BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

The BNM Quarterly Bulletin presents a quarterly review of Malaysia's economic, monetary and financial developments. It includes the Bank's latest assessments on the direction of the economy going forward. The Bulletin also provides insights on current economic and financial issues, including highlights of policy initiatives undertaken by Bank Negara Malaysia in pursuit of its mandates.

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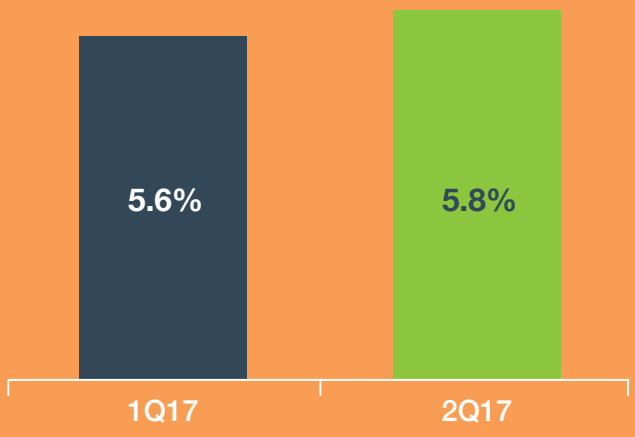
Key Highlights on
Economic and Financial Developments in 2Q 2017

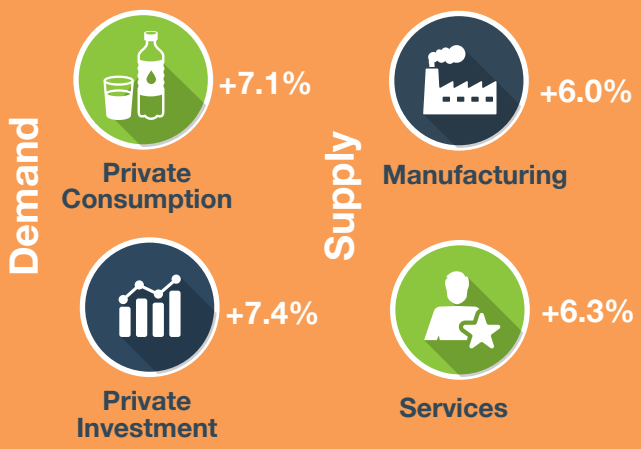
Stronger GDP growth of 5.8%

Continued growth in domestic demand and across major economic sectors

Real GDP Growth (Annual change)



Main driver of GDP Growth in 2Q17 (Annual change)



Decline in inflation due mainly to lower domestic fuel prices

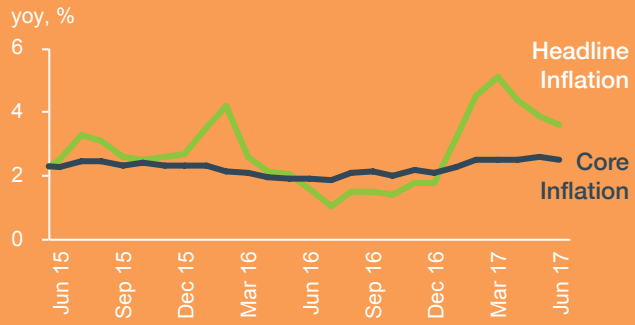
Inflation in the transport category was lower

Crude Oil Prices
2Q17:
USD50/barrel
1Q17: USD54/barrel

RON95 Petrol
2Q17:
RM2.10/litre
1Q17: RM2.23/litre

Core inflation remained relatively stable

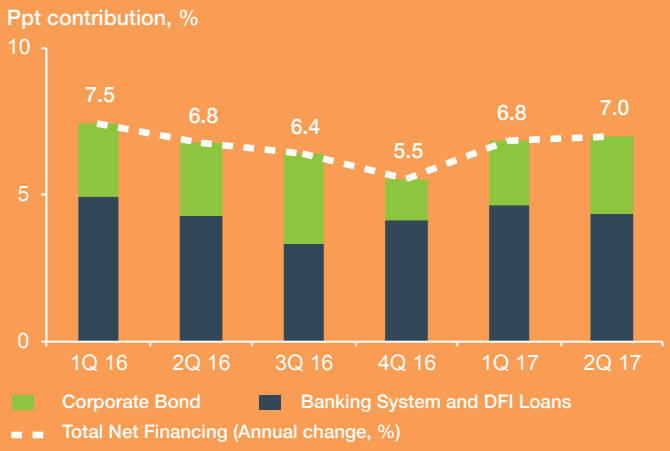
Headline and Core Inflation



Financing needs continued to be met with asset quality remaining intact

Financing to the private sector continued to improve

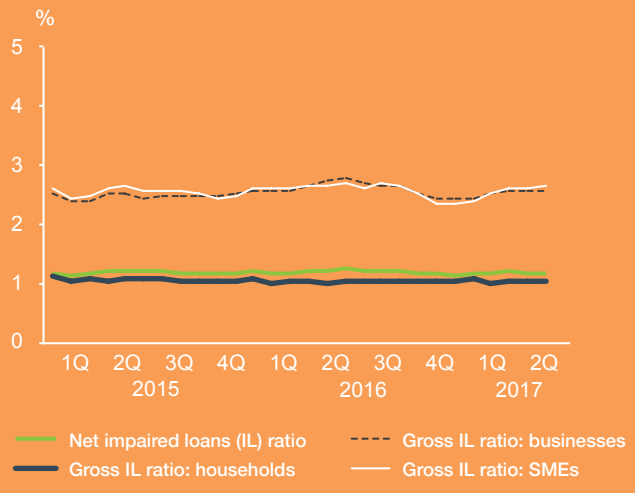
Net Financing Growth*



*Net financing comprises outstanding banking system and DFIs loans and outstanding corporate bonds.

Overall asset quality in the banking system remained healthy

Banking System Loan Quality



Source: Department of Statistics, Malaysia and Bank Negara Malaysia unless stated. For more information, visit www.bnm.gov.my

Key Highlights on

Feature Articles

Outcomes of the Reference Rate Framework: Moving Towards More Efficient and Transparent Practices

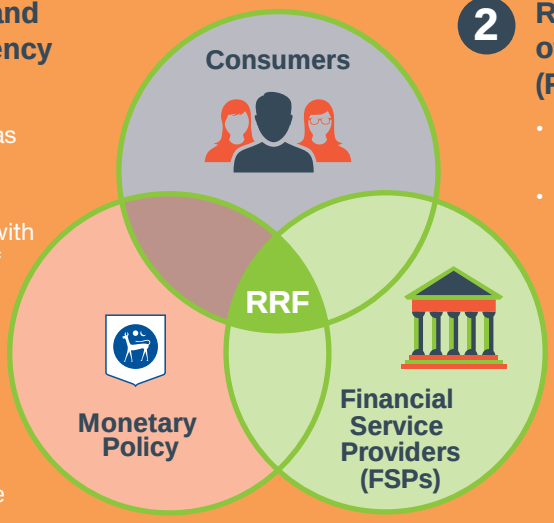
Implementation of the Reference Rate Framework (RRF) is driven by 3 outcomes

1 Efficient pricing and greater transparency for consumers

- Consumers benefit as loan pricing is more efficient
- More transparency with greater disclosure of loan products

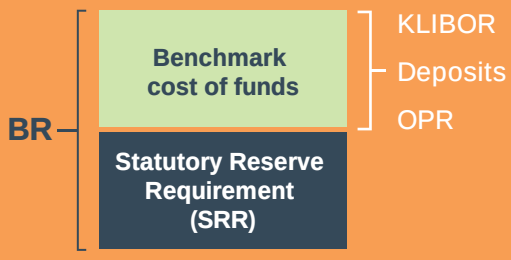
3 Enhance MP transmission

- Better transmission from policy rate to the real economy
- Effective pass-through from OPR to BR



2 Reflect funding strategies of Financial Service Providers (FSPs)

- Flexible-rate loans are priced using the Base Rate (BR) that varies with market conditions
- BR reflects funding strategies and moves with benchmark chosen by FSPs



Liberalisation of Motor Insurance Business: Rewarding Good Risk Management

Why liberalise?

Under tariff, some policyholders pay more premiums than they should to support riskier drivers and vehicles



Tariff (fixed pricing)
Good and bad drivers pay similar premiums, despite having different risk profiles

Liberalisation (risk-based pricing)
Equitable pricing ensures good risks are recognised and bad risks incentivised to improve

How are premiums calculated?

More factors will be taken into account in determining premiums

Rating factors used in tariff	Pricing enhanced through loadings and/or NCD	Broader rating factors
• Sum Insured • Cubic Capacity	• Insured's Age • Vehicle Age • Past Claims Record	• Vehicle Model • Driving Experience • Driving Behaviour • Security Features

What can consumers do?

Actions that can be taken to control premiums that you will ultimately pay

- ☑ Maintain vehicle well and adopt good driving behavior and safety measures
- ☑ Purchase motor cover which best suits your needs and risk exposure
- ☑ Shop around for the best coverage

Source: Department of Statistics, Malaysia and Bank Negara Malaysia unless stated. For more information, visit www.bnm.gov.my

International Economic Environment

HIGHLIGHTS

- **Continued recovery in global growth, supported by stronger investment in major economies.**
- **Sustained export growth in the Asian economies following continued strength in global demand.**
- **Improvement in equity market performance amid lower volatility.**

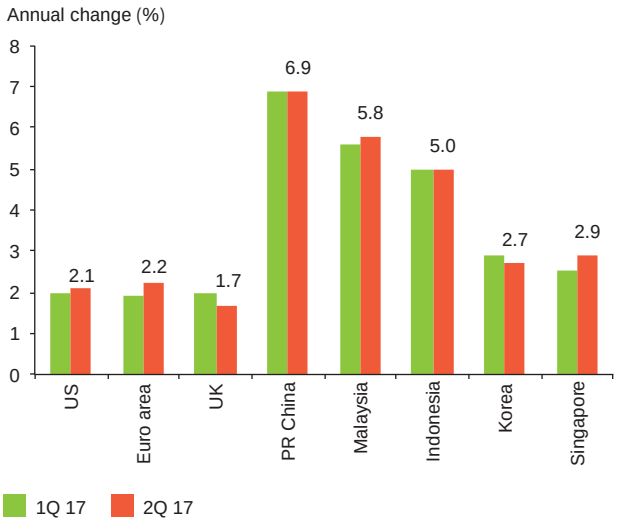
Global growth continued to expand

The global economy continued to expand in the second quarter of 2017. Growth was also becoming more synchronised across the advanced and emerging economies. Indicators such as the manufacturing purchasing managers' index (PMI) and industrial production expanded at a faster pace, particularly in the advanced economies. Similarly, manufacturing PMIs in Asia have remained above the usual trend observed since the global financial crisis. This indicates that global recovery has become more entrenched.

Second quarter GDP releases showed sustained performance in the advanced economies. In the US and euro area, growth drivers were more balanced as the uptrend in investments continued to complement private consumption. Capital imports rose in tandem with stronger investment to cater to increasing demand and higher capacity utilisation. Domestic demand in PR China lent further support to global demand, as ongoing policy tightening has yet to show signs of feeding into the real economy. These key developments continued to drive global trade. As a result, Asia benefitted from the recovery in global demand amid sustained strength in domestic demand.

Continued Global Economic Expansion in 2Q 2017

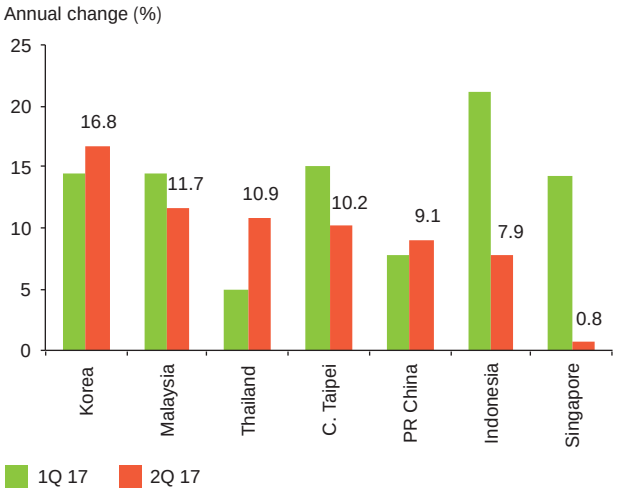
Chart 1: Real GDP Growth



Source: National authorities

Sustained Export Growth in 2Q 2017

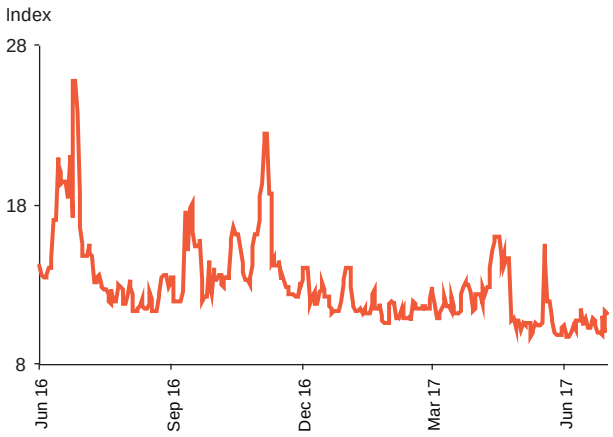
Chart 2: Export Growth of Selected Asian Economies (in USD terms)



Source: Bloomberg

Low Volatility in the Financial Markets

Chart 3: Chicago Board Options Exchange (CBOE) Volatility (VIX)



Source: Bloomberg

Sustained exports from Asian economies

During the quarter, global trade continued to show a firmer growth momentum. Trade expanded across product categories and destinations. This suggests that the strength in external demand was more broad-based. Continuous improvements in investment in the advanced economies and sustained demand from PR China arising from infrastructure and property construction provided the impetus to global trade.

Key trends in exports during the quarter included a rapid rise in trade for the electrical and electronics (E&E) and commodities sectors. These sectors contributed to higher exports from the Asian economies, many of which are major producers of electronics or commodity-based products. Exports from Korea, Chinese Taipei and Singapore benefitted from higher shipments of semiconductors for use in electronic products. In Korea, exports rose 16.8% in the second quarter of 2017, following six straight months of double-digit growth. This reflected final demand for capital and consumer goods in both the advanced economies and PR China, particularly in the lead-up to flagship smartphone model launches in the second half of 2017.

Similarly, exports from Indonesia grew at 7.9% on continued shipments of commodities such as oil and gas, coal, and iron and steel, particularly to PR China.

Improvement in market indices amid lower volatility

Most major equity indices improved in the second quarter of 2017, as businesses in the advanced economies continued to record improvements in corporate profits. This was noteworthy given the weakness in earnings seen since 2014. Broad-based growth improvements in many economies around the world also provided tailwinds to global stock markets.

Volatility in the global financial markets was lower as developments during the quarter were largely within market expectation. However, there were two episodes of temporary spikes in volatility due to political and geopolitical developments. In April, geopolitical tensions rose following a US military strike on Syria and increasing signs of a deeper conflict with North Korea. In the later part of the quarter, changes in key personnel by the US administration triggered concerns over the future course of US pro-growth regulatory and fiscal policies.

Developments in the Malaysian Economy

HIGHLIGHTS

- **The Malaysian economy grew by 5.8% in the second quarter.**
- **Headline inflation declined to 4.0% due mainly to lower domestic fuel prices.**
- **Current account surplus widened to 3.0% of GNI due to a higher goods surplus and smaller deficit in the services and primary income account.**

The Malaysian economy grew by 5.8% in the second quarter of 2017

The Malaysian economy recorded a stronger growth of 5.8% in the second quarter of 2017 (1Q 2017: 5.6%). Private sector spending continued to be the main driver of growth. On the external front, growth was further supported by the robust expansion in real exports of goods and services (9.6%; 1Q 2017: 9.8%) following strong demand for manufactured and commodity products. Real imports moderated slightly to 10.7% (1Q 2017: 12.9%) following more moderate expansion in investment. On a quarter-on-quarter seasonally-adjusted basis, the economy recorded a growth of 1.3% (1Q 2017: 1.8%).

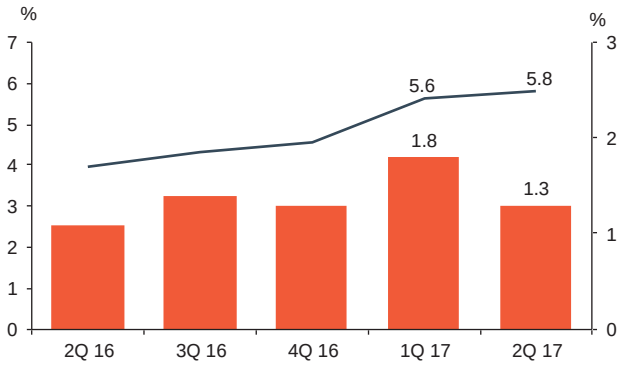
Domestic demand driven by the private sector

Domestic demand grew by 5.7% in the second quarter of the year (1Q 2017: 7.7%), supported by continued expansion in both private sector expenditure (7.2%; 1Q 2017: 8.2%) and public sector spending (0.2%; 1Q 2017: 5.8%).

Private consumption recorded a growth of 7.1% (1Q 2017: 6.6%), supported by the improvement in private sector wages amid continued strength in employment growth. During the quarter, consumer sentiments continued to improve, providing further impetus to household spending.

Stronger Growth in 2Q 2017

Chart 4: GDP Growth

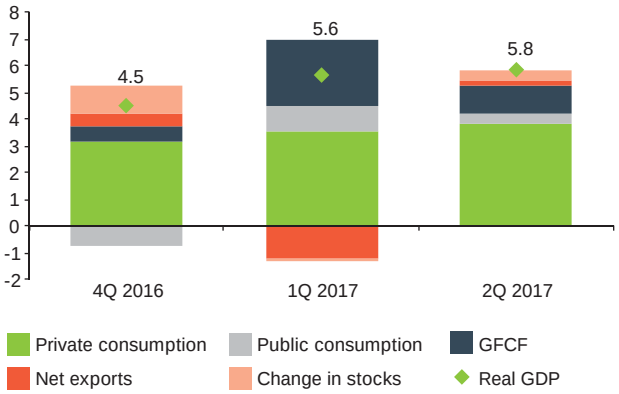


Source: Department of Statistics, Malaysia

Private Sector Demand Remained the Key Driver of Growth

Chart 5: Contribution of Expenditure Components to GDP Growth

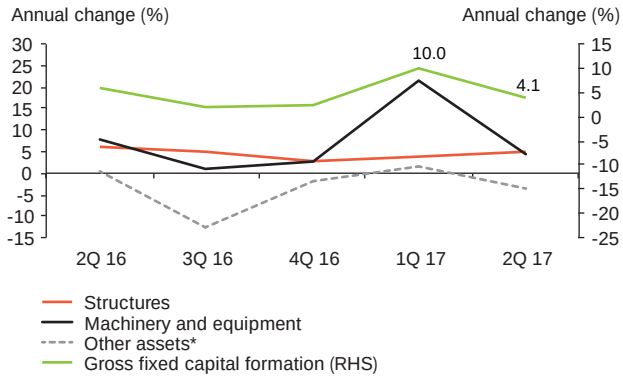
Annual change (%), Contribution to growth (percentage points)



Source: Department of Statistics, Malaysia

Gross Fixed Capital Formation Expanded More Moderately

Chart 6: GFCF Growth by Type of Assets



*Other assets include mineral exploration, research & development and capitalised planting

Source: Department of Statistics, Malaysia

Private investment expanded by 7.4% in the second quarter (1Q 2017: 12.9%), mainly in the services and manufacturing sectors. In line with the recovery in demand, manufacturers undertook capacity expansions, machinery and equipment (M&E) acquisitions and replacements to cater for new orders. This was evident across both the export- and domestic-oriented manufacturing sub-sectors. In the services sector, investment was supported mainly by expansions in the utilities, healthcare and food & beverage and accommodation sub-sectors. During the quarter, business sentiments continued to improve in tandem with better external and domestic conditions amid lower financial market volatility.

Public consumption growth moderated to 3.3% (1Q 2017: 7.5%) following slower growth in the spending on emoluments, and supplies and services.

Public investment declined by 5.0% in the second quarter (1Q 2017: 3.2%). This was attributable to the lower spending on fixed assets by public corporations, which more than offset the higher expenditure by the Federal Government.

Gross fixed capital formation (GFCF) expanded at a moderate pace of 4.1% (1Q 2017: 10.0%). This was due to lower growth in private investment and a decline in public sector capital spending. By type of assets, the moderation in machinery and equipment (4.4%; 1Q 2017: 21.8%) and contraction in other type of assets (-3.7%; 1Q 2017: 1.4%) more than offset the improvement in structures investment (5.1%; 1Q 2017: 3.8%).

Continued expansion across major economic sectors

On the supply side, all economic sectors continued to expand.

The services sector registered higher growth during the quarter. Growth in the wholesale and retail sub-sector improved, driven by higher household spending. The finance and insurance sub-sector also continued to benefit from the improvement in performance of the capital market and insurance segment. In the transportation and storage sub-sector, growth was principally supported by robust external trade and higher air passenger traffic.

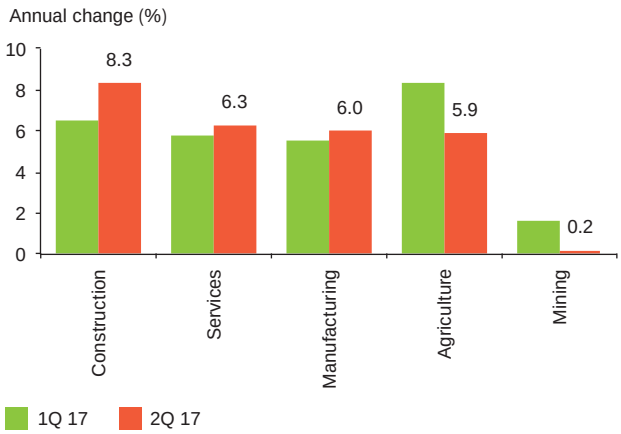
The manufacturing sector growth was driven by both the export- and domestic-oriented industries. The strong performance of electronics and electrical segment, in line with higher global demand for semiconductors, continued to spur the export-oriented industries. The domestic-oriented industries benefitted from the strength in demand for food-related products in view of the improved consumer sentiments, and higher production of construction-related materials supported by robust construction activity.

In the agriculture sector, growth remained firm as crude palm oil yields continued to recover from the negative impact of El Niño. Growth in the construction sector was higher, driven mainly by civil engineering activity in the transportation and power plant segments.

Growth in the mining sector moderated on lower crude oil production as part of the global initiative to reduce oil supply. The performance of the sector was also affected by lower natural gas production amid a major maintenance shutdown of a large gas field in Sabah.

Higher Growth Across Most Economic Sectors

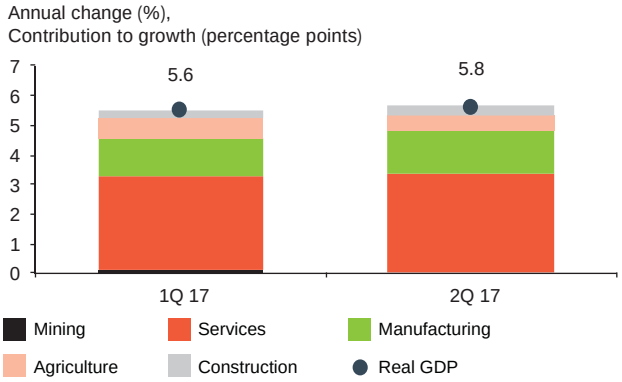
Chart 7: Growth by Sector



Source: Department of Statistics, Malaysia

Higher Contribution to Growth from Services, Manufacturing and Construction Sectors

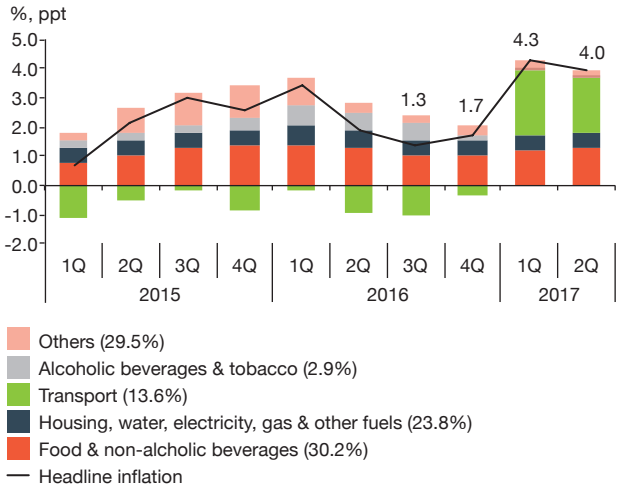
Chart 8: Real GDP by Economic Sector



Source: Department of Statistics, Malaysia

Lower Inflation Mainly Reflected the Decline in Domestic Fuel Prices

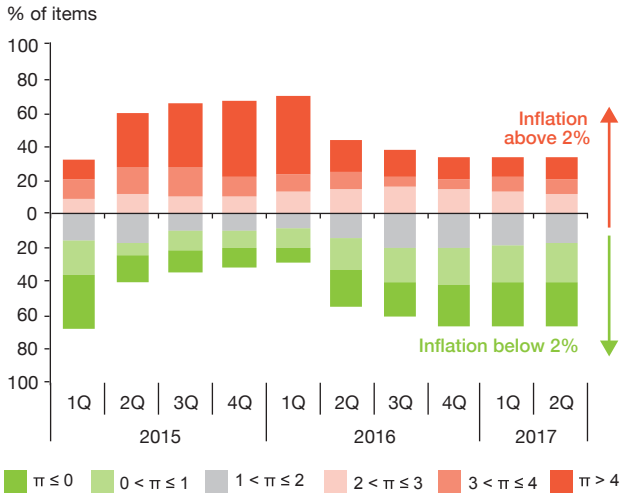
Chart 9: Headline Inflation



Source: Department of Statistics, Malaysia and BNM estimates

Inflation Pervasiveness Remained Broadly Stable

Chart 10: Inflation Pervasiveness



Source: Department of Statistics, Malaysia and BNM estimates

Headline inflation declined due to lower transport prices

Headline inflation[1] moderated to 4.0% in the second quarter of 2017 (1Q 2017: 4.3%) due mainly to lower *transport* inflation of 13.4% (1Q 2017: 16.2%). During the quarter, prices of RON95 petrol averaged RM2.10 per litre, lower than the average of RM2.23 per litre in 1Q 2017. The lower domestic fuel prices were due mainly to the lower global oil prices amid a stronger ringgit exchange rate during the quarter. However, inflation in the *food and non-alcoholic beverages* category was slightly higher at 4.3% (1Q 2017: 4.2%) reflecting the stronger demand during the festive season. Prices in the *meat* and *fish and seafood* sub-categories increased by 4.5% and 7.0%, respectively, during the quarter (1Q 2017: 3.4% and 5.3%, respectively).

Inflation during the quarter was not pervasive. The percentage of items in the CPI basket registering inflation of more than 2% remained unchanged at 33%. However, the sustained increase in the prices of *food away from home* and *rental* led to the slightly higher core inflation of 2.5% in second quarter of 2017 (1Q 2017: 2.4%).

[1] As measured by the annual change in the Consumer Price Index (CPI).

Labour market showed tentative signs of improvements

Labour market conditions showed tentative signs of improvements in the second quarter of 2017, as the labour force expansion of 56,300 persons was exceeded slightly by stronger net employment gain of 58,900 people. As such, the unemployment rate decreased to 3.4% of the labour force (1Q 2017: 3.5%). The labour force participation rate was sustained at 67.7% of the working age population (1Q 2017: 67.7%). Higher vacancies posted on a major job search website, at 65,478 positions, indicate increased demand for new hires (1Q 2017: 61,760 positions).

Private sector wages continued to rise, mainly due to stronger growth in manufacturing wages in the second quarter of 2017 (11.2%; 1Q 2017: 3.2%) and major services sub-sectors (5.4%, 1Q 2017: 5.1%). Wage growth during the quarter was broad-based, supported by both domestic- and export-oriented manufacturing and services industries.

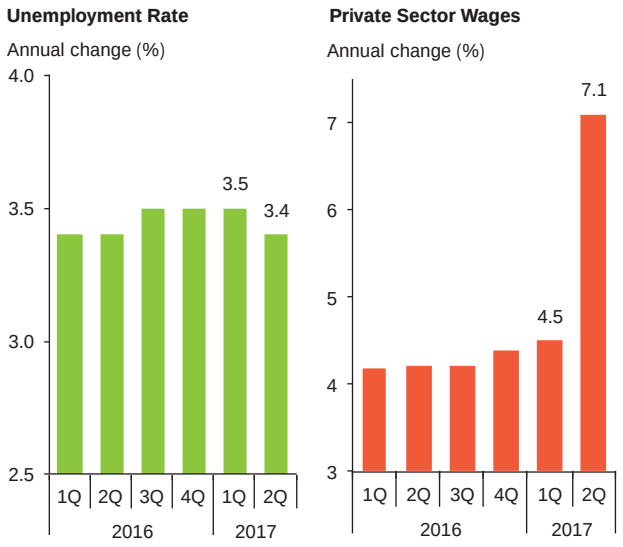
External sector performance remained strong

Gross exports continued to grow strongly by 20.6% in the second quarter of 2017 (1Q 2017: 21.3%). Robust gross exports growth was broad-based, driven by double-digit growth in manufactured and commodities exports.

Higher demand from Malaysia's key trading partners, particularly PR China, the EU and Japan, supported the strong growth in manufactured exports. E&E remained the key driver of gross exports, registering growth of 22.6%. This was driven by the 25.3% increase in semiconductor exports, which benefitted from strong global demand, particularly for semiconductors used in smartphones and storage devices.

Steady Unemployment Rate and Improvement in Wage Expansion

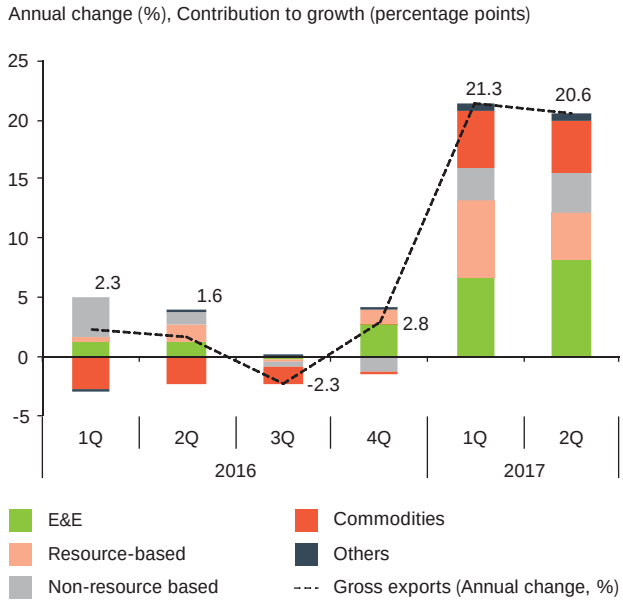
Chart 11: Labour Market Indicators



Source: Department of Statistics, Malaysia

Export Growth Supported Mainly by E&E Exports

Chart 12: Gross Exports by Products

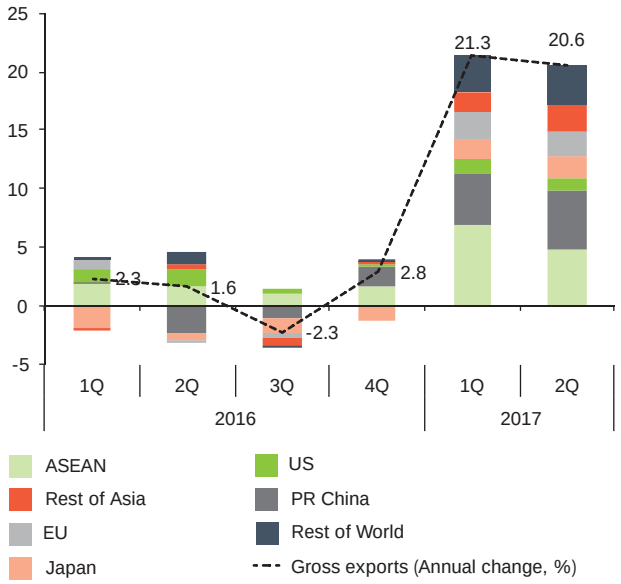


Source: Department of Statistics, Malaysia

Exports was Also Broad-based Across Markets

Chart 13: Gross Exports by Markets

Annual change (%), Contribution to growth (percentage points)

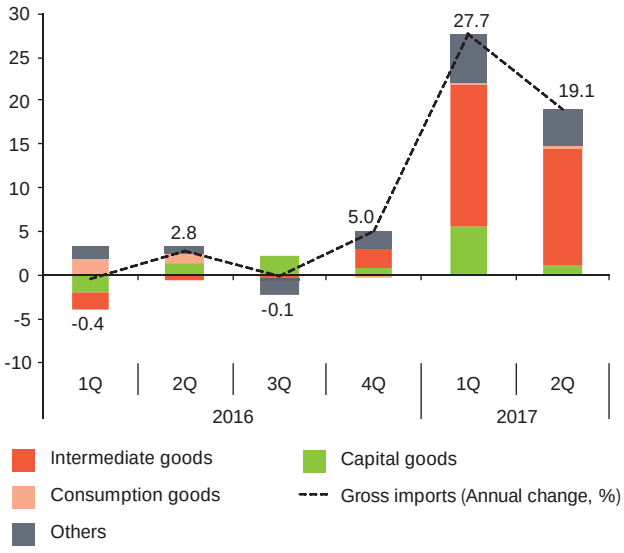


Source: Department of Statistics, Malaysia

Strong Imports, Particularly in Intermediate and Imports for Re-exports

Chart 14: Gross Imports by Products

Annual change (%), Contribution to growth (percentage points)



Source: Department of Statistics, Malaysia

Non-resource based manufactured exports expanded in the second quarter, largely on account of higher exports of iron and steel products, and manufactures of metals. Resource-based manufactured exports however, moderated due mainly to lower exports of petroleum products, and chemical products. Demand from PR China remained strong amid moderation in demand from the ASEAN region. Commodity exports were supported by higher production of crude oil and CPO, and stronger LNG prices.

Gross imports also remained strong, registering growth of 19.1% in the second quarter of 2017 (1Q 2017: 27.7%). Robust growth was underpinned by higher intermediate imports and imports for re-exports, in line with strong manufacturing export performance. Capital imports moderated to 6.9% in second quarter of 2017 from the exceptionally high growth recorded in first quarter of 2017 of 42.0%, on account of the delivery of significant high-value imports. As export growth outpaced import growth during the quarter, the trade surplus increased to RM24.1 billion (1Q 2017: RM18.9 billion).

Current account surplus increased

The current account surplus widened to RM9.6 billion in the second quarter of 2017 (1Q 2017: RM5.3 billion) accounting for 3.0% of GNI (1Q 2017: 1.7% of GNI). The higher surplus was due to a larger goods surplus and smaller deficit in the services and primary income account.

The goods surplus widened to RM27.0 billion in the second quarter of 2017 (1Q 2017: RM25.3 billion) as exports continued its robust pace, while intermediate and capital imports moderated from the first quarter of 2017. The deficit in the services account was lower at RM5.0 billion (1Q 2017: a deficit of RM6.2 billion). The travel account recorded a larger surplus of RM8.3 billion (1Q 2017: RM7.6 billion). During the quarter, construction services exports also increased, reflecting receipts from civil engineering construction projects in Cambodia, India, Qatar and Vietnam. This was partly offset by higher net payments for transportation services, and telecommunications, computer and information services.

The smaller deficit in the primary income account in the second quarter of 2017 (-RM8.2 billion; 1Q 2017: -RM9.9 billion) was largely attributable to higher income generated by Malaysian firms investing abroad (RM12.4 billion; 1Q 2017: RM11.4 billion). Profits accrued to foreign investors in Malaysia were broadly unchanged (RM19.4 billion; 1Q 2017: RM20.0 billion).

The deficit in the secondary income account was slightly higher at -RM4.2 billion (1Q 2017: -RM3.9 billion). Outward remittances increase to RM8.7 billion (1Q 2017: RM8.5 billion) while inward remittances slowed to RM4.4 billion (1Q 2017: RM4.6 billion).

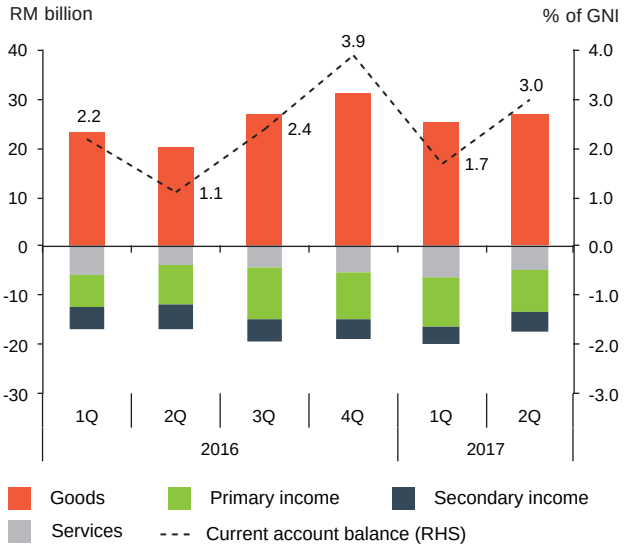
Financial account recorded net inflows

In the second quarter of 2017, the financial account registered a net inflow of RM7.3 billion (1Q 2017: net outflow of RM8.8 billion), attributed mainly to a turnaround in the portfolio investment account (net inflow of RM16.0 billion; 1Q 2017: net outflow of RM31.9 billion).

Portfolio investment by non-residents recorded a net inflow of RM18.8 billion (1Q 2017: net outflow of RM22.9 billion), due mainly to a resumption in purchases of Malaysian Government Securities (MGS) and higher participation in the equity market.

Larger Goods Surplus and Lower Deficits in the Services and Primary Income Accounts

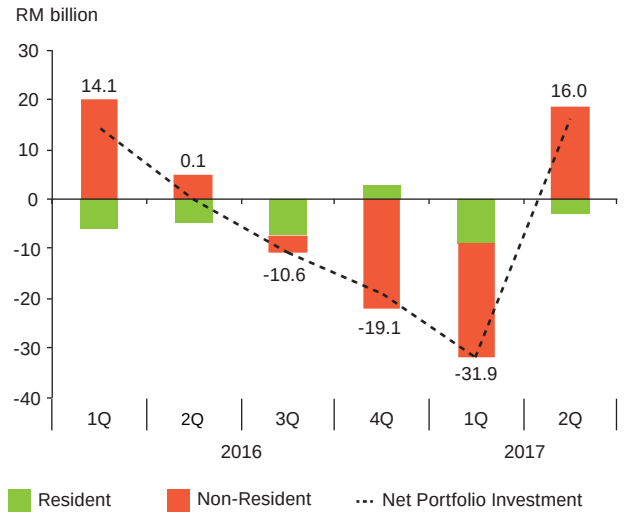
Chart 15: Current Account Balance



Source: Department of Statistics, Malaysia

Turnaround in Net Portfolio Flows, Mainly by Non-resident Investors

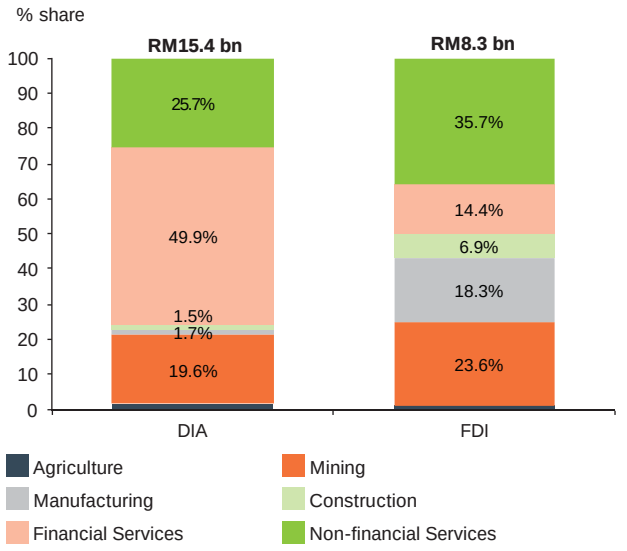
Chart 16: Portfolio Investments



Source: Department of Statistics, Malaysia

DIA and FDI Channeled Mostly into the Services Sector

Chart 17: Net Direct Investment Flows by Sector

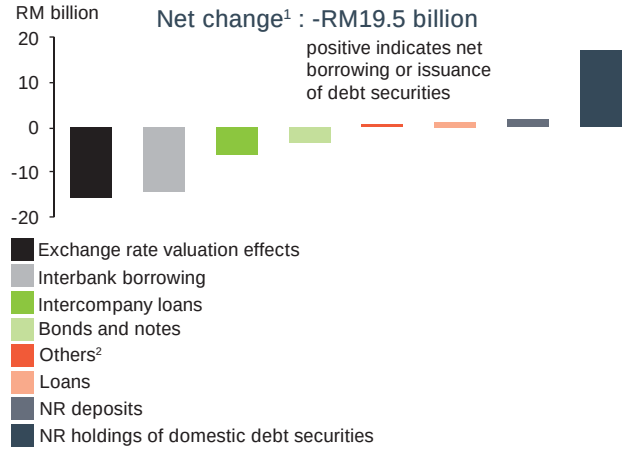


Note: Figures may not necessarily add to 100% due to rounding

Source: Department of Statistics, Malaysia

Lower External Debt in 2Q 2017

Chart 18: Changes in External Debt



[1] Changes in individual debt instruments exclude exchange rate valuation effects
[2] Comprises trade credits, IMF allocation of SDRs and other debt liabilities
Note: NR refers to non-residents

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

Investor sentiments improved during the quarter, supported by the announcement of initiatives to develop the onshore financial market, stronger ringgit performance, expectations of better corporate earnings outlook and domestic growth prospects. Resident portfolio investment registered a lower net outflow of RM2.8 billion (1Q 2017: net outflow of RM9.0 billion), as the continued net acquisition of equity securities abroad by domestic fund managers was partially offset by net liquidation of debt securities overseas.

The direct investment account registered a net outflow of RM7.1 billion (1Q 2017: net inflow of RM8.3 billion), as the accumulation of direct investment assets more than offset the incurrence of direct investment liabilities during the quarter. Direct investment abroad (DIA) by Malaysian companies rose to RM15.4 billion (1Q 2017: net outflow of RM8.7 billion), on account of higher earnings retained for reinvestment and drawdown of intercompany loans by subsidiaries abroad. DIA was channeled mainly into the *financial services* sub-sector and the *mining* sector. Foreign direct investment (FDI) decreased to RM8.3 billion (1Q 2017: net inflow of RM17.0 billion), due mainly to lower reinvestment of earnings and injection of equity capital from parent companies. FDI inflows were concentrated in the *real estate activities* and *information and communication* sub-sectors, followed by the *mining* sector.

The other investments account recorded a net outflow of RM1.3 billion (1Q 2017: net inflow of RM14.2 billion), due mainly to the maturity of currency and deposits placed by foreign financial institutions in Malaysian banks and the net extension of trade credits by Malaysian exporters.

Following these developments, the overall balance of payments registered a surplus of RM2.7 billion in the second quarter (1Q 2017: a deficit of RM1.8 billion). Errors and omissions, which include the revaluation changes on reserves, amounted to -RM14.3 billion or -3.3% of total trade.

Manageable external debt

Malaysia's external debt amounted to RM877.5 billion, equivalent to USD202.3 billion or 66.9% of GDP as at end-June 2017 (end-March 2017: RM897.0 billion or USD200.8 billion). The lower external debt largely reflects the valuation effects following the strengthening of the ringgit against selected major and regional currencies and net repayment of interbank borrowing during the second quarter. There were also net repayment of intercompany loans and redemption of maturing bond and notes by the private sector. These declines were partly offset by an increase in

non-resident holdings of domestic debt securities, especially MGS, and a small increase in non-resident deposits.

Malaysia's external debt remains manageable given its currency and maturity profiles, as well as the availability of large external assets. About one-third of total external debt is denominated in ringgit (32.8%), mainly in the form of NR holdings of domestic debt securities and ringgit deposits in domestic banking institutions. As such, these liabilities are not subjected to valuation changes from the fluctuations in the ringgit exchange rate.

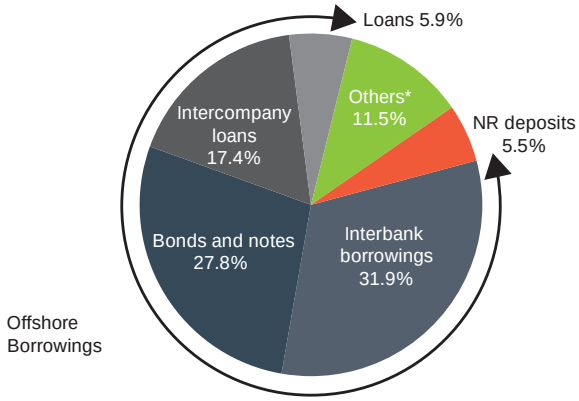
The remaining external debt of RM589.9 billion (67.2%) is denominated in foreign currency (FC) and most are hedged, either naturally through foreign currency earnings or through the use of financial instruments. The bulk of these obligations are offshore borrowings, raised mainly to expand productive capacity and to better manage financial resources within corporate groups. As at end-June 2017, the offshore borrowing remained low at 39.7% of GDP compared to 60.0% of GDP during the Asian Financial Crisis.

Of the total FC-denominated external debt (inclusive of valuation effects), more than one-third is accounted by interbank borrowing and FC deposits in the domestic banking system, which amounted to RM220.5 billion. This largely reflects the banks' intragroup liquidity management and placements of deposits from foreign parent entities, which are subjected to prudent liquidity management practices. Among these are internal limits on funding and maturity mismatches. This is then followed by long-term bonds and notes issued offshore which amounted to RM163.9 billion as at end-June 2017, primarily to finance asset acquisitions abroad that will generate future income. The intercompany loans are normally subjected to flexible and concessionary terms, such as no fixed repayment schedule or low interest rate.

From a maturity perspective, more than half of the total external debt is skewed towards medium- to long-term tenure (55.9% of total external debt), suggesting limited rollover risks. It is important to note that international reserves is not the only means in which banks and corporations rely on to meet their short-term external obligations, given the export earnings of borrowers and external assets. The latest reserves position of USD99.4 billion as at 31 July 2017 is only about a quarter of total external assets, with the remaining external assets being held by banks and corporations. International reserves is 1.1 times the short-term external debt and is sufficient to finance 7.9 months of retained imports.

About Half of FC-denominated Debt Subjected to Prudent Liquidity Management Practices and Flexible Terms

Chart 19: Breakdown of Foreign Currency-denominated External Debt (% of share)



*Includes trade credits and miscellaneous, such as insurance claims yet to be disbursed and interest payables on bonds and notes

Box Article 1

Global Value Chains and the Drivers of Exports in Malaysia[1]

Authors: Lim Ming Han and Tng Boon Hwa

HIGHLIGHTS

- **Malaysia is deeply involved in Global Value Chains (GVCs), specialising in the final stages of the production process (backward linkage).**
- **High GVC participation has reduced the impact of exchange rate movement on Malaysia's exports.**
- **There should be a stronger policy imperative to spur companies to reduce reliance on a low-cost production strategy to remain competitive.**

Introduction

Malaysia has long maintained a high degree of openness to trade, with a trade to GDP ratio of 128% as at 2016 (world average: 88.5%). This openness facilitated the economy's deep integration into the Global Value Chain (GVC) as it started developing in earnest during the 1990s. The formation of GVC was motivated by the desire for efficiency gains, and led to stages of production becoming more dispersed across countries.

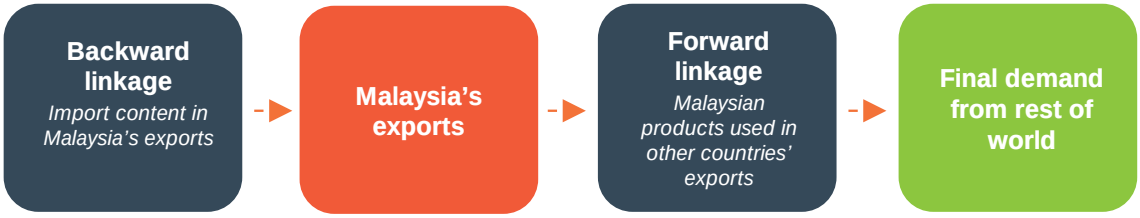
A consequence of GVC participation is a weaker link between exports and the exchange rate[2]. With trade within GVCs, exports have sizable imported inputs. A larger share of imported inputs reduces the effect of exchange rate movements. For example, an exchange rate depreciation raises the cost of imported inputs, hence limiting the exchange rate related revenue gains from export proceeds.

This Box Article identifies the extent of Malaysia's participation in GVCs, and how this influences the drivers of Malaysia's export volumes to its determinants – foreign demand, export prices and, in particular, the exchange rate.

Malaysia's participation in the Global Value Chain (GVC)

Diagram 1 shows the two main aspects of participation in the GVC. Backward linkages measure the use of imported inputs to produce goods for exports, while forward linkages reflect other economies' use of Malaysian products as inputs into their exports. Countries with higher forward linkages tend to specialise in the early stages of GVC, and vice versa for those with higher backward linkages.

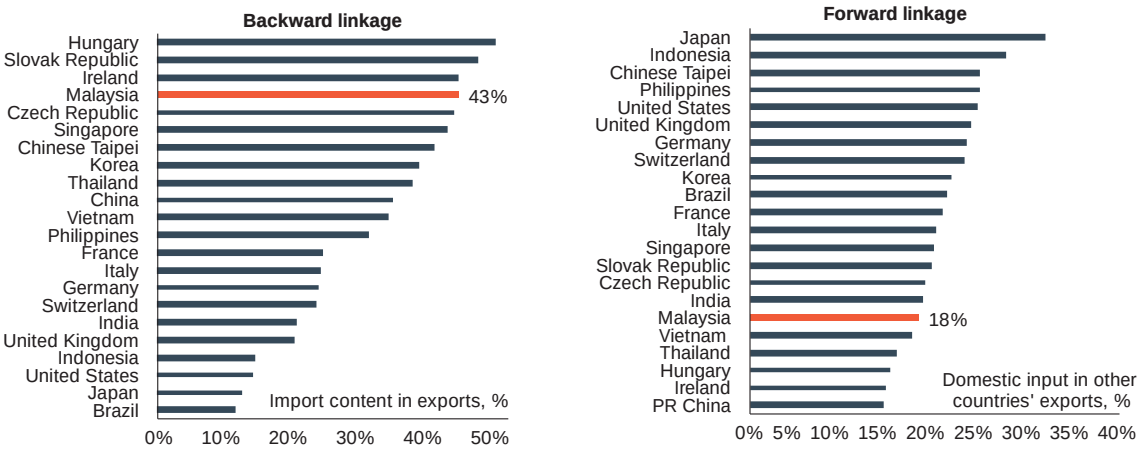
Diagram 1: Conceptual Chart of Malaysia's GVC Participation



[1] A technical version is forthcoming in the Bank Negara Malaysia Working Paper series.
[2] Ahmed et al (2015) and Ollivaud et al (2015).

To shed light on Malaysia's position in the GVC, Chart 1 illustrates the degree of backward and forward linkages for selected countries. Malaysia's backward linkage, as measured by the high import content of its exports of 43%, is amongst the highest in the region (e.g.: Singapore, Thailand, Chinese Taipei, Philippines, Indonesia and Korea). In comparison, Malaysia's forward linkages, measured by its products used in other economies' exports at 18%, is relatively lower. Together, this reflects Malaysia's specialisation in the end stages of GVCs.

Chart 1: Backward and Forward Linkages of Selected Economies (Avg. 2001-2012)



Source: OECD- WTO: Statistics on Trade Value-Added database, Bank Negara Malaysia

The Implications of Malaysia's role in GVC on Exports

To provide an understanding of the role of GVCs in influencing exports, a model of Malaysia's aggregate exports was estimated[3].The 4 drivers of exports considered are external demand, relative export price, the exchange rate and the import content of Malaysia's exports to capture Malaysia's backward linkages in the GVC[4]. The importance of each driver is shown in Chart 2.

Broadly, the findings show that external demand is the most important driver, accounting for an average of 29% of export volume growth (Table 1). This is not surprising and reflects the fact that exports are driven predominantly by global demand conditions. Relative export price is also a key factor with an average contribution of 26%. The ringgit exchange rate plays a supporting role, accounting for an average 14% of export volume growth.

Chart 3 illustrates how backward linkages reduce the effects of the exchange rate on Malaysia's exports. The combined exchange rate effect is split into the stand-alone exchange rate effect (dark blue bars) and its interaction with backward linkages within the GVC (red bars). The results show that the exchange rate effect on exports are dampened by up to 45% when accounting for the economy's high degree of backward linkages. Intuitively, this implies that the increased cost of imported inputs from a depreciated exchange rate reduces the associated revenue gains from higher export proceeds by an average of 45%.

[3] An error correction model (ECM) was estimated to capture the roles of demand and each price component in driving export volume growth in both the short- and long-run, while also capturing the persistence of the exchange rate movement in the transmission mechanism. This was done using data from 2000 to 2016.

[4] External demand is the weighted GDP of Malaysia's top 30 export partners. Relative export price refers to the ratio of Malaysia's export price to global export price, and the ringgit exchange rate refers to the USD/MYR exchange rate, which also includes its interaction with backward linkage. Forward linkage is not included as Malaysia's input used in other countries' exports is directly captured in the exports data.

Table 1:

Contribution of the Determinants of Export Volume Growth (Average 2005-2016)

Determinants	Contribution (%)
External Demand	29
Relative Export Price	26
Exhange Rate (USD/MYR) *(inc. its interaction with backward linkages)*	14
Others	31

Source: Bank Negara Malaysia

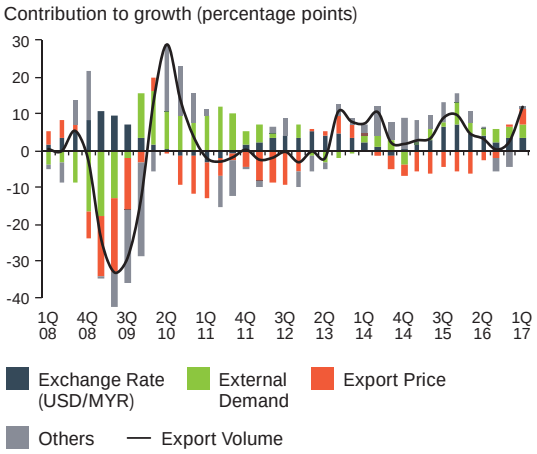
Table 2:

GVC and the Exchange Rate Effect

Determinants	Contribution (ppt)
Exchange rate *(A)*	4.2
Exchange rate interacted with *GVC (B)*	1.9
Final exhange rate effect* *(C = A - B)*	2.3
Offsetting effect *(%) (B / A)*	45%

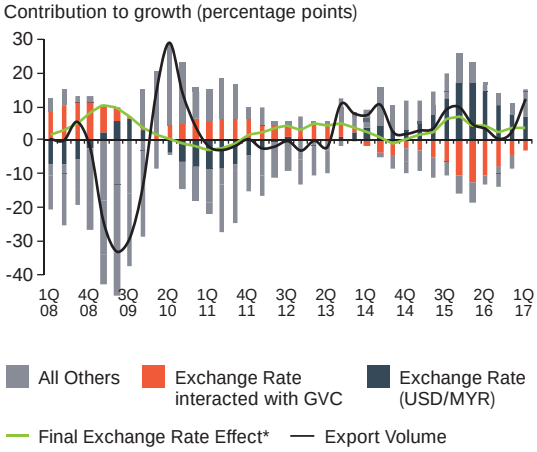
Source: Bank Negara Malaysia
* The Final Exchange effect (C) is the difference between the Exchange Rate (A) and its interaction with GVC (B).

Chart 2: Drivers of Export Volume Growth



Source: Bank Negara Malaysia

Chart 3: Drivers of Export Volume Growth



Source: Bank Negara Malaysia

Conclusion and Broader Policy Implication

Malaysia's deep integration in the GVC has implications on the drivers of its exports. While external demand remains the most important driver of exports, integration into the GVC has reduced the sensitivity of the exchange rate on exports. The exchange rate contribution has been larger in recent years, in line with depreciation of the ringgit exchange rate. Going forward, exports growth will be supported mainly by foreign demand, as global economic conditions continue to improve and the ringgit exchange rate stabilises. At the broader level, the analysis also illustrates that Malaysia is no longer able to compete on cost. This is evident from the negative contribution from relative export price to exports growth since the Global Financial Crisis (Chart 3). There should therefore be a stronger policy imperative to develop industries which produce niche products that do not rely on a low-cost production strategy to be competitive.

References

Ollivaud, P., E. Rusticelli and C. Schwellnus (2015), "The Changing Role of the Exchange Rate for Macroeconomic Adjustment", OECD Economics Department Working Papers, No. 1190, OECD Publishing, Paris.

Swarnali Ahmed, Maximiliano Appendino and Michele Ruta (2015), "Global Value Chains and the Exchange Rate Elasticity of Exports", IMF Working Paper.

Monetary and Financial Developments

HIGHLIGHTS

- **Ringgit was the best performing currency in the region during the quarter.**
- **The cost of funds raised in the bond market declined amid non-resident inflows and continued support from domestic institutional investors.**
- **Lending rates remained stable during the quarter.**

The ringgit appreciated the most in the region during the quarter

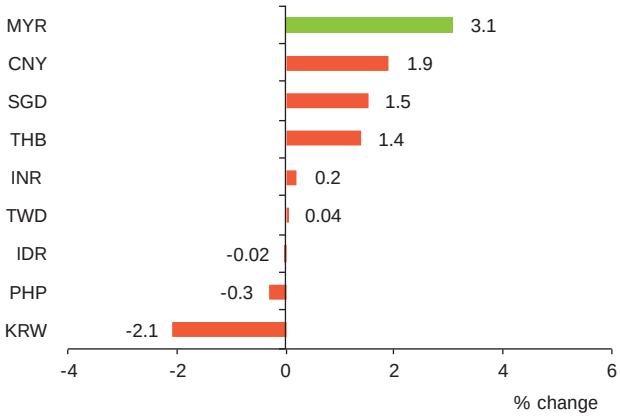
The ringgit and most regional currencies appreciated against the US dollar during the quarter, driven mainly by continued weakness in the US dollar. The weak US dollar was due to policy uncertainties in the US. The ringgit, however, appreciated the most during the quarter amid non-resident inflows into Malaysia's financial markets. This was driven by encouraging domestic macroeconomic conditions, which include the strong GDP growth and exports performance. The positive ringgit sentiments were also supported by the further liberalisation of the bond market and foreign exchange hedging requirements announced by the Financial Markets Committee. Going forward, the ringgit will continue to be driven by a confluence of external and domestic factors. These include the timing and pace of monetary policy normalisation by major central banks, global political development, and domestic economic performance.

Domestic monetary and financial conditions remained supportive of economic activity

Domestic monetary and financial conditions remained supportive of economic activity during the period. Bond yields declined amid non-resident inflows and ongoing support from domestic institutional investors. Liquidity conditions continued to remain sufficient while stable retail funding costs continued to provide support to private sector financing.

Most Regional Currencies Appreciated Against the US Dollar

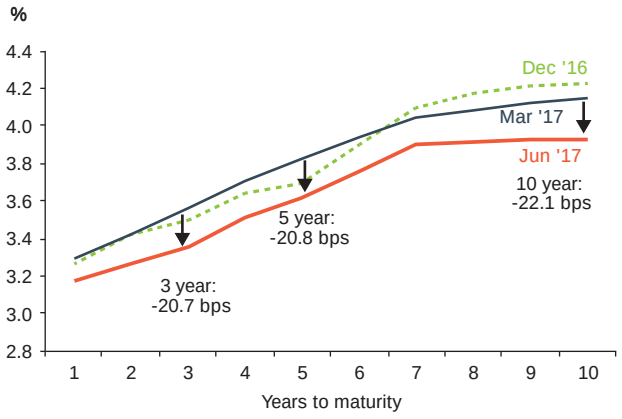
Chart 20: Summary of Performance of Regional Currencies Against USD (1 Apr - 30 June 2017)



Source: Bank Negara Malaysia

Bond Yields Declined During the Second Quarter

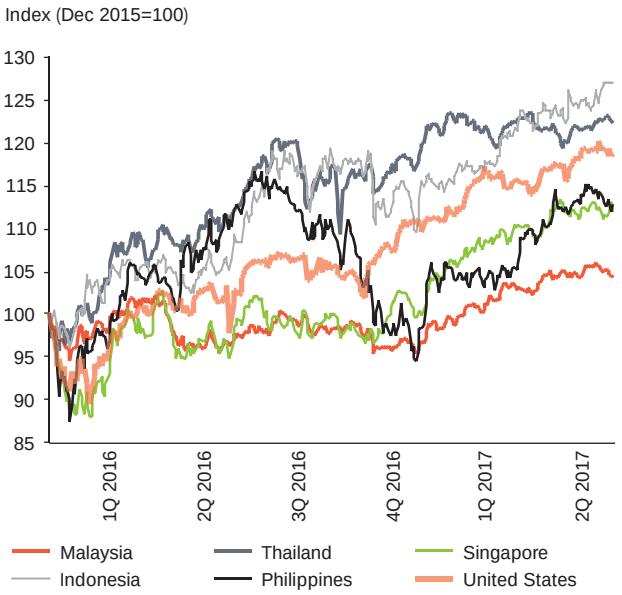
Chart 21: Trend in MGS Yields



Source: Bank Negara Malaysia

Increase in Domestic Equity Market was in line with Global Equity Markets

Chart 22: Regional Equity Indices



Source: Bloomberg

Bond yields declined amid the resumption of non-resident inflows

Bond yields declined in the second quarter amid the resumption of non-resident inflows into the MGS market amounting to RM13.7 billion. The inflows partly reflected positive developments arising from the further financial market development measures. Continued demand from domestic institutional investors also put further downward pressure on yields. As a result, the 3-year, 5-year and 10-year yields declined by 21, 21 and 22 basis points respectively. Yields in the corporate bond market were also driven down by sustained demand from domestic institutional investors.

Continued upward momentum in the domestic equity market

During the second quarter, the FBM KLCI increased by 1.4% to close at 1,763.7 points at end-June 2017 (end-March 2017: 1,740.1 points). The domestic equity market continued to be supported by non-resident inflows, albeit at a slower pace compared to the previous quarter. Sentiments in the domestic market were supported by the stronger-than-expected GDP growth in the first quarter of 2017 and an improved ringgit outlook. Towards the end of the quarter, however, sentiments turned cautious amid concerns over stock market overvaluation in the US and a decline in global oil prices.

Lending rates were stable during the quarter

Both nominal wholesale and retail borrowing costs remained stable throughout the quarter. The 3-month KLIBOR was unchanged at 3.43%. In the retail market, the weighted average base rate (BR) was steady at 3.61% and correspondingly, the weighted average lending rates (ALR) on outstanding loans remained stable throughout the quarter (end-June: 5.20%).

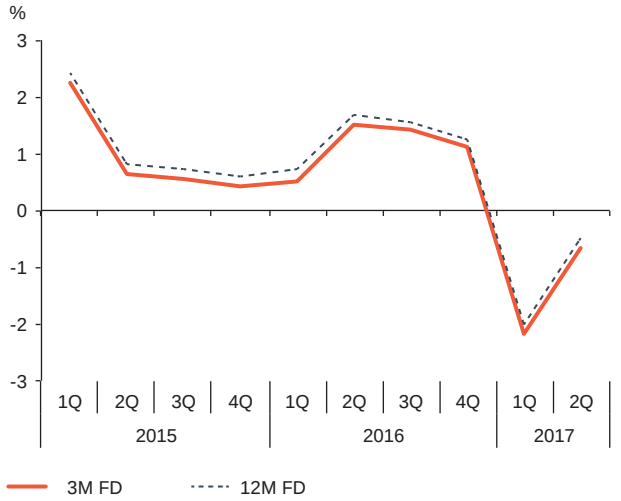
Reflecting the moderation in headline inflation, real fixed deposit (FD) rates have turned less negative in the second quarter. In particular, the real 12-month FD rate increased to -0.50% in June, compared to -2.03% in March. Going forward, given that inflation is projected to moderate further in 2017, real deposit rates are expected to turn positive towards the end of the year.

Liquidity conditions remained sufficient for financial intermediation

In the banking system, liquidity conditions remained sufficient at both the institutional and system-wide levels. The level of surplus liquidity placed with BNM moderated slightly, reflecting the lower use of liquidity injection operations amid net inflows during the quarter. At the institutional level, most banks continued to maintain surplus liquidity positions.

Real Deposit Rates have Turned Less Negative Amid Moderating Inflation

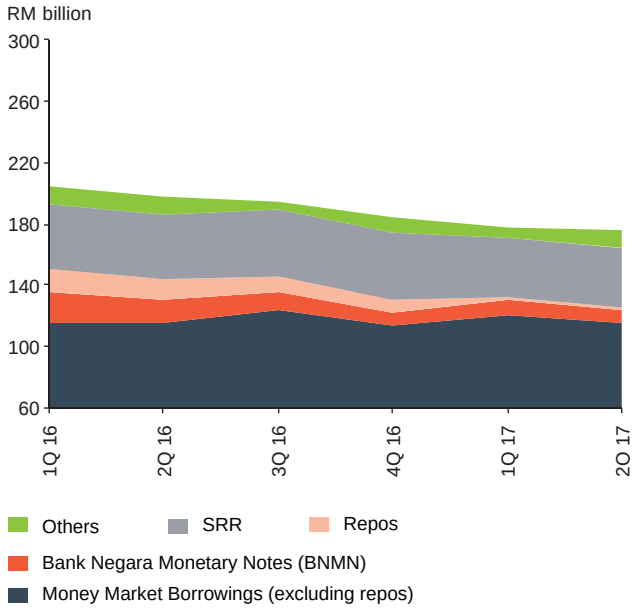
Chart 23: Real FD Rates (by Maturity), as at end-period



Source: Bank Negara Malaysia

Outstanding Surplus Liquidity Placed with BNM Moderated Slightly

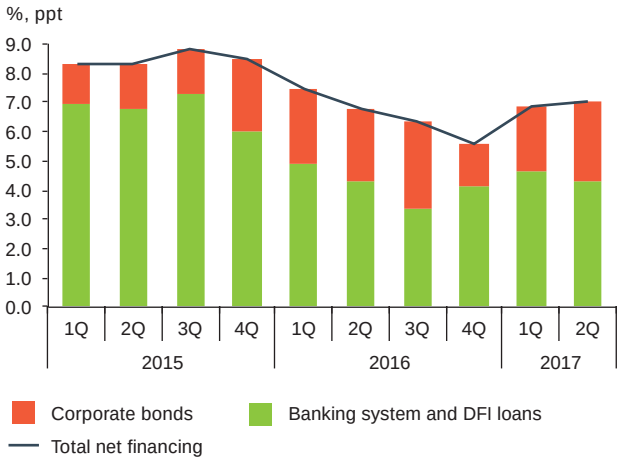
Chart 24: Outstanding Ringgit Liquidity Placed with Bank Negara Malaysia (at end-period, RM billion)



Source: Bank Negara Malaysia

Improvement in Net Financing Growth Driven by Stronger Growth in Outstanding Corporate Bonds

Chart 25: Contribution to Net Financing* Growth



* Net financing is comprised of outstanding banking system and DFI loans and oustanding corporate bonds

Source: Bank Negara Malaysia

Net financing improved during the quarter

The growth of net financing increased to 7.0% in the second quarter of 2017 (1Q 2017: 6.8%), mainly reflecting the improvement in the growth of net outstanding issuances of corporate bonds (2Q 2017: 11.8%; 1Q 2017: 9.8%) amid a moderation in the growth of loans extended by the banking system and development financial institutions (DFIs) (2Q 2017: 5.6%; 1Q 2017: 6.0%). The growth of outstanding business loans extended by the banking system and DFIs moderated to 6.6% (1Q 2017: 7.1%) during the quarter. Loans to SMEs recorded an annual growth of 7.0% (1Q 2017: 9.3%), with the level of loan disbursed sustained at RM69.3 billion (1Q 2017: RM71.8 billion). The growth of outstanding household loans extended by the banking system and DFIs continued to moderate to 5.1% (1Q 2017: 5.4%), mainly reflecting the moderation in loans for the *purchase of non-residential property; purchase of residential property* and *personal financing*.

Managing Risks to Financial Stability

HIGHLIGHTS

- **Debt servicing capacity of businesses and households remained sound, although upticks in impairment were observed in some segments.**
- **The presence of long-term foreign and domestic investors have provided stability and liquidity to the domestic bond market.**
- **Domestic financial stability is expected to remain preserved, supported by the sustained health of financial institutions, and orderly markets and liquidity conditions.**

Domestic financial stability remains intact

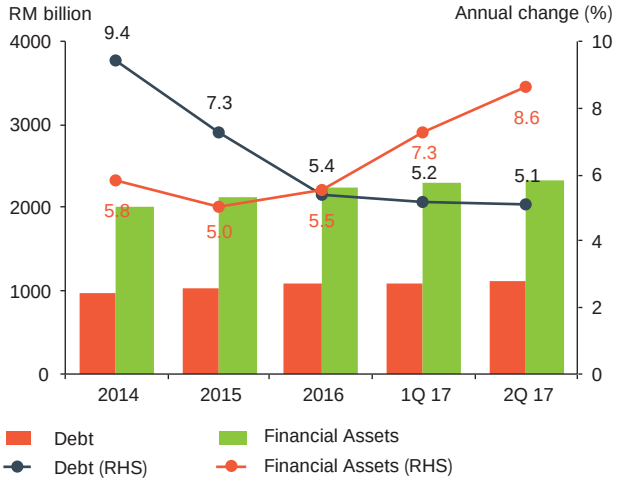
Domestic financial stability was supported by strong institutions and orderly market conditions. In line with global trends, overall volatility in the domestic financial markets was low amid improved sentiments. In addition, domestic financial institutions continued to demonstrate sound overall asset quality and profitability. Liquidity and funding conditions remained conducive for the financing needs of businesses and households.

Sustained debt servicing capacity of businesses and households

Household debt recorded an annual growth of 5.1% in the second quarter of 2017 (1Q 2017: +5.2%). Loans for the purchase of residential property continued to be the key driver of growth, expanding by 8.7% (1Q 2017: +8.6%). Bulk (64%) of household debt is for wealth accumulation. The overall debt repayment capacity of households is expected to remain sound and continue to be supported by steady income growth and stable labour market conditions. Further, aggregate household financial assets and liquid financial assets remained high at 2.1 and 1.5 times of debt respectively. At the end of the quarter, total household debt amounted to 85.6% (1Q 2017: 86.7%) of GDP.

Growth of Household Financial Assets Continued to Outpace That of Debt

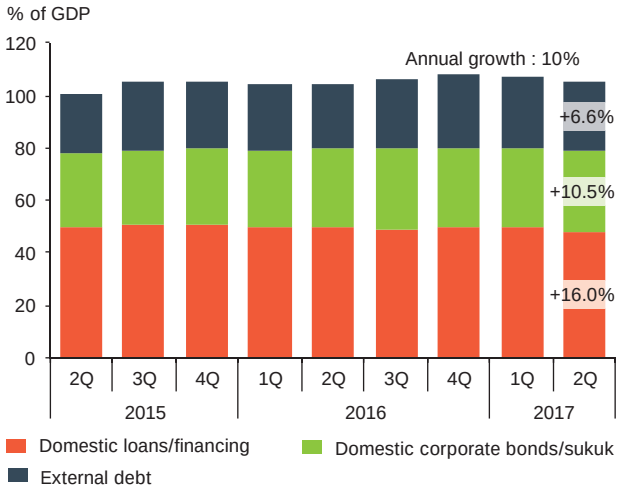
Chart 26: Household Sector Debt and Financial Assets



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

Total Business Borrowings in the Quarter was Driven by New Corporate Bonds/Sukuk Issuances

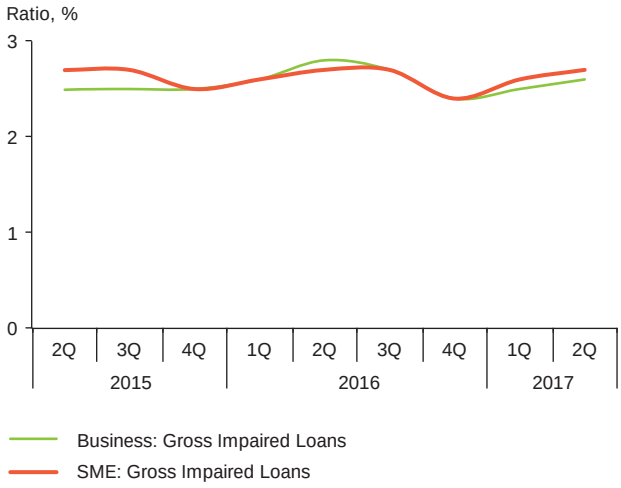
Chart 27: Business Sector NFC-Debt-to-GDP



Source: Bank Negara Malaysia

Overall Banking System Business Loans Portfolio Remains Sound

Chart 28: Business Sector Gross Impaired Loans



Source: Bank Negara Malaysia

Household delinquencies and impairment for banks and non-banks as a group remained at low levels of 1.5% (1Q 2017: 1.3%) and 1.7% (1Q 2017: 1.6%) respectively. Both recorded slight upticks as some borrowers in the vulnerable income segment (earning less than RM3,000 per month) continue to be affected by the higher cost of living. This particularly contributed to higher impaired personal financing granted by non-banks, which grew annually by 4.7% during the quarter. However, potential systemic risks arising from financial institutions' exposures to the household sector are limited. First, the majority of new household borrowers have prudent debt service ratios (DSR), while 41% of borrowers with newly approved loans have DSR of below 40%. Second, the share of borrowings by the vulnerable income segment is now lower at 21.9% (2013: 28.4%) – for banks, this share is at 19.1% (2013: 25.1%) as loan affordability assessments continue to improve. Third, potential losses to banks for vulnerable households under a simulated scenario were estimated at less than 10% of banks' excess capital buffers (above regulatory minimums). This is under the assumption of a tripling of prevailing probabilities of default and severe loss given default.

In the second quarter of 2017, total business borrowings grew annually by 10% (1Q 2017: +11%). This was driven by new fund raising in the corporate bond and sukuk markets, which expanded by 10.5% (1Q 2017: +10.3%). Recent issuances were mainly in the real estate, infrastructure and power sectors. External borrowings were slightly lower due to exchange rate valuation effects, following the strengthening of the ringgit against some major and regional currencies during the quarter. This was partly offset by increases in non-resident holdings of domestic debt securities issued by non-financial corporations (NFCs) and a marginal increase in net borrowings. The annual growth in outstanding bank financing to businesses moderated slightly to +6.6% (1Q 2017: +7.1%), due to slower growth in financing to the real estate, agriculture and transportation sectors. Total financing by banks and development financial institutions to SMEs recorded an annual growth of 7% (1Q 2017: +9.3%).

Financial health of firms remained intact, given improving domestic and external demand. The aggregate leverage of Malaysian NFCs[2], as measured by the median debt-to-equity ratio, increased marginally to 45.4% (4Q 2016: 43.5%) in the first quarter of 2017. This was supported by satisfactory debt servicing capacity and liquidity

[2] Based on 120 listed firms on Bursa Malaysia with 85% market capitalisation (excluding financial institutions).

positions. On aggregate, the median interest coverage ratio (ICR) remained significantly above the prudent threshold of two times, at 9.6 times, albeit lower than 11.8 times recorded in fourth quarter of 2016. The lower ICR was due to moderate earnings in the consumer-related sectors (i.e. automotive and retail sectors) amid cautious discretionary spending. The aggregate median cash-to-short-term debt (CASTD) ratio remained stable at 1.2 times, above the prudent threshold of one time. Overall, the ratios of impaired and delinquent loans recorded marginal increases, but remained low at 2.6% and 0.4% (1Q 2017: 2.5% and 0.3%) of total bank lending to businesses respectively. Higher impairment and delinquencies were observed in the real estate activities, wholesale and retail and oil & gas (O&G) sectors.

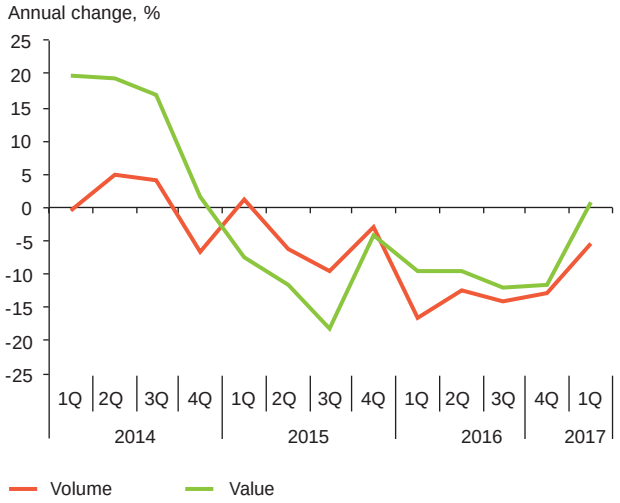
Given the persistent low oil prices, the credit risk outlook for the O&G sector is expected to remain challenging. Notwithstanding this, the overall debt servicing capacity and liquidity positions of O&G companies remained satisfactory, with the median ICR at 23.4 times (4Q 2016: 28.2 times) and median CASTD ratio at 3.4 times (4Q 2016: 2.4 times). The impaired loans ratio recorded slight improvement to 4.2% (1Q 2017: 4.3%) while the delinquent loans ratio remained stable at 0.1% (1Q 2017: 0.1%) as at second quarter of 2017. Risks to the banking system remained limited as exposures to the sector accounted for about 6.7% of total exposures.

Activities in the housing market have shown some signs of a pick-up, with total housing transaction value recording a positive annual growth of 0.9% (4Q 2016: -11.6%), the first time since 2015. Housing transaction volume has also showed improvement, recording a smaller contraction of 5.4% (4Q 2016: -12.7%) in the first quarter of 2017. This was mainly contributed by transactions for the purchase of houses priced above RM500,000 in both the primary and secondary markets. Based on preliminary data, the average house price registered an annual growth of 5.3% in the first quarter of 2017 (4Q 2016: +7%). Financing by banks for the purchase of affordable houses remains available as reflected by the loan approval rate of about 72% for houses priced below RM500,000. New launches of houses in this price segment, however, remains lagged, a trend observed since 2015. Consequently, housing affordability remains challenging, particularly for first-time house buyers.

Risks to financial stability arising from speculative activity in the housing market remains muted. The annual growth in the number of borrowers with

Housing Transactions Improved Both in Terms of Volume and Value

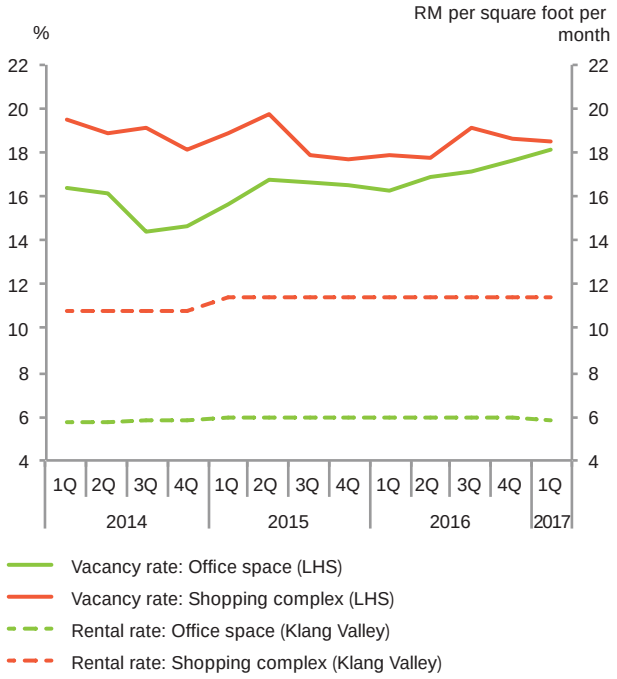
Chart 29: Property Sector Transaction Volume and Value



Source: National Property Information Centre

Vacancy and Rental Rates of Office Space and Shopping Complex Remained Depressed

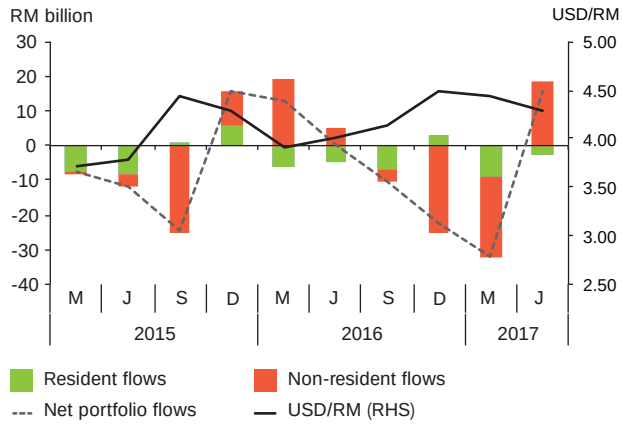
Chart 30: Office Space and Shopping Complex Vacancy and Rental Rates



Source: National Property Information Centre, Knight Frank, Jones Lang Wootton and internal computation

Both Government Bonds and Equities Recorded Net Foreign Inflows

Chart 31: Financial Market Net and Gross Portfolio Flows and Ringgit Exchange Rate Movement



Source: Department of Statistics, Malaysia

three or more outstanding housing loans (a proxy for speculative buyers) stood at 1.4% (4Q 2016: +1.4%). The number of housing loans settled within three years (the typical duration required to complete construction after a property is acquired) – another indication of speculative purchases – eased to 9.2% (4Q 2016: 11.9%) of total settled housing loans.

Vacancy and rental rates in the office space and shopping complex segments remained depressed in the first quarter of 2017, reflecting sanguine tenant demand on the ground. The continued excess supply in the commercial property segment, if left unaddressed, could become a long-term structural issue with wide implications to the economy. Direct risks to banks from lending to property developers, including end-financing, in the office space and shopping complex segments remained small at 5.1% of total bank loans. This is supported by sound lending and valuation practices. The delinquency and impairment ratios for these exposures remained low at 0.7% and 1%, respectively (1Q 2017: 0.8% and 1.1%, respectively).

Domestic financial market conditions remained orderly

Investor sentiment continued to be affected by concerns on the US administration's ability to execute pro-growth policies, uncertainty surrounding the pace and timing of the US Federal Reserve interest rate normalisation, volatility in the commodities market and geopolitical risks. Despite these external developments, overall volatility in the domestic financial markets remained low. Average volatility of 10-year MGS yields, the equity market and the ringgit declined to 10.3%, 6.4% and 2.6% in the second quarter of 2017, respectively (1Q 2017: 17.4%, 7% and 4.7%, respectively). This was partly attributed to improved domestic sentiments amid better-than-expected GDP growth in the first quarter and favourable corporate earnings. The implementation of the Financial Markets Committee (FMC) measures also contributed to the stability in the foreign exchange market.

In the second quarter of 2017, there were net portfolio investment inflows of RM16 billion (1Q 2017: net outflows of RM31.9 billion). This was partly due to a resumption of inflows into the government bond market across all tenures. As at end of the quarter, non-resident investor holdings amounted to 26% (1Q 2017: 24.7%) of total outstanding Malaysian government bonds.

The quarter also saw continued inflows into the domestic equity market, leading to higher non-resident holdings of 23% (1Q 2017: 22.4%) of total equity

market capitalisation. Along with global equity markets, the FBM KLCI rallied by 1.4% in the second quarter of 2017 to end higher at 1763.67 points (1Q 2017: 1740.09 points). Technology, construction, financial and consumer sector stocks had driven gains in the market. The average price-to-earnings (PE) ratio for the FBM KLCI stood at 16.8 times, comparable against a long-term average of 16.5 times (1Q 2017: 16.8 times).

In addition, trading liquidity in the capital markets was sustained with the bid-ask spreads for MGS and FBM KLCI at 0.1% and 0.4% of mid-price, respectively (1Q 2017: 0.2% and 0.4%, respectively). The monthly turnover ratios for MGS and FBM KLCI were lower at 11.3% and 2%, respectively (1Q 2017: 14.1% and 2.1%, respectively).

In the currency market, the ringgit appreciated by 3.1% against the US dollar to end the quarter at RM4.2940 per US dollar (1Q 2017: RM4.4265). A similar trend was observed against other major currencies. As at end of the quarter, the 5-year cross-currency basis swap spread stood at 59 basis points (bps) (1Q 2017: 50 bps), lower than the 2016 peak of 93 bps following the US presidential election outcome. The 5-year sovereign credit default swap spread narrowed to 85.5 bps (1Q 2017: 107.6 bps).

Market risk exposures supported by risk management and hedging strategies

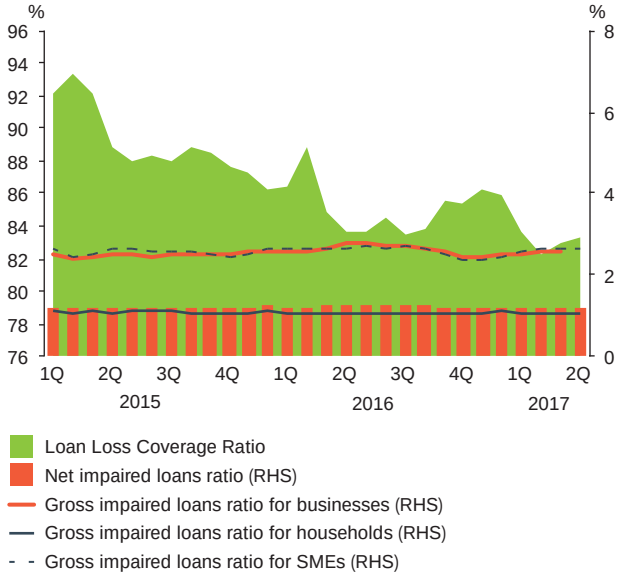
Banks' exposures to market risks remained largely in the form of FX risk, with FX net open position of 7% of total capital as at end-June 2017 (1Q 2017: 6.2%). Exposures to interest rate risk in the trading book and equity risk remained low at 1.1% and 1.1% of total capital, respectively (1Q 2017: 1.1% and 1.2%, respectively). For the insurance and takaful industry, market risk exposures were slightly higher at 14.9% (1Q 2017: 14.4%) of total capital available, in line with higher valuation in the financial markets. Equity risk, which formed the bulk of insurers' market risk exposures, rose to 9.1% (1Q 2017: 8.7%) of total capital available.

Sustained financial health of the banking system

In the second quarter of 2017, the banking system recorded a higher pre-tax profit of RM9.2 billion (1Q 2017: RM8 billion), contributed by dividend income from subsidiaries and higher net interest income from financing activities. The average cost of funds declined marginally to 2.71% as at end-June 2017, lower than the 3-year average of 2.75%. The weighted average lending and financing rates of

Healthy Asset Quality Observed in the Banking System

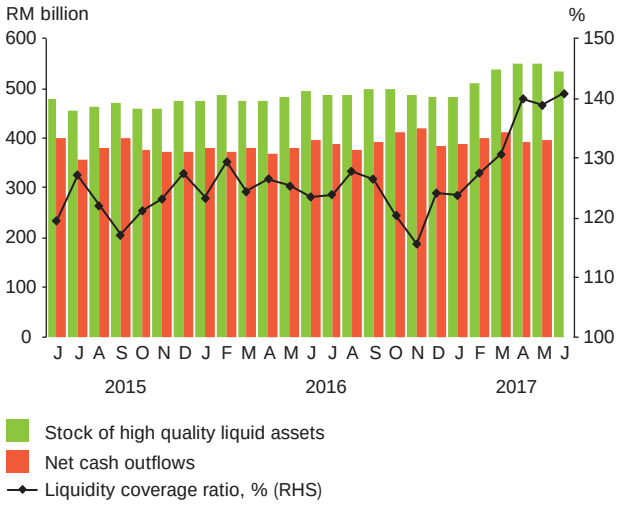
Chart 32: Banking System Loan Quality



Source: Bank Negara Malaysia

Banking System Liquidity Sufficient to Buffer for Adverse Liquidity Shocks

Chart 33: Banking System Basel III Liquidity Coverage Ratio



Source: Bank Negara Malaysia

conventional and Islamic banks declined marginally to 5.19% and 5.17%, respectively (1Q 2017: 5.21% and 5.18%, respectively). Healthy asset quality supported the lower loan loss provisions that were observed during the quarter. Banks' interest margin (net of operating costs and loss provisions) increased marginally to 0.65 percentage points (ppts) (1Q 2017 average: 0.62 ppts), attributed to lower interest expense and provisions.

In the insurance and takaful sector, general insurers and takaful operators recorded higher operating profit of RM761 million in the second quarter (1Q 2017: RM495 million) on account of improved claims incurred across key business lines. In particular, claims incurred on fire insurance and takaful decreased by 40%. Correspondingly, industry claims ratio improved to 55.2% (1Q 2017: 62.9%). On the other hand, life insurers and family takaful operators recorded a reduction in profitability with excess income over outgo decreasing to RM4.4 billion (1Q 2017: RM6.1 billion). This was largely attributed to lower net capital gains particularly from equity holdings, as the FBM KLCI index rallied at a slower rate compared to the previous quarter.

Domestic funding conditions remained favourable and supportive of financing activities. Total banking system placements, reverse repos and statutory reserves with Bank Negara Malaysia which can be unwound to meet liquidity needs, stood at RM175.7 billion, providing comfortable buffers against unexpected cash outflows or adverse liquidity shocks. Under the Basel III Liquidity Coverage Ratio (LCR), the banking system LCR stood at 141% (1Q 2017: 131%), with all banks reporting LCR levels above 100%, well above the current minimum regulatory requirement of 80%.

Both the average cost of deposits for banks and the 3-month KLIBOR were relatively unchanged at 2.51% and 3.43% (1Q 2017: 2.55% and 3.43%, respectively) as at June 2017, respectively. Domestic operations were predominantly funded by ringgit deposits (65% of total funding). Banking system deposits annual growth moderated slightly to +3% (1Q 2017: +3.3%), driven by lower deposit growth from individuals (2Q 2017: +3.9%; 1Q 2017: +5.7%).

While the bulk of banks' funding remained in the form of deposits, banks continued to diversify their funding structure through the issuance of medium-term ringgit and foreign currency denominated funding instruments. The total new issuance of debt securities by the banking sector for the second quarter of 2017 amounted to RM7.1 billion (1Q 2017: RM3.4 billion). This contributed towards further reducing maturity and currency mismatches in the banks' funding structure. Taking into account the broadened funding structure, the loan-to-funds[3] ratio (LTF) stood at 83.3% (1Q 2017: 82.8%) at the end of the quarter.

Online SME Financing Platform: A one stop platform for convenient access to financing and structured assistance

The Credit Guarantee Corporation Malaysia Berhad (CGC), in collaboration with the Bank and the financial industry, is developing an Online SME Financing Platform (the Platform). Originally mooted by the Bank to reduce search costs and improve access to financing, the Platform is expected to provide a more convenient, efficient and transparent process catering to a wider group of SMEs, through the following:

- An **Online Application Platform** that matches SMEs' financing needs with suitable financing products from various institutions and funds catering to SMEs. The Platform would substantially reduce time costs for SMEs[4], by providing fast, convenient and simultaneous access to products through a single interface with online processing. Among other things, SME applicants will be able to submit loan documents digitally (paperless), which will be accessible by multiple banks.

- Unmatched and rejected applications will be referred to the **Financial Accelerator Lab**, which provides structured assistance to enable SMEs to improve their eligibility for financing in the future, by connecting them to alternative fund providers and capacity building programmes.

The Platform is expected to be launched in the fourth quarter of 2017. Potential future enhancements to enhance the inclusiveness of the Platform include integration with other agencies to facilitate more efficient customer onboarding and leveraging on psychometric analysis and big data analytics to support credit evaluation, in particular for startups and small businesses without a credit track record or collateral.

[3] Funds comprise deposits and all debt instruments issued (including subordinated debt, debt certificates/sukuk, commercial papers and structured notes).
[4] Research from the Federal Reserve Bank of New York finds that small business borrowers often spend almost 25 hours of their time on paperwork for bank loans and approach multiple banks during the application process (September 2013) 'Fall 2013 Small Business Credit Survey'.

With More Than 40 Financial Institutions and 152 Dedicated Government Programmes, Applying for Financing Poses Significant Time Costs for SMEs

Chart 34: Avenues for SME Financing in Malaysia

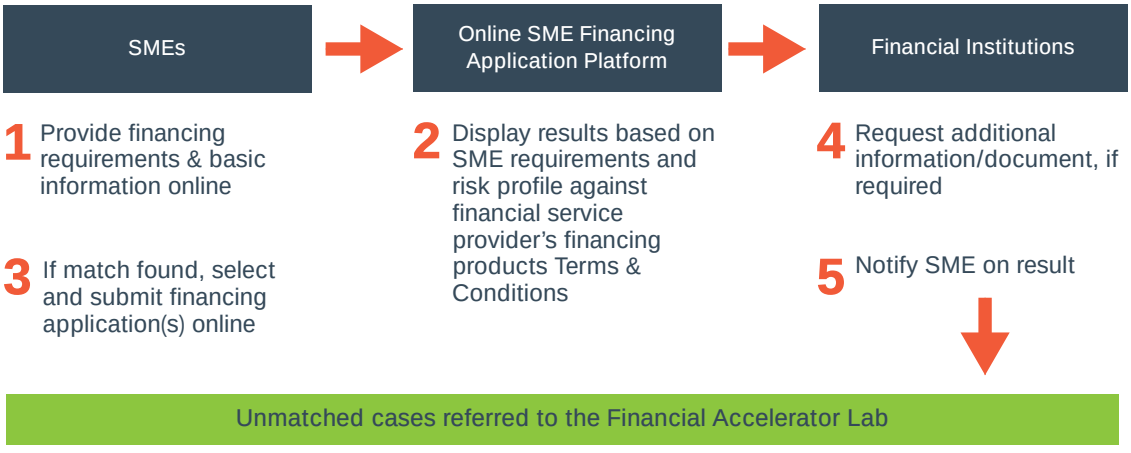


FINANCIAL INSTITUTIONS	GOVERNMENT PROGRAMMES	OTHERS
Banking Institutions	Guarantee Schemes	Leasing & Factoring
Development Financial Institutions	Government Funds	Ar-Rahnu / Pawn Broking
	Government Crisis Funds	Microfinance Institutions
		Venture Capital
		Crowdfunding / P2P

Source: SME Integrated Plan of Action 2016, National SME Development Council

Unmatched and Rejected Applications Will be Referred to the Financial Accelerator Lab

Chart 35: Referrals to Financial Accelarator Lab



Source: Credit Guarantee Corporation Malaysia Berhad (CGC)

Box Article 2

Factors Affecting Foreign Investors' Bondholding in Malaysia

Authors: Azizul Sabri Abdullah and Norasyikin Mohamad Razali

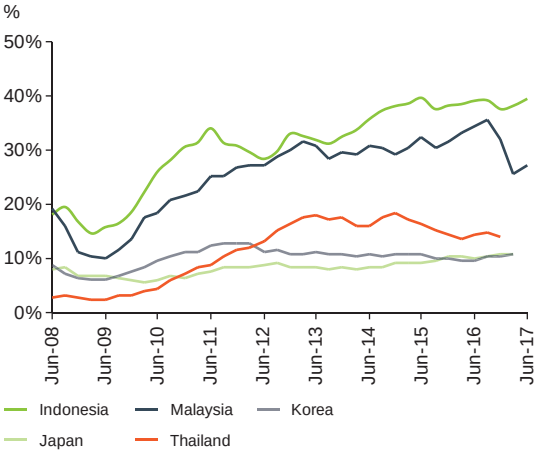
HIGHLIGHTS

- **Malaysia has significant presence of foreign investors' participation in the market that arises from the deep, liquid and investors-friendly bond market.**
- **Long term investors hold 55% of bond holdings.**
- **Despite large and sudden portfolio outflows, Malaysia bond market has remained stable and liquid due to the continuous and diverse participation from the long-term foreign investors and the domestic investors.**

Introduction: Foreign holdings of Malaysian government bonds

Foreign investors comprise a significant composition of Malaysian bond market, contributing to its position as one of the largest and liquid markets in the region and recognition as part of the major global and regional indices. As at end-June 2017, foreign holdings of Malaysian government bonds stood at RM169.9 billion or equivalent to 26.0% of total outstanding. The numbers have fluctuated over the years, reaching as high as 34.7% in November 2016.

Chart 1: Foreign Holdings of Regional Countries Government Bonds

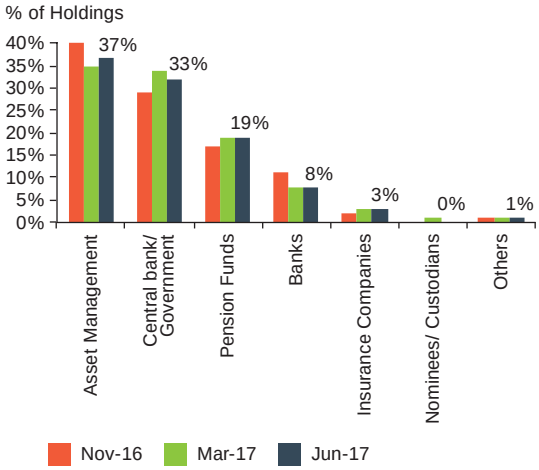


Source: Asian Bonds Online

- Malaysia has among the highest foreign participation in the region, second behind Indonesia;
- Malaysia's foreign holding fell towards end 2016 following US presidential election result; and
- Despite reduction in November 2016, foreign holdings in Malaysia are still higher than Thailand, Japan and Korea.

BNM classifies the major investor groups as asset managers, central banks and governments, pension funds, banks, insurance companies, nominees and custodians, and others. As at end-June 2017, long-term investors, such as central banks and governments, pension funds and insurance companies, held 55% of the holdings, while medium to longer term investor, i.e. asset managers, held 37% of the holdings.

Chart 2: Distribution of Foreign Holdings of Government Bonds (%)

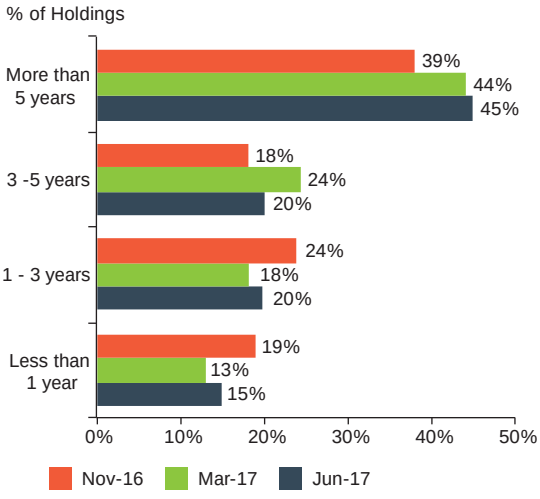


Source: Bank Negara Malaysia, Bond Info Hub

- Malaysian bond market has a diverse profile of foreign investors;
- Biggest foreign investors group in Malaysian bond market is asset managers at 37% of total foreign holdings; and
- Except asset managers and banks, foreign investors have raised their holding from November 2016 level.

Holding by foreign investors are well spread across different bond maturities. As at end of June 2017, more than 65% are in medium and longer dated bonds of more than 3 years maturity. Short dated bonds are mainly held by banks and asset managers. In addition, the foreign bond holdings are also widely distributed with the top 50 investors making up slightly more than 70% of the total foreign holdings. These top 50 also only comprise 10.9% of the total bonds outstanding. Holding by any single investor is also manageable as none of the investors hold more than 1% of the total bonds outstanding.

Chart 3: Breakdown of Foreign Bondholding by Maturity Profile (%)



Source: Bank Negara Malaysia

- Holdings by foreign investors are well spread across different maturities;
- Foreign investors have raised their holding in medium to long term bond compared to November 2016; and
- Short dated bonds are mostly held by banks and asset managers.

Malaysian bond market is attractive to foreign investors due to its deep, liquid and investors-friendly market

Foreign investors' participation in the Malaysian bond market has been driven by spectrum of factors:

Strong economic fundamental



5.2%
average GDP

Among the high economic growth countries in the region

- Strong economic fundamentals of Malaysia. The country, with a stable A- rating, has consistently been among high economic growth countries within the region, where the Gross Domestic Product (GDP) has recorded an average growth rate of 5.2% between 2011 and Q1 2017. Stable policies; monetary and fiscal, as well economic policy in general, contributes to the sound fundamentals.

Attractive investment return



A- Investment grade rating

Positive yield differential against major economies

- Attractive investment return for an investment grade country, Malaysia bond market offers positive yield differential in an environment of sustained global monetary policy accommodation and prolonged period of low interest rates.

Deep and liquid bond market



Largest in ASEAN

Third largest in Asia after Japan and Korea

- Depth and liquidity of the Malaysian bond. The market, at 94.6% of GDP, is the largest in ASEAN and the third largest in Asia, after Japan and Korea. A well-developed market infrastructure including the existence of primary dealers obligated to provide two-way prices provide further liquidity and price transparency in the secondary market.

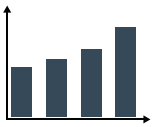
No restriction in foreign investment



No imposition of minimum holding period nor taxes on income and capital gain

- Liberalised investing environment that does not impose any minimum holding period or taxes on interest income and capital gain which are major hindrances on other developing markets for foreign investors.

Inclusion into various global benchmark indices



Inclusion of Malaysia in World Government Bond Index and JP Morgan Government Bond Index

- Inclusion into various major global benchmark indices such as World Government Bond Index and JP Morgan Government Bond Index.

There are also challenges brought by foreign investors

Foreign investors' participation has brought significant benefits[1] in the form of greater investors' diversity and broader investors' base, and with it, greater depth and liquidity to the market. The enhanced liquidity and additional demand also have helped to reduce borrowing cost for both corporate and government when raising funds from the bond market.

However, the increased participation has brought some challenges.

i. The high headline composition of foreign holdings has generated concerns in the past among analysts and international credit rating agencies that it could become a source of vulnerability. Its reversal could have adverse impacts on bond yields and the resulting outflows may cause undue pressure on ringgit. Nevertheless, we should note that the aggregate numbers mask the underlying diversity of the holders.

ii. Foreign investors' holding of local currency bonds contributes to higher external debt. This often has been cited by international credit rating agencies as a source of vulnerability, notwithstanding Malaysia's external assets are more than its external debt.

iii. Foreign investors' flows can be fickle and highly reactive to global market sentiments. It may result in sudden and significant portfolio outflows, creating volatility to the onshore financial markets. This was evident following bonds' holding adjustment of RM26.6 billion in 2013 during the Taper Tantrums[2] and RM60.6 billion in November 2016 to March 2017 after the surprised result of US presidential election and expectation of US interest rate hike.

iv. The sharp reversal of foreign investment had led to rising market volatility and impacted financial markets stability. During these episodes, the government bond yields increased by up to 93 basis points across the yield curve, a slight increase compared to regional countries that have lower foreign participation. Volatility was more pronounced in the foreign exchange (FX) market. From the ensuing capital outflows, ringgit weakened by 4.47% to close at 4.4230 as at end of March 2017, and ranked among the worst performing currencies in the region. Liquidity in the FX market also suffered, compounded by the lack of USD supply from export proceed conversion, with bid-ask spread widened by as much as 110 pips.

The risks of foreign investors' participation were articulated by Jaime Caruana of Bank for International Settlements in his closing panel remark in 2011 at Bank of Japan-BIS high level seminar:
"We must admit that the elimination of barriers to cross-border investment – even it may be beneficial to local bond market development – can at times run counter to policymakers' mandate of stabilising the financial system and macroeconomy when capital inflows are large and volatile. These trade-offs are very real."

[1] The benefits of foreign participation were reflected in IMF's Working Paper 10/88 in 2010 that "Foreign investors could act as catalysts for the development of local bond markets, particularly by diversifying the institutional investor base and creating greater demand for local EM debt securities." The benefits were also echoed by a study by World Bank and IMF (2001) that stated "Foreign investors are an important source of demand for fixed-income securities. Through the positive pressure they place on the quality and services of intermediaries and their emphasis on sound, safe, and robust market infrastructure, they have contributed to the development of national capital markets in many countries."

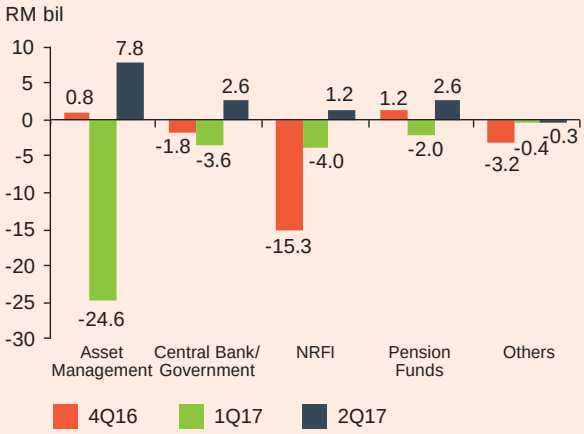
[2] May to September 2013.

While long-term investors' holdings remains steady, factors affecting short-term investors impact stability of foreign holdings

Detailed analysis showed that the recent portfolio adjustment was driven primarily by foreign banks and some asset managers. These investors sold a total of RM49.5 billion of Malaysian government bonds during November 2016 to March 2017, compared to RM10.0 billion that were sold by other investors. Furthermore, the adjustment was from short dated bonds, where RM38.4 billion was sold compared to RM21.1 billion of other bonds.

Foreign investors investing in short dated bonds faced minimal price risk arising from interest rate movement. Hence, in a "risk-on" and "risk-off" environment, portfolio adjustment is swift, resulting in higher volatility in capital flows. This behaviour was apparent after BNM strengthened enforcement actions to reduce the influence and delink the offshore non-deliverable forward (NDF) market from the onshore FX market. It can be argued that these investors took advantage of the liquid and risk-free government bonds to support their exchange rates views.

Chart 4: Change in Non-resident Holdings by Types of Investor



Source: Bank Negara Malaysia, internal computation

In contrast, long-term foreign investors are less affected by swing in market sentiments. Their investment remains stable and at times contrarian to the short-term foreign investors' activities, providing stability to the overall foreign bond holdings. However, some of these long-term foreign investors are index-trackers, and any changes to the benchmark index will lead to rebalancing of their investment portfolio. If this were to happen, their actions can also be destabilising to the market as it creates volatility and outflows. This has been observed to some degree with the recent inclusion of additional countries that causes reduction in Malaysia's weight in the global benchmark index. Some of the RM21.5 billion of Malaysian bonds sold in March 2017 by foreign asset managers was triggered by the need to rebalance their portfolio according to the index's weight for Malaysia.

Malaysian bond market remains robust, despite volatility caused by high foreign holdings

In summary, there is a trade-off between the liquidity and benefits brought by foreign investors and the impact of their participation to the stability of the financial market. Foreign participations expose the market to abrupt reversals, and this may impact orderly functioning of the financial markets. Furthermore, foreign investors' participation open up demand for offshore hedging and the presence of offshore trading creates a new avenue for speculative and heightened volatility. There is a need to relook at the role of foreign investors in domestic bond markets.

Foreign holdings of Malaysian bonds have reduced significantly from its peak, and are now hovering at a more manageable level. The Malaysian bond market now has higher participation of medium to long-term investors, contributing to better stability to the market. Consequently, efforts to safeguard market stability will gear towards supporting this environment and have a truly diverse composition of investors. The reduction in the foreign participation, to a certain extent, contributes towards a more stable bond market.

Bank Negara Malaysia, together with the Financial Market Committee, has introduced several measures to enhance the development of the bond market. Investors now have additional flexibility to actively hedge their exposure while residents have more interest rate hedging avenues through greater liberalisation of regulated short-selling. Adherence to best standard and market practices to promote a fair and effective financial market, while ensuring market order and stability, are strengthened with the issuances of Principles for a Fair and Effective Financial Market and the Code of Conduct for Malaysian Wholesale Financial Markets. Information reporting and settlement infrastructure are being enhanced to provide greater information transparency and surveillance of the financial markets. All these initiatives and measures will contribute towards developing financial markets that are deep and liquid, which will safeguards the interest of not only foreign investors, but also the Malaysian economy and the rest of other market participants.

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The Bank's Policy Considerations

HIGHLIGHTS

- **The OPR was maintained at the prevailing level of 3.00%, amid positive growth momentum and moderating headline inflation.**
- **Existing macroprudential measures and other measures to manage associated risks emanated from household and business sectors, and property market continue to remain relevant.**

The MPC maintained the OPR at 3.00%

At the May and July Monetary Policy Committee (MPC) meetings, the MPC maintained the Overnight Policy Rate (OPR) at 3.00%.

By mid-year, there was firmer indication that the Malaysian economy would register higher growth in 2017. The global economy continued to strengthen, with more synchronised growth across economies driven by sustained private consumption growth. This stronger domestic and global demand conditions, together with improved sentiments, are supporting a more favourable investment outlook globally. For Malaysia, the positive spillovers from the stronger external sector performance have been felt through both the income and investment channels. The sustained private expenditure growth will remain supported by higher wages and employment, and new and ongoing infrastructure projects. Headline inflation is expected to continue moderating in the second half of the year after peaking in March, mainly reflecting the waning effect of global cost factors. Underlying inflation, as measured by core inflation, is expected to be sustained by the more robust domestic demand. Nevertheless, underlying inflation is expected to remain contained, after increasing from 2.1% in 2016 to 2.5% in the first half of 2017.

Monetary and financial conditions remained resilient and supportive of economic activity. The ringgit has remained stable with a more balanced demand and supply of foreign currencies following the implementation of the two financial market development measures. Liquidity conditions have improved, with an increase in net banking system liquidity following the net portfolio inflows during the quarter.

The MPC is cognisant of the recent positive growth developments and will continue to assess the sustainability of this growth momentum, which is dependent on incoming information. At the same time, the MPC will continue to monitor for any signs of demand-pull inflationary pressures. In this regard, the MPC will assess the balance of risks surrounding the outlook for domestic growth and inflation.

The Bank's Financial Stability Committee (FSC) assessed that domestic financial stability remains preserved

The 51st FSC meeting was held on 1 August 2017. During the quarter, the FSC observed that key sources of risks to domestic financial stability stemmed from heightened credit risk in certain business segments and an oversupply of high-end condominiums and commercial property, which in the view of FSC, required increased vigilance.

Overall debt repayment capacity of households was assessed to remain intact. This was despite a slight deterioration in credit quality for vulnerable households. Household debt continued to expand with a more moderate growth of 5.1%. The risk outlook of the financial system remains stable while liquidity conditions continue to be supportive of domestic financial intermediation. The domestic financial market is expected to remain orderly amidst uncertainty in the global environment.

Other policy highlights in the second quarter of 2017

During the quarter, the Bank implemented several initiatives to preserve financial stability and provide a conducive environment for the sustainable growth of the economy:

- To curb the growth of illegal financial schemes, financial institutions have been directed to strengthen controls to prevent the facilitation of illegal fund movements. An inter-agency initiative led by the Attorney General Chambers under the National Coordination Committee to Counter Money Laundering will assess the current legal framework and take joint enforcement action on any financial fraud and scams. The public was also urged to stop participating in such schemes.

- The Bank continued to promote higher standards of stress testing and sound risk management practices for all banking institutions.

- The motor tariff liberalisation came into effect on 1 July 2017, with the premium for motor insurance products now determined by individual insurers and takaful operators in a more risk sensitive methodology. On the same date, the policy to diversify distribution channels for life insurance and family takaful products to promote greater accessibility became effective.

- The migration to PIN & PAY was successfully implemented. Close to 23 million payment cards in Malaysia have been replaced with PIN-enabled cards. All payment card terminals deployed in Malaysia, including outdoor payment terminals at petrol stations, have also been upgraded to support the use of PIN.

Macroeconomic Outlook

HIGHLIGHTS

- **Global growth to expand at a faster pace in 2017, supported by improvements in both advanced and emerging market economies.**
- **The Malaysian economy is expected to record a stronger growth in 2017.**
- **Headline inflation is expected to moderate further in the second half of 2017, and to average within the forecast range of 3.0% - 4.0% for 2017 as a whole.**

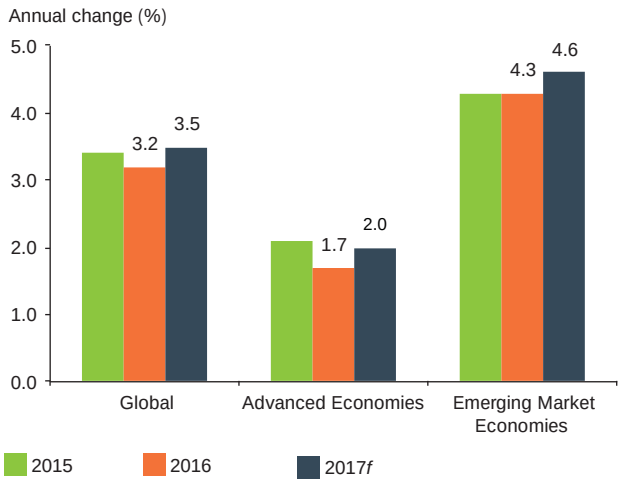
Global growth to expand at a faster pace, supported by improvements across regions

Continued strengthening of the global economy in the second quarter, reaffirms the positive outlook of global growth in 2017. In the advanced economies, growth prospects remain favourable. Economic data releases point to a positive investment outlook. Of significance, labour market conditions are projected to tighten further, lending impetus to private consumption. Growth in the emerging market economies is expected to continue benefitting from strong external demand amid sustained domestic activity. As export growth remains robust, potential spillovers to the domestic economy reinforce the possibility of stronger momentum going forward.

Nevertheless, the growth outlook remains subject to several risks. These arise mainly from the pace of monetary policy tightening in major economies, protectionist policies, and political uncertainty in parts of Europe. Geopolitical tensions and swings in oil price also pose risks to global growth prospects.

Growth Improvements Projected Across Regions

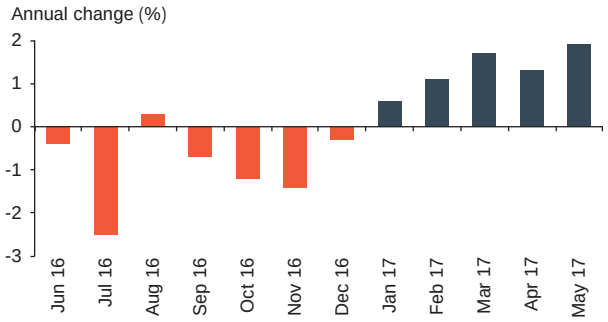
Chart 36: Real GDP Growth



Source: IMF World Economic Outlook (July 2017)

Leading Indicators Point to Continued Expansion in the Domestic Economy

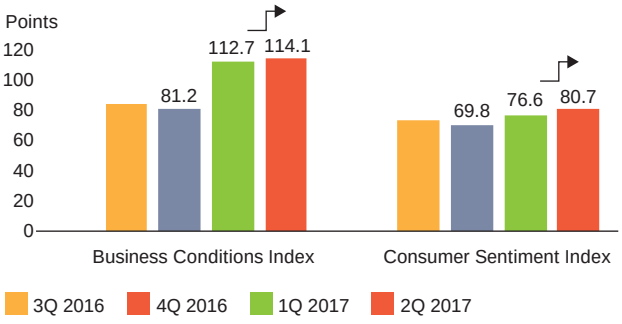
Chart 37: Composite Leading Index



Source: Department of Statistics, Malaysia

Sentiment Indicators Improved in 2Q 2017

Chart 38: MIER Business Conditions and Consumer Sentiment Indices



Source: Malaysian Institute of Economic Research

The Malaysian economy is expected to register higher growth in 2017

Given the continued strong performance in the second quarter of 2017, the Malaysian economy recorded a strong growth of 5.7% in first half of 2017. At this point, compared to the beginning of the year, there are considerable improvements in the operating environment of the economy. Looking ahead, it is likely for the Malaysian economy to expand by more than 4.8% for the whole year of 2017. Leading indicators such as the Department of Statistics Malaysia's composite leading index, MIER Business Conditions Index and MIER Consumer Sentiments Index, suggest continued expansion of the domestic economy. Private consumption will be underpinned by continued wage and employment growth, with support from various policy measures to raise disposable income. Investments will be driven by the implementation of new and ongoing infrastructure projects, and higher capacity expansion in the manufacturing and services sectors. The stabilisation of commodity prices is also expected to lend support to investments in the mining sector. On the external front, exports are expected to benefit from the improvement in global growth, especially among Malaysia's key trading partners. Overall, the economy is expected to record a stronger growth in 2017.

On the supply side, the improvement in both external and domestic demand conditions will benefit the manufacturing and services sectors. The agriculture sector's growth will be underpinned by a recovery in CPO yields post-El Niño. Growth in the mining sector is projected to be mainly supported by output from the ramping up of production in new gas facilities. In the construction sector, new and existing civil engineering projects will drive the sector going forward.

Headline inflation for 2017 will average within the forecast range of 3.0% - 4.0%

Headline inflation is expected to moderate further in the second half of 2017 due mainly to lower contribution from fuel products. The stronger recovery in the production of US shale oil is expected to contain the upward pressures on global oil prices. In addition, the base effect from lower fuel prices in 2016 will diminish given the relatively higher fuel prices in the fourth quarter of 2016. Headline inflation is expected to average within the forecasted range of 3% - 4% for 2017 as a whole.

1 Feature Article

Outcomes of the Reference Rate Framework: Moving Towards More Efficient and Transparent Practices

Authors: Chuah Kue Peng and Zul-Fadzli Abu Bakar

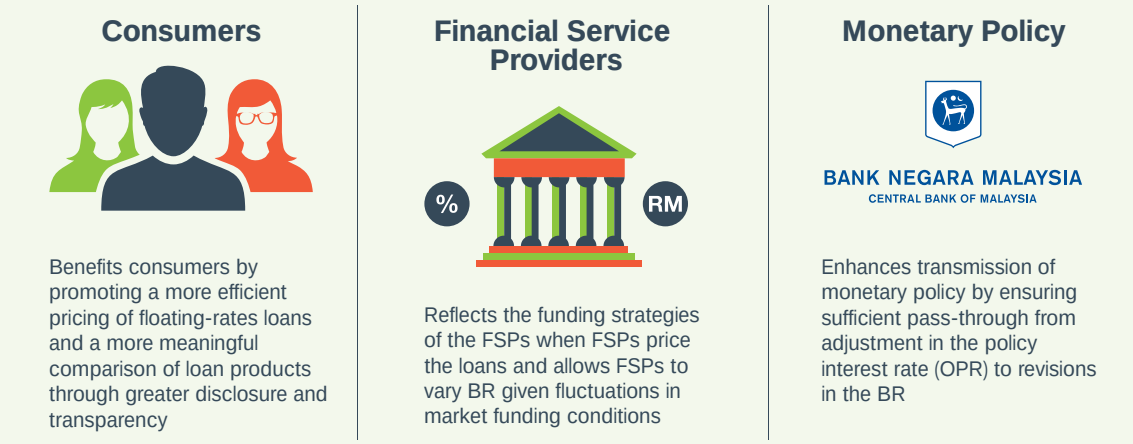
HIGHLIGHTS

- The Reference Rate Framework introduced in January 2015 replaced the Base Lending Rate with the Base Rate as the reference rate for retail floating-rate loans and financing facilities.
- Implementation of the Reference Rate Framework is driven by three outcomes:
  - benefit consumers with more efficient pricing and greater transparency;
  - reflect funding strategies of financial service providers; and
  - enhance transmission of monetary policy.
- The results observed thus far indicate that the Reference Rate Framework is on-track to achieve its intended outcomes.

Introduction

The Reference Rate Framework (RRF) was introduced in January 2015 to replace the Base Lending Rate (BLR) with the Base Rate (BR) as the main reference rate for the pricing of new retail floating-rate loans and financing facilities[1]. The RRF aims to achieve three key outcomes: to benefit consumers by providing more efficient pricing and transparency; to better reflect funding strategies of financial service providers (FSPs) while encouraging greater discipline in the pricing of retail financing products; and to effectively transmit monetary policy (Figure 1). This article discusses how the three objectives have driven the implementation of the RRF and the revisions made to the framework in August 2016. It also highlights the extent to which the intended outcomes have been achieved.

Figure 1: Three Outcomes Drive the Implementation of the Reference Rate Framework



Source: Bank Negara Malaysia

[1] Further details in the Bank Negara Malaysia Annual Report 2014 Box Article: The New Reference Rate Framework.

i) Benefits consumers with more efficient pricing and greater transparency

The BR is an important consideration for consumers when taking a floating-rate loan as changes in this rate will affect monthly loan repayments (Figure 2). Specifically, consumers need to be aware of what constitutes the benchmark cost of funds used to calculate the BR and how this can affect movements of the BR. The characteristics of the benchmark cost will determine the pass-through from changing funding conditions of FSPs to BR[2,3].

The shift to the BR regime serves to benefit consumers given the more efficient and transparent features of the framework. The components of the BR are clearly defined and determined only by the FSPs' relevant benchmark cost of funds and the Statutory Reserve Requirement (SRR). As such, the adjustment mechanism of the BR is more efficient as it only reflects movements in funding costs of FSPs that are either driven by changes to monetary policy, market conditions or SRR adjustments.

Another aspect of an efficient pricing practice is that only sustained changes in funding costs are allowed to be passed on to the BR. This requirement under the RRF serves to safeguard consumers from excessive BR fluctuations. The revision of the RRF in August 2016 further mitigates BR fluctuations by only allowing FSPs to revise their respective BRs at quarterly intervals.

Implementation of the RRF creates greater transparency to borrowers through several ways. First, FSPs are required to publish their BR, by prominently displaying the BR on their websites and at all their branches, and disclose the indicative effective lending rate for a standard housing loan[4]. These disclosure requirements are intended to facilitate a meaningful comparison by the consumers amid the varying BR offered by FSPs. Second, following the revision of the RRF in August 2016, FSPs are now required to disclose the benchmark cost of funds used to compute the BR, factors that would result in movements of the BR and to notify borrowers of a change in the benchmark cost of funds. These requirements are intended to make the movements of the BR more transparent and help consumers better anticipate movements of the BR. Third, FSPs are required to provide advance notice to borrowers prior to a change in the monthly loan repayments, to ensure that consumers are aware of the changes.

Close to three years after the implementation of the RRF, consumers are increasingly more responsive to the greater transparency of the RRF. From April 2017 to June 2017, the number of views received on the BR comparison table provided on the Bank's website[5] has increased more than three-fold compared to that in the first year after the implementation of the RRF. The transparency in the RRF has empowered consumers to make well-informed comparisons and decisions when choosing from a variety of loan products offered.

ii) More efficient and transparent practices by Financial Service Providers (FSPs)

For FSPs, the implementation of the RRF incentivises banks to efficiently manage their funding risks and pricing of floating-rate loans. The RRF ensures that FSPs compute their BR using only benchmark funding costs that reflect their funding strategies. This way, the framework ensures that only relevant costs are used in the pricing of loans and in future adjustments to the consumers' monthly loan repayments. Furthermore, as the lending rates on BR-based loans adjust to changes

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[2] For example, a more volatile benchmark cost of funds may result in larger and more frequent fluctuations in the BR and monthly instalments, while a more transparent benchmark cost would let borrowers anticipate future BR movements.

[3] The effective lending rate, which is the BR plus a fixed spread charged by FSPs, is another key consideration for consumers. The spread reflects other loan pricing components, including credit risk, liquidity risk, operational costs and profit margins of the FSPs. Therefore, the spread can be considered as a comparable measure of efficiency across FSPs, which in turn facilitates a more informed decision making by consumers.

[4] Refers to a housing loan with financing amount of RM350,000 for a tenure of 30 years with no lock-in period.

[5] A comparison table for the BR, BLR and indicative effective lending rate of 24 FSPs is published on the Bank's website: *http://www.bnm.gov.my/index.php?ch=en_announcement&pg=en_announcement&ac=19*

in market funding conditions, the RRF better facilitates FSPs' management of interest rate risk. Under the RRF, other risk premia and non-cost factors are now captured in the fixed spread above the BR. Once a loan is contracted, the spread remains fixed and can only change over the life of the loan if there are substantial changes to the creditworthiness of the borrower. This requirement encourages greater discipline in managing funding risks by FSPs when determining the pricing of their loans.

To ensure effective implementation of the RRF, FSPs are required to select the benchmark cost of funds that is most reflective of their funding strategies. Initially, when the RRF was introduced in early 2015, the 3-month Kuala Lumpur Interbank Offered Rate (KLIBOR) was a popular choice for the benchmark cost among FSPs due to its simplicity. However, towards the end of 2015, the BR began to diverge from developments in the 3-month KLIBOR. Competition for more stable sources of funding during the period had led to higher wholesale and retail cost of funds for FSPs. While market conditions began to stabilise by early 2016, deposit costs remained elevated before gradually moderating. This led to some upward revisions in the BR between January and May 2016 despite the decline in the 3-month KLIBOR. Following this temporary divergence between the 3-month KLIBOR and the BR, some FSPs began to review and adopt a new benchmark cost to better reflect funding strategies. As a result some FSPs began to compute their BR using a composite rate that comprised the 3-month KLIBOR and their internal funding costs such as deposit rates.

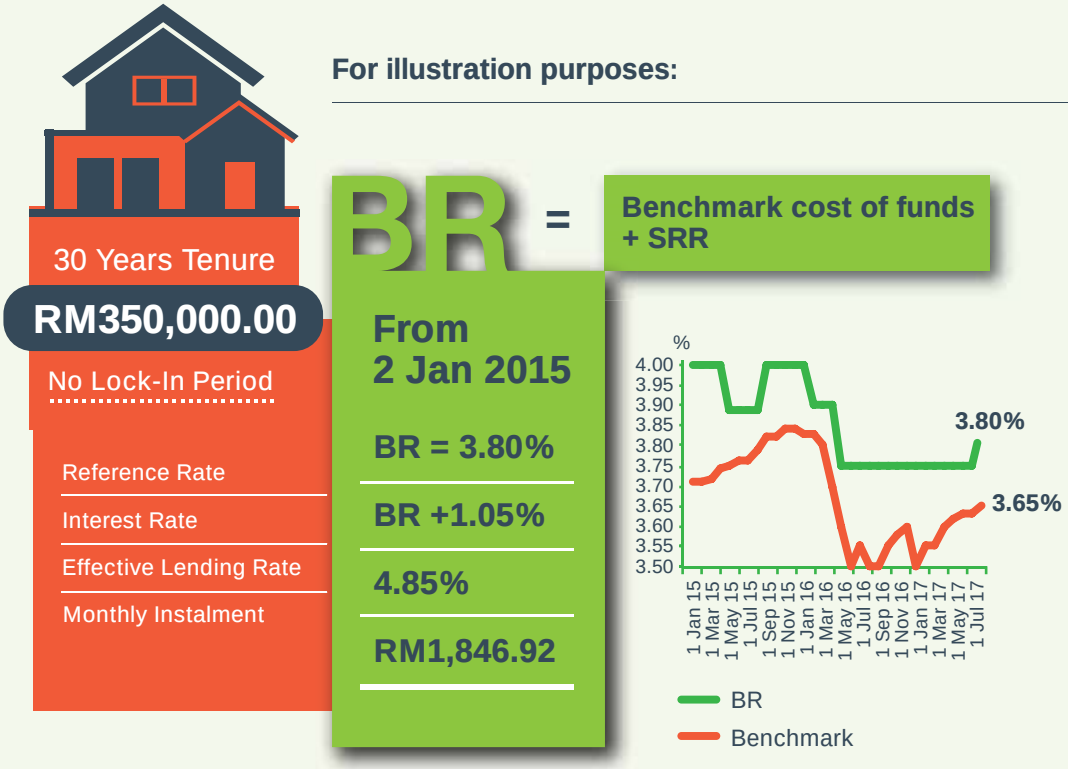
iii) Enhances monetary policy transmission

The BR is intended to vary with fluctuations in the cost of funds stemming from both changes in market funding conditions and adjustments in the OPR. The latter provides a transmission channel from OPR adjustments to lending rates on both new and existing retail loans, and consequently influence the domestic economy (Figure 3).

Following the latest OPR reduction of 25 basis points in July 2016, a higher pass-through from monetary policy to the reference rate was observed. Specifically, the weighted average BR of commercial banks declined by 21 basis points, equivalent to an 84% pass-through, within two weeks of the OPR reduction. In comparison, the pass-through to the BLR was historically lower at around 70%.

The improved transmission, with most FSPs reviewing a shift in their benchmark cost of funds from the 3-month KLIBOR towards a composite of the 3-month KLIBOR and internal funding, there was a concern that the strength of future monetary transmission might diminish over time. The choice of the benchmark cost of funds used to calculate the BR is important as it will influence the strength of the pass-through of monetary policy. A KLIBOR-based benchmark cost for example, will have a strong pass-through since the KLIBOR tends to be very responsive to changes in OPR. With FSPs increasingly referencing their internal funding costs, there was a concern that these funding sources may not necessarily be as responsive to the changes in the OPR. To address this concern, the revision of the RRF in August 2016 requires the computation of the BR to be based on the FSPs' marginal cost of funds of the benchmark cost chosen. The marginal cost of funds refers to the incremental cost that would be incurred by the FSPs to obtain new funding. This requirement would ensure that the transmission of monetary policy to lending rates remains strong. Furthermore, FSPs are also required to revise their respective BR within seven working days of the OPR change to facilitate relatively quicker monetary transmission to lending rates.

Figure 2: Considerations For Consumers When Taking a Floating-rate Loan

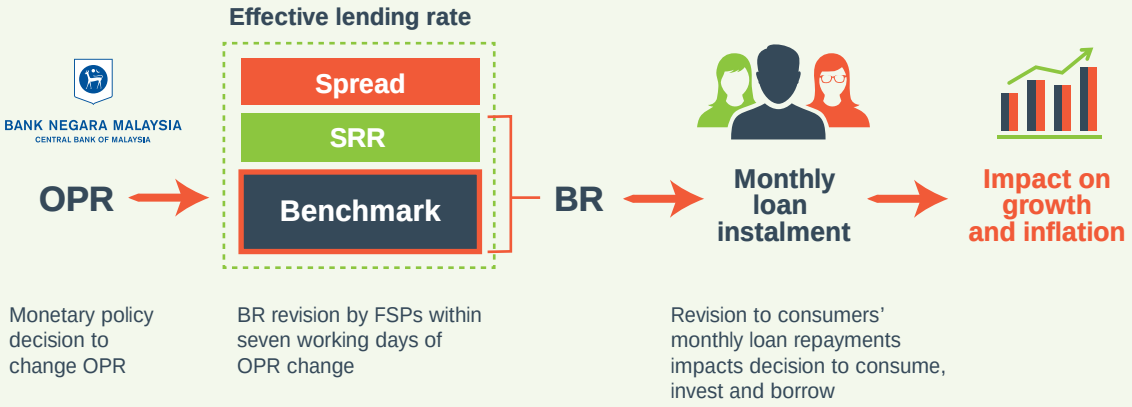


What should you do as a borrower?

1. Compare the effective lending rates quoted by different financial institutions before taking a new floating-rate loan.
2. Ask for a Product Disclosure Sheet (PDS) that constitutes the effective lending rate and total repayment amounts for the loan.
3. Ask the financial institution to explain what constitutes the benchmark cost of funds used to compute the Base Rate and the factors that may lead to a change in the benchmark cost and the Base Rate. The Base Rate should reflect the movements of the benchmark cost of funds.
4. The amount of monthly repayments will increase or decrease or the financing tenure may change when there is a change in the Base Rate.
5. Compare the different Base Rates and benchmarks offered by different financial institutions. A comparison table is provided on Bank Negara Malaysia's website. *http://www.bnm.gov.my/index.php?ch+en_announcement&pg=en_announcement&ac=19*
6. Borrowers should assess the affordability of loan repayments if the effective lending rate increases in the future.
7. Borrowers should receive notifications from the financial institution when there is a revision to the Base Rate and monthly repayments, and if the financial institution changes the definition of the benchmark cost of funds.

Source: Bank Negara Malaysia

Figure 3: Monetary Policy Transmission (OPR Pass-through to BR)



Source: Bank Negara Malaysia

With revisions made to the RRF, movements of the BR are expected to be more responsive to changes in monetary policy. The intention is to build a stronger relationship across the OPR, BR and market interest rates, which would facilitate a more complete adjustment from monetary policy to consumers and real economic activity.

Going forward, the Bank will continue to monitor closely the implementation of the RRF to ensure that the intended outcomes achieved continue to improve further, marking a step towards more efficient and transparent practices as the financial landscape develops further.

2 Feature Article

Liberalisation of Motor Insurance Business: Rewarding Good Risk Management

Authors: Izian Sherwani Mansor and Afiza Abdullah

HIGHLIGHTS

- **The liberalisation of motor insurance achieves more equitable pricing which reflects the underlying risks and appropriately differentiates good and bad risks.**
- **Broader rating factors will be taken into account in determining fairer premiums for consumers.**
- **Consumers will benefit from healthy competition which will lead to improvements in service quality, expanded range of products and continued access to motor insurance cover at competitive prices.**

What is motor insurance liberalisation?

Liberalisation of motor insurance means that the price, scope of coverage and terms and conditions of motor insurance products will no longer be dictated by the Motor Tariff which until 2012, was last reviewed in 1978. Under the new environment, the pricing of motor insurance products will be determined by individual insurers based on risk factors and competitive forces. Products and pricing will no longer be standardised and may vary from one insurer to another. This allows motor insurance providers to be more responsive to consumer preferences and market conditions. It also achieves more equitable pricing which better reflects the underlying risks and appropriately differentiates between good and bad risks. Consumers with good risk profiles should expect better pricing for their insurance premiums.

The liberalisation process is carried out in two phases. Phase 1 which was implemented on 1 July 2016 saw some insurers introducing new motor insurance products with non-tariff features, at market rates. Under Phase 2, which began on 1 July 2017, two existing motor insurance products covered by the tariff were liberalised. These are:

(i) products that provide coverage for third party losses and loss or damage to an insured's own vehicle due to fire or theft only; and

(ii) products that provide comprehensive coverage, comprising coverage as per (i) above as well as damage to an insured's own vehicle from any accident.

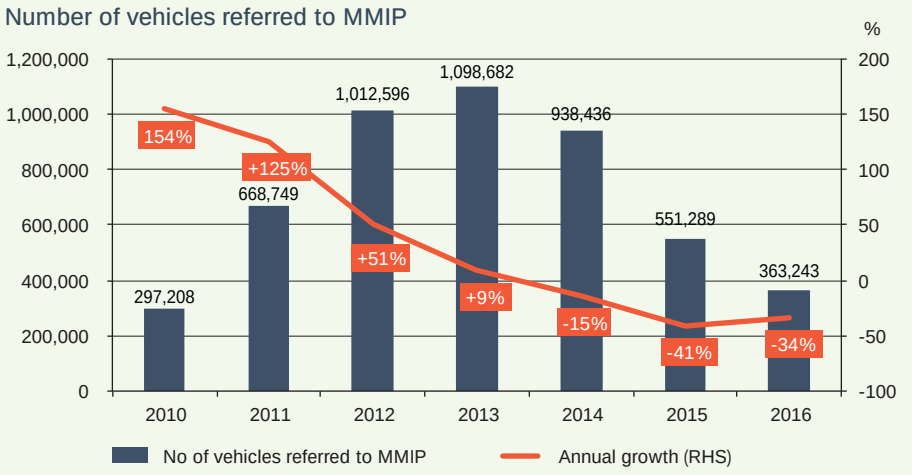
Compulsory third party insurance required under the Road Transport Act will remain controlled under the tariff. This aims to ensure continued affordable access to compulsory motor insurance during the transition and facilitate gradual and orderly market adjustments. Further liberalisation will be subject to a review by Bank Negara Malaysia in 2019 to assess the readiness of the market to support subsequent phases of liberalisation.

Addressing pricing inequity and incentive problems under a tariff environment

Under the tariff arrangement, significant cross-subsidies exist between risk segments resulting in some policyholders paying more premiums than they should, compared to relatively riskier drivers and vehicles. Beyond a certain point, broad-based adjustments to tariff rates which increase the extent of cross subsidies would lead to sub-optimal outcomes. Insurance would become economically inefficient for good risks, resulting in adverse selection and reduced capacity for motor insurance among insurance providers.

Evidence of this was observed in 2012 when over a million private vehicles had to turn to the Malaysian Motor Insurance Pool (MMIP) to obtain motor insurance cover following actions by several insurers to decline motor (especially third party) risks due to prolonged and sustained losses. Risks in the pool were subjected to significant premium increases at the time. Underwriting conditions subsequently eased with gradual tariff premium adjustments introduced under the New Motor Cover Framework in 2012. The adjustments fully anticipated an eventual transition to a more sustainable, market-based pricing environment in order to reduce the distortions mentioned earlier.

Chart 1: The Small Premium Adjustments had Partially Resulted in Some Insurers Accepting Motor Risks Previously Declined Due to Misaligned Pricing



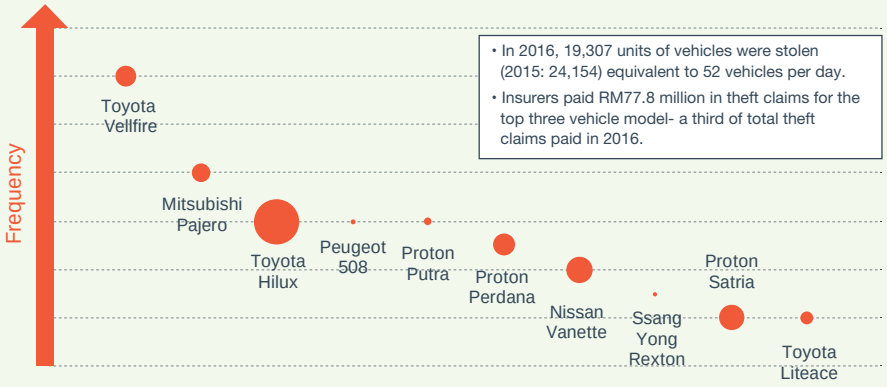
Source: Malaysian Motor Insurance Pool (MMIP)

Between 2011 and 2016, the insurance industry also paid out more than RM2.8 billion in claims for losses from vehicle theft. Despite a disproportionately higher incidence of theft observed for specific vehicle models, insurers were unable to differentiate pricing accordingly under a tariff environment and this led to increased pressure on overall premiums.

These developments illustrate the problems associated with a tariff system in which weak incentives exist for vehicle owners, manufacturers and drivers to manage risks. This in turn leads to higher premiums over time which are not properly attributed to and borne by those risks that contribute most to losses. The lack of competition between insurers also weakens the functioning of market mechanisms that allow optimal prices to emerge, and impedes innovation and service quality improvements which ultimately benefit consumers.

Chart 2: Higher Incidence of Theft is Observed for Specific Vehicle Models in Malaysia

Top 10 frequently stolen vehicles in 2016



Note:
1. The size of the bubble represents the number of theft count for each vehicle model
2. Frequency is calculated by dividing the number of theft count by total policy count

Source: Vehicle Theft Reduction Council

How premiums are calculated and early observations of premium trends in the liberalised environment

Insurance is based on a pooling concept where similar risks are pooled together. In a liberalised environment, similar risks can be grouped together in more granular pools, thus allowing prices to more accurately reflect the risks presented.

More factors will also be taken into account in determining premiums. Under the tariff, premiums were largely driven by sum insured, cubic capacity of the vehicle engine, age of driver and age of vehicle. While these factors remain relevant in the liberalised environment, premiums may also be further differentiated based on other additional factors such as vehicle make and model, security features in the vehicle, driving experience and behaviour, duration the vehicle is on the road, location of a vehicle when not in use and record of traffic offences. The factors that drive pricing will vary between insurers.

Based on pricing models of 11 out of 26 insurers sampled by Bank Negara Malaysia as at end July 2017:

- Both premium increases and decreases within a range of +/-10% were observed across all risk pools. This suggests insurers are appropriately differentiating between lower and higher risks consistent with more equitable pricing.
- A reasonable dispersion of premium adjustments that were less than +10% was observed, suggestive of more refined pricing models by some insurers.
- Premiums generally decline with age, reflecting higher risks associated with younger and less experienced drivers, in particular below the age of 25 years. Some policyholders within the age band of 40 and 50 years old may experience marginally higher premiums, which is partly attributed to the use of their vehicles by young adult children of driving age.
- Downward adjustments in premiums were more prevalent for newer cars compared to older cars.
- No significant differences were observed across vehicle makes and models which may indicate a more cautious approach taken by insurers before fully reflecting risk factors in price adjustments. In the initial phase of liberalisation, this is likely to tamper the effects of premium adjustments across risk groups. An exception, however, was observed for high theft-prone vehicles which are likely to attract higher premiums.
- Higher premiums were observed for vehicles in West Malaysia than those in Sabah and Sarawak. This is mainly due to differences in risk levels and risk exposure arising from traffic density and road conditions.

These observations do not take into account more specific individual risk factors that insurers may apply in calculating premiums for individual policies. An insurer can apply such additional factors (for example, how often a vehicle is used or security features installed by a vehicle owner) to adjust premiums either higher or lower than that indicated by their pricing models.

Consumers should therefore make comparisons of products in terms of features, premium rates and scope of protection, to select the product that best suits their needs. Consumers should also be mindful that price should not be the only determining factor when purchasing coverage. Insurers' customer service standards and claims handling are other important considerations in deciding which product to buy and which insurer to buy from.

More choice and control for consumers

With liberalisation, a wider range of product options is being offered by insurers to suit different needs. Telematics insurance is one such product. It takes into account the extent of use of vehicles and driving behaviour in determining premiums, where drivers can enjoy premium discounts for vehicles that are used less often or if safer driving behaviour is observed.

With greater flexibility in product design, policyholders can also choose different levels of coverage for the perils that best suit their risk exposure instead of standardised perils under the tariff, thus having more control over the extent of coverage and hence, premiums that they will ultimately pay. Consumers can also take practical measures to influence the premiums that they pay, for example parking in secure facilities when not in use, installing anti-theft devices or considering vehicle specifications that can reduce insurance risk when buying a car.

As insurers will offer different product options and flexibilities, it is important that consumers shop around. Information on motor insurance and takaful providers, product options, and convenient on-line channels to obtain premium quotations from insurers is available through the 'product selector' provided at Persatuan Insurans Am Malaysia's (PIAM) and Malaysian Takaful Association's (MTA) websites. Alternatively, consumers can go to the websites of individual insurers directly, or through Bank Negara Malaysia's website, for information and quotes.