Civil Servants' Debt: Risks and Policy Considerations

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Introduction: A Closer Look into Civil Servants' Debt

Malaysia's level of household indebtedness trended lower to 83.8% of GDP as at end-June 2018 (2015 (peak): 89% of GDP), following a series of cross-cutting measures since 2010 to strengthen lending practices by both banks and major non-bank financial institutions (NBFIs[1]). Risks associated with the accumulation of unsecured borrowings, which drove the earlier expansion in household debt, have also receded considerably with growth of personal loans decelerating from its peak of 25.2% in 2008 to 2.4% as at end-June 2018. Despite these positive developments, the Bank remains vigilant towards attendant risks from household debt. One segment that has received special attention is the civil servants, which accounts for one-fifth of total household debt. Since 2012[2], household debt by civil servants has increased by a compound annual growth rate (CAGR) of 7.6%, outpacing the overall nominal GDP growth (CAGR: 6.2%). This box article highlights the key findings of a recent study on civil servants' indebtedness undertaken as part of the Bank's on-going surveillance of household debt. It examines the profile of civil servants' borrowings, trends and risks in civil servant debt, and the potential impact to financial stability. Policy considerations to support more sustainable and prudent debt accumulation among the civil servants are also discussed.

I. Stylised Facts of Civil Servants' Borrowings: Debt for Consumption

As at end-February 2018, total outstanding civil servants debt stood at RM236 billion, equivalent to 20% of total household debt or 17% of GDP, higher than levels observed in 2012 (18% total household debt or 15% of GDP). A closer profiling of indebted civil servants revealed notable differences compared to the overall national profile of household debt (Diagram 1). Almost all civil servants (97%) have some form of borrowings, with 62% of credit obtained from NBFIs (national average: 18%). Almost half of their borrowings are for consumption purposes (personal financing, motor vehicles, credit cards and others), substantially higher than the national average of 35%. By geographical location, close to half of those indebted live in four key urbanised states, where costs of living are relatively higher. About two-thirds of civil servants earn less than RM5,000 per month.

II. Trends in Civil Servant Debt and Potential Risks

(a) High debt service ratio (DSR) and low financial buffers

Civil servants' debt repayment capacity remained lower than the average borrower at the national level. More than half of their monthly income is used to repay debt compared to one-third for average borrowers (Chart 1). Significantly higher DSR levels are also observed for civil servants across all income groups. After considering their monthly expenditure on basic necessities[3] and debt obligations, civil servants are left with limited financial buffers to weather shocks. This is more acute among those earning less than RM5,000 per month with only 15% of monthly income (equivalent to about RM360 to RM586) available for expenditure on discretionary items and savings. It should be noted that discretionary expenditures include spending on communication, clothing and recreational services, which would be considered essential for most people today to participate meaningfully in society.

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1 Including development financial institutions and major credit providers such as hire purchase lenders.
2 Earliest data on civil servant indebtedness.
3 The average monthly expenditure on basic necessities is estimated from the Household Income and Expenditure Survey (HIES) by the Department of Statistics, Malaysia. For this study, basic necessities are defined as: (i) food and non-alcoholic beverages; (ii) housing rental and maintenance; (iii) water, electricity, gas and other fuels; (iv) transportation; (v) education; and (vi) healthcare.

Diagram 1: Profile of Indebted Civil Servants

* This study covers 1.26 million out of 1.6 million civil servants. This comprises permanent Federal Government employees and police only (excluding army, State Governments, statutory bodies and local authorities)

** Personal financing, motor vehicles, credit cards and others

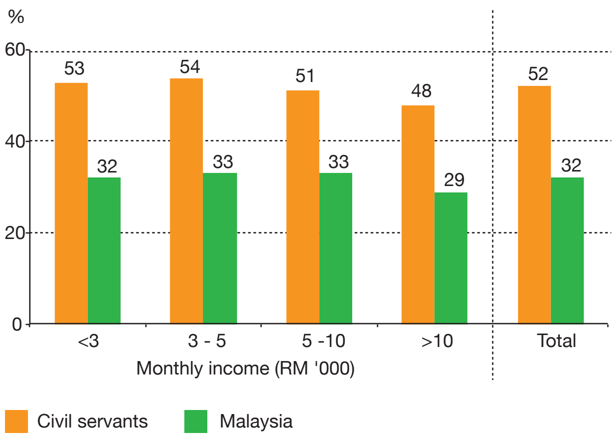
Source: Accountant General's Department of Malaysia and Bank Negara Malaysia

(b) Increased growth and share of personal financing

While the expansion in civil servants' debt over the past six years has been marginally slower than total household debt (CAGR of 7.6% and 7.7%, respectively), notable differences can be observed in terms of the growth drivers (Chart 2). Personal financing has been one of the major contributors to debt accumulation by the civil servants with a 2.3 percentage points (ppt) contribution to civil servants' debt growth, about four times higher than its contribution to growth in overall household debt (0.6 ppt). This has resulted in the larger share of personal financing to civil servants' total debt (34%), compared to the national level (15%) (Chart 3). Civil servants' personal financing share to total debt has also been on an increasing trend since 2012, in contrast to the declining share observed at the national level. Based on anecdotal evidence, personal financing is commonly used to sustain the standard of living and lifestyle choices of borrowers and for small business use.

Chart 1: Debt Service Ratio (DSR) by Income Group

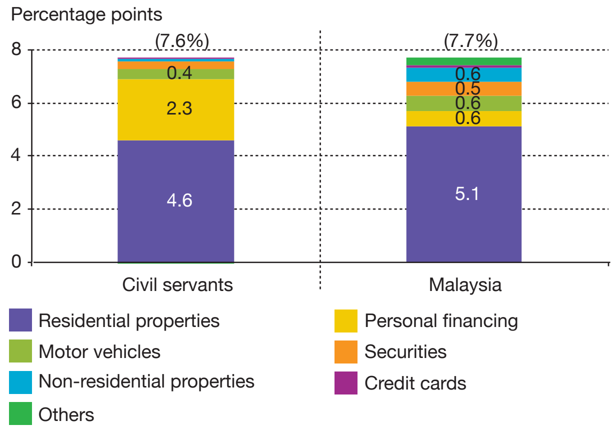
More than half of civil servants' monthly income is used to repay debt compared to one-third for average borrowers



Source: Accountant General's Department of Malaysia and Bank Negara Malaysia

Chart 2: Contribution to Growth in Debt

The contribution of personal financing to civil servants' debt growth was about four times that of national levels



Note: (..%) denotes the CAGR 2012-2018

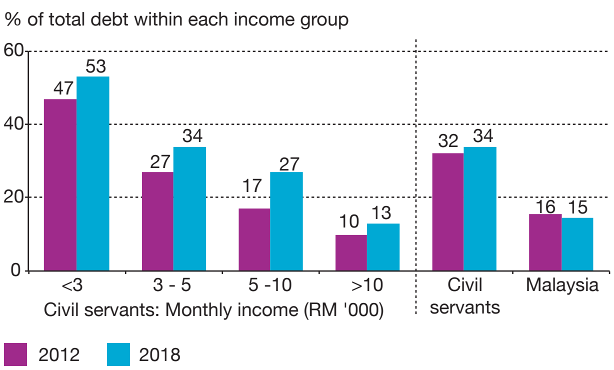
Source: Accountant General's Department of Malaysia and Bank Negara Malaysia

(c) Higher share of borrowers in negative financial margins[4] (FMs)

Notwithstanding the lower financial buffers among civil servants, differences in the share of civil servant borrowers with negative FMs were modest (8.5% of total civil servant borrowers compared to the national average of 6.5%) (Chart 4). Notably, negative FMs were more pronounced among civil servants in the mid- to higher-income groups, including those earning more than RM10,000 per month. This is in contrast to the observations at the national level, where those earning less than RM3,000 per month have the highest share of negative FM borrowers. This may be attributed to the differences in the salary structures. Within the lower income segments, the average starting salary of civil servants was observed to be higher than the national

Chart 3: Personal Financing by Income Group

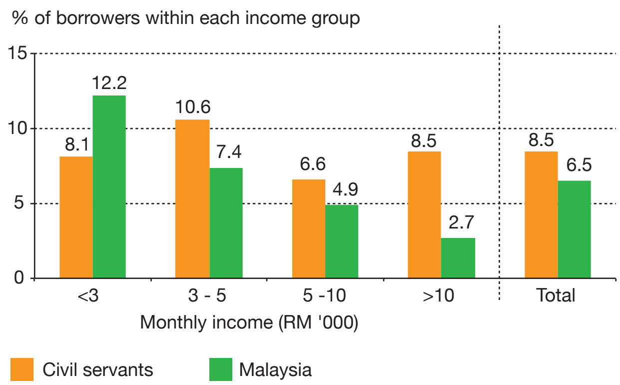
Civil servants' share of personal financing to total debt has been on an increasing trend since 2012, across all income groups



Source: Accountant General's Department of Malaysia and Bank Negara Malaysia

Chart 4: Borrowers with Negative FMs by Income Group

Civil servant borrowers have higher share of borrowers with negative FMs compared to the national average



Source: Accountant General's Department of Malaysia and Bank Negara Malaysia

[4] Financial margin is defined as the balance of borrower's monthly disposable income and liquid financial assets, after deducting debt repayments and expenditure on basic necessities.

average. However, for borrowers earning above RM3,000, faster salary increments in the private sector contribute towards bolstering financial buffers which in turn reduces the incidence of negative FMs. Civil servant borrowers with negative FMs were also consistently observed to have a high proportion of personal financing, with overall debt servicing commitments consuming more than 60% of income.

III. Limited Impact from Credit Exposures of Financial Institutions to Civil Servants

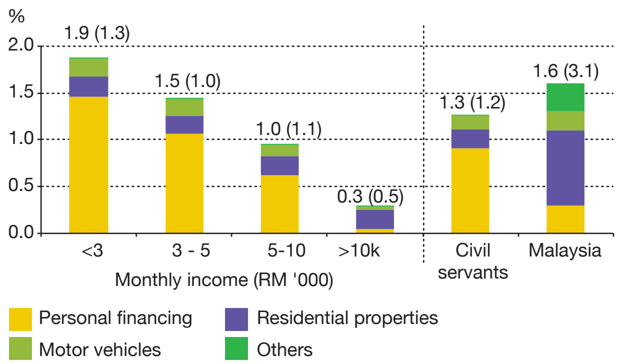
Asset quality of civil servant borrowings from banks and NBFIs remained sound with an aggregate impairment ratio of 1.3%, which is lower than the ratio for overall households of 1.6% (Chart 5). This is given that a significant portion of the monthly repayment of civil servant borrowings are deducted via automatic salary deduction facilities. This mechanism has played an important role in reducing credit risk exposures to civil servants. However, the overall impairment ratio of civil servants and in particular for those earning below RM5,000 per month has been gradually rising since 2012. Of significance, personal financing accounted for more than two-thirds of impaired loans by the civil servants. These findings are consistent with the profile of participants enrolled under *Agensi Kaunseling dan Pengurusan Kredit's* (AKPK) Debt Management Program which point to poor financial planning skills and cost of living pressures, associated with lower income borrowers as key factors contributing to financial distress.

An assessment of the debt-at-risk[5] (DAR) was also conducted to assess the potential impact of risks to financial institutions emanating from lending to civil servants. This assessment was based on a set of conservative assumptions, namely:
- 100% probability of default of borrowers with negative FMs;
- 100% loss given default for all loans, except housing loans, where a 40% loss is applied; and
- Automatic salary deduction schemes that mitigate credit risks are disregarded.

Under this scenario, the DAR of civil servants is estimated to be about RM24 billion, representing only 2.2% of total household debt or 10% of total civil servants' debt. Across income groups, the bulk of the DAR is from the RM3,000-5,000 group, accounting for 42% of total DAR (Chart 6). This is similar to the profile observed at the national level, underscoring higher risks from borrowers in this income group (refer to Financial Stability and

Chart 5: Impairment Ratio of Civil Servants' Debt by Purpose and Income Group

Impairment ratios for overall civil servants and those earning below RM5,000 per month have been gradually rising since 2012

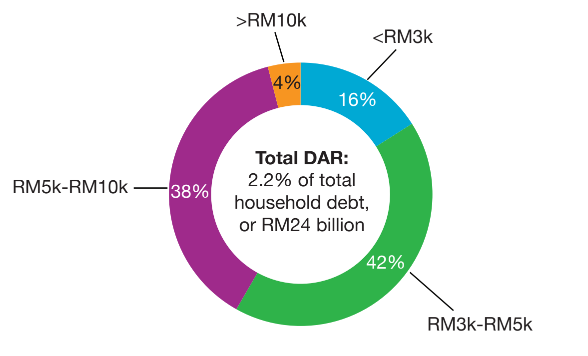


Note: (...) denotes impairment ratio in 2012

Source: Accountant General's Department of Malaysia and Bank Negara Malaysia

Chart 6: Debt-at-Risk (DAR) of Civil Servants by Income Group

Bulk of the DAR is from those earning RM3,000-5,000 per month



Source: Accountant General's Department of Malaysia and Bank Negara Malaysia

[5] The proportion of debt of borrowers with negative FMs to total household debt after taking into account the collateral value.

Payment Systems Report 2017, Box Article, 'Indebted to Debt: An Assessment of Debt Levels and Financial Buffers of Households'). These results affirm that risks to financial stability emanating from direct lending to civil servants remain limited. Risks are further mitigated with the expanded coverage of financial education and debt management programmes provided by AKPK to include civil servant borrowers and NBFIs since 2014.

Policy Considerations

While the civil servants' indebtedness poses limited risks to financial stability, the higher share of borrowings from NBFIs, and relatively weaker financial resilience could see risks of financial hardship increasing within this group of borrowers. This in turn could have broader socio-economic implications.

Several policy priorities will be key to promote more sustainable debt accumulation among civil servants and households more broadly:

(i) Expediting the legislation of the Consumer Credit Act to improve consumer welfare and protection

NBFIs account for 18% of total household debt, the bulk of which is to civil servant borrowers. A significant part of NBFIs lending, including lending by money lenders and credit co-operatives which focus on low- to middle-income groups, remains unevenly regulated. A review of existing oversight arrangements for all consumer credit providers is important to strengthen the regulatory framework for consumer credit activities in Malaysia. To this end, the Consumer Credit Act which is currently being formulated by the Government and the Bank aims to (i) promote a prudent and responsible credit culture among borrowers and lenders; (ii) strengthen the protection of consumers in their dealings with consumer credit providers; and (iii) promote a coordinated and coherent regulatory and oversight framework for consumer credit activities.

(ii) Formulation of a National Strategy for Financial Literacy

Increasing awareness on financial matters and strengthening financial management skills will contribute to better and more informed financial decisions. The Bank, in collaboration with AKPK[6], has already introduced various programmes such as Money Sense and *Program Pengurusan Wang Ringgit Anda* (POWER!) to enhance financial literacy and debt-management capabilities across various target groups. This needs to be expanded to deliver a national, coordinated approach to financial education across various aspects of financial management and demographics. The Financial Education Network, established by the Bank together with other Government agencies[7] in 2016 is currently formulating a National Strategy for Financial Literacy with the following thrusts to: (i) nurture responsible financial values from young; (ii) encourage the adoption of a healthy financial lifestyle; (iii) inculcate positive financial attitudes and behaviour among targeted groups; (iv) support long term financial and retirement planning; and (v) empower individuals to manage risks and returns.

(iii) Pursuing a more sustainable strategy towards housing the nation

Housing debt accounts for 49% of civil servants' debt. In the current environment where houses are "seriously unaffordable", the Government is taking steps to increase the supply of affordable homes and improve the rental market as a viable alternative to home ownership, thereby reducing the level and need for housing debt. Measures being pursued to promote a more vibrant rental market with strengthened protection of the rights of both tenants and landlords include the formulation of a Residential Rental Act, establishing a Tenancy Tribunal, and the provision of tax relief on rental income that meet specified eligibility criteria. These should be accelerated.

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[6] For a more detailed account, please refer to Financial Stability and Payment Systems Report 2017, Box Article, 'AKPK – Advancing Prudent Financial Behaviour'.

[7] A collaboration between the Bank and other agencies (Securities Commission, AKPK, Ministry of Education, Ministry of Higher Education, Employee Provident Fund, Perbadanan Insurans Deposit Malaysia, and Permodalan Nasional Bhd).

(iv) Strengthen underwriting practices among large NBFI lenders to civil servants

As NBFIs account for more than 60% of lending to civil servants, continued efforts to strengthen their underwriting practices will have an important role in promoting more sustainable civil servant debt accumulation going forward. Access for NBFIs to the civil servants' automatic salary deduction facility should be contingent upon NBFIs demonstrating responsible financing practices. DSR limits applied under such facilities should also be informed by the outcomes of affordability assessments for different borrower groups and subjected to review to reflect the changing circumstances of the borrowers. Limits should be strictly enforced.

(v) Enhance income growth prospects

Given that income is one of the main determinants of financial buffers and debt servicing capacity, relevant reforms to strengthen links between civil servants' pay and rewards to productivity would have an important impact in improving the financial resilience of civil servants. This would also improve the delivery of public services as well as enhance the efficiency of the broader economy.

Conclusion

This study reveals that civil servants are highly indebted with their debts continuing to accumulate in recent periods. It also shows the weaker debt servicing capacity of borrowers in this segment compared to the national average. The high level of indebtedness and low financial buffers, while currently posing limited financial stability risks, could have broader socioeconomic implications. Policy priorities, including measures to improve financial literacy and strengthen the oversight and lending practices of NBFIs, are key to achieve a more sustainable level of civil servant debt accumulation, and avert the build-up of risks in future.

References

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