

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

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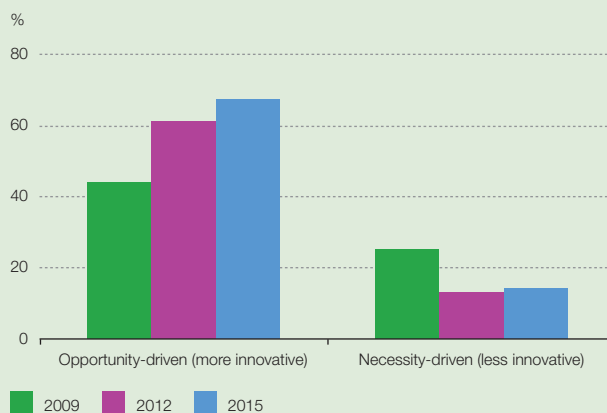
Business financing in Malaysia has evolved over the past decade. Among the more significant developments is the increasing prominence of capital market financing of business activity, which correspondingly reduces the concentration on bank financing. More recently, financing demand has also reflected 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

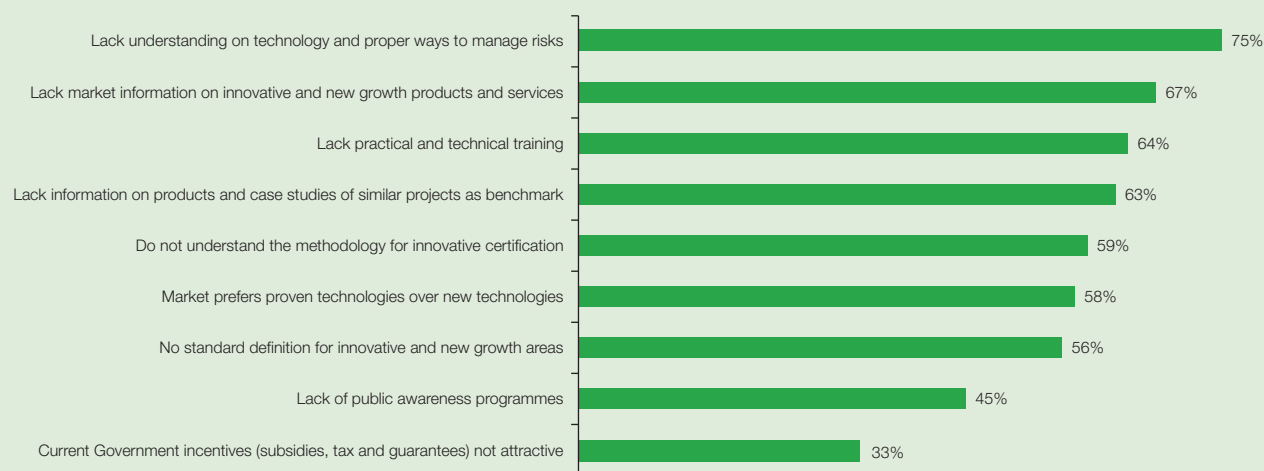
Such businesses face challenges in accessing bank-based financing, largely due to the characteristics of bank financing, which are often incompatible with the financing of innovative and new growth ventures:

- 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 cyclical 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

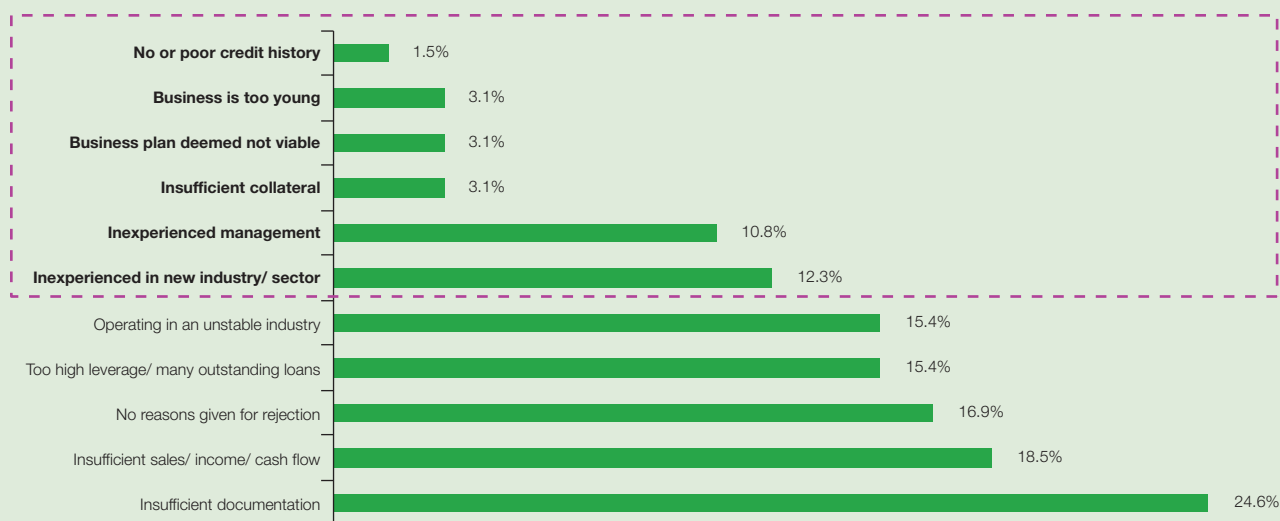


Source: Bank Negara Malaysia

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.

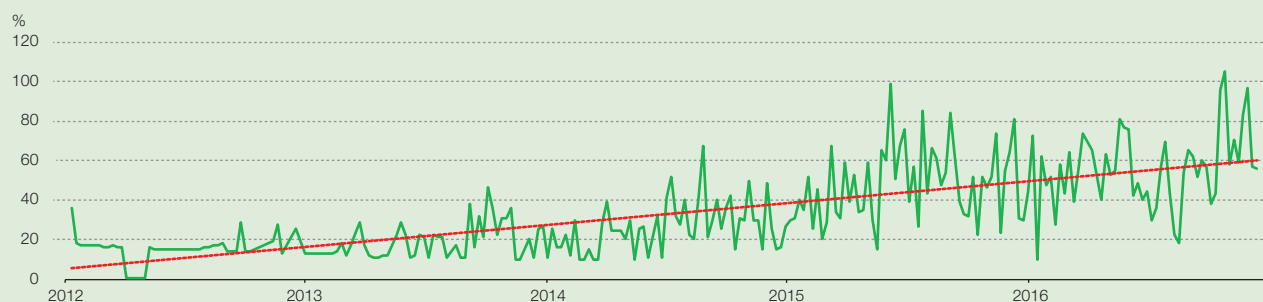
The development of alternative finance can help to bridge this gap by opening up new financing opportunities for innovative and early-stage businesses. Notable examples include:

- 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

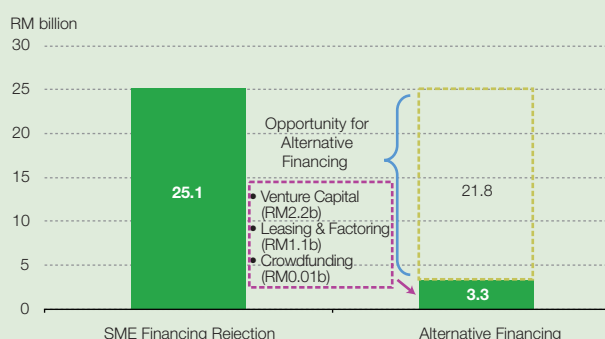


Source: SME Corporation Malaysia Survey

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.