

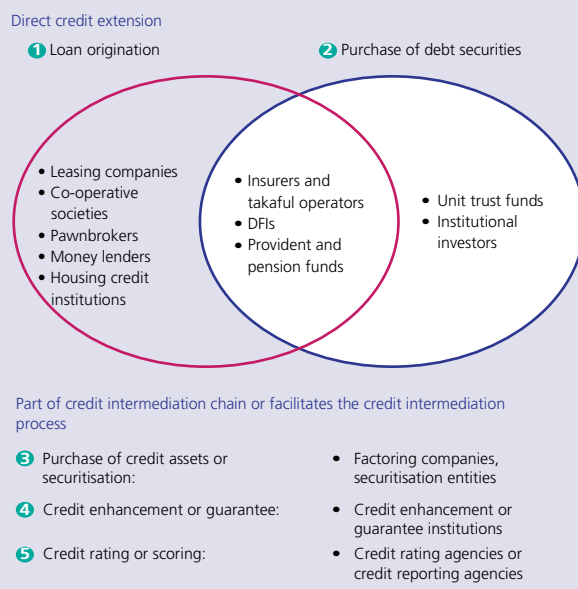
## Non-bank Intermediaries in Malaysia

Following the global financial crisis, greater attention has been focused on the role and scope of institutions operating within the shadow banking system in transmitting risks to the financial system. The failure of a number of such institutions during the crisis resulted in significant risks that were transmitted more widely through the financial system which ultimately had a disruptive impact on the intermediation of funds in a number of economies. As a result, there has been a high degree of global attention accorded to the activities of those operating outside the regulated banking system. In facilitating authorities across jurisdictions to become more aware of, and better understand these entities and their activities, the Financial Stability Board had issued some guidance which describes the shadow banking system as credit intermediation undertaken by entities and involving activities outside the regular banking system. Systemic risks from such entities and activities can arise either directly as a result of the prominence of the shadow banking system in supplying credit or liquidity to the economy, or indirectly through its interconnectedness with the banking system. This article provides an overview of the characteristics and size of credit intermediation activities undertaken by non-bank entities within the financial system in Malaysia.

In Malaysia, non-bank credit intermediaries have a complementary role to banks in providing financial services to specific market segments. The nature and scale of their activities are, however, considerably less complex and account for a much smaller share of total credit intermediated by the banking system compared with that observed in some advanced economies during the global financial crisis<sup>1</sup>. Banks represent the mainstay of the financial system, accounting for 61% of total credit intermediated in Malaysia<sup>2</sup> or 142% of gross domestic product (GDP). Including insurers, takaful operators and six development financial institutions (DFIs), about 73% of total credit intermediated or 170% of GDP is attributed to institutions that are prudentially supervised by the Bank.

Chart 1

### Non-bank Credit Intermediation Activities and Entities in Malaysia



<sup>1</sup> According to a Federal Reserve Bank of New York staff report, the volume of credit intermediated by the shadow banking system in the US was nearly twice (about 1.8 times) as large as the volume of credit intermediated by the traditional banking system prior to the global financial crisis. See Pozsar, Z, Adrian, T, Ashcraft, A and Boesky, H (2010), 'Shadow Banking', Federal Reserve Bank of New York, *Staff Report*, no. 458, July.

<sup>2</sup> Includes loans, holdings of debt securities, securitisation and credit guarantees or enhancements.

Several factors explain the lower propensity of non-bank credit intermediation activities in Malaysia to transmit shocks to the banking system.

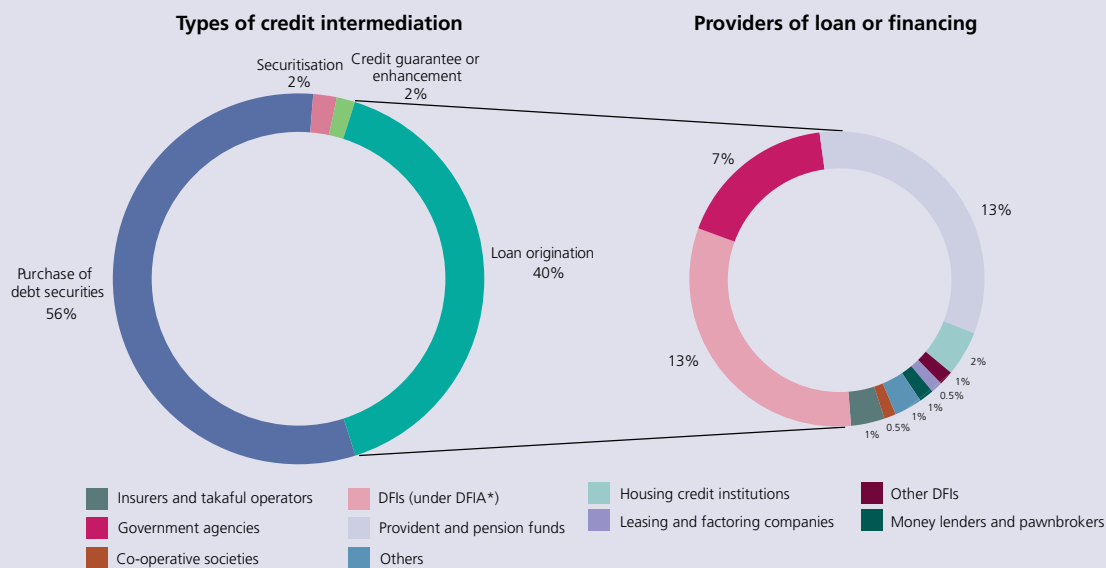
**(i) Low complexity of activities and entities**

Non-bank credit intermediation activities are predominantly concentrated on the purchase of plain vanilla debt securities and traditional lending activities. Securitisation and credit enhancement activities account for only about 3.7% of credit intermediation by non-bank entities (Chart 2). Structured investment vehicles (SIVs), asset-backed commercial paper conduits and complex securitisation structures are also not common.

A well-capitalised banking system and the continued availability of ample liquidity in the domestic financial system have reduced banks' reliance on securitisation as a source of funding or for capital management, with the loan-to-deposit ratio of the banking system remaining below 85% since 2004. Asset-backed securitisation activities have continued to decline as a share of total debt securities outstanding (2011: RM15.7 billion or 1.8% of total debt securities outstanding; 2010: RM16.2 billion or 2.1% of total debt securities outstanding). Cagamas MBS Berhad, a subsidiary of the national mortgage corporation<sup>3</sup>, is the primary issuer of asset-backed securities (ABS) in the Malaysian financial system to account for close to half (45.8%) of ABS outstanding. At present, the ABS issued by Cagamas MBS Berhad is backed entirely by the Government's staff housing loans as the underlying assets. The securitisation of assets originated by a number of banks and non-bank entities account for 18% and 36.1% respectively, with volume remaining very modest in the recent years. Meanwhile, overall risks arising from credit guarantee activities remain low given the small size of outstanding guarantees of RM13.6 billion, including those provided by the Credit Guarantee Corporation to small and medium enterprises (SMEs). The strengthened risk management practices and infrastructure of banks have also contributed towards improved asset quality as evidenced by low impaired loan losses. The use of securitisation or credit enhancement instruments to construct highly-leveraged speculative positions in the domestic financial system is thus well contained.

Chart 2

**Composition of Credit Intermediation Activities Undertaken by Non-bank Entities**



\*DFIA refers to the Development Financial Institutions Act 2002

Source: Bank Negara Malaysia survey, Ministry of Housing and Local Government, various financial statements and internal estimates

<sup>3</sup> The national mortgage corporation, Cagamas Berhad, is majority owned by the banking institutions.

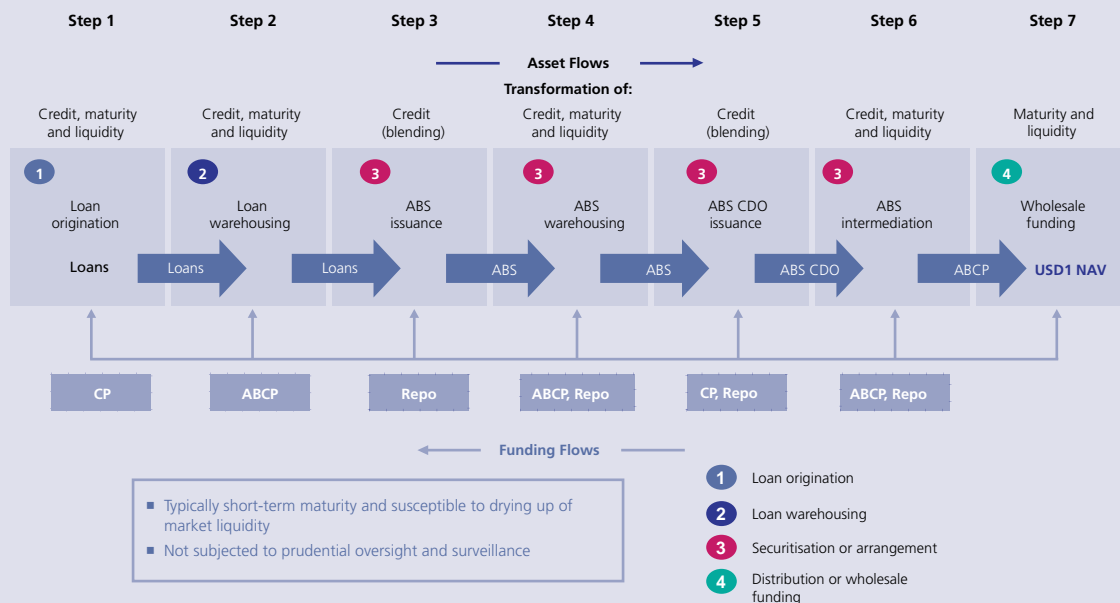
**(ii) Low maturity and liquidity mismatch risk**

Non-bank credit intermediaries in Malaysia are generally not reliant on complex market-based funding to undertake maturity or liquidity transformation. This reduces the susceptibility of non-bank credit intermediaries in Malaysia to a sudden market liquidity shock or liquidity dislocations. The small share of debt securities issued by non-bank credit intermediaries as a proportion of total outstanding debt securities further limits any impact of stress faced by these intermediaries on overall market liquidity.

**Chart 3**

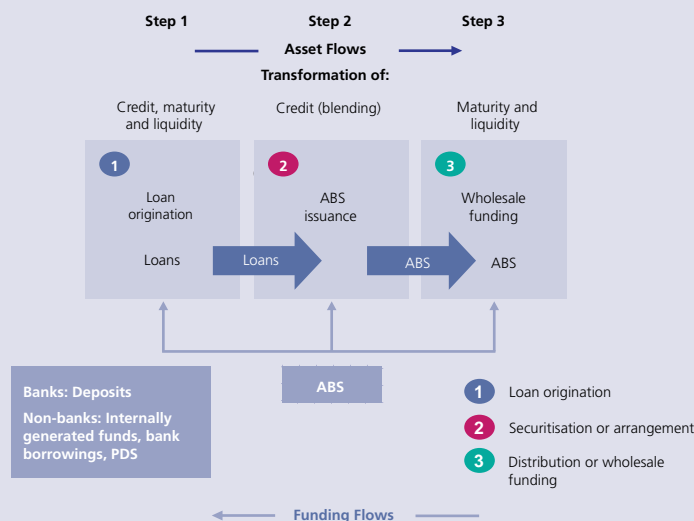
**Stylised Representation of Credit, Liquidity and Maturity Transformation Using Market-based Funding**

**Credit intermediation chain in advanced economies**



Source: Federal Reserve Bank of New York Staff Report no. 458

**Credit intermediation chain in Malaysia**



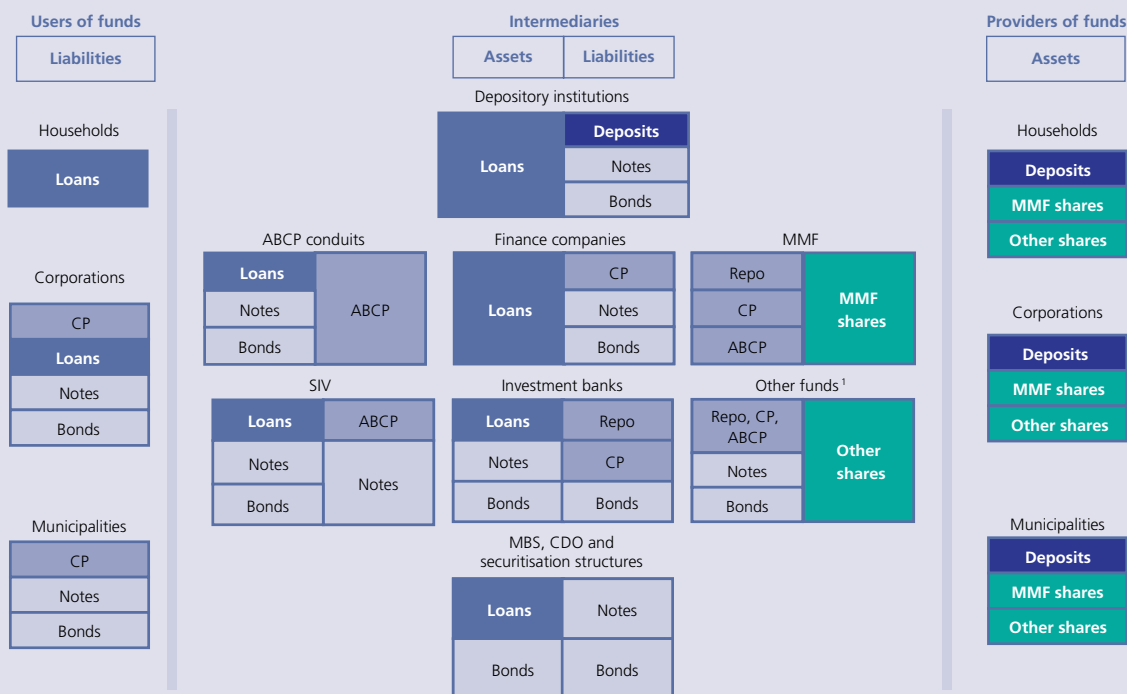
Note: ABS: Asset-Backed Securities, ABS CDO: Asset-Backed Securities Collateralised Debt Obligations, ABCP: Asset-Backed Commercial Paper, CP: Commercial Paper, Repo: repurchase agreements, NAV: Net Asset Value and PDS: Private Debt Securities

Source: Bank Negara Malaysia

While the Malaysian bond market has grown in size and depth over the years, reliance on debt securities by non-bank credit intermediaries to fund credit activities remains relatively low. For the larger non-bank credit intermediaries, the majority of the credit activities are funded from member contributions whilst for the remaining, the main source of funding is internally-generated funds. The private debt securities issued by non-bank credit intermediaries amounted to RM29.6 billion or 3.5% of outstanding debt securities as at end-2011. Of the debt securities issued by the non-bank credit intermediaries, commercial paper accounted for 2.2%, amounting to RM651 million or 11.2% of total commercial paper outstanding. While a small number of non-bank entities have relied on commercial paper, any potential impact on credit intermediation to financial stability arising from any decline in market liquidity is limited, given the small scale of their activities as well as size of standing facilities and credit lines from banks. The exposure of non-bank credit intermediaries to maturity mismatches is also limited, with an average maturity tenure of private debt securities issued of 8.2 years, whilst the financing granted by these entities, which formed the majority of assets, is largely for the medium-term not exceeding nine years.

Chart 4

Complex Financial Interlinkages between Various Components of Financial System in the US



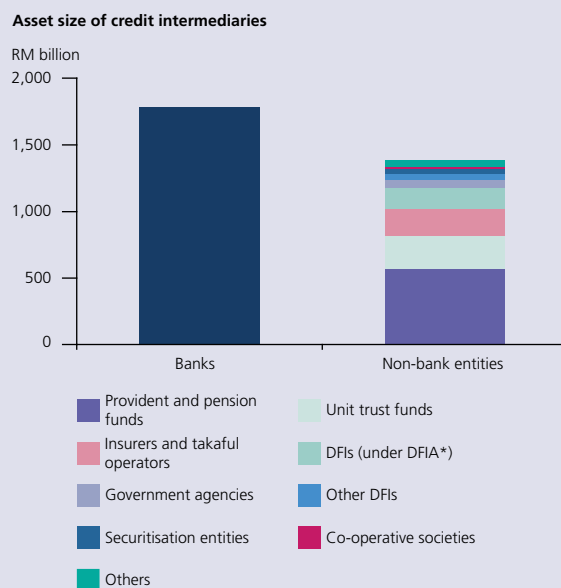
<sup>1</sup> Includes securities lending cash reinvestment pools, hedge funds, mutual funds and other asset managers  
 Note: CDO: Collateralised Debt Obligations, MBS: Mortgage-Backed Securities, MMF: Money Market Fund, SIV: Structured Investment Vehicle and Repo: repurchase agreement  
 Source: Financial Crisis Inquiry Commission Preliminary Staff Report, "Shadow Banking and the Financial Crisis", May 2010

**(iii) The interlinkages with the financial system are well contained**

Direct financial interlinkages between non-bank credit intermediaries and the banking system primarily take the form of deposit placements with banks and counterparty risk exposures. Such counterparty risk exposures arise from banks' lending to, or holdings of debt securities issued by, the non-bank credit intermediaries. On an aggregate basis, deposit placements by non-bank credit intermediaries accounted for approximately 10% of total banking system deposits as at end-2011. Provident and pension funds, insurers and takaful operators, and a few large unit trust funds account for the bulk of these deposits (69.7%), with the balance dispersed among other small non-bank financial entities. The placement of deposits by the provident and pension funds, insurers and takaful operators, and unit trust funds are spread out across a number of banking institutions, hence, minimising the risk of funding concentration at the individual bank level. While lending to and holdings of debt securities issued by non-bank credit intermediaries by the banking institutions have expanded over the years, such credit risk exposures remain small, accounting for only 2.9% of total outstanding loans and debt securities held by the banking system or 21% of the capital base of the banking system. Given the relatively small size of non-bank credit intermediation in the financial system, interlinkages among these intermediaries are also limited.

**(iv) The bulk of the activities and entities are subject to oversight**

Insurers, takaful operators and DFIs that are under the prudential oversight of the Bank account for 26% of assets held by non-bank credit intermediaries. Unit trust funds, which account for 18% of assets held by non-bank credit intermediaries, are under the purview of the Securities Commission Malaysia (Chart 5). The five-fold growth of the unit trust industry over the recent decade was driven primarily by the financialisation of the high savings level of households. Another part of the assets (41%) are held by statutory provident and pension funds managed by the Employees Provident Fund and the Retirement Fund (Incorporated) whose establishment, management and operations are governed under specific legislation. As the medium- and long-term and strategic investments by provident and pension funds generally match the long-term nature of their liabilities, these entities have minimal maturity or liquidity transformation risk. In Malaysia, credit rating agencies, which facilitate the credit intermediation process, are also subject to oversight by the Securities Commission Malaysia while the Registrar of Credit Reporting Agencies established under the Credit Reporting Agencies Act 2010, which is expected to commence operations in 2012, will govern the operations of private credit bureaus.

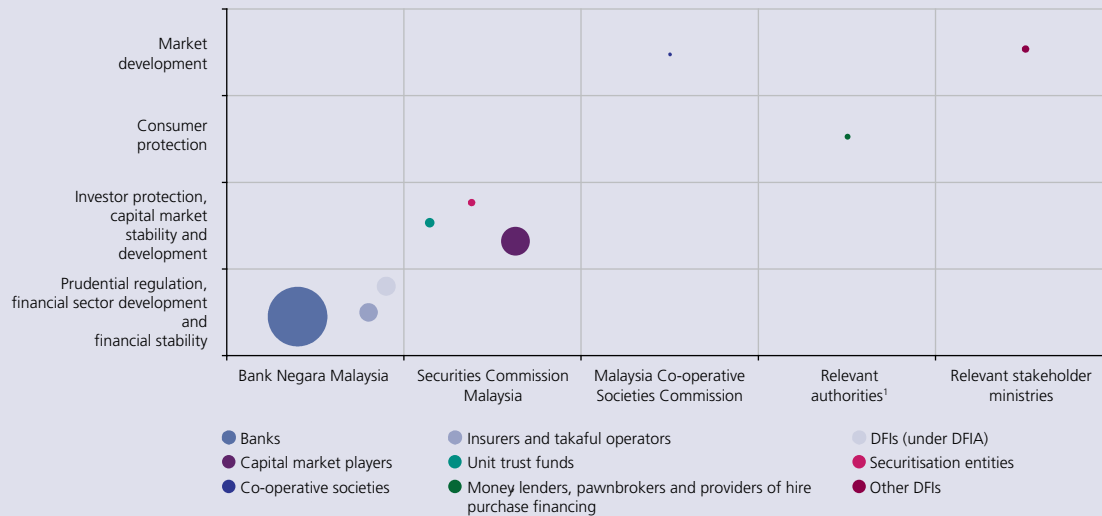
**Chart 5****Size of Various Credit Intermediation Entities and Activities and Oversight Structure**

\* DFIA refers to the Development Financial Institutions Act 2002

Source: Bank Negara Malaysia survey, Securities Commission Malaysia, various financial statements and internal estimates

Chart 5 (continued)

## Size of credit intermediation activities and oversight structure



\* DFIA refers to the Development Financial Institutions Act 2002

<sup>1</sup> Money lenders and pawnbrokers are licensed by the Ministry of Housing and Local Government while hire purchase activities are governed by the Hire Purchase Act 1967 which is administered by the Ministry of Domestic Trade, Co-operatives and Consumerism

Source: Bank Negara Malaysia survey, Securities Commission Malaysia, Malaysia Co-operative Societies Commission, Ministry of Housing and Local Government, Ministry of Domestic Trade, Co-operatives and Consumerism, various financial statements and internal estimates

In the more recent period, the activities and size of assets of non-bank lenders, which are not under the prudential oversight of the Bank, have expanded. The growth in financing extended has been mainly focused on the household sector but continues to represent a small share (5.9%) of total financing to households. To ensure these developments do not, over time, contribute towards the imprudent build-up of leverage in the household sector, the Bank's surveillance of developments in lending activities by the non-bank lenders has been strengthened in close cooperation with the relevant supervisory authorities. Specific measures have also been implemented to ensure that credit co-operative societies and large building societies observe responsible financing practices that are consistent with regulations applied to the financial institutions under the Bank's purview.

The ongoing surveillance and oversight of the shadow banking system is supported by the Central Bank of Malaysia Act 2009. The Act accords the Bank the ability to collect data and information on non-bank entities which are not regulated by the Bank for the purpose of monitoring emerging risks in the financial system, and where appropriate, take necessary risk mitigation measures to ensure that the risks are contained. The Bank's monitoring framework has consequently been enhanced to better capture developments in the sector and to monitor the sector's interlinkages with the banking system. Efforts are also underway to establish new, and strengthen existing, inter-agency cooperation arrangements that will provide for the effective exchange of information and improve policy coordination and implementation. This includes continued enhancements to the Bank's Memorandum of Understanding (MoU) with the Securities Commission Malaysia and the formulation of an MoU that is underway with the Malaysia Co-operative Societies Commission. Notwithstanding these efforts, the Bank also remains cognisant of the global issues surrounding the regulation of and proposed safeguards on the shadow banking system, including those under the initiatives of the Financial Stability Board. Where necessary, an assessment will be made for the need for regulatory measures on non-bank credit intermediaries in Malaysia to ensure that the activities of these entities do not contribute towards significant build-up of risks in the financial system.