FINANCIAL SECTOR ASSESSMENT PROGRAM

MALAYSIA

SUSTAINABLE ADOPTION OF INNOVATIVE CHANNELS FOR FINANCIAL INCLUSION

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GLOSSARY

AFI	Alliance for Financial Inclusion
AIM	Amanah Ikhtiar Malaysia
ATM	Automated Teller Machine
BAFIA	Banking and Financial Institutions Act
BNM	Bank Negara Malaysia
BSN	National Savings Bank (Bank Simpanan Nasional)
CDM	Cash Deposit Machine
DFI	Development Financial Institution
DFIA	Development Financial Institution Act
DVP	Delivery-versus-payment
DPI	Designated Payment Instrument
EMV	Europay-Mastercard-Visa
ETP	Economic Transformation Programme
FELDA	Federal Land Development Authority
FI	Financial Institution
FOP	Free-of-payment
FPX	Financial Process Exchange
FSAP	Financial Sector Assessment Program
FSBP	Financial Sector Blueprint
FSMP	Financial Sector Masterplan
GDP	Gross Domestic Product
GPFI	Global Partnership for Financial Inclusion
IBA	Islamic Banking Act
IBG	Inter Bank GIRO
LSMS	Living Standard Measurement Surveys
MFI	Microfinance Institution
MNO	Mobile Network Operator
MSME	Micro, Small, and Medium Enterprises
NKEA	National Key Economic Area
NFC	Near Field Communication
NGO	Non-Governmental Organization
PEMANDU	Performance Management & Delivery Unit
POS	Point of Sale
RENTAS	Real Time Electronic Transfer of Funds and Securities
SKM	Malaysia Cooperative Societies Commission (Suruhanjaya Koperasi Malaysia)
SME	Small and Medium Enterprises
YPEIM	Yayasan Pembangunan Ekonomi Islam Malaysia

EXECUTIVE SUMMARY[1]

This note focuses on the regulatory and market environment relevant to the emergence and adoption of innovative delivery channels to promote greater financial inclusion in Malaysia. Financial inclusion is defined here not only as providing *access* to financial services, but also as enabling and promoting increased *usage* of those services. Achieving higher levels of access and usage requires an extensive and efficient retail payments infrastructure, affordable financial products that meet the needs of customers, and actions to address cultural and social factors that influence customers' choices. This note therefore considers the implications for financial inclusion of Malaysia's evolving retail payments landscape and the country's potential to go beyond providing physical access to services. The analysis is based on wide ranging discussions with financial institutions, payment service providers, government authorities and microfinance entities, conducted in April 2012. The recommendations generally follow the principle that policies creating an enabling business environment are likely to prove more successful than policies that may not fully recognize the role of commercial interest as a driver for achieving sustainable financial inclusion.

Malaysia has achieved remarkable progress in providing access to basic bank accounts to the majority of the population and credit to small and medium enterprises. The country performs well in traditional financial inclusion indicators such as penetration of bank accounts, which reaches the level observed in many high-income countries. Malaysian authorities have long recognized financial inclusion as a policy priority and are currently working on several measures to address remaining gaps, widening the range and improving the quality of financial services, with current focus on ensuring that all sub-districts of the country have physical access to the banking sector.

Increasing access and usage will depend, to a large extent, on greater availability of technology-enabled channels that go beyond brick-and-mortar branches and leverage on existing third-party infrastructure such as retailers and neighborhood shops, which are usually referred to as "retail agents." Increased usage of a wider range of financial services through such channels will depend on the design of innovative and attractive products that cater to the needs of the unserved and the underserved, by an array of bank and nonbank providers. The Malaysian government sets a broad policy agenda with potentially great impact on these objectives.

Using retail agents offers substantial potential to extend access to and usage of basic banking and electronic payment services offered by banks and nonbanks. It can reduce transaction costs to a fraction of that incurred with traditional branches. It can also provide greater convenience to existing financial services while serving as a platform for the development and delivery of new products and services. Also, using agents presents the

[1] This note was prepared by Denise Dias, World Bank consultant.

opportunity to extend access and usage through technology while preserving the human element that is prized by some segments of the society. As shown in countries where this business model has succeeded, using agents may cater for a variety of business objectives in addition to pure geographic expansion of access, such as a) client diversification; b) creation of cross subsidies across the distribution network that enable reaching otherwise non-commercially viable clients; c) cost savings by moving low ticket transactions out of high cost channels (branches); and d) cost savings by gradually reducing cash handling in areas already served by branches.

Despite the opportunities to harness available technology and the relatively well-developed payment system infrastructure, our analysis indicates there are certain key challenges still to be overcome. First, banks need to feel more competitive pressure in the markets on which they currently focus (profitable high- and high-middle income segments) before they will invest more heavily in product and channel innovation to cater to lower income clients**.** Second, the expansion of the card acceptance network is hindered by pricing practices of the card industry which reduce incentives for small merchants to participate. Third, mobile phone-enabled products, including mobile money (e-money through mobile phones), have not yet offered a value proposition and a user-friendly interface sufficient to encourage their widespread adoption by the mass market (a challenge faced by most countries fostering financial inclusion). Hence, and despite an enabling regulatory framework, there has been little uptake of the existing e-money products, other than the transportation card Touch 'n Go, and limited linkages between these products and bank accounts. Lastly, some segments of Malaysian society may still be reluctant to conduct cashless and faceless transactions.

There are only a few regulatory obstacles for the use of agents by banks (there is already an enabling framework for nonbanks) and for development of other alternative delivery modes. Relevant regulation is generally permissive while maintaining minimum standards for the safety and security of transactions and the protection of users. The draft Agent Banking Guidelines offer a potentially solid basis for the development of the business by banks, but will need to be adjusted to better ensure banks can operate in this market on a sustainable basis and can serve unbanked customers. In addition, the framework for approving physical access points across the banking sector lacks clarity and needs improvement to allow for more dynamism and competition to foster inclusion.

In this note we present a number of recommendations for consideration which are summarized in the table below.

Focus topic	Recommendations
Policy framework	-Should the domestic card switch continue to be pursued, ensure its design should ensure it does not stifle product innovation -Ensure MyClear's merchant acquisition operation is undertaken on a commercially sustainable basis to ensure both that merchant services will be delivered continuously over the long term and that it does not preclude new entrants in this business

	-Improve financial inclusion data to inform policy choices, particularly regarding usage of existing services and channels
Regulatory & Supervisory Framework	-Lift the limitation on locations where agents can be deployed -Allow unbanked customers to use agents -Allow use of agent network managers by banks deploying agents -Introduce a tiered KYC system to simplify low value (hence low risk) account opening -Permit (low-value) account opening at agent locations -Create a level playing field between foreign-owned and local banks with respect to their ability to expand branch and non-branch channels
Business Environment and Dynamics	-Raise awareness of the potential benefits and opportunities created by partnership models between e-money issuers and banks for advancing the e-payments agenda -Consider an alternative strategy (e.g., new regulatory measures) should MyMobile fail to encourage usage of mobile banking by the mass market -Gradually increase disincentives for the use of cheques

I. INTRODUCTION

1. **To further increase the reach of financial services, Bank Negara Malaysia (BNM) has identified the need to expand the distribution network of the financial sector by harnessing technology-enabled delivery channels.** This Technical Note focuses on the opportunities and the challenges for the sustainable implementation of innovative channels, such as retail agents and mobile phone enabled transactions, as means to achieve financial inclusion.

2. **Financial inclusion is defined in this Note as a situation where financial services are not only readily accessible, but also widely used by the majority of the population in meeting all or most of their financial needs.** Going beyond providing access to enabling increased usage of services such as bank accounts requires, in addition to dealing with obstacles such as cultural barriers, an extensive and efficient retail payments infrastructure. For already providing bank accounts to the majority of the population, Malaysia presents a great potential to increase usage by encouraging adoption of electronic payments for everyday transactions (e.g., airtime top ups, remittances), by both banked and unbanked persons. Hence, this note considers that financial inclusion is intimately related to the current policies for developing retail payments, and analyzes the implications of Malaysia's evolving payments landscape.

3. **After a brief overview of the state of access to basic financial services and the institutional potential for expansion in Malaysia**, the note analyzes the market environment and the policy and regulatory frameworks that may have an impact on the emergence and sustainability of delivery modes that could cater to underserved and unserved communities. The analysis is based on wide ranging discussion with financial institutions,

payment service providers, government authorities and microfinance entities, conducted in April 2012. The recommendations in Section 4 follow the principle that policies creating an enabling business environment are more likely to be successful than policies that do not recognize the role of commercial interest as a driver for sustainable financial inclusion.

II. OVERVIEW OF FINANCIAL INCLUSION AND POTENTIAL FOR EXPANSION

4. **Malaysia generally performs well in some traditional financial inclusion indicators.** With 92% of its adult population having bank accounts,[2] the country presents one of the highest levels of bank penetration in the East Asia and Pacific region, comparable to many high-income economies. Similarly, SME financing has reached a lending value relative to GDP comparable to a number of high-income countries and consumer loans are widespread. Remittances are increasingly accessible and mostly channeled through a diverse regulated sector where nonbanks play an important role. Many factors have contributed to these achievements, including targeted regulations, reforms for greater liberalization of the financial sector and formalization of retail financial services, and a sustained increase in average income levels. There is little information available on the level of usage of bank accounts, and BNM is planning to add usage indicators to its financial inclusion statistics.

5. **There is relatively good physical coverage of banking services in the country** and 80% of Malaysian adults find it convenient to access them according to a recent nationally representative survey. All 144 districts have at least one bank access point. Nonetheless, fifty-four percent of the sub-districts (mukims) with more than 2,000 inhabitants (449 mukims) as yet have no access points, i.e., branches, kiosks (sales stands), mini branches, post office agents, or mobile vans. There is less information on the distribution of nonbank access points, such as remittances agents. BNM is encouraging financial institutions, particularly banks, to increase their footprint to all sub-districts with the purpose of facilitating access to financial services by all Malaysians.

6. **Malaysian authorities have long recognized financial inclusion as a policy priority and continue fostering greater access to address remaining gaps.** There are several relevant policies in place[3] and a high level of consistency among them. A key policy document is the Financial Sector Blueprint (FSBP), which sets a roadmap for policy and regulatory decisions that could impact the adoption of innovations such as new delivery channels to increase the range and quality of financial services to all potential client segments.

7. **Although the largest banks reach the mass market as a consequence of their extensive distribution network (including part of the rural population), most commercial banks demonstrate limited interest in designing and implementing**

[2] Source: BNM.
[3] These include the Economic Transformation Plan, the SME Masterplan, and the National Cooperative Policy.

innovative products and channels to serve lower-income clients. For this market, most banks limit their offer to the compulsory basic bank accounts, which they need to offer, by regulation. This seems to be related to continuous high profitability in the high-end client segments, on which banks currently focus. Although competition in these segments is high, it has not been sufficient to push banks to expand to new client segments and geographies, or to increase usage of bank accounts by the currently banked mass market.

8. **Despite the general limited interest in lower-income clients by the banking sector, a few banks are likely to lead further inclusion.** They have a good level of sophistication and physical outreach, and the current reach of bank accounts may help them promote more innovative products through alternative channels. A few nonbanks, particularly the e-money issuers, may also have a prominent role if they are able to scale up their e-money business and drive adoption of more types of transactions. In the remittances market, nonbanks in Malaysia are driving innovation and may see more opportunities for partnerships with banks and nonbanks offering alternative products and channels. E-money issuers may also have a role in fostering greater usage of bank accounts by partnering with banks. Specialized microfinance institutions and cooperatives may become engaged in product innovation and even be used as agents of other bank and nonbank providers, but their small size and footprint does not permit scalability on their own.

III. FOCUS AREA: SUSTAINABLE ADOPTION OF INNOVATIVE CHANNELS

9. **Increasing banks' footprint will depend, to a large extent, on greater use of technology-enabled channels that go beyond brick-and-mortar branches and leverage on existing third-party infrastructure such as retailers and neighborhood shops**. These new delivery modes can reduce costs for both banks and clients considerably, as observed in countries such as Brazil, Colombia, Peru, South Africa, India and Mexico, where the use of retail agents has helped increase access and usage of payment and bank services such as basic bank accounts. This model can also help reduce use of cash in some instances (cash is an important cost item for banks serving communities outside larger urban centers). Reducing cash and increasing electronic payments is key for sustainable, cost-effective, innovative delivery channels.

10. **The FSBP sets an agenda for encouraging the use of innovative channels by banks and nonbanks, coupled with an agenda for migrating to electronic payments**. The e-payments agenda includes, for instance, creating incentives for small merchants to accept cards, increasing the number of point-of-sale (POS) in the country, improving security features of mobile banking, and promoting a conducive pricing structure for payment services. These are all initiatives that, if implemented, could potentially reduce the cost of delivering services to underserved communities and advance the financial inclusion agenda.[4]

[4] The FSBP (Recommendation 2.1.10) advocates for greater flexibility for financial institutions to introduce new products and cost-effective channels, such as gradually removing existing restrictions on foreign-owned

(continued)

Therefore, they are very important for enabling financial inclusion. This section analyzes the underlying infrastructure and the policy and regulatory environment relevant to the financial inclusion and e-payments agendas. It also provides insights into the potential challenges from the demand side, according to our consultations with stakeholders in Malaysia.

A. Telecommunications and Payments System Infrastructure

11. **Well-developed payment system infrastructure and telecommunication services are key for the rapid and safe adoption of innovative channels for financial inclusion, and Malaysia provides such infrastructure.** They may determine which business models for service delivery can emerge and thrive and define where, when, and how conveniently clients can conduct financial transactions using a range of instruments and different types of access points. This includes, for instance, the level of efficiency and openness with which a country operates the large value payment system, or the rules for sharing of telecommunications infrastructure.

12. **Penetration of mobile phones in Malaysia is nearly universal, with more registered accounts than the total population.** The number of Internet accounts is much lower, equivalent to approximately 59% of the total population. Twenty one percent of Internet users access the Internet via their mobile phones. Mobile connection is reliable virtually anywhere in the country, except in few rural and isolated areas. The large number of phones on use and the reliability of the service create a great potential for financial institutions to offer a convenient channel for clients to conduct financial transactions relying on wireless communications. In addition to providing a communication platform, mobile phones can also function as a payment instrument and a card acceptance device, potentially substituting cards and POS and reducing per-transaction costs even further.

13. **The Malaysian government plays a central and increasing role in providing infrastructure for electronic retail payments**. Through MyClear, a company wholly owned by BNM, the government operates RENTAS – the real time gross settlement (RTGS) system, the cheque clearing system (e-SPICK) and four other retail payment systems, briefly described in Table 1. These systems facilitate electronic interbank transactions captured through POS, ATMs and the Internet. The retail systems were all acquired by MyClear in September 2011, from MEPS, the bank-owned ATM network. The purchase was part of BNM's effort to advance the e-payments agenda, with the stated goal to reduce the cost of electronic transfers. Some players have suggested that MyClear would need to reduce fees even further to encourage expansion of electronic payments and investment in non-branch channels. This measure has been articulated in the FSBP.

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banks to establish branches and non-branch delivery channels. The underlying goal is to promote electronic payments nationwide and greater competition.

Table 1: Retail payment systems operated by MyClear

System	Brief description
FPX	Internet based online system to switch payments between e-commerce websites and bank's Internet banking systems.
GIRO (IBG)	Interbank electronic transfers, same day
e-debit	Switching of PIN-based, online real time debit card purchases.
MyMobile	Open platform for mobile phone initiated transactions (in pilot phase with Maybank, CIMB and Public Bank)

14. **The cost of VISA and Mastercard payment card transactions are generally considered high by market players and the regulator**. VISA processes over 80% of total card transactions in Malaysia. VISA's interchange fees were not disclosed to the FSAP team, but market players agree that they result in merchant discount fees between 1.5% and 2.5%, that seem to be relatively high for small merchants in Malaysia, according to our interviews. Both VISA and Mastercard admit their current business models do not accommodate the economics of small merchants and that the costs borne by small merchant would need to be relatively lower to allow their participation.

15. **The Malaysian government is considering implementing local switching, clearing and settlement of domestic payment card transactions.** MyClear is in the process of building a local switch that is likely to be mandatory for all domestic card payments. The goal is to reduce the costs of card transactions and encourage more merchants to accept cards, including small merchants. While some are fully supportive of the switch, not all players consulted agree that this is the best solution, arguing that a mandatory switch could stifle competition[5] and innovation in products that are usually offered by switch providers, and undermine the development of the card industry. Others question whether MyClear is well-equipped to provide a safe, secure and reliable service, continuously upgrade the systems, and achieve sufficient transaction scale to reach sustainability.[6]

B. Payment products and distribution channels

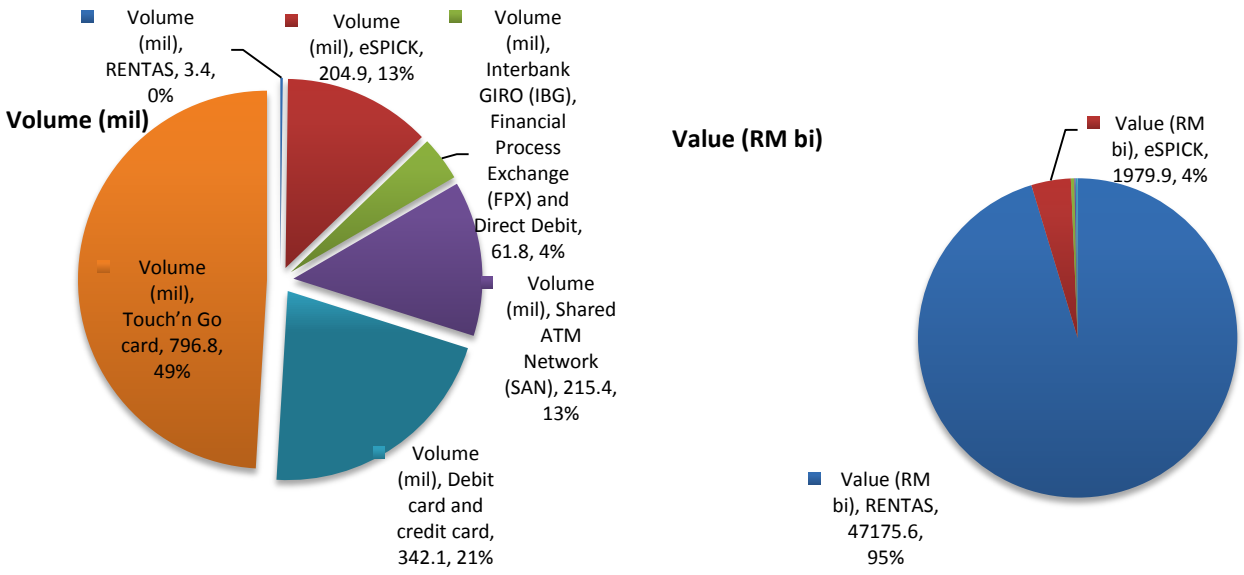
Payment products

16. **The adoption of electronic payments by Malaysians is important for the viability of innovative delivery modes and for increased usage of a range of financial services including bank accounts.** Although cash is still king, Malaysians increasingly embrace electronic payments. Over 80% of noncash retail payment transactions are conducted electronically as depicted in Figure 1. Touch n' Go, a toll and transportation payment card, is the system with the largest volume of transactions, while RENTAS and eSPICK account for

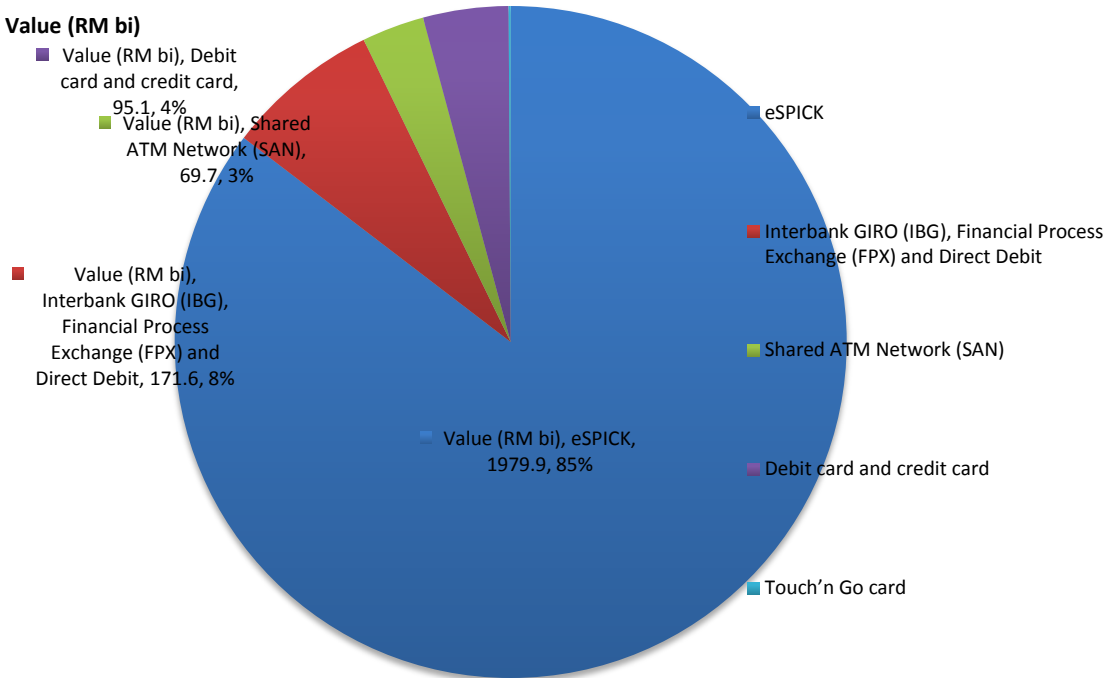
[5] The concern with competition is specifically related to the products and services provided by the switch, rather than the switching function itself.
[6] BNM has subsequently indicated that the adoption of the domestic switch is held in abeyance.

over 99% of the total value of transactions. Annual electronic payment transactions per capita have more than doubled from 14.3 in 2003 to 50 in 2011[7] and BNM intends to increase it to 200 by the end of 2020. The number of cheques issued has declined considerably in the last decade and BNM seeks to halve this number by 2020. One of the measures planned to facilitate this process is to allow higher charges on cheques to reflect the cost of processing this payment instrument. Reduction is also facilitated by the ability to make electronic interbank transfers at ATMs, branches and through the Internet and mobile phones (in some banks), although uptake of these channels is not yet high (4% of the total volume of electronic transactions).

Figure 1: Major Payment Systems and Instruments in 2011



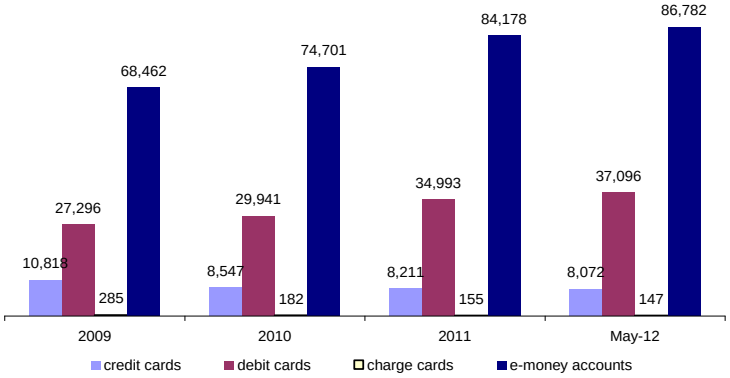
[7] Financial Sector Stability Report, 2011.



Source: Financial Stability and Payments Systems Report 2011

17. **The number of cards in the system has grown around 20% from December 2009 to May 2012 pushed by the growth in debit cards and Touch n' Go accounts**. Credit cards have declined in number, partly due to BNM's recent measures to avoid excessive household indebtedness, but mostly due to the imposition by the government of a RM50 tax per card, since January 2010. There has been substantial growth in debit card usage, which jumped 8.2 times in transaction volume between 2005 and 2010. BNM encourages investment in debit rather than credit based payments. However, Malaysia still lags most of its peers in the region in debit card usage.

Figure 2: Evolution of card-based services (in '000s)



Source: BNM

18. **The prevalence of e-money accounts is explained almost exclusively by the high penetration of Touch 'n Go, a transportation payment card**. Besides being used for payments at toll plazas, bus and train stations, Touch n' Go (TNG) cards can be used in selected parking sites, retail and food outlets and theme parks. Reloads range from RM10 to RM500, and 65% of them are made in cash. There are 9 million TNG cards making 4.4 million monthly transactions worth approximately RM450 million, of which **90% are related to transportation, showing limited uptake of retail purchases and other functions**. TNG has managed to enable MyKad (the national identification smart card) with a TNG wallet. However, customers have shown resistance to use their MyKads as a payments device. Among the 15 million TNG-enabled MyKads, only 180,000 are active (i.e., conduct at least one transaction in a month).

19. **Other e-money issuers have not been able to achieve scale.** Today, there are 17 nonbank e-money issuers operating in the country, mostly offering domestic and international person-to-person transfers, with limited but slowly growing penetration in retail purchases and remittances. These include the e-money schemes operated by the two largest mobile network operators (MNOs), Celcom and Maxis, and money remitters such as Mobile Money International. Maxis' MMoney has only 30,000 accounts, of which only 10% are active. Celcom's Aircash has 200,000 accounts, with similar activation rate. Mobile Money International is a multi-MNO, multi-bank platform founded 7 years ago to provide SMS based international remittances, mostly to Indonesia, using over 1,000 agent points. It has over 200,000 accounts, half of which are active. All these mobile money schemes offer top-ups at a variety of points, including ATMs and the MNOs use their extensive network of over 17,000 airtime dealers throughout the country.

20. **MNO e-money issuers could achieve more rapid expansion in number of accounts by adopting a different operational model.** TNG has a much larger number of accounts than its peers because it has transformed its toll cards (which were used exclusively for transportation purposes, i.e., a closed loop) into e-money accounts that can be used outside TNG's payment network (e.g. at Starbucks and other retailers). According to our consultations, Celcom and Maxis would be interested in converting airtime accounts into e-money accounts to allow payment transactions at retailers using airtime. While there is no regulatory prohibition, MNOs are reluctant to comply with the requirement of depositing 100% of airtime sales (equivalent to the total e-money issued) into a trust account. This is a common requirement for e-money issuing in other countries to provide protection for client funds, and is observed by TNG. The reluctance of the MNOs in using the regulatory framework and promoting more extensively their products to increase adoption and usage may be linked to the conflict with other priorities inside the company, such as dealing with stiff competition in the wireless business.[8]

[8] This is partly corroborated by the fact that, different from what has happened in countries where MNOs have developed large e-money business, Malaysian MNOs have not created a separate entity to conduct the e-money portion of the business.

21. **The limited uptake of e-money other than TNG also suggests that other types of partnerships could be pursued, including with the banking sector**. Allowing the issuer's core products such as airtime to be used as e-money alone would not necessarily substantially increase adoption and usage of the accounts for small payments and transfers. Although there is already an enabling regulatory environment, promoting greater uptake and usage may include more integration with the mainstream financial system, through partnerships with banks and remittances providers, beyond offering withdrawal facilities for e-money accountholders. Financial institutions could become agents for banks, and e-money operators could become agents for banks, potentially expanding the reach of electronic payments and bank services in urban and rural areas.

Distribution channels: ATMs

22. **At 6 per each 10,000 adults, the number of ATMs in Malaysia is below the average of high-income countries**. A network of shared ATMs offers an array of services (see Figure 3) and is largely interoperable. ATMs do not usually accept deposits, which are done through cash and cheque deposit machines. In spite of the range of services offered and the increase in cashless transactions at ATMs,[9] nearly 90% of ATM transactions are withdrawals (the other 10% include transactions such as airtime top up and interbank transfers). Most of the providers interviewed suggest clients are reluctant to use this channel for cashless transactions. ATMs can be used by clients of 20 banks, but clients of conventional foreign-owned banks pay 4 times more than other clients (RM4 instead of RM1) for a transaction in a shared ATM.[10] This pricing is determined by MEPs, the company operating the network.[11]

23. **In addition to ATMs, banks offer a total of 4,031 cash and cheque deposit machines, which are usually located next to an ATM or a bank branch, or stand alone inside malls and department stores**. The main reason given for not using ATMs with deposit capability is the risk of jammed bills and envelopes in the ATMs.

Figure 3: ATM network in Malaysia

11,800	20	Withdrawals Interbank transfers and payments Airtime top-up Cross border withdrawals	18.2 million *Nearly 90% are domestic withdrawals*	Singapore Indonesia Thailand China Korea
ATMs connected to MEPS	**Banks connected to MEPS**	**Services at MEPS ATMs**	**Monthly transactions *(excludes balance inquiries)***	**Countries linked up to MEPS switching**

[9] Cashless transactions at ATMs have increased 21% in the past four years.
[10] The discriminatory pricing does not seem to apply to foreign-owned Islamic banks.
[11] As mentioned above, MEPS divested four other retail payment services and has transferred the related systems (and around 80 staff) to BNM's MyClear.

Distribution channels: POS network

24. **Malaysia is still far from reaching high-income country standards of POS penetration and there are many government initiatives to change this**. There were about 9 POS per 1,000 inhabitants in 2011, up from 8 in 2010. This is comparable to many upper middle-income countries, but below the level observed in high-income countries (over 20 POS per 1,000 inhabitants). The business model typically adopted by card companies and card issuing banks has not resulted in expansion of the card acceptance network to small merchants. The monthly flat fees these merchants pay to their acquirers, added to the merchant discount fee associated with card transactions can be prohibitive for smaller merchants. These costs will need to come down to expand the POS network to smaller merchants.

25. **In addition to the plan to operate a domestic switch discussed in Section A, MyClear has started to acquire small merchants** (usually referred to as Tier 3 and Tier 4), through four private companies. Two thousand new businesses have been added between December 2011 and April 2012. The POS deployed in these merchants accept proprietary and VISA/Mastercard cards. Although this development may raise concerns about competition and distortions in the merchant acquiring business, our consultations suggest that the approach is widely accepted and supported by both the bank sector and the card industry, since, at present, there is no appetite by these players to invest in small merchants that are not able to attract large transaction volumes to cope with the costs imposed by card companies and acquiring banks. As it would be required from any provider, MyClear needs to build a viable operation that is sustainable over the long term. This is to ensure the services are offered on a continuous basis to underserved areas. This is also important to reduce the risk of distortions that could prohibit new entrants, were other players interested in competing in this market (e.g. government subsidies).

Distribution channels: Internet and mobile banking

26. **Internet banking transactions increased 5.7 times between 2006 and 2011, being offered by nearly all banks, while only 13 banks (and not all the largest banks) offer mobile banking.**[12] Implementation and promotion of mobile banking (access to bank accounts through the mobile phone) seems to be limited by the need for banks to create multiple interfaces (one for each MNO). This makes investment in this channel a more complex and expensive endeavor for banks. Also, mobile banking still targets the high-end client segments, despite the high penetration of both bank accounts and mobile phones in all income levels. In addition, most market participants consulted believe Malaysians are suspicious of cashless and faceless transactions and are particularly resistant to pay a small fee for electronic means when cash transactions are free.

[12] Source: BNM website, accessed in May 3, 2012.

27. **A common multi-bank, multi-MNO platform for mobile banking is being implemented, but needs to improve its user experience to encourage adoption by the mass market**. MyMobile is an open platform operated by MyClear, designed to encourage adoption of mobile banking by account holders of all income levels. It can be used by any bank, and is currently being piloted by three large banks. They currently offer interbank transfers, airtime top-up and balance enquiries. The system uses USSD.[13] Customers are uniquely identified by a mobile phone number and an ID number provided during registration with the bank. MyClear has temporarily waived switching fees for interbank transfers through MyMobile.

28. **The service is theoretically easy to use, as the sender does not need to know the recipient's bank account number**. Our consultations suggest that improvements can be made in the user interface of this product.[14] This is mainly because concluding a transfer requires too many steps, which discourages customers to use it instead of cash or cheques, at least for retail purchases. MyClear is aware of the need to make improvements and is working on it. As these adjustments are made, other services, such as bill payments, will be added. The objective is making MyMobile the main platform for mobile banking in Malaysia and reaching a point where the mobile phone can be used seamlessly for small payments. To allow that, MyClear plans to leverage near field communication (NFC), but that would require phones to be adequately equipped,[15] which cannot be done in the short-term.

Distribution channels: Branches

29. **Rural areas and the outskirts of larger urban centers are usually covered by offices of nonbank rather than bank remitters**. The remittances business is served by over 3,800 branches, between nonbank (1,526 branches) and bank operators (2,302 branches). Agents are used in small numbers. New rules on money business services have introduced more flexibility for the use of remittance agents and there are expectations that they will increase in number.

30. **BNM has been encouraging banks to expand or at least not reduce their branch network** (for instance, by making it difficult for banks to close branches in rural areas). Foreign-owned banks are required to comply with a policy establishing a minimum rural-to-urban branch ratio imposed by BNM when applying for new branches. However, there is limited public information on how banks distribute branches across urban and rural areas. The largest branch networks are naturally those of the largest banks. Maybank has the most extensive footprint, followed by CIMB, Public Bank and BSN. According to our

[13] Unstructured Supplementary Service Data is a protocol used to communicate mobile phones to the service provider's computer, in a real time connection during a USDD session.
[14] This is a problem in nearly all mobile money products using USDD around the world.
[15] Only newer high-end phones are equipped with integrated NFC device, while a NFC "sticker" would need to be attached to other phones.

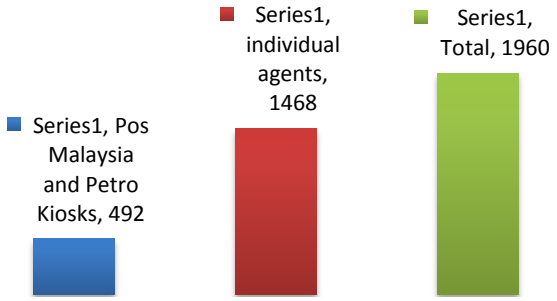
consultations, BSN and Agrobank, due to their developmental mandate, have a more important presence in rural areas and outside larger urban centers.

Distribution channels: Use of agents

31. **There seems to be agreement in the banking industry that branches will not drive financial inclusion**. Branches have high fixed costs, making it economically unviable as a delivery channel for intermediating small value transactions typical of low-income customers. Expanding outreach to lower density or lower income areas requires channels that are considerably cheaper, and probably partnerships with other entities, such as nonbank e-money issuers, for product innovation to encourage greater usage (i.e., high number of transactions). However, most players seem to have limited understanding of alternative, more cost effective channels, particularly of how agent banking is successful in other countries and how it could work in Malaysia. There is also some skepticism regarding the potential uptake of electronic and agent-based transactions outside larger urban centers.

32. **A few banks have been using alternative channels to increase outreach while keeping costs down**. These channels include kiosks (e.g., a stand inside a supermarket), mobile units and retail agents. Kiosks are usually deployed in shopping malls and large department stores, having little direct impact in increasing outreach. Experience with agents is very incipient. The limited penetration into the agent banking business includes that of Maybank and RHB (e.g., with with POS Malaysia, the post office), and BSN at pilot stage (e.g., with petrol stations, convenient stores and other retail agents). BSN also has a mobile unit with a fixed itinerary covering underserved communities. The unit is much cheaper than a full-fledged branch, but much more expensive than a typical retail agent. In total, there are 1,960 retail agents operating on behalf of Malaysian banks.

Figure 4: Retail agents operating on behalf of banks in Malaysia (March 2012)



Source: BNM

33. **Agent banking has great potential to extend access to and increase usage of basic banking and electronic payment services**. Since certain segments of the Malaysian society are perceived to prefer personal contact over faceless transactions, agents can extend access

while preserving the "human" element that is most prized. Petrol stations, post offices and chain provision stores are located within 5km from most adult Malaysians and at least one bank is already offering services through provision stores (BSN).[16] They may be well placed to operate as agents and bring banks closer to communities, similar to what has been achieved elsewhere, most notably India, South Africa and several countries in Latin America, where retailers have been providing basic payments and banking services. While Malaysian banks are still starting to consider this channel, all nonbank e-money issuers, including MNOs, already use thousands of retail agents to market and sell their products.

C. Regulatory Framework for Innovative Channels

34. **BNM has clear and broad regulatory and supervisory powers over payment services and banking products and channels**. The Payment System Act (PSA) 2003 gives regulatory and supervisory powers to BNM over payments, including the power to designate systemically important payment systems and payment instruments.[17] Under the Banking and Financial Institutions Act (BFIA) 1989, the PSA (2003), and the Central Bank of Malaysia Act (BNMA) 2009, BNM may issue rules and guidelines for payment products and instruments to establish minimum operational, risk management, reporting and market conduct requirements.

35. **BNM is able to form a fairly complete view of the risks of new offerings and their potential to expand financial inclusion during the approval process and also during supervisory review**. Under the PSA (2003) and related regulations[18] any person wishing to operate a payment system needs to obtain a notification from BNM and those wishing to issue a designated payment instrument need prior approval. Applicants need to submit a comprehensive set of information for BNM scrutiny, ranging from articles of association to the proposed fees and charges. BNM has a small but well prepared team overseeing payment service providers including MEPS, MyClear and other providers, and applies a combination of supervisory techniques to assess risk, including a Frauds Reporting System.[19]

36. **There is a good degree of openness and certainty for electronic money businesses.** The regulation allows for competition and institutional diversity by permitting participation of a wide range of bank and nonbank providers. E-money issuers are allowed to and do use temporary booths and agents, which are key for the viability and sustainability of their businesses. Many e-money issuers have seized the opportunity to offer remittances

[16] Source: BNM.
[17] The Financial Services Bill, which is expected to be passed in the coming months, has a provision to allow BNM to set standards for payment systems, including to facilitate interoperability.
[18] See Submission Guideline for Operating Payment System or Issuing Designated Payment Instrument.
[19] The Frauds Reporting System is managed by the Statistics Department, and accessed by several departments, including supervision, Consumer Protection and Market Conduct Department and Payments and Settlement Systems Policy Department.

using technology-enabled channels such as Internet and mobile phones, based on the Money Services Business Act 2011, which is friendly to innovative remittance channels, including agents.

37. **The regulation provides for clear and proportional requirements for ensuring safety in the deployment of electronic channels and transactions.**[20] Overall fraud losses in electronic transactions are negligible, accounting for 0.001% of total value of retail payment transactions in 2011.[21] BNM recently required PIN verification for all card transactions starting January 2015. The card companies and the banks have suggested that the total cost of frauds in credit cards does not justify the investment to shift to PIN-based transactions and that this could delay investment in other areas, such as expansion of the branch network.

38. **The regulations, including consumer protection rules, seem to provide enough flexibility and do not represent an obstacle for the development of innovative delivery channels and products.** Although some institutions have raised concerns about the intrusiveness of the e-banking and the outsourcing regulations[22] none was able to pinpoint specific regulatory obstacles. A possible explanation for the negative comments may be the level of detail required by BNM in order to approve new products and channels.

39. **The framework for approving physical access points across the banking sector needs improvement to allow for more dynamism and competition to foster inclusion**. Banks are able to use a "file-and-launch" system for faster implementation of new products[23] but new channels (e.g. a new branch) do not benefit from the file-and-launch option.[24] According to our consultations, and despite the apparent existence of written guidance, there is confusion in the market on whether the rules for new products and channels apply equally across different types of institutions (local banks, DFIs and foreign-owned banks).

40. **The branch ratio policy may be limiting foreign and local banks' ability to invest in new access points on a commercial basis**, resulting in lower levels of investment. This has the potential to impede achievement of financial inclusion goals by stifling competition at higher end client segments, where foreign banks usually focus. The FSBP's has stated the goal of providing greater flexibility for foreign-owned banks to expand, even if in a gradual manner, and this should include the branch ratio. Using the branch ratio policy to spur banks, including domestic banks, to go to underserved communities, may end up limiting investment and curbing competition. Greater flexibility (including flexibility for all types of banks to close branches) could potentially help in the development of sustainable agent banking and greater interested in underserved clients and communities.

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[20] See the Guidelines on the Provision of Electronic Banking (e-banking) Services by Financial Institutions.
[21] Source: BNM.
[22] See Guidelines on Outsourcing.
[23] See Guidelines on Introduction of New Products, which does not apply for designated payment instruments such as charge cards, credit cards, and electronic money.
[24] Source: BNM.

41. **There is no specific regulation to govern the use of agents by banks, but BNM plans to issue one in the coming months.** BNM has allowed the existing agent schemes to operate based on a regulation on shared banking services, which will be supplanted by the upcoming Guidelines on Agent Banking, published by BNM for consultation with banks in April 2012.[25] The Guidelines set minimum requirements for financial institutions (convention and Islamic banks and DFIs) using agents, while keeping them responsible and accountable for agent banking activities.

42. **According to the Guidelines, agents may offer: a) deposits; b) withdrawals; c) fund transfers; d) loan payments; and e) bill payments**. They are prohibited from a) opening bank accounts; b) offering money changing; c) conducting loan appraisals; d) subcontracting their agency agreement; and e) charging customers extra fees.[26] Any type of registered business with a permanent business premise may be an agent, subject to minimum operating requirements which, according to our consultations, do not seem to form a barrier for the development of this channel.

43. **It is not clear at this point whether requirements designed to enhance security will become a hurdle for agent banking.** Agent transactions need to be online, on a real time basis and conducted within the premises of the agent only. Daily cash withdrawals are limited to RM500 or RM5,000 per customer,[27] depending on whether the agent is part of a chain network or is an independent sole proprietary agent. Transactions must be secured by end-to-end encryption, and 3 levels of verifications (for withdrawals via POS) or 2-factor authentication (for other transactions).

44. **The regulation encourages but does not impose interoperability of agents across different banks, which is an adequate approach at least for the initial stage of development of this business.** Finally, the draft establishes minimum risk management and governance standards, including minimum contractual clauses for the agency agreements, frauds detection systems and complaints handling mechanisms. Financial institutions will be required to report agent transactions to BNM on a monthly basis.

45. **Although generally following international good practices for agent banking, in certain respects the draft potentially limits the viability of the business**. The most relevant feature is that it would only permit banks to use agents in certain locations where there are no other bank access point such as branches, kiosks, and mini branches. Another potential constraint is the prohibition on agents to open accounts on behalf of banks. In addition, it restricts agent operations to account-based transactions, which would make this

[25] The Guidelines on Agent Banking were subsequently issued on August 15, 2012.
[26] In addition to the fees banks may charge for agent transactions.
[27] Transaction limits (and whether the limits are set depending on type of agent – which is not very common in other countries' agents regulations) may be changed depending on the result of the public consultation, according to BNM.

new channel out of the reach of unbanked customers willing to do simple transactions such as paying a utility bill.[28]

46. **The draft regulation is much more restrictive than the current framework for e-money issuer using agents**. It does not provide a level playing field between banks and nonbanks in this regard, by limiting location and account opening. Such limitations could deter investment and growth in this channel, as it has done in Kenya, where the Central Bank has taken a similar approach, i.e., instituting a stricter regulation for banks using agents, comparatively to the rules applicable to nonbanks and limiting banks' ability to sign up agents.

47. **Given the high penetration of identification documents in Malaysia, KYC requirements[29] are not usually identified by the market as a constraint** for financial inclusion except for those offering remittances to foreign workers.[30] The regulation applies equally across banks and nonbanks and different financial products. Some market players argue that KYC requirements may be one of the reasons why around 20% of outward remittances are done in the informal sector. However, the regulation only requires customer due diligence (CDD), which includes obtaining and verifying very basic client information, for transactions equal to or above RM3,000 (approximately USD1,000) for nonbank remittances. This flexibility should meet the needs of the majority of foreign workers sending money home from Malaysia.

48. **Although regulation does not pose explicit obstacles, AML/CFT concerns by BNM may limit the full potential of agent banking**. Although there is no prohibition in the AML/CFT regulation for banks to use agents to conduct document verification, BNM is not comfortable with the concept and does not plan to implement such flexibility, at least not in the first phase of implementation of agent networks. This is in part justified by the lack of a regulatory definition of low-risk accounts.[31] If there was such a definition, account opening at agents could be restricted to such account.

IV. RECOMMENDATIONS

49. **Based on our analyses, we suggest BNM adopt the following measures**.

1. **Review certain aspects of the Draft Agent Banking Guidelines:**

[28] Under the Guidelines on Agent Banking that were ultimately issued (August 2012), this restriction was eliminated. Fees for unbanked customers can be collected in cash.

[29] Anti-Money Laundering and Anti-Terrorist Financing Act 2001, Standard Guidelines on Anti-Money Laundering and Counter Financing of Terrorism (AML/ CFT), and AML/CFT Sectoral Guidelines.

[30] Banks have also noted that the need to identify beneficial owners of corporate clients is a hurdle for business, but this has limited relevance from a financial inclusion perspective.

[31] Low-risk accounts are those with regulatory limitations to their monthly balances and/or transaction volumes. Such limitations reduce the risk of their being used for criminal purposes.

- **Lift the limitation on locations where agents can be deployed**. Experience in other countries show that building a successful agent business is not easy and depends on achieving scale and creating cross subsidies across the network.[32] Large networks mixing underserved and served areas are more likely to be successful, because they provide clearer incentives for both the bank (it meets two objectives: geographic expansion, and cost savings by pushing low-value transactions out of fixed-cost channels) and the agent (by distributing costs throughout the network, banks are able to offer slightly higher fees per transaction to certain agents, if needed, to incentivize an increase in transaction volume). Sustainable agent banking can support a variety of business objectives, in addition to geographic expansion, such as a) client diversification; b) creation of cross subsidies across the network; d) cost savings by moving low ticket transactions out of high cost channels (branches); e) reducing costs of cash handling by increasing convenience of electronic transactions in areas already served by branches.

- **Allow unbanked customers to use agents by reviewing the provision requiring deductions of transaction fees from the customer's bank account.**[33] The draft Guidelines on Agent Banking require transaction fees to be deducted directly from the client's account, meaning that all clients transacting at agents must have a bank account and that all transactions are account-based. This would impede unbanked clients to use agents for transactions such as bill payments and remittances. This is an additional factor impacting the sustainability of the agent business, which requires high volume of low-cost transactions. Also, banked clients would not be able to use agents that have exclusivity agreements with another bank (although BNM indicates that it will discourage exclusivity agreements). While the intention of the regulator was to protect consumers against agent abuse, the regulation will exclude unbanked customers and is likely to impact the business proposition for banks.

- **Allow use of agent network managers**.[34] Network managers are companies specialized in selecting, hiring, training and managing the operations of

[32] A useful resource in this topic is CGAP's Agent Toolkit, available at www.cgap.org. Banks that roll out an agent network typically start by placing agents near branches to provide customers with a more convenient service point. This accelerates customer adoption and allows the banks to cover investment costs quickly. Then banks build the network out of these areas.
[33] This provision indeed was eliminated from the final guidelines issued in August 2012.
[34] The final guidelines accepted this recommendation. Consideration of proposed arrangements will be made on a merit basis.

agents, servicing hardware and software, providing communication and marketing materials, among other activities. These have shown to be valuable risk-management tools for banks in other countries, and key to expand agent networks rapidly, without the need to create large in-house teams. The experience elsewhere shows that large networks will use a mix of both in-house and outsourced agent management. Typically, in-house teams take care of chains and agent network managers take care of small independent agents.

- **Permit low-value account opening at agents, on behalf of banks. Introducing a tiered KYC system to benefit low value (hence low risk) accounts may help.** To allow agents to conduct basic KYC on behalf of banks, BNM could introduce an AML/CFT framework differentiating risk levels according to account balance sizes. Only low risk accounts (with low average account balances) would be opened at agent locations. Such approaches have been taken, for instance, in Mexico and South Africa. Banks should be kept responsible for ensuring that agent KYC practices adhere to minimum standards and BNM staff should evaluate banks' internal controls with regard to KYC at agents. By having such good identification documents (MyKad smart cards) with a low level of identity fraud, Malaysia has a unique opportunity to allow agent account opening in a safer manner than many upper middle-income countries pursuing financial inclusion goals which are struggling with poor identification systems.

2. **Create a level playing field between foreign-owned and local banks to expand branch and non-branch channels.** Although foreign banks in Malaysia would generally not be expected to cater to underserved communities or lower-income segments, they can play an important role in increasing competitive pressure in high-end markets, which have in other countries been a reason for banks to diversify into middle, low-middle and lower income client segments and take advantage of enabling agent banking regulations. Requiring foreign banks to go to underserved communities (e.g. the branch ratio policy) may limit investment in branches and other channels, curbing competition. Greater flexibility (including flexibility for all types of banks to close branches) could potentially help in the development of sustainable agent banking. Allowing more flexibility for foreign banks has already been noted as a necessary measure, in the FSBP.

3. BNM has a limited role in pushing for changes in the business models of e-money issuers such as MNOs, but it may find it helpful to **raise awareness of the potential benefits and opportunities of partnerships between banks and e-money issuers for advancing the e-payments agenda and financial inclusion**. This could be done through workshops and industry meetings.

4. **Advance the adoption of e-payments:**

- **Consider an alternative strategy (e.g. regulatory measures) should MyMobile fail to encourage usage of mobile banking.** It is too early to evaluate MyMobile's success and how it will impact the use of mobile banking by the mass (banked) market. BNM should be open to alternatives in case MyMobile fails. One option is encouraging or mandating the industry to reach common standards for mobile banking, with support from the Malaysia Communications and Multimedia Commission. This was successfully done in Singapore for instance.

- **Should the domestic card switch continue to be pursued, ensure its design does not stifle product innovation.** Operating the domestic card switch presents challenges such as continuously upgrading the system to ensure the services it provides are secure and reliable. Weaknesses in security, reliability and availability of electronic payment services may undermine the potential to use innovative delivery channels and increase preference for cash payments. The switch should also be able to continuously design new products to meet the evolving demand of member banks and avoid a situation where the monopoly it represents in effect stifles innovation in retail payments. BNM should evaluate alternative measures to reduce the cost of card payments, such as defining fairer membership, access and pricing standards to be applied by the existing switching infrastructure.

- **Ensure that MyClear's merchant acquisition operation is undertaken on a commercially sustainable basis to ensure both that merchant services will be delivered continuously over the long term and that it does not preclude new entrants in this business, should they exist.** MyClear's initiative aims to address the current limited competition for smaller merchants, on terms that are attractive to the merchants. As it would be the case for any other provider, this business needs to be based on viability and sustainability over the long term, to ensure a) this measure does not stifle eventual competition (in case other players become interested in this market) by creating distortions; and b) services will not be interrupted in the future due to non-viability.

- **Provide disincentives for the use of cheques**, such as allowing charges to be imposed on cheques below a certain amount, to reflect their higher cost. This should be done gradually as coverage of electronic payments increases and their cost goes down. This measure is already considered in the FSBP.

5. **Further improve financial inclusion data to inform policy choices, particularly regarding usage of existing services and channels**. Remarkable progress has been achieved by BNM in demand and supply side information, particularly with recent survey efforts. Areas for potential improvement include:

   - Collect and disseminate data on the distribution of branches, ATMs, POS, kiosks, and agents as between rural and urban areas and across different types of entities (foreign, local, conventional, and Islamic banks, and money remitters), and on the penetration of bank accounts by rural and urban areas and by income segment, and cross such data with the data on distribution networks

   - Investigate whether banks' customer due diligence policies are stricter than regulatory requirements, and if so, the underlying reasons, and whether supervisory practice has any influence on encouraging overly conservative practices that impact financial inclusion

   - Consider whether it is useful to investigate the underlying reasons for the pervasiveness of inactive banks accounts through demand side survey. The recent demand side survey focused on access, reasons for not having financial services, and level of satisfaction, but not on level of usage. There is data available from Brazil, South Africa and India showing that basic accounts, despite having increased in absolute numbers, are not being fully used, presenting very low transaction levels.

   - Our consultations suggest there is a general belief that Malaysians are particularly price sensitive with regard to financial services and that some social and age segments are reluctant to use electronic channels and conduct faceless transactions. Since the e-payments agenda is key for advancing financial inclusion, these hypotheses could be tested through additional consumer surveys to produce relevant information to the market and to BNM.