

Banking Sector

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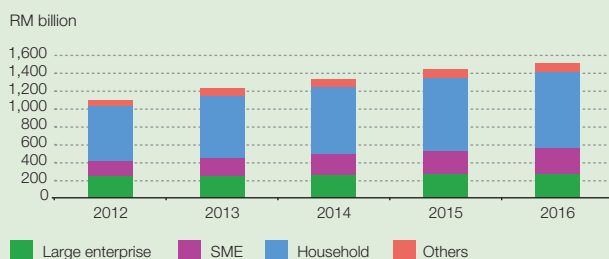
Banking Sector

PERFORMANCE OF THE BANKING SECTOR

Financing activity remained supportive of the economy during the year. Outstanding financing by the banking system expanded by 5.3% in 2016 to RM1,521.5 billion (2015: RM1,445.1 billion) (Chart 2.1).

Chart 2.1

Outstanding Banking System Financing



Source: Bank Negara Malaysia

Financing growth was driven by financing to the household sector, which recorded a growth of 5.3%. The pace of growth continued to moderate (2015: 7.7%) in line with measures aimed at promoting responsible financing practices, which have in turn mitigated risks from the higher levels of household indebtedness. Overall business sector financing expanded by 4.9%, with growth largely driven by financing to small and medium enterprises (SMEs), which grew by 9.2%. Banking institutions remain

cautiously optimistic in lending to SMEs, despite continued uncertainties in the outlook for the global economy. The approval rate for SME financing by banking institutions remained healthy at 77.3% in 2016. Banking institutions and development financial institutions (DFIs) continue to work closely with the Credit Guarantee Corporation Berhad (CGC) and government agencies to develop financial products and provide technical assistance for SMEs, lending important support to the key role of SMEs as a growth driver of the economy. SMEs can also expect to benefit from additional fund allocations announced under the 2017 Budget.

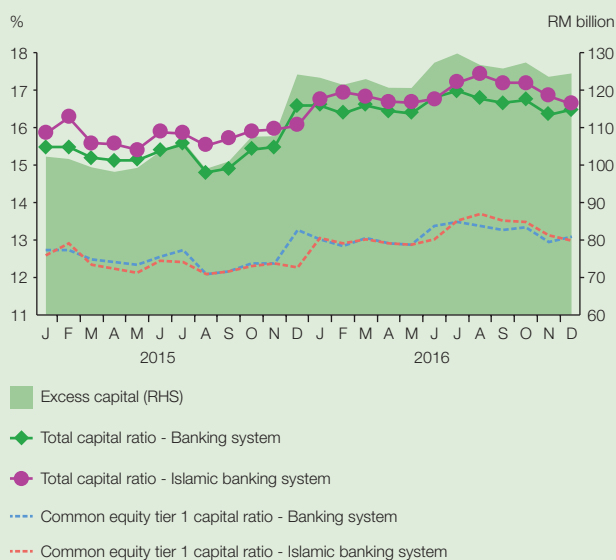
In line with slower financing activity, banking system assets grew at a more moderate pace by 3.8% in 2016 to RM2,443.6 billion (2015: 6.1%). The capacity of the banking sector to absorb losses remained strong, supported by high levels of capitalisation. Common equity tier 1 (CET1), tier 1 and total capital ratios of the banking system remained well above the minimum regulatory levels at 13.1%, 14.0% and 16.5%, respectively (2015: 13.3%, 14.2% and 16.6%, respectively). Banking institutions' capital in excess of minimum regulatory requirements increased slightly by 0.2% to RM124.5 billion as at end-2016 (Chart 2.2). A significant part (approximately 85.1%) of this continued to be represented by high quality loss-absorbing capital in the form of equity, retained earnings and reserves.

2017 Budget Allocation for SMEs

- RM500 million for Unit Peneraju Agenda Bumiputera (TERAJU) to assist in the expansion of Bumiputera companies.
- RM200 million for Perbadanan Usahawan Nasional Berhad (PUNB) to implement the Entrepreneurship and Business Premises Financing Programme.
- RM130 million for National Export Promotion Funds to support export promotion programmes by the Malaysian External Trade Development Corporation (MATRADE), Malaysian Investment Development Authority (MIDA) and SME Corporation Malaysia (SME Corp).
- RM100 million for an Export Fund under TERAJU to support Bumiputera companies venturing abroad, as part of the Government's wider effort to boost the contribution of SMEs to 25% of total exports by 2020.

Chart 2.2

Banking System: Capital Adequacy Ratios and Excess Capital



Source: Bank Negara Malaysia

The strengthened capitalisation of banking institutions was observed amid largely stable levels of risk-weighted assets (RWA) which declined marginally to 63.1% as a share of total assets (2015: 64.4%), in line with slower financing growth. Increased holdings of high quality liquid assets by banking institutions to meet liquidity requirements also contributed to the decline. The leverage ratio of the banking system, which measures the tier 1 capital base relative to non-risk weighted assets, stood at 7.7% as reported by banking institutions during the observation period, more than double the suggested minimum level under Basel III. Although banking institutions are not required to comply with a leverage ratio requirement under domestic rules at this juncture, they remain in a comfortable position to do so. With the remaining design and calibration issues of the leverage ratio nearly finalised by the Basel Committee on Banking Supervision (Basel Committee), the Bank expects to consult the industry on the proposed leverage ratio standards for domestic application in the first half of 2017.

The Malaysian banking sector remains strong and well-capitalised

The banking system, including Islamic banking institutions, recorded higher pre-tax profits of RM32.2 billion (2015: RM29 billion) in 2016. Returns on assets and equity correspondingly increased marginally to 1.34%

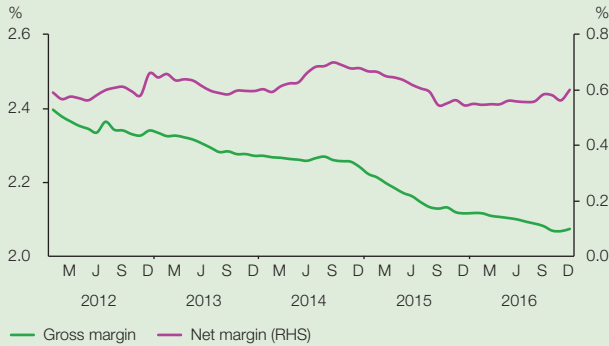
and 12.5%, respectively (2015: 1.32% and 12.3%). The stronger earnings performance was driven by treasury activities amid more volatile financial market conditions. In particular, banking institutions recorded higher net gains of RM1.8 billion from sales of “available-for-sale” instruments and foreign exchange transactions. Earnings were further bolstered by higher dividend contributions from subsidiaries, which grew by 27.8% to account for 10.3% of pre-tax profits. These dividends were mainly contributed by Islamic banking operations on the back of strong financing growth (refer to ‘Performance of the Islamic Banking Sector’ in the Chapter on ‘Islamic Finance Development’ for further details). Higher net interest income from financing activities also supported earnings, contributed mainly by an increase in term financing for the purchase of property and working capital.

Gross interest/financing margins narrowed, reflecting the competitive financing rates offered by banking institutions amid moderating financing growth and a marginal increase in the average cost of funds (2016: 2 basis points). Notwithstanding this, net interest/financing margins after operating costs and loss provisions improved slightly (Chart 2.3), as banking institutions showed further efficiency gains. Much of this was driven by the adoption of new technologies to streamline operations and reduce overheads. Measures taken by some banking institutions to optimise their workforce in line with refocused business directions also helped to cap annual increases in staff costs. Overall, pre-tax profits per employee, an indicator for revenue efficiency, increased by 14.9% for the year.

The asset quality of banking system loans deteriorated slightly, mostly on account of the anticipated weakening of loan performance in the oil and gas-related (O&G), automotive and real estate sectors (refer to ‘Managing Credit Risk Exposures to Businesses’ in the Chapter on ‘Risk Developments and Assessment of Financial Stability in 2016’ for further details). The share of impaired loans rose to 1.24% of total loans net of individual impairment provisions (2015: 1.20%) (Chart 2.4). A more broad-based deterioration in asset quality was not observed, owing to strengthened risk management practices in recent years, particularly for the household sector following the implementation of the Bank’s strengthened standards on responsible financing. Banking institutions continued to maintain prudent provisions for loans with a high loan loss coverage ratio of 90.2% (2015: 96.3%). This was further reinforced by collective impairment provisions and regulatory reserves held by individual banking institutions above the minimum required level of 1.2% of net loans.

Chart 2.3

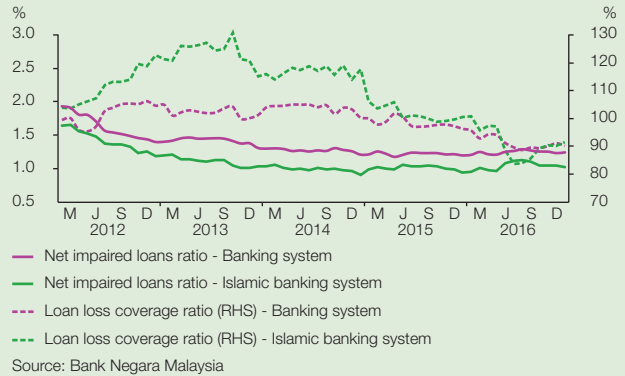
Banking System: Gross and Net Interest Margins



Source: Bank Negara Malaysia

Chart 2.4

Banking System: Net Impaired Loans Ratio and Loan Loss Coverage Ratio



Source: Bank Negara Malaysia

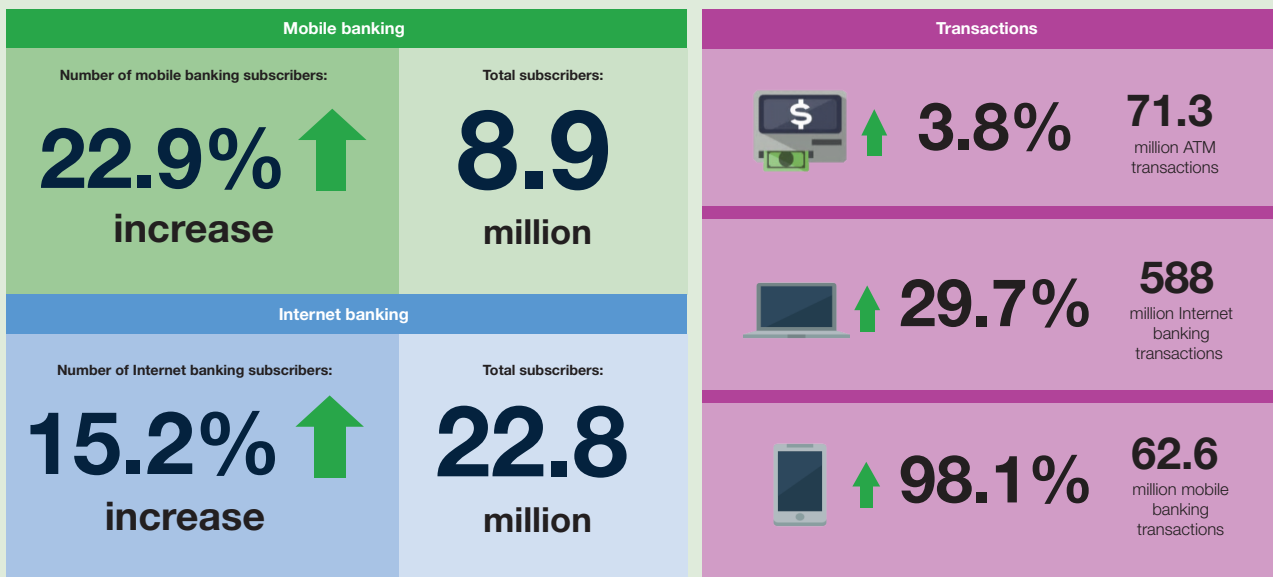
DEVELOPMENTS IN THE BANKING SECTOR

In 2016, the Malaysian banking landscape continued to be shaped by technological advancements and greater internationalisation of the financial system. The use of technology to deliver financial services saw a significant take-up, with a wider range of banking transactions increasingly conducted through self-service terminals and digital channels such as mobile banking, online banking and mobile applications (Diagram 2.1). In particular, mobile banking transactions registered a sharp increase of 98.1%. At the same time, new innovations continue to rapidly

emerge with the proliferation of financial technology (FinTech) start-up companies. Such companies are smaller and more agile towards digital developments, but typically face challenges in penetrating the market due to a lack of familiarity and trust among financial consumers. To unlock potential synergies provided by more technologically focused service providers, banking institutions are exploring collaborative approaches in the pursuit of innovation. These include the creation of accelerator programmes, through which banking institutions provide FinTech companies with critical access to industry knowledge to refine their products for market validation. This in

Diagram 2.1

Use of Self-Service Terminals and Digital Channels in 2016



Source: Bank Negara Malaysia

turn increases the potential for nascent initiatives to be transformed into commercially viable solutions.

Banking institutions continue to tap into the enormous potential of financial technologies

The Bank is highly supportive of these developments, which have enabled the application of cutting-edge technologies in various aspects of banking (refer to 'FinTech Innovation' in the Chapter on 'Cross-Sector Developments' for further details on developments across the financial sector). Notable innovations include simplified and more secure procedures for on-boarding and verification of new customers using biometric authentication methods. Banking institutions also increasingly tapped opportunities presented by the use of artificial intelligence to improve access to financial products and better support customer relationships. In the payments space, contactless payments, enabled by near field communication technology, continued to gain traction. These developments continue to lend support to efficiency gains and lower compliance risks for banking institutions under operating conditions that remain challenging. For DFIs in particular, technological progress has also advanced the financial inclusion agenda. Key initiatives include the digitisation of services through virtual teller machines and mobile automated teller machines (ATMs), which widen outreach and provide greater access to banking services for rural communities.

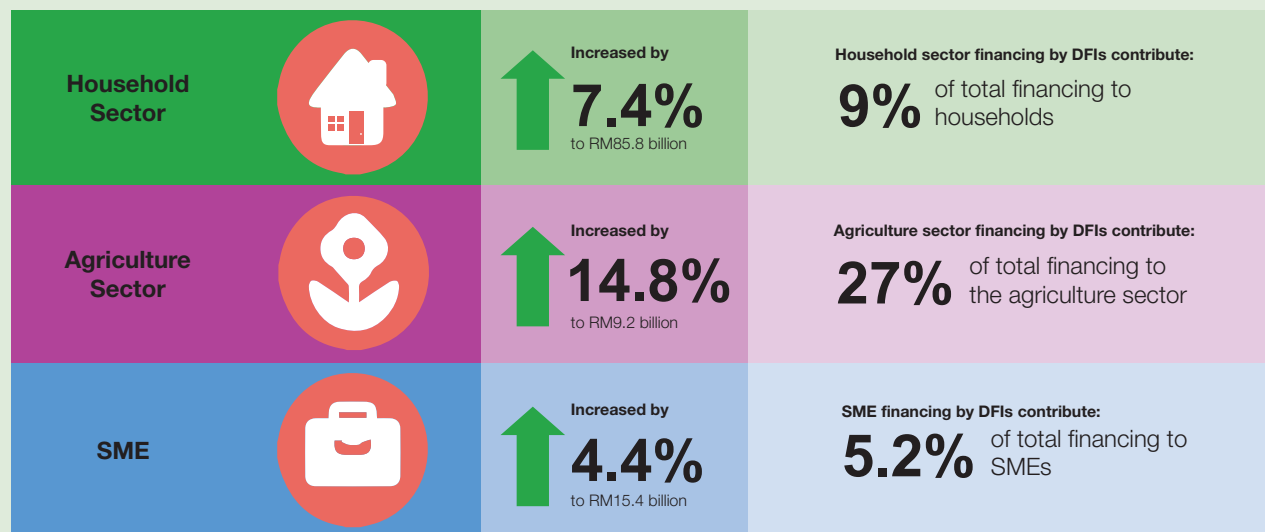
During the year, a commercial banking licence was granted to China Construction Bank (Malaysia) Berhad, further strengthening economic and financial interlinkages with one of Malaysia's key trading partners. Under the Financial Services Act 2013 and Islamic Financial Services Act 2013, a banking institution seeking entry into the domestic market is assessed against prudential criteria and the extent to which the entity will serve the best interest of Malaysia. The Bank has further refined its processes for evaluating the latter, which involves deeper engagements with applicants on their ability and commitment to deliver their value propositions. Such engagements also served to communicate development priorities for the banking sector, which include supporting growth in high value-added economic activities, fulfilling the needs of niche segments in the domestic market, and providing high-skilled employment opportunities in Malaysia. As at end-2016, the number of licensed banking institutions in Malaysia stood at 57, comprising 29 domestic banking institutions and 28 foreign-owned banking institutions.

Inclusive growth

The Bank, in collaboration with the banking industry, continued to direct efforts towards promoting inclusive access to affordable banking services for all segments of the Malaysian population. For the six DFIs under the purview of the Bank, total financing outstanding to the targeted growth sectors of these institutions

Diagram 2.2

DFI's Financing to Targeted Growth Sectors



Source: Bank Negara Malaysia

expanded by 5.7% in 2016 to RM143.3 billion. While the growth was largely driven by financing to the household and agriculture sectors, a positive trend was reflected across lending to all key targeted sectors (Diagram 2.2).

As at end-2016, total financing outstanding for micro enterprises under the *Skim Pembiayaan Mikro* stood at RM921.8 million. In total, RM3.5 billion in financing has been approved, benefiting more than 200,000 micro enterprise accounts under the scheme to date since its inception in 2006.

Accessibility to financial services by unserved and underserved communities remains a key priority

The outreach of banking services also made further headway during the year. The number of financial services access points nationwide increased from 10,166 to 11,248, providing 99% of Malaysians with convenient access to safe, reliable and affordable financial services. As at end-2016, 97% of sub-districts in Malaysia had at least one financial access point.

Initiatives to Support Financing for Innovation and New Growth Areas

- **Lowering entry costs through enabling regulation**

Two key regulatory initiatives were introduced to promote the adoption of technology within the financial sector, namely the Bank's Regulatory Sandbox and the Securities Commission Malaysia's regulatory framework on peer-to-peer (P2P) financing. These aim to provide a proportionate regulatory environment for innovative financial solutions that can enhance the effectiveness of existing financial services, or create new services that cater to unmet needs. In addition, the new market proposed by Bursa Malaysia in September 2016 will allow SMEs to be listed at a lower cost under a more flexible regulatory environment. This is expected to broaden the funding reach of SMEs, while serving as a springboard for a more formal listing on the ACE board.

- **Reducing information asymmetries by leveraging on new data sources**

With the growing sophistication in data analytics, the use of non-financial information to support credit decision-making is gaining traction. For instance, e-commerce platforms have drawn on transactional and payment data of their users to establish credit profiles, which have enabled them to venture into small business lending. Similarly, data harvested through integrated e-services enables lenders to identify changes in borrowers' loan repayment capacity, thereby reducing delinquencies and defaults. Recognising the potential in these approaches, the Bank is encouraging banking institutions and DFIs to explore big data analytics (e.g. by using an individual's shopping history, utility bill records, home and work addresses) and psychometric assessments to evaluate the credit profiles of potential borrowers with little or no track record. The Bank will continue to closely monitor these developments to ensure that the regulatory environment remains accommodative to new approaches to credit evaluation.

- **Developing a seamless SME financing process**

The Bank is working with the industry to develop an integrated online platform to make it easier for SMEs to source financing. The aim is to reduce the time taken by SMEs to identify the appropriate financing product and fulfil documentation requirements that may differ across banking institutions. The platform seeks to streamline financing applications of SMEs, while recommending a range of suitable financing packages based on the applicant's financing needs and risk profile. This will overcome the need for SMEs to approach individual banking institutions separately, and at the same time reduce banking institutions' costs associated with the credit assessment process and non-standardised documentation. The platform will also provide practical support to unsuccessful applicants by linking them to relevant advisory and capacity building channels by the Government.

- **Improving bankability through capacity building**

The Bank in collaboration with the financial industry, organised several programmes during the year to elevate the fund raising capabilities of SMEs. To this end, the programmes sought to further develop entrepreneurs' financial management skills and knowledge. On the supply-side, measures continue to be pursued to address the preconditions for banking institutions to accept intangible assets (such as intellectual property, which tends to be the sole asset of innovative start-ups) as collateral. The recent establishment of a pool of appraisal experts is an important step in developing the capacity of both the banking sector and SMEs to value intellectual property rights which, in turn, should accelerate the acceptance and use of these assets as collateral for financing. In addition, the National Innovation Agency Malaysia and PlaTCOM Ventures Sdn. Bhd. have established the Tech Commercialisation Platform to provide businesses with end-to-end investor matching and advisory support, from product research to prototype development, and ultimately, commercialisation.

This was driven by the continued expansion of the agent banking network with the number of agent banks now exceeding 7,900 (2015: 6,902). Over 12,000 savings accounts were opened via the agent banking network in 2016 and the number of transactions performed through agent banks increased by 58.6% to 100.3 million, valued at approximately RM8.5 billion (end-2015: 63.2 million transactions; RM5.7 billion).

In November 2016, the Bank launched a Financial Inclusion microsite to further enhance access to information by members of the public and SMEs on various financial inclusion initiatives. The microsite provides a centralised platform for all financial inclusion related information, including the products and services offered by financial institutions in Malaysia. This complements measures that continue to be pursued by the Bank, in collaboration with the industry and key agencies, to improve financing conditions for businesses supporting innovation and in new growth areas.

Collaborative efforts to promote inclusive growth are also being undertaken by the banking industry. In September 2016, an industry working group was established to pursue a more coordinated approach to delivering corporate social responsibility initiatives by the financial sector, thereby increasing their impact. This seeks to tap on opportunities to expand available resources and improve administrative efficiencies by pooling industry efforts to empower communities. To this end, raising the level of literacy among the urban poor has been identified as an immediate priority.

Professionalisation of the banking industry

Efforts to raise the bar for professional conduct, knowledge and competence of the banking industry gained further momentum during the year. In a joint declaration with the Asian Institute of Chartered Bankers (AICB), banking institutions committed to enrol board members and key employees in the Chartered Banker programme. This represents an important step in the professionalisation of the banking workforce. The Chartered Banker qualification provides a reputable development pathway for members of the banking profession that aims to create a highly-skilled and ethical workforce. This is achieved by holding individuals who obtain the Chartered Banker qualification to high standards of professional and ethical conduct in the provision of banking services, thereby strengthening public trust and confidence in the banking sector.

REGULATORY AND SUPERVISORY FRAMEWORK

Implementation of Basel III standards

The implementation of Basel III standards remained a key focus of the Bank's regulatory and supervisory activities in 2016. Banking institutions transitioned smoothly to the higher minimum Liquidity Coverage Ratio (LCR) requirements, which was raised to 80% in 2017, in line with global transition arrangements. Most banking institutions were already reporting LCR positions above 100% as at end-2016.

A thematic review of LCR practices concluded that the standards are being implemented effectively across banking institutions, supported by adequate board oversight and internal controls. Improvements were also observed in the quality of reporting and timeliness in generating key liquidity metrics following the enhancements to banking institutions' operating systems. This work is now well advanced for most banking institutions. To ensure greater consistency in the interpretation of key LCR parameters such as the definition of stable deposits and operational accounts, the Bank published additional guidance which addressed variations noted during the review. Overall, banking institutions have better integrated LCR compliance with wider governance and risk management processes. This in turn is expected to reinforce sound liquidity management practices across banking institutions.

Greater integration between liquidity standards and banking institutions' risk management arrangements is expected

Complying with the planned Net Stable Funding Ratio (NSFR) requirement is expected to be more challenging, given its focus on longer-term funding to reduce maturity mismatches. For some institutions, meeting the requirements will entail a significant rebalancing of their balance sheets in favour of more stable and longer-term sources of funding, or assets that require less stable funding. It is important that this process does not have any unintended impact on financial intermediation by the banking sector. Industry engagements were intensified in 2016 to better understand the specific challenges of individual banking institutions, which will contribute to the calibration of the NSFR standards and relevant transition arrangements. From the engagements, banking institutions appear to be well-placed in their ability to extend maturity profiles and diversify sources of

funding to comply with the NSFR. Strategies that banking institutions are considering to pursue include the issuance of medium and long-term securities, as well as longer-term money market instruments for retail customers and SMEs, such as retail negotiable instruments of deposit (NIDs).

Based on observation data, the banking system NSFR stood at 103.2% as at end-2016, with more than half of banking institutions reporting positions above 100%. The Bank will continue to closely monitor these positions and may consult the industry on the proposed NSFR standards after the second quarter of 2017.

Going forward, the Bank will be undertaking a comprehensive review of liquidity risk management practices in the Malaysian banking sector aimed at elevating industry-wide standards. This will take into account underlying changes in the funding profiles of banking institutions as well as developments in key funding markets (refer to the box article 'Evolving Funding Dynamics of Banks' in the Chapter on 'Risk Developments and Assessment of Financial Stability in 2016' for further details). Areas to be covered under the review will include the governance, identification, measurement, monitoring and control of liquidity risk.

The Bank's regulatory reform agenda will remain anchored by domestic priorities

The Basel Committee expects to finalise the remaining components of its post-crisis reforms in the first half of 2017. This will address further enhancements to the risk-based capital framework to make the requirements of the global standard simpler, more risk-sensitive and comparable across jurisdictions. In respect of these reforms, a key priority for the Bank in the medium-term will be to improve the risk capture of banking institutions'

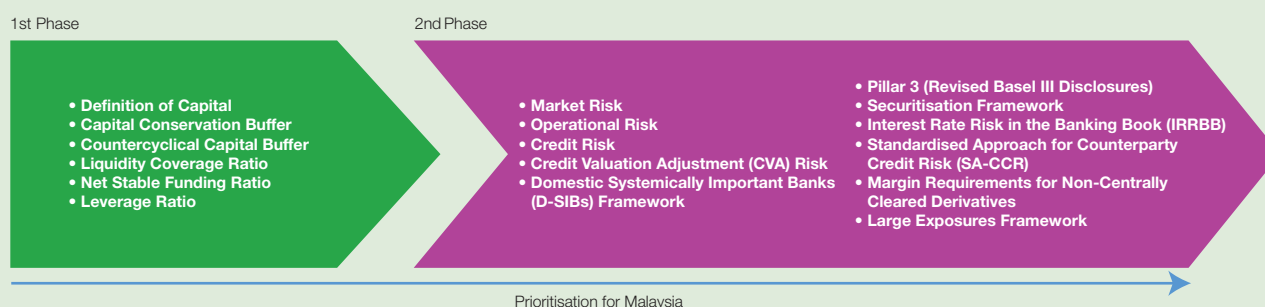
activities in the regulatory capital framework (refer to '2nd Phase' under Diagram 2.3), supported by an assessment of risks in the context of the domestic financial system. To this end, the Bank will commence a review of existing requirements for credit, market and operational risk in 2017, with a view to strengthen banking institutions' resilience against these risks. This will include strengthened capital requirements against counterparty credit risks for derivative exposures, in line with the increased activity of banking institutions in a more developed derivatives market. Overall, the sequencing of the reforms will consider the impact to the Malaysian economy, having regard to internationally agreed timelines and implementation progress globally.

Recovery and resolution planning

The Basel standards are also complemented by broader international efforts to strengthen the resilience of the global financial system and address major shortcomings in the pre-crisis regulatory framework. These include reforms proposed by the Financial Stability Board to improve the recoverability and resolvability of financial institutions, particularly those that are systemically important. In this regard, the Bank and the Malaysia Deposit Insurance Corporation continued to advance work to develop the domestic recovery and resolution planning framework for Malaysia. The first phase of work focuses on the banking sector, which will be followed by an extension of the framework to insurers and takaful operators at a later stage. The Bank expects to conduct a pilot exercise with identified banking institutions to test the recovery planning framework in the second half of 2017. This will determine the final policy guidance to be issued to the industry.

Diagram 2.3

Implementation of Key BCBS Reforms



Source: Bank Negara Malaysia

Key enhancements to credit risk management standards

- Strengthens requirements on credit risk measurement to promote greater sophistication in loss estimation approaches.
- Heightens governance expectations, with a focus on the involvement of the board and risk control function in the credit approval process.
- Expands requirements on the management of exceptional credits and the management of credit concentration, country and transfer risks.
- Introduces group-wide credit risk oversight expectations for risks arising from activities across entities within the group and jurisdictions.
- Promotes sound management of credit risk inherent in specific activities of insurers and takaful operators, such as the purchase of debt securities and ceding of risks to reinsurers or retakaful operators.

Credit risk management

In January 2017, the Bank issued revised standards on credit risk management for public consultation. The revised standards aim to elevate credit risk management practices across the industry, taking into account developments in the size and diversity of product offerings, greater internationalisation of the financial system and the growing role of domestic capital markets as an alternative source of financing. The standards also address requirements that will support the effective implementation of the Malaysian Financial Reporting Standards 9: Financial Instruments (MFRS 9) by financial institutions, and promote alignment with prudential objectives.

Stress testing

Regulatory expectations on stress testing were refined in 2016 to achieve more robust and forward-looking assessments of risks by banking institutions. Stress testing is a critical tool used to identify key vulnerabilities and material risks in banking institutions. It provides key input to the determination of the risk appetite and limits by banking institutions as well as capital, liquidity, recovery and resolution planning. The proposed changes were published in October 2016.

One new requirement is for banking institutions to conduct reverse stress testing, which seeks to uncover events or scenarios that could result in the banking institution becoming non-viable. Identifying such events or scenarios can help banking institutions develop a sharper focus on the risks that they are undertaking, whether the risks are within their risk appetite and the actions required to avert unacceptable risks. Such an exercise is expected to serve as input into the banking institution's risk management strategies and recovery plans to ensure that the banking institution is in a position to respond swiftly to the occurrence of any trigger event. Results of reverse stress tests (in addition to stress test results based on the Bank's prescribed scenarios and internally developed scenarios) are required to be periodically reported to the Bank. These submissions will supplement the Bank's financial stability and supervisory assessments.

Managing conduct risks

Over the years, the Bank has intensified efforts to promote fair, responsible and professional business conduct amid continued competitive pressures and volatility in financial markets. In tandem with strengthened expectations, improvements continue to be

Key enhancements to stress testing standards

- Promotes forward-looking assessments by requiring multi-year stress tests with a prescribed minimum time horizon of three years.
- Introduces expectations to account for spillover of risks from affiliates to the banking institution.
- Improves the quality of stress testing by requiring banking institutions to consider the interlinkages between different risk types during a stressed scenario.
- Strengthens banking institutions' risk mitigation strategies and recovery plans by requiring reverse stress testing to identify tail risks.

observed in the business conduct practices of banking institutions. Notably, the adoption of responsible financing practices has become more firmly entrenched. This is reflected in more consistent affordability assessments in the offering of financial products by banking institutions. Market conduct matters are also receiving greater attention from boards and senior management, and are more integrated within business plans of banking institutions. In addition, lower incidents of inaccurate or misleading advertisements flagged by the Bank during the year point to ongoing improvements in fair marketing practices by banking institutions.

A greater emphasis on market conduct was observed across the banking sector

The Bank remains vigilant in monitoring and assessing conduct risks in the banking sector. In an era of more pervasive digital banking, the Bank has directed greater attention to the management of conduct risks associated with the wider adoption of technology by banking institutions, which can increase exposures to financial fraud (see also 'FinTech Innovation' in the Chapter on 'Cross-Sector Developments'). Banking institutions are taking steps to increase consumer awareness of precautionary measures that should be taken when accessing financial services through digital platforms. The increasing reliance on technology and digital channels for financial services also potentially increases the risk of unauthorised access to confidential customer information. During the year, banking institutions were required to conduct an independent review of the effectiveness of current controls in place to protect the confidentiality of customer information. The scope of the review examined the collection, use, storage and disposal of customer information. The review uncovered opportunities to further strengthen controls at several banking institutions, which are being acted upon by the banking institutions concerned. These relate mainly to improving system-based controls to prevent unauthorised access to confidential customer information and monitoring systems to detect unauthorised disclosures. More generally, banking institutions have been reminded to ensure that they maintain and regularly update internal training programmes that emphasise the responsibility of staff to strictly adhere to procedures for handling confidential customer information.

Supervisory actions were taken by the Bank against 24 banking institutions (including DFIs) in 2016 for

various non-compliances with conduct requirements issued by the Bank, as follows:

- Four banking institutions were directed to enhance control measures to prevent the unauthorised disclosure of customer information;
- One banking institution was directed to cease the imposition of prohibited fees;
- Six banking institutions were directed to modify and improve the level of disclosure in marketing materials to ensure product risks and pertinent information are clearly disclosed. The banking institutions were also required to revise the terms in contracts that were deemed unfair or detrimental to the customer's interests;
- 19 banking institutions were directed to ensure that basic banking services are offered as an option to all customers; and
- Seven banking institutions were directed to address gaps with respect to requirements in responsible and transparent financing policies.

Beyond regulatory efforts, industry-led initiatives continue to play a key role in building trust, enhancing operational efficiency and improving customer service. A joint effort between banking institutions and industry associations is currently under way to promote greater harmonisation of Customer Service Charters, which set out the fundamental principles and standards of customer service. This will serve as the basis for an industry-wide Customer Satisfaction Index survey, which is planned for 2017.

REGIONAL AND INTERNATIONAL CO-OPERATION

The regional operations of domestic banking groups expanded (three-year compounded annual growth rate of total overseas assets: 17.1%) with prospects for future growth expected to improve further on the back of bilateral agreements facilitated by the ASEAN Banking Integration Framework (ABIF).

In 2016, the Bank entered into bilateral arrangements with Otoritas Jasa Keuangan, Bangko Sentral ng Pilipinas and the Bank of Thailand, paving the way for greater market access and operational flexibilities for qualified ASEAN banks in support of intra-regional trade and investment activities. Regional integration is expected to intensify over the next decade, aided by regional arrangements for financial stability that were established by ASEAN governors and finance ministers in April 2016, to promote greater regulatory transparency, capacity building and co-operation within the region.

The Role of Alternative Finance to Fund the Needs of a New Economy

By Zarina Abd Rahman and Samuel Lee

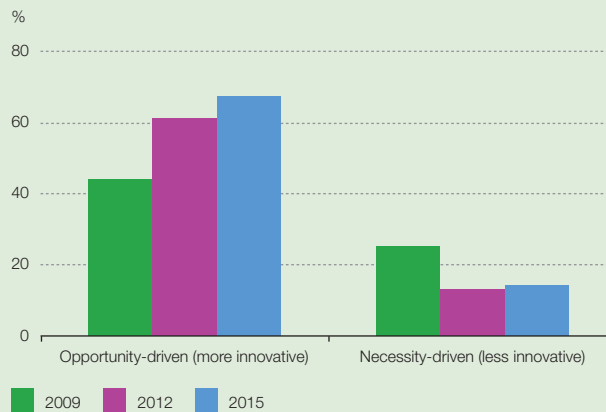
Business financing in Malaysia has evolved over the past decade. Among the more significant developments is the increasing prominence of capital market financing of business activity, which correspondingly reduces the concentration on bank financing. More recently, financing demand has also reflected broader shifts in economic activity towards those that are more knowledge-based with higher deployment of technology. This has spurred new sources of financing to meet changing demand drivers and novel lending approaches and programmes by traditional lenders. While the banking sector continues to be the predominant provider of financing, there has also been a gradual expansion in alternative finance (for the purposes of this article, alternative finance refers to financing methods outside of traditional bank-led debt finance, and includes leasing and factoring). This article explores the potential for alternative finance to complement bank-led debt financing in meeting the financing needs of increasingly diverse and innovative businesses.

Alternative Finance as a Complementary Source of Funds

In recent years, Malaysian businesses, including SMEs, have increasingly adopted Information and Communication Technology (ICT) in their operations. Start-ups are also increasingly opportunity-driven, and as such, are more likely to adopt and deploy innovation to capitalise on new trends (Chart 1). This has led to the emergence of the sharing economy and e-marketplaces. A core premise of the sharing economy is the ability to generate economic value by maximising existing asset utilisation (uptime) and enabling convenient and cost-efficient access to resources without the need for ownership. E-marketplaces, meanwhile, leverage on virtual platforms to more efficiently match the supply and demand of goods and services, thus minimising holding costs. Underpinning these propositions is a growing trend of businesses that are inventory-light and intellectual property-centric.

Chart 1

Nature of Businesses for Start-ups



Source: SME Corporation Malaysia

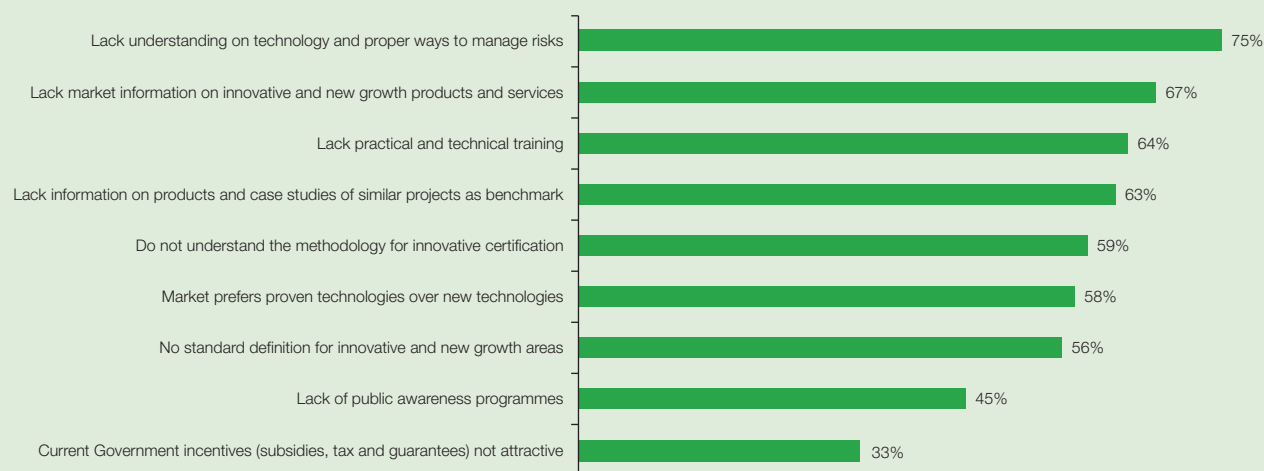
Such businesses face challenges in accessing bank-based financing, largely due to the characteristics of bank financing, which are often incompatible with the financing of innovative and new growth ventures:

- The credit evaluation process of banks is heavily reliant on collecting and analysing large volumes of historical and quantitative data. The proliferation of credit scoring models used by banks may also accentuate cyclicalities in bank lending, resulting in new growth businesses facing greater difficulty in accessing bank financing during economic downturns.

- Credit evaluations are sometimes supplemented with relationship data, which relies on information collected over the course of a long-standing banking relationship. These include knowledge of a borrower's character and integrity, trusted references, or standing in the local community. However, such relationship-based assessments have decreased in significance as banks move towards more centralised systems for credit assessments and decision-making, which is commensurate with their growing size and complexity.
- Collateral, mainly in the form of commercial and residential real estate, remains a key feature of lending to lesser-known businesses with a limited track record, and is used by banks as a buffer against credit losses. Such collateral is generally lacking among newer businesses, as noted above. The dependency on collateral also reflects a degree of organisational inertia, whereby banks have been relatively slow to develop domain expertise in new growth areas or adopt new approaches and technologies for managing risks (Chart 2).

Chart 2

Key Challenges in Financing Innovative and New Growth Areas

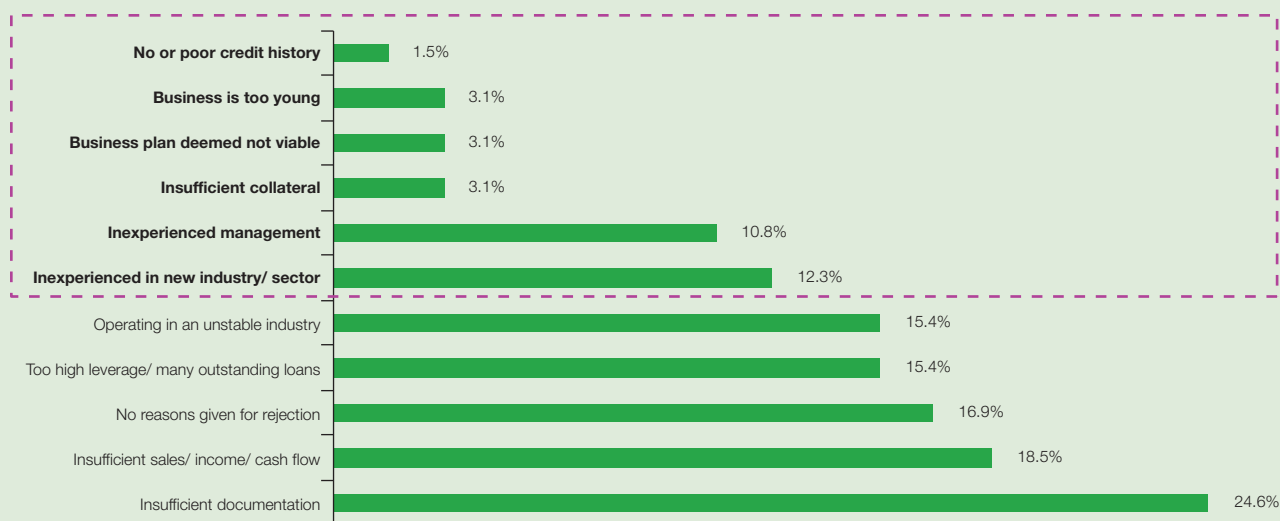


Source: Bank Negara Malaysia

The reasons for loan rejections commonly quoted by SMEs affirm these observations (Chart 3).

Chart 3

Reasons for Bank Rejecting Loans, as Quoted by SMEs



Source: SME Corporation Malaysia Survey

To a large extent, bank behaviours reflect their obligations to protect depositors' interests. This restrains banks from undertaking excessive risks. Even if riskier businesses are adequately credit-screened, borrowers have strong incentives to use funds for more risky projects since all of the upside accrues to them, while banks and depositors largely bear the downside risks from defaults on interest and principle repayments.

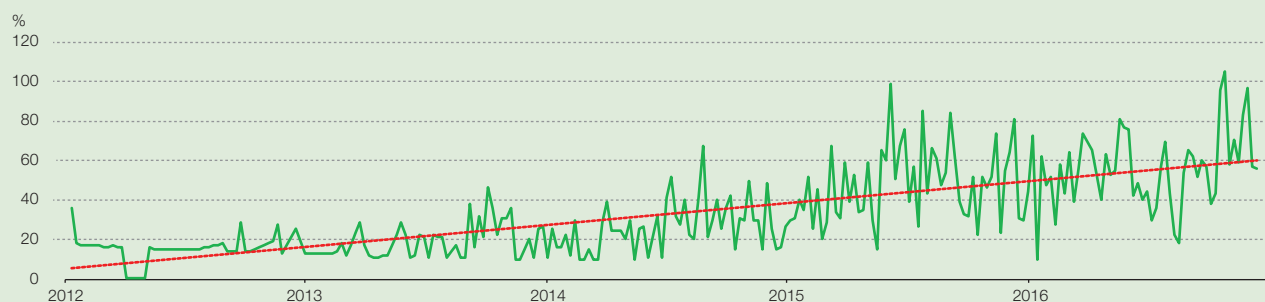
The development of alternative finance can help to bridge this gap by opening up new financing opportunities for innovative and early-stage businesses. Notable examples include:

- Crowdfunding and peer-to-peer lending, which lowers search costs for both lenders and borrowers;
- Private equity and venture capital, which allows for more aligned risk and return expectations of fund providers;
- Asset-based lending structures, which takes into account the value-generation capacity of reference assets; and
- Factoring, which enables less creditworthy borrowers to improve cash flows by substituting their credit risk with that of more established customers.

Alternative finance models are also increasingly leveraged on digital platforms, further increasing their efficiency and potential to address financing gaps in the economy. Data points suggest that the utilisation of alternative financing methods, though relatively small compared to traditional bank lending, have increased. Recently, six registered market operators have been licensed by the Securities Commission Malaysia to operate equity crowdfunding platforms. The platforms raised a total of RM6.2 million in funding for start-ups in 10 months. Public awareness on alternative financing avenues has also trended upwards (Chart 4) and businesses have increasingly reported using alternative financing methods (Chart 5), supported by the growth in non-bank financial intermediation.

Chart 4

Google Searches for "Crowdfunding" in Malaysia (index)



Source: Google trends

Chart 5

SMEs Reported Using Alternative Financing

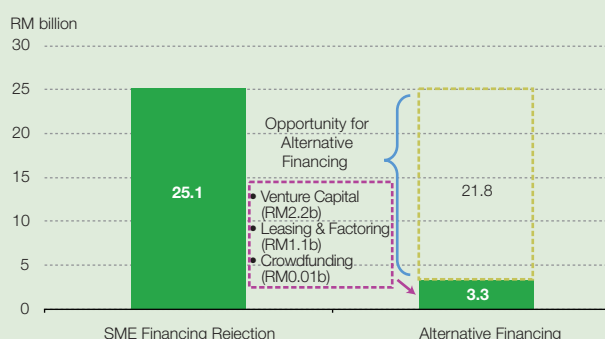


Source: SME Corporation Malaysia Survey

There remains significant room to support the development of alternative finance in Malaysia. In 2015, key outstanding alternative financing, which encompasses venture capital, leasing and factoring, and crowdfunding, amounted to RM3.3 billion compared against RM25.1 billion in total SME financing applications that were rejected by banks. This suggests an estimated financing gap of RM21.8 billion that could potentially be met by alternative finance (Chart 6). The gap between the current volume of factoring and leasing in Malaysia (at 0.64% and 0.69% of gross domestic product [GDP] respectively) and global average factoring and leasing volumes in more developed countries (at 4.55% and 1.55% of GDP¹ respectively) points to further opportunities for an additional RM48 billion in financing that could be raised for Malaysian SMEs through factoring and leasing facilities.

Chart 6

SME Financing Gap as at 2015



Source: Bank Negara Malaysia

Bank-intermediated Alternative Finance in Malaysia

Banking institutions themselves have had a role in encouraging the development of alternative finance in Malaysia. This is most evident in the Islamic banking sector, with the application of investment intermediation and value-based banking practices underpinned by Shariah contracts contributing to the growth of alternative finance. Notably, the innovative use of equity- and exchange-based financial instruments such as *musharakah* and *ijarah* offer differentiated value propositions, which allow risks to be shared between investors and business owners. This utilises investment account structures that are managed by Islamic banking institutions.

The provision of alternative finance that combines commercial and social objectives through *waqf* and other donation-based arrangements to deliver more direct benefits to society is also gaining traction within the Islamic banking sector. The application of cash *waqf* to eradicate poverty and improve access to education and health services for those in need is an example of a wider intermediation role that the Islamic banking sector is well-placed to perform (refer to Chapter on 'Islamic Finance Development' for further details on investment accounts and *waqf*).

A number of banks have also introduced invoice trading platforms, an electronic complement to traditional factoring, to support viable but cash-strapped businesses. The platform enables SMEs to convert their receivables into cash in a quick and efficient manner, and at more competitive rates, due to a transparent online bidding process for receivables on the platform. It also reduces fraud associated with multiple financing generated from the same invoice. Invoice trading is expected to grow, with electronic-based platforms playing a more important role in crowding-in sophisticated investors as well as institutional funders. The potential to tap into a wider, new consumer base has also seen the increasing participation of banks as institutional funders in bank-intermediated invoice trading platforms.

¹ Global Leasing Report 2016, White Clarke Group, 2016; Annual Review, Factor Chain International, 2016.

Policy Priorities to Further Develop Alternative Finance

Priorities to further develop alternative finance as an important source of early-stage financing will need to encompass the following:

- Strengthening institutional arrangements to coordinate, align and drive developmental policies for alternative finance through a top-down approach. This requires detailed consideration of appropriate regulatory and legal frameworks, and the supporting financial infrastructure to provide efficient access to, and delivery of, alternative financing solutions.
- Improving the quality, coverage and integrity of data on alternative financing to inform both public policy and private credit decisions. Standards should be established for alternative finance providers to report accurate and timely data to oversight authorities. Economic data should also be segmented to provide visibility on innovative and new growth industries.
- Establishing a unified collateral registry for movable assets. Such a registry can substantially expand the collateral base for financing by enhancing transparency and preventing fraud. This will benefit SMEs in particular, through the ability to unlock the value of movable assets such as machinery and inventory, which often account for the majority of SMEs' capital stock.
- Promoting the development of open application programme interfaces (APIs) that enable third-party developers to leverage on the database of financial institutions to deliver faster, cheaper and customised solutions. This will need to be supported by common standards for data sharing by financial institutions as well as requirements on information security, data exchange and other data-related policies.
- Intensifying public engagement and education initiatives to raise awareness among SMEs on available alternative financing avenues. Efforts to encourage fund providers (including angel investors) to participate more actively in alternative finance markets are also important.