Zeti Akhtar Aziz: Scaling new heights after the banking consolidation

Speech by Dr Zeti Akhtar Aziz, Governor of Bank Negara Malaysia, at the opening of the Malaysian Banking Summit 2001, Kuala Lumpur, 17 May 2001.

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Distinguished Guests, Ladies and Gentlemen,

Introduction

While we cannot predict the future with any certainty, we can most certainly by our actions taken today contribute towards determining the future that we aspire. To do so, we need to have at the outset, a clear vision of what the future should be like. The Financial Sector Masterplan (FSMP) is about defining the blue print for the financial structure that is envisioned to best serve our economy, as we move forward to the next stage of development. It is within the context of this vision, that the Plan outlines the strategies to be adopted in the transition for the development of the desired financial system. While envisioning the future provides the strategic focus and the common goal, of greater importance, is the action that needs to be taken to make it happen. It is our actions, and initiatives taken now that will help realise this vision in the future.

It is indeed my pleasure to be here today at the Malaysian Banking Summit 2001 which is most aptly themed “Scaling New Heights After the Banking Consolidation”. This summit is both relevant and timely. It is relevant, given that we are now embarking on the task of driving the future development of our nation’s financial sector. It is timely, given, that the masterplan which has just been released early this year outlines our vision of the desired financial system as we advance forward. In relation to this, it is also recognised that the financial landscape is being shaped by powerful forces of change, in particular, the advances in technology. It is therefore time for concrete efforts by all parties involved to work towards the realisation of our common vision that has been outlined in the Financial Sector Masterplan.

The focus of my presentation today will be on the banking sector. Let me begin by first providing a perspective on the significance of the banking sector in general and within the Malaysian financial system and economy before proceeding to provide an overview of where the banking sector stands today. This is followed by a discussion of the strategies that are expected to drive the process. More specifically, the key building blocks that are necessary, that will provide the basis on which subsequent blocks can be built.

The role and significance of the banking system

The banking sector remains at the core of our financial system. A well functioning and efficient banking system is vital for achieving robust economic performance. Within the context of the economy, the banking sector performs three main functions. The primary function of the banking sector is essentially the intermediation of funds from savers to borrowers. In performing the mobilisation of savings, depositors need to be assured of the safety of the deposits and the efficiency in the manner the funds are mobilised. As part of the intermediation process, banks channel these savings to productive investments. This however, involves taking risks. The credit decision making process therefore needs to be rigorous. Banking institutions however, need to fully appreciate their special role in the credit delivery system. There is no inherent conflict between pursuing sound banking practices and having the proactive role in disbursing loans to promote growth. These two objectives are complementary. In the process, banks would expand their loan base and the availability of financing would enhance the growth prospects of the economy. Ultimately, it is the loans granted that is central to the profitability of the banking system. An excessive risk aversion among bankers would restrict the flow of credit in the economy and would have adverse effects on the profitability of the banking system and on economic growth. Banking institutions therefore need to play their role in the economy in order to facilitate and contribute to the overall functioning and growth of the economy.

Finally, the banking sector also provides a means of payment both nationally and internationally. The banking system facilitates an efficient and safe means of making and receiving payments. Public confidence in the banking system is therefore vital to ensure payments can be made on a safe and timely basis. While there may be new channels for payments, banks will continue to be special. The state-of-the-art security measures which are important in providing assurance and confidence to the public as well established in the banking system. There are also other safeguards and processes to deal with fraud to provide customers with the highest level of confidence.

The current situation: where the banking sector stands

Despite the trend towards a more diversified financial sector, the banking sector has continued to be the most significant component of the financial sector. As at end of the year 2000, the banking sector provided 83% of the total financing to the economy, with total credit provided by the banking sector accounted for 133.9% of our GDP. While this trend can be expected to continue, the banking sector will remain the dominant component.

The banking sector has emerged from the East Asian crisis significantly strengthened. Malaysia has taken full advantage of the conducive economic environment over the last two years to implement financial restructuring and structural reforms in the banking sector and is well placed to chart the medium and long-term agenda for the financial system as embodied in the Financial Sector Masterplan. The banking system has also emerged relatively resilient and is well placed to meet the slowdown in economic growth and uncertainties in the global markets. The risk-weighted capital ratio of the banking system has remained at a healthy level of 12%, even after writing off the total goodwill that has arisen from the merger exercise against the capital base of anchor banking institutions. The capital ratio is expected to increase further in coming months once the capital raising plans of at least two institutions are implemented in the near term.

The healthy capital ratios mean that the banking system would not be constrained in meeting the financing needs of viable investments and businesses. This is particularly important in an environment in which the main source of economic growth is to be from domestic sources. Positive trends have also emerged on lending activities since the year 2000 with the loan growth being now firmly in positive territory. For the first three months of this year, loan approvals and disbursements have expanded at an annual rate of 6.7% and 8.7% respectively. Total loans outstanding, including the private debt securities (PDS) held by the banking institutions have expanded at an annual rate of 6.6%. A structural shift in financing patterns from traditional bank lending to the private debt securities (PDS) market can be observed to have occurred. Total loans and PDS outstanding increased at an annual rate of 7.6% as at the end of March 2001. On the portfolio quality of the banking institutions, it can be expected that non-performing loans will increase in an environment in which there is a slowdown in economic activities. However, the level is expected to be contained well within manageable proportions. NPLs increased to 7.1% as at end-Mac 2001 based on a 6-month classification period mainly due to the expiry of the indulgence for the classification of a number of loans that were granted earlier under the debt restructuring process. As at end-March 2001, another RM2.6 billion worth of loans are yet to be classified as NPL. Although such loans have yet to be classified as NPL, banking institutions are only allowed to recognise interest on a cash basis. Furthermore, starting last financial year, banking institutions are required to set aside 20% specific provisions on these loans.

The asset quality and the level of NPLs are one of the indicators closely monitored by the Central Bank. For the banking sector, credit due diligence should take place not only at the time the loan is made but also during the entire period in which the loan is outstanding. Bank Negara Malaysia conducts regular stress tests to assess the NPL levels and capital positions of banking institutions under more difficult economic scenarios and most stringent provisioning requirements. The results of these forward looking assessments indicate that the banking system continues to be resilient even under the worst case scenario. Under these scenarios, the risk weighted capital ratio would remains above the 10% level. Thus, while NPLs can be expected to increase, the magnitude can be absorbed by the banking system without threatening its solvency position nor disrupting the payments system. The banking system can still be expected to record another profitable year in 2001. This will contribute towards further strengthening the capital base and provide further buffer for banking institutions to meet unexpected shocks to the system.

One of the areas where significant growth will take place is the Islamic banking and takaful. Since 1983, the measures implemented by Bank Negara Malaysia to expand Islamic banking on a nationwide basis in terms of the number of players through introduction of the Islamic Banking Scheme (IBS), which allows conventional banking institutions to offer Islamic banking products and services using their existing infrastructure. Since its inception, the significance of the Islamic Banking

Scheme has been on a progressive upward trend, recording an average annual growth of 64% in terms of assets over the period 1994-2000. As at end 2000, the total assets of Islamic Banking Scheme stood at RM33 billion. The number of banking institutions participating in the scheme has also increased significantly from 17 in 1993 to 47 in 2000.

A major accomplishment by the domestic banking industry was the consolidation that took place in the year 2000. The consolidation of the domestic banking institutions represents a major structural enhancement to the banking system. With the legal mergers now completed, the focus has been on the operational integration process to allow the merged banking institutions to operate as a single entity. Opportunities must also be taken to assess existing processes and relook at the possibility of rationalising the various processes on a group-wide basis. This will allow for the new group structure to achieve greater operational efficiency and cost effectiveness as well as potential productivity gains in the future.

The completion of the legal and operational merger will also place the Malaysian banking institutions in a better position to meet future business challenges and respond to the forces of change. Banking institutions would be expected to leverage on the opportunities presented by the consolidation to exploit economies of scale, diversify and strengthen their earning base and create bigger market presence. Hence, the flexibility to conduct cross-selling within the group would need to be fully utilised. Cross-selling of banking products would allow the existing customer base of each institutions within the group to be more comprehensively serviced.

These encouraging trends in the banking industry in terms of performance and resilience however will not be enough. To forge ahead in this new economy, it will require more than just the adoption and implementation of gradual and incremental changes. Strong management teams that are committed to bringing about overall performance improvements, capacity enhancements, agility on a continuous basis, and the courage to implement strategic changes will be key to the process. Strategic changes in the banking sector can take many forms, and this may vary, depending on the individual organisation's strengths and opportunities. Paradigm shifts would mean that new strategies would have to be conceptualised and articulated to address the increasingly complex issues at hand. I am sure that this Banking summit will provide an excellent platform for bankers to discuss new and relevant ideas to deal with some of these issues.

Benchmarking against the best

A key recommendation that will drive improvements in the banking sector is the benchmarking exercise. These indicators are to be used to monitor performance and help establish priorities and strategic plans to enhance performance. The benchmarks should not only encompass macro data but should also include micro data on the cost and returns of the different products, transactions, customer segments and delivery channels. It is through the monitoring of such detailed ratios would banking institutions be able to evaluate their key strengths and capabilities. This understanding would help banking institutions re-examine existing business models, define future focus, by leveraging on their respective strengths to enhance shareholders value.

While indicators and benchmarks have been used previously, this is the first time that a wide-ranging set of indicators will be formulated to form a basis for such a systematic assessment. A committee comprising of a number of industry players, the Association of Banks and Bank Negara Malaysia has now been set up this drive the benchmarking exercise. The group is responsible for developing the quantitative and qualitative benchmarks that would serve as 'drivers' of performance improvement. To initiate this process Bank Negara Malaysia has begun to disseminate reports to banking institutions, benchmarking each bank's performance against that of the industry on the basic indicators. Banking institutions should not consider this benchmarking exercise as an additional burden or as a cumbersome process of statistical collection and reporting that has been imposed by the regulator. A change in mindset is required at all levels of management if the benchmarking is to set new levels of performance in the industry. It needs to be recognised that tracking our progress in achieving the greater heights is an important part of the process. Boards of directors are certainly expected to show commitment to drive this process. Banking institutions need to formulate clear plans with clearly defined milestones in addition to the resources required to achieve the set goals. In essence, baselines for future comparisons need to be established. Banking institutions must therefore allocate adequate resources to this strategic initiative.

In the new financial landscape that is to come, it will become clear that only few will emerge to compete effectively and efficiently across all banking markets and to provide the full range of banking services. As such, bankers will be forced to re-examine existing business models to see where their strengths lie and to what opportunities these strengths can be applied to enhance returns. There may be advantage to move towards strategic differentiation among the banks in order to better serve the relevant market segment or niches. This may involve market specialisation or functional specialisation as banks decide which functional areas or combinations of risk management, customer service, product innovations and other areas are their comparative advantage.

As we move forward, we can expect customers' expectations to take a quantum leap. Banking will no longer involve providing standard products to customers. Today, transactions can take place at any time and any place and through any delivery channel. In order to remain relevant as financial intermediaries, banking institutions would need to be sensitive to customer needs for greater efficiency and convenience. There is now a growing demand for financial products to be personalised and customised to the individual needs of corporate and retail clients. Banking institutions would therefore need to be more proactive and innovative in packaging and marketing their products. While customers will expect wider range of products to be offered, of greater importance is for the banking institutions to be able to provide these products at competitive pricing. As competition intensifies, banking institutions will have no option but to be more innovative in pricing which will result in further narrowing of margins.

Banking institutions would also need to consider new business arrangements and approaches in order to enhance returns. One way this can be achieved is through strategic alliances, which is already widely practised by global players. Strategic alliances have become a viable strategy for banks contemplating new markets. Through these alliances, banks can complement their existing strengths with those of their partners' capabilities, distribution channels, and access to new markets.

At the individual banking institution level, the ability to make real improvement would also depend very much on the availability of competent human resource. The quality of manpower will be a defining element of performance and competition among the banking institutions. Attracting the best skills and talents in the industry must also be complemented with better management and communication so that there is an awareness and understanding of visions and shared values throughout the organisation. Just as the change of management mindset is a key factor that is needed to embrace strategic change, changing employees' mindset becomes a key factor to building commitment towards the overall success of the organisation.

Towards this end, training and development of employees must also be seen as a contributing factor towards value creation within the banking institutions rather than merely to comply with regulatory requirements or as a non-revenue function that is costly and unnecessary. Only with both competence and commitment from the organisation's workforce, and their continuing training and development, will real strategic change take place.

To achieve our vision for a stronger banking system that is more effective and efficient, banking institutions will need to recognise the greater role of knowledge and ICT in the changing economic landscape. There are some clear benefits including increased convenience, increased access to information, speed of transactions, and enhanced control and management of personal finances. Banking institutions are therefore urged to explore and capture new opportunities offered by the advances in ICT. The new innovations will be an integral part of the financial landscape. A more logical response would perhaps be the full integration of high technology systems into the "brick and mortar" facilities that banking institutions already offer. With online technology, new levels of customer segmentation can be achieved. In this context, close coordination between the existing channels and the online channel is needed to fully optimise an integrated multichannel approach.

As we undergo the transition towards a more deregulated and a more market oriented financial system, strong corporate governance and risk management becomes a key part of successful institutions. With the larger pool of resources after the merger process, banking institutions are expected to further enhance these capabilities. Specifically, the adoption of best practices with regard to credit practices would be monitored, consistent with the requirement of the credit risk management guidelines to be issued by Bank Negara Malaysia.

In such environment, the need to ensure adequate and effective consumer education and protection would also become even more crucial. The prevention of any disruptions in the level or reliability of services to bank customers and also their protection from potential unfair practices reflects favourably on the ability of the financial system to absorb increasing competition in such an environment.

There needs to be active and structured consumer education programmes to increase consumer understanding of banking institutions' products and services, which will in turn give rise to more active consumerism. In pursuing this effort, Bank Negara Malaysia together with the banking institutions have established a working committee for the Consumer Education Programme in November last year. The working committee will facilitate and coordinate the launching of a Consumer Awareness Campaign nationwide. The objectives of this initiative are threefold, i.e. to educate and enhance consumer knowledge on personal financial issues; to improve legal protection for consumers and customer redress avenues; and to increase product transparency and disclosure.

Working closely with the consumer associations, the committee aims to identify and clarify misleading information on products and services available to the banking public. In moving towards a standard full disclosure model for products, the committee will determine the minimum level of product transparency to ensure that consumers are clearly informed of all risks and liabilities associated with the product. In addition, a review of the current legal protection for consumers will be conducted to provide further assurance to the public that their rights will not be compromised. As part of this exercise, the committee intends to publish information leaflets and pamphlets on specific issues that have been raised by consumers. In the longer term, it is hoped that a more active consumerism would increase consumer pressure for market efficiency leading to more innovation by the banking institution. It will also entail greater market discipline among these institutions while increasing consumer buying power and reducing consumer complaints arising directly from ignorance. It is envisaged that all these factors will push the local banking institutions towards a higher level of professionalism and efficiency.

In line with the on-going efforts to accord further protection to consumers, the "Guideline for Lending Institutions Accepting Guarantee for a Credit Facility" issued by Bank Negara Malaysia in 1995 is currently being reviewed. As an initial step, I am pleased to announce the waiver clause, which pertains to the ability of the prospective guarantor to voluntarily waive his rights under the guideline, will be removed. In addition, the threshold of credit facilities which are covered under the Guideline will now be increased from RM200,000 to RM250,000.

Conclusion: Making it happen

The financial sector masterplan has identified the building blocks for an effective and efficient financial system that will meet Malaysia's requirements as we advance forward into the next decade. The Plan has provided a shared vision, a common goal to be achieved over the next ten years. The various initiatives that are required to realise this vision form the building blocks. It needs to be recognised however, that the objectives that have been outlined cannot be achieved within a short period of time. It is an evolutionary process rather than a discontinuous process. The realisation of the vision however, involves initiatives to be taken now by the industry. Having the medium and longer term goals outlined provides a basis to ensure the short term initiatives will be consistent and coherent with the long term objective. In other words, the construction of the building blocks must move in the right direction and must begin now. As part of the process, each banking institution needs to formulate their own strategic plans and short-term action plans within this longer term perspective.

While the foundations have been built and the plans are in place, the future is by no means secure. It is only with the combined efforts of all the stakeholders, especially the banking institutions themselves that the probability to scale these greater heights will be enhanced.