RISK OUTLOOK FOR 2018-2019

PREAMBLE

I am privileged to be standing here at the last slot between a highly successful conference and going home.

I am not the typical RAM speaker who tends to be a specialist, someone polish and extremely good at what they do. I am different, maybe better. ☺

The topic entrusted to me is challenging, given the interesting times we are in. Over the last 2.5 months, we have a new Government. Our national debt is now RM1 trillion. Leadership in many institutions and GLCs have changed. High profile infrastructure projects have been shelved. GST will soon be transitioned into SST. The World Cup is over and we also have Trump, Brexit and trade wars bringing uncertainty to global economic and risk markets.

However, many things remain the same. In Malaysia, we still see economic growth in 2018/19. The property overhang will remain for some time given our national penchant for tall iconic buildings. The interest rate environment looks stable. The Ringgit still hovers at the exchange rate of 4 to the USD. We still have a job!

What are the challenges and opportunities that we, as professionals, will face in the short to medium term?

THE ECONOMY

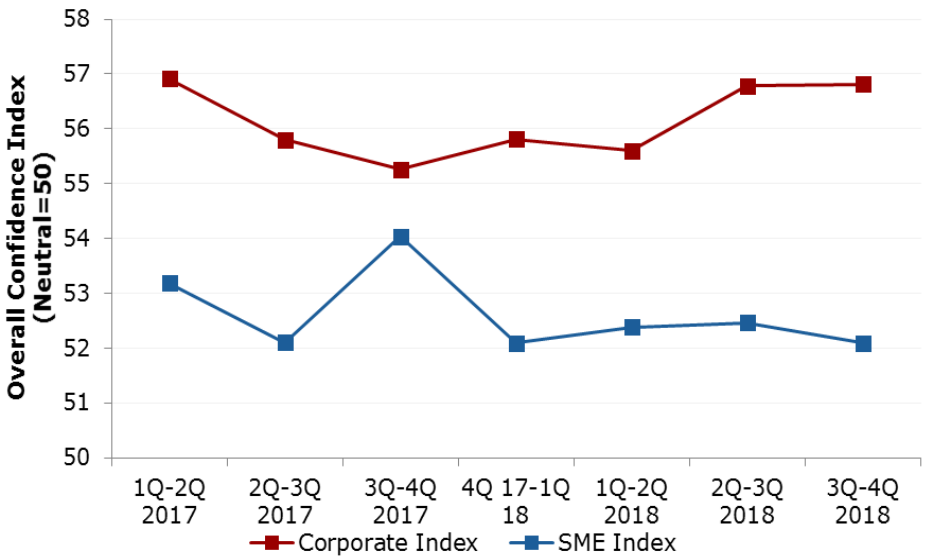
The forecast for the economy is that it will be Cloudy (with a chance of a thunderstorm).

The economy should grow reasonably well in 2018 at 5.2%, tapering from the 5.9% in 2017. We see GDP moderating to 4.8% in 2019. Inflation meanwhile looks to be moderating to below 2% (indicative 1.5%).

Business Confidence remains positive. The RAM Business Confidence Index is a comprehensive quarterly survey on business sentiment in Malaysia covering 3,500 SMEs and Corporates. We measure forward-looking expectations on 7 key aspects, namely, *turnover, profitability, business expansion, hiring, capital investment, capacity utilisation and access to bank financing*. An index value of 50 is the neutral benchmark while a value above 50 indicates positive sentiment; below 50 shows negative sentiment.

The latest RAM Business Confidence Index (RAM BCI) released in end-June 2018 suggest that firms remain upbeat about their business outlook going into the third and fourth quarters of 2018. The Corporate and SME indices again charted positive sentiment at a respective 56.8 and 52.1, with continued improvement in their turnover and profitability sub-indices. The sustained positive readings indicate Malaysia's economic resilience in 1H 2018 is likely to carry through to the second half of the year, supported in particular by the Corporate segment's firm optimism.

Figure 1: RAM BCI overall index values



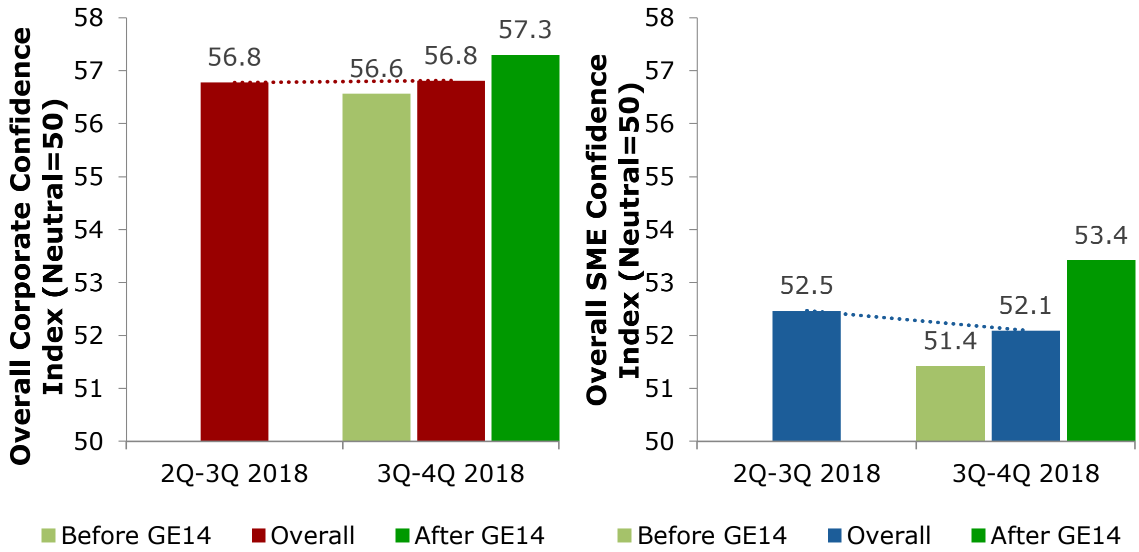
Source: RAM BCI

Generally more upbeat business sentiment following GE14

The results of our survey also show that the outcome of the 14th General Election (GE14) may have partly contributed to the more upbeat sentiment among firms. Notably, both the Corporate and SME segments display higher overall indices after GE14 compared to before the event.

The 3Q-4Q 2018 survey was conducted in April and May. In this round of index calculation, we have separated respondents to pre-GE14 and post-GE14 buckets, based on when they were surveyed; about 35.4% of the 1,000 Corporates and 33.4% of the 2,500 SMEs were surveyed after GE14. We observe that the Corporate and SME indices were higher by a respective 0.7 and 2.0 points in the post-GE14 sample relative to the pre-GE14 sample (refer to Figure 2).

Figure 2: Business sentiment improved among firms surveyed after GE14



Source: RAM BCI

SMEs still pessimistic about access to bank financing

Drilling down to SMEs' ability to access bank financing, the RAM BCI sub-index covering this aspect has been hovering within the "negative sentiment" territory for the last four surveys; it stands at 48.1 (-0.4 points) for 3Q-4Q 2018. This suggests some concerns over their funding conditions. This appears to also be an issue pertinent to only SMEs, as their larger Corporate counterparts have consistently recorded positive readings for this sub-index in the last six surveys, suggesting generally less difficulty in obtaining bank financing.

Moving forward, short-term economic uncertainties remain. On the domestic front, a slew of potential new measures, such as the change in tax regime, the review of major government-linked projects and the proposed increase in minimum wages, by the new administration may impact domestic businesses. Meanwhile, on the global front, the impact of the US Federal Reserve's rate hikes and the repercussions of the ongoing US-China trade war also present challenges. While businesses have shown more positive confidence following the results of GE14, these prevailing uncertainties may dampen the prospect of business optimism translating fully into eventual tangible results.

The economy will face many headwinds going into second half 2018 to 2019.

POLICY CLARITY

One risk area that has heightened following the change in Government is on policies. We know the Government's intentions from its election manifesto. However, these intentions need to be formalized into policies and decisions. Some of these policies can have significant impact on markets until clarity is observed with the policies.

For example, the removal of GST and introduction of SST will reduce tax collection by about RM23 billion. Even as we know that the SST regime will be introduced with Sales Tax at 5% and 10% and Service Tax at 6%, it is still unclear what are the categories impacted. Companies will need time to readjust to new guidelines and compliance.

Similarly, the intention to abolish toll rates for highways raise uncertainty for concessionaires and the bond market. What is the implication on bondholders and the bond market? We don't know until the intention is morphed into a concrete plan.

Risk professionals are forward looking in managing risks. Assessing these risks are challenging in a period of policy uncertainty.

The Government will have many challenges in implementing change. We can only hope that the changes are well thought out with good implementation.

TRADE, CURRENCY AND INTEREST RATE

President Trump has started a trade war which he hopes to win. This will not make the world a better place.

The trade war is not just against China but also hits exports from Europe, Canada, Japan and South Korea, among others. Countries like Malaysia will likely be collateral damage as we are an integral nation in regional and global supply chains especially in electronics. Malaysia's exports are about 60% dependent on global supply chains. A study by DBS indicate that a trade war could cause Malaysia to lose 0.6 percentage points of economic growth in 2018, with the impact doubling in 2019. In Asia, South Korea, Malaysia, Taiwan and Singapore are most at risk from a trade war due to our trade openness and exposure to supply chains.

The uncertainty in trade will further stress emerging economies where portfolio funds have migrated following the increase in USD interest rate under the pretext of a flight to safety. How will this affect the Ringgit? If your company is affected, how do you hedge against trade? Are we to maintain existing interest rate in the face of pressure to the currency should oil prices drop?

I don't have the answer.

CREDIT OUTLOOK

There is good news in the credit outlook. RAM rated portfolio comprises approximately 300 issuers with RM740 billion of sukuk/bonds outstanding. RM125 billion of corporate bonds were raised in 2017 and we expect another RM100 billion to be raised in 2018.

RAM published its **2017 Corporate Default Study** in March 2018. There was no rated issuer default in 2017 and we expect more of the same in 2018.

Overall, there was some weakening in credit quality arising from sector-led downgrades eg. media and automotive. In 2017, there were 10 rating downgrades and 5 upgrades. 91% of the rated portfolio has a stable outlook and 82% of the portfolio is rated AA or higher.

RAM published its **Banking Bulleting** in March 2018. The outlook on the banking sector is stable. Loan growth in 2018 is expected to be in the region of 5%, with leading indicators seeing a 5% increase in loan applications and 10% increase in loan approvals. Household debt had eased to 84% of GDP in 2017 from 88% in in 2016. The capital and credit-cost impact from the implementation of the MFRS 9 will be manageable at an estimated 35-40 bps in 2018. Funding and liquidity profile is sound. Gross NPL is at 1.6% with 100% loan loss coverage. We can all sleep well at night as there will not be a banking crisis.

The industry sectors that require **monitoring** will be the Electronics, Property, Energy, Construction, Infrastructure and Plantation due to external and policy direction. The trade war initiated by USA will impact the Electronics sector sooner rather than later. The unsold properties will impact cash flow of property developers. The volatility in oil prices will impact both upstream and downstream players, as well as our currency and national budget. Malaysian solar panel manufacturers are also subject to tariffs by USA and India. The construction sector will be hit by any slowdown in both the property and infrastructure sectors. And we need to look out for trade barriers impacting the oil palm plantation sector.

TECHNOLOGY (DISRUPTORS) AND CYBER SECURITY

The core challenge to Risk Professionals in the future is not the economy and credit risk. You all have the requisite skill sets to deal with these challenges of the old economy.

In the age of technology, fast evolving technology and cyber risk pose a conundrum to companies and professionals. Embrace technology for the opportunities and consequently we will have to embrace the risks arising from these opportunities. How do we manage these risks?

The development of the internet was not designed for cyber security but it has definitely made our world a better place. The convenience we have today is possible because of the innovative technologies that have brought down prices of hardware and software.

Companies are digitalizing their business. We all have to develop an online strategy, be it for sales or social media.

We rely on IT security expert that sells us best firewalls, antivirus, internet security, monitoring tools and faster bandwidth. Software developers give us applications to reach target customers. Oftentimes we rely on these experts that over promised the security environment of their products and services.

I attended a cyber security training recently which shocked me in terms of issues that affect companies in the cyber space, especially those involved in online sales. RAM's IT Department reports to me, so I am totally aware of the issues impacting technology and businesses. I have dealt with phishing attacks, malware and ransomware. We regularly have both external and internal penetration tests for our IT network. What I saw during the training makes me rethink on risk mitigation strategies concerning IT. Let me explain.

Firstly, there is a need to review and monitor the IT administrators of the companies. This is not based on KPIs and reports. Our IT administrator are the custodian of the most critical aspects of our daily operations. Nothing gets done without our computers and servers. These IT custodians oversee many servers and applications in our office. It is human weakness that we tend to use similar passwords across different applications. Sometimes, the weakest link in our IT defences are the same people we rely on to ensure IT security. A misstep by an IT administrator can cause serious damage to a company's operations.

Secondly, the online business model has holes especially with payment gateways. When you click on a button to purchase a product, we move from the website selling the product to a payment gateway hosted by another application. I was surprised to see the ease with which my cyber security trainer manages to change the payment amount of a purchase easily. He purchased an iPhone 10 for RM4! This same expert shows the ease with which he accessed security networks with administrator rights! Although these sites are not mine, I am obliged to appoint this guy to review my entire network just in case my regulator, the Securities Commission, thinks I am negligent.

Thirdly is the idea that we have business continuity plans where our servers and database are backed up. At RAM, we have invested heavily to ensure that our Cyberjaya site backs up our data religiously. My SOPP says I should not lose more than 1 day of data. In practice, we theoretically are backed on instantaneously with a worst case scenario of 15 minutes loss of data. What will happen to our systems in the event that we suffer a ransomware attack? Our diligence will ensure that the ransomware will also potentially impact the back-up site. Sure, there are tape backups on a daily basis, weekly basis and monthly basis. However, the theoretical expectation of no disruption or minimal disruption is a fallacy.

Without a doubt, issues of cyber security will be the number 1 issue affecting risk professionals. There are many other issues with technology but we have to move on.

CLIMATE CHANGE AND SUSTAINABILITY

This is my current passion and I am privileged to lead the team developing products and solutions for RAM and our clients. This is also the area that Risk and Insurance Management professionals need to be familiar with. Globally, industries are repositioning themselves to meet issues of environment and sustainability.

Climate change is REAL and it is impacting people and countries around the world. Rising sea levels and changing weather patterns are affecting communities worldwide. Coastal cities are looking at being wiped out unless they find solutions. There are risks and also opportunities. Many of us are developing new businesses around climate change. Are risk professionals ready to embrace the change?

The push to decarbonize is a key megatrend arising from the Paris Climate Accord (also known as COP21 – the Conference of Parties of the United Nations Framework Convention on Climate Change held in Paris in 2015). With public awareness, companies are increasingly under social, investor and regulatory pressure to lower emissions and reduce their environmental footprint leading to significant shifts in strategy as we move to a low carbon economy.

In Malaysia, we are seeing the focus on renewable energy. Norway wants to divest their oil assets. Cars are becoming electric. Construction industries are looking at sustainable building materials. Green homes and buildings are in demand. Companies and industries that are not preparing for change will be left behind. Opportunities exist for professionals to assist in the transition of businesses. Supply chains need to be evaluated. Palm oil from deforestation are barred from markets. Banks have stopped lending to projects causing environmental damage. We can all play our part in ensuring that our companies contribute to the social and environmental change.

The G20 Financial Stability Board has formed a Task Force on Climate-related Financial Disclosures to assist the transition for the financial industry. The banking industry is transforming its lending guidelines. I was told by a CEO of a Malaysian bank that they rejected loan applications that have negative environmental impact.

Similarly, change is beginning to happen in the insurance industry on the integration of environmental, social and governance risks into insurance underwriting for the benefit of risk managers, risk carriers and investors. The ClimateWise Insurance Advisory Council is launching an open-source framework to support investors and regulators assess how the transition to a low carbon economy will impact the financial performance of infrastructure investments.

Investors are playing their part. The United Nations-supported Principles for Responsible Investment has 1,961 signatories that manage USD81.7 trillion of ESG-sensitive assets as at April 2018. RAM Ratings was an inaugural signatory for credit rating agencies with the PRI in 2016 to support investors.

In Malaysia, both Khazanah and KWAP are signatories to the PRI. It is a desire of the two funds to see their investee companies implement good ESG practices to ensure sustainable long-term returns.

At RAM, we started a sustainability business at RAM Consultancy. In addition to undertaking Sustainability Rating, we are also engaged in providing green finance opinions, consultancy, training and reporting. We are helping clients with best practices, transitioning policies, rebranding products and services and also assess the green finance market. We are also measuring the impact of companies in promoting and supporting the 17 United Nations Sustainable Development Goals. We want to be ready for the transition economy.

Risk and insurance management professionals can lead in this green revolution. We can be custodian to mitigate against green washing and ensure that the world is a better place.

Climate change will be the long-term risk that we all have to managed.

[Not covered: Terrorism, Regulatory and Compliance]

Thank you.

Chris W.K. Lee
CEO, RAM Consultancy Services Sdn Bhd