

Development of the Financial Sector

BANKING

Financing by the banking sector (including Islamic banks) remained supportive of economic activity throughout 2018 (Chart 2.1). Total outstanding financing grew faster by 5.6% to RM1,673.5 billion (2017: 4.1%). Household financing, which accounted for 57.3% of total financing extended by the banking sector expanded by 5.6% during the year (2017: 5.1%) after a period of moderating growth that followed the implementation of macroprudential measures in 2013 to encourage more responsible lending. The uptrend was largely driven by higher securities financing. Business sector financing similarly recorded a stronger growth of 5.4% (2017: 1.8%), contributed mainly by financing to the construction sector to support infrastructure projects such as the Pan Borneo Highway and LRT 3. Small and medium enterprises (SMEs) continued to be supported by the banking sector during the year, with RM65.5 billion in financing approved to over 108,700 SME accounts. Financing to SMEs remains a strategic focus of banking institutions, having increased substantially over the years to account for about half of outstanding financing to businesses (Diagram 2.1). Further insights on SME financing needs are elaborated in Box Article 'Understanding Financing through the Lens of SMEs'.

Development financial institutions (DFIs) continue to play an important role in supporting strategic economic sectors and advancing Malaysia's developmental and socio-economic objectives. Total outstanding financing by DFIs amounted to RM143.1 billion as at end-2018, mainly channelled to infrastructure, SMEs, exports, agriculture and underserved household segments. In particular, financing to SMEs and the agricultural sector registered double-digit growth of 11.7% and 10.7%, respectively. DFIs also account for the bulk (75.5%) of financing to micro entrepreneurs under the *Skim Pembiayaan Mikro* which saw a total of RM292.2 million disbursed during the year. Total outstanding financing under the scheme stood

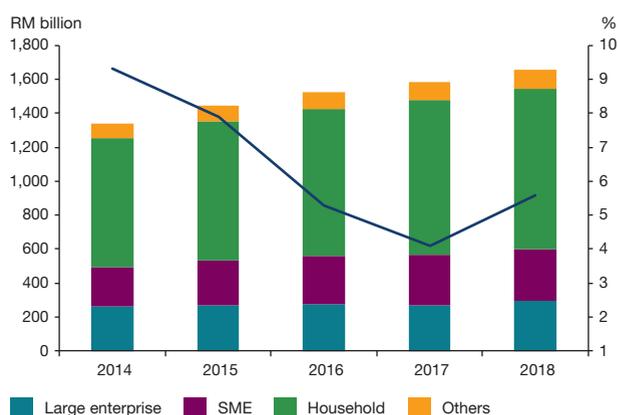
at RM910.7 million as at end-2018. Specialised products were also introduced by DFIs in late 2017 to assist the bottom 40% household income (B40) group, including a targeted microfinancing programme for agro-based micro entrepreneurs. To date, a total of RM5.2 million of financing has been channelled to more than 1,600 microfinance accounts under the programme.

Fostering innovation through the Fintech Regulatory Sandbox

The Bank supports technological advances that can improve the quality, efficiency and accessibility of financial services. The Fintech Regulatory Sandbox (Sandbox) continues to be an important avenue to test innovative financial solutions and business models. The seven solutions, covering insurance aggregators, digital remittance, digital identification (electronic Know-Your-Customer, eKYC) and secured chat banking that were approved in 2017 continued to be live-tested throughout 2018. Drawing on

Chart 2.1: Outstanding Banking Sector Financing

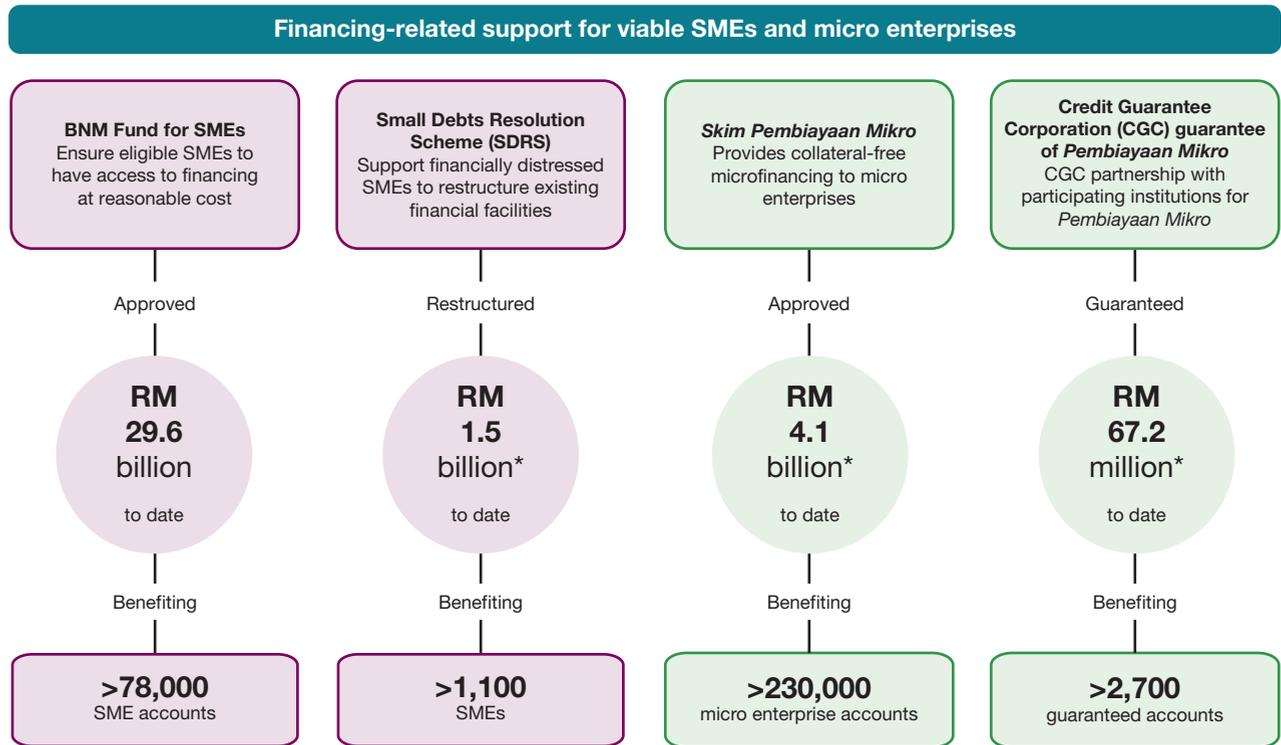
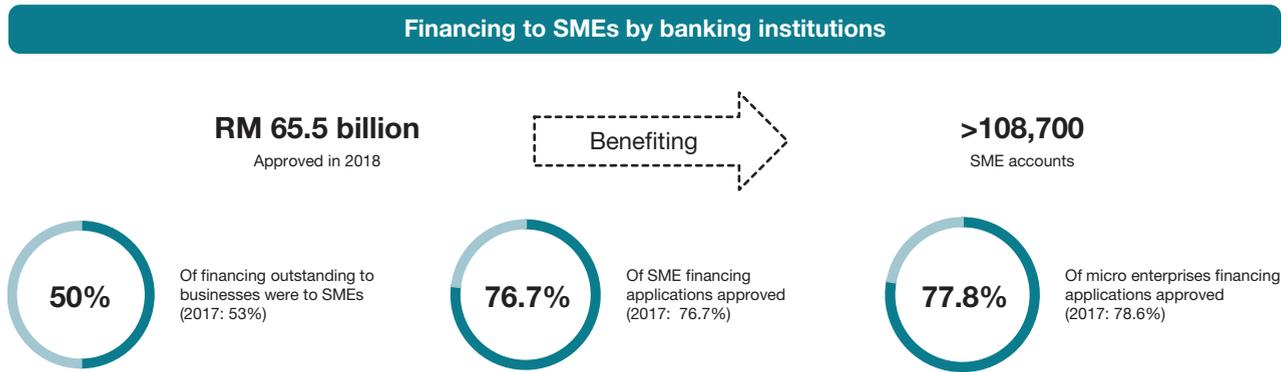
Growth of banking sector financing picked up in 2018



Source: Bank Negara Malaysia

Diagram 2.1

Key Statistics on SME Financing



* figures include financing from DFIs

Source: Bank Negara Malaysia

feedback received during the testing phase, several of the Sandbox participants were able to improve and expand their product offerings to better meet consumer needs. By 2019, all solutions are expected to conclude live-testing and exit the Sandbox. Firms with viable solutions will be able to offer their products in the market under a regulatory regime that has been suitably adapted through the Sandbox process.

In 2018, the Bank received 17 new applications to test innovative financial solutions and business models in the Sandbox. Applications received during the year, which are being reviewed by the Bank, were noticeably more diverse and sophisticated in nature. These include solutions in digital banking, peer-to-peer insurance and the use of artificial intelligence across the financial services value chain.

To accelerate the deployment of high-impact innovations that have a proven or clear potential to improve financial services, the Bank has introduced a specialised thematic track for the Sandbox (Specialised Sandbox). This allows for a more targeted approach in identified high-impact areas, while continuing to provide wide coverage of other innovative solutions.

Building on its well-defined scope, the Specialised Sandbox uses more focused and standardised testing parameters for more efficient experimentation and better performance data collection. The first Specialised Sandbox focuses on eKYC processes given the potential to enable more efficient and accessible financial services through digital on-boarding. Two Fintech companies and seven banks have been approved to test their eKYC technology under the Specialised Sandbox track.

The Specialised Sandbox uses more focused and standardised testing parameters for more efficient experimentation and performance data collection

Facilitating Open Application Programme Interface (API) adoption

Significant progress was made in the Bank's work on facilitating Open API adoption within the financial services sector. In January 2019, the Bank issued a policy document on Publishing Open Data using Open API. The policy document sets out the Bank's recommendations to the industry in developing and publishing Open APIs on publicly available data. The recommendations include design considerations for Open APIs as well as security measures to protect against cybersecurity threats, proportionate to the sensitivity of data being shared through Open APIs. The publication of Open APIs by financial institutions is expected to increase the pace of financial innovation by enabling open and portable access to data and services. This in turn can promote competition, and improve the quality and efficiency of financial services.

The recommendations dovetail with the Bank's ongoing efforts with the industry to develop technical specifications for Open APIs. Led by the Bank, the Open API Implementation Group (IG) was formed in March 2018 to identify and develop standardised Open APIs for high-impact use cases. Membership of the IG

is diverse, comprising selected financial institutions, Fintech firms and relevant agencies based on the specific use cases. The IG has developed standardised specifications for Open APIs on product information in relation to SME financing, credit card and motor insurance/takaful. Leveraging on these specifications, IG members are expected to publish their Open APIs in the first half of 2019. It is envisioned that this will be a catalyst for more innovative solutions that enable customers to access and compare financing and insurance/takaful products from a wide range of providers, and in turn choose the services that are best matched to their specific needs.

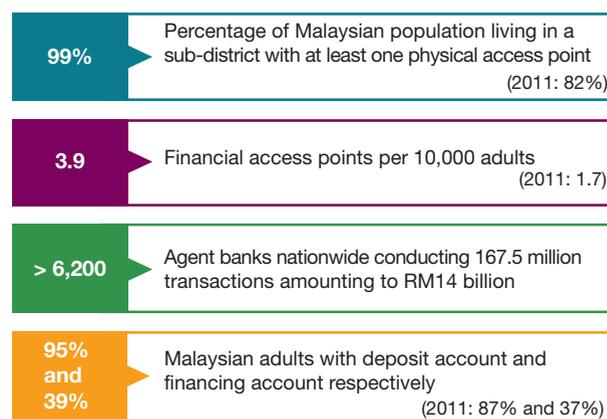
Moving forward, further work will be undertaken on secure methods for allowing trusted third parties to access a broader scope of banking and insurance/takaful information through Open APIs, with the customer's consent. This will be done in collaboration with the industry to assess the risks involved, establish the enabling regulatory environment and identify necessary safeguards to protect consumers and the integrity of financial services.

Promoting meaningful access to financial services

Malaysia has made significant strides in financial inclusion, as a result of intensified efforts over the years in promoting access and usage of financial services to all segments of the society. Financial access points are present in almost all sub-districts, propelled by the introduction of agent banks since 2012, while supply-side data provided by financial institutions show that 95% of Malaysian adults have deposit accounts (Diagram 2.2).

Diagram 2.2

Selected Financial Inclusion Indicators



Source: Bank Negara Malaysia

The Bank periodically conducts a demand-side survey at the national level to supplement the supply-side data on financial inclusion, as well as to identify on-the-ground issues relating to financial access and usage. The latest survey conducted in 2018 highlighted an improved take-up of financial products and greater usage of digital channels (Diagram 2.3).

In December 2018, the Bank, in collaboration with three financial institutions and Technology Park Malaysia piloted a Community Empowerment Programme with low-income communities in Sabah and Terengganu to help the community save and invest. In addition to providing suitable financial products for the community, the financial institutions also helped with the provision of communal infrastructure to enhance the productivity of economic activities. In one programme, this included the provision of drying cabins to expedite the time required to produce dried fish and anchovies, which contributed towards improving the income prospects for the community and making them more bankable in turn.

Leveraging on technology to drive financial inclusion

The Bank views digital innovation as an important enabler to promote greater access, quality and responsible usage of financial services. To this end, the Bank partnered with the United Nations Capital Development Fund (UNCDF) and Malaysia Digital Economy Corporation (MDEC) to launch the Digital Innovation Hub (Innovation Hub) and Inclusive Fintech Accelerator Program (Accelerator Program).

The Innovation Hub is largely aimed at meeting the needs of the low-income segment of the population, with a focus on enabling service providers (including financial institutions and Fintech start-ups) to use technology in promoting inclusive finance. The Innovation Hub also seeks to build a community of innovative and resourceful developers. Participating service providers are expected to benefit from the cross-fertilisation of ideas and market research generated via the Innovation Hub, particularly to better tailor their products and services to meet the requirements of the underserved in Malaysia.

Under the Innovation Hub, the Accelerator Program was launched during the year. The Program aims

to address specific financial inclusion pain points within Malaysia, with four key focus areas: spending, saving, borrowing and financial planning. The first of a series of accelerator programmes was jointly organised by the Bank and UNCDF in December 2018, with further programmes and initiatives lined up in the coming year.

The Innovation Hub is largely aimed at meeting the needs of the low-income segment, by enabling greater use of technology in promoting inclusive finance

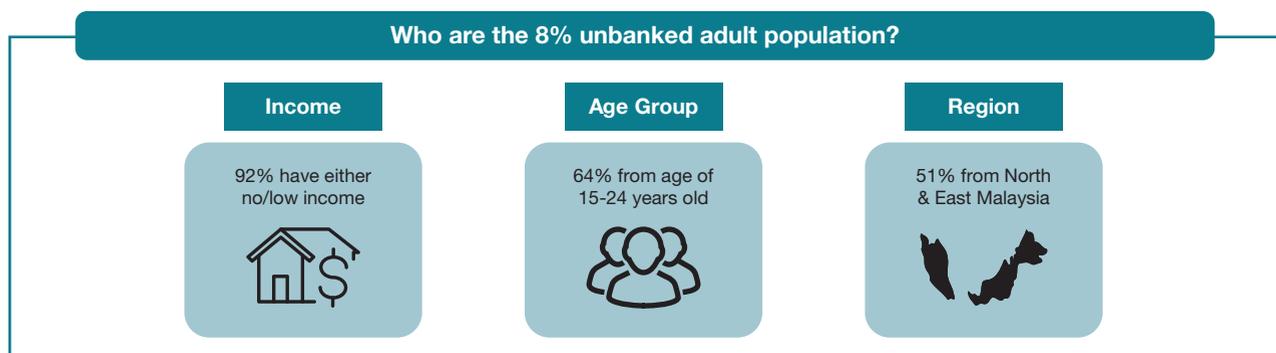
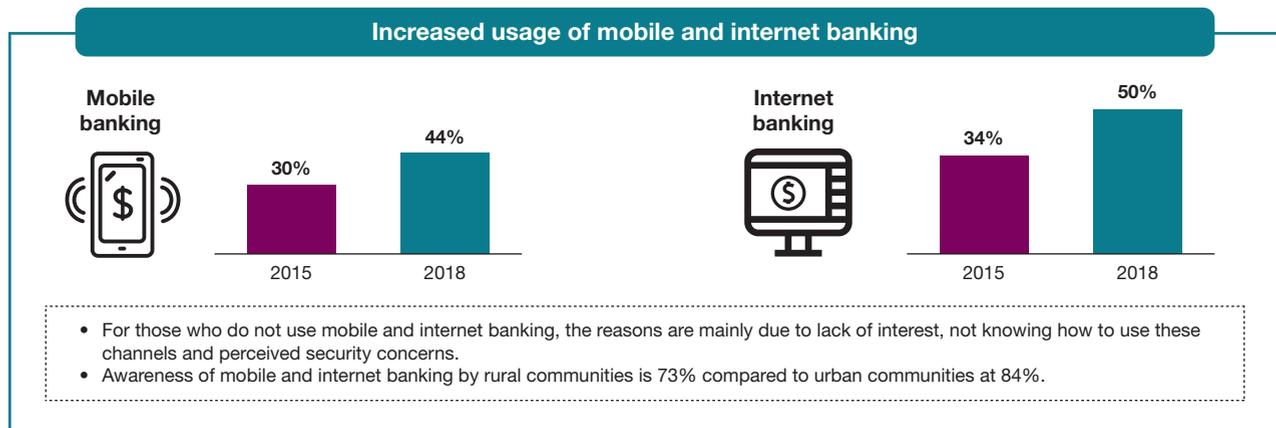
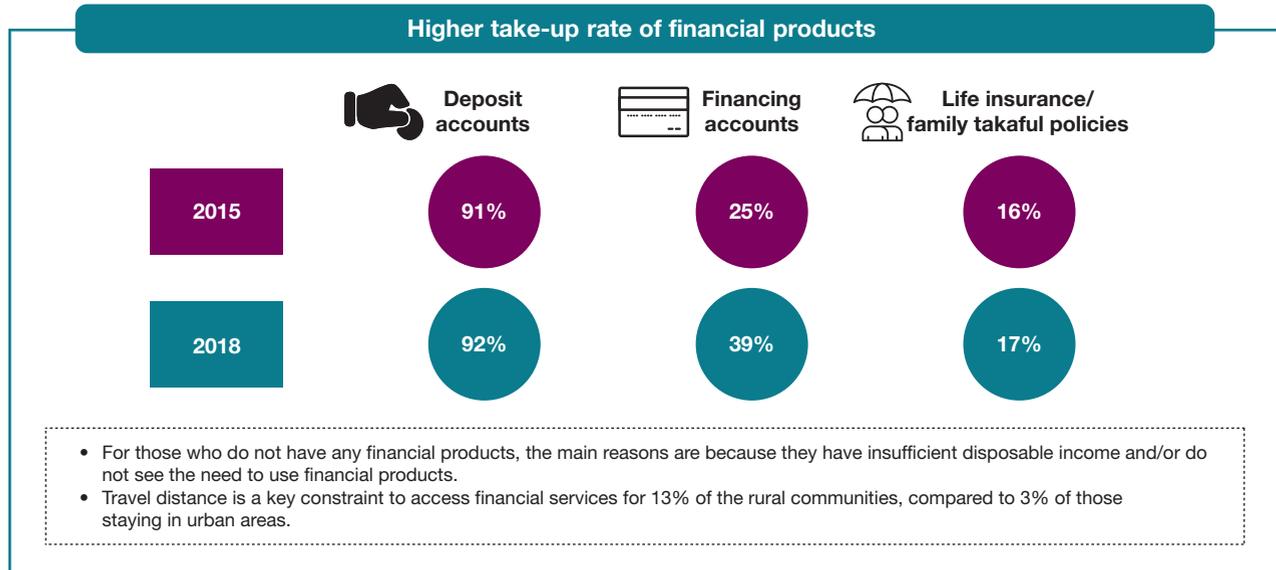
Improving access to finance for SMEs

As part of ongoing initiatives to support the increasingly diverse financing needs of SMEs, an online financing aggregator platform or “imSME”, operated by the CGC was launched in February 2018. The imSME matches SMEs’ financing needs with suitable financing products from various institutions while minimising the search costs associated with financing. Since its launch, financing amounting to RM46.9 million was approved for 405 SMEs. In addition, 2,515 SMEs that did not initially qualify for financing were assisted by the imSME’s Financial Advisory Team, which provides practical guidance and support to these SMEs to address their financing needs. 41% of the SMEs assisted were able to secure financing from financial institutions and alternative financiers (such as peer-to-peer platforms). The remaining were referred to capacity building agencies that will work with these SMEs to improve their eligibility for financing. Financial institutions have also been reminded to improve the information that they provide to SMEs on fees and charges, the reasons for financing rejection and the available avenues to lodge complaints to better empower SMEs to take actions in relation to their financing requirements.

While SME access to financing has improved significantly over the years, there are pockets of SMEs that still face issues in obtaining financing from financial institutions. The Bank continues to work with the industry and relevant ministries and agencies to address specific access issues, and at the same time intensify awareness programmes. During the year, over 8,100 SMEs attended 50 awareness programmes organised by the Bank across the nation. More than 1,100 SMEs also

Diagram 2.3

Key Findings of Demand Side Survey 2018



Source: Bank Negara Malaysia

participated in more targeted financial seminars and clinics which covered areas such as sources of financing, financial management, financing

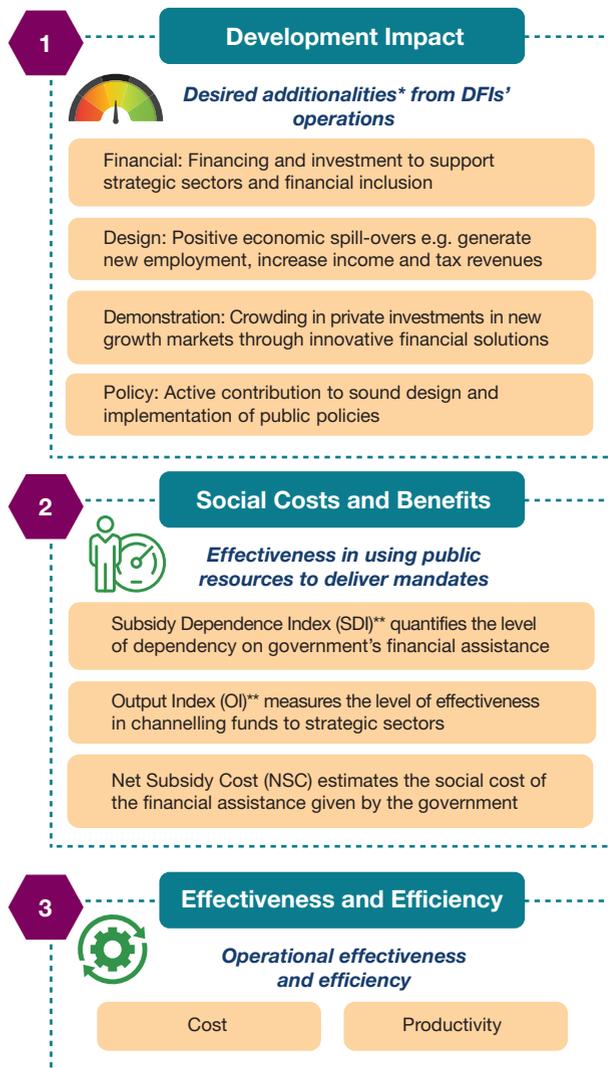
application requirements and processes, avenues to seek information and redress, e-payments and business insurance or takaful protection.

Enhancing the role of DFIs

DFIs continue to play an important role in promoting economic growth and social development. In 2018, the Bank collaborated with the World Bank and DFIs to develop an enhanced performance measurement framework for DFIs. The new framework aims to capture the broader contributions of DFIs by moving beyond the narrow focus of financing growth indicators, and integrating developmental key performance indicators (KPIs) to measure the socio-economic impact of DFIs' operations (Diagram 2.4).

Diagram 2.4

The New Performance Measurement Framework for DFIs



* Additionalities refer to the positive impact attributable to DFIs beyond that which is delivered under a fully commercial or profit-driven environment

** Both SDI and OI are also intended to promote financial sustainability and minimise credit market distortions

Source: Bank Negara Malaysia

The framework aims to encourage a stronger alignment between the performance of DFIs and their development impact. Further, in supporting the development of strategic and new growth sectors, the framework emphasises the need for DFIs to be financially sustainable, while minimising credit market distortions. The framework is being operationalised in phases and will continue to evolve as DFIs refine their KPIs to better reflect their mandates. Preliminary results of the measurement framework during the year suggest that the impact of DFIs extends well beyond providing the necessary financing to also include creating employment opportunities and upskilling targeted segments (Diagram 2.5).

Work continues to progress in building the necessary systems and capabilities within DFIs to effectively monitor and evaluate performance and development outcomes. This has been actively supported by the Bank, working with its partners, including the World Bank and relevant government ministries and agencies. Going forward, institutionalising the new framework and ensuring its effective implementation will continue to be a key priority for DFIs and a focus of the Bank's regulatory and supervisory activities. In parallel, the Bank is also engaging with the Government to review the DFI landscape to take into account developments in the financial system and changes in Malaysia's economic structure and priorities. This seeks to provide a sharper focus in the mandates of DFIs while optimising performance and synergies.

Diagram 2.5

Preliminary Developmental Outcomes Based on Selected Schemes by DFIs

Financial Additionality	
74%	Percentage of DFI financing portfolios to underserved segment (2016 – 2017)
3,024	Start-ups received agriculture financing (2015 – 2017)
Design Additionality	
570 jobs	Jobs created and revenue increase as reported by 44 survey respondents who obtained total RM2.2 billion financing for cross-border ventures (2010 – 2017)
RM6.75 billion	
502 SMEs	SMEs with improved profitability, sales growth, technology use and export-market penetration due to intensified value-added assistances provided (2016 – 2017)
Demonstration Additionality	
7.8%	Loan syndication portfolio against total financing in 2017, as a proxy for crowding-in of private investments (2016: 4.6%)

Source: Bank Negara Malaysia

Efforts are also being pursued to enhance DFIs' capability and capacity to deliver their mandates effectively. Specialised development finance programmes developed in collaboration with the Asian Institute of Chartered Bankers, the Iclif Leadership and Governance Centre and the World Bank were introduced. These complemented development-focused technical programme offerings that were led by the Association of Development Finance Institutions of Malaysia.

INSURANCE AND TAKAFUL

The Malaysian insurance and takaful sector recorded higher total premiums and contributions which increased by 4.9% to RM66.6 billion (2017: RM63.5 billion). Total insurance and takaful assets correspondingly increased by 3.2% to RM309.1 billion (2017: RM299.5 billion). Insurance and takaful penetration, measured as the percentage of total gross premiums and contributions over GDP remained at 4.7%. Insurance and takaful density, measured as the percentage of total gross premiums and contributions per capita, rose marginally to RM2,050 (2017: RM1,980) as at end-2018. Insurance/takaful coverage also remains uneven with the vast majority of Malaysians, mainly in the lower income segments, without insurance/takaful protection. This is reflected in the penetration rate of life insurance and family takaful, measured as the percentage of Malaysians who own at least one individual or group life insurance policy or family takaful certificate, which was little changed at 41%.

During the year, six composite insurers and takaful operators converted their composite licenses into separate single life/family and general licenses, while five composite insurers and takaful operators retained only their life/family licenses. This completed the process for the conversion of composite licenses

which began in 2013 to strengthen the management of general and life/family insurance and takaful business, as required under the Financial Services Act 2013 (FSA) and Islamic Financial Services Act 2013 (IFSA).

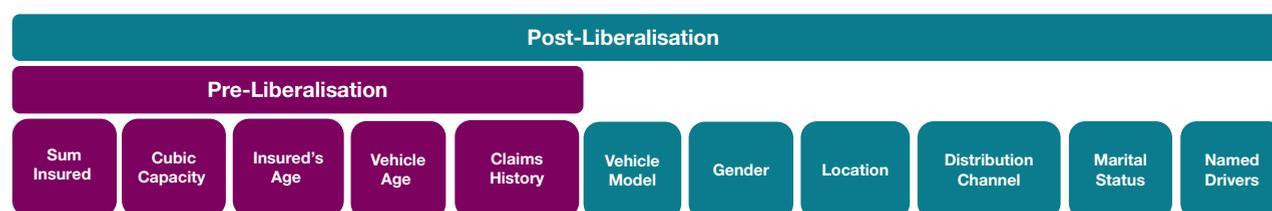
Phased liberalisation of motor and fire tariffs

The phased liberalisation of the motor and fire insurance tariffs, which commenced in 2016, entered its third year. Phase I, which took effect on 1 July 2016, enabled the introduction of new products and add-on covers priced at market-determined rates. Phase II, which commenced on 1 July 2017, saw the removal of tariff rates for 'Comprehensive' and 'Third Party, Fire and Theft' products to allow for further pricing reforms.

Further differentiation in pricing to reflect risks continued to be observed in 2018 based on an expanded set of risk rating factors used by insurers and takaful operators in setting premiums and contributions (Diagram 2.6). During the year, 17 general insurers and takaful operators filed premium and contribution revisions with the Bank for six vehicle classes. In the mass market vehicle segment, premiums and contributions generally varied within a 10% range of former tariff rates. About 34% of policies and certificates experienced lower rates than the tariff, 10% of policies and certificates saw rates unchanged and 56% of policies and certificates saw rates increase compared to the tariff. Meanwhile in the higher-risk vehicle segments, particularly theft-prone vehicles, premium and contribution rates increased by up to 30%. In other vehicle segments with better claims experience, rate decreases by up to 60% from the tariff rates were observed. More importantly, stronger pricing incentives for safe driving and vehicle

Diagram 2.6

Commonly Used Rating Factors



Source: Bank Negara Malaysia

security are expected to lead to improvements in the overall motor claims loss experience. This in turn will support more sustainable premium and contribution rates over time.

New motor and fire product innovations offered in the market increased by 39% to 249 new products in 2018 (2017: 179 new products), mainly driven by new motor products to meet different risk protection needs, such as:

- i) E-hailing extension cover that provides coverage for the driver, vehicle, passengers and third parties during the use of private cars for e-hailing services, in line with the requirements set by the Ministry of Transport;
- ii) Products using telematics to monitor consumer driving habits, thereby enabling the offering of lower premiums or contributions to reflect safer driving; and
- iii) Pay-as-you-drive endorsements where drivers with low mileage are eligible to receive a refund, upon completion of the twelve-month policy period.

Moving forward, the Bank expects the adoption of technologies such as the use of telematics or usage-based products to gain more traction. This will facilitate further refinements to pricing based on individual risk profiles.

The Bank expects the adoption of technology and usage-based products to enable the industry to refine their pricing based on individual risk profiles

The Bank is currently developing proposals for the next phase of liberalisation. These will consider appropriate and gradual adjustments of premiums and contributions for compulsory 'Third Party' motor and fire products, including their timing. While the compulsory 'Third Party' motor insurance/takaful segment continues to make losses with an aggregate combined ratio of 108% in 2018, improvements in the overall motor portfolio experience as a result of the liberalisation under Phases I and II are expected to mitigate the impact of under-pricing at the current level of premiums and contributions.

Progress of Life Insurance and Family Takaful (LIFE) Framework

Through the LIFE Framework issued in November 2015, the Bank has set out a roadmap of reforms

to support the long-term development of the life insurance and family takaful industry. In 2018, further progress was made in the implementation of these reforms:

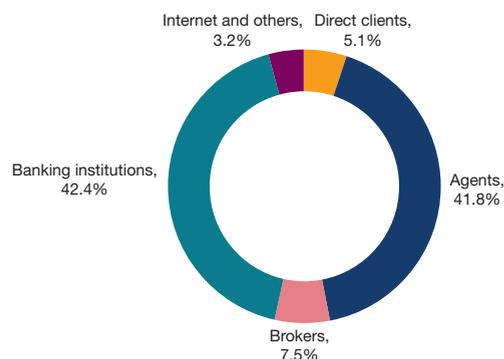
j) Greater accessibility and outreach of life insurance and family takaful products

Since June 2017, life insurers and family takaful operators have been required to offer pure protection term products via direct distribution channels. Customers are also provided with tools to facilitate self-assessment of the suitability and affordability of a product. Direct distribution channels, such as the Internet, are intended to promote an additional and convenient channel for the public to purchase insurance/takaful products. As of 2018, their share of new premiums and contributions has increased to 3.2% from the previous year (2017: 2.4%) as more policyholders become aware of alternative access channels, although it remains low (Chart 2.2).

With effect from March 2019, products offered through direct distribution channels will be expanded to include pure protection critical illness and medical and health insurance/takaful products. As such products are more varied in their design and coverage across the industry, insurers and takaful operators will be required to comply with strengthened disclosures to provide customers with appropriate information to make informed purchasing decisions.

Chart 2.2: Life Insurance and Family Takaful - New Premiums and Contributions by Distribution Channels

Agency and bancassurance continue to be main channels of new business



Source: Bank Negara Malaysia

ii) **Gradual removal of limits on operational costs**

The limits on commissions and agency-related expenses for investment-linked products will be liberalised in tandem with the implementation of the Minimum Allocation Rate (MAR) for investment-linked insurance and family takaful products starting July 2019 and July 2020, respectively (see Chapter 3 'Regulatory and Supervisory Framework'). This is expected to promote a more competitive and diverse insurance/takaful market, while safeguarding consumers' interests through the MAR, which sets out the minimum proportion of premium/contribution to be allocated to the policy owner/takaful participant's unit fund.

The progressive liberalisation of commission limits is being undertaken in parallel with reforms to agency incentives aimed at mitigating risks of mis-selling. In this regard, the first year of implementation of the Balanced Scorecard (BSC) framework which came into effect on 1 January 2018, has shown positive results in contributing to better consumer outcomes. Significant improvements were observed in the sales process, with a comprehensive customer fact-finding process completed in 77% of sales, as compared to only 28% in 2016. This underscores greater care and diligence exercised by agents to properly assess consumers' needs prior to recommending an insurance/takaful product. Policy and certificate persistency has also improved, with a higher share of 73% and 68% of agents meeting or exceeding the persistency targets in the first and second year, respectively (2016: 66% and 61%). In addition, agents were more committed to their professional development, with 85% meeting required Continuous Professional Development (CPD) hours (2016: 72%).

Developments in Medical and Health Insurance and Takaful

As part of efforts to control medical claims inflation which has driven the cost of medical and health insurance/takaful higher in recent years, a Medical Cost Containment Task Force was established by the industry in 2018. The Task Force, which comprises high-level industry representatives and technical experts, will initiate a study on the drivers of medical claims inflation and potential cost containment measures. The study is expected to be published by the third quarter of 2019 and will provide evidence-based analysis to inform future initiatives. The Task Force, in

collaboration with the Association of Private Hospitals Malaysia, will also consider measures to achieve meaningful price transparency for healthcare services that can contribute towards lower costs and enable individuals to make informed decisions about their medical care. This includes making information on the cost of common procedures more readily available to the public and increasing the level of transparency in itemised charges for healthcare services.

Perlindungan Tenang

The *Perlindungan Tenang* initiative launched in November 2017 encourages insurers and takaful operators to offer affordable, accessible and simple products that are targeted to meet the needs of underserved Malaysians, in particular the bottom 40% household income (B40) group. Ten insurers and takaful operators currently offer *Perlindungan Tenang* products.

Life insurance or family takaful products sold under *Perlindungan Tenang* cost between RM5 and RM13 per month in premiums/contributions for sum assured/participated between RM15,000 to RM33,000. Since its launch, over 29,500 policies and certificates have been sold, comprising 28,900 life policies and family takaful certificates and over 600 fire or flood policies and certificates. The announcement in Budget 2019 of a two-year stamp duty exemption for *Perlindungan Tenang* products is expected to further reduce the cost of purchase and encourage higher take-up.

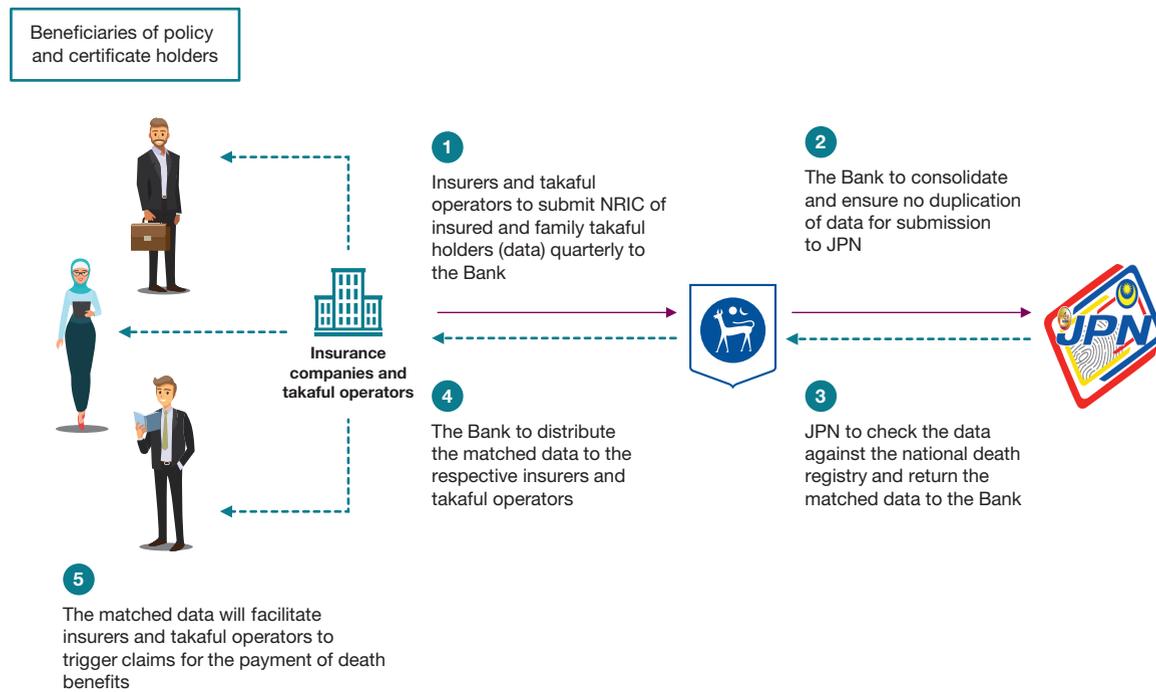
A B40 protection fund was also announced in Budget 2019 to complement the *Perlindungan Tenang* initiative. The fund, which is elaborated in the Box Article 'Expanding Insurance and Takaful Protection for the B40 Population', will enable B40 policy and certificate holders to understand and experience insurance/takaful, and eventually support them to secure protection over the longer term from the insurance/takaful market.

Enhancing claims process through data-checking arrangement with National Registration Department (Jabatan Pendaftaran Negara, JPN)

Based on industry estimates, more than RM300 million in insurance and takaful benefits are unclaimed by beneficiaries due to records that are not updated by policy and certificate holders. To improve the efficiency

Diagram 2.7

Data-checking Arrangements with JPN



Source: Bank Negara Malaysia

of the claims process and to reduce the incidence of unclaimed death benefits among Malaysians, the Bank is finalising arrangements with JPN to facilitate the conduct of periodic checks by insurers and takaful operators against the national death registry (Diagram 2.7). This will enable insurers and takaful operators to pro-actively contact and pay the benefits to the rightful beneficiaries. The arrangement is expected to be operational in 2019.

Promoting regional cooperation in the insurance sector

The Bank hosted the 21st ASEAN Insurance Regulators' Meeting (AIRM) in November 2018. Areas of common interest were discussed, including the development of microinsurance to increase insurance penetration, observance of the revised International Association of Insurance Supervisors (IAIS) Insurance Core Principles, risk financing and management of catastrophe risk and regional capacity-building initiatives supported by the ASEAN Insurance Training and Research Institute. Public-private partnerships

were also recognised as an important way to promote financial resilience against disaster risks and digitalisation in the insurance sector.

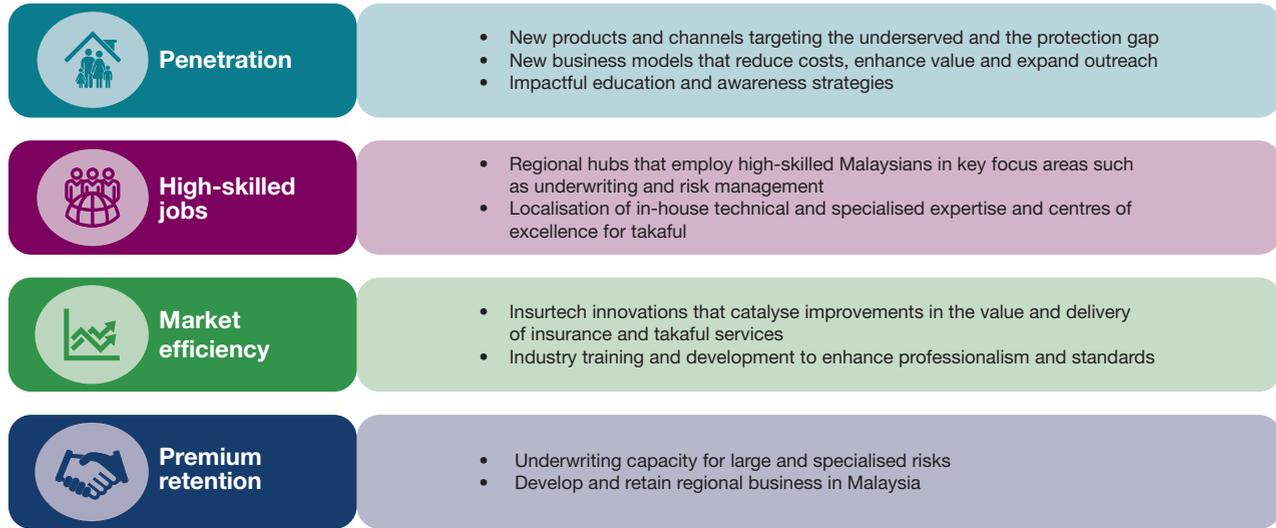
Greater regional insurance integration continued to progress with ASEAN member countries agreeing upon guiding principles for the implementation of the ASEAN Insurance Integration Framework (Framework). As part of Malaysia's commitment to the Framework, Malaysia has liberalised the cross-border supply of marine, aviation and transit (MAT) insurance to allow regional insurers to underwrite MAT insurance of Malaysian risks with the Bank's approval. This would increase the capacity and lower the costs for insurance of MAT risks.

Securing meaningful value propositions for Malaysia

In line with the 'best interest of Malaysia' (BIOM) criteria for shareholding as set out in the FSA and IFSA, the Bank continues to facilitate the commitment and delivery of meaningful value propositions from shareholders that apply to acquire

Diagram 2.8

Priority Development Areas in the Best Interest of Malaysia



Source: Bank Negara Malaysia

substantial interests in insurance companies and takaful operators. As a result of commitments made, insurers and takaful operators have taken steps to establish actuarial and operation hubs, and innovation labs in Malaysia. Moving forward, the Bank is providing more focus to such propositions by identifying priority development areas (Diagram 2.8) and elaborating expectations for commitments to these priorities to be reflected in and aligned with the business and growth strategies set out for operations in Malaysia. This aims to ensure that commitments are translated into long-term economic benefits for the country, and delivered sustainably.

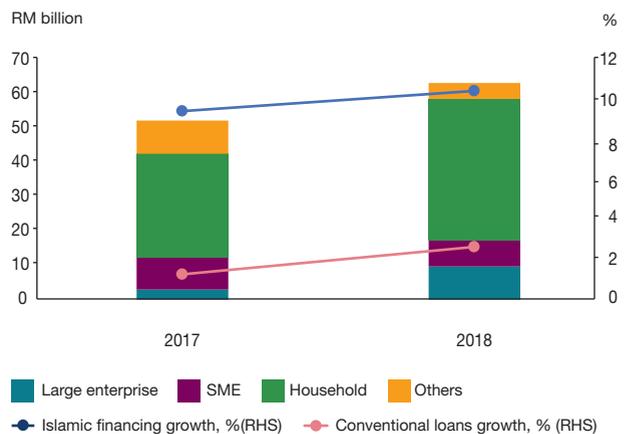
ISLAMIC FINANCE

In 2018, financing by Islamic financial institutions grew by 10.5% to RM668.7 billion (2017: 9.4%) (Chart 2.3). The share of Shariah-compliant financing as a proportion of total banking sector financing increased further to 36.6%, as compared to 34.9% in 2017. This significant growth was partly contributed by the injection of additional Islamic financing assets arising from a merger between an Islamic bank and a non-bank institution in early 2018. Islamic financing to both households and businesses grew by 11.5% and 8.9% respectively, with home financing to households (+5.9%) and financing to large corporates (+4.6%) being the primary contributors to overall financing growth. Growth of business financing to

SMEs moderated to 8.9% (2017: 12.5%), in line with the more moderate growth of the economy. On the funding side, Islamic deposits and investment accounts saw steady growth of 10.2% to RM742.3 billion (2017: 11.7%). Islamic banks' pre-tax profits grew by 14.8% to RM7.7 billion (2017: 19.8%), resulting in returns on equity (ROE) of 15.7% and on asset (ROA) of 1.1% despite higher provisions following the implementation of MFRS 9 for the banking industry. This compares with the ROE of 12.0% and ROA of 1.5% achieved by conventional banks in Malaysia.

Chart 2.3: Growth of Islamic Financing

Islamic financing grew by 10.5% during the year



Source: Bank Negara Malaysia

Strong demand for Shariah-compliant protection solutions sustained the growth of the takaful industry in 2018. The total net contributions of family and general takaful business grew 15.9% to RM9.56 billion (2017: 9.5%), with an increased market share of 16.6% (2017: 15.2%) of total insurance and takaful premiums and contributions. Total assets of takaful funds correspondingly grew by 7.1% to RM31.37 billion (2017: 9.3%).

Both the family and general takaful industry remained highly concentrated in selected business segments. During the year, new family takaful business grew by 13.1% to reach RM 4.91 billion in gross contributions (2017: 10.0%). Mortgage term and investment-linked plans, which accounted for 65.1% of total contributions (2017: 64.6%), continued to drive new business growth. In general takaful, motor and fire products remain dominant, accounting for 82.4% (2017: 80.7%) of business underwritten. Initiatives by takaful operators in the more recent period to diversify into new business lines, including commercial and trade-related risks, have yet to show a significant impact. For the year, gross general takaful contributions increased by 9.0% to RM2.79 billion (2017: 6.3%, RM2.56 billion).

The takaful sector remained profitable, albeit at a lower level. Excess income over outgo of family takaful was RM2.17 billion, a decline of 14.0% from 2017 (2017: RM2.53 billion), due to higher costs and benefit payments to takaful participants. Meanwhile, operating profits of general takaful declined by 33.0% to RM201.8 million (2017: RM301.2 million), on account of increased new business strain as a result of heightened competition in the takaful industry.

Value-based intermediation (VBI) reinforcing the positive impact of Islamic finance

Following its conceptualisation in 2017, the final Strategy Paper on VBI which focuses on strengthening the roles and impact of Islamic finance has since been issued by the Bank and the VBI Community of Practitioners (CoP), an industry group comprising nine Islamic banks. VBI encapsulates the industry's vision for Islamic banks to be more impact-driven, reinforcing the overarching intent of Shariah to promote good and prevent harm. Importantly, VBI is also consistent with global finance initiatives in support of achieving the United Nation's (UN) Sustainable Development Goals (SDG).

Awareness and support for VBI gained momentum during the year. The 6th biennial Global Islamic Finance Forum (GIFF) 2018 organised by the Association of Islamic Banking and Financial Institutions Malaysia (AIBIM) which was themed "Value-based Intermediation – Beyond Profit" culminated in the industry's collective commitment and action plans towards contributing to a sustainable financial ecosystem. During the event, the Bank in collaboration with the industry issued an Implementation Guide for VBI that provided useful insights on value-based banking practices and VBI case studies. In addition, two new tools were published for public consultation to facilitate the operationalisation of VBI – a VBI Financing and Investment Impact Assessment Framework (VBIAF) and the VBI Scorecard. The VBIAF provides guidance on the assessment of financing and investment applications taking into consideration economic, social and environmental impacts, while the VBI Scorecard supports the implementation of impact-based performance measurement frameworks in Islamic financial institutions.

The Bank, in collaboration with the industry issued an Implementation Guide for VBI that provides insights on value-based banking practices and case studies

Islamic banks continued to make progress in driving the VBI agenda through enhanced offerings and strong institutional commitments. The year saw the issuance of the world's first SDG sukuk by a licensed foreign Islamic bank, which references the UN's SDGs for the use of its proceeds. Meanwhile, to support an efficient energy sector, a local banking group has offered preferential financing rates for the purchase of new hybrid vehicles and Green Building Index certified residential properties. Several CoP members have also made global commitments to sustainable finance through their participation in global networks such as the Global Reporting Initiative, Global Alliance for Banking on Values and Principles for Responsible Banking (an initiative by the UN Environment Programme Financial Initiative).¹

¹ UNEPFI is a partnership between United Nations Environment and the global financial sector created in the wake of the 1992 Earth Summit with a mission to promote sustainable finance. More than 230 financial institutions, including banks, insurers, and investors, work with UN Environment to understand today's environmental, social and governance challenges, why they matter to finance, and how to actively participate in addressing them.

The Bank has also been admitted as a plenary member of the Network for Greening the Financial System (the Network) since October 2018. This membership is in line with the increasing focus on promoting sustainable finance and understanding the impact of environmental and social risks on institutional resilience and financial stability more broadly. The Network consists of a group of central banks and supervisors engaged in forward-looking research in the area of environmental and social risks. The Bank's participation will serve to inform Malaysia's regulatory and supervisory response to the management of risks by financial institutions arising from environmental changes.

Moving forward, the Bank and the industry aim to work closely with government agencies, civil societies and the public to increase awareness and encourage more active participation in supporting sustainable financial solutions.

Intensifying Islamic finance support towards growth of halal businesses

Islamic finance is recognised by the Government as a key enabler to support the growth of the halal industry. In 2018, the Islamic finance industry came together to participate in the Malaysia International Halal Showcase (MIHAS). A total of 865 business leads were generated at the event. A profit rate subsidy of 2% has also been earmarked by the Government in the 2019 Budget as part of an RM1 billion SME Shariah-Compliant Financing Scheme to finance halal exporting companies. The scheme will be made available through Islamic financial institutions.

Going forward, the Islamic banking industry is expected to increasingly leverage on the facilities available through the Asian Development Bank (ADB) Trade Finance Programme and Supply Chain Finance Programme to further expand its capacity in financing the halal industry. The programme offers, among others, guarantee facilities which help manage trade financing risks, in particular for trade with higher-risk emerging markets.

Developing talent ecosystem for Islamic finance

Talent development continues to be a key priority, with significant inroads being made to strengthen the talent development ecosystem for Islamic finance.

The Strategic Coordination Committee (SCC)² established by the Bank in September 2017 continues to play an important role in harnessing the complementarities between the existing professional bodies and training providers in Islamic finance, namely the Association of Shariah Advisors in Islamic Finance, the Chartered Institute of Islamic Finance Professionals and the Islamic Banking and Finance Institute Malaysia (IBFIM). A collaborative framework has also been initiated between these institutions to leverage on their combined expertise, experience, and resources to advance the professional development of the Islamic finance workforce.

The Bank has continued to pave the way for greater integration of Islamic finance within the higher education curriculum, particularly through the publication of the Educators' Manuals on Shariah standards and operational requirements. The Bank, in collaboration with the International Council of Islamic Finance Educators (ICIFE), International Shariah Research Academy, and IBFIM, has published the Educators' Manuals on *musyarakah* (profit and loss sharing), *mudarabah* (profit sharing), *tawarruq* (asset purchase on a deferred basis with subsequent sale to third party for cash), *ijarah* (leasing) and revised *murabahah* (cost plus profit). Fourteen universities have since agreed to adopt the Educators' Manual as part of their academic syllabus. A series of training programmes on the manuals were also conducted for faculty members. In 2019, two additional Educators' Manuals will be developed, namely on *istisna'* (construction or manufacturing) and *qard* (loan).

A key milestone for the International Centre for Education in Islamic Finance (INCEIF) during the year was the award of the prestigious accreditation by the Association to Advance Collegiate Schools of Business (AACSB) International, placing INCEIF's academic programmes among a select 5% of business programmes in the world that are AACSB-accredited. The AACSB accreditation recognises institutions that demonstrate a focus on

² Comprises representatives from the Bank and heads of the Islamic finance talent affiliates institutions i.e. INCEIF, International Shariah Research Academy (ISRA), IBFIM, Association of Shariah Advisors in Islamic Finance (ASAS) and Chartered Institute of Islamic Finance Professionals (CIIF). The Committee was established in 2017 to develop strategies to raise the quality and range of talent offerings available to meet the needs of the Islamic financial sector, and to address overlaps to maximise operating and financial synergies across the Islamic finance talent affiliates institutions.

excellence in all areas, including teaching, research, curriculum development and student learning. The achievement reinforces INCEIF's important role and impact in building a high-quality talent pool for Islamic finance industries across the globe.

MONEY SERVICES BUSINESS (MSB)

During the year, outward remittances grew significantly by 23.3% to RM40.64 billion (2017: RM33 billion). The increased offering and use of digital MSB services continued to accelerate the migration of remittances to formal channels. It is estimated that over RM900 million of total remittances recorded were transactions previously conducted through informal channels, compared with an estimated RM500 million in 2017.

Reflecting the increasing adoption of technology within the sector, there were more service providers offering electronic remittance (e-remittance) in 2018, with 20 companies (2017: 17) offering mobile and web-based remittance services catering to both retail and corporate customers. Several providers have also introduced e-remittance for the purpose of trade payments. Following regulatory changes in November 2017 to allow qualified remittance providers to conduct eKYC when on-boarding new individual customers, three e-remittance providers obtained the Bank's approval during the year to implement eKYC processes. The effective use of regulatory technology to conduct eKYC enables remittance service providers to authenticate identity documents and perform facial recognition of customers remotely, with the ultimate aim of achieving outcomes that are comparable or superior to face-to-face procedures. This has had a significant impact in encouraging the wider use of formal remittance channels, by reducing the costs of conducting customer due diligence (CDD) and improving access in locations where remittance service providers do not have a physical presence. On average, the cost of e-remittance transactions was 2.1% in 2018, lower than the average cost for over-the-counter remittance transactions of 2.9%.

During the year, the retail currency exchange business recorded a turnover of RM79.4 billion (2017: RM79.2 billion). This was supported mainly by sustained demand for common currencies such as the Singapore dollar, US dollar, Chinese Renminbi and regional currencies from both

inbound and outbound travellers. In the wholesale segment, a lower turnover of RM13.5 billion was recorded in 2018 (2017: RM15.5 billion), as more currency exchange providers sourced and cleared foreign currencies through banks and other retail currency exchangers.

Beyond improving access and efficiency, e-remittance has helped to reduce transaction costs for customers

Digitalisation has also gained traction in the currency exchange segment with the introduction of the multi-currency electronic wallet. This innovative product enables customers to exchange and make payments in various currencies electronically, eliminating the need to carry physical foreign currencies.

The MSB Advisor aggregator mobile application introduced in 2017 by the Malaysian Association of MSB further promotes the use of authorised MSB channels. The application enables customers to electronically search for the best deals, locate the nearest authorised MSB operators and review their services, providing greater convenience to consumers both before and after using an MSB service. Consumers can also use the application to report illegal MSB activities to the Bank.

Outreach to promote formal MSB channels

The Bank continues to direct efforts toward educating the public on the importance of dealing only with authorised service providers and the risks of using informal channels. During the year, the Bank took Project Greenback 2.0 to its second Malaysian champion city, Kota Kinabalu (GBKK). The two-year GBKK builds on the success of the first Project Greenback 2.0 in Johor Bahru, and continues the close collaboration between the Bank and the World Bank. Initiatives implemented under the GBKK centred on educating foreign workers on identifying formal MSB channels and promoting the use of e-remittance solutions among individuals and businesses on a wider scale.

Over the course of 10 outreach programmes that were conducted from March until December 2018, GBKK reached out to more than 9,000 people covering both foreign and domestic workers. Under the GBKK, more than 2,400 new users signed up for e-remittance services, with the total transaction value

Project Greenback 2.0

Project Greenback 2.0 (Greenback 2.0) is an initiative developed by the World Bank aimed at increasing the efficiency and transparency in the remittance market through the use of innovative approaches. Greenback 2.0 also supports the implementation of the SDG, developed by the United Nations, to achieve the reduction of remittance costs and eradication of poverty. This includes cooperation between migrant communities, remittance industry players and public authorities to promote financial education focusing on remittance services and targeting migrant workers. The initiative was launched in 2011 in selected cities (Remittance Champion Cities) starting with Turin (Italy) and Montreuil (France). In Malaysia, the project has been rolled out in two cities: Johor Bahru (in 2015 as the first Remittance Champion City in Asia) and Kota Kinabalu (in 2018), through a collaborative effort between the World Bank and the Bank, with support from the industry players, government agencies, businesses and foreign worker communities.

in Kota Kinabalu increasing to RM12.2 million for the period March to December 2018 (49% higher than the value recorded over the same period in 2017). Greater competition and increased efficiency in the provision of remittance services have also significantly reduced the cost of remittance transactions in Kota Kinabalu to 2.4% for the period March to December 2018 (2017: 4.5%). In other parts of Malaysia, similar outreach programmes have also been carried out in areas with a significant presence of foreign workers and SMEs.

Fostering international partnerships

During the year, the Bank collaborated with the International Fund for Agricultural Development and the World Bank to jointly organise the first Asia-Pacific regional Global Forum on Remittances, Investment and Development (GFRID) 2018 in Kuala Lumpur. The GFRID was attended by over 400 practitioners from public and private sectors across 50 countries to share best practices and build partnerships in maximising the development impact of remittances. The event culminated in the identification of specific actionable outcomes directly linked to the UN's 2030 Agenda for Sustainable Development and its SDGs. These include: (i) strengthening the collection, analysis and application of remittance-related data to foster effective policies on remittance and consumer empowerment; (ii) promoting regulatory harmonisation in the region to encourage innovation and increase market efficiency, while safeguarding the integrity of remittance services; and (iii) leveraging on remittance to advance the financial inclusion agenda. Such outcomes are envisaged to foster greater collaboration among authorities and the MSB industry to increase the development impact of remittance services in supporting sustainable development and inclusive growth in the region.

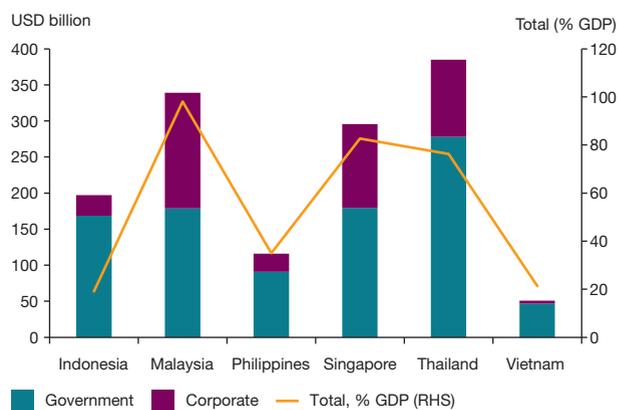
FINANCIAL MARKETS

In 2018, the Malaysian bond market continued to remain an important source of financing for both the public and corporate sector, retaining its position as one of the largest markets in Southeast Asia (Chart 2.4). Outstanding government and corporate bonds grew by 8.8% to RM1.4 trillion in 2018, which represents 51.7% and 46.7% of GDP, respectively (2017: RM1.3 trillion, government: 49.7% of GDP; corporate: 45.7% of GDP). Sukuk, at 60.1% of total outstanding debt securities (2017: 58.8%), continued to dominate issuances (Chart 2.5).

Various external developments during the year including the normalisation of monetary policy by the Federal Reserve and global volatility triggered by the US-China trade tensions contributed to a global risk-off sentiment, which saw portfolio outflows from emerging markets including Malaysia.

Chart 2.4: ASEAN Outstanding Local Currency Debt Securities Market

The Malaysian debt securities market continues to stand as one of the largest in ASEAN



Source: Asian Bonds Online

Chart 2.5: Outstanding Debt Securities and Sukuk (Government and Corporate)

Sukuk dominates total outstanding debt securities



Source: Bank Negara Malaysia

Nevertheless, the depth of the debt securities market continued to support orderly market conditions. This was underpinned by strong financial institutions and domestic institutional investors, as reflected in continued active secondary trading in the government securities market which recorded a turnover of RM1.2 trillion in 2018.

Bond yields remained stable amid strong demand for Malaysian Government Securities (MGS) and Malaysian Government Investment Issues (MGII). The average bid-to-cover ratio recorded in 2018 was 2.293 times (2017: 2.198 times), with active participation from mainly banking institutions, insurance companies and domestic institutional investors.

Bond yields remained stable while demand for MGS and MGII remained strong, reflecting active participation from mainly banking institutions, insurance companies and institutional investors

The share of non-resident holdings of Malaysian government bonds declined from 27.7% to 22.7% as of December 2018, with the composition of stable investors such as other central banks, pension funds and insurance companies increasing relative to short-term investors. Stable investors represent more than half of non-resident holdings of Malaysian government bonds at 52%, lending greater resilience to the domestic bond markets.

In contrast with the more bullish performance in 2017, the ringgit depreciated by 1.8% against the dollar to close at RM4.1385 in 2018 on broad US dollar strength (Chart 2.6). Downside risks for the ringgit were mitigated by Malaysia's continued current account surplus of the balance of payments and sound economic fundamentals.

The implementation of several financial market development initiatives in 2016 has helped to bolster the domestic market's resilience to shocks. Ringgit volatility increased marginally to 4.6% (Chart 2.7), largely due to the combination of domestic election outcomes, global external headwinds and oil price volatility during the year. In the foreign exchange (FX) market, bid-ask spreads for USD/RM remained stable at 24 pips on average for 2018 (2016 and 2017 average: 35 pips), supported by sufficient domestic market liquidity.

Measures to manage the spillover from the USD/RM non-deliverable forwards (NDF) market complemented by the further development of the onshore FX derivatives market had helped to stabilise the onshore rates despite the volatile capital flows experienced by emerging markets. Speculative transactions on the ringgit subsided with a significant decline recorded in the daily average NDF volume, while the volume of domestic spot and forward contracts had risen with the daily onshore forward turnover increasing by more than one-third compared to 2017 (Chart 2.8). Greater flexibility accorded to fund managers to dynamically manage their FX risk and hedge their positions further supported the development of the onshore

Chart 2.6: Ringgit Exchange Rate against the US dollar

Ringgit depreciated 1.8% against the US dollar in 2018



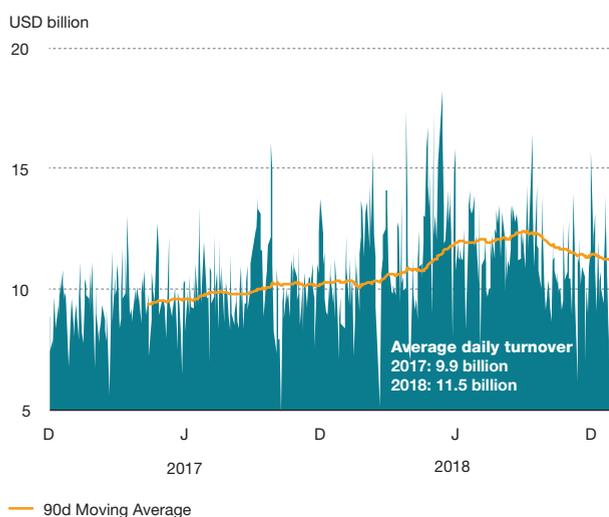
Source: Bank Negara Malaysia

Chart 2.7: Onshore USD/RM One-Month Implied Volatility

Ringgit volatility remained stable throughout 2018

Source: Bank Negara Malaysia

Chart 2.8: Daily FX Turnover

Average daily turnover in the onshore market increased in 2018

Source: Bloomberg

FX market. As at end-2018, more than 80 fund managers had registered with the Bank for dynamic hedging flexibilities, with total eligible assets exceeding RM120 billion.

The progressive liberalisation of foreign exchange administration (FEA) policies over the years has contributed to the greater decentralisation of reserves which are held by corporates and financial institutions, thus enabling external obligations to be met without creating claims on the Bank's

international reserves. As at end-2018, the international reserves stood at USD101.4 billion, which is sufficient to finance up to 7.4 months of retained imports and is 1.0 time the short-term external debt.

Enhancement of FEA policies

On 17 August 2018, the Bank announced further changes to the FEA policies aimed at improving operational efficiencies and facilitating risk management by businesses and financial institutions, while at the same time preserving financial stability in times of greater global uncertainty.

Enhancing financial markets' transparency and efficiency

In May 2018, the Bank implemented requirements to provide greater transparency on the beneficial ownership of debt securities through segregated account structures maintained in RENTAS. Compliance, which must be observed at the investment execution level, is mandatory for all resident and non-resident investors in RENTAS debt securities. The operationalisation of this initiative is also in line with global developments, notably the adoption of the Legal Entity Identifier as a unique identifier for the maintenance of accounts.

Enhancements were also undertaken to the Ringgit Operations and Monitoring System operated by the Bank to strengthen its surveillance of the FX market. This system facilitates reporting by all licensed onshore banks of their FX transactions and positions on a daily basis to the Bank for the purpose of monitoring market conditions. The enhancements support more effective near-time surveillance by the Bank of FX conversions and flows.

In line with greater digitalisation in the financial sector, the Bank is also working towards the creation of a framework for electronic trading platforms, which will detail the form of establishment and other requirements to be complied with by platform providers. This is envisaged to improve market efficiency and productivity, whilst supporting client diversity through enhanced access provided for wholesale market participants. An Exposure Draft is expected to be published in the first half of 2019.

Enhancements to FEA policies in August 2018:

i. Greater flexibility in the management of export proceeds

Exporters are allowed to automatically sweep export proceeds into their Trade Foreign Currency Accounts maintained with onshore banks to meet up to six months' foreign currency obligations without the need to first convert proceeds into ringgit. The flexibility is available upon exporters establishing their six months' foreign currency obligations with their respective onshore banks.

ii. Flexible hedging of foreign currency obligations

Greater flexibility is provided, upon application to the Bank, for residents to hedge:

- foreign currency obligations beyond six months (i.e. for current account obligations and foreign currency loan repayments); and
- foreign currency exposures arising from invoices issued in foreign currency under international pricing practices for domestic trade in goods and services.

iii. Wider access for non-residents to the onshore financial market

Non-resident corporations are now allowed to trade in ringgit-denominated interest rate derivatives via the Appointed Overseas Offices, subject to back-to-back arrangements with onshore banks. This aims to further deepen the onshore market for interest rate derivatives to support risk management activities by businesses.

Understanding Financing through the Lens of Small and Medium Enterprises (SMEs)

By Karunajothi Kandasamy, Samuel Lee and Ng Shyue Jer

Introduction

Small and medium enterprises (SMEs)¹ play a critical role in generating income, employment, innovation, and facilitating social cohesion. With about one million establishments² in the country, SMEs contribute 37.1% of the Malaysian GDP, 66% of employment and 17.3% of exports.³ The positive linkage between entrepreneurship and growth is well established⁴, but a growing body of research focusing on the importance of finance in supporting SME development shows that firms with access to loans grow at a faster rate than those without such access.⁵

As part of the Bank's functions to promote a sound, progressive and inclusive financial sector, efforts have been directed towards developing a holistic SME financing ecosystem. This includes addressing information asymmetry and market imperfections, which are key barriers to finance. There have been significant strides made in the areas of credit information; credit guarantees; specialised funds; advisory services; redress and debt resolution arrangements. Financing to SMEs now constitute 48.7% of total financing outstanding by financial institutions to businesses (2010: 37.6%) and 17.5% of total financing outstanding (2010: 14.4%).

In 2018, as part of ongoing efforts by the Bank to promote continued access to financing for SMEs, a demand-side SME Finance Survey (the Survey) was conducted to obtain a better understanding of the financing needs and behaviour of SMEs. This article presents the Survey findings, which provide insights on the following:

1. Key characteristics and financing behaviour of Malaysian SMEs;
2. Underlying challenges in financing; and
3. Policy implications moving forward.

Survey Scope and Methodology

A total of 1,529 formal⁶ SME businesses participated in the Survey, which covered firm and entrepreneur characteristics, business performance and challenges, as well as access to finance and usage of financial services. A stratified sampling approach was deployed to ensure representativeness of the national distribution. In addition, a sample of 223 informal businesses was also surveyed to understand their unique financing needs and concerns.

Profile of SMEs

The majority of Malaysian SMEs are microenterprises (77%) and the bulk of these businesses are concentrated in the services sector (89%).⁷ In terms of legal set-up, SMEs mostly operate as sole proprietors (61%, Diagram 1).

Insights from the Survey Findings

1. Key Characteristics and Financing Behaviour of Malaysian SMEs

The Survey showed that more than 90% of the SMEs served the domestic market, with 7% exporting their products and services. About 83% of SMEs reported utilising Information and Communications Technology (ICT) in their business operations (Diagram 2), with 22% that have their own website and 14% that operate online stores. More than half of the respondents (53%) used professional services including auditors, accountants or financial advisors to manage their financial accounts.

¹ Includes microenterprises.

² Based on the 2018 estimates by the Department of Statistics, Malaysia.

³ 2017 data on GDP, employment and exports sourced from the Department of Statistics, Malaysia.

⁴ Beck, Demiurgic-Kunt, Levine, 2005. SMEs, Growth and Poverty, National Bureau of Economic Research (NBER) working paper series.

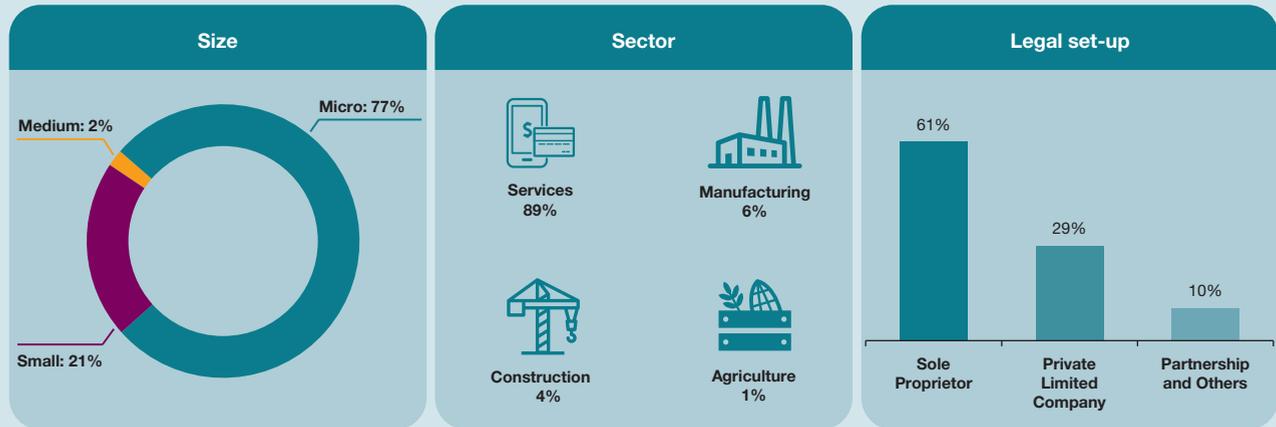
⁵ Ayyagari, Juarros, et al. 2016. Access to Finance and Job Creation; Firm Level Evidence across Developing Countries, World Bank Group.

⁶ Registered with the Companies Commission of Malaysia (SSM).

⁷ Based on the 2016 Economic Census, Department of Statistics, Malaysia.

Diagram 1

Profile of SMEs by Size, Sector and Legal Set-up



Source: Department of Statistics, Malaysia

Diagram 2

Characteristics of Malaysian SMEs

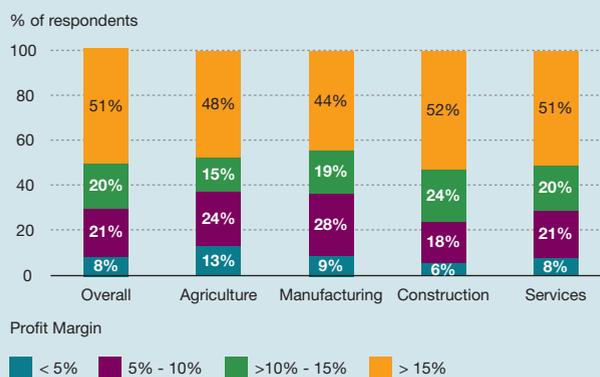


* Less than 3 years in operation

Source: Bank Negara Malaysia

Despite the challenging business environment in the first quarter of 2018, a majority of SMEs (71%) recorded profit margins of above 10% (Chart 1) and were able to maintain positive cash flows. Manufacturing firms reported higher levels of productivity and paid higher wages for new graduate hires compared to other sectors.

Chart 1: Profit Margin of SMEs by Sector

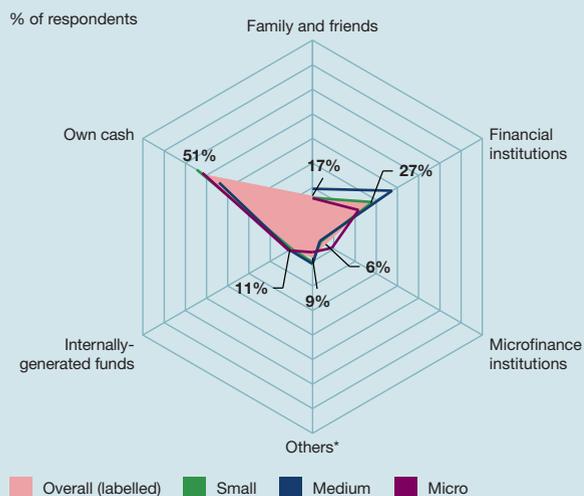


Source: Bank Negara Malaysia

On financing, respondents reported utilising funds from a variety of sources, both internal and external, with own cash contributions being the main source. Among other funding sources, about 27% of the respondents had facilities with financial institutions, followed by family and friends, internally-generated funds and microfinance institutions (Chart 2). In the microenterprise segment, 22% had financing facilities with financial institutions, including 9% of respondents who secured financing under the *Pembiayaan Mikro*⁸ facility.

Sources of financing also vary through the business lifecycle. At the initial stage, young firms tend to rely on their own cash and informal sources such as family and friends. This is consistent with most research findings, which attribute such behaviour typical of young firms to information opacity; lack of collateral, track record and financial skills; as well as high transactional costs.⁹ As businesses mature (typically after five years in operation), they tend to rely more on external financing in the form of both debt and equity, including bank financing (Chart 3).

Chart 2: Sources of Financing by Firm Size

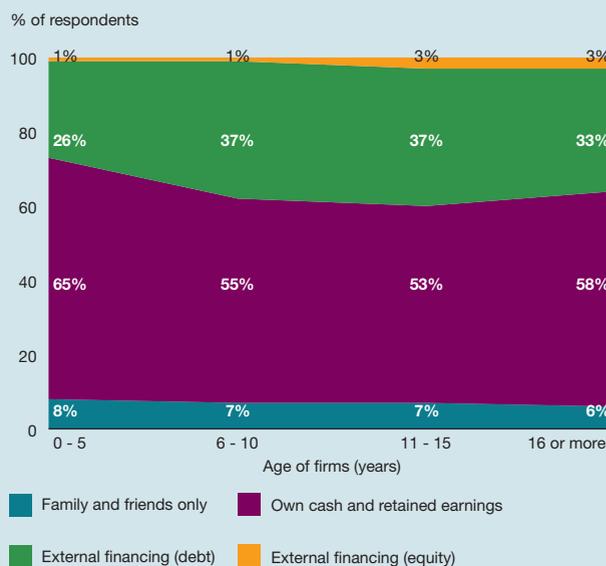


* Others include alternative finance and Government grants

Note: Figures labelled refer to % of total firms. Firms can provide multiple answers

Source: Bank Negara Malaysia

Chart 3: Sources of Financing by Age of Firms



Source: Bank Negara Malaysia

Among the SMEs that had applied for financing, most indicated that they were able to secure financing. About 22% of the respondents had applied for financing in the six months prior to the Survey, with the majority (94%) of their applications being approved.

- About 13% applied to financial institutions with 91% of their total financing applications approved, while the remaining 9% applied to other sources,¹⁰ with a 99% approval rate.
- Women-owned firms reported higher demand for financing (33% of women-owned firms applied versus 22% for all respondents), but experienced a lower approval rate of 83% (overall: 94%) mainly due to the lack of track record and insufficient documentation. Most of these firms obtained unsecured financing from microfinance institutions, banking institutions and development financial institutions.
- About 44% of the respondents were first-time borrowers.
- The main purposes of the financing applications were for the purchase of assets (building, property, machinery and equipment: 23%), working capital (22%) and starting a new business (19%).
- On average, the majority of the applications (89%) was approved within one month and the funds were disbursed within the subsequent month (87%).

⁸ A specialised microfinance scheme that is non-collateralised for business financing of up to RM50,000.

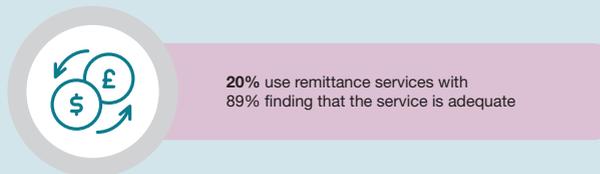
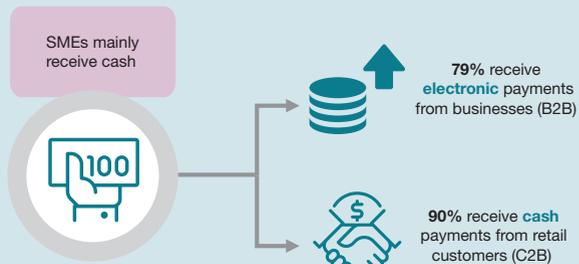
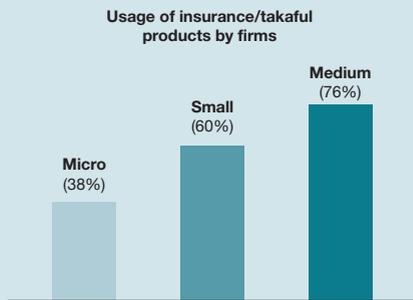
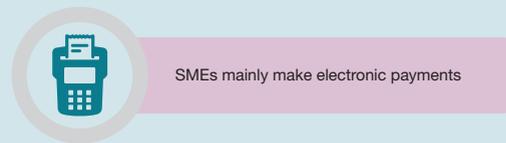
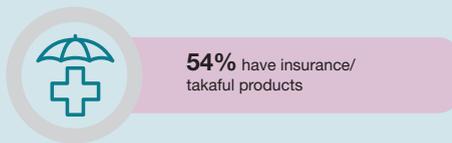
⁹ Berger, Udell, 1998. *The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle*; Organisation for Economic Co-operation and Development (OECD), 2015. *New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments*.

¹⁰ The main providers of other sources were Amanah Ikhtiar Malaysia (AIM) and TEKUN.

The Survey also provided insights on SMEs' usage of other financial services, such as insurance, takaful and e-payments (Diagram 3). More than half of the respondents have insurance or takaful products, although this was less prevalent among microenterprises. While the current take-up has been low, potential future demand for insurance and takaful by SMEs is significant for all products across the board, with emerging interest particularly in securing protection for risks associated with cyber security, professional indemnity, payment default and damages in crops. SMEs mainly made electronic payments, but preferred cash in receiving payments from customers. It was also observed that cheques remained popular for payments to suppliers and other B2B (business to business) transactions.

Diagram 3

SMEs' Usage of Other Financial Services



Note: Firms can provide multiple answers

Source: Bank Negara Malaysia

2. Underlying Challenges in Financing

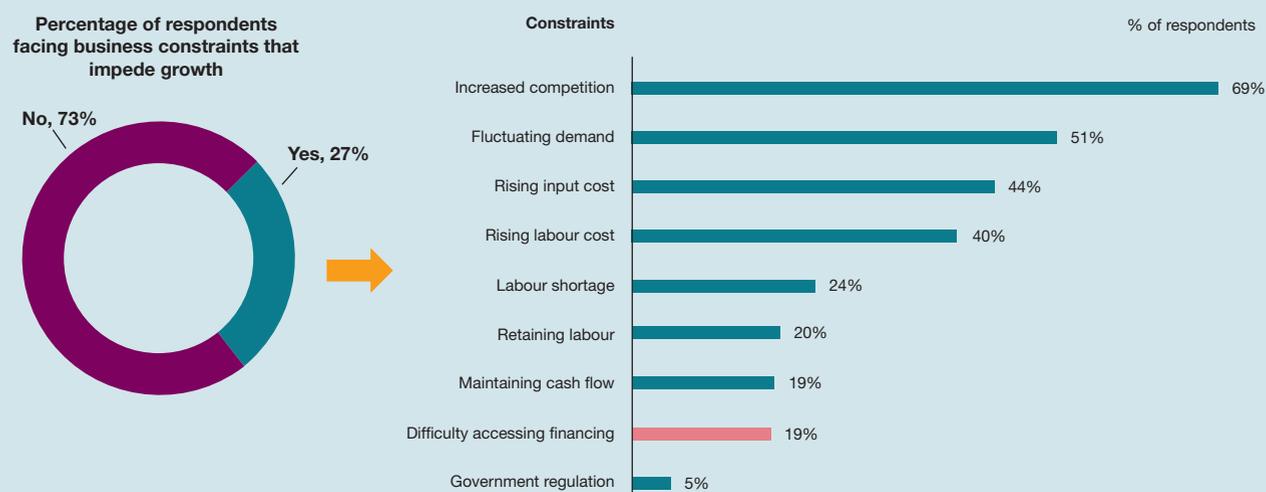
a) Financing barriers mainly relate to documentation, costs and business viability

Among the key constraints to business growth, difficulty in accessing sufficient financing was ranked low, second to last out of the nine constraints identified by SMEs (Chart 4). Nevertheless, the findings from the Survey revealed some financing barriers faced by SMEs:

- SMEs that experienced rejections of their financing applications cited insufficient documentation, insufficient cash flow to meet repayments and non-viable business plans as the main reasons for rejection.
- SMEs involved in automation, innovation, manufactures of goods, and exports experienced higher rejection rates compared to the overall SMEs (Chart 5). Firms that automated stated insufficient collateral and projects perceived to be of higher risk as key reasons for rejection. The rejected applications were mainly for the purchase of machinery and equipment and ICT tools, as well as undertaking research and development (R&D). These projects could be deemed to be higher risk as they may involve moveable and intangible assets with low salvage value in the event of commercial failure, and involve the use of new and untested processes with high uncertainty on returns.¹¹ Innovative firms cited insufficient documentation as a key factor for rejection. Exporting and manufacturing firms that faced greater difficulty obtaining financing were mainly firms that were newly established with limited repayment track records.
- Businesses that needed financing but did not apply (41%) were either cautious in taking on debt, unsure of their repayment capacity, or found the application process too difficult.
- About 46% of the respondents stated that the financing products offered by financial institutions did not meet their business needs due to high financing costs (50%), insufficient financing amount (42%) and onerous documentation requirements (29%). The average financing rate that respondents were willing to pay was 3.88%, well below the average lending rates to SMEs of 6.18% at the time of the Survey (second quarter 2018).

The challenges raised by businesses in the Survey point to opportunities for improvements in the on-boarding process of financial institutions (including documentation requirements) and financial management capabilities of SMEs to enhance their creditworthiness. New approaches to credit assessments by leveraging on technology and big data also present opportunities to increase access to financing for SMEs.

Chart 4: Business Constraints Faced by SMEs

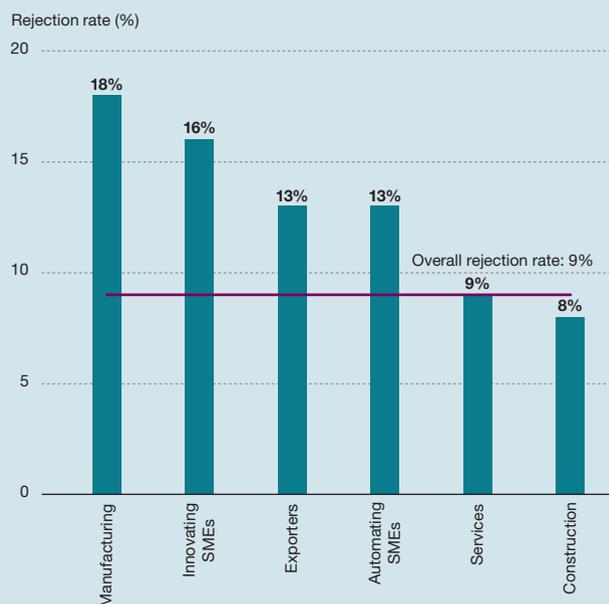


Note: Firms can provide multiple answers

Source: Bank Negara Malaysia

¹¹ OECD, 2004. Financing Innovative SMEs in a Global Economy.

Chart 5: Rejection Rate of Financial Institutions for Key Segments



Source: Bank Negara Malaysia

b) Funding is the most sought after form of government assistance

The Survey indicated that the main constraints to SME growth were factors associated with operating and business conditions, namely increasing competition (69% of respondents), fluctuating demand (51%), rising input costs (44%) and rising labour costs (40%). However, when asked which form of government assistance would be most useful, financial assistance (e.g. grants, soft loans, guarantees) was consistently preferred by a significant majority of SMEs as being most useful (Chart 6). This could suggest that SMEs lacked awareness on other forms of government assistance which could be better suited to address specific challenges faced, including capacity building support, regulatory responses or access to new markets.

Findings from the Survey further suggest that certain factors such as the level of education, membership in trade associations, and ICT usage are positively linked with higher awareness (Chart 7). These factors can be leveraged upon in the development of future awareness programmes to ensure more effective outreach.

c) Higher demand for financing for automation and technology

About 19% of the respondents indicated that they have automated their operations, 15% actively leveraged on technology to innovate or introduced new products and processes, while some 17% (especially medium-sized firms) were preparing for Industry 4.0.¹² Businesses that had automated their operations (mainly in the wholesale trade, computer and IT-related services, and machinery and engineering equipment manufacturing) reported higher revenue per worker on average by about 90%, compared to those that did not automate. The move to automate therefore holds significant potential for enhancing the growth and contribution of SMEs to the economy, for which financing will be a key enabler.

Firms using technology¹³ generally had higher demand for financing compared to the overall respondents (Chart 8), but also faced higher rejection rates. In particular, for automating firms the purpose of financing was mainly to

¹² Industry 4.0 or Fourth Industrial Revolution is a name given to the current trend of automation and data exchange in manufacturing technologies. It includes amongst others cyberphysical systems, the Internet of things, cloud computing, cognitive computing, big data and autonomous robot.

¹³ Refers to firms that automate and enhance productivity as well as innovate.

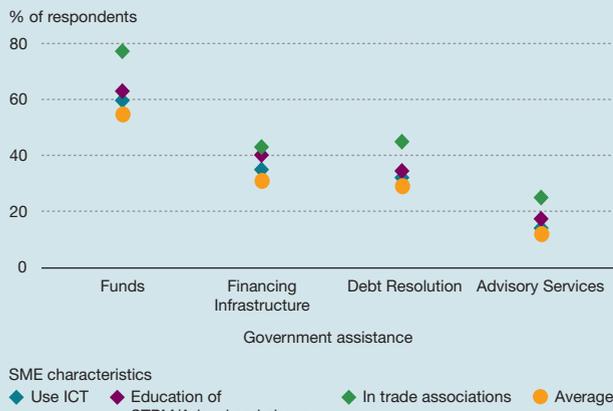
Chart 6: Government Assistance Deemed Most Useful by SMEs versus the Key Constraints Faced



Note: Firms can provide multiple answers
Source: Bank Negara Malaysia

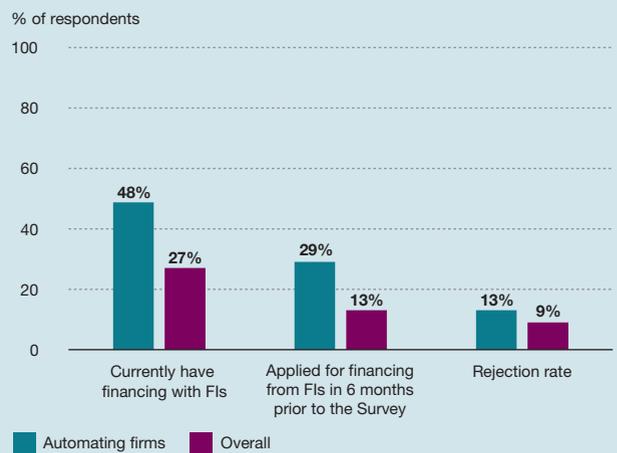
purchase machinery and equipment and ICT tools including hardware and software, as well as to undertake R&D activities. Such financing can involve higher risks associated with uncertain values and security attached to intangible or movable assets, including their ability to generate cash flows, hence resulting in the higher rejection rate. A further reason may be a lack of customised products in the market for financing automation due to inadequate experience in evaluating innovative technologies and pricing the associated risks.¹⁴

Chart 7: SME Awareness on Government Assistance



Note: Firms can provide multiple answers
Source: Bank Negara Malaysia

Chart 8: Financing Behaviour of Automating Firms



Source: Bank Negara Malaysia

¹⁴ Shroder, 2017. The Challenges of Industry 4.0 for Small and Medium-sized Enterprises.

At the same time, the Survey revealed that automating firms were open and willing to share information with financial service providers. They also have higher ownership of assets (three times higher than those not automating). Therefore there are opportunities to better understand the distinct profile and financing needs of automating firms, enhance and customise product offerings for automation, as well as review collateral policies and the supporting infrastructure to tap into movable assets and intangibles as acceptable collateral.

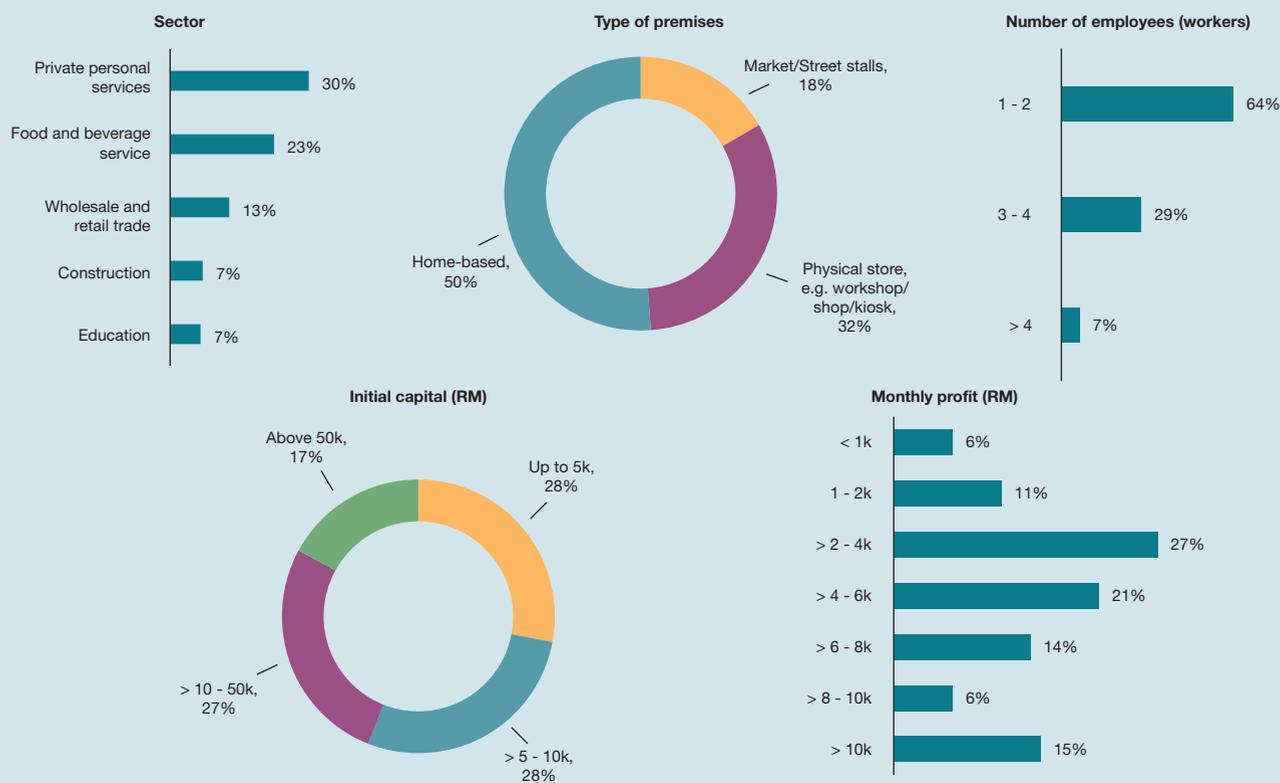
d) Persistence of informal businesses further limits access to finance

The Survey also revealed that unregistered firms¹⁵ generally recorded higher profitability averaging at 17.7%, compared to 16.1% by formal SMEs. These firms rely heavily on funds from family and friends and own cash at the initial stage, and continue to depend on family and friends, and internally-generated funds even as their business expands, with low access to external financing. The lack of access to critical resources and assistance could limit their scope for growth.¹⁶

Only 6% of the owners of unregistered firms indicated that they intended to formalise their business in the next two years. The World Bank Enterprise Surveys indicated that common reasons for firms not registering include the lack of information on how to register, time taken to register, taxes to be paid, and the lack of perceived benefits from formalisation. Other studies have also highlighted high entry costs, strict labour regulations, lack of access to resources and a complicated registration process as being deterrents to formalisation.¹⁷ These factors, potentially also relevant in the case of Malaysia, could be further examined through future surveys to encourage greater formalisation of businesses.

Diagram 4

Key Characteristics of Informal SMEs



Note: As % of respondents, k denotes thousand

Source: Bank Negara Malaysia

¹⁵ Businesses not registered with the Companies Commission of Malaysia (SSM). However, 36% of these firms have been registered with other authorities such as local authorities, ministries, societies and associations.

¹⁶ International Finance Corporation (IFC), 2013. Closing the Credit Gap for Formal and Informal Micro, Small, and Medium Enterprises.

¹⁷ Ibid.

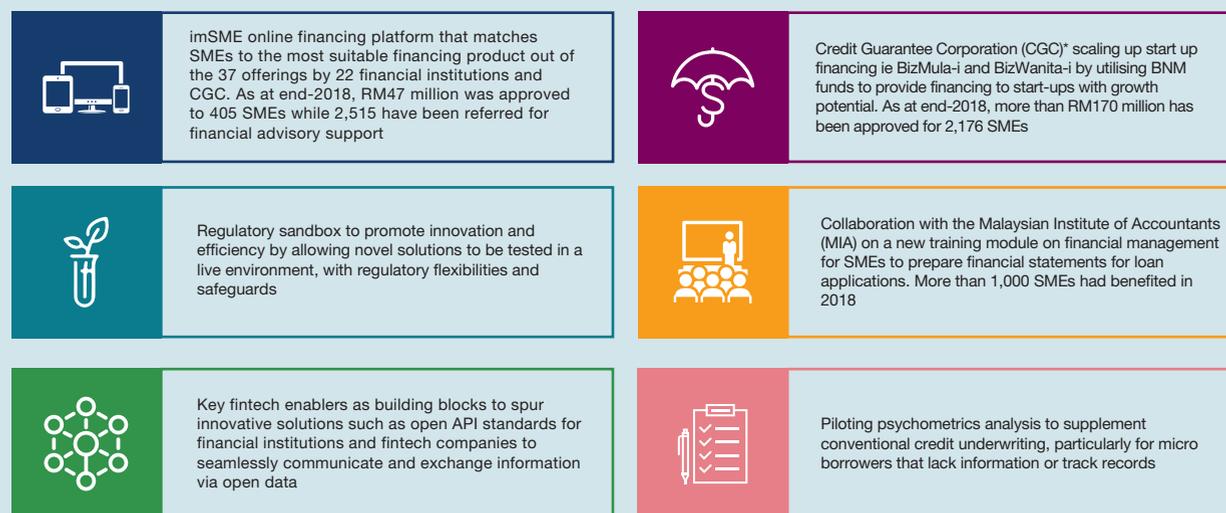
3. Policy Implications

The Survey findings affirm that existing policy priorities, which are directed at encouraging greater innovation by financial institutions, enhancing the efficiency of financing processes, credit enhancement products for SMEs and strengthening the financial management capabilities of SMEs remain relevant in light of barriers to financing that still exist among pockets of SMEs. Recent initiatives by the Bank in collaboration with key stakeholders are described in Diagram 5. In addition, areas for further development to address new and emerging needs of SMEs for financing include:

- a) Establishment of a secured transaction framework:** The on-going effort to establish a modern and unified movable property security interest legislation, and a centralised collateral registry for movable assets in Malaysia marks an important step in improving the infrastructure for access to finance particularly for SMEs. Currently, unincorporated firms that make up close to 70% of SMEs do not have a legal framework to use movable assets as collateral. The new framework would broaden the range of assets that SMEs can use to borrow (e.g. machinery and equipment, intellectual property, inventories, agriculture products) in addition to more conventional collateral in the form of building or property.¹⁸ A World Bank study¹⁹ has shown that secured transactions increased access to bank finance by 8 percentage points and lowered the cost of financing by 3 percentage points.
- b) Formalisation to enhance access to finance:** Given that the informal segment is estimated to account for about 29.6% of Gross National Income in Malaysia,²⁰ well designed incentives for businesses to formalise will further expand access to financing for such businesses to grow. This should be accompanied by measures to identify and address the key reasons for businesses choosing not to formalise. Impact studies²¹ in other countries have shown that just addressing business registration processes and costs alone proved to have little effect on encouraging firms to formalise, but when combined with monetary incentives (e.g. grants) or market access opportunities (e.g. criteria to bid for public procurements), they provide stronger inducements for firms to register.

Diagram 5

Recent Initiatives to Enhance SME Financing



* CGC Malaysia assists marginal but potentially viable SMEs, particularly those with inadequate collateral and track record to obtain financing from financial institutions, via guarantee schemes.

Source: Bank Negara Malaysia

¹⁸ Statistics from United Nations Commission on International Trade Law (UNCITRAL) indicated that 78% of capital stock worldwide is in movable assets.

¹⁹ Across 73 countries in 2013.

²⁰ Estimate by Friedrich Schneider in 2012 in 'The Shadow Economy and the Work in the Shadow: What Do We (Not) Know?'

²¹ IFC, 2013. Closing the Credit Gap for Formal and Informal Micro, Small, and Medium Enterprises.

Studies²² have also shown that access to benefits such as social protection schemes, commercial finance services and business development services as well as facilitative tax administration (increasing the threshold for taxation) have contributed to the formalisation of firms. Such incentives should be balanced with better enforcement, which may include stiffer penalties for non-compliance with business regulations, to reap the full benefits of policy interventions.

c) Promote alternative finance: A well-diversified financial landscape is necessary for SMEs to have access to a wide range of financing options best suited to meet their specific needs and for different stages of their business life-cycle. Moving forward, alternative finance is expected to play a bigger role in complementing bank financing to bridge the “financing gap” in catering to firms that are ill-suited to financing by deposit-funded banks. Amongst these include technology-based start-ups and innovative firms. High asymmetries in information and sparse financial information, reliance on intangibles, high uncertainty on returns, as well as informal governance and management arrangements that tend to be characteristics of such firms, especially in their early stages, pose particular challenges to traditional bank lending, and can disproportionately increase the risk of losses to depositors.²³ Currently, alternative finance, which includes venture capital, equity crowdfunding, angel investments, leasing, factoring and peer-to-peer financing, accounts for less than 3%²⁴ of total SME financing in Malaysia and is fragmented with numerous players. A more holistic approach to its development with greater coordination among relevant authorities would serve to build an enabling ecosystem with appropriate regulations, incentive systems and supporting infrastructure to foster and accelerate the growth of alternative finance in supporting SMEs.

²² International Labour Organisation (ILO), 2016. Policies, Strategies and Practices for the Formalisation of Micro and Small Enterprises.

²³ OECD, 2016. New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments; Bravo-Biosca, 2013. Access to Finance for Innovation: Rationales and Risk of Public Intervention.

²⁴ Compiled from data sourced from Bank Negara Malaysia, Securities Commission, SME Corporation Malaysia and various authorities. In comparison, alternative finance accounts for over 20% share of SME finance in the United States.

Expanding Insurance and Takaful Protection for the B40 Population

By Liung Miao Shan and Siti Nur Shuhada Nor Baharin

This box article describes the features, operationalisation and the intended outcomes of the *Skim Perlindungan Nasional B40, mySalam* (the Scheme) that was recently introduced by the Government effective 1 January 2019. The Scheme aims to reduce the vulnerability of households in the bottom 40% income group (B40) to income shocks from unexpected hospitalisation or critical illnesses. It is applicable to eligible *Bantuan Sara Hidup Rakyat* household recipients aged between 18 and 55 years old.

The Scheme complements the Bank's ongoing initiatives to increase insurance and takaful coverage, particularly among the underserved segment, thus strengthening business and household resilience to financial shocks. To this end, the Bank launched the *Perlindungan Tenang* initiative in December 2017, which attracted participation from 10 insurance and takaful players to provide simple and affordable insurance and takaful products. Through innovations to product design and the customer journey, such as digitalising distribution channels and claims submissions, insurers and takaful operators have become more responsive to the needs of this segment.

Understanding the Needs of the B40 Income Group

A key risk faced by the B40 is the immediate financial ramifications of a temporary loss of income owing to the inability to work as a result of hospitalisation or illness. The Financial Capability and Inclusion Demand Side (FCI 2018) Survey¹ found that 62% of those who struggled to make ends meet over the period of 12 months surveyed are from the most vulnerable segment earning less than RM1,000 a month. Low-income households earning less than RM2,000 did not fare much better, with them spending 95% of their earnings on living costs, leaving them with little savings against economic shocks or emergencies. 86% of respondents that cited difficulties raising emergency cash of RM1,000, an amount roughly equivalent to one month's minimum wage, are from the low-income households earning less than RM1,500 a month. For the B40, a diagnosis of a critical illness or a protracted period of hospitalisation could plunge the household into poverty or debt in a matter of weeks, particularly if the spouse has to also take on the role as caregiver. These observations on the B40 are consistent with national reports² and feedback from insurers and takaful operators.

Barriers to obtain affordable and suitable insurance and takaful protection still exist, as products that are currently available on the market are better suited to the needs of the more affluent market segments. Product and process complexities have also made understanding insurance inherently difficult for many. This in turn discourages demand for insurance and takaful, particularly among the B40. Based on consumers surveyed in FCI 2018, among those who have never purchased any insurance and takaful products, three in five indicated that it was due to a lack of general understanding on insurance and takaful, or because they did not know how to assess or choose such products. Financial and information constraints typically faced by the B40 further compounds the difficulty that they face in making decisions on insurance and takaful purchases.

Based on data published by the Employees Provident Fund, Malaysia's existing social protection system provides benefits for only 38% of working age Malaysians³, with the rest (approximately 13.7 million people) excluded from such protection. This remaining group includes the self-employed, informally employed (such as day earners) and housewives. Notwithstanding recent public policies⁴ to expand coverage to these subgroups, many of these individuals are low-income workers, and interruptions to their income stream owing to an inability to work can have a significant impact on their well-being as well as that of their dependants. This need remains underserved by both private insurance and takaful and public social protection.

¹ Bank Negara Malaysia, 2018.

² The State of Households – Different Realities, Khazanah Research Institute, 2018.

³ Defined to be those aged 16 to 60 years old.

⁴ Self-employed Employment Injury Scheme under Social Security Organisation (SOCSO) and *Caruman Sukarela Insentif Suri* (i-Suri) under Employees Provident Fund (EPF).

Scheme to Bridge the Protection Gap and Transition the B40 to a Sustainable Private Market

Given the observed gaps above, the Scheme will provide immediate protection for the eligible B40. The Scheme has also been designed to meet the following longer-term objectives:

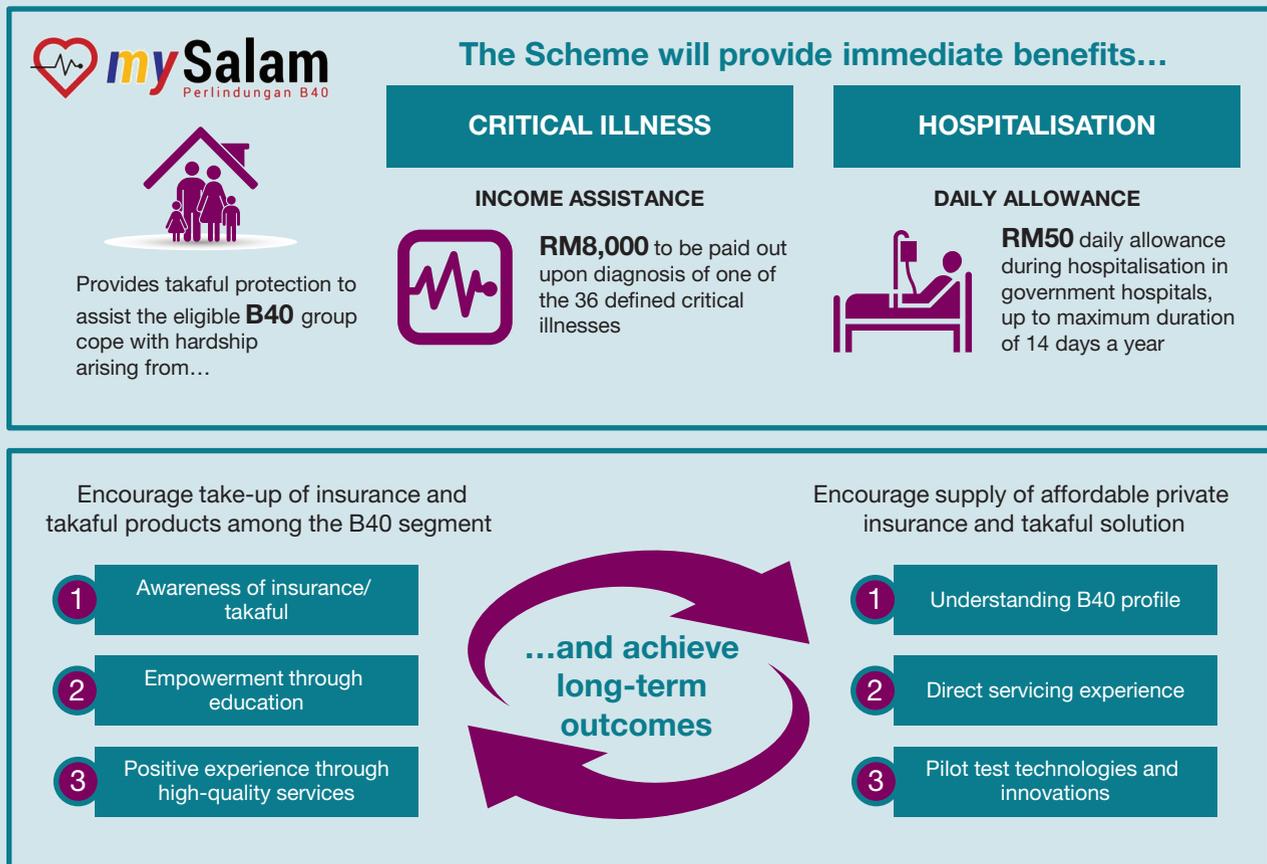
A) Encourage take-up of insurance and takaful among the B40 by building greater awareness, a positive experience and trust

A key barrier to the take-up of insurance and takaful coverage lies in its particular nature where the benefits of being covered are not immediately apparent, while the costs are. With limited resources, this trade-off is even more pronounced among the B40 segment. The Scheme therefore seeks to provide opportunities for the B40 to experience first-hand the financial benefits of insurance and takaful, and to build positive familiarity and confidence in related procedures. Various studies⁵ have shown that having personal experience with insurance products can create a sustainable demand for insurance. By providing protection against temporary income displacement, the Scheme deals with a key risk facing the B40.

Under the Scheme, participating insurers and takaful operators must meet defined servicing standards in line with *Perlindungan Tenang* principles. The standards include product features and services that provide convenient access and are easy to understand and to claim for benefits covered. This is critical to allow the

Diagram 1

Objectives and Intended Outcomes of the *Skim Perlindungan Nasional B40, mySalam*



Source: Bank Negara Malaysia

⁵ Using Subsidies for Inclusive Insurance: Lessons from Agriculture and Health, International Labour Organization, 2014.

B40 to have positive user experiences and develop greater confidence in insurance and takaful. To this end, the Scheme has introduced a dedicated online portal and hotline to service all enquiries and claims. In addition, the Scheme will continue to explore more effective outreach and distribution channels, such as via hospitals.

B) Promote the supply of commercially viable and affordable insurance and takaful products and services that meet the needs of the underserved segment

The Scheme is designed based on core insurance and takaful principles and is not intended to serve as a form of long-term social welfare. It will be provided for a limited period with the intention of eventually migrating the B40 to fully subscribe to private insurance and takaful products.

At present, the lack of data on the B40 is often cited by the industry as a challenge in facilitating product design and pricing. With this Scheme, comprehensive B40 data such as claims and customer profiles collected over the duration of the Scheme will support more accurate and sustainable product design and pricing. This will encourage broader and more competitive private market solutions that cater to the underserved segments. In addition, the Scheme will also serve as a testbed for the development of innovative delivery channels, including digital solutions and public-private partnerships to effectively reach and serve the target segments.

In the longer term, it is envisaged that affordable private insurance and takaful will be more widely available to and accessed by various segments of society and the economy to manage a wide range of financial risks and life events.

Operational Sustainability to Support Longer-Term Objectives

The Scheme is funded by the insurance and takaful industry. Initial funding will be provided by foreign insurance shareholders that elect to contribute to the Scheme in lieu of their commitment to reduce their shareholdings to not more than 70%. Contributions to the Scheme will similarly promote the objectives of divestment to achieve greater long-term economic benefits for Malaysia through wealth sharing and higher insurance penetration.

A trust fund has been set up to manage the contributions from insurers and takaful operators to the Scheme. In this initial stage, the Scheme will pay premiums or contributions from the fund on behalf of the B40 to participating insurers and takaful operators for standardised coverage. The product will be underwritten and serviced by participating insurers and takaful operators at cost with profits ploughed back into the Scheme.

The Scheme leverages on the existing infrastructure of insurers and takaful operators to deliver effective and efficient servicing. Additional supporting infrastructure to accommodate the high volume of servicing, such as the aforementioned online portal, will be developed by the Scheme for use by all participating insurers and takaful operators. This model will allow the Scheme to manage its costs and ensure its sustainability over the duration of the Scheme.

The Scheme is expected to play a key catalytic role in the development of suitable insurance and takaful products and services for the underserved segments in Malaysia. It also presents unique opportunities for industry players to gain an in-depth understanding of customer needs and encourage more Malaysians to protect themselves against financial shocks through insurance and takaful protection.