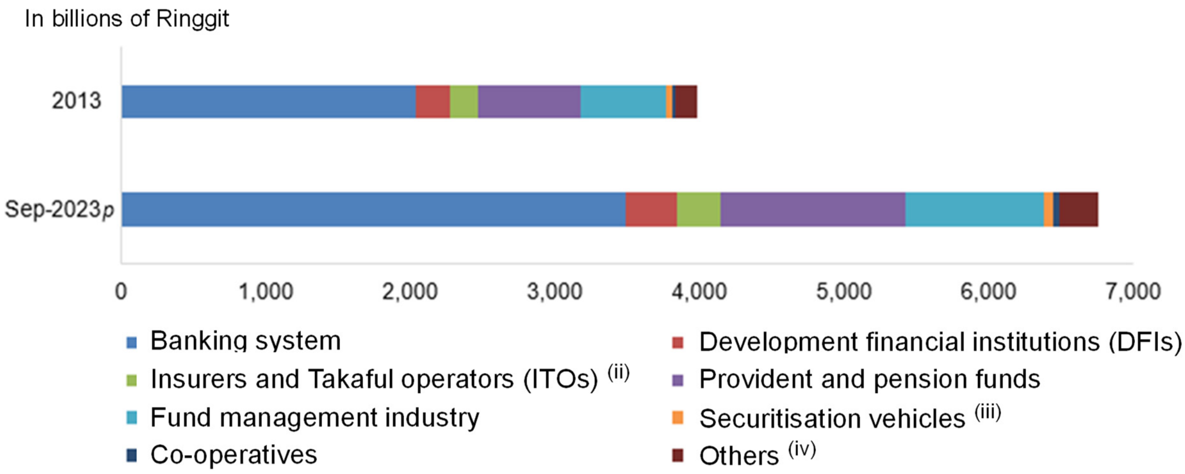
The changing nature of the financial system: implications for resilience and long-term growth in emerging market economies (EMEs)

Bank Negara Malaysia

The Malaysian financial system: an overview

Financial system: total assets by type of institution — Chart 1



p = preliminary. Data for non-regulated DFIs, provident and pension funds, co-operatives and others, are based on latest available figures as of December 2022 and June 2023.

(i) Includes DFIs not regulated by the Central Bank of Malaysia under the Development Financial Institutions Act 2002. (ii) Excludes investment-linked unit funds. (iii) Includes Cagamas Berhad (National Mortgage Corporation) and structured finance vehicles (asset-backed securities). (iv) Includes housing credit institutions, education financing provider, social security organisation, government-owned trustee company, pawnbrokers, money lenders, non-bank providers of hire purchase and credit sales, non-bank credit card issuers, and leasing and factoring companies.

Sources: Central Bank of Malaysia; Securities Commission Malaysia; Malaysia Co-operative Societies Commission; published financial statements; internal estimates.

The banking sector maintains a dominant role in the Malaysian financial system, holding total assets of MYR 3.5 trillion or about 1.9 times[1] GDP, with loans constituting about 58% of these assets (see Chart 1). The liability structure of the banking system is dominated by a diversified deposit base which accounts for approximately 78% of total funding, of which 35.9% is from retail deposits. The banking system's consistently strong positions in terms of capital (total capital ratio: 18.2%; 2013–19 average: 16.3%) and liquidity (Liquidity Coverage Ratio: 151.5%;

[1] Data quoted in the paper are as of end-September 2023 unless stated otherwise.

2015–19 average: 135.3%) have contributed to its resilience against both domestic and external shocks. An important development in the recent decade has been the growing significance of Islamic finance (Islamic financing stood at 45.6% of total loans/financing of the entire banking system, as of end-December 2023). In 2021, digital banks were also licensed to help address market gaps in access to financial services, particularly for some segments of individual and SME customers. These banks, however, remain in early stages of operation in Malaysia.

Aside from banks, non-bank financial institutions (NBFIs)[2] in Malaysia play a complementary role in the provision of financial services, making up 49.9% of total financial system assets. The NBFI sector has expanded by 67.4% over the past decade, with total assets growing from MYR 2 trillion in 2013 to MYR 3.3 trillion in 2023. About 40% of NBFIs' assets are attributable to provident or pension funds, thus limiting shadow banking risk related to maturity transformation. As the redemption risk is low, these funds engage in strategic investments with a longer-term view. Fund management/collective investment vehicles make up 30% of NBFIs' assets. While the sector's size is substantial, risk of excessive leverage is limited by rules imposed by the Securities Commission that prohibit such vehicles from engaging in leveraged investments.

While the banking sector remains as the dominant source of financing in the Malaysian financial system, the domestic bond and sukuk market continues to play an essential role as an alternate source of funding. Malaysia has a relatively well developed bond market.[3] Total outstanding debt securities stand at MYR 2 trillion, equivalent to 1.1 times GDP. The bond market complements bank-based financing and serves as an alternative source of funding, especially for large corporations. Over the period 2010 to 2023, the bond market grew at a compounded average growth rate (CAGR) of 7.6%, compared with growth in domestic bank credit of 6.1% (see Chart 2). Government bonds, comprising Malaysian Government Securities (MGS) and Government Investment Issues (GIIs), account for 54.9% of total outstanding bonds, while issuances of corporate bonds have continued to grow as an important source of funding, particularly for larger corporations.

Malaysia's prominence in the global sukuk (Islamic bond) market has also contributed to the debt market's depth, which grew at a CAGR of 11.9%[4] between 2010 and 2023. Collectively, these elements have helped promote the stability of Malaysia's funding markets through various economic cycles.

[2] Based on the Financial Stability Board (FSB) definition, NBFIs include the broad measure of all non-bank financial entities, comprising all financial institutions that are not central banks, banks or public financial institutions.

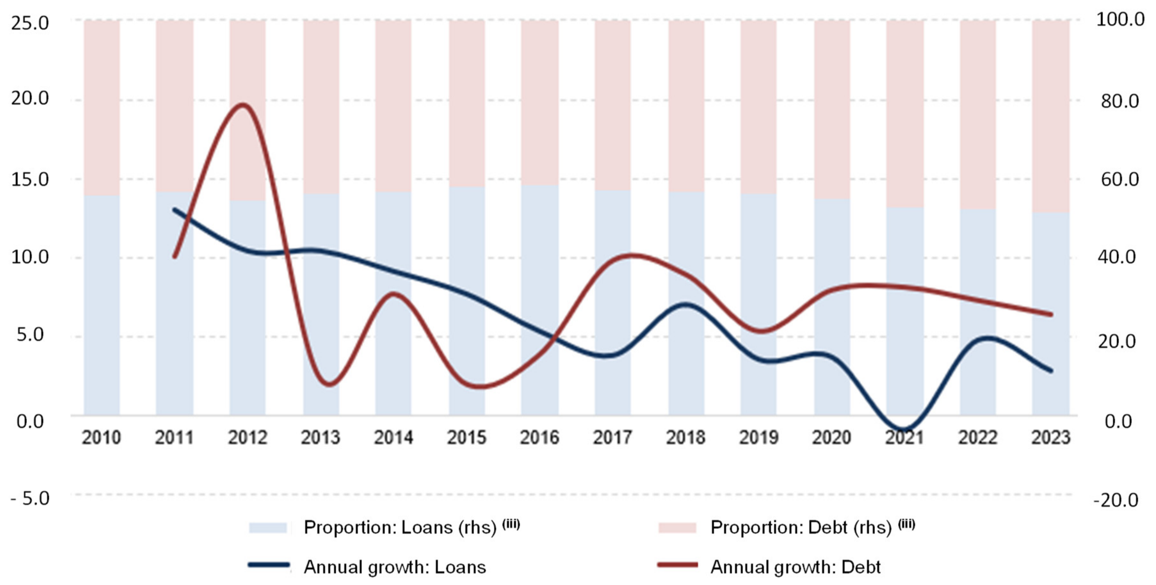
[3] Measured as a percentage of GDP, the Malaysian bond market is the third largest in size in Asia, following Japan and Korea.

[4] Total issuance of sukuk was approximately MYR 244.9 billion and total outstanding sukuk MYR 1.3 trillion at end-September 2023. Malaysian sukuk securities accounted for about 36% of global issuance and 40% of the total stock of sukuk securities outstanding globally.

Annual growth of loans(i) and debt(ii) financing

In per cent

Chart 2



(i) Refers to the total outstanding loans to the private non-financial sector from the banking system and DFIs. (ii) Total outstanding public and private debt, both conventional and Islamic. This encompasses issuances from the government, the central bank and corporate entities. (iii) Refers to the percentage share of each component relative to the total sum of outstanding loans and debt.

Source: Central Bank of Malaysia.

Developing Malaysia's bond and sukuk markets

The growth in the Malaysian bond market has been driven by a range of initiatives aimed at deepening and broadening the market. Among these initiatives are efforts to widen the investor base, which include enhancing participation from diverse market players such as banks and NBFIs, as well as insurance and takaful operators (ITOs). While the market is largely dominated by major domestic institutional investors (DIIs), such as banks and pension funds, there has been strong participation on the part of non-resident investors. The share of non-resident holdings in the bond market peaked at around 24% in 2014 and has averaged around 16% of the overall bond market in the past 10 years.

While the greater participation from non-resident investors has increased potential vulnerabilities to external developments, Malaysia's bond market has remained orderly given the significant presence of DIIs, which help facilitate price discovery and liquidity.

The bond market has also benefited from substantial developments in market infrastructure established following the 1998 Asian financial crisis (AFC).

These developments include the enhancement of price discovery process through the Bond Information and Dissemination System (BIDS) and the establishment of domestic credit rating agencies. Additionally, a more efficient issuance process was implemented through the Fully Automated System for Tendering (FAST) and the development of a real-time gross settlement system (RENTAS) to reduce settlement risk. Accordingly, these initiatives have contributed to an increasing spectrum of bond issuances beyond the more typical AAA-rated bonds and across a wider variety of maturities. This has helped expand funding sources for firms with differing funding and risk profiles.

The successful implementation of the capital market master plans (CMP1 and CMP2) was also crucial in advancing bond market development post-AFC. These master plans were centred around increasing transparency, refining trading mechanisms for efficiency and enhancing risk management protocols. Key initiatives under these master plans included moving to a full disclosure framework from a merit-based framework, establishing an MGS auction calendar that led to the establishment of benchmark yield curves, and gradual introduction of new asset-backed securities (ABS) products and real estate investment trusts (REITs) as alternative investment options.

Malaysia has also gradually extended the maturity profile of government bonds, fostering the development of a well formed long-term yield curve and establishing credible benchmarks for tenors ranging from three to 30 years. Volume-weighted average maturity of government bond issuances grew from 6.8 years in 2009 to 12.4 years in 2023. The improved liquidity and market depth in benchmark government bonds provides reliable reference pricing for high-quality private sector issuers to obtain long-term funding for infrastructure and developmental projects that have longer time horizons that cannot be met through bank financing. Naturally, as the government yield curve developed to comprise longer-tenor benchmarks, these private sector issuers were able to raise funds according to their requirements, reducing exposure to rollover risks.

More recent initiatives to enhance domestic bond market infrastructure include the introduction of the dynamic hedging programme in 2016 to develop domestic hedging facilities. This has been effective at allowing institutional investors to actively manage the FX exposure of their invested assets onshore. As at end-2023, 148 investors were registered for the dynamic hedging programme with onshore hedging activities recording an average daily FX turnover of USD 15.5 billion in 2023.

Malaysia is also actively pursuing the electronification of inter-primary dealer (PD) trading to improve government bond market liquidity and depth. This would eradicate barriers in communications such as trades that are reported manually which are prone to human errors, allowing for more efficient real-time price transparency.

Concurrently, Malaysia has intensified efforts to position itself as a global Islamic finance gateway. A key priority to achieve this is strengthening the vibrancy and sophistication of the Islamic financial markets via instrument diversification and providing regulatory clarity. These aim to widen the range and volume of Shariah-compliant investable assets, including to international investors. In this regard, the Islamic Financial Market Subcommittee (IFMC) set up by the central bank was tasked to explore strategies to enhance foreign investors' participation in domestic sukuk issuances. Thus far, the IFMC has made key progress in the area of hedging. This has led to a Shariah Advisory Council ruling on the permissibility of anticipatory hedging, subject to specified conditions. This initiative is aimed at further developing the Islamic derivatives market in a way that aligns with both Shariah principles and prudent risk management practices.

The Malaysian Islamic finance market also plays a key role in pushing the country's sustainability agenda. As part of Malaysia's efforts, the government issued sustainable sukuk in 2021 via the issuance of USD 800 million in 10-year and USD 500 million in 30-year trust certificates, the world's first US dollar sustainability sukuk issued by a sovereign. The sukuk was issued based on the newly established government of Malaysia Sustainable Development Goal (SDG) sukuk framework, which was developed to demonstrate how the government of Malaysia intends to enter into the SDG sukuk to fund projects that will deliver environmental and social benefits which are in close alignment with SDGs.

Domestic credit growth is strongly associated with economic growth and property prices

Households' and businesses' demand for credit is supported by growth in consumption and investment activities amid stable income growth. In Malaysia, credit growth has been driven mainly by loans for the purchase of residential property by households and loans for investment purposes by businesses. In terms of economic sectors, the growth in business loans has largely been contributed by the manufacturing and services sectors.

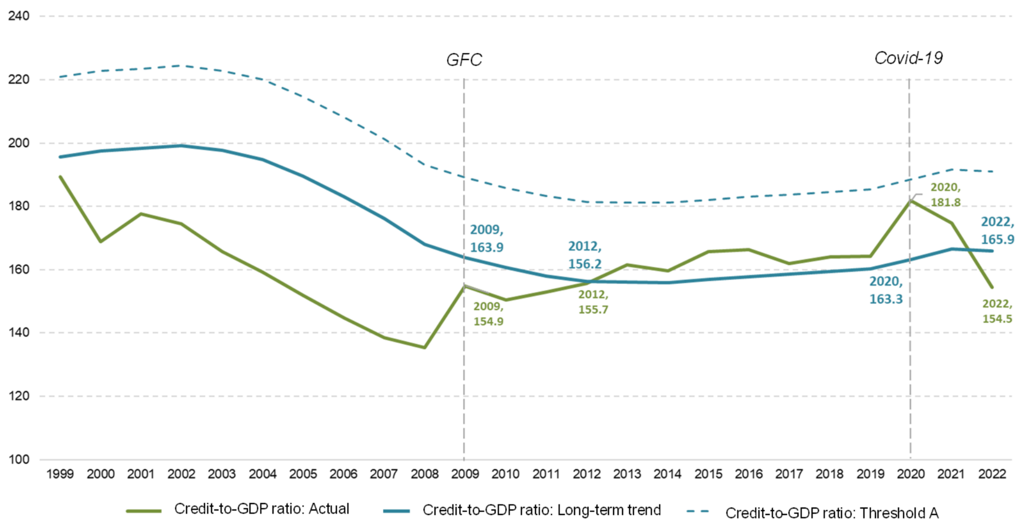
In the early 2010s, Malaysia witnessed a period of exuberance in the property market, leading to significant increases in property prices and resulting in strong growth of property loans. Speculative investment activities were also observed during the period (2010 annual growth of borrowers with three or more outstanding housing loans: 15.5%; 2015–19 average: 2.1%). The Malaysian House Price Index (MHPI) expanded by 10.3% on average between 2010 and 2013, increasing household loans for the purchase of residential properties, which accounted for 45% of total household debt. Based on the credit-to-GDP (CTG) ratio gap[5] and the annual growth rate of CTG as indicators for credit excessiveness,[6] Malaysia's CTG gap in 2009 remained within the threshold of 1.5 times its standard deviation (see Chart 3), while CTG grew higher than 10% (14.4%, see Chart 4) due to a GDP contraction following the Great Financial Crisis.

[5] The credit-to-GDP ratio gap is the divergence between the actual credit-to-GDP ratio and its long-term trend.

[6] Dell'Ariccia et al classified an episode as a credit boom if either of the following two conditions is satisfied: (i) the deviation from trend is greater than 1.5 times its standard deviation ("Threshold A") and the annual growth rate of the credit-to-GDP ratio > 10% ("Threshold B"); or (ii) the annual growth rate of the credit-to-GDP ratio exceeds 20%. The second condition is introduced to capture episodes in which aggregate credit accelerates very gradually but credit growth reaches levels that are well above those previously observed in the country. See G Dell'Ariccia, D Igan, L Laeven and H Tong, with B Bakker and J Vandenbussche, "Policies for macrofinancial stability: how to deal with credit booms", *IMF Staff Discussion Note* SDN/12/06, June 2012.

Credit-to-GDP ratio

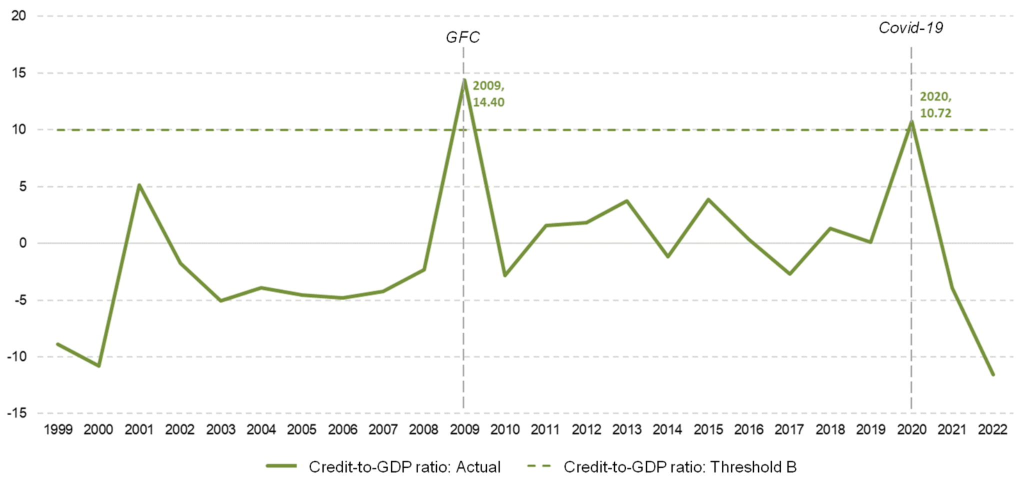
In per cent | Chart 3



Source: Bank for International Settlements.

Annual growth of credit-to-GDP ratio

In per cent | Chart 4



Source: Bank for International Settlements.

Managing the risks of excessive finance: implementation of macro- and microprudential measures

In response to these signs of emerging risks, a set of macro- and microprudential measures aimed at avoiding excessive household indebtedness and strengthening responsible lending practices by key credit providers was introduced from 2010 onwards and remains in place today. These measures include the imposition of a maximum loan-to-value (LTV) ratio of 70% for the third and subsequent house financing facilities and an LTV ratio limit of 60% for all housing loans by non-individuals; higher risk weights were also introduced under the capital adequacy framework, from 75% to 100% for housing loans with LTVs exceeding 90%; and the maximum tenure for financing granted for the purchase of residential and non-residential properties was capped at 35 years.

Apart from borrowings for the purchase of residential properties, Malaysia also experienced high growth in credit card transactions (outstanding credit card balances 2010: 14.2%, 2009: 5.8%), which was partly due to increasingly easier access to credit cards as a payment instrument. While financial stability risks were limited, pre-emptive measures were put in place to ensure households did not become overly indebted beyond their financial means. These included raising the minimum income eligibility, limiting the number of credit cards individuals could have, and imposing an aggregate credit limit for those with annual income of MYR 36,000 and below, commensurate with their ability to repay.

These measures collectively helped to moderate the high credit growth, ensuring credit continued supporting GDP growth in a sustainable manner. Consequently, the CTG ratio converged towards its long-term trend in the 2017 to 2019 period. The bulk of the financing given was channelled into the purchase of residential and non-residential property as well as working capital for businesses, which contributes to home ownership, investment and business activities. The growth of credit card balances slowed to an average of 3.3% during 2017 to 2019, suggesting that the introduced measures were effective. Overall impairment trended lower at an average of 1.6% (2009–13 average: 2.7%), reflecting borrowers' improving debt repayment capacity.

The CTG ratio increased sharply again to 10.7% in 2020. However, this was largely driven by a contraction in GDP following a series of stringent movement control measures to contain the Covid-19 pandemic rather than being an indicator of excessiveness in credit growth. Credit demand grew only modestly, at 3.8%, during this period. Credit growth post Covid-19 has also been modest (2022: 2.3%, June 2023: 2.0%), driven mainly by household loans for the purchase of residential property. This reflects a gradual recovery in spending on big ticket items. CTG declined by 11.6% in 2022 but expanded by 1.0% in 2023, showing no signs of credit excessiveness.

Expanded role of NBFIs during the Covid-19 pandemic

Historically, NBFIs have played a crucial role during periods of market stress and significant withdrawal of non-resident investors from the domestic capital market. During such episodes, these entities have often stepped in to purchase government bonds and domestic equities, driven by attractive valuations and investment opportunities, effectively acting as an automatic stabiliser during times of market stress. This also helps provide the necessary funds to finance planned fiscal outlays. The capacity and willingness of NBFIs to play such a crucial role have helped to maintain investor confidence and reinforce Malaysia's resilience in the face of external economic shocks.

During the pandemic, the automatic stabiliser/countercyclical role of NBFIs in the government bond market became more apparent. Like many countries, Malaysia saw an increase in the issuance of government debt. NBFIs, who are already large holders of government papers, subscribed to 24% of new government bonds issued between 2020 and 2022 (2015–19: 28%). More notably, the average annual amount of new government bonds purchased by NBFIs during the pandemic (MYR 37.7 billion) grew by 30% compared to the five-year pre-pandemic average (MYR 29.4 billion).

NBFIs also played a key role in complementing the government's four economic stimulus packages introduced between 2020 and 2022. The country's largest provident fund implemented measures to ease cash flow strains. These included limited early withdrawal schemes for members to withdraw their retirement savings before reaching the mandatory retirement age. A significant majority of members, particularly among the lower-income segments, drew down on their retirement savings to meet daily expenses and sustain loan repayments between 2020 and 2022.

Meanwhile, credit-related NBFIs granted loan moratoriums to their borrowers, akin to those extended by banks. Most of these moratoriums were initially offered on a blanket basis to all borrowers before transitioning to a more targeted assistance programme. Some NBFIs provided direct funding to the government for Covid-related expenses, while some also provided rental waivers to SMEs who tenanted their office buildings. There were also NBFIs that played a more facilitative role, for example by implementing government-related assistance such as managing unemployment benefits or rolling out reskilling programmes. While such measures played an important role in mitigating the impact of the crisis, over the longer term the expanded role of NBFIs observed during the Covid-19 crisis could amplify the sovereign-bank nexus given substantial interlinkages between NBFIs and the financial sector as elaborated above.

Supporting Malaysia's long-term growth and transition to a high-income nation: what can a central bank do?

For Malaysia, policy measures to promote the efficient allocation of finance for long-term growth are focused on the following:

- Enhancing the diversity of the funding landscape to better meet the needs of households and businesses;
- Harnessing technological advancements to improve efficiency and inclusivity of financial services; and
- Positioning the financial system to facilitate an orderly transition to a greener economy.

Diversity of funding

Financing support for high-growth firms in Malaysia is increasingly aligned with Malaysia's National Investment Aspirations (NIAs).[7] Financing approvals by Malaysian financial institutions to SMEs in NIA areas are on an uptrend, with healthy growth in sectors such as manufacturing of chemicals and pharmaceuticals, electrical and electronic products, and transport equipment. Among firms seeking bank financing, those in high-growth sectors are enjoying favourable approval conditions, as indicated by higher approval rates across loan purposes compared to the overall SME segment, with more than 90% of these borrowers obtaining their required financing in full.

Nevertheless, the share of both financing outstanding and disbursements to SMEs in NIA sectors remain relatively small at only 5%. This partly reflects the higher perceived risks associated with high-growth sectors, innovative firms and new strategic areas. Relying on deposit-funded intermediaries like banks may lead to inefficient allocation of capital to support frontier economic sectors.

Continued development of alternative financing sources and financial instruments has been critical to support the increasingly diverse funding needs across the business life cycle, encourage firms to embrace strategic pivots to enhance competitiveness, boost the growth of innovative SMEs and promote longer-term financial stability. This includes blended finance, venture capital, private equity, equity crowdfunding and social finance.[8] Termed as "alternative finance", it has enormous potential to support growth of new and innovative enterprises.

[7] The National Investment Aspirations (NIAs) refer to overarching strategic developmental objectives to increase economic complexity, create high-value jobs, extend domestic industry linkages and develop new and existing clusters. Strategic sectors deemed to be aligned with the NIAs include the manufacturing of electrical and electronic products, chemicals, medical devices and pharmaceuticals, machinery and equipment and transport equipment (eg aerospace); information and communication technology; research and development; and higher education. See further details in the box article "Securing future growth through quality investments", published in the Central Bank of Malaysia *Economic and Monetary Review 2019*.

[8] Social finance pools recognised sources of funds such as donation and cash waqf to provide funding towards social outcomes. This approach complements public sector finance, commercially driven financial solutions and the corporate social responsibility activities of institutions, collectively promoting enhanced socioeconomic resilience.

Currently, the size of the alternative finance market in Malaysia is small compared to regional peers and developed markets.[9] Alternative finance accounted for only 0.4%[10] of GDP in 2022, a slight growth from 0.3% in 2018, and only 2% of SMEs reported utilising these avenues. Venture capital funding in particular is relatively underdeveloped compared to other countries in the region.[11]

As part of a multi-pronged approach supported by various stakeholders involved in the funding and startup ecosystem, the central bank is playing a more targeted role in the alternative finance space. Interventions have been focused towards supporting a larger role for development and Islamic financial institutions to explore equity or blended financing in support of more sustainable SME funding solutions and growth of social finance. Meanwhile, government co-investment funds administered since 2019 have been instrumental in crowding in private investors and spurring growth in alternative funding. The Securities Commission Malaysia, on the other hand, is responsible for establishing the frameworks to regulate and strengthen development of private equity markets as well as online lending and investment platforms. Its five-year capital market master plan includes measures such as a more structured framework to encourage participation of angel investors, as well as support towards co-investment models involving institutional investors and venture capital or private equity firms. Other ministries and agencies in charge of technology, investments and entrepreneurship have also spearheaded efforts in fortifying the innovative industry ecosystem over the past few years.

Digital innovations

Technological advancements offer the financial sector numerous opportunities to enhance accessibility, efficiency and innovation. Digital innovation and data analytics employed by incumbents, fintech providers and digital banks[12] alike offer tailored solutions to the unique challenges and fulfil the unmet needs of unserved and underserved segments, thus possessing the potential to improve the efficiency and effectiveness of credit allocation. A key policy priority for financial sector regulators in Malaysia is to ensure the regulatory approach caters for digital-first business models and entrants, prioritising those that can advance greater financial inclusion, while ensuring a balance of risks and benefits.

For the central bank, our policymaking approach considers three overarching principles:

- **Parity**: implementing the same type of regulations for the same type of risk;

[9] Based on publicly available data for the year 2018, the size of alternative finance as a percentage of GDP is 1.2% in Indonesia, 1.7% in Australia and 8.2% in the United Kingdom.

[10] Source: Central Bank of Malaysia.

[11] See World Bank, *Malaysia: assessment of the start-up financing ecosystem*, March 2022.

[12] In April 2022, the Ministry of Finance approved five digital bank licences, out of a total 29 applicants. Three were approved to be licensed as commercial banks under the Financial Services Act 2013, and the other two as Islamic banks under the Islamic Financial Services Act 2013. See Central Bank of Malaysia, "Five successful applicants for the digital bank licences", 29 April 2022.

- **Proportionality**: implementing regulations that are proportionate to the benefits and risk; and
- **Neutrality**: prioritising desirable outcomes whilst remaining agnostic to different technologies, systems and approaches.

These principles are applied in the central bank's licensing framework for entry of digital-first players such as digital banks. The framework enables the admission of innovative players with strong value propositions, while simultaneously safeguarding the integrity and stability of the financial system. This is operationalised through an initial or "foundational" phase of operations where digital banks are subject to a simplified regulatory framework commensurate with asset size limits imposed on their activities.

Measures are also in place to enable innovation and more efficient banking practices, such as the central bank's regulatory sandbox and electronic know-your-customer (e-KYC) policies. Introduced in 2016, the regulatory sandbox facilitated testing of various technologies and business models (eg digital insurance, peer-to-peer family takaful, buy-now-pay-later, digital remittance). Results of testing within confined parameters were useful in contributing to policy adaptations while ensuring that risks were within manageable levels. Meanwhile, regulatory guidance on e-KYC adoption in the financial sector aims to ensure that digital innovations remain compatible with expectations for financial institutions to ensure robust risk management practices in customer identification and verification to preserve the integrity of financial transactions.

Moving forward, regulatory focus remains on supporting Malaysia's financial industry to take advantage of the upsides of digitalisation, while managing the associated risks – especially those that may threaten system-wide stability, consumer outcomes, and confidence in the financial sector. Key focus areas include enhanced regulatory guidance for critical digital enablers such as cloud and artificial intelligence/machine learning (AI/ML), and efforts to strengthen industry cyber security readiness and responsiveness. The central bank is working closely with the financial industry to advance the development of an open data ecosystem for Malaysia's financial sector that can unlock greater market innovation, promote consumer empowerment and advance financial inclusion, with a more immediate focus on enabling open banking and open finance.

Green economy

Climate change and environmental degradation pose unprecedented challenges and opportunities that will reshape the economic and financial landscape. Against this backdrop, the primary focus of policymakers in Malaysia is to promote financial system resilience by continuing efforts to improve climate-related and environmental risk management in the financial sector. Simultaneously, given its central role in allocating and deploying economic resources, the financial sector could be a catalyst for advancing environmentally sustainable practices and financing green initiatives. In response to these developments, policy measures have been focused on:

- **Supporting an orderly transition to a low-carbon economy**. Financial institutions are actively encouraged to incorporate ESG considerations into their decision-making processes. The issuance of the Climate Change and Principle-based Taxonomy (CCPT) guidance document introduces a progressive system of transition categories (Climate Supporting, Transitioning and Watchlist) while emphasising the need for financial institutions to consider broader environmental impacts and the principle of "no significant harm" in business operations. Other than that, sector-specific[13] toolkits have been developed for financial institutions to incorporate ESG risk considerations in their financing and investment decisions.
- **Integrating climate-related and environmental risks into prudential regulation and supervision**. Regulatory guidance establishes expectations for financial institutions to incorporate climate risk management and scenario analysis in their risk management practices. This is important to enhance the financial sector's resilience against climate-related risks and to facilitate a just and orderly transition to a low-carbon economy.
- **Enhancing the role of the sukuk markets in facilitating green and greening investments.** The government has further bolstered its commitment to sustainability by issuing MYR-denominated sustainability sukuk, garnering strong support from institutional investors and financial institutions. These efforts signify Malaysia's dedication to enhancing the liquidity of domestic sustainability sukuk and fostering a robust ecosystem for green financing within its capital markets.

Another emerging policy priority is to support small businesses' orderly transition towards greener and more sustainable practices amid the climate crisis, which in turn are critical determinants for Malaysian firms' growth and global competitiveness moving forward. Under the Joint Committee on Climate Change (JC3), in May 2023 the central bank, in collaboration with the financial industry and strategic partners, established an SME Focus Group (SFG)[14] to accelerate transition and adoption of sustainable practices and green business models by SMEs. Additionally, the central bank has realigned its Fund for SMEs to incentivise or crowd in private financing into newly identified areas and to support the transition towards a low-carbon future, specifically through two targeted facilities:

- The **Low Carbon Transition Facility (LCTF)** was established in 2022 to encourage SMEs to adopt sustainable and low-carbon practices in their business operations. This includes providing financing for the purposes of improving energy efficiency, increasing usage of sustainable materials for production and obtaining sustainability certification. Under the LCTF, in late 2022 the central bank, in collaboration with FIs and strategic partners, launched the **Greening**

[13] To date, sectoral guides have been issued for the following six activities/sectors: palm oil; renewable energy; energy efficiency; oil and gas; construction and infrastructure; and manufacturing.

[14] The SFG announced three initiatives in 2023 to support SMEs' transition: (i) introduction of the ESG portfolio guarantee scheme by the Credit Guarantee Corporation and a consortium of banks; (ii) the ESG Jumpstart Information Portal to equip SMEs with foundational information to jump-start their sustainability journey; and (iii) development of an ESG Jumpstart Guide to provide practical step by step guidance for SMEs to build basic ESG knowledge and navigate critical ESG issues, risks and opportunities.

Value Chain (GVC) programme to assist Malaysian SMEs in implementing long-term and impactful changes to green their operations through technical advisory and support by strategic partners, as well as transition financing.

- The **High Tech and Green Facility (HTG)** was designed to assist SMEs and innovative startups to grow their businesses and invest in strategic sectors and technological fields (eg digital tech, green tech and biotech).

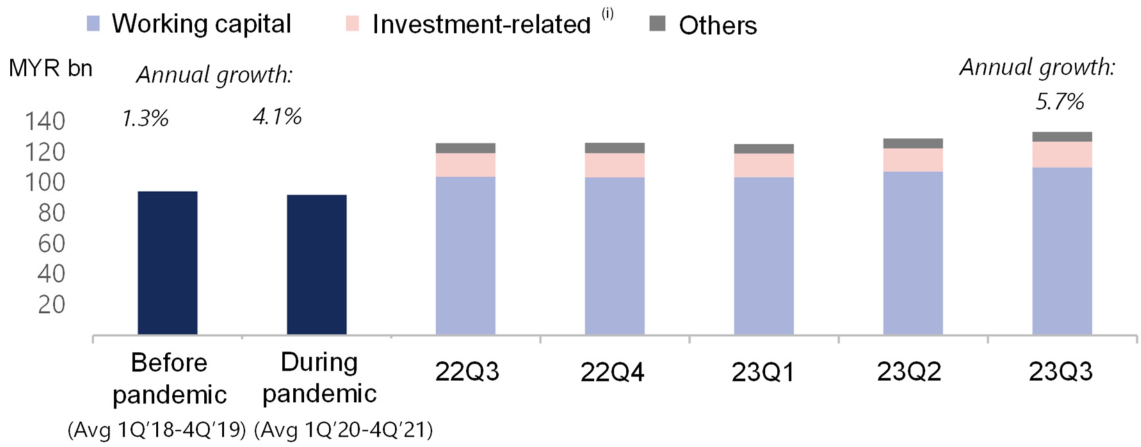
More than MYR 1.2 billion in financing has been approved to date under the LCTF and HTG, enabling more than 550 SMEs to start their transition journey. SMEs under the GVC programme have begun to measure their greenhouse gas emissions, and more than 40 of these have begun reporting emissions.

Box

Financing Malaysia's SMEs[15]

SME financing disbursements by purpose

Chart 1



(i) Investment-related purpose includes financing the purchase of non-residential properties, residential properties for business use, fixed assets (including cars), and construction activity.

Source: Central Bank of Malaysia.

Throughout the Covid-19 pandemic, a continued flow of credit to Malaysian SMEs,[16] supported by accommodative policies,[17] helped viable businesses in managing tight cash flows and staying resilient over the periodic disruptions to economic activity. Although banks were more cautious in lending to borrowers and

15 Refers to loans from banks and development financial institutions (DFIs).

16 SMEs accounted for 38.4% of GDP, 48.2% of employment and 10.5% of exports in 2022 (source: Department of Statistics, Malaysia).

17 Measures by the central bank included significant monetary policy easing, temporary regulatory and supervisory flexibilities, and establishment of relief facilities paired with credit guarantee schemes.

sectors that were hit hardest by the pandemic, including SMEs,[18] they continued to support viable borrowers by undertaking additional measures to complement credit risk assessments, including more extensive background checks and the use of alternative information sources as well as more frequent engagements to better assess the borrowers' financial and operating conditions. Overall SME financing approval rates gradually recovered by 2021 with the resumption of economic activity, while financing demand for liquidity needs also abated after peaking at the onset of the crisis.[19]

Since then, outstanding SME loans have continued to expand at a strong pace (September 2023: 6.7%, December 2022: 5.8%), amid sustained high levels of disbursements and higher approval growth supported by better approval rates. Forthcoming disbursements have continued for working capital purposes for firm expansion amid better business activity, while selected segments[20] have also continued to draw down on credit lines to bridge their cash flow needs amid persistent or renewed operating challenges and the high-cost environment. Notably, financing of SMEs' investment needs has gained momentum since late 2021 and there was a significant disbursement uptrend in 2023, reflecting positive investment sentiments amid the stronger economic footing.

Composition-wise, the top sectors for credit approvals and disbursements remained unchanged – namely services, especially in the wholesale and retail trade, manufacturing and construction sectors – aligned with the sectoral distribution of SMEs nationally and their economic contribution. In terms of approval growth, SMEs in property-related sectors (ie construction and real estate) were the single largest contributors in the post-pandemic period, marking a shift from banks' cautious lending to these sectors given structural weaknesses before the pandemic.

Another important development has been the significant growth in approval volume to microenterprises during and after the pandemic, with the average number of accounts approved annually in these periods almost doubling from pre-pandemic levels in line with the demand for financing.[21] This underscores FIs' countercyclical role in helping the traditionally underserved segment to weather the economic downturn, while also reflecting the culmination of long-standing initiatives to improve access to financing for microenterprises.

[18] SMEs were disproportionately affected by containment measures given lower liquidity buffers, also evidenced by the segment's reliance on targeted repayment assistance programmes (after September 2020), which followed the blanket moratorium period (April–September 2020).

[19] SMEs' demand for working capital financing peaked in April 2020, in part reflecting the availability of the Special Relief Facility established under the central bank's Fund for SMEs. Demand then normalised, with pockets of pressing needs remaining in Covid-affected sectors.

[20] For example, SMEs in construction, manufacturing, and wholesale and retail trade sectors.

[21] Post-pandemic refers to the period 2022–YTD September 2023, while pre-pandemic refers to the period 2018–19.

Enhancing SMEs' resilience in Malaysia: overcoming financing and ecosystem barriers in the post-pandemic era

The pandemic posed unprecedented challenges for SMEs, affecting their survival, growth and competitiveness.[22] SMEs responded to cash flow strains by cutting operating costs and downsizing operations while adapting to new operating conditions by leveraging digital platforms, diversifying their businesses and changing their business models. At the peak of the pandemic, the government and central bank prioritised policy support, ranging from financial relief through to fiscal measures[23] and repayment assistance for SME borrowers,[24] to cushion the immediate impact of the crisis.

Notwithstanding the impact of the pandemic, certain SME segments generally find it more difficult to obtain financing due to inherent challenges, particularly "young" firms and microenterprises, given limited or no credit history and collateral. To address some of these constraints and ease access to financing, the central bank and the financial industry have continuously enhanced the financing ecosystem. This includes establishing various facilities under the central bank's Fund for SMEs[25] to complement bank lending to SMEs and ensuring other forms of assistance are available, such as debt advisory and resolution, existing credit information infrastructure and financing facilitation. In addition, credit guarantee institutions such as Syarikat Jaminan Pembiayaan Perniagaan Berhad (SJPP), a wholly owned company of Minister of Finance, and Credit Guarantee Corporation Malaysia Berhad (CGC) continue to bolster bank lending via credit guarantee schemes, especially to SMEs with no or insufficient collateral. Meanwhile, in formulating policy recommendations, the central bank conducts active surveillance on the state of SME financing and policy analysis on an ongoing basis, including industry engagements with SMEs.

[22] During the pandemic, SMEs in Malaysia experienced a significant decline in revenue, cash flows and profitability. See World Bank, "Impacts of COVID-19 on firms in Malaysia", *COVID-19 Business Pulse Surveys*, round 3, July 2021.

[23] For example, wage and other subsidies, tax incentives, grants.

[24] For example, moratoriums, deferments and restructuring of loans.

[25] The Fund for SMEs provides financing at a reasonable cost to targeted segments or strategic areas for selected purposes, including for microenterprises. Further information available from https://www.bnm.gov.my/funds4sme.