

# 2013

## DEVELOPMENT OF THE FINANCIAL SECTOR

- 69 Ensuring Effective and Efficient Intermediation
- 71 *Box Article: Developing the SME Financing Ecosystem*
- 77 Strengthening the Insurance and Takaful Industry
- 78 *Box Article: Reforms in the Life Insurance and Family Takaful Industry*
- 80 Promoting an Inclusive Financial System
- 81 Developing Deep and Vibrant Financial Markets
- 84 Enhancing Malaysia's Interlinkages with Regional and International Economies
- 85 Malaysia as an International Islamic Finance Marketplace
- 87 *Box Article: Diversification of Islamic Banking Business and Products Driven by Shariah Contracts*
- 92 Continued Development of Human Capital
- 94 Key Priorities Moving Forward



## DEVELOPMENT OF THE FINANCIAL SECTOR

The financial sector saw further growth and development in 2013 to better serve the needs of the economy. Central to this was the progressive implementation of the strategies and initiatives set out in the Financial Sector Blueprint 2011-2020. The financing ecosystem was further strengthened to ensure that the financial sector continues to meet the evolving needs of the Malaysian economy, and financial intermediation remains uninterrupted against a more challenging global economic environment. Financial inclusion continued to be supported by a wider range of distribution channels, and the offering of new products and services by financial service providers to meet the needs of a diverse and evolving consumer base.

The progressive implementation of the strategies and initiatives set out in the Financial Sector Blueprint 2011-2020 continued to support the growth and development of the financial sector

Regional and international linkages further expanded as Malaysian financial institutions embarked on regional expansion to support the financing needs of Malaysian corporates that are increasingly establishing their footprint outside the country. The admission of new foreign financial institutions over the last few years had added diversity and is intended to create a more competitive market and contribute to the capacity of the domestic financial system to support Malaysia's economic transformation. The Association of Southeast Asian Nations (ASEAN) integration framework and developments in Islamic finance further reinforced the growing regional and international complexion of the financial sector. The development of talent to drive the financial sector forward continues to be an important agenda in 2013 and beyond. Along with the strengthening of institutional

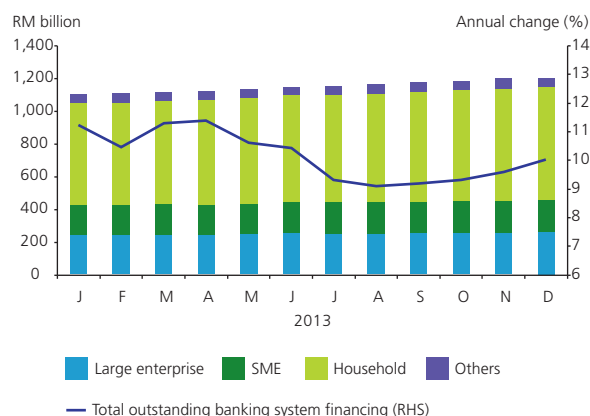
arrangements to meet the demands of a changing financial landscape, focus is now increasingly placed on growing a deep pool of high-calibre workforce characterised by high standards of professionalism, ethics and quality.

### ENSURING EFFECTIVE AND EFFICIENT INTERMEDIATION

During the year, banking institutions and development financial institutions (DFIs) continued to effectively mobilise funds to support the financing needs of businesses and households. Loans to households continued to represent the bulk of financing assets in the banking system, increasing to 57.5% of total outstanding loans (2012: 56.4%). The pace of growth in new household loans has moderated in response to measures implemented by the Bank to reinforce responsible financing practices in an environment of rising household debt levels. Financing to small and medium enterprises (SMEs) increased to 42.1% of total business financing as at end-2013 (2012: 40.5%). The debt securities and sukuk markets continued to be the main avenue for the corporate sector to raise financing, accounting for 61.5% of total outstanding corporate financing (2012: 61%).

Chart 2.1

#### Outstanding Banking System Financing



Source: Bank Negara Malaysia

The sustained growth in financing to SMEs reflects a strong financing ecosystem in Malaysia that has been developed through deliberate and comprehensive strategies undertaken since the establishment of National SME Development Council in 2004. This is further elaborated in the box article 'Developing the SME Financing Ecosystem'. Existing special funds under the Bank also continued to ensure the availability of financing to SMEs at reasonable costs in selected sectors such as food, manufacturing and services. As at end-2013, a total of RM24.3 billion in financing had been approved to more than 58,000 SMEs under these funds. The continued financing support has enabled a steady stream of these companies to grow and develop into large enterprises. In 2013, another 563 SME accounts that had collectively received total financing valued at RM2.1 billion were re-designated as large enterprise accounts, reflective of the success of these initiatives.

Support for SME financing continued to benefit from the financing and guarantee schemes provided by Credit Guarantee Corporation Malaysia Berhad (CGC). During the year, CGC in collaboration with a participating Islamic financial institution launched its first Islamic Portfolio Guarantee Scheme (the Scheme), which enables SMEs to gain quick access to a Shariah-compliant financing facility of amounts ranging from RM100,000 to RM800,000 with a financing tenure of between 36 to 84 months. Under this Scheme, faster turnaround times for approval of guarantees and disbursement of loans are facilitated through a set of pre-determined eligibility criteria and simplified application procedures and documentation. These features are expected to attract more Islamic financial institutions to participate in the Scheme which is targeted to benefit up to 1,500 SMEs. CGC also launched two other guarantee schemes, Enhancer Bumi and Enhancer Bumi-i, which facilitate access to financing for Bumiputera SMEs by providing guarantees of up to 90% of financing, at competitive guarantee fees. Under Enhancer Bumi, CGC targets to provide guarantees for financing worth RM80 million to 200 SMEs in 2014.

Micro enterprises continued to receive financing support from the financial sector under the *Pembiayaan Mikro* scheme. Since its inception in 2006, total financing amounting to RM2.4 billion has been approved to more than 150,000 microfinance accounts. The average processing

time for financing applications under the scheme has also improved to five days (from seven days before), reflecting the further simplification of processes and better familiarity of banks and DFIs with credit assessments for this group of borrowers.

In line with efforts to enhance the capabilities of financial institutions to support high value-added activities, the Bank continued to facilitate engagement and knowledge sharing sessions for financial institutions to better understand the funding needs and business prospects of innovative enterprises, and to provide an avenue for dialogue on products and services required by these enterprises. In May 2013, the Bank, together with the Intellectual Property Corporation of Malaysia and the Association of Islamic Banking Institutions Malaysia, co-organised an Intellectual Property (IP) Valuation Roundtable to discuss issues around the use of IP as collateral and the methods employed in the valuation of IP. This is intended to pave the way for banking institutions to consider viable alternatives to traditional assets which may be accepted as collateral for financing.

---

### Efforts continued to be undertaken to enhance the capabilities of financial institutions to support high value-added activities

---

Another important growth area which the Bank has continued to support is financing for green technology. As at end-2013, total financing under the Green Technology Financing Scheme (GTFS) increased to RM1.6 billion (2012: RM1.1 billion), extended to 120 companies. Findings of a survey conducted by the Bank in January 2013 observed that 36 banks or 58% of all banking institutions, including DFIs, participated in green technology financing, with an additional 10 banks indicating interest to support green technology financing under their business plans over the next three years. Several banks have also further expanded their product offerings during the year to support corporations carrying out environmentally-friendly activities and undertaking the installation of photovoltaic systems in houses. These trends are expected to continue as financial institutions deepen their knowledge and experience in financing green technology.

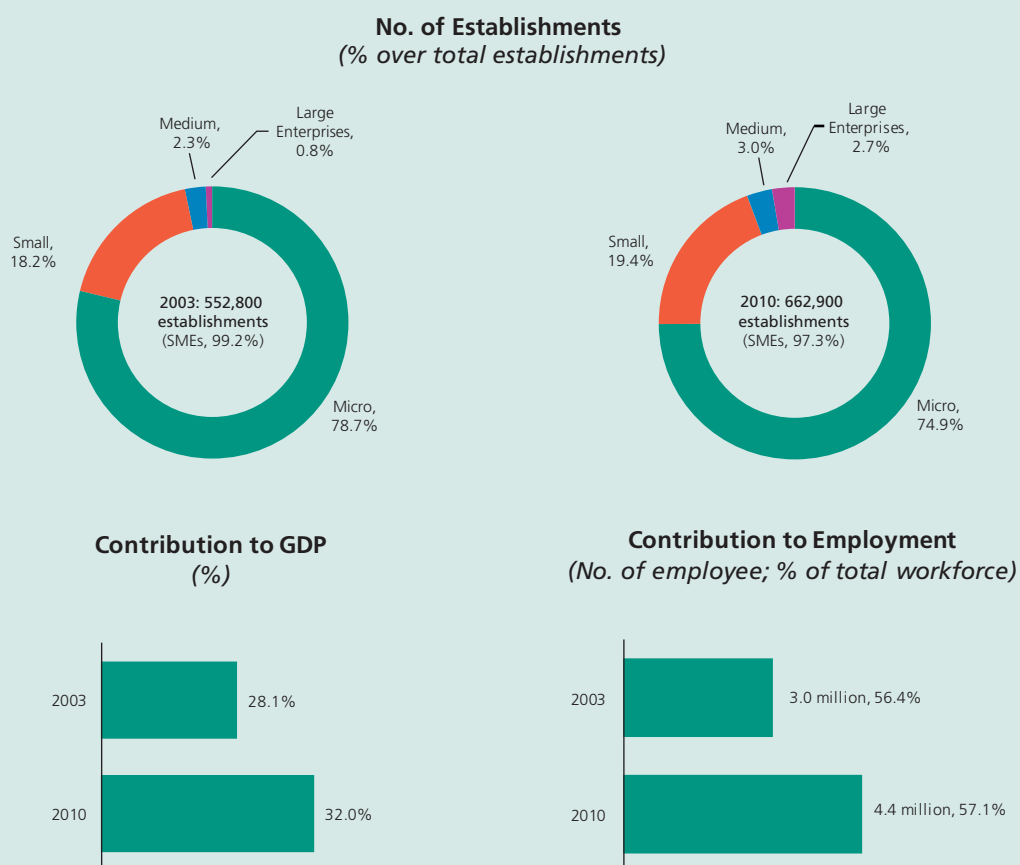
## Developing the SME Financing Ecosystem

### Introduction

SMEs are a critical component of the Malaysian economy, contributing a third of gross domestic product (GDP) and providing job opportunities to more than four million workers or 60% of total employment (Diagram 1). Based on the most recent census data compiled in 2011, the number of SMEs grew by 20% to over 662,000 compared with the last census of 2005. SMEs accounted for 97.3% (2005: 99.2%) of total business establishments. The development of the SME sector is crucial in ensuring balanced growth and shared prosperity as the country transitions into a high value-added, high-income economy. In particular, the sector contributes significantly to poverty alleviation due to the micro enterprises that make up more than three quarters of total SMEs. This sector is an important source of income and self-employment for low-income households, particularly in the sub-urban and rural areas.

**Diagram 1**

### SME's Contribution to the Economy



Source: Department of Statistics, Malaysia

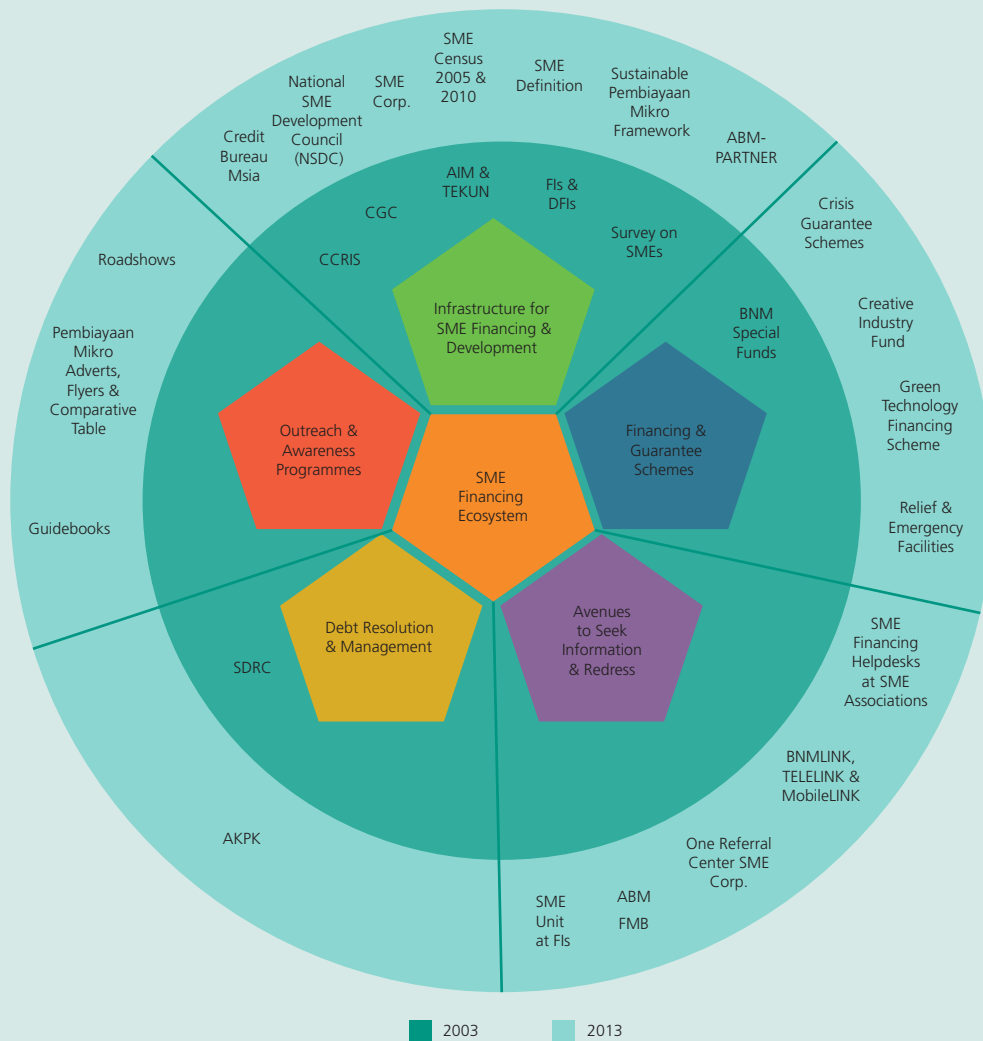
Recognising the importance of SMEs' contribution for sustainable growth, the Bank has collaborated with the relevant Ministries and agencies since 2001 to develop a holistic and coordinated framework for the development of this sector. This culminated in June 2004 with the establishment of the National SME Development Council (NSDC), chaired by the Prime Minister and comprising 16 Ministries and key agencies, as the highest policy-making body for SME development. The NSDC plays a pivotal role in driving policy, monitoring the implementation of development programmes and improving the quality

of and access to information to inform both policy and business decisions. An important focus of the NSDC has also been on promoting greater access to financing and advancing initiatives to build and strengthen the capacity of SMEs to grow and succeed.

The NSDC drove a number of key initiatives such as the establishment of a national SME data baseline through the Census for Establishments in 2003 and the adoption of a standardised definition which provided a clear focus for development programmes. The SME definition was recently revised to reflect changes in economic structure, business trends and inflation-adjusted indicators of size. This will ensure that policies and programmes are directed at the targeted segments. In line with the nation's economic transformation agenda, the NSDC continues to focus on creating an enabling environment for the SMEs to prosper as well as nurturing and developing their capacity to be commercially viable and competitive in the global market.

Diagram 2

Evolution of SME Financing Ecosystem



Source: Bank Negara Malaysia

The Bank was the Secretariat for the NSDC until 2008, when the role was assumed by the Small and Medium Industries Development Corporation (SMIDEC), which was later transformed in 2009 as SME Corporation Malaysia (SME Corp). SME Corp acts as the central coordinating agency for SME policies and programmes across relevant Ministries and agencies. It also serves as the point of reference for information and advisory services.

An important element in this holistic development framework is an inclusive financing ecosystem. This includes establishing effective institutional arrangements for financing and development through the establishment of specific schemes and providing avenues for information, advice and redress as well as debt resolution and management, and outreach programmes.

### **Building the Foundations of an SME Financing Ecosystem**

The initial stages of building a financing ecosystem involved developing key infrastructure and institutional arrangements that expanded access to financing while promoting a sound credit culture. Initiatives by the Bank included the SME Client Charter guidelines which lifted the standards of efficiency and effectiveness in providing financial services to the enterprises. These standards have been raised further under the ABMPARTNER initiatives in recent years which have streamlined application processes and turnaround times across the financial industry. The Central Credit Reference Information System (CCRIS) has also played a critical part in improving the ability of banking institutions to undertake credit assessments and monitor the performance of borrowers. This is complemented by the Credit Bureau Malaysia which enabled the development of credit history which would in turn, enhance the prospects for SMEs to obtain financing.

In 2006, *Skim Pembiayaan Mikro* was introduced under the National Sustainable Microfinance Framework. This scheme enables fast, easy and convenient access to business financing without collateral from participating financial institutions (PFIs), thereby overcoming problems arising from the lack of credit history and collateral which often prevented SMEs from qualifying and obtaining financing facilities. A common branding platform has enabled the scheme to achieve scale and enhance its outreach to micro enterprises across the country. Under this scheme, PFIs manage their credit risk exposures by placing greater emphasis on assessments of business viability and cash flow patterns of borrowers. In addition, amount of financing extended will be increased over time as borrowers build good repayment track records. PFIs are also given access to funding at a lower cost from the Bank's Micro Enterprise Fund. The sustainability of the scheme is further supported by guarantees from CGC covering groups of borrowers with similar risk profiles and the ability of PFIs to set financing rates that reflect the risks assumed. Experienced PFIs also have developed customised products meeting the needs of small borrowers. For example, certain financing products are packaged with training in financial management and advisory services that are provided by the PFIs or in collaboration with other agencies such as SME Corp. Such value-added services will help micro enterprises better manage their businesses and in turn contribute to the sustainability of the scheme.

The *Skim Pembiayaan Mikro* complements other Government-sponsored microfinance programmes such as Amanah Ikhtiar Malaysia (AIM) and Yayasan Tabung Ekonomi Kumpulan Usaha Niaga Nasional (TEKUN). Since its inception, a total of RM2.4 billion of financing was approved under the scheme, which is supported by over 2,400 access points nationwide. As at end-2013, the total number of accounts under the scheme stood at 68,000 with total financing outstanding of RM857 million.

Guarantee schemes also played an important role that enable viable SMEs but without adequate collateral or track records to obtain financing. In this respect, the CGC was established in 1972 to pioneer the provision of guarantee schemes and has since developed a wide range of products and services to meet the needs of SMEs through widely distributed branches nationwide. To date, CGC has assisted more than 417,100 SMEs to obtain financing worth RM50.3 billion. More recently, the adoption of risk-based pricing model and the offering of portfolio guarantees have enabled CGC to further expand its reach to a larger number of viable SMEs. The corporation has also rewarded

borrowers with excellent repayment track records with rebates as an added incentive. CGC has maintained a healthy financial position in performing its mandate, enabling it to repay RM2.2 billion in loans that were provided by the Bank, including a RM300 million loan of which RM150 million was repaid and the balance was converted into equity. This also demonstrates that, with the appropriate structure and proper governance processes established, policy initiatives with a social mandate could be implemented in a financially sustainable manner.

---

### With the establishment of appropriate structure and proper governance processes, policy initiatives with a social mandate could be implemented in a financially sustainable manner

---

Development financial institutions (DFIs) play an important role in supporting priority sectors. Such institutions include the Small Medium Enterprise Development Bank Malaysia Berhad (SME Bank) which serves SMEs across all sectors, Bank Simpanan Nasional which focuses on the provision of microfinancing to micro enterprises, and Bank Pertanian Malaysia Berhad (Agrobank) which serves entrepreneurs in the agricultural sector. Since the responsibility for regulation and supervision of these institutions was vested in the Bank under the Development Financial Institutions Act 2002, broad measures were taken to significantly strengthen the institutional capacity and capability of these institutions to better serve their respective mandates in a sustainable manner. A customised prudential framework was implemented to promote sound corporate governance, risk management and financial prudence. As at end-2013, the total financing outstanding by DFIs amounted to RM13.3 billion, extended to 101,865 financing accounts. The DFIs' financial position has also improved substantially. Between 2005 and 2013, the gross impaired financing ratio had improved from 10.4% to 5.6% and the capital position remained strong at 20.9% as at end-2013 (end-2008: 22.4%).

The Bank has also set up special funds to ensure the availability of funds at reasonable costs. These include the Fund for Food (3F), Bumiputera Entrepreneur Project Fund-i (BEPF-i), Fund for Small and Medium Industries 2 (FSMI2), New Entrepreneurs Fund 2 (NEF2) and the Micro Enterprise Fund (MEF) which provide financing support for SMEs in specific sectors including new growth areas. With an initial allocation of RM11.4 billion, more than 58,000 SMEs have received financing from these funds. On a revolving basis, the total financing extended to date totalled RM24 billion as repayments of financing were used to finance new loans. In 2009, the Bank introduced BEPF-i managed by CGC to provide contract or project financing for Bumiputera entrepreneurs with an initial allocation of RM300 million. As at end-2013, a total of RM418 million financing was approved, benefitting more than 700 Bumiputera entrepreneurs. The asset quality remained stable attributed to the strengthened credit assessment process using cash flow analysis coupled with intensified recovery process undertaken.

Measures were also instituted to assist SMEs in managing challenges arising from economic and financial crises and natural disasters. During the Global Financial Crisis of 2008-2009, more than 10,500 SMEs received assistance through various channels including the Working Capital Guarantee Scheme (WCGS), the Industry Restructuring Loan Guarantee Scheme, and the SME Assistance and SME Modernisation Facilities. To enhance the safety net and emergency relief facilities due to natural catastrophes, a RM10 million SME Emergency Fund was established by SME Corp. Financial institutions have also stepped forward to provide other forms of financial relief, including temporary moratoriums for financing repayments, as demonstrated during the floods of December 2013. Similar support was provided under the Special Relief Guarantee Facility to 4,640 affected SMEs during earlier floods in 2007.

### The Expanding Frontier for SME Financing

Building on the strong foundation laid by earlier measures to ensure access to financing, the policy focus has shifted towards facilitating financing for new growth areas and enhancing capacity and growth potential through advisory services and financial education.

The Bank, together with the financial sector, Government agencies and other stakeholders collaborated to spur investments and financing for new growth areas such as green financing and other innovative and strategic sectors. The Bank facilitated various avenues to bring businesses and financiers together to create a better understanding on the dynamics of financing required in these new areas. This included the Green Technology Financing Forum and seminars that were held in collaboration with the Institute of Bankers Malaysia (Institut Bank-Bank Malaysia, IBBM) to promote dialogue and increase awareness of transformative solutions for green technology financing. Support for financing facilities in new growth areas currently include GTFS established in 2010 with a fund of RM3.5 billion to facilitate financing in the energy, building, water and waste management, and transportation sectors. In addition, a RM200 million Creative Industry Fund was launched to spur commercial activity in the creative industry and a RM2 billion SME Financing Scheme-Islamic was established to cater for the various innovative sectors.

With increasing complexity in the financing ecosystem, the availability of avenues for SMEs to obtain information and redress has become more important. These avenues are widely available through the financial institutions, the Association of Banks in Malaysia (ABM) and SME Corp. This is further complemented by the Financial Mediation Bureau (FMB) as an additional avenue for borrowers to resolve disputes with financial institutions, and the Credit Counselling and Debt Management Agency (AKPK) which provides counselling and debt management services to individuals and sole proprietors. The Small Debt Resolution Scheme (SDRS) was established by the Bank in 2003 as a platform to assist SMEs in resolving debt and to avert defaults. Since its establishment, the scheme has helped 875 SMEs and restructured more than RM925 million of impaired loans.

**Diagram 3**

#### Key SME Financing Indicators

	2003 <sup>1</sup>	2006 <sup>2</sup>	2013 <sup>2</sup>
SME financing outstanding in RM mil (No. of accounts)	81,995 (406,086)	117,631 (615,634)	212,900 (676,144)
<i>Pembiayaan Mikro</i> outstanding in RM mil (No. of accounts)	-	84 (10,181)	857 (68,360)
Financing to green technology sector under GTFS in RM mil (No. of accounts)	-	-	1,580 (120)
% to total business financing	38.4	44.5	42.1
Average size of SME financing (RM)	202,000	191,000	315,000
Impaired loan ratio (%)	14.5	10.4	3.8

<sup>1</sup> Refers to banking institutions only

<sup>2</sup> Refers to banking institutions and DFIs

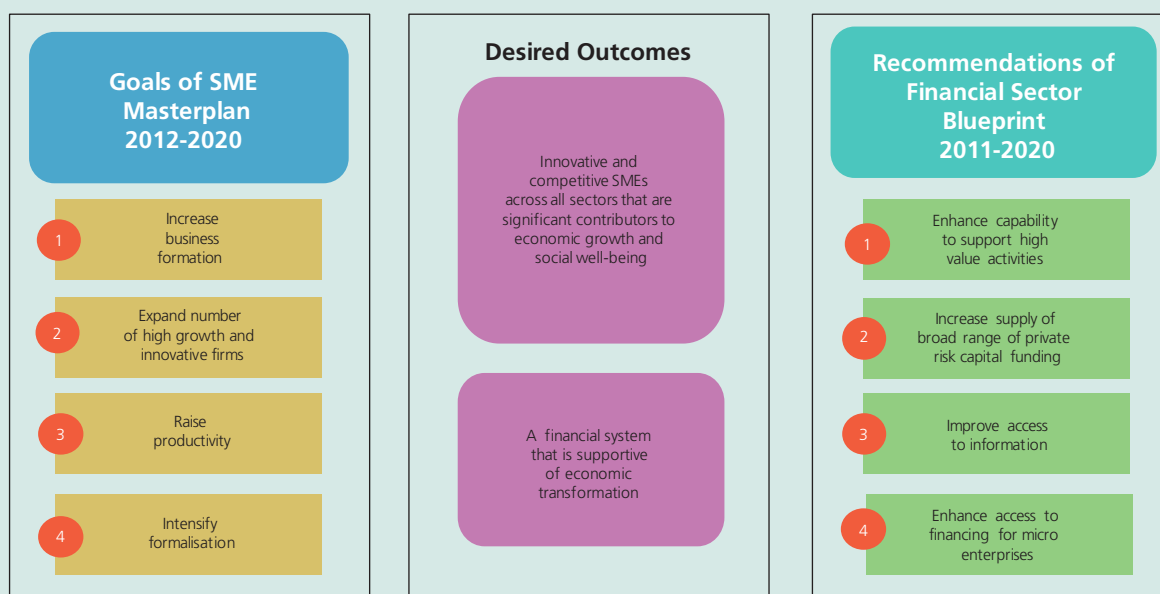
Source: Bank Negara Malaysia

Outreach programmes have been intensified to continuously educate SMEs especially micro enterprises on the availability of financing sources, assistance, and qualifying requirements. Chambers of businesses and associations have continued to run SME Financing Help Desks nationwide following training programmes initiated by the Bank for staff and members of the associations since 2011. The Bank also continues to disseminate educational materials and actively participate in outreach events organised by Ministries and agencies in collaboration with associations and other strategic partners.

The comprehensive and collaborative approach in developing the financing ecosystem has delivered significant outcomes. Total financing has doubled over the last decade, while the quality of financing has improved markedly from an impaired loans ratio of 14.5% in 2003 to 3.8% in 2013. Responsible financing practices by the financial institutions, and clients that are more informed and responsible in obtaining and utilising financing facilities, have also contributed to improved risk profiles of borrowers. These developments have seen Malaysia ranked 1st for six consecutive years by the World Bank in its 'Doing Business' reports since 2009 for 'Getting Credit'. Malaysia is also ranked 5th by the World Economic Forum for 'Ease of Access to Loans'.

Diagram 4

### Holistic SME Development Framework



Source: Bank Negara Malaysia and SME Corporation Malaysia

Moving forward, continuous support for the development of the sector remains imperative for Malaysia's economic transformation. The SME Masterplan 2012-2020 (SMEMP) emphasises its importance as a strategic sector for achieving a high-income and high value-added economy while maintaining balanced and inclusive growth. With action plans directed at the focus areas of technology and innovation, marketing, human capital and entrepreneurship, infrastructure, the legal and regulatory environment, and access to financing, the sectors' contribution to GDP is projected to increase to 41% in 2020. This is complemented by recommendations under the Financial Sector Blueprint 2011-2020 (the Blueprint) which aims to further develop and expand the financing ecosystem. With the successful implementation of the SMEMP and the Blueprint, the SMEs will continue to be a key driver of sustainable growth of the Malaysian economy.

The Bank is also improving the quality and coverage of information captured on green technology financing activities and their performance, beginning with the reporting of key indicators on green technology financing trends and performance by financial institutions. The submission of this information will be on an annual basis beginning 2014 onwards. Information gathered from these submissions will be used as input to develop and refine policy strategies and shared with the industry where relevant to support financing activities. The Bank will also continue to engage closely with the Government and other key stakeholders to facilitate a holistic approach to the development of the green technology industry in order to realise its full potential as a future growth industry in Malaysia.

## STRENGTHENING THE INSURANCE AND TAKAFUL INDUSTRY

The insurance and takaful industry has evolved over the years to become a significant contributor of economic growth. The industry registered positive net premium and contribution growth at an average of 8.9% annually from 2003 to 2013. Total combined assets of the insurance and takaful industry correspondingly grew by 7.3% to reach RM230.2 billion. Net premiums and contributions collected by the insurance and takaful industry in 2013 accounted for 4.9% of gross domestic product (GDP). For the life insurance and family takaful industry, the total number of policies in force as a percentage of total population has increased from 40.9% in 2003 to 53.1% in 2013. The industry is now more competitive with stronger institutional arrangements, including a wider range of intermediaries and distribution channels that deliver an array of products to consumers. Advances in the regulatory and supervisory framework have ensured that the growth in the insurance and takaful sector is also well-supported by adequate financial resources and sound risk management practices.

Building on these developments, the Bank published the concept paper on the Life Insurance and Family Takaful Framework (the Framework) in November 2013 to pave the way for market forces to work more effectively in further encouraging greater operational efficiency and innovation in the industry. This, in turn, will contribute to higher insurance and takaful penetration. The Framework outlines proposals to increase operational flexibility

accorded to insurers and takaful operators while improving consumer benefits, further diversify delivery channels, strengthen disclosures to consumers and drive higher professional standards among intermediaries. Further information on the Framework is provided in the box article 'Reforms in the Life Insurance and Family Takaful Industry'.

---

## The Life Insurance and Family Takaful Framework to pave the way for market forces to work more effectively in further encouraging greater operational efficiency and innovation in the industry

---

In the general insurance and takaful sector, the Bank remains focused on achieving the two-pronged objectives set out under the New Motor Cover Framework introduced in 2011, which are to improve efficiency in the motor claims settlement process and to ensure continued access to motor insurance and takaful protection on a viable basis. During the year, further initiatives were advanced to this end, including:

- **The implementation of the second out of four rounds of motor premium adjustments which took effect from February 2013.** The adjustments are part of the transition towards a market-based pricing mechanism for motor insurance and takaful risks by 2016. The third party policy annual premium adjustments for the majority of motorcycles and private cars ranged between RM2 to RM34, similar to the level of adjustments implemented in 2012;
- **The establishment of an Accident Assist Call Centre (Accident Assist) which commenced operations on 3 June 2013.** Accident Assist provides a public service to those involved in road accidents by facilitating early claims notifications to insurers and takaful operators, and connecting vehicle owners to approved motor repair workshops. Members of the public are provided with 24-hour access to Accident Assist via its hotline number 1300-22-1188 for the following services which are provided nationwide:
  - Assistance in obtaining roadside emergency services such as arranging for towing services to approved workshops;

## Reforms in the Life Insurance and Family Takaful Industry

In November 2013, the Bank published proposals to implement a package of reforms in the life insurance and family takaful industry aimed at raising the efficiency and effectiveness of delivery channels and promoting greater product innovation. The proposals, which were outlined in a concept paper on the Life Insurance and Family Takaful Framework (the Framework), are expected to improve consumer experience and drive higher productivity in the insurance sector, in turn contributing to a higher level of penetration of life insurance and family takaful products in Malaysia (refer to Table 1). The proposals support three key thrusts as follows:

**Table 1**

### Summary of Proposals Under the Life Insurance and Family Takaful Framework

Accord greater operational flexibility	Improve effectiveness of delivery channels	Empower consumers and elevate intermediaries' professionalism
<ul style="list-style-type: none"> <li>• Remove operating cost limits applicable to investment-linked products in the form of commission and agency related expenses               <ul style="list-style-type: none"> <li>↳ To preserve policyholders' value, a certain percentage of the premium/contribution payable must be allocated to the policyholder's/participant's unit fund before any deduction of charges</li> </ul> </li> <li>• Remove commission limits for pure protection products (pure term, medical and health and critical illness) subject to insurers and takaful operators offering those products via direct distribution channels</li> </ul>	<ul style="list-style-type: none"> <li>• Align commission limits for bancassurance and corporate agents</li> <li>• Incentivise growth of financial advisers (FA) by:               <ol style="list-style-type: none"> <li>i. Lowering the paid-up capital requirement from RM100,000 to RM50,000</li> <li>ii. Expanding the list of recognised qualifications</li> <li>iii. Ensuring broad access for FAs to a wide range of products that can be recommended to suit consumer needs and preferences</li> </ol> </li> </ul>	<ul style="list-style-type: none"> <li>• Implement balanced scorecard for the remuneration of intermediaries</li> <li>• Enhance disclosure standards to aid decision-making by consumers</li> <li>• Introduce product aggregator to facilitate product comparison</li> <li>• Introduce online insurance/takaful account to provide information on policy status</li> <li>• Remove limits on agency financing scheme</li> </ul>

#### (i) Accord greater operational flexibility

The removal of prescribed operating limits on agency remuneration and management expenses aims to encourage investments by life insurers and family takaful operators in the development of new and innovative product offerings. This is expected to be achieved as insurers and family takaful operators gain more flexibility in managing their operating expenses. To facilitate an orderly transition towards a more liberalised environment, these flexibilities will be implemented in stages with appropriate safeguards for consumer protection. Operating limits will initially be removed for investment-linked and pure protection products. To ensure that policy premiums/contributions are preserved to create value for policyholders and are not eroded by excessive agency and management expenses, a minimum proportion of premiums/contributions (before charges) will be required to be allocated to policyholders' funds that are set aside for investments. These flexibilities will be progressively extended to a wider range of products, subject to effective competition and an adequate focus demonstrated by insurers and family takaful operators on promoting the interests of policyholders.

#### (ii) Improve effectiveness of delivery channels

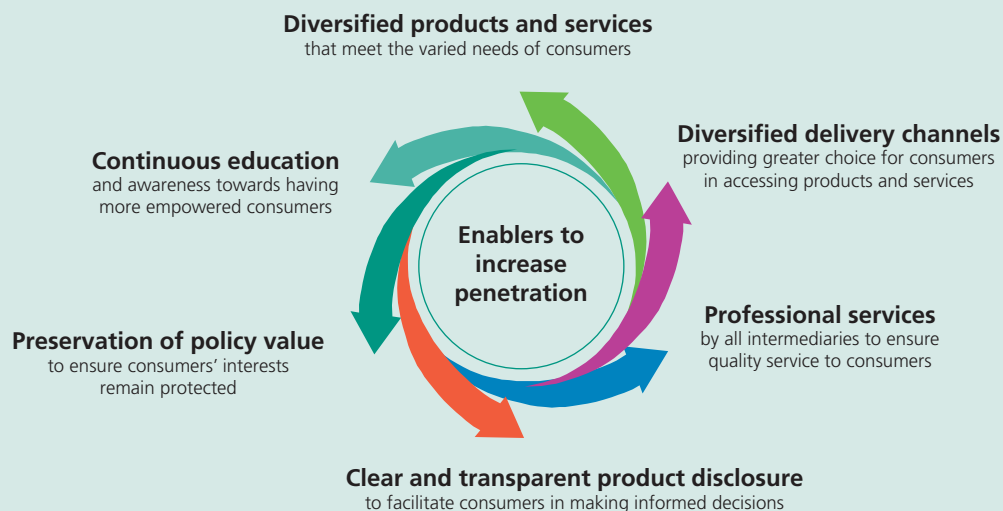
The use of bancassurance will be further promoted through a review of the commission structure, and the financial advisory channel will be further developed to complement the agency force in serving consumers in the more complex life insurance and family takaful product segments. These measures would promote a diversity of delivery channels for consumers to access products through the channel that is most convenient, cost-efficient and appropriate for their needs, thus ensuring that different segments of the society are well served.

**(iii) Empower consumers and elevate intermediaries' professionalism**

To elevate the quality of advice and service provided by intermediaries to policyholders, insurers and takaful operators will be accorded more flexibility to reward intermediaries through a differentiated remuneration system based on productivity, professionalism, quality of service and qualifications attained. This is expected to lift the professional standards of intermediaries by providing strong incentives to upgrade their skills and enhance the value added to consumers. The up-skilling of intermediaries will also enhance opportunities for business expansion. In addition to improving the quality of advice, support for consumers to make informed decisions will be strengthened through higher standards of disclosure, the establishment of an online product aggregator and introduction of online accounts to provide relevant and timely information to consumers in a form that promotes comparability between products and service providers. These measures will be supported by continuous financial education and awareness initiatives to strengthen consumers' financial capability.

**Future landscape**

The Framework is envisioned to raise operational standards across the industry, meeting the needs across all consumer segments through innovative products and services, diversity of delivery channels and proper product disclosure that is supported by quality advice. This will be underpinned by ongoing initiatives in empowering consumers to be able to discern their own life insurance and family takaful needs (refer to Diagram 1).

**Diagram 1****Desired Attributes of the Life Insurance and Family Takaful Industry Under the Future Landscape****Consultation on the Framework**

During the two-month consultation period which ended on 9 January 2014, the Bank had received 254 submissions in response to the request for feedback. The Bank is reviewing all comments and will further engage key stakeholders prior to finalising the Framework.

- Information on making a motor insurance or takaful claim; and
- Information on the nearest hospital, police station, fire station and approved workshop from the location of the road accident;
- **The development and dissemination of a Motor Claims Guide (the Guide) containing key information on making a motor insurance or takaful claim.** The Guide, which is currently available electronically on the websites of the Bank, the General Insurance Association of Malaysia (Persatuan Insurans Am Malaysia) and the Malaysian Takaful Association, aims to help vehicle owners and road accident victims navigate the motor claims process with greater confidence and protect them from fraudulent and intimidating practices by unscrupulous parties after an accident. The Guide will also be made available at major public touch points across the country in 2014, including Government hospitals and police stations.

To date, eight out of 11 identified initiatives under the New Motor Cover Framework have been implemented. Collectively, these initiatives have contributed to improvements in the claims settlement process and practices, as observed in the shorter average time taken to settle a third party bodily injury claim in 2013, which reduced by up to three months compared to the time taken in 2011.

As part of the move towards more market-oriented pricing and incentive systems in the general insurance and takaful sector, measures are also being pursued to further improve underwriting efficiency and address escalating costs, in particular containing costs associated with frauds and abuses. These include arrangements to support more effective sharing of information among industry players in monitoring and preventing fraudulent activities. This will serve to curb the escalation of claims costs resulting from unscrupulous practices which are incurred by the industry and ultimately passed on to consumers through higher premiums. Such cost containment measures are important to ensure that insurance premiums and takaful contributions remain affordable in the long run under a market-based pricing environment.

## PROMOTING AN INCLUSIVE FINANCIAL SYSTEM

Ensuring that all segments of the population have the opportunity to participate in the formal

financial system continues to be an important agenda of the Bank. During the year, the Bank continued to promote wider access to financial services through various delivery channels and supported more effective use of financial services through an expanded range of products and services tailored to the needs of the underserved. As a result, the number of deposit accounts per 10,000 adults continued to increase to 32,846 (2012: 30,735) as at end-2013.

Initiatives aimed at widening the outreach of financial services made significant inroads during the year. The Agent Banking Framework, after just over a year of implementation, made a significant impact in bringing financial services to Malaysians all over the country. All districts (*daerah*) and Parliamentary constituencies now have access to basic banking services. The total sub-districts (*mukim*) served has increased to 92.5% (2011: 46.4%), well ahead of the target level of 90% by the end of 2014. Similarly, the total State Legislative Assembly (*Dewan Undangan Negeri*) districts served has increased to 99.8% (2011: 72.9%) and is expected to reach 100% by March 2014. Agent banks have been very well received, with clear benefits for all the parties involved. The lower set-up costs provide substantial savings to financial institutions, agents have benefited from an increased flow of customers to their business premises, and consumers in smaller districts have welcomed the ability to conduct banking services in less formal and more familiar surroundings. The expansion of agent banking channels continues to be carried out within a regulatory framework that promotes the professional conduct of agents and safeguards the security and integrity of agent banking transactions. In 2014, a review of the Guidelines on Agent Banking will be undertaken by the Bank to expand the scope of services provided by the agent banks to better meet the needs of the underserved.

---

### All districts and Parliamentary constituencies now have access to basic banking services

---

The implementation of MyMobile, the mobile banking and payments platform has also had an important impact on enhancing access to financial services. The MyMobile

platform is operated by Malaysian Electronic Clearing Corporation Sdn. Bhd. (MyClear) with participation by three banks and three mobile network operators. MyMobile leverages on mobile phone network coverage to enable customers with mobile phones to access services such as balance enquiries, fund transfers, bill payments and mobile prepaid reloads without needing an Internet connection or the use of smartphones. In the nine months since its launch in March 2013, MyMobile attracted over 130,000 subscribers and enabled transactions valued at RM16.2 million. Several measures are currently being undertaken by MyClear to further simplify the usage of MyMobile in order to promote wider adoption.

Reflecting the high priority placed on advancing the domestic financial inclusion agenda and the Bank's active role in supporting financial inclusion initiatives at the international level, the Bank co-hosted the 5th Global Policy Forum (GPF) with the Alliance for Financial Inclusion (AFI) in September 2013. The AFI is a global network of 108 financial policymakers from developing and emerging economies working together to increase access to financial services for the 2.5 billion people who do not have access to the formal financial system. With the theme 'Driving Policies for Optimal Impact', GPF was attended by more than 400 participants from 80 countries. The three-day event explored optimal financial inclusion policy strategies that achieve financial inclusion, financial stability and consumer protection objectives. Important themes that emerged from these discussions were the role of proportionate financial regulation in increasing financial inclusion, the importance of according equal attention to the quality aspects of financial inclusion and the need for more comprehensive data to support quantifiable and measurable national goals. The GPF concluded with the launch of the Sasana Accord by the AFI network, which aims to reinforce and strengthen the commitments of AFI members under the Maya Declaration towards increasing financial inclusion. Specifically, members committed to the following under the Sasana Accord:

- Further strengthen the AFI network's commitment to the Maya Declaration through the adoption of quantifiable and measurable financial inclusion targets;
- Ensure that financial inclusion policy making and strategies lead to results that are supported by credible evidence and data,

and undertake robust measurement of the impact of financial inclusion programmes; and

- Focus on building institutional capacity and talent among the AFI network members for the formulation and implementation of financial inclusion policies that will deliver the optimal impact for financially unserved communities.

## DEVELOPING DEEP AND VIBRANT FINANCIAL MARKETS

The debt securities market continued to develop as an efficient platform for fundraising and investment. The total outstanding debt securities in the market amounted to RM1,058.9 billion, a growth of 2.9% from 2012. The Malaysian debt securities market remained the largest in Southeast Asia, at 107.6% of GDP. Issuances during the year declined to RM504.4 billion (2012: RM639.5 billion), reflecting the challenging global economic conditions which restrained corporate fundraising activities. The Malaysian debt securities market nonetheless remained conducive for the issuance of debt with a wide range of maturity profiles. A significant development in the Government debt securities market during the year was the inaugural issuance of 30-year Malaysian Government Securities (MGS) worth RM2.5 billion in September 2013. The issuance, with a yield of 4.9%, received strong support from both local and foreign investors as a long-term investment option, which is evident from the high bid-cover ratio of 2.4. The issuance is also expected to serve as a catalyst for the issuance of longer-term securities, thus lengthening the maturity profile of issuances in the domestic market. On the demand side, the profile of investors in the debt securities market also continued to expand to include a more diverse mix of retail, corporate and institutional investors, with an increasing participation of international investors.

---

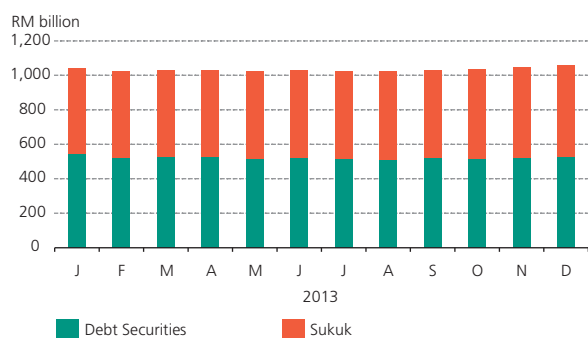
### The inaugural issuance of 30-year Malaysian Government Securities is expected to serve as a catalyst for the issuance of longer-term securities in the domestic market

---

While the domestic financial markets have grown significantly in breadth and depth over the past decade, the further development of the financial

Chart 2.2

### Outstanding Debt Securities and Sukuk (Public and Private)



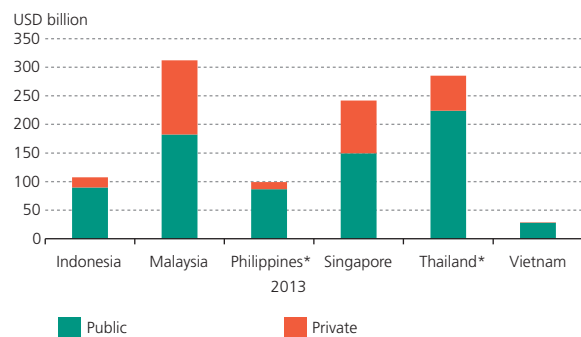
Source: Bank Negara Malaysia

markets moving forward will focus on meeting the needs of a more developed and internationally integrated Malaysian economy. This entails having in place a wide range of liquidity management and hedging tools, flexible foreign exchange administration rules, a highly efficient payment and settlement infrastructure that enables seamless transfers and clearing of securities and funds, and an enhanced regulatory and supervisory framework.

In the money market, the submission of the Kuala Lumpur Interbank Offered Rate (KLIBOR) continues to be monitored closely by the Bank. Arising from the governance framework on the KLIBOR submission process issued by the Bank in 2013, all the KLIBOR contributors have now put in place the required governance framework

Chart 2.3

### ASEAN Outstanding Local Currency Debt Securities Market



\* As at end-September 2013  
Source: Asian Bonds Online

to support more robust submissions. These have collectively further elevated the credibility and integrity of the domestic money market and specifically, the use of KLIBOR as a reference rate.

As part of efforts to support trade and investment activities, the use of renminbi as an additional currency of settlement continued to be enhanced. The range of available money market instruments and foreign exchange flexibilities was expanded to encourage the increased utilisation of renminbi by businesses and corporations. This included the introduction of the Renminbi Liquidity Facility (RLF), which stemmed from the Currency Swap Arrangement between the Bank and the People's Bank of China, to facilitate more effective renminbi liquidity management by financial institutions in Malaysia through an additional avenue to borrow or lend renminbi from/to the Bank. Instruments introduced under the RLF include renminbi money market instruments, renminbi/ringggit foreign exchange spot, forward and swap instruments and renminbi repurchase facilities provided against a range of eligible collateral issued by the Government, the Bank and member governments of Executives' Meeting of East Asia and Pacific Central Banks (EMEAP).

### Wider range of money market instruments were introduced to support the use of renminbi as an additional currency of settlement

In the domestic foreign exchange market, the total turnover of foreign exchange transactions during the year recorded a slight decline of 2.6% to USD2.6 trillion (2012: USD2.7 trillion), largely reflecting the more cautious sentiment of non-residents due to uncertainties surrounding the scale back of the US Federal Reserve's asset purchase programme. Despite the demanding external conditions, the average daily turnover in the foreign exchange market remained relatively stable at USD10.4 billion (2012: USD10.8 billion), accounting for 3.4% of GDP. This provided continued support for cross-border investment, trade and business activities. This is further evidenced by Malaysia's strong position in the 2013 Triennial Central Bank Survey published by the Bank for International Settlements in December 2013, where Malaysia ranked the

third fastest growing foreign exchange market among 53 jurisdictions globally over the period of 2007-2013, recording a three-fold increase, or an expansion of 21.3% annually.

As part of ongoing efforts to deepen the domestic foreign exchange market, further liberalisation of the foreign exchange administration rules was undertaken during the year. Flexibilities for hedging were expanded to allow for more efficient management of foreign exchange risks and support innovative financial product offerings by domestic financial institutions to facilitate trade and investment activities. The expanded flexibilities included further room for residents and non-residents to undertake anticipatory hedging transactions involving ringgit with licensed onshore banks. Reflecting the increased hedging opportunities available, the total foreign exchange derivatives volume has expanded by over 2.5 times during the period of 2007-2013, or 16.6% annually and now comprises a wide range of instruments in a variety of currency pairs. These include foreign exchange and cross-currency swaps, which form 82% of the total domestic foreign exchange derivatives volume in 2013, foreign exchange forwards at 16% and options at 2%. In terms of gross notional exposure, the interest rate derivatives market continues to form the largest portion of the domestic derivatives market and has continued to serve the needs of financial institutions, businesses and institutional investors to manage interest rate risks, with a total gross notional outstanding of RM621.1 billion as at end-2013, representing growth of 3.5% from 2012.

Further flexibilities were also granted for investments in foreign currency assets and the offering of foreign currency securities in Malaysia to spur greater product innovation. Residents and non-residents are now allowed to invest in foreign currency assets offered onshore as well as to issue foreign currency securities in Malaysia. These flexibilities aim to increase liquidity in the domestic foreign exchange market through the accumulation of foreign currency funds and encourage the further diversification of asset classes in Malaysia, in addition to widening the spectrum of investors and issuers in the domestic market. Reflecting the increased flexibility, liquidity in non-ringgit currency pairs, as measured by the daily turnover of third currency pairs increased by 30% to USD2.4 billion in 2013 (2012: USD1.8 billion). Flexibility was also accorded to qualified non-resident financial

institutions that meet prudential requirements set by the Bank to offer ringgit trade financing facilities in collaboration with a licensed onshore bank. The flexibility aims to reduce the costs of doing business by facilitating trade settlements in local currencies, thereby reducing foreign exchange exposures. This measure has also enhanced potential business opportunities for licensed onshore banks through collaborations with non-resident financial institutions. As at end-2013, two branches of a Malaysian bank in the People's Republic of China (PR China) were granted flexibility to offer ringgit trade financing to facilitate trade settlements with Malaysia.

Foreign participation in the domestic debt securities market continued to be facilitated through an efficient payment and settlement infrastructure. In November 2013, services offered by Euroclear were further enhanced to enable same day income payment services for MGS and Malaysian private debt securities. Consistent with the service standards of many international financial centres, all International Central Securities Depositories participating in domestic markets will now be able to provide same value day settlement for ringgit securities thus enabling foreign investors to receive their debt securities proceeds within the same day. The participation of Malaysia in the Pan-Asian Central Securities Depository Alliance Initiative Platform has also increased investment in the Malaysian debt securities market. Since the launch of the platform in March 2012, total foreign investments in ringgit-denominated debt securities in the Malaysian financial markets has increased by 71.6%.

Recognising the importance of the enforceability of netting arrangements for investor confidence and the efficient functioning of the financial markets, the Government has proposed for the development of a netting legislation as part of measures announced in the 2014 Budget. In addition to measures in the near term to amend existing laws that may impede netting, the proposed netting legislation will secure a more permanent netting-friendly status for Malaysia by protecting netting rights under financial market contracts from any unintended impact of future legislation.

New regulations in the US prohibiting proprietary trading activities and investments in, or sponsoring of, hedge funds and private equities are likely to pose significant challenges to financial market

activities in major markets, which may have an impact on the liquidity in the bond and derivatives markets, particularly in relation to proprietary trading activities. Nonetheless, the implication on the domestic financial markets is expected to be minimal as trading of sovereign assets, such as MGS and Government Investment Issues (GII), by US banks in the host country is exempted under the rules, subject to certain conditions. This is further supported by a diversified market participant base, which would ensure continued liquidity in the domestic financial markets.

### ENHANCING MALAYSIA'S INTERLINKAGES WITH REGIONAL AND INTERNATIONAL ECONOMIES

Malaysia's interlinkages with regional and international economies have continued to deepen. As at end-2013, six domestic banking groups now have overseas operations in 22 countries worldwide, including in all ASEAN countries. Total overseas assets of the domestic banking groups increased by 15.4% to RM362.1 billion in 2013 (2012: RM313.8 billion), accounting for 20.5% of the total assets of these groups (2012: 19.2%).

Further progress on the regional financial integration efforts was achieved in 2013, with the high-level principles and elements of the ASEAN Banking Integration Framework (ABIF) now being at an advance stage of being finalised. A key element of ABIF is the establishment of a set of principles for identifying a core of qualifying ASEAN banks that will serve as regional standard bearers and spearhead the banking integration process within the ASEAN region. It is envisaged that these qualifying ASEAN banks will progressively be accorded greater market access and operational flexibility based on the assessment of mutual benefits to home and host countries. This, in turn, will enhance the central role of ASEAN banks in facilitating intra-regional trade and investments, and contribute significantly to regional growth. ABIF will be supported by strengthened infrastructure and regulatory arrangements to ensure that financial stability is preserved. As part of efforts to ensure its effective implementation, ASEAN countries have also worked on defining clear arrangements for monitoring the implementation of ABIF and ensuring that the activities of qualifying ASEAN

banks are subject to effective regulatory and supervisory oversight on an ongoing basis, both on a solo and consolidated basis.

With ASEAN approaching the 2015 target date for the formation of an integrated economic community, the Central Bank Governors of ASEAN released a summary report in 2013 to guide the implementation of financial integration initiatives by 2020. Entitled 'The Road to ASEAN Financial Integration - A Combined Study on Assessing the Financial Landscape', the summary report is a joint initiative of the ASEAN central banks and monetary authorities, the ASEAN Secretariat and the Asian Development Bank. The report provides a regulator's perspective on the current financial landscape in ASEAN and details the recommended approach to integration for ASEAN as envisaged by the Central Bank Governors of ASEAN. Importantly, the report provides clarity on ASEAN's key preconditions and envisaged milestones for the liberalisation of financial services, capital account, payment and settlement systems, and capital markets in the region.

Promoting effective collaboration and coordination between regional regulatory agencies in maintaining financial system stability has become more important as more financial institutions engage in regional and international cross-border activities. Regional central banks continued to collaborate closely during the year through the EMEAP Monetary and Financial Stability Committee in the surveillance of risks and deliberation of emerging issues that may affect regional monetary and financial stability. Under this forum, the Bank led an initiative to strengthen the regional crisis management and resolution arrangements - including arrangements to improve information flows, coordinate regional central bank responses and enhance existing policy toolkits where relevant - for dealing with potential crisis scenarios. These arrangements were endorsed at the 18th EMEAP Governors' Meeting, which was hosted by the Bank in Kuala Lumpur on 29 June 2013.

Reflecting the deepening financial and economic ties between the PR China and Malaysia, the Bank established a representative office in Beijing which was officially launched in November 2013. In conjunction with the establishment of the Beijing representative office, financial cooperation between the two countries was further strengthened with the signing of a Cross-Border

Collateral Arrangement (CBCA) between the Bank and the People's Bank of China. Under this CBCA, home currency collateral in the form of securities or cash may be used by financial institutions operating in Malaysia and the PR China to obtain local currency liquidity in the host country, thereby facilitating cross-border liquidity management by financial institutions both during normal times and in crises. The Bank has also signed CBCAs with the Monetary Authority of Singapore and Bank of Thailand in 2011 and 2012 respectively.

Collaboration with the Hong Kong Monetary Authority (HKMA) was further enhanced during the year through newly established arrangements between the Bank and HKMA in August 2013 to develop the offshore renminbi business and to strengthen cooperation in the area of Islamic finance. This included the establishment of a platform to review the opportunities and enabling conditions for developing offshore renminbi products and services. In the area of Islamic finance, a private sector-led joint forum was held to discuss the current developments in Islamic finance and measures to advance the development of Islamic capital market in Hong Kong SAR. The joint forum also agreed to leverage on the established mutual recognition framework for Islamic funds between Hong Kong SAR and Malaysia to encourage a wider range of Shariah-compliant fund offerings in Hong Kong SAR and Malaysia.

Broader collaboration and cooperation with strategic partners were also promoted during the year through various bilateral cooperation agreements to strengthen financial and economic linkages and enhance mutual cooperation. The Bank signed several new Memoranda of Understanding during the year with Autoriti Monetari Brunei Darussalam, the Central Bank of the United Arab Emirates and the Central Bank of Myanmar, and a bilateral swap arrangement with the Bank of Korea. The Memoranda of Understanding encapsulate arrangements for cooperation in the development of the financial sector including Islamic finance, cross-border banking supervision, as well as in the development of human capital and capacity building initiatives. The bilateral local currency swap arrangement between the Bank and the Bank of Korea will facilitate the exchange of local currencies between the two central banks of up to KRW5 trillion or RM15 billion to support bilateral trade by reducing transaction costs through the use of local currencies for trade settlements.

## MALAYSIA AS AN INTERNATIONAL ISLAMIC FINANCE MARKETPLACE

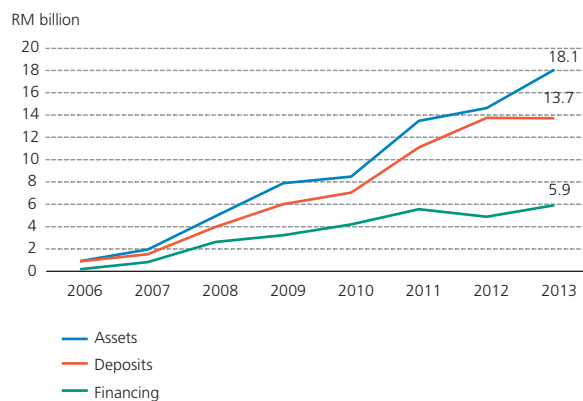
The Islamic finance industry continued its growth trajectory during the year supported by several key initiatives that have further advanced the internationalisation of Islamic finance. In 2013, the Islamic banking sector (including DFIs) recorded a growth of 16.5%, to account for 25.7% of total assets in the overall banking system. The volume of foreign currency business conducted by International Islamic Banks and International Currency Business Units also continued to grow, with total foreign currency assets amounting to RM18.1 billion in 2013 (2012: RM14.6 billion).

In the takaful sector, total assets of takaful funds grew by 10% to RM20.9 billion, while total takaful contributions accounted for 14% of total premiums and contributions in the insurance and takaful industry (including reinsurance and retakaful). To enhance the potential return to contributors, further flexibility was granted to takaful operators to invest abroad any amount of investment-linked funds of resident clients. This is an increase from the previous limit allowed of 50% of net asset value of funds belonging to their resident clients with domestic ringgit borrowing.

During the year, the Bank conferred the 'Emas' status, Malaysia's designation for foreign currency-denominated sukuk originating from

Chart 2.4

### Foreign Currency Assets, Financing and Deposits of International Islamic Banks and International Currency Business Units



Source: Bank Negara Malaysia

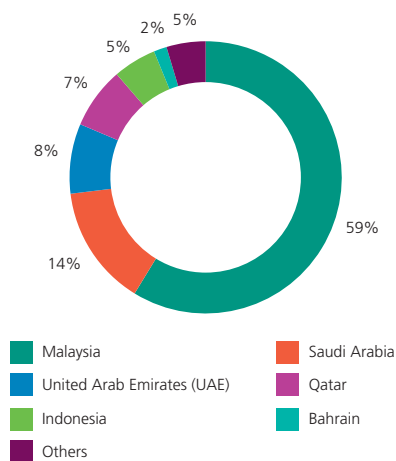
Malaysia, to two sukuk issuances by Islamic Development Bank and a corporation in Malaysia. Since its introduction in 2009, 11 sukuk issuances have been conferred the `Emas` status, reflecting Malaysia's evolution into a multi-currency platform for sukuk issuances. Malaysia remained the global leader in the sukuk market, with total sukuk issuance of approximately USD82.4 billion in 2013, accounting for 68.8% of global sukuk issuances, and total sukuk outstanding at USD158.2 billion as at end-2013.

As part of initiatives to expand the scope of Islamic financing activities, the Bank has continued to strengthen the end-to-end Shariah contract-based regulatory framework. The framework provides the necessary operating parameters that enable financial institutions to provide a wider range of risk-sharing products and services, while ensuring compliance with Shariah. The framework is underpinned by a comprehensive set of Shariah contract-based standards which address Shariah and operational requirements for different types of Shariah contracts. These standards provide greater clarity in respect of the application of Shariah contracts to the terms and conditions of Islamic financial products, in addition to strengthening the management of Islamic financial transactions. For details on the different risk and return profiles of various Shariah contracts, refer to the box article `Diversification of Islamic Banking Business and Products Driven by Shariah Contracts`.

During the year, global interlinkages in Islamic finance were further enhanced through several key initiatives. This included expanding the availability

Chart 2.5

#### Total Outstanding Sukuk Globally in 2013



Source: Islamic Finance Information Service, Zawya, Bloomberg, Kuwait Finance House Research

of financial instruments to support the efficient management of cross-border Islamic financial flows. To facilitate the efficient management of cross-border liquidity by Islamic financial institutions, in August 2013, the International Islamic Liquidity Management Corporation (IILM) issued its inaugural USD490 million short-term cross-border sukuk with an A-1 rating by Standard & Poor's Rating Services. The sukuk has a tenure of three months and is backed by sovereign assets. A network of seven multi-jurisdictional primary dealers from Asia (including two Malaysian banking institutions), the Middle East and Europe were appointed to trade the sukuk globally, thus promoting its liquidity. The Bank's Fully Automated System for Issuing/Tendering was utilised as the platform for issuance. The sukuk has been accorded regulatory recognition in Malaysia as a liquid asset for purposes of complying with the liquidity requirements, and a low risk credit under the capital adequacy framework applicable to banking institutions.

---

To facilitate the efficient management of cross-border liquidity by Islamic financial institutions, the International Islamic Liquidity Management Corporation issued its inaugural short-term cross-border sukuk

---

As part of efforts to widen the investor base for sovereign sukuk, the Government issued an inaugural GII of RM4 billion in July 2013 based on the *murabahah* concept to replace the *bai'inah* concept which was used in the earlier issuances. Under the *murabahah* concept, the contract is a certificate of indebtedness arising from a deferred mark-up sale transaction of an underlying asset based on Shariah principles. This concept should attract greater participation from domestic and international investors and increase the depth and vibrancy of Malaysia's sukuk market. The encouraging response from investors was evident in the oversubscription to the issuance by almost three times.

On 1 August 2013, the Prime Minister unveiled the Malaysia International Islamic Financial Centre's

## Diversification of Islamic Banking Business and Products Driven by Shariah Contracts

The Islamic Financial Services Act 2013 provides the legal foundation for a comprehensive regulatory framework for the Islamic finance industry in Malaysia. An important focus under this framework is the development of Shariah and operational standards for key Shariah contracts. The standards outline the underlying Shariah principles and provide guidance on sound practices and effective governance for each contract. These standards are intended to promote transparency and consistency of Shariah contract application to enhance certainty and strengthen Shariah compliance by Islamic financial institutions, as well as to serve as a key reference to catalyse greater mutual respect of Shariah opinions across jurisdictions. Ultimately, these standards are envisioned to promote the offering of a broad range of Islamic finance products that can cater to more diverse customer needs and preferences.

In the last few decades, the focus of Islamic banks has been the provision of financing services to individuals and corporations, mostly for the purchase of assets and working capital (this business will be described as ‘financing’ in this article). Nevertheless, there is now increasing attention on other forms of Shariah contracts, including equity-based or risk-sharing contracts such as *musharakah* (partnership), and exchange-based contracts such as *ijarah* (lease) (these contracts will be described as ‘primary’ in this article). These primary Shariah contracts can distinguish Islamic products from the products of conventional banks and underpin additional funding options that can be offered by Islamic banks. This article explores the implications of Shariah contracts with a range of risk-return profiles for Islamic banks and their customers, and how a diversity of Shariah contracts can enhance growth opportunities for Islamic banking business.

### Risk-Return Profiles of Various Shariah Contracts

The relationship between risk and return in Islamic finance is captured in the Islamic legal maxim of ‘*Al ghum bil ghum*’, which in essence refers to the concept of ‘no risk, no return’. This legal maxim requires a contracting party to undertake risk and bear responsibilities as a precondition for entitlement to profits. This requires both Islamic banks and customers to assume certain responsibilities which may include mutual risk-taking. Profits earned by Islamic banks and the pricing of banking services must correspondingly reflect the responsibilities and the level of risk borne by each party.

Guided by this principle, Islamic finance provides a diverse spectrum of Shariah contracts with different risk and return profiles under two models, namely the primary and financing models. The primary model is operationalised through a single Shariah contract where contracting parties share the same types of risks (under risk-sharing contracts), or where Islamic banks assume specific risks (under exchange-based contracts). Under the primary model, Islamic banks would be exposed to a wider range of risks such as business risk and risks associated with the holding and management of physical underlying assets, in addition to financial risks.

On the other hand, the financing model is applied through a combination of certain primary Shariah contracts with other ancillary contracts, such as *wa’d* (promise) and *wakalah* (agent). These ancillary contracts enable Islamic banks to mitigate specific risks and achieve the principal objectives of a particular transaction. As an example, where the objective is for an Islamic bank to provide financing to a customer by purchasing an asset on behalf of the customer, *wa’d* is used to effect the eventual transfer of the asset to the customer since the bank does not have the intention to own the asset purchased. Hence, consistent with the principal objective of providing financing under this model, the ultimate risk and return profiles are similar to that of conventional financing.

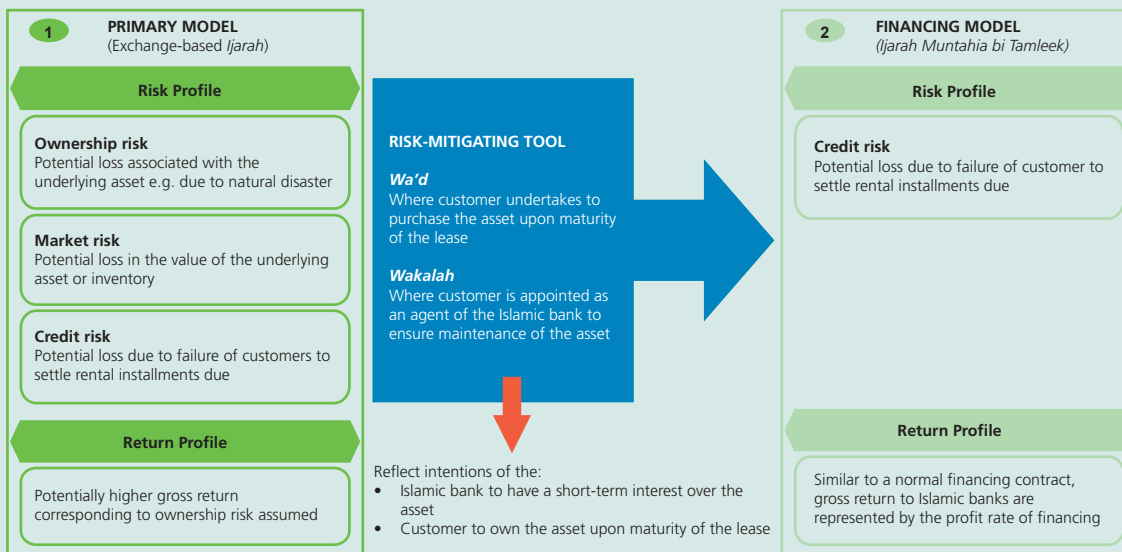
These models will give rise to different risk and return profiles corresponding to the degree of responsibilities and the level of risk borne by Islamic banks and customers. Diagram 1 provides an example of how risk and return profiles vary for different Shariah contracts under primary and financing models.

Diagram 1

### Samples of Different Risk-return Profiles of Two Shariah Contracts (*Ijarah* and *Musharakah*) under Primary and Financing Models (from a Bank's Perspective)

#### Contract application

*Ijarah* contract is a lease contract that transfers ownership of usufruct of asset in exchange for rental payment. The ownership of the asset remains with the Islamic bank as lessor throughout the lease period.

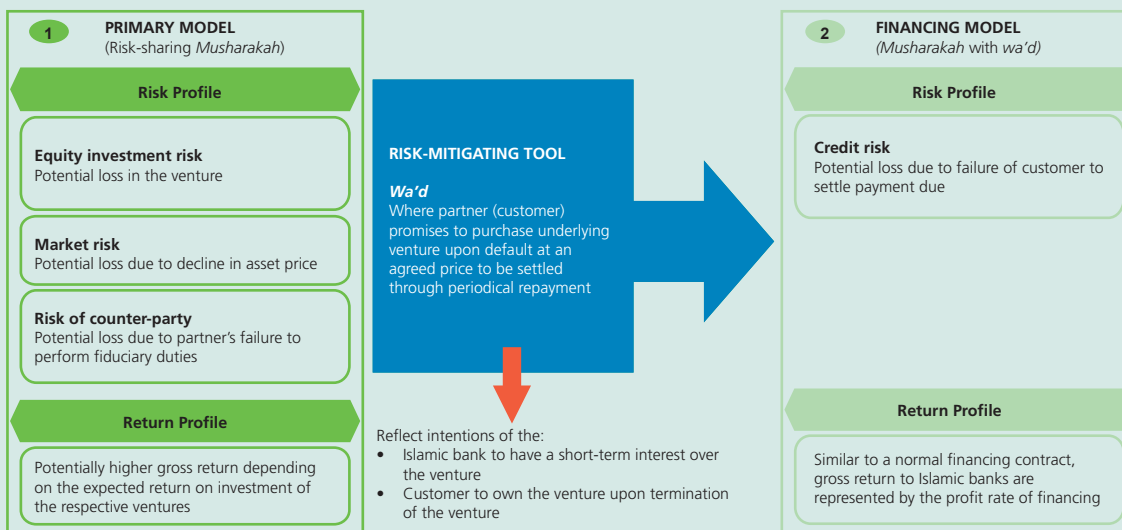


#### Alteration in risk profile

- Primary : Ownership risk entails Islamic banks to bear maintenance costs related to ownership of asset such as quit rent for house
- Financing : Transfer of asset ownership upon maturity of lease through *wa'd* create commitment from customer to purchase the asset, hence, enabling Islamic banks to eventually shift ownership risk to customer via *wakalah*

#### Contract application

*Musharakah* is primarily used to set up a business venture between partners who contribute capital and share profits of a business venture according to predetermined profit-sharing ratio. Upon default or termination of the venture, both partners will exit via a dissolution of the venture or selling of the venture to a third-party at a mutually agreed price.



#### Alteration in risk profile

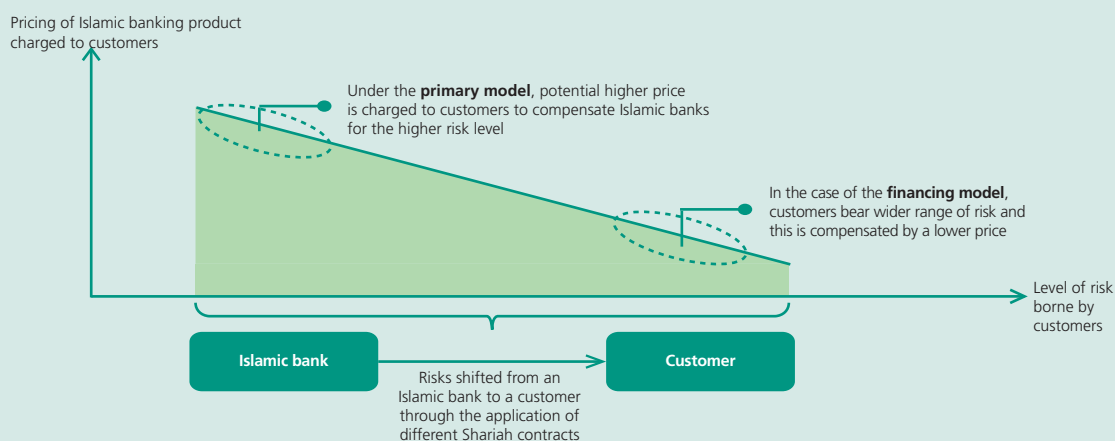
- Primary : Islamic banks and customers share the risk of a venture, hence bearing risks associated with equity investments
- Financing : A promise by the customer to eventually purchase the asset would ultimately expose Islamic banks mainly to credit risk

## Impact on Pricing to Customers

Different levels of risks and obligations borne by Islamic banks and customers under various Shariah contract applications would translate into different pricing levels, as shown in Diagram 2.

**Diagram 2**

### Illustration of the Inverse Relationship between the Level of Risks Borne by Customers to the Pricing of Islamic Banking Products



Under the financing model, Islamic banks assume mainly credit risks, with customers bearing greater responsibility of wider range of risks such as those arising from dealing directly with suppliers or defects in the acquired asset. The profit margin earned by the Islamic bank will be commensurately lower, while customers benefit from the lower pricing for the financing obtained. Conversely, under the primary model, the pricing of Islamic banking products will be relatively higher commensurate with the responsibility and level of risk assumed by the Islamic bank.

The different attributes of the financing and primary models thus provide a broader range of product options for customers with differentiated pricing to meet their specific preferences and needs. Diagram 3 illustrates an example of a product offered under *murabahah* contract.

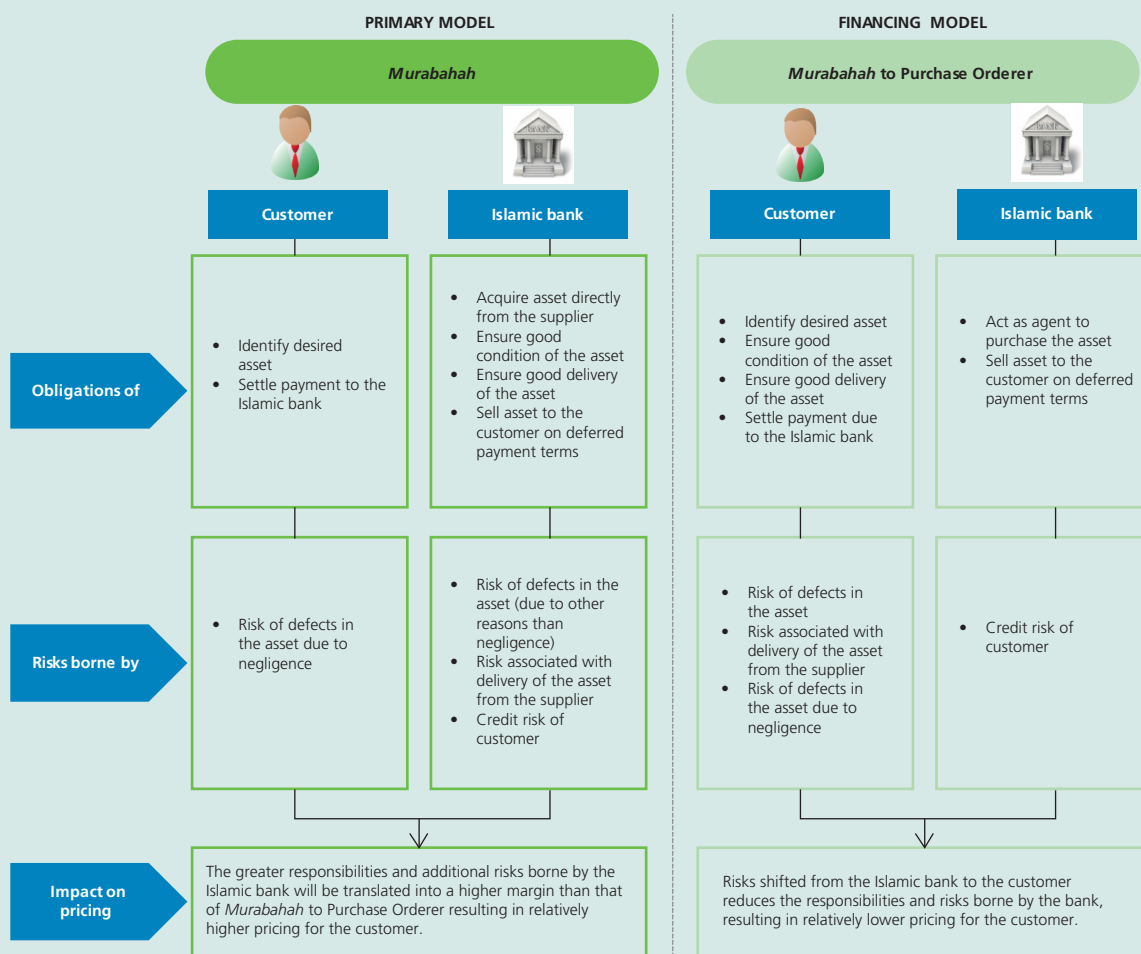
### Regulatory Expectations on Islamic Banking Operations

The risks and obligations borne by Islamic banks under various Shariah contracts will require significant modifications on the design of existing infrastructures in Islamic banks. These risks and obligations also have direct implications on the appropriate governance arrangements, business conduct, strategies and risk management to ensure that Islamic banks perform their fiduciary duties effectively and efficiently.

Diagram 4 depicts the differentiated regulatory expectations for the operations of Islamic banks when offering products under the financing and primary models. These regulatory expectations form an integral part of the Shariah and operational standards of key Shariah contracts that are currently in various stages of development by the Bank. To date, the Bank has issued final Shariah and operational standards for *murabahah* in April 2013, while concept papers on 11 other Shariah standards and two operational standards have been published for industry feedback.

Products under the primary model require additional governance and risk management measures that are appropriate for the risks inherent in the contracts, in addition to existing arrangements for managing financial risks. Regulatory capital requirements should also reflect the types and level of risks involved to ensure that risk exposures of an Islamic bank are backed by an adequate amount of high quality capital. This is to ensure that risks and infrastructure required are adequately considered in the business strategies of Islamic banks that offer such products.

Diagram 3

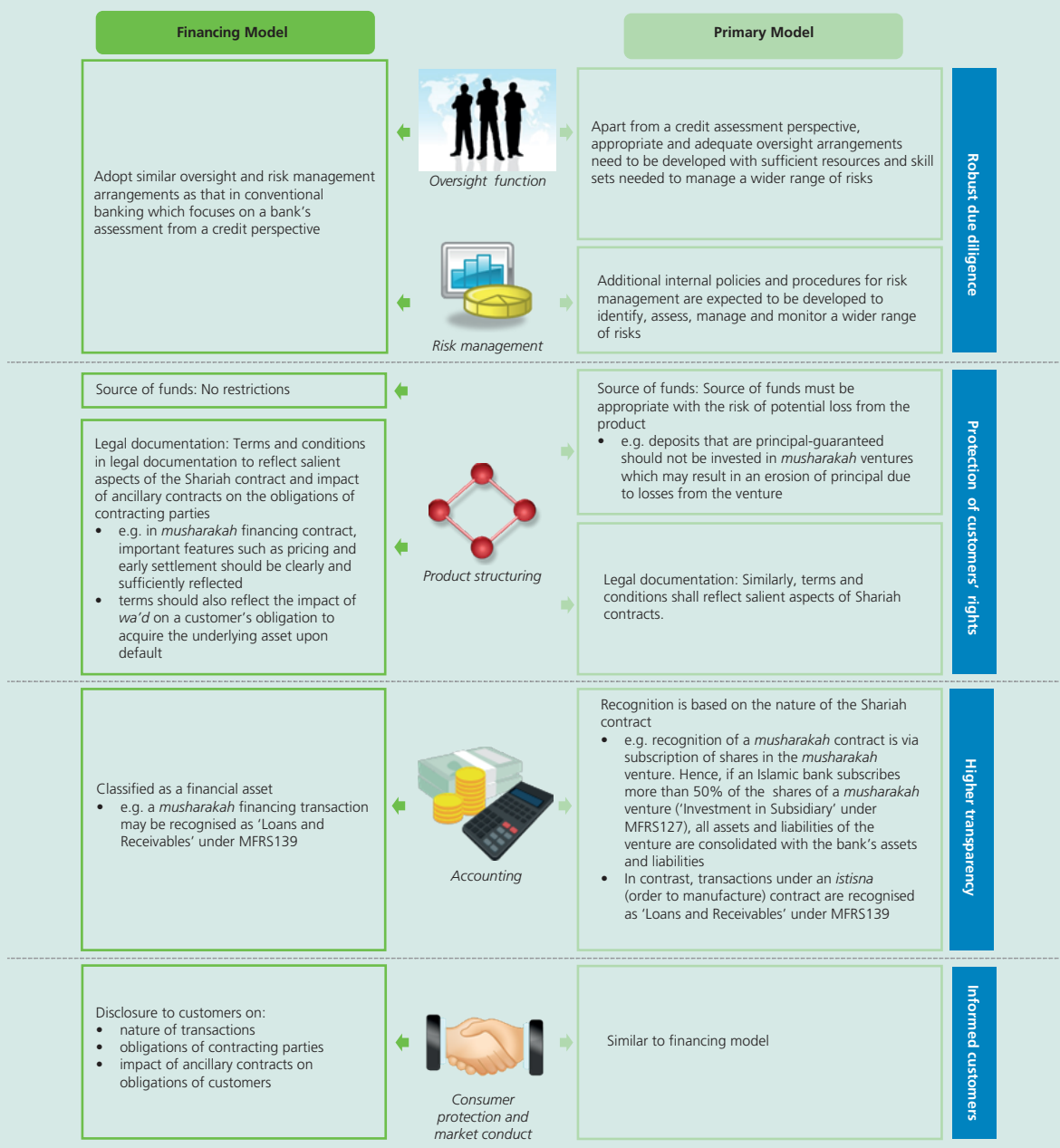
An Example of a Product Offered under *Murabahah* Contract

The terms and conditions of each product have to clearly reflect the salient aspects of the contracts, in order for customers to be fully informed of their rights and obligations. Market conduct requirements, including disclosures, also vary based on the nature of products offered to ensure a high level of transparency that commensurate with the risks borne by customers. Products must be structured to ensure that funds placed by customers are properly channelled in accordance to the agreed terms and conditions. These policies and infrastructure are important to ensure the interests of customers and other stakeholders are protected, which in turn will promote confidence and trust in Islamic banks.

Islamic banks should also conduct suitability assessments to ensure that products recommended, from among the different types of Shariah contracts available, are the ones that best serve the needs and preferences of customers. The active participation of customers in seeking a clearer understanding of Islamic products, especially how these products may differ from that of conventional banks, is also important to ensure that the expectations of customers are met by the benefits acquired and obligations assumed under an Islamic financial transaction. Significant efforts are needed to educate and promote greater awareness among customers on the different options available under both financing and primary models. Among initiatives by the Bank to promote more informed customers include the issuance of Guidelines on Product Transparency and Disclosure that outlines disclosure principles and requirements that must be observed by banks.

Diagram 4

Differentiated Regulatory Expectations on the Operations of Islamic Banks under Various Shariah Contracts



Conclusion

There are significant opportunities for the product offerings of Islamic banks, currently largely concentrated on the financing model, to expand into products based on the primary model. The potential for this new business area is growing given the demand for such products, particularly among small and medium enterprises. The evolution of a comprehensive mix of products based on primary and financing models is a major move which will significantly alter the current banking business model of Islamic banks. Hence, Islamic banks should ensure that the necessary infrastructures are developed to accommodate this change. Ultimately, this will place Islamic banks in an advantageous position to cater to a wider range of customers, in turn creating a competitive edge for Islamic banks while providing the conditions for the sustainable and expanded growth of the Islamic finance industry going forward.

(MIFC) new global brand identity 'Malaysia: World's Islamic Finance Marketplace'. It denotes the increasing connectivity of Malaysia's Islamic financial institutions with the global financial community through deeper markets in cross-border multi-currency transactions, which are supported by an enabling financial infrastructure. In conjunction with the launch, the enhanced MIFC portal was also rolled out. The portal provides Islamic finance news feeds, live market data on securities and indices and thematic analyses and research papers. Following these enhancements, traffic to the website has almost tripled in terms of monthly average visits from more than 145 countries.

As the international dimension of Islamic finance advances further, another key focus is developing Malaysia as a reference centre for Islamic financial transactions. An important development in this respect has been the comprehensive review of relevant legislation by the Law Harmonisation Committee (the Committee), aimed at creating a more conducive legal environment for the efficient conduct of Islamic financial transactions. The Committee produced the Law Harmonisation Committee Report in October 2013, which documented the Committee's recommendations. Among them are recommendations to:

- Introduce provisions in court rules on the imposition of late payment charges on judgments for debts in Islamic financial cases, as permitted by the Shariah Advisory Councils of the Bank and the Securities Commission. This recommendation has been successfully implemented;
- Enhance access to Islamic financing for consumers which involve the charging of reserve land, through recommended amendments to reserve land legislation in all states in Malaysia;
- Facilitate Islamic financing involving landed property through the recognition of Islamic finance in the National Land Code 1965; and
- Facilitate the introduction and use of innovative and globally accepted Shariah-compliant product structures for the Islamic money market through appropriate modifications to the Companies Act 1965 which would enable the more efficient conduct of collateralised commodity *murabahah* transactions.

The Committee is currently working together with the relevant Government ministries, departments and agencies to take these recommendations forward.

Moving forward, the Committee will focus on consequential legal issues that may arise from the issuance of Shariah operational standards under the Islamic Financial Services Act 2013 (IFSA 2013). The Committee will also be assessing the sufficiency of available mechanisms for resolving disputes involving Islamic financial transactions with the view to further improve existing arrangements for the resolution of cross-border disputes.

## CONTINUED DEVELOPMENT OF HUMAN CAPITAL

In the past decade, initiatives for the development of human capital in the financial sector have centred on the provision of high-quality training and education for financial services professionals at all levels of the organisation. During this period, new institutions for education and training were established and existing ones have been transformed in line with the evolving needs of the financial sector. Going forward, these institutions will be crucial in meeting demands for the highest standards of quality, professionalism and ethics in the financial sector as it supports Malaysia's transition into a high-income economy.

---

Going forward, talent development initiatives will focus on ensuring higher standards of quality, professionalism and ethics in the financial sector

---

To better meet the needs of the industry, in December 2013, the Institute of Bankers Malaysia (Institut Bank-Bank Malaysia, IBBM) repositioned itself as the Asian Institute of Chartered Bankers and also launched the Asian Banking School. The transformation of IBBM should expand its outreach to banking professionals within the region and raise its profile as a professional body through instituting professional standards, conducting examinations and granting awards. The transformation also enables separate structures and mandates appropriate to the distinct strategic focus and operational independence of the Asian Institute of Chartered Bankers and the Asian Banking School. A new curriculum of the

Asian Banking School will be introduced in 2014, to cater to the evolving learning needs of the industry by moving beyond traditional classroom modes of instruction to leverage on the latest technologies in education.

To ensure that investments in training meet industry needs and raise standards in the quality of professional development, the Finance Accreditation Agency (FAA) was officially launched on 6 September 2013 with the support of the Bank and the Securities Commission. The FAA provides independent quality assurance and accreditation services for training and development programmes offered in the financial services industry. Considerable progress has been made during the year, with 97 learning programmes being accredited under the FAA Quality Framework and 15 worldwide training providers registered with the FAA as a precursor to the submission of programmes offered by these providers to FAA for accreditation in due course. The FAA is currently also developing Learning Standards for various sectors of the financial services industry as a clear guide to training providers on the minimum standards required for accreditation in terms of the design, development and delivery of learning programmes.

---

## The establishment of a Financial Services Professional Board would provide assurance of the highest standards of competence and integrity of the financial services workforce

---

A key lesson from the crisis and more recent episodes of financial market manipulation is the importance of a strong culture of professionalism and ethics in the financial industry to ensure its long-term sustainability and public trust in the financial system. With this in mind, the board of the Asian Institute of Finance supported the establishment of a Financial Services Professional Board (the Board) to promote, advocate and facilitate the development and adoption of professional standards and ethical practices across the different sectors

of the financial industry, providing the public an assurance of the highest standards of competence and integrity of the financial services workforce. The Board will be industry-led comprising leading financial practitioners, and supported by non-financial industry experts, of international repute. Its role will include the advocacy of a strong professional code of conduct and an ethical framework for financial service professionals. In establishing professional standards, the Board will engage closely with both regulators and industry representatives from insurance, banking, Islamic finance and capital markets.

Existing institutes of education and training have continued to enhance their programmes to better serve the needs of the industry.

- For senior management and the board of directors of financial institutions, the Iclif Leadership and Governance Centre (Iclif) organised the inaugural Leadership Energy Summit and launched its 'Leaders Room' initiative which features a series of talks and interviews with notable leaders. The Asian Leadership Index (the Index), another new initiative planned for 2014, aims to profile the leadership landscape across 18 countries in the region. The Index will provide insights into leadership gaps in areas such as gender, generation, education level, nationality, type of organisation and industry, and will be used as input for Iclif's future development programmes for leaders.
- In Islamic finance, the International Centre for Education in Islamic Finance (INCEIF) introduced a new Industrial Doctor of Philosophy programme aimed at elevating the quality of core thought leaders in the industry and partnered with a global management consultancy group to develop a behavioural leadership competencies blueprint for the global Islamic finance industry.

Going forward, a high-level Financial Services Talent Council (the Council) will be established to formulate strategies aimed at ensuring a sustainable pool of high-quality talent for the financial sector. Through its work, it is expected that the Council will have a key role in shaping the direction of talent strategies to deal with the most pressing challenges faced by the financial industry in the management of human capital. This will include addressing challenges arising from the increasing talent mobility across

borders and institutions, a multi-generational workforce with diverse career motivations and aspirations, and the need for training programmes and delivery structures to remain relevant in a rapidly evolving industry.

## KEY PRIORITIES MOVING FORWARD

Continued focus will be accorded to the development of a progressive, sustainable and inclusive financial sector that is able to drive Malaysia's transformation towards a high value-added, high-income economy within this decade. This will be guided by the Financial Sector Blueprint 2011-2020, with a focus on the following areas:

- First, efforts will be intensified to increase the capacity of financial institutions and financial markets towards providing value-enhancing products and services for new growth areas, particularly in the technology and knowledge-based sectors, which are critical to support the country's move up the economic value chain. This will entail more innovative financing schemes and approaches to support entities in the early start-up phases;
- Second, focus will be directed towards encouraging the development of a broader range of products and services to meet the diverse and distinct financial needs of consumers, including the underserved. The Bank will work with the industry to promote the provision of long-term savings products with favourable returns and low committed periodical savings to inculcate a healthy savings culture among low-income households that will help them meet financial goals, such as home ownership, and achieve financial security. To better protect lower income groups and small businesses against unexpected adverse events, the Bank will also seek to make affordable insurance and takaful products more widely available to vulnerable groups through accessible channels;
- The third area of focus will be the implementation of market-based reforms to

enhance competition and improve efficiency and transparency in the insurance and takaful industry. An immediate priority will be to ensure that adequate safeguards are in place and working effectively to protect the interests of consumers and support an orderly transition towards a more liberalised insurance and takaful landscape. Active engagement will be undertaken with the industry associations to enable them to play a more proactive role in facilitating the gradual liberalisation of the industry in an orderly manner while preserving market discipline among the insurers and takaful operators;

- The fourth area of focus will be the development of a comprehensive regulatory framework to facilitate a greater diversification of Islamic banking businesses and products. The Bank will implement a transition plan to facilitate the classification of different types of Islamic accounts offered by banks either as investment accounts (principal non-guaranteed) or Islamic deposits (principal-guaranteed), in accordance with the requirements of the IFSA 2013. Moving forward, efforts to promote certainty and strengthen Shariah compliance of Islamic financial transactions will continue through the issuances of Shariah and operational standards of key Shariah contracts. Necessary infrastructures to support a wider range of product offerings are also being developed, including a joint initiative between the Bank and the Islamic banking industry to create a platform that allows direct funding into business ventures by investment account holders; and
- The fifth area of focus will be to continue to build on and further strengthen Malaysia's regional and international financial linkages. This will include operationalising the ASEAN Banking Integration Framework and promoting a wider range of sukuk issuances to facilitate cross-border liquidity management and support the effective intermediation of the increasing flow of international Islamic funds.