

## Malaysian Banks' Profitability – Past Trends and Future Prospects

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### Introduction

#### **Bank profitability matters for financial stability and sustainable economic growth**

Healthy profitability levels among banks is fundamentally important to ensure the financial system remains resilient and can support effective credit intermediation in the economy. Stable profits support the accumulation of capital buffers<sup>1</sup> which enable banks to continue providing financial services to consumers even during periods of stress, thus acting to dampen the impact of adverse developments in the real economy. Attracting new capital to support bank lending activity is also much easier when banks are profitable. Existing shareholders and new investors are more likely to provide additional financial support for banks that have sustainable profitability levels given greater certainty on investment returns. Conversely, low profitability could impinge on banks' willingness and capacity to lend, thereby constraining the availability of financing to the economy. Sustainable levels of bank profitability also have effects in mitigating potential threats to financial stability. Banks that persistently record low profits may be incentivised to take undue risks to improve their profitability. For example, in order to generate higher returns, banks may be more willing to take outsized bets on riskier unproductive exposures which can lead to increased financial fragility moving forward.

Given the importance of sustainable banking system profitability to financial sector resilience and the wider economy, this article reviews the trends in, and key drivers of bank profitability in Malaysia. It further considers how a moderation in economic and credit growth, as well as changes in the operating environment could affect bank profitability moving forward.

### Bank profitability trends and drivers

Malaysian banks' profitability has been on a moderating trend in the current decade. While the pre-tax profits of the banking system have grown steadily over the years, banks' returns on equity (ROE) and assets (ROA) have largely trended below the current decade average since 2014 (Chart 1). Market valuations of publicly listed banks, as reflected by the median price-to-book and price-to-earnings ratios, have also been trending lower in line with market expectations on banks' future profitability (Chart 2). An empirical study<sup>2</sup> on the determinants of Malaysian banks' profitability over the period between 2010 and 2018 identified cyclical patterns in credit and economic conditions, and structural changes in the domestic banking industry, specifically increasing competition and improvements in cost efficiency, as having important effects in driving bank profitability.

#### **Cyclical patterns in credit and economic conditions**

The bulk (68.5%) of Malaysian banks' gross income is contributed by **interest income** from lending activities, reflecting the dominant role played by banks in financing the economy (Chart 3). As such, banking system income and profitability typically moves in tandem with cyclical patterns in financial intermediation and economic activities (Chart 4). From 2010 to 2014, banks' pre-tax profits grew strongly at a compounded annual growth rate (CAGR) of 8.9% as banks went through a period of rapid balance sheet expansion driven by strong growth in lending activities, both to households and businesses. At its peak, credit to households grew by an annual rate of 14.2% in 2010. Bank profitability was further underpinned by improvements in asset quality during this period as stable economic conditions supported borrowers' repayment capacity and led to lower credit losses for banks (Chart 5).

<sup>1</sup> Retained earnings, which reflects the net profits accumulated over time after dividends are paid out to shareholders, is one of the largest components (49%) of banks' capital. Retained earnings is an element of Common Equity Tier 1 (CET1) capital which is regarded as the highest quality component of bank capital under Basel III capital requirements in terms of going-concern loss absorption capacity (BCBS, 2010).

<sup>2</sup> The study identified credit growth and bank-specific variables such as cost efficiency (measured as cost-to-income ratio), funding costs, degree of income diversification or lack thereof (measured as proportion of non-interest income to gross income) and capitalisation as important determinants of Malaysian banks' profitability during this period.

Chart 1: Banking System – Profitability

Returns on equity and assets have largely trended below current decade average since 2014

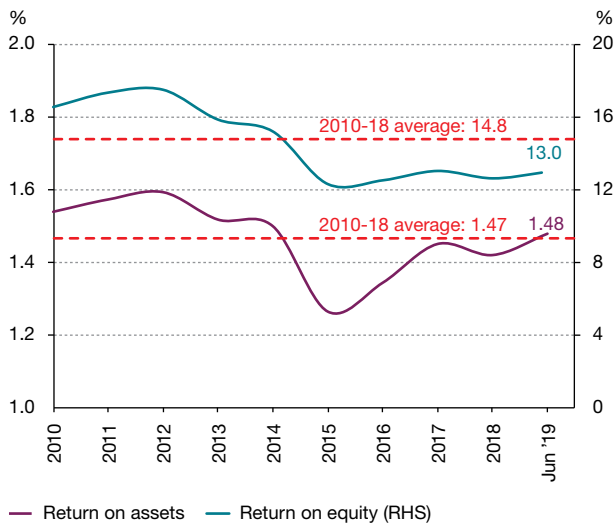


Chart 2: Banking System – Price-to-Book and Price-to-Earnings Ratios of Publicly Listed Banks in Malaysia

Market valuations have been trending lower in line with market expectation on banks' future profitability

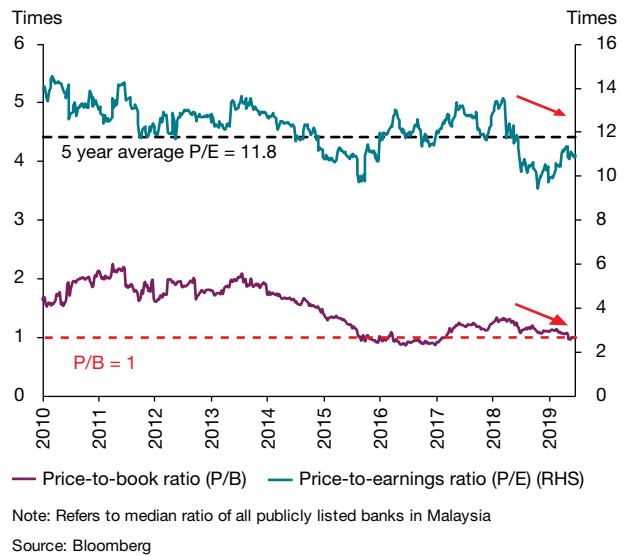


Chart 3: Banking System – Income, Cost and Profit before Tax

Bulk of Malaysian banks' gross income contributed by interest income from lending activities

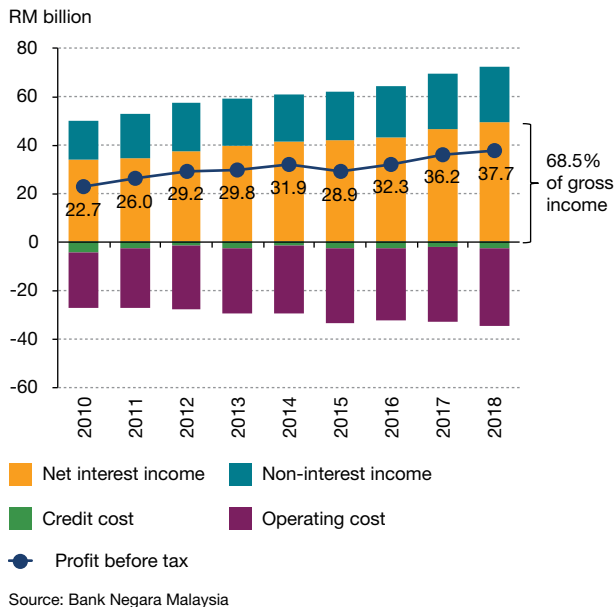
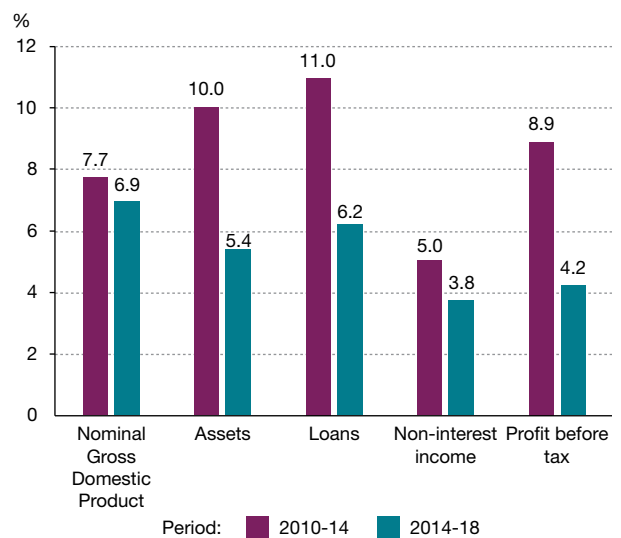


Chart 4: Banking System – Compounded Annual Growth Rate of Assets, Loans, Non-Interest Income, Profit before Tax and Nominal Gross Domestic Product

Profitability and income typically moves in tandem with cyclical patterns in financial intermediation and economic activities

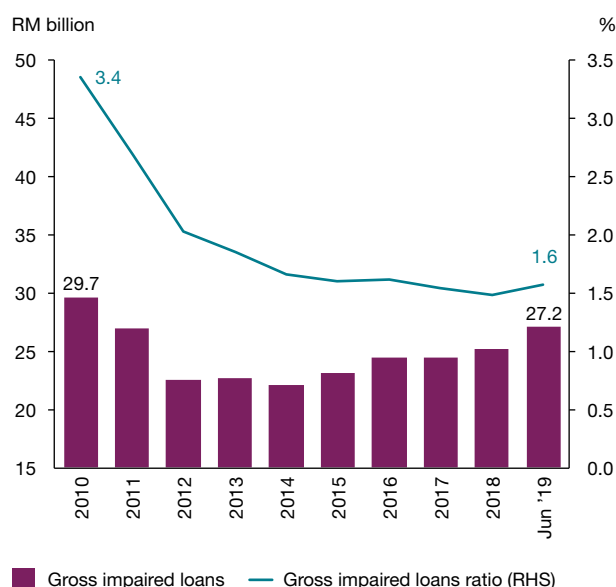


In the subsequent period between 2014 and 2018, banks' balance sheet expansion slowed significantly, driven by a more moderate growth in the economy and tighter financial conditions. During this period, the Malaysian economy was affected by a confluence of domestic and external factors which saw increased non-resident portfolio outflows, weaker oil prices, escalating trade tensions and a lower global growth trajectory. Correspondingly, growth in bank credit and income slowed as there was lower demand for financing and other banking services from businesses in line with the more moderate pace of economic activity. Adjustments by banks to responsible financing guidelines introduced in 2012 also had an effect on moderating household credit growth. Bank profitability was further impacted by higher loan impairments driven by financially-stretched households and business sectors that were most affected by the economic slowdown and tighter financial conditions such as the oil and gas, construction and manufacturing sectors. The moderation in bank profitability during this period, however, was not unique to Malaysia. Similar trends were observed in peer banking systems<sup>3</sup> as global financial and economic developments weighed on global banking activity and profits (Chart 6).

Of note, financial drivers (as represented by banks' asset and loan growth) had a larger impact on bank profitability between 2010 and 2018 compared to economic drivers (as represented by growth in the nominal GDP). This suggests that credit cycles matter more to bank profits than economic cycles, and is consistent with recent studies on determinants of bank profitability in emerging markets.<sup>4</sup> Periods of rapid credit expansion can therefore amplify the impact on bank profitability and resilience when economic conditions deteriorate. Hence, prudential standards and countercyclical policies play an important role in preventing the build-up of systemic risk by dampening financial cycles.

Chart 5: Banking System – Stock of Gross Impaired Loans and Gross Impaired Loans Ratio

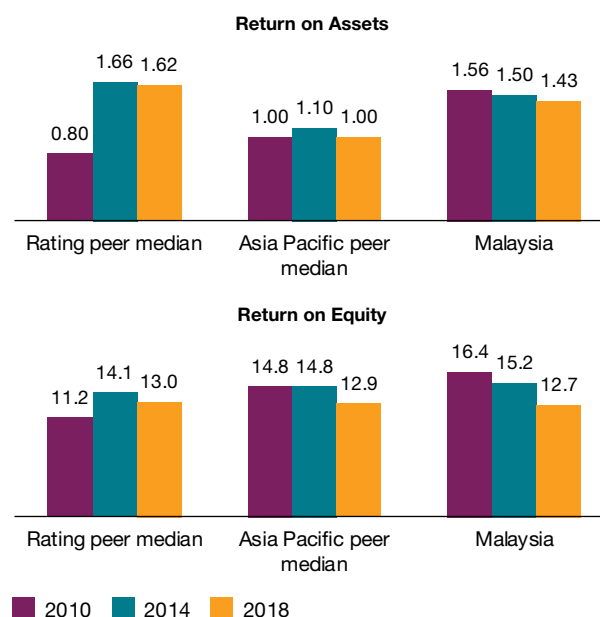
**Between 2010 to 2014, banks' profitability was further underpinned by improvements to asset quality under stable economic conditions**



Source: Bank Negara Malaysia

Chart 6: Cross-country Comparison of Banking System Profitability

**Malaysian banks' profitability trends are similar to peer banking systems**



Source: Bank Negara Malaysia, International Monetary Fund and central bank websites

<sup>3</sup> Refers to regional peers comprising Australia, China, Hong Kong SAR, India, Indonesia, Japan, Philippines, Singapore, South Korea, Thailand and Vietnam, and banking system rating peers based on the Standard & Poor's Banking Industry Country Risk Assessment (S&P BICRA) methodology. Under the S&P BICRA methodology, Malaysia is in Group 4 along with Estonia, Iceland, Israel, Mexico, New Zealand, Saudi Arabia and Spain.

<sup>4</sup> For example, see Kohlscheen, Murcia and Contreras, 2018.

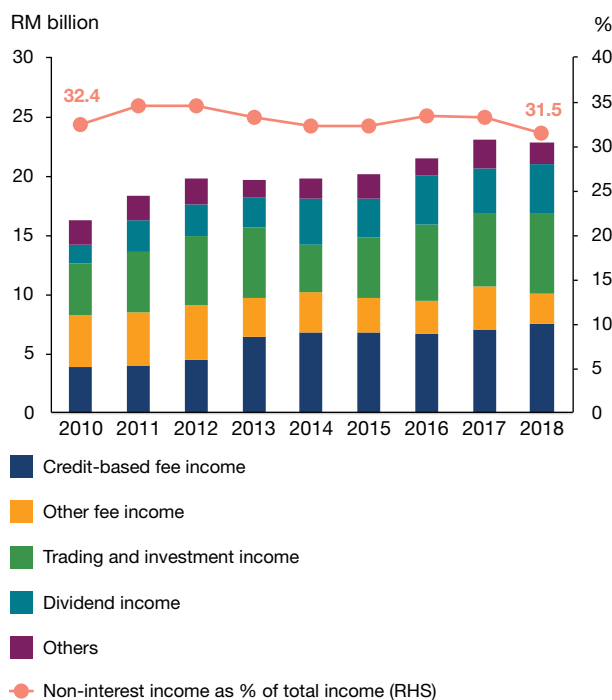
Broader credit and economic conditions were also observed to have an important influence on banks' **non-interest income**. Despite its significance as a share of total income (31.5% in 2018), almost half of banks' non-interest income comprising fees and commissions is associated with activities related to the provision of credit (Chart 7). This is not surprising, given that banks are more likely to acquire fee-based revenue from the provision of ancillary services that support their financing-related activities, such as commitment and guarantee fees. The contribution of fee-based income to banks' profitability is therefore highly correlated with trends in banks' financing activity and interest income.

Trading and investment income – the next largest component of banks' non-interest income – has typically been more volatile. This reflects fluctuations in equity prices, bond yields and exchange rates, particularly during periods of increased portfolio investment flows (Chart 8). Nevertheless, the impact of adverse market movements has been mostly limited given banks' prudent risk-taking behaviour and low market risk exposures, as highlighted in the Section on Market Risk (see pages 23 to 24). The contribution from trading and investment activities to bank revenue accordingly remained positive throughout the decade including during periods of heightened financial market stress experienced by banks between 2014 and 2015.

In line with the expansion across regional markets in Asia over the last decade, the overseas operations of domestic banking groups (DBGs) have become an increasingly important income source with a higher contribution to group earnings (Chart 9). However, while offering potential diversification benefits, they have had limited effects in reducing variability in DBGs' profits due to the strong financial and economic interlinkages within the region and a focus on traditional lending activities.

Chart 7: Banking System – Non-Interest Income

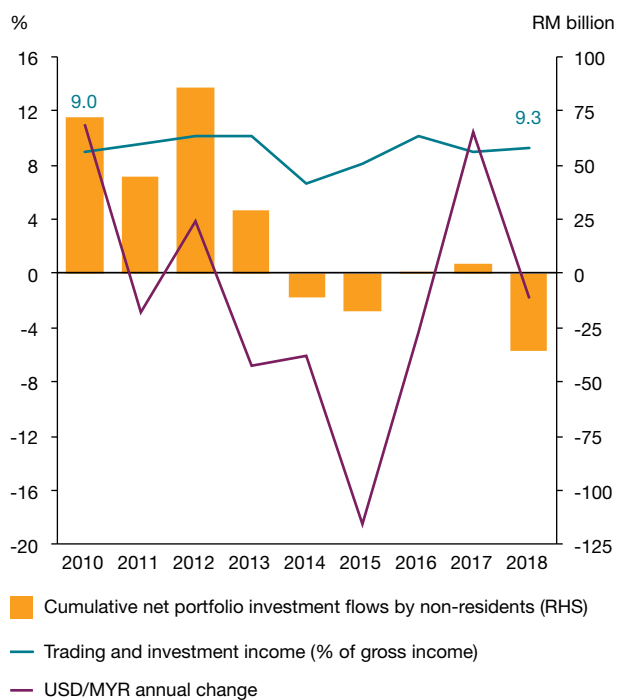
**Non-interest income contribution to total income while significant, has largely remained unchanged over time**



Source: Bank Negara Malaysia

Chart 8: Banking System – Trading and Investment Income

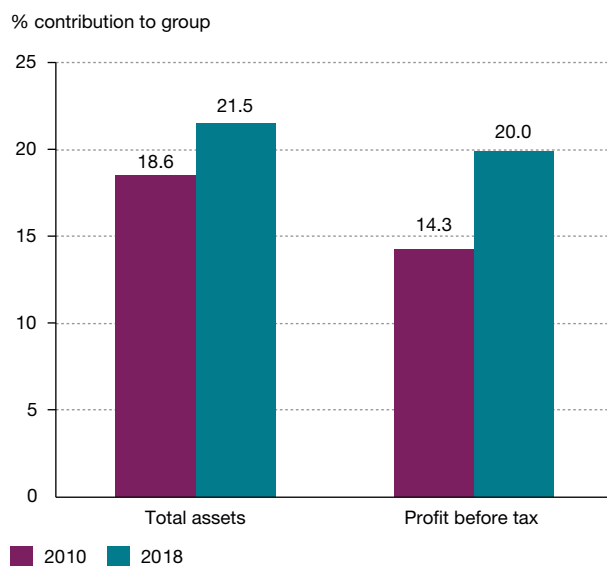
**Trading and investment income has typically been more volatile particularly during periods of increased portfolio investment flows**



Source: Bank Negara Malaysia and Department of Statistics, Malaysia

Chart 9: Domestic Banking Groups – Overseas Operations Contribution to Group

**Overseas operations have become an increasingly important income source for domestic banking groups**



Note: Refers to median ratio for domestic banking groups

Source: Bank Negara Malaysia and banks' financial statements

**Growing competitive pressures on both sides of the balance sheet for banks**

The moderating trend in bank profitability also reflects an intensification of competition among banks over the years on both sides of their balance sheets. On the funding-side, an increase in the share of more stable and longer-term fixed deposits in recent years has been accompanied by greater competition for stable funding as banks geared up to comply with new liquidity regulations<sup>5</sup> under Basel III (Chart 10). This has driven up overall costs of funding (Chart 11). Intense competition for funds has further constrained banks' ability to pass through downward adjustments in the Overnight Policy Rate to deposit rates. On the asset-side, banks' ability to pass on higher funding costs to customers has been similarly constrained by strong price competition in the retail segments, in particular housing loans (which forms 32% of banking system loans) as banks continued to compete to maintain market share. Correspondingly, banks' lending rates have been slower to adjust to changes in overall funding costs, leading to narrower margins. In this environment, banks have increasingly sought to leverage their market positions more effectively to generate additional revenue through targeted cross-selling to existing clients and strategic partnerships to expand and deepen their commercial lending activities.

**Improvements in cost efficiency**

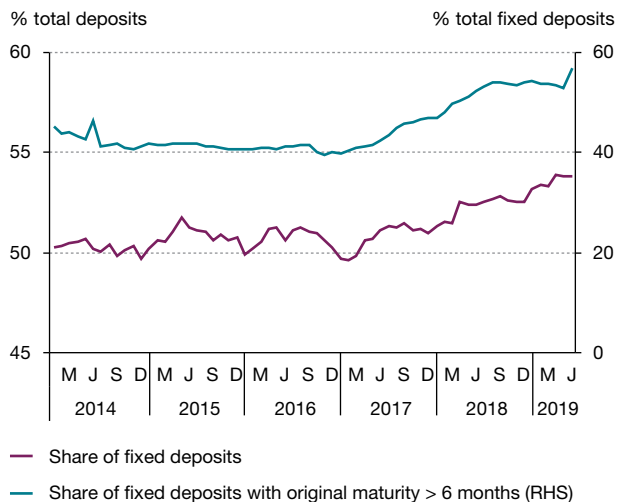
Malaysian banks' cost efficiency, measured by total cost-to-income ratio, has improved in recent years and compares favourably with peer banking systems (Chart 12). This reflects a strong focus by banks on cost optimisation, particularly over the last few years amid declining interest margins.<sup>6</sup> Notably, banks have actively pursued initiatives to rationalise headcount for selected business functions, increase automation and investments in information technology (IT) systems and infrastructure to improve operational efficiency, and optimise branch networks. These improvements to cost efficiency have shored up bank profits in an environment where banks are experiencing margin compressions. While interest margin declined by 53 basis points between 2010 and 2018, banks' interest margin net of total operating and credit costs has improved (Chart 13).

<sup>5</sup> Refers to Basel III Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) requirements which strengthen the resilience of the banking system against liquidity and funding shocks.

<sup>6</sup> The difference between interest rates at which banks extend financing and interest rates banks pay for funding, including deposits.

Chart 10: Banking System – Fixed Deposits

**Banks have shifted towards more stable and longer-term fixed deposits in recent years to comply with new liquidity regulations**

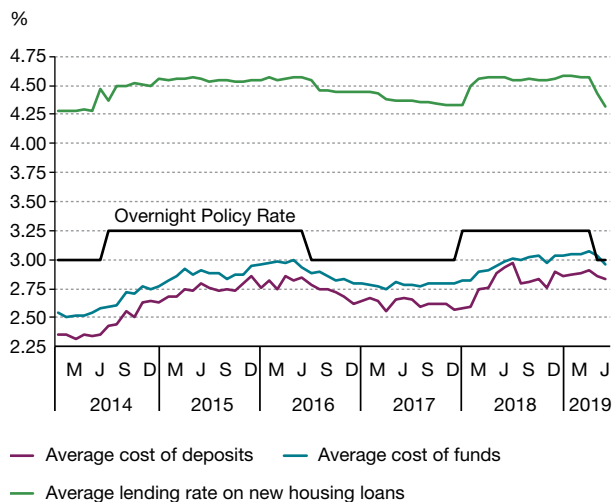


Note: Fixed deposits include Commodity Murabahah accepted (Islamic term deposits) by Islamic banks. Composition of fixed deposits by original maturity refers to commercial banks only

Source: Bank Negara Malaysia

Chart 11: Banking System – Average Cost of Deposits, Average Cost of Funds and Average Lending Rate on New Housing Loans

**Intense competition has constrained banks' ability to pass through downward adjustments in the Overnight Policy Rate to deposit rates**

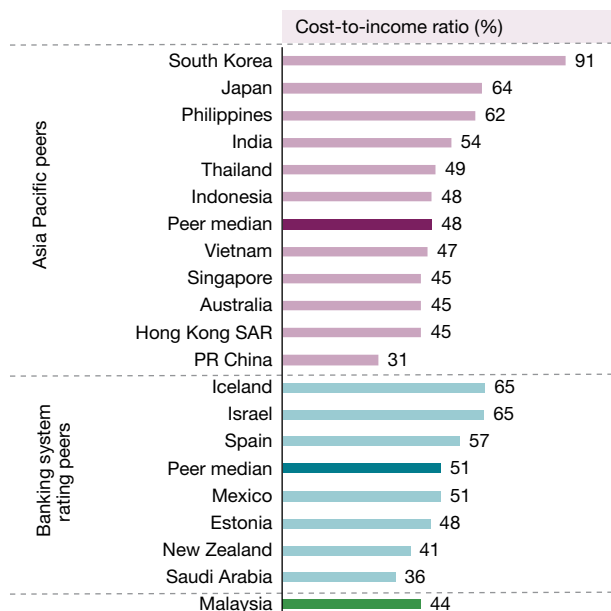


Note: Average cost of deposits and average cost of funds refer to median of major banks in Malaysia. Average lending rate on new housing loans refers to weighted lending rate on new housing loans approved by commercial banks

Source: Bank Negara Malaysia

Chart 12: Cross-country Comparison of Banking System Cost Efficiency

**Malaysian banks' cost efficiency notably better than most regional and rating peer banking systems**

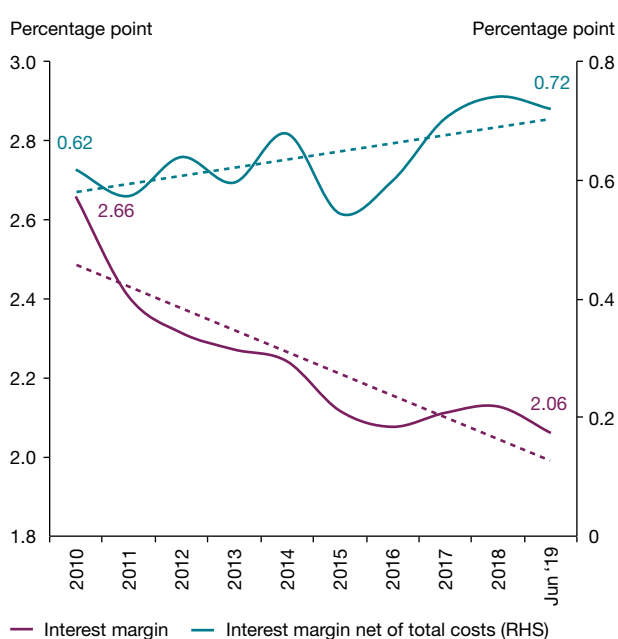


Note: Based on data as at end-2018. Banking system rating peers are based on S&P BICRA methodology

Source: Bank Negara Malaysia and International Monetary Fund

Chart 13: Banking System – Interest Margin

**Strong focus on cost optimisation has enabled banks to better withstand interest margin compression**



Note: Total costs refer to impairment provisions and operating costs

Source: Bank Negara Malaysia

## Factors influencing future bank profitability

### ***Moderate economic and credit growth amid external uncertainties***

Moving forward, softer economic and market conditions amid uncertainties in the external environment will continue to weigh on demand for bank financing and financing-related services, which could place a drag on bank profits. Higher impairments from vulnerable household segments and business sectors that continue to experience challenging conditions could further weigh on profits. However, the potential impact of weaker asset quality is likely to be muted given the more forward-looking approach to provisioning already adopted by banks following the implementation of Malaysian Financial Reporting Standards 9: Financial Instruments (MFRS 9) in 2018. In addition, as highlighted in the Section on Resilience and Performance of the Banking Sector (see pages 29 to 30) banks continue to maintain ample buffers against potential credit losses. This is expected to place banks in a better position to support continued financing growth which is a key driver of bank profitability.

### ***Business model challenges arising from technological innovation in financial services***

Banks' profitability will also be impacted by disruptions to current business models driven by continued technological innovation in financial services, evolving customer preferences and developments in open banking.<sup>7</sup> Globally, these trends have contributed to a decoupling of services traditionally performed by banks such as deposit-taking and the provision of credit, potentially ceding a key source of bank profits to more diverse competitors including Fintech<sup>8</sup> companies, Bigtech<sup>9</sup> companies and digital banks. A survey conducted by PwC in 2018 covering financial industry participants from 71 countries estimates that 24% of existing banks' revenue is at risk due to the entry of new players in the financial industry. Other estimates have placed up to 20% of banking business at risk of being disintermediated as a result of open banking.<sup>10</sup> The squeeze on profitability is more likely to be apparent across non-capital intensive business lines such as payment and settlement services and retail banking where more agile new entrants are able to exploit frontier technologies for competitive advantage and superior cost efficiency. The impact on bank profitability can also arise from competitive pricing strategies by banks to maintain their market share, resulting in lower revenue and interest margins. In addition, increased risk-taking to maintain profitability could further negatively impact future profits.

### ***Banks remain well-positioned to capitalise on these developments***

Despite the potential challenges posed by economic uncertainties and increased competitive pressures, a number of factors are expected to support the ability of banks to take advantage of current and future trends and sustain healthy profits moving forward.

Public confidence in banks remains high,<sup>11</sup> giving banks a key advantage over new entrants. Malaysian banks have demonstrated resilience in past periods of heightened uncertainties and continue to strengthen the underpinnings of this resilience, notably by preserving strong financial buffers and prudent risk-taking. Malaysian banks continue to sustain healthy profits, with the major publicly listed banks expected to maintain profitability levels above the average cost of capital<sup>12</sup> as implied by the ROE market consensus estimates for the next three years (Chart 14). Bank resilience is further reinforced by the Bank's long-standing approach to supervision that is forward-looking and risk-focused.

<sup>7</sup> Open banking generally refers to the sharing of data in an ecosystem of consumers, financial institutions and third-party service providers such as Fintech companies. This allows third-party service providers to build their own applications and offer services to financial institutions' clients.

<sup>8</sup> Refers to technology-enabled innovation in the provision of financial services. Fintech companies refer to companies that utilise Fintech and operate primarily in the financial services industry.

<sup>9</sup> Refers to major technology companies whose core business are not in financial services. Bigtech companies typically offer financial services as part of a much wider set of activities (BIS, 2019).

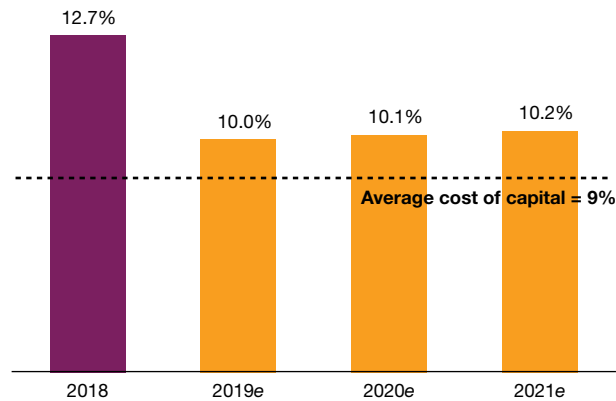
<sup>10</sup> Study by Swinton and Roma (2018) covering the UK market.

<sup>11</sup> Results from a recent survey published in the Financial Services Reputation Index 2019 report for Malaysia by MHP Communications indicated that 88% of respondents view banks positively. Many of the survey respondents attribute the trustworthiness of the sector in the past decade to increased regulation and competition.

<sup>12</sup> The average cost of capital for Malaysian banks refers to the average expected annual stock returns for all listed banks estimated using a Capital Asset Pricing Model for the period between 2014 and 2018. The yield on 10-year Malaysian Government Securities is used as the risk-free rate while returns on the FBM KLCI is used to derive the market risk premium. The estimated average cost of capital of 9% for Malaysian banks is largely in line with global estimates of average cost of capital for banks (ECB, 2015).

Chart 14: Banking System – Return on Equity Estimates for Publicly Listed Banks in Malaysia

**Major listed banks expected to maintain profitability levels above the average cost of capital**



e Estimates

Note: Return on equity estimates for 2019 onwards refer to the median consensus estimates for all publicly listed Malaysian banks

Source: Bank Negara Malaysia and Bloomberg

Banks are also hastening their digital adoption and accelerating investments in infrastructure and human capital to align internal processes and existing business models with a digital strategy. For many Malaysian banks, such efforts are already underway as banks integrate technologies such as advanced analytics, artificial intelligence (AI) and open Application Programming Interfaces (APIs) to enhance operational efficiency, improve service quality and tap new growth opportunities. To support their digital transformation strategies, banks are investing in digitally upskilling their workforce. While commitments to digital adoption strategies will entail significant investments in the near-term, such efforts are expected to pay off in the long-term by enhancing the competitiveness of banks.

In addition, there is growing traction in partnerships between banks and Fintech firms, as evidenced by initiatives piloted in the Bank's Fintech Regulatory Sandbox. To date, seven banks were approved or are under review to test innovative solutions in partnership with Fintech firms. Such collaborations offer significant advantages by combining access to capital and funding, a broad customer base and banking expertise (including legal, compliance and risk management) provided by banks, with innovative ideas and deep knowledge of emerging technologies provided by new entrants and start-ups. This has produced applications and financial solutions ranging from electronic know-your-customer (eKYC) processes to alternative credit scoring models, robo-advisory services and trade financing solutions using blockchain technology.

## Conclusion

Sustainable bank profitability is a cornerstone of a resilient financial system and essential to support economic growth. In the past, the profitability of Malaysian banks has largely been supported by sustained stable macroeconomic conditions, prudent credit risk management practices, and continuous improvements in cost efficiency. Despite a recent moderation in growth, current profitability levels of banks remain resilient even under more challenging economic conditions. Strong capital and liquidity buffers further support continued financing activities by banks, thus sustaining bank profitability. Looking ahead, banks are expected to remain well-positioned to maintain and enhance their competitive advantage, supported by a high level of public confidence in the banking system and ongoing efforts to embrace new technologies.

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