Zeti Akhtar Aziz: The Malaysian banking industry - gearing up for excellence

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Malaysian Banking & Financial Services Summit 2002 - "Gearing up for excellence", held in Kuala Lumpur, 20 May 2002.

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Ladies and Gentlemen,

The drive for excellence in the banking industry is a matter of priority, given that the well being of the banking sector is integral to the health and prosperity of the Malaysian economy. The advanced progress achieved in the restructuring and consolidation of our banking system in the recent year, has provided us with the strong foundation on which to develop and strengthen further the banking sector so that, it is better positioned to respond to the new and changing requirements of the economy and better abled to become more efficient and competitive. The focus of our strategies has therefore shifted from financial restructuring to that of capacity building and to ensuring the soundness and stability of the system. In essence, our drive for excellence in this phase of our development of the financial sector is to achieve an enhanced level of effectiveness and competitiveness in the banking sector. The issue before the banking industry is therefore the strategies and actions needed to gear up for this excellence.

Ladies and Gentlemen,

It is my pleasure to be here again at this year's Malaysian Banking and Financial Services Summit organised by ASLI. This Summit indeed provides an opportunity for bankers and the private sector to discuss the issues facing the banking industry. It is now just over a year since the release of the Financial Sector Masterplan. It is therefore also a good time to undertake stock taking. Today, I would like to take the opportunity to discuss the progress that has been achieved over the recent year. I would also like to discuss some of the critical issues in the strategies that are being adopted by the banking institutions in charting their strategic course to enhance capacity and capability to achieve improved effectiveness and competitiveness.

During the period of slower economic growth in 2001, following the global downturn in the technology sector, the banking sector clearly demonstrated its resilience and underlying strength. During this period, domestic sources of growth was important in sustaining the economy. Access to financing in this environment was therefore particularly important. The strengthened position of the banking sector in terms of quality of portfolio, capitalisation and profitability enabled them to continue to perform their intermediation function without disruption. The banking sector generally remained profitable and financially sound during this period. At the end of this first quarter, the risk weighted capital ratio was sustained at 12.5%. Profitability of the banking industry had also continued for the third consecutive year since the Asian crisis. While profits for the calendar year 2001 was affected by the higher level of provisioning during the year, the banking system has recorded a higher profitability of RM 2.4 billion in the first quarter of 2002. This represented a 72.3% increase over the preceding quarter. It reflected the lower loan loss provisions and the lower overhead expenses during the period.

Of importance is that financing activities during this period was sustained. Financing by the banking system increased by 5.2% in 2001. Consumer credit extended by the banking system rose by 11.9% supporting further the strong consumer spending. Similarly, loans for the purchase of transport vehicles recorded a strong growth of 27.4% while loans for the purchase of residential property expanded by 9.3%. There was also strong demand for loans by the retail sector reflecting the positive response to the low interest rate environment and the fiscal stimulus measures to spur the domestic economy. Loans disbursed to the manufacturing was also high accounting for 27.7% of the total loans disbursed.

Important aspects of enhanced effectiveness and competitiveness of the banking institutions is whether there is enhanced access, convenience, timeliness, and customised service, and whether the treatment by the banker and the quality and price of the service has improved. The changing nature of the industry has forced banking institutions to augment traditional product offerings with new products and services designed to be more solution oriented. However, in most cases, there are barriers, or reluctance, to phasing out the older products. The result is a widening of the total product array and confusion for customers and amongst employees. Competition is forcing many banks to take a defensive posture. In many instances, the banking institutions do not have the financial information systems capable of measuring the true profitability of individual products and services. There needs to be an ability to monitor and identify the products and customer relationships that may make a questionable, or even negative, and those that contribute to earnings.

As customers become increasingly aware of alternative solutions, institutions will understandably feel compelled to fill gaps in their offerings to maintain relationships. The critical success factor will be to ensure that this is done at a profitable pricing point - and that the addition of new products does not decrease the profit contribution of existing products and services. For these reasons, it will become increasingly important to have a comprehensive product or service profitability measurement system. A significant progress achieved in the recent year, is the enhanced network of delivery channels over and above the network of branches throughout the country. Eight domestic banking groups are now offering the full range of banking services through the internet. In addition, four foreign banks are offering transactional internet banking services.

Malaysia has had significant foreign presence in our banking system since the 1880s. Unlike several of the East Asian economies that have liberalised only recently, Malaysia has always had a significant foreign presence that has represented an important benchmark against which the domestic banks can be measured. While the domestic banking institutions have moved in a deliberate manner to build up their capabilities to expand and provide new services, foreign banks have for the most part been able to move much faster. The more innovative foreign banks have in fact continued to grow their business despite the branching restriction. They are able to leverage on the research and development initiative, expertise and off-the-shelf products or inherit new delivery systems already tested by their parent banks. As such, the foreign banks have generally been better abled at identifying and reacting to changes in the market much faster than most domestic banking institutions. They are able to open new distribution channels that operate beyond the traditional delivery methods for financial services. Using new delivery systems and largely relying on new technologies, foreign banks have generated a more competitive environment for the domestic banks. Progress has nevertheless been achieved as the gap between domestic banks and foreign banks in terms of return on assets has narrowed. On an annualised basis, the ROA of the domestic banks has improved to 1.2% for the first quarter this year compared with 1.5% for the foreign banks. The gap was 1.1 percentage points in June last year. More importantly, the ROA of the top quartile of the domestic banks is even higher at 3%.

Ladies and Gentlemen,

In these competitive and challenging times, excellence in marketing capabilities, innovative and efficient distribution network, product development capabilities and customer relationship and care require the ability to harness these different competencies, formulate a coherent enterprise-wide strategy, that is then executed effectively. For that to happen, banks have to look within their organisations for the answers. Before resources are allocated, before a marketing direction and strategy is established, before the organisation is restructured, the bank needs to decide what its strategic business will be within the context of its markets - exactly what type of financial service provider it will be.

As part of the efforts to enhance efficiency and thus alleviate the level of competitiveness, significant strategies were initiated during the year. This included the consolidation, the rationalisation of common functions and operations across institutions in the group, outsourcing of non-core activity and leveraging on cross- selling of the products and services within the group. Following the consolidation of the 54 domestic banking institutions into ten banking groups, there was significant rationalisation of the wide range of common functions and operations across institutions in the group. Six banking groups have also now leveraged on cross-selling of their products and services across institutions in the group.

A further impetus towards achieving this would be the merging of the commercial banking and finance company businesses in the banking group into one single entity. In this phase of development of the financial system, the commercial bank in the banking group would hold two licences, a commercial banking licence and a finance company licence. Under this arrangement, the domestic commercial banking institutions would in addition to its banking business, be able to undertake finance company business. Commercial banks would therefore be able to leverage on the opportunities presented by the two licences to take advantage of economies of scale, diversify and strengthen their earning base and create an enhanced market presence.

Other areas of improvement in respect of operational efficiency was in terms of the average core system downtime which showed that for the first quarter this year, seven domestic banks did not experience any computer downtime or disruptions in their payments system matching the performance of the foreign banks. Of significance is that in the operations of the ATM networks where seven domestic banks reported downtime of not exceeding 2 hours compared to four foreign banks. In terms of turnaround time for retail loan applications, an indicator of customer service standards, during the final quarter of 2001, the top quartile domestic banks took 2 days on average to approve a housing loan application compared to 2.5 days taken by the top quartile foreign banks. Meanwhile, lost credit cards were replaced within a day for both the domestic and foreign banks in the top quartile.

While the gaps in operational efficiency and productivity have improved, there remains great scope for further improvement particularly in areas where the domestic banks are evidently behind the foreign banks. For instance, productivity standards of the counter personnel as measured by the number of counter transactions per counter employee for the domestic banks averaged approximately 5,000 compared with 11,000 for the foreign banks. Meanwhile, the number of domestic banks that did not experience any disruption in their retail deposit and loan initiation systems is significantly lower than that of the foreign banks. In terms of the time taken to approve new credit card applications it averaged 8 days for the domestic banks compared with 6 days for the foreign banks.

As can be seen from the scorecard, the consolidation programme for the domestic banking sector was a necessary pre-requisite to enhance the sector's capacity to compete. Size alone however, is not a sufficient condition that will result in producing efficient and competitive banks and it does not offer guarantee of success. Being a large bank is however, an important enabler to achieving enough scale to be able to invest in cutting-edge technology and management systems and to attracting the talent required to compete with the best players in the market. Domestic institutions need to be able to meet the range of products offered by foreign competitors. But the larger scale and wider range of activities will demand stronger management teams. With the completion of the merger programme in December 2000, the banking groups are at various stages in building up their management team and enhancing corporate governance. A number of measures have been implemented to ensure that banking institutions' Boards and key committees have sufficient representation of independent directors and that the Boards are encouraged to appoint qualified professionals to run the banks. Towards this end, Bank Negara has liberalised the remuneration package of the chief executive officers of banking institutions and left it to the Boards to formulate appropriate packages to attract the necessary talent and determine their remuneration package.

In the final analysis, a more competitive banking system should produce benefits to their customers and the business in terms of easy access, quality choices and competitive prices. An indicator of the improved level of competitiveness has been the narrowing of margins. During the year 2001, gross interest margins of banking institutions have narrowed to 3.86% for the commercial banks from 4.3%. This reflected the larger reduction in the average lending rate vis a vis the average cost of funds. Competitive interest rates were particularly evident for mortgage and hire purchase loans reflecting strong demand for credit for these sectors. The competitiveness of the domestic banks in terms of the gross interest margin has also improved. The gap between the domestic banks and foreign banks has narrowed from 0.92 percentage points as at the beginning of year 2000 to 0.69 percentage points as at the end of 2001.

Ladies and Gentlemen,

Banks which do not make investments to take advantage of the new technology may find themselves losing customers to the better-quality or lower-cost products of banks that do. Investing in IT however, entails high cost and an uncertain payoff. The changes brought about by IT - new products, more sophisticated customers, changing cost structures, and enhanced competitive pressures - have all combined to transform the structure of the banking industry. And with further development of new technology, the industry will likely continue to evolve. Advances in IT have also resulted in new database technology and data-mining techniques that can expand the range of services that banks may offer their customers. The winners will be those who are able to harness on the capability of ICT in making strategic decisions - in terms of enabling better alignment of businesses, enhancing organisational capacity and capability such as in risk management, and building better customer relationships. Today, decisions on ICT investments demand a more thorough assessment, extending beyond the cost implications, to include better human resource redeployment, more efficient work flow process and system interface, expandability of the technology platform and the level of complexity to users and customers.

As banking institutions continue to adopt greater sophistication in the application of ICT, efforts must also be intensified to develop ICT-savvy employees and to increase customers' understanding and acceptance of the new approaches. While the efficiency of electronic means of doing banking, such as electronic kiosks and internet banking is valued, the need for personal attention cannot be ignored. While being engrossed in the technology race this is a factor that should not be neglected. Banking business after all is about cultivating relationships, which will become more challenging as customers become more well informed and knowledgeable as they move up the income curve.

Ladies and Gentlemen,

In this period of rapid change, where change is the only constant, the successful organisations will be those that are able to recognise and identify the forces of change and how it affects them and make the required internal adjustments in response. This is by no means an easy task. Change mandates a need to create a new organisational mindset, capable of identifying opportunities and responding to them. Such organisations will be those comprising individuals with a clear sense of mission and empowerment and in which every level of the institution is motivated and focussed on achieving a consistent set of corporate objectives. In a service organisation, it will always be the type of talent that is hired and retained that will make the difference. This is perhaps the greatest challenge facing banks. The level of knowledge and expertise is vital to achieving excellence in providing the required services. Currently, the skills and expertise are insufficient compared to the global providers.

In assessing how well a customer is served, quality is a key factor especially when dealing with service operations. The role of quality, and its inter-relationships with operational aspects of a service organisation has been expressed in what has been described as the "service-profit chain" as follows: (i) profit and growth are stimulated primarily by customer loyalty; (ii) loyalty is a direct result of customer satisfaction; (iii) satisfaction is largely influenced by the value of services provided to customers; (iv) value is created by satisfied, loyal and productive employees; (v) employee satisfaction results primarily from high-quality support services and policies that enable employees to deliver results to customers.

Superior insights on customer needs will be an important advantage. This will involve recognising the diverse needs of the different customer segments. There is now already a discernable change in the pattern of customer behaviour. There is now an increasing shift towards a customer base that has less need for the standard distribution systems for most banking services. "If you build it, they will come" used to be the by-word for domestic banking institutions. A new branch would naturally attract new customers. Now, while customer relationship is of vital importance, these needs to be addressed in the context of the needs of the younger customers for retail services who do not want the "inconvenience" of a branch. The preference is for services as much as possible over the telephone, ATM or Internet. Writing cheques has become an inconvenience. This new generation of customers have their own ideas of what a bank should be and successful banks need to respond to this change.

A further segment that will gain in importance is that of the small and medium-sized enterprises (SMEs) given its growing significance in the economy. The main concern with respect to banking for the SMEs is access to credit. Among the issues that have been raised is the quality of service delivered in terms of accessibility, the lack of responsiveness, lack of understanding of their business, poor branch level service, and poor turn around time. Other complaints have centered on the high collateral demands and the general perception of a lack of willingness to extend financing by the banking institutions. While the recent year showed an encouraging trend with loans to SMEs increasing by 3.1%, the issue of the overall services provided to SMEs need to be enhanced. Bank Negara Malaysia has undertaken a survey through the banking institutions on the SME profile and requirements. This will represent an important database for the development of a comprehensive framework for the development of SMEs initiated by Bank Negara. The survey findings will also be useful for the banking industry in formulating its own strategic plans with respect to this segment. With the advances in technology, banking institutions should be in a position to enhance access and quality of service for the SMEs.

Ladies and Gentlemen,

The performance of the banking institutions is also being gauged from the perspective of the shareholders. There are several significant issues affecting shareholders in the current environment. The global trend is being driven partly by an increased focus by banks on the financial performance and on the creation of shareholder value. In essence, the potential for growth lies in the value of their investments. This would be the right thing to do in the interest of long-term survival. There are enough examples of companies around the world that had lost track of the true reason for venturing into a particular business and as a result, they find themselves no longer in the business. Despite narrowing of interest margins and high costs, the banking industry has been able to increase their returns with the average return to shareholders in 2001 being 14.5%.

Banks, like other companies in a free market economy, have a responsibility to generate returns for their shareholders. It is in the interests of the community as a whole that they do so, otherwise we could end up with a weak banking sector. But any company maximises shareholder value subject to constraints. These may be imposed by laws and regulations, or by the expectations of society. This means that if banks wish to preserve their reputation and the confidence of their customers, on which ultimately the strength of their franchise depends, they should act in a way that is seen to be fair and reasonable. To do otherwise, may in the long-term, be inconsistent with the objective of creating shareholder value.

Ladies and Gentlemen,

Let me take a moment to say a few words on Islamic banking. Today, Islamic banking in Malaysia has firmed its position as a viable and vibrant component of the banking system. Bank Negara Malaysia has been in the forefront in providing the necessary and required infrastructure for the sector to grow further. From a market share of virtually nil a decade ago, Islamic banking has captured more than 8% of the assets of the banking system and is poised to reach 20% by 2010. We capitalized on the dual banking system which we believed is the right approach, and we will continue to embark in this direction. There are currently two Islamic banks and 33 conventional banks with Islamic windows offering the full range of Islamic financial services, and the industry has recorded commendable growth at an annual rate of 48% in terms of assets. At the end of March 2002, the assets mobilised by the Islamic banking sector amounted to RM 59 billion. Deposits and financing mobilized during the same period amounted to RM 48 billion and RM 30.1 billion respectively.

Islamic banking in Malaysia is now at the threshold of entering its next stage of development, to expand on a global basis, to gain greater acceptance as an effective and efficient means of intermediation and to contribute to the overall wealth creation. Policies and measures will be formulated to not only increase the capacity and the capability of the Islamic banking players but also to set the stage for Malaysia to be an active player in global developments in Islamic banking and finance.

Ladies and Gentlemen,

New players, new technologies, the push to globalisation and continuing deregulation are still driving change in the financial services industry. Productivity, service quality, customer satisfaction and cost are key factors that drive the performance in a financial services organisation. In this uncertain world, the drive towards excellence can only be realised if strategic steps are taken today to enhance capability and capacity, thereby securing the well being of the banking industry and thereby the ability of the industry to contribute to the overall economic prosperity of our nation.

On this note, Ladies and Gentlemen, I wish you a successful Summit.

Thank you.