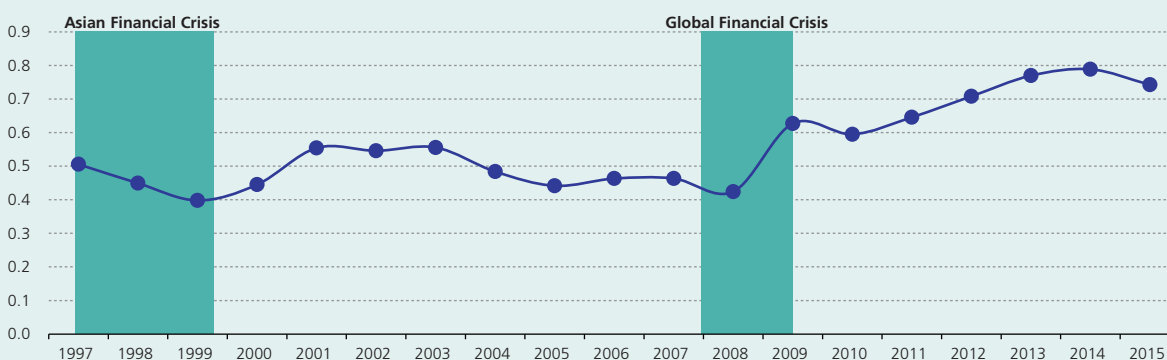


Financial Deepening and Implications on Financial Stability

Malaysia has experienced significant financial deepening, most notably in the recent two decades. This is evident from the breadth and depth of the major components of the financial system, its accessibility and efficiency, and the diversity of players and instruments (Chart 1). The financial system has expanded five times since 1998 to about 400%¹ of GDP as at end-2015, reflecting strategies that were pursued to support the needs of the growing economy while strengthening its resilience to shocks. The more significant role of non-bank financial institutions² (NBFIs), in particular, has enhanced access to a wider range of funding and investment options for households, businesses and financial institutions. On one hand, this has contributed to a more efficient allocation of financial resources and dispersion of risks within the economy, but it also requires a broader understanding of the sources of risk to financial stability and the channels through which these risks are transmitted to and within the financial system (Chart 2). This article reviews the evolution of financial intermediation in Malaysia and its implications for the management of financial stability, including concerns that can arise from interlinkages between the banking system and other financial intermediaries, and activities that encourage excessive leverage or which involve maturity and liquidity transformation and imperfect credit risk transfers.

Chart 1

Malaysian Financial Depth Index



Note: The index is constructed from the following indicators as a ratio to GDP: (i) stock market capitalisation; (ii) outstanding domestic public debt securities; (iii) outstanding domestic private debt securities; (iv) banking system assets; (v) fund management industry assets; (vi) provident and pension fund assets; (vii) insurance industry assets, and (viii) other non-bank financial institutions (NBFIs) assets

Source: Bank Negara Malaysia and internal computation

Evolution of Financial Intermediation in Malaysia

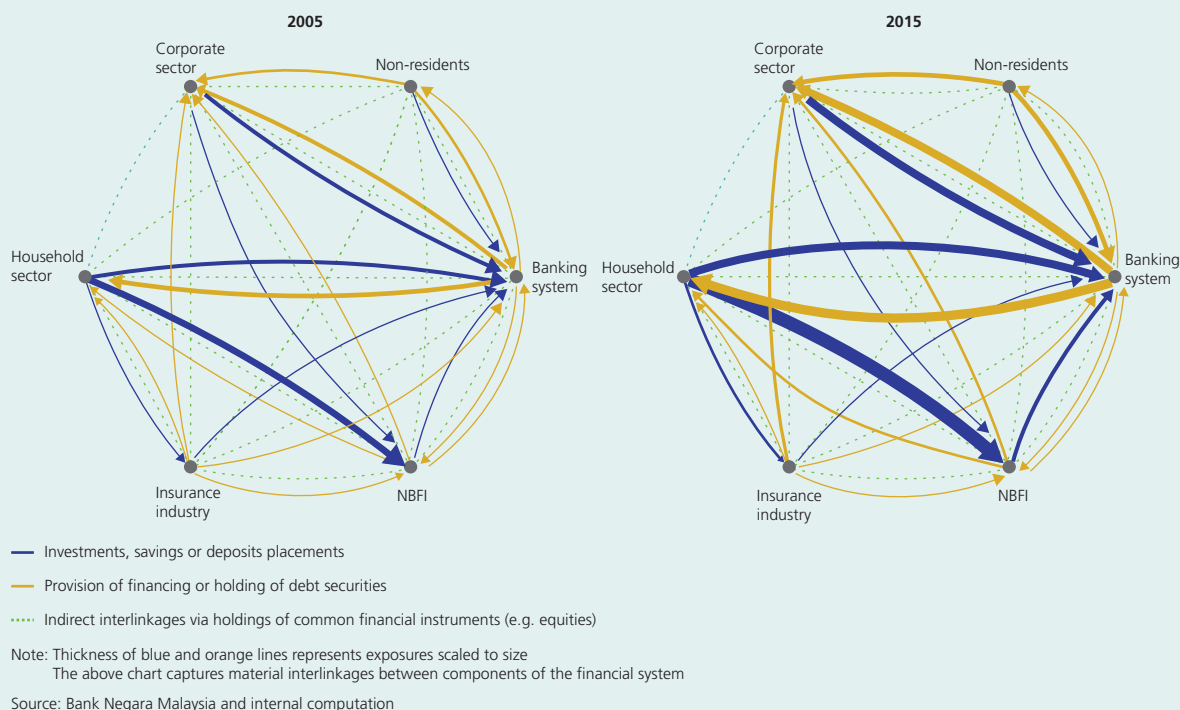
While banks retain a primary role in financial intermediation in Malaysia, a significant feature in the evolution of the financial system over the last decade has been the growing significance of the domestic capital market and NBFIs (Chart 3). Total outstanding debt securities grew at a compounded annual growth rate (CAGR) of 10.4% over the past decade to RM1,127.2 billion or 97.4% of GDP as at end-2015. The average maturity of debt securities has also lengthened, from 3.1 years in 2005 to 6.1 years in 2015, underpinned by issuances of longer-dated securities with maturities as long as 30 years. This has enabled businesses to source funding for projects with long gestation periods or for longer-term expansion plans more efficiently, while reducing refinancing risks. For insurance companies and provident and pension funds, the ability to invest in financial instruments with longer tenures has also reduced asset-liability mismatch risks.

¹ Computed based on outstanding loans granted by financial institutions, market capitalisation of the equity market and outstanding debt securities.

² For the purpose of this article, NBFIs comprise insurers and takaful operators, development financial institutions, provident and pension funds, fund management industry, social security organisation, securitisation vehicles and other non-bank lenders such as pawnbrokers, moneylenders, co-operatives, providers of hire purchase financing, leasing and factoring companies, building societies and non-bank provider of education financing.

Chart 2

Interlinkages between Components of the Financial System



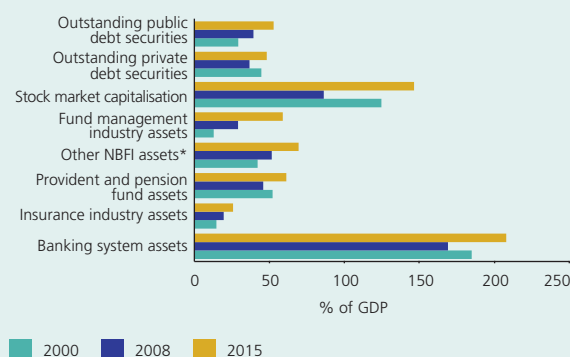
The development of the derivatives and securitisation market in Malaysia has been gradual and more measured. While the demand for derivatives for hedging purposes has been on an increasing trend, the market remains relatively small. Securitisation activities, predominantly linked to housing loans granted to civil servants, are mainly structured to reduce maturity mismatches rather than to transfer credit risk. Given their strong capital positions, ample liquidity and manageable credit risk exposures, banks in Malaysia generally do not rely on the asset-backed securitisation market to support their lending activities. As at end-2015, asset-backed securities stood at RM11.4 billion or about 1% (2005: 3.4%) of total outstanding debt securities.

In parallel with the more developed capital market, the role of NBFIs in the mobilisation of savings and investments has also increased in significance. To a large extent, this stemmed from the more vibrant and liquid capital market, but it also reflects a higher level of financial sophistication and awareness among households of the broader range of alternative savings and investment instruments available. Over the past decade, NBFIs assets have tripled, and currently account for almost half (49%) (2005: 41%) of total financial institutions' assets as at end-2015. About 70% of NBFIs asset growth was driven by the fund management industry and the provident and pension funds. The net asset value of wholesale funds that cater to institutional investors has expanded by more than four times over the past five years to account for about 13% of assets of the fund management industry. Whilst a large share of wholesale funds is invested in money market instruments including deposits, such funds are estimated to represent less than 3% of bank deposits. The demand for private retirement savings to complement mandatory retirement saving schemes and existing welfare safety nets has also increased, with the assets under management of private retirement schemes expanding about four times to RM1.2 billion (2013: RM0.3 billion) since they were launched in 2012. The bulk of the NBFIs (representing more than 95% of total NBFIs assets) is subject to the oversight by either the Bank, Securities Commission Malaysia, Malaysia Co-operative Societies Commission and Government ministries.

An expected consequence of the broader range of wealth management instruments and a deeper financial market has been a moderation in deposit growth (CAGR between 2010 to 2015: 7.9%; CAGR between 2005 to 2010: 10.5%). In the more recent period, this has been further compounded by a search for yield amid a prolonged low interest rate environment and the higher volume of capital flows. These developments are reflective of financial deepening and a more mature and open financial system. Banking institutions in Malaysia have, for a few years now, also begun to tap into alternative sources of stable funding through the domestic capital market. This reflects both adjustments made by banks to adapt to slower deposit growth as well as measures taken by banks to diversify and improve the stability of their funding base. As at end-2015, medium-term funding instruments, in ringgit and foreign currency, have increased to represent 5.1% (2010: 2.9%) of banks' total liabilities. This has resulted in the progressive lengthening of the maturity profile of bank funding sources to between three to five years (as opposed to less than one year for deposit-based funding). The maturity mismatch between bank funding and assets (which have an average duration of 11.9 years) has correspondingly improved.

Chart 3

Components of the Financial System



*Refers to development financial institutions (DFIs), co-operatives, building societies, leasing and factoring companies, social security organisation, national mortgage corporation, non-bank provider of education financing, pawnbrokers, moneylenders and outstanding asset-backed securities. Assets for the year 2015 are based on preliminary figures.

Source: Bank Negara Malaysia, Securities Commission Malaysia, Malaysia Co-operative Societies Commissions and internal computation

Implications for the Management of Financial Stability

The combination of a bank-based and market-based financial system has reduced risks associated with a concentration in specific financial markets, institutions or instruments to meet financing needs (Table 1). Notably, in line with the higher share of business financing from the private debt securities market, the concentration of bank exposures to large businesses has been declining (2015: 18.9%; 2005: 22.6%). During the same period, banking sector exposures to households and SMEs have been increasing (2015: 74.8%; 2005: 72.4%) driven by ample liquidity conditions, alongside sustained efforts to promote financial inclusion.

The growing significance of loans to households and SMEs has resulted in greater dispersion of credit risks in the banking system, with attendant changes in credit risk management approaches by banking institutions. This includes the wider use of credit scoring models for risk assessments, supported by credit information from the Central Credit Reference Information System (CCRIS) which continues to serve as a major component of credit scoring models. CCRIS also provides a strong foundation for promoting the development and growth of private credit reporting agencies to further enhance the provision of high quality consumer credit information to help borrowers and lenders make informed financial decisions. Reflecting the increased exposure of financial institutions to households and SMEs, institutional arrangements have also been put in place to pre-emptively respond to potential stress in

Table 1

Financing Profile of Non-financial Corporations

	1998	2015
	RM billion	
Domestic financial institutions*	307.5 (78%)	672.4 (52%)
Debt securities market	5.1 (1%)	337.3 (26%)
External borrowings	83.5 (21%)	287.4 (22%)

*Refers to borrowings from Malaysian banks, DFIs and other NBFIs

Note: Figures in the parentheses are quoted as percentage of total debt of non-financial corporations

Source: Bank Negara Malaysia and internal computation

these segments. This includes the setting up of the Credit Counselling and Debt Management Agency (Agensi Kaunseling dan Pengurusan Kredit, AKPK) and the Small Debt Resolution Scheme by the Bank to facilitate debt resolutions and provide financial management advisory services.

Since 2010, the Bank has also implemented macroprudential measures to manage risks from the higher level of household indebtedness. A key focus of the measures was to ensure that banks comply with responsible financing practices through requirements for banks to carry out proper affordability assessments and observe prudent debt service ratios in their lending processes and decisions. These measures were also extended to NBFIs to reduce opportunities for regulatory arbitrage given the increasing role of such institutions in intermediating household funding needs. With sustained growth in housing loans and rising property prices, measures (including fiscal measures) were also implemented to reduce speculative purchases in the property market. Collectively, these measures have contained the build-up of risks in the household and property sectors.

Another dimension of risks in household lending relates to the changing composition of household assets and the potential effects this may have on household financial buffers (Chart 4). Although a significant share (73.8%) of household financial assets continues to be held in deposits, deposit-like instruments and provident and pension savings, the proportion of assets invested in higher-yielding asset classes such as equities and unit trusts has increased. In the recent periods, the heightened volatility in the equities market resulted in marginal decline in the value of household's equity investments (2015: -0.7%; 2014: -3.6%). The value of investment-linked and other non-guaranteed insurance policies which are largely invested in equities and debt securities was similarly affected. Although this may increase risks of deterioration in household loan performance, such risks are largely mitigated by the sound lending standards that banks have continued to observe.

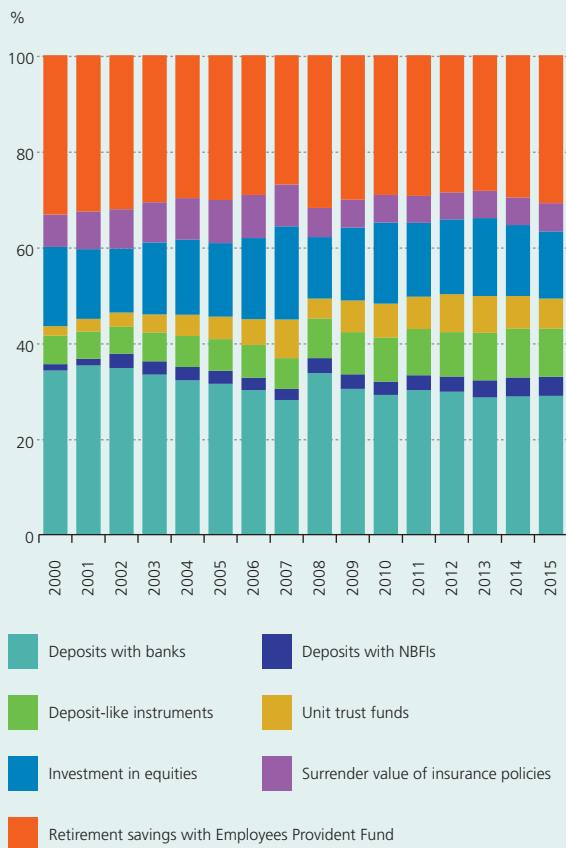
More developed domestic financial markets have also enabled Malaysia to better weather periods of global economic uncertainty and international financial market volatility. Since the 2008 Global Financial Crisis, recurring episodes of market volatility have been tempered by the presence of large and strong institutional investors, including insurance companies, and provident and pension funds. This provided support to asset prices and contributed towards preserving liquidity in the domestic debt securities and equities markets during periods of sustained sell-offs by non-residents. At the height of both the Global Financial Crisis and during the taper tantrum period in 2013, the bid-ask spread and turnover ratio remained relatively stable (Chart 5). Intermediation activities continued undisrupted, reflecting a more resilient financial system as the broad range of domestic funding sources reduced vulnerabilities to external developments.

At present, risks to financial stability from the growing significance of market-based instruments and NBFIs in financial intermediation mainly arise from the resulting increased interlinkages between various components of the financial system. Banking institutions are exposed to risks through holdings of common assets with significant NBFIs, such as provident and pension funds, insurance companies and non-resident investors. Any stress in such NBFIs resulting in the widespread disposal of assets held in common with banks could lead to volatile and significant price movements with direct consequences for bank balance sheets. Currently, this risk is relatively low as bank holdings predominantly consist of higher-rated and more liquid debt securities which are generally more resilient to repricing risks. As at end-2015, holdings of public debt securities and private debt securities rated 'AA' and above account for 58% of the treasury portfolio of banks while equity investments remain small at 1.1% of treasury portfolio (refer to Chapter 1 on 'Risk Developments and Assessment of Financial Stability in 2015').

As the pattern of financial intermediation in Malaysia continues to evolve to keep pace with the growing and changing needs of the economy, policy flexibility to identify and mitigate potential risks and vulnerabilities is paramount. In Malaysia, this has been supported by a strong legal and surveillance framework (Diagram 1) and significantly strengthened inter-agency co-operation arrangements at both domestic and regional levels which facilitate the effective exchange of information and policy coordination, thus promoting the effective management of risks to financial stability.

Chart 4

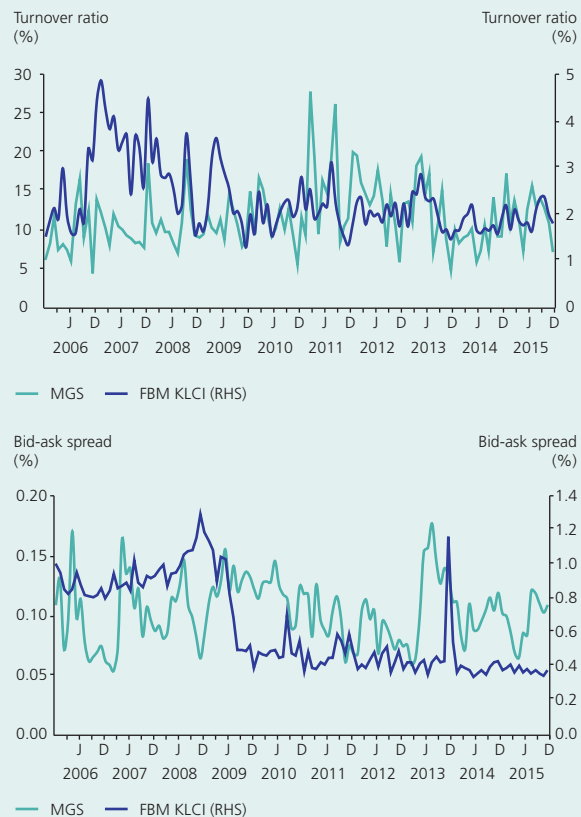
Composition of Household Financial Assets



Source: Bank Negara Malaysia, Securities Commission Malaysia, Bloomberg and internal computation

Chart 5

Monthly Turnover Ratio and Bid-Ask Spreads of MGS and FBM KLCI



Note: Average bid-ask spreads of MGS and FBM KLCI are as % of mid-price

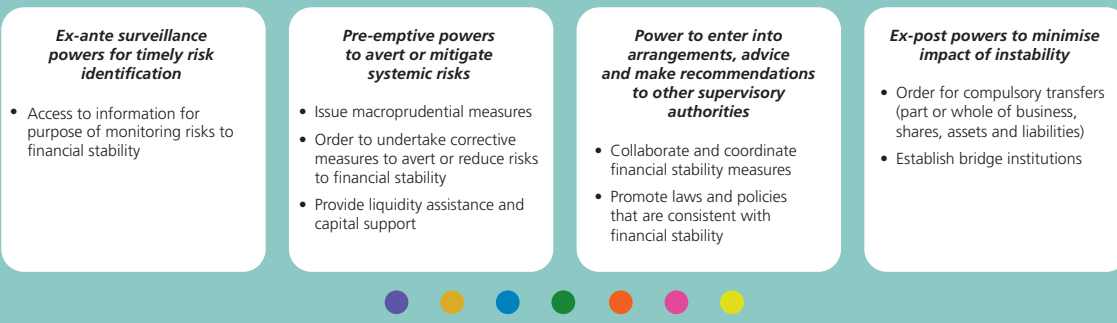
Source: Bank Negara Malaysia and Bloomberg

Diagram 1

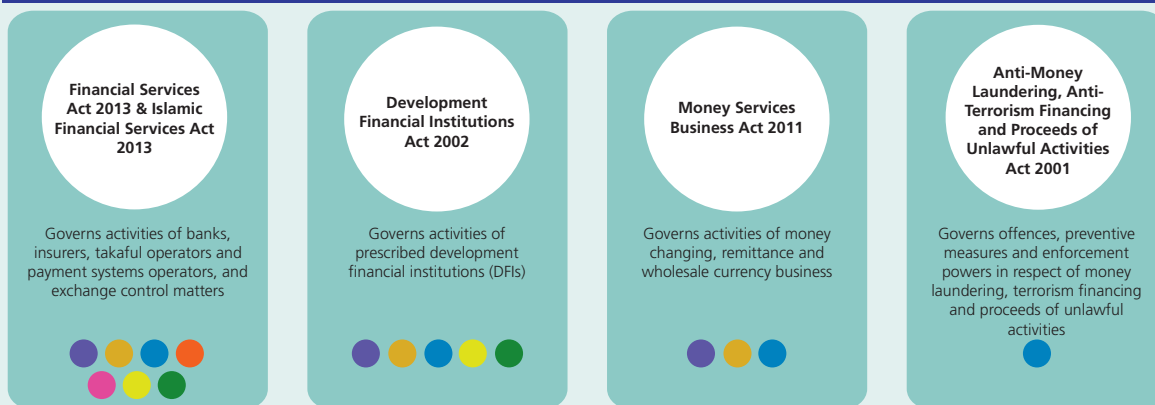
Legal Framework and Collaborative Arrangements to Safeguard Financial Stability

Central Bank of Malaysia Act 2009

- Provides clarity in the Bank's financial stability mandate and its statutory responsibilities to regulate and supervise financial institutions, provide oversight over the money and foreign exchange markets, exercise oversight over payment systems, and develop a sound, progressive and inclusive financial system.
- Provides the Bank a broad range of powers and tools to safeguard financial stability.



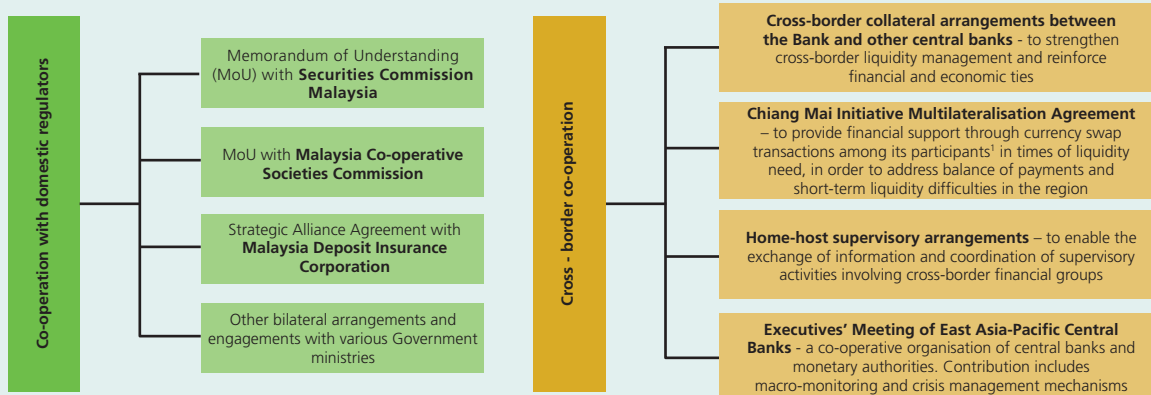
Reinforced by regulatory laws administered by the Bank



Focus of legislation:

- Prudential regulation and supervision
- Fair, responsible and professional business conduct
- Deterrence of financial crime
- Financial safety nets
- Orderly financial market and payment systems
- Shariah compliance
- Tools for crisis management and prevention

Enhanced domestic and regional collaborative arrangements



¹ Refers to ten members of the Association of Southeast Asian Nations (ASEAN), PR China (including Hong Kong SAR), Japan and South Korea

Source: Bank Negara Malaysia

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