

Presentation by Tunku Dato' Ahmad Burhanuddin
“Financial crisis and the challenges ahead – perspective from Malaysia”
University of Malaya, 12 March 2009

Dear esteemed Chairman

Fellow panel members:

Dato' Gan Ah Tee - Managing Partner of BDO Binder

Mr. Leonard Ariff Abd Sahar - Director of Pharmaceuticals Division, Chemical Company of Malaysia Berhad

Dr. Roslee Shah Shahrudin - Department of Finance and Banking, University Malaya

Honored guests, Ladies and gentlemen

Assalamualaikum warahmatullahi wabarakatuh and Good Evening

First of all, I would like to express my sincere gratitude to the organizing committee, the Department of Banking and Finance-University of Malaya and the Malaysian Accountancy Research and Education Foundation for inviting me to become a panelist and to share my views on the topic of our discussion today titled “Financial Crisis and the Challenges Ahead - Perspective from Malaysia”. Amid the “perfect storm” that has engulfed the world and quickly reaching our shores, there is a need for us to confront the inevitable, to continually evaluate and bolster Malaysia’s position to ensure that it is not overwhelmed.

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Over the last one year or so, we have seen how the financial crisis has magnified and engulfed the globe with disastrous consequences. Although much has been highlighted and discussed, please allow me to give you my summarized perspective of the financial crisis in its 3 stages and the resulting chain of events of the 3 “Tsunamis”:

- i. The financial crisis started off with the subprime crisis where a major decline in home prices and real losses in subprime mortgage and personal loans resulted in significant mark-to-market losses as well as devaluation of structured assets. This led to the failure of players directly involved in the crisis.
- ii. The subsequent contamination of the real estate, credit card, motor vehicle loans markets as well as the freeze of non-government credit markets such as commercial papers, interbank and investment grade bonds resulted in dissipating of liquidity and spike of capital costs led to a credit market freeze and the failure of institutions with weak liquidity and capital.
- iii. The inherent need for deleveraging, further asset price correction, losses in loans guaranteed by securities as well as losses in prime retail, corporate and SME loans, had a severe profit impact and higher capital requirements forcing an economic downturn.

This is exemplified in the latest saga of the ongoing financial crisis where the British government has become the majority shareholder in Lloyds Banking Group PLC in exchange for insuring more than 260 billion pounds (367 billion dollars) in toxic assets. The deal means the government's stake in Britain's third largest bank will surge from 43.5 percent currently, to at least 65 percent and possibly as high as 77 percent.

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As a condition for the deal, Lloyds promised to increase lending primarily to businesses by 28 billion pounds (39 billion dollars) over the next two years. This, ladies and gentlemen, encapsulates the financial crisis namely mounting toxic assets, the write-off and erosion of capital, lack of confidence and liquidity, the system risk and the all-out efforts required. In unanticipated precedent, global financial giants have been forced to seek state bailouts as a last measure to remain solvent and in business.

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If we look at global Banking and Financial industry, the valuations of global banking giants have shrunk to their lowest levels in decades as a result of the ongoing financial crisis. To cite a few examples, the values of Citibank, Barclays, Bank of America and UBS have fallen by 98%, 91%, 90% and 85% respectively. But, are we there at the end of the road or will we see much worse scenario in banking and financial landscape?

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Although South East Asian banks have been somewhat spared from this global carnage (for now), they have been affected due to the broad sell-off in financial companies due to investor fear and the threat of a global economic slowdown. In fact, the total value of each of the three largest banks in Malaysia currently exceeds total value of Citibank. But, is South East Asia really going to be okay? Can we sustain the crisis? And, for how long?

The financial standing of Malaysian banks in contrast to its peers in the US and Europe continued to remain relatively strong in the face of the global financial

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turmoil and resultant economic slowdown. As at end-December 2008, the banking system's average risk-weighted capital ratio and core capital ratio stood at 12.7% and 10.6% respectively. More importantly, there is a negligible exposure to sub-prime securities and more than 90% of total assets are denominated in ringgit.

The Malaysian government had implemented the following measures to maintain the stability of the financial system and stimulate growth:

- i. All ringgit and foreign currency deposits with commercial, Islamic and investment banks will be fully guaranteed by the government through Perbadanan Insurans Deposit Malaysia until December 2010.
- ii. The guarantee would be extended to all domestic and locally incorporated foreign banking institutions.
- iii. All insurance companies and takaful operators have access to Bank Negara Malaysia's liquidity facility.
- iv. (Most importantly) 5 billion ringgit was injected into Value Cap Sdn Bhd to invest in undervalued companies listed on the Kuala Lumpur Stock Exchange. (But, will this help?)
- v. Reduce the overnight policy rate and statutory reserve requirement to 2.0% respectively to lower borrowing costs, stimulate loan growth and inject further liquidity in the system.

Let me give you a bit of update on the banking system here in Malaysia. The excess liquidity in the Malaysian banking system has grown further to an estimated 219.9 billion ringgit in mid-January 2009. Bank's total deposits increased significantly by 29.3 billion ringgit or 11.3% year-on-year in December 2008. As the deposit growth was slower than the 12.8% loan growth, bank's loan-to-deposit ratio tightened to 73.5% in December 2008 compared to 72.2% a year ago. However, net funds raised in the capital market were significantly lower in December 2008 at only 271 million ringgit versus 4.7 billion ringgit in the preceding month reflecting adverse conditions and tight liquidity as a result of

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the financial crisis.

Despite fears of a spike in NPLs in light of the slower economic growth, banks managed to reduce the 3-month net NPL ratio to 2.2% in December 2008 after maintaining a ratio at 2.4% in September to November 2008. On an annual basis, the net NPL ratio was lower by 0.98% year-on-year. The loan loss coverage, meanwhile strengthened from 73.4% a year ago to 87.2% in December 2008.

The better-than-expected NPL ratio reflects bank's increased adoption of sophisticated risk management systems, prudent lending policies, proactive measures to assist borrowers restructure even before they become non-performing and swifter loan recovery. This is in contrast to the Asian financial crisis back in 1997 where gross NPL shot up to a high of 20%.

Notwithstanding, the resilience of all banks will be tested in the first half of 2009 as the operating environment deteriorates further. Average loan growth in 2009 is likely to fall to 1% to 2% versus 12.8% in 2008. The slowdown in loan growth will be led by the business loan segment, which has been showing weakness in recent months.

The average gross NPL ratio is expected to rise to 7% as compared to 4.8% in 2008. The outlook remains cautious in view of the deteriorating economic conditions, which may lead to cash flow problems for companies and loss of income for individuals due to retrenchments and pay cuts. This will, in turn, lead to higher delinquencies in both business and consumer loans. There are also concerns that the 30% increase in residential prices in the past two years may be a bubble that could affect banks and the NPL ratio during an economic downturn.

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Questions are being asked regarding the sufficiency and adequacy of existing regulatory and legal framework such as Basel II, IAS39 and Sarbanes Oxley given its ineffectiveness in averting this financial crisis. There are certain quarters that argue that more governance and regulatory oversight are required in the new world economic order as capitalism has failed to self-regulate as a result of greed and extreme risk taking. But, the question is, how much regulation is enough regulation?

We have seen the scandals involving Enron, WorldCom and others that led to tighter and more complex rules and regulations. We have seen the implementation of new Accounting Standards, Sarbanes-Oxley Act, Basel II and Glass-Steagall Act, with the objective to safeguard the interests of the public. But, do they?

There are certain quarters that believe that the tighter regulations may have helped to open Pandora's box and caused more damages. Look at what happened to Lehman Bros, Bear Sterns, Merrill Lynch and Wachovia.

Perhaps, this is the right time to revisit the laws and regulations to prevent the excessiveness that has occurred in the past.

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The talk of countries adopting more protectionist policies to assist its domestic industries at the expense of its global peers has also shifted the global economic and trade fundamentals. Key shifts are also taking place within respective industries as the various components of business are being reassessed. All in all, this will almost certainly lead to profound changes.

The risks to the global economy arising from the financial crisis vary significantly by region:

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- i. In the US, greater risks include credit markets and deleveraging, housing prices and consumer spending whilst lesser risks include business investment and exports
- ii. In Europe, greater risks include credit markets and deleveraging and exports whilst lesser risks include housing prices, consumer spending and business investment.
- iii. In Asia, greater risks include exports and business investment whilst lesser risks include credit markets and deleveraging and commodity prices.

Global growth prospects have deteriorated rapidly in recent months due to continued deleveraging, faltering consumer sentiment and business confidence as well as wide spread layoffs that are spreading beyond the financial services into manufacturing, construction and related services.

Financial market strain continues to pull down the real economy sending both global output and trade plummeting across the globe. The US, Europe and Japan are heading towards a deep recession as the tight credit markets, falling asset values and household wealth destruction buffet consumer spending and fixed investment. Rising unemployment and the spike in job cuts have led to a sharp pullback in consumer spending.

According to the IMF, world growth is projected to fall to 0% in 2009 with advanced countries suffering their deepest recession since World War Two. World trade is expected to contract 2.8% with gradual recovery projected in 2010. The outlook is highly uncertain and the timing and pace of recovery depends critically on strong policy actions.

The leaders of the G20 had declared in November 2008, that they would take whatever further actions necessary to stabilize the financial system, including the use of monetary support, use fiscal measures to stimulate domestic

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demand, help emerging countries gain access to finance and stress the International Monetary Fund's important role in the crisis, encourage the World Bank and other Multilateral Development Banks to use their full capacity and to ensure that these institutions have sufficient resources.

There has been global policy coordination in the easing of macro-economic policies via interest rate reductions and easing fiscal policies as well as the stabilization of financial markets thru the provision of short term liquidity, protection of savings and deposits, injection of public funds to recapitalize the banks and to address regulatory deficiencies.

The current trends have no historic precedents. The financial landscape and global economy are being re-written as we speak. As a result, we may see a new economic order.

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There have also been global efforts to counter the global slowdown with coordinated efforts to inject stimulus packages to jump start flagging economies, lower interest rates, sustained currency management and assistance to ailing industries. Global efforts to shore up growth since the third quarter of 2008 are estimated at 3 trillion dollars or 3% of global GDP.

Notwithstanding, all eyes are on the US and President Obama is counting on a multi-pronged assault to lift the country out of recession: a 787 billion dollar stimulus package of increased federal spending and tax cuts, a revamped bailout program for troubled banks and a \$75 billion dollar effort to stem home foreclosures.

But, economists are concerned that the jobs situation seems to be killing any hopes for an economic recovery later this year as some had hoped. The unemployment rate leapt to 8.1% from 7.6% in January, the highest in more

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than 25 years. Some economists now predict the unemployment rate could hit 10% by year-end and peak at 11% or higher by the middle of 2010.

Since 2000, US consumer debt to GDP grew at a compounded annual growth rate of 4.3% whilst EU corporate debt to GDP grew at 4.6%. Returning to relative debt levels of 1990 would imply an aggregate de-leveraging of USD17.5 trillion across the US economy that in turn could last up to 20 years in a worse case scenario.

There have also been question marks regarding the actions required to remove bad loans from bank balance sheets. It is estimated that US banks may currently hold as much as 2 trillion dollars of impaired assets. Unless these impaired assets that currently weigh down bank balance sheets are removed, credit flows will be restricted. To date, plans to remove these bad assets have been plagued by concerns on how best to value these assets.

Nevertheless President Obama and Federal Reserve Chairman, Ben Bernanke have said clearly that the United States will provide whatever capital is needed to keep US banks solvent and that they do not plan to nationalize even deeply troubled banks.

Maybe, the question we want to ask is this, to what extent government intervention is prudent? How much is enough?

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The slowdown in the global economy has invariably impacted Malaysia. Let me briefly touch on the state of the Malaysian economy and where we at CIMB see it.

Reflecting the sharper than expected contraction in exports and total investments, the Malaysian economy moderated severely to 0.1% in the fourth quarter of 2008 from 4.7% in the third quarter. This is the slowest pace of growth in eight years since the third quarter of 2001 when real GDP was -0.4%.

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For the full year, real GDP grew by 4.6% in 2008 as opposed to 6.3% in 2007. Sluggish exports were largely responsible for the near zero GDP growth with net exports subtracting a larger 5.5% from the fourth quarter 2008 real GDP growth versus -2.6% in the third quarter of 2008. As evidenced by the worst monthly drop in 28 years where exports slumped 27.8% in January from a year earlier, the continuous contraction in exports will remain a big drag on growth for a few more quarters.

The current and forward indicators point to further sharp economic downturn particularly in the first half of 2009:

- i. Malaysia's leading index contracted further by 2.9% in December 2008 compared to -2.5% in November 2008. Three consecutive months of falls signals that the Malaysian economy is headed towards a sharp slowdown.
- ii. Global OECD leading index fell for the 19th consecutive month, with the index fast approaching the low during the 1970s oil shocks. The worsening external outlook together with the lower commodity price effects will continue to push Malaysia's exports into deeper contraction in the first half of 2009.
- iii. Domestically, the rising layoffs and retrenchments pose a threat on consumer spending. However, some mitigating measures are already in place to provide partial relief to consumers. These include lower interest rates, a 3% reduction in EPF employees' contribution rate as well as other financial assistance for retrenched workers outlined in the recent Mini Budget.

Although private consumption will fall, we do not expect a repeat of 1998 Asian financial crisis where there was massive wealth destruction stemming from the steep fall of equity prices and the devalued ringgit. The cost of financial adjustment was severe for both the household and corporate sectors, which were heavily involved in property and stock markets.

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iv. Loan indicators namely loan applications and approvals continue to contract since September 2008, reflecting the largely lower business loans applications. In January 2009, loans applied and loans approved contracted even more sharply by 21.0% and 35.6% respectively versus -18.8% and 23.7% in December 2008. Loans disbursed reversed to contract by 10.0% in January 2009 as compared to +0.6% in December 2008 and +7.4% in November 2008.

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The growth of public expenditure (24.3% of GDP) is critical to keep growth on the right side of zero, assuming timely spending on targeted sectors. In November 2008, the government rolled out a 7.0 billion ringgit fiscal stimulus package which zeroed in on projects with economic multiplier impact, namely the construction and maintenance of public amenities, schools, clinics, hospitals as well as construction of low-cost housing.

It was established that although 6.5 billion ringgit of the first package had been disbursed to the respective ministries and agencies, only 1 billion ringgit has been spent on projects.

The timely and quick implementation of fiscal spending program is highly critical given that the public sector is the prime anchor of growth engine. Any delay in fund disbursements or slack in the implementation capacity will limit the intended impact to the economy.

On 10 March 2009, the Government unveiled a second stimulus package amounting to 60 billion ringgit or 9% of GDP to be implemented over two years. The breakdown of the 60 billion ringgit includes 15 billion ringgit fiscal injection, 25 billion ringgit Guarantee Funds, 10 billion ringgit equity investments, 7 billion ringgit private finance initiatives and off-budget projects as well as 3 billion

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ringgit worth of tax incentives.

The package's focus is wider and more comprehensive compared to the first package of 7 billion ringgit. It encompasses various economic sectors and target groups. These include workers, consumers, investors, SMEs, exporters and unemployed graduates. The establishment of guarantee funds, equity investments and public finance initiative are expected to the medium-to-long term capacity of the economy.

Technically speaking, the additional actual cash outlays, inclusive of tax incentives for this year are 13 billion ringgit. The balance of 47 billion ringgit is considered as "non-budget" spending and may not have immediate impact on the economy, taking into account the time lag for these funds to kick in.

Larger spending and lower revenue collection would push the fiscal deficit higher to an estimated 54.5 billion ringgit or 7.6% of GDP in 2009 versus 4.8% of GDP in 2008. 2009's fiscal deficit marks the highest ratio since 1998 after having posted 12 consecutive years of fiscal deficit.

However, with ample domestic liquidity, high national saving (38.2% of GNP) as well as low public debt (41.4% of GDP), we do not foresee any funding problem to finance the budget deficit. In this current difficult economic condition, it is inevitable that the fiscal deficit will be sharply higher due to both revenue shortfall and much higher finance cost.

Malaysia is not alone in running fiscal deficits. Given the government's top priority now is to avert a protracted severe economic downturn, we view the widening budget deficit and its negative implication on the country sovereign rating a secondary concern as long as the deficit is temporary without compromise on the fiscal sustainability.

Compared to the November 2008 stabilization package, this mini budget has

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more measures that affect the banks as its objective of helping retrenched workers and SMEs involves in some aspects their dealings with banks.

These measures will have a more direct though not significant impact on banks. The deferment of housing loans will avoid a spike in NPLs for the housing loan segment as the defaults by those who have been laid off will be avoided at least for one year.

However, the impact on bank's bottom-lines will be minimal as credit costs for housing loans are low because these loans are mostly secured against properties. The delay in the tax charged on the deferred interest payment leads to timing difference but its tangible impact is muted.

Apart from lightening house buyers' burden, this measure is, to a certain extent, positive for property transactions and demand for housing loans. However, we do not expect the impact to be significant given the glum economic outlook and rising retrenchments.

The government guarantee will provide greater comfort to banks in their lending to the SME segment. Notwithstanding, it will only benefit SMEs which still have viable projects and sustainable businesses. In our view, it will not be able to rejuvenate SME loan growth amidst these poor economic conditions. The credit enhancements will help companies with strong credit ratings to access the capital market and boost activities in the capital market. The flip side is that this will lead to an easing of corporate loan growth from last year's strong pace.

Reflecting the worsening external conditions as well as flagging domestic demand, we estimate that the Malaysian economy will may contract up 1% in 2009. The Malaysian government has revised 2009's real GDP growth estimate for the second time to between -1% and 1% from 3.5% previously. Recent data releases on exports as well as other global regional leading economic indicators suggest the economic downturn could be deeper than projected.

Preliminary estimate suggests that the output contraction could come in steeper

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at 3% to 5% in the first half of 2009. The anticipated stronger fiscal impact in the second half of 2009, the trickle down effect of the all time low interest rates, is not likely to neutralize the much larger economic contraction in the first half of 2009, dragged by sharper than expected contractions in exports and industrial output.

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The financial crisis has raised an issue on the corporate responsibility or rather, on where you draw the line between the profitability and your responsibility as a corporate. To illustrate this, let's take a look at Microsoft. With a operating income of almost 6 billion dollars, they plan to eliminate 5,000 jobs worldwide. Yes, their profit is lower by 8% but it's 6 billion dollars and still, they are cutting 5,000 people. And because of that, their families are affected. And look at Honda, their decision to drop their F1 for 2009 season will cause a possible loss of jobs for its 600 members of staff, but the ripple effect on the industry and the psyche of the people. Those are examples and there are a lot more of those. The question is, how do we balance the two, profitability and responsibility as a corporate?

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Above all, whatever has been said about the crisis, in the end, we have to believe that everything is from Allah, a Qada' & Qadar from Him. This verse from Surah Al-Ra'd (Juz 13) was sent to me by Chairman of Executive Committee of Khazanah, Tan Sri Dato' Mohd Nor Yusof who is also the Chairman of CIMB Group, and I think it's a good reminder for all of us. It says that Allah endows the earth and he sends nourishments like rain to water the land, for man to reap and add value that is creating economic activities. Then, He sends a flood that makes the froth surface to the top and it is meant to differentiate the good and the bad and eventually the bad or evil is swept away like froth or scum that floats. And in the end, it is the good that endures. Maybe

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the crisis is the way of restoring the world to its pure and good and sweeping away all the bad.

Thank you.

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