Muhammad bin Ibrahim: Malaysia's experience in macroprudential policies and insights on financial inclusion

Remarks by Mr Muhammad bin Ibrahim, Deputy Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the Meeting of Central Bank and Monetary Authorities of the Organisation of Islamic Cooperation Member Countries, Surabaya, Indonesia, 6 November 2014.

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Allow me to share the five broad principles which the design, deployment and calibration of macroprudential policies in Malaysia are premised upon:

First, macroprudential policies introduced must be complementary to other microprudential, monetary and fiscal policies

I will share on the measures we implemented since November 2010, where we introduced a series of macroprudential policies in concert with a package of monetary, fiscal, regulatory, supervisory and long-term structural measures (e.g. enhancing housing supply) to curb the excessive credit-fuelled speculation in the Malaysian housing market and to reign in the increasing level of household indebtedness. This required coordination with other part of the government.

There was one particular measure that we introduced in November 2010, called a loan-to-value (LTV) ratio where a maximum limit of 70% was imposed on the third and above outstanding house financing per individual. A cap of 10 years on the tenure of financing for personal use and 35 years on the tenure of house financing were also introduced in July 2013 together with gradual implementation of real property gain tax, consumer education and debt management measures. The approach must be comprehensive as macroprudential measures will not be effective if it is done in isolation.

Since we operate in a dual financial system, all macroprudential measures are applicable to both the Islamic and conventional financial systems, as both have exposures in housing market and household debts.

Second, the measures were targeted to minimise unintended cross-sectional spillovers

Instead of a broad-based LTV ratio limit, we imposed the measure only on borrowers with three or more house financing to ensure a continued access to financing for eligible first time house buyers and those investing long-term in a second house for wealth diversification. In Malaysia, we have an on-line system called Central Credit Reference Information System or (CCRIS)) which allows us to have more granular data to monitor borrowers with multiple outstanding house financing. In other words, we have an on-line system where each citizen and companies having exposures in the banking system will have their data centralised in one particular database. That way we know at any point in time, the detail exposures of any companies and individuals.

The other important point to note is that we did not narrow the application of measures to specific geographical locations and house type or price in order to avoid circumvention or abuse as developers and lenders can easily build or finance houses at the edge of a restricted zone or price range, or even create a new house type (e.g. Small Office Home Office (SOHO)). In this case, we need to conduct a bit more research before we implement any macroprudential policies.

The caps on financing tenure, together with requirements to comply with responsible financing practices (including adoption of prudent debt service ratio (DSR) threshold and definition of income and debt obligations for computation of DSR), were not limited only to banks. The caps were also imposed on non-regulated entities in order to avoid regulatory arbitrage or shifting of risks to these non-bank lenders.

Third, preserving appropriate discretion for authorities to act is important, with respect to the timing, mix and calibration of measures. We do not adopt a rule-based approach to the implementation of macroprudential measures.

The reason is that, it can avoid a "self-fulfilling prophecy" if the formula for determining the timing, quantum and criteria for the deployment of macroprudential policies are made public or applied in mechanistic way – unintended consequences could arise or systemic risk could suddenly build up right before the effective date as economic agents try to "beat the clock" by getting ahead of the implementation.

This approach provides us with greater flexibility to use an optimal mix of macroprudential and other measures under varying circumstances – this is different from the UK where legal constraints limit the choice of macroprudential instruments that can be used, or compared to Turkey which uses quantitative triggers for the new reserve requirement framework.

However, discretion needs to be accompanied with ***political willingness to act*** when required – this has to be demonstrated over time and supported by a matured, effective governance and accountability framework. In Malaysia, we ensured that the key administrators in the Government fully understand the objective of the macroprudential measures to keep the household indebtedness and the housing speculation in check, prior to the implementation.

Fourth, pre-emptive implementation is key to create space for measures to be implemented progressively and incrementally. This is important to ensure orderly adjustments; avoid "overshooting" or over-reaction among affected parties; and minimise unintended deleveraging.

Timely calibration, and where required, uplifting or introduction of other measures are critical in this aspect.

The effectiveness of macroprudential measures are inherently difficult to assess. It is therefore extremely important that macroprudential measures are well-supported by effective surveillance systems and capability. This provides the agility for authorities to respond to market reactions which can often be unpredictable. Very often, there will be a need to extend or recalibrate the measures to ensure that they remain effective.

For example, following the implementation of the LTV ratio limit of 70% on the third and above outstanding housing loan per individual in November 2010, we observed an increasing growth of housing loans undertaken by non-individual (registered business) borrowers, i.e. they used their business entities to buy properties. This was clearly a circumvention of the measures, leading to the introduction of a LTV ratio limit of 60% on housing loans by non-individuals in December 2011. We need to actually look at how the market reacts to the measures introduced. It can only be done if we have an effective surveillance framework.

Fifth, effective communication is crucial

4Cs – clarity, concise, consistent and credible – core features of effective communication:

i. Clarity – market, investors and public typically fear the worst in absence of clear information.

ii. Concise – "more" is not always effective; we allow for some "constructive ambiguity".

iii. Consistent way of communication across time and different stakeholders would strengthen credibility.

iv. Credible – reducing misinformation helps shape and influence expectations.

It may not always be possible to engage with affected parties prior to the implementation of some macroprudential policies. For example, there was a spike in the growth of average house prices in the few months leading up to the announcement of the first LTV ratio limit. This could be due to a rush to lock in financing at a higher LTV ratio prior to rumoured timing of implementation of the limit. Some developers and banks also used aggressive marketing campaigns (e.g. "buy before the LTV ratio limit kicks in!") before the effective date of the measure. In this case, we opted to impose the measures with immediate effect on the date of announcement to minimise circumvention.

Let me delve on another key policy priority, which is financial inclusion. I will raise five points that I hope will provide some perspectives on financial inclusion based on our experiences back home.

First, financial inclusion is an international agenda that has captured the attention of many governments which has national importance

The 2.5 billion unbanked and underserved remains a global challenge. A significant portion of them are from countries with predominantly Muslim population, thus there is an urgency to address imbalances among the "ummah".

For comparison, 2.5 billion people is equal to the population of China and India combined or is equal to 8 times the population of USA.

Financial inclusion can only be achieved with the collective effort of all countries. Peer-to-peer learning and sharing of best practices can help countries leapfrog the trial and error stages in designing and implementing financial inclusion policy, without having to reinvent the wheel.

For example, when we introduced microfinancing, we made a tour to Indonesia to learn about how Indonesia actually implemented microfinancing. With that knowledge, we implemented microfinancing in Malaysia and it has been very successful. When we wanted to introduce agent branch banking, we went to Mexico and Brazil to learn on how they actually use agent branch banking as effective means to expand financial services. We learnt and implemented some of the measures on financial inclusion. We avoid unnecessary mistakes and reduce cost in implementing of those policies.

In this case, we found that it is useful to be a member of the Alliance for Financial Inclusion (AFI) – a network of policymakers from developing countries working together to advance financial inclusion globally – where we can collaborate to develop more innovative, contextualised and effective financial inclusion solutions, and this is one area which I believe has the potential to grow. OIC members, who are not a member of AFI, may wish to consider becoming one.

Second, commitment from the top drives the financial inclusion policy implementation on the ground

Leadership and clear vision on outcomes are important elements in driving the financial inclusion agenda.

In Malaysia's experience, the New Economic Model (NEM) emphasised the goal of inclusiveness to enable all communities to fully benefit from the economic development.

In line with the Government's vision for an inclusive economy and to promote accountability, Bank Negara Malaysia legislated financial inclusion as one of the primary functions of the Bank. This is to ensure that the pursuit of financial inclusion as a policy priority will be passed down to the future generations of central bankers. It would help if there is a clear mandate and accountability so that resources can be allocated and mobilised.

Setting a national target has shown to galvanise real tangible policy changes on the ground. During the Global Policy Forum in Kuala Lumpur last year, the 121 members of AFI have adopted the Sasana Accord to set quantifiable and measurable financial inclusion indicators as national targets.

It is also encouraging to know that 28 OIC members have direct membership in AFI, while 4 others are indirectly affiliated through regional central banks.

Further, financial inclusion solutions typically involve cross-disciplinary collaboration. Policymakers could consider a national coordination mechanism, for example, in the case of Tanzania and Mexico to effectively identify policy priorities and allocate the right resources in implementing the policies.

Third, data and technology are key enablers of innovative policy solutions

Robust data collection and gap analysis help policymakers to connect with realities on the ground and identify real needs for intervention. Data also facilitates monitoring and impact assessment to determine if a particular policy is achieving its intended outcome.

Technology plays a critical role as it provides low cost, scalable channels to deliver financial inclusion solutions. It is particularly effective in overcoming geographical barriers to financial inclusion.

The Malaysia's experience in agent banking shows how data and technology enable innovative policy solutions. It also helps to make an informed decision on resource allocation.

In 2011, the Bank conducted the Financial Inclusion Demand Side Survey to complement supply side data collected from financial institutions. Data highlighted that there was a lack in the provision of access points, as only 46% of 837 sub-districts with a population of more than 2,000 have at least one financial access point.

The cost of building brick-and-mortar branches to outreach to rural users is high. Hence, the Bank developed the agent banking initiative to leverage on technology and deliver financial services to the rural groups in a low cost and scalable manner. It saves cost and the impact is enormous.

Under the agent banking initiative, licensed financial institutions provide financial services to customers through third-party agents, such as retail outlets and post offices. Agents perform banking transactions such as deposit and withdrawal of funds in a safe manner using real time terminal technology i.e. Point-of-Sale (POS).

Putting in place a mechanism to monitor performance is crucial to determine whether policy initiatives are effective. Just to give a flavour of what we have done, we actively track the coordinates of agent banks to ensure that access is provided to sub-districts in need of financial access points. Since its implementation in 2012, 95% of sub-districts now have at least one financial access point, a significant increase from 2011. As at August 2013, there were 5,661 agents and the total number of transactions has exceeded 25 million, with a total value of RM2.8 billion.

Fourth, Islamic finance can play a huge role in financial inclusion given the strong parallels between the two

The concept of financial inclusion – to develop a prosperous, egalitarian economy that contributes towards social development and social justice – is very much in line with the core principles of the Islamic economy, which place great emphasis on social justice, inclusive growth and equitable distribution of resources.

In advancing the Islamic financial inclusion agenda, crucial criteria such as injection of innovation and enhancement of products and services as well as distribution channels to reach targeted groups especially the rural areas are essential:

- One of such example in Malaysia is the introduction of profit and risk sharing investment accounts, where savings are matched with funding required by SMEs for financing specific projects.
- Greater outreach to microenterprises and SMEs can also be achieved through the wider application of equity-based structures in financing for Islamic microfinance and SMEs. This contributes towards the overall objective of generating inclusive growth that enhances job creation.
- Other financial products such as microtakaful and waqf can also provide a financial solution for lower income groups and small businesses.
- Through Islamic finance, we can also further explore the concept of agent banking or branchless banking to leverage on the role of traditional community centres such as mosques. This would harness more efficient means of outreach amongst Muslims, which is of particular relevance in many OIC Members.
- Another important sphere that has not been explored exhaustively, Islamic financial institutions may also leverage on its large distribution network to facilitate the collection and mobilisation of zakat and waqf.

Fifth, proportionate regulation can achieve objectives of inclusion, stability and integrity

Proportionate regulation ensures that the costs of regulation do not outweigh the benefits of regulation and that regulation is commensurate to risks.

Of significance, proportionate regulation protects the stability and integrity of the financial sector, and at the same time encourages innovative financial inclusion solutions. It is important to recognise that regulation that is proportionate to risks does not necessarily equate to "lighter regulation" as many perceive. For example, there are fundamental differences between the risk drivers in microfinance and commercial banking. Microfinancing is labour-intensive, usually highly decentralised, and among the borrowers, the factors that are predictive of repayment capacity are very different from commercial bank borrowers. These differences need to be better understood to achieve well-designed regulatory frameworks.

For example, Mexico's tiered bank account approach prescribes different degrees of Know-Your-Client (KYC) requirements and transaction restrictions that are proportionate to the value of the account. A low value account requires less KYC requirement due to typically lower money laundering risk. However, the lower KYC requirement is compensated by more transaction restrictions. The proportionate approach expanded access to bank accounts.

On stability, Pakistan introduced proportionate capital requirements for microfinance institutions based on the size of the population they intended to serve. Microfinance institutions at district, regional, provincial and national levels have varying capital requirements, so that they could serve distinct market niches sustainably without the burden of holding excess capital that is disproportionate to the risk.

The global Standard-Setting Bodies (SSB) have adopted proportionality as a principle in developing risk-based standards. SSBs are collaborating with developing countries through the Alliance for Financial Inclusion (AFI) to clarify implementation of standards, build supervisory capacity and address data issues. This has helped countries to better implement proportionate regulation worldwide.

To end my discussion today, let me summarise that macroprudential regulation and financial inclusion – could indeed go a long way in enhancing the financial wellbeing of a country and the people, and promoting sustainable growth through complementary factors. Differences across jurisdictions are inevitable, particularly in comparing the various regulatory systems and socioeconomic structures amongst all OIC Members. This is where collaboration can help us achieve a greater level of understanding. I believe this meeting is the appropriate channel for enhanced cooperation amongst financial regulators of OIC Members – be it together, or through other platforms such as AFI – to ensure our respective financial systems are well regulated and inclusive.