bank Negara

The Star graphics

Stress testing

Deloitte Malaysia financial services industry leader Justin Ong says stress testing on banks has helped Malaysian banks embrace a more rigorous and forward-looking view in their planning.

"A licensed banking institution in Malaysia is expected to have a rigorous and forward-looking stress testing programme that commensurates with the nature, size and complexity of its business operations and risk profile.

"Over time, the stress testing has been strengthened, via the introduction of reverse stress testing in 2017. As part of the stress testing programme, a licensed bank in Malaysia needs to determine its point of non-viability and estab-

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Banks have been working on developing their recovery plans

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lish triggers for management action before the viability or solvency of the banking institution is threatened," Ong says.

Worth noting, he adds is that since 2021, Malaysian banks have been working on developing their recovery plans.

"Each bank is required to identify and plan for the execution of a suite of recovery options to restore its long-term viability in case of an extreme adverse scenario or event.

"This demonstrates that Malaysian banks are committed to ensuring that there is a well-developed plan in place to ensure the overall recoverability of financial institutions."

KPMG Malaysia head of banking Ahmad Nasri Abdul Wahab says the risk of any banking system facing a crisis exists, and this is not unique to Malaysia, given the interconnected nature of the global economy and the reliance on global trade and supply chains of today.

"Recognising this, banks are always subjected to rigorous risk management practices imposed by regulators.

"This is reflected in the continuous issuance of updates and guidelines, such as recovery plan guidelines, which aims to ensure that banks are prepared to execute timely and effective recovery actions in the event of near financial non-viability."

Like his counterparts, Ahmad points out that Bank Negara requires banks to maintain healthy capital and liquidity buffers, and to adopt robust risk management practices, including rigorous stress testing to ensure that they remain resilient during extreme stress scenarios.

"By doing so, it aims to safeguard the stability of our banking system and protect the interests of depositors and other stakeholders."

UOB Malaysia senior economist Julia Goh says following the recent financial turmoil in the United States, the US Federal Reserve and authorities have turned more cautious and are prepared to deal with any further financial instability.

"This would include a potential pause to interest rate hikes.

"Coming to Malaysia, the risk factors differ in a sense that Bank Negara has been less aggressive in hiking rates and property prices here are comparatively more muted relative to other countries," says Goh.

"Based on Bank Negara's latest financial stability analysis, credit risks among the listed corporations here are manageable helped by the reopening and economic recovery. However there was an increased number of firms-at-risk in the construction and real estate segment which was attributed to persistent oversupply.

"The silver lining is that Malaysian banks have strong capital and liquidity buffers that are sufficient to absorb a potential increase in credit losses from the business sector."

OCBC Bank chief economist Selena Ling says while there was an initial knee-jerk reaction to the news of SVB and other Western banks faltering, the Malaysian banking system remains resilient with sound credit fundamentals including capital adequacy, liquidity coverage and net stable funding ratios at 18.8%, 154% and 118%, respectively, last year.

"As of January 2023, excess capital buffers amounted to RM141.5bil and gross non-performing loan remains stable at 1.7%."

Citing information from a RAM Ratings report, Ling adds that loans and deposits are also well diversified across sectors.

Less than 25% of Malaysian bank holdings are in bond securities, and on average, less than 40% of the bond holdings are classified as held to maturity, while the rest are marked to market, she adds.

Ex-investment banker turned private investor Ian Yoong has an interesting take and says that despite the generally strong balance sheets of Malaysian banks, he expects Bank Negara to persuade banks in Malaysia – especially the smaller ones – to merge eventually.

"Banks are after all the last bastion of financial stability in any economy. Mergers of small banks with larger banks will not only shore up their balance sheets but optimise operating expenses. The advent of digitisation and digital banking have reduced the need for extensive branch networks."

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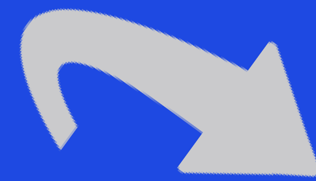

Addressing the gaps

WHILE economists and bankers feel that the overall Malaysian banking system remains sound, there's been another issue that has been gaining attention in the aftermath of the Credit Suisse saga.

What happens when investors get burnt badly after buying financial products from local lenders and financial companies?

Case in point – the Credit Suisse Additional Tier-1 (AT1) bonds which were written down to zero after the Swiss lender was bought out by its rival UBS recently.

Although there has been no official sales figures, it is understood that these bonds were sold all the way here by several investment banks, leaving a trail of losses for the once hopeful investors.

This begs the question, who is responsible?

To be sure, these bonds, themselves complex products, were likely sold to sophisticated investors who probably knew of all the possible risks, unlike mom-and-pop type of investors.

But while it is a fact that investors should know the risks of any investment before they go into it, and all the required information is normally found on the necessary term sheets, the question of whether relationship managers (RMs), financial advisers or whichever bank or asset management firm which sells investment products to clients should also be held accountable when things go sour is up for discussion.

This is especially when the losses are major and there were many early red flags surrounding a particular investment, some industry observers say.

In the case of the Credit Suisse AT1 bonds, *StarBizWeek* has received some emails from investors who had bought them, with one saying that he had, late last year, raised some concerns over Credit Suisse's financial troubles to the local RM that sold him the AT1 bond back in 2020, only to be told that the firm was comfortable with their position where Credit Suisse was concerned.

Notably, the issue was highlighted amid news of downgrades of Credit Suisse's debt ratings and the bank's financial woes.

In a separate issue, it was reported recently that the auditor of one of the US banks which went bust in March had failed to raise the red flag on certain issues and had even given the bank a clean bill of health, just two weeks before it collapsed.

"Again, the clients, sophisticated or not, seem to be the victims here, so what can be done?" asks one observer.

Sunway University economics professor Yeah Kim Leng says if the risks of a certain investment product were not fully explained to investors, the financial advisers involved would need to shoulder part of the blame for losses suffered by investors.

Yeah says in some cases, regulatory authorities may need to review the financial adviser's role, responsibilities and practices, in order to address any gaps in regulations, training and education as well as code of conduct.

Deloitte Malaysia financial services industry leader Justin Ong says there isn't an easy solution to this issue.

Generally, within the finance industry, there has been no shortage of well-publicised and highly damaging misconduct scandals over the past decade, Ong says.

"We are operating in a 'trust deficit' financial services industry today. Misconduct risk is pervasive, and there isn't a simple solution to this problem."

He says damaging misconduct scandals within the financial services industry over the past decade has been propelled in the light of an increasing number of financial scandals such as the Wells Fargo account fraud, the Libor-rigging scandal in the UK, and as recent as April 2018, a currency trader from HSBC was convicted of fraud for front-running.

"Based on research by the Fixed Income, Currencies and Commodities Markets Standards Board, banks globally have paid some US$375bil (RM1.65 trillion) in conduct fines over the past five years. The problem is widespread, and Malaysia is no exception," Ong adds.

Within Malaysia, he says the set-up of the Consumer Credit Oversight Board Task Force in July 2021 is a commendable effort to better provide fair treatment of borrowers.

"Currently, there are multiple laws governing consumer credit activities and there are fragmented regulatory and supervisory frameworks and varying levels of protection accorded to consumers."

KPMG Malaysia head of banking Ahmad Nasri Abdul Wahab says in Malaysia, financial institutions (FIs) are required to comply with the Fair Treatment of Financial Consumers framework, which mandates that FIs act fairly and prioritise their customers interests by exercising due care, skill and diligence.

"The framework sets out clear outcomes that FIs must achieve to ensure the fair treatment of their customers, including access to suitable financial products, clear disclosure of product information and pricing, and prompt and efficient customer service and complaint resolution.

"Customers who feel that an FI has not acted in their best interest can lodge a complaint with Bank Negara which takes such complaints seriously.

"I think the availability of this channel for customers to voice their concerns and grievances is good, as it allows the practice of transparency and accountability in the financial sector, which directly enhances consumer confidence in the industry."

AMMB Holdings Bhd group chief executive officer Datuk

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Relationship managers must have good understanding of risks involved

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Sulaiman Mohd Tahir says it is important that RMs selling complex products such as AT1 bonds have a good understanding of the risks involved and can advise clients accordingly.

"While RMs may have KPIs and sales targets to meet, it is important that these targets do not come at the expense of the clients' best interests," Sulaiman says.

Commenting on the Credit Suisse AT1 bonds specifically, he says the sale and purchase of complex financial products like AT1 bonds require a specific level of knowledge and expertise from both the client and the RM.

"In Malaysia, clients must meet the definition of a sophisticated investor as defined in the Capital Markets and Services Act 2007, to purchase such products. Additionally, RMs are required to be licensed by the Securities Commission (SC) and pass Modules 6 and 7 of the SC's Licensing Examinations, which set a minimum standard of competency required to act as intermediaries in the Malaysian capital market."

Sulaiman adds that banks are also expected to provide in-house product training to their RMs to ensure that they have the necessary product knowledge. — **By YVONNE TAN**