Zeti Akhtar Aziz: Towards world-class banking - efficient, effective and resilient banking system

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Malaysian Banking Summit 2004, Kuala Lumpur, 14 May 2004.

*   *   *

Bismillahirrahmanirrahim

The turn of the century has seen a significant transformation of our banking sector. The changes have been driven by the new emerging economic opportunities, changing customer requirements, new technology, the more competitive environment and changes in the regulatory and supervisory framework. This period has also seen significant progress achieved in the strengthening of the domestic banking system. The strengthening of the banking sector has been driven by the restructuring, re-engineering, rationalisation and consolidation that has been undertaken during this period. Indeed, this progress has been achieved against a background of a challenging global financial and economic environment. As we strive for high performance benchmarked against international standards, we must not lose sight of the context of the financial and economic environment in which we operate. Central to this is a common vision of developing a world class banking system that is best able to serve the nation and thus contribute to economic growth in an environment of financial stability. The expectations are thus for the banking system to be able to provide the intermediation function that is effective, efficient, resilient, and that supports sustainable economic growth.

Ladies and Gentlemen,

It is indeed my pleasure to be invited again to this year's Malaysian Banking Summit. This annual summit, organised by ASLI, has become an important forum for the industry to share and discuss issues that are of importance to the financial sector.

To ensure that the financial system is best placed to serve the economy, important attention has been directed to enhance the financial infrastructure to increase access to financing to meet the new, more complex and differentiated demands of the various sectors of the economy, to enhance efficiency in the banking institutions and the functioning of the financial markets, and to put in place other supporting infrastructure that reinforce the achievement of these objectives. These efforts have been complemented by measures to ensure the soundness and stability of the system.

High performance of the industry would require the banking institutions to increasingly offer greater product differentiation and value added services. This requires resources to be directed to research and development to introduce a wider range of structured and customised products and to become a one-stop financial services solution provider. The ability of the banking institutions to address the needs and preferences of specific segments and focus on customer relationships in a timely and cost effective manner is key to achieving competitive advantage and long-term sustainability.

The journey towards realising the vision

Ladies and Gentlemen,

The banking system policy has evolved from financial sector restructuring during the late 1990s to institutional development and capacity building, and the development of supporting infrastructure to enhance efficiency and the strengthening of prudential regulation to enhance resilience and preserve stability. In terms of the development of the financial infrastructure, efforts were intensified towards evolving a more diversified financial infrastructure to facilitate the economic transformation into a more diversified economic structure. This has involved the development of a more diversified financial structure anchored by a more efficient and resilient banking system, to support economic transformation and growth. The strategies to achieve this vision are outlined in the Financial Sector Masterplan launched in March 2001.

Three years into the Financial Sector Masterplan, positive results have been achieved on several fronts.

- The capacity of the banking sector now has strengthened with the level of capitalisation at its strongest, reflected by the risk-weighted capital ratio of the banking system that has been consistently maintained at above 13%. This has enhanced the resilience of the banking sector and is reflected in the ability of the banking system to weather a number of adverse external developments in the recent period, without any destabilising and disruptive consequences.
- Following the consolidation exercise in 2002, the banking system today is characterised by larger and better-capitalised domestic banking institutions operating within larger banking groups, benefiting from economies of scale to provide a wider range of products and services to cross sell, and therefore widen the reach nationwide.
- Domestic banking institutions have also embraced a higher level of technology and improved business processes.
- There have been marked improvements in the level of efficiency. Operating cost of domestic banking institutions has declined from 41.2% in 2001 to 40.3% of total income in 2003. There have also been improvements in turnaround time in processing loans and in response time in resolving customer problems.
- There has also been a higher level of innovation and introduction of new products and services to meet the customer needs that are becoming increasingly complex and sophisticated. These services include wealth management, structured investment products, bancassurance and Islamic financial products.
- New delivery channels through innovative technology-based mechanisms such as internet and mobile banking have enhanced the delivery of products and services as well as widened access to banking services.
- Despite a more competitive environment, domestic banking institutions have been able to sustain their market share at 80%. The domestic banks commanded a 83% share of the outstanding loans to the small and medium enterprises, while their market share in the credit card business has increased from 46% in 2000 to 54% of total credit cards issued in 2003.
- With the increased investment in risk management systems, the risk management capability in the banking sector has been further strengthened on all fronts through increased availability of risk management tools. This has been reinforced by enhanced prudential policies. Banking institutions are now better positioned to withstand challenges arising from unfavourable developments.
- The resumption of credit growth has now gathered momentum to meet the growing financial demands of the economy, while keeping risks at acceptable levels. There has also been significant shifts in the asset portfolio composition. Following the initiatives to promote SME access to financing, banking sector loans to this sector have increased significantly to account for 38% of total business loans. Retail lending for consumption has also increased. The strong banking system has been well positioned to meet customer demand for financial services. Indeed, the banking industry has continued to benefit from strong demand for household credit.
- The enhancement to the legal infrastructure including enactment of the Payment Systems Act 2003 will serve to strengthen Bank Negara Malaysia’s payment system oversight, and to provide the legal framework to ensure that payment systems are protected from disruptions and its consequent effects on financial stability.
- The Islamic financial system has evolved to form a vital component of the Malaysian financial system. The Islamic banking system now accounts for almost 10% of the total assets of the banking system, from 6.9% in 2000. Significant milestones have been achieved in developing the Islamic financial infrastructure as well as in the development of the prudential regulatory and supervisory framework in meeting the changing requirements of the new economy.

- Following the intensified consumer awareness and literacy programme that has been implemented, there is evidence of growing consumer involvement in product development and delivery. Customers are demanding greater service quality and product offerings to fulfil their preferences and requirements.

Philosophy of financial regulation

Ladies and Gentlemen:

The ability of regulators, banking institutions and market participants to respond to the changing financial landscape is key to the development of an efficient, effective and resilient banking system. Given the unique role of the banking system in the economy, and the importance of maintaining public confidence and trust in the banking system, regulation and supervision is a vital component of a well-developed financial system.

In designing and implementing financial regulation, a careful balance is made between achieving the objective of promoting efficiency in the banking system and the objective of maintaining financial stability. Consideration also needs to be given to the socio-economic agenda. In addition, a fine balance needs also to be made between the objective of promoting competition and innovation and that of maintaining prudence and stability in the financial system.

In line with this, the regulatory approach has become increasingly more “principle-based” rather than “rule-based”. To ensure that regulation remains relevant in preserving financial stability, while allowing sufficient flexibility for banking institutions to design their own strategies and market niches, the regulatory approach is increasingly focussed on developing broad prudential guidelines and principles, rather than prescribing common requirements across institutions and activities. The Central Bank is therefore moving away from prescribing detailed rules and regulations to govern the activities of banking institutions. Regulation will instead focus on identifying risks at the system level, and on ensuring that individual banking institutions have the necessary capacity in terms of internal controls and systems to undertake and manage risks. This, therefore, does not mean less regulation.

As the strength of individual institutions is often the first line of defence against any crisis, the responsibility is therefore increasingly on the board and management of individual institutions to strengthen the resilience of the institutions. The Central Bank’s focus is increasingly on the need for banking institutions to adopt and promote good governance, integrity, strong internal controls and risk management practices. Greater regulatory scrutiny is undertaken to ensure that the shareholders, board of directors and management of banking institutions are “fit and proper” and have the capacity to discharge their responsibilities and accountabilities. This is reinforced by greater transparency and disclosure requirements. Integrity and transparency is critical for financial institutions to gain public trust and investor confidence.

Strategic ICT investment as driver for performance

Ladies and Gentlemen:

In an era where advancements in technology have significant impact on our daily activities, we are constantly presented with the challenge to make decisions on the best ICT products that will meet our preferences and requirements. Similarly, in the financial industry, advancements in ICT have certainly had a significant impact on how businesses operate and on the landscape that they operate in. The financial services industry is one of the single largest users of technology. The rapid advancement of technology will indeed continue to drive improvements in the banking system, particularly new technology with respect to information management systems, product development, risk management and delivery of products and services. A recent industry survey has estimated that the global ICT spending on enhancement of branch network alone was more than USD15 billion in 2001 and expected to increase to USD20 billion by 2005.

Not all of such investments however, will produce the desired improvements. IT investments need to be backed by strong business justification and implementation consideration. New technologies need to be adopted with adequate review as to how it will operate within the broader organisational context. This also applies to initiatives to implement organisation-wide IT enhancements, so that it will bring about the intended results. Indeed such investments as in the CRM application need to be well tailored to individual business models.

Wasteful investment needs to be avoided. The key is to align and integrate ICT into the business models. As technology end-users, the industry is faced with a multitude of product offerings with solutions to improve processes and business activities. This has required sound decision making. The assessment on the return on IT investment needs to be based on a longer time horizon, incorporating both qualitative and quantitative benchmarks to ensure that it will translate into improved performance. A key part towards achieving such return targets would be to ensure smart deployment of IT applications within the organisation. Underlying this process is the need for close interaction between technology and business operators in the customisation stage. Such new applications need to be reviewed as to how they will contribute towards improving product and services delivery, aid in risk management activities, and enhance management capability.

Opportunities from regional integration

Ladies and Gentlemen:

Another important development that is taking place is the growing regional integration, driven by increasing intra-regional trade and investment flows. Asia has seen a rising pattern of intra-regional trade and investment where trade between countries in the region now accounts for almost half of Asia's trade from just a fifth over a decade ago. Malaysia's share of trade with ASEAN member countries now accounts for 24% of our total trade reflecting higher intra-regional trade (notably, increased imports from lower-cost suppliers such as Thailand, Indonesia and the Philippines) and better economic performance of ASEAN countries. In 2003, Malaysia recorded strong growth in exports of 29.6% to China and 26.7% to Hong Kong. Large businesses and corporations have begun to review their business architecture more aggressively and have moved to relocate their business operations. Such structural shifts driven by new demand patterns and new ways of organising production have led to increased specialisation and complementarity within the region.

ASEAN alone offers a huge growing market of 500 million people. Therein lies the opportunities for the domestic banking institutions, opportunities to support Malaysian businesses and investors who are venturing abroad and opportunities to diversify across geographical sectors and across product range. The role of banking institutions needs to extend beyond the traditional role of being a financier, to manager of financial relationships. Each time a borrower ventures abroad, new opportunities are created. As managers of such financial relationships, banking institutions can be part of this process by fostering the banking relationship into a long-term strategic partnership, and by providing the right range of financial products.

These opportunities may also be realised by setting up presence in new markets. It can also be in the form of partnerships or strategic acquisition of an existing banking institution in a foreign market. Mergers or alliances in services and products can be pursued through co-branding or complementary products, delivery channels and marketing or product development. Alliances can also be formed to capitalise on intangible assets such as human capital. Such alliances can also translate into increased innovation in processes, structures, business models and ultimately innovation in products and services. Indeed, strategic alliances have been growing, cutting across many industries and business segments. As banking institutions are able to fulfil the differentiated demands and expectations, this would enhance their capacity to compete in both the domestic and external markets and thus be able to capture the opportunities accorded from liberalisation and globalisation.

Customer-centric banking system

Ladies and Gentlemen:

As the financial landscape evolves and competition intensifies, banking institutions need to respond to the changing market needs, and continually reassess strategies and alternatives in this rapidly changing and dynamic market and shift from just the traditional offerings. Consumers are becoming increasingly discerning and demanding. Strategic decisions about the future needs to be made to sustain the ability to offer and deliver unique value propositions to customers whilst at the same time effectively managing customers' expectations.

An area that banking institutions may venture into is micro-financing. Micro-enterprises perform an important economic activity for a large segment of the country's population. While institutional arrangements are being put in place to increase access to financing for such micro-enterprises, the banking sector with its large network of branches can become an important channel for such financing.

These could be provided via a micro-financing window. Global experience has shown that such micro-financing operations can be successful and profitable with good loan portfolio quality.

As part of the efforts to raise the quality performance in the financial services sector, Bank Negara Malaysia initiated a nation-wide survey in 2003 to assess the requirements, expectations and the satisfaction level of consumers on the quality of products and services offered by banking institutions. While the primary objective of the study is to develop an index on the levels of quality of customer service, the findings indicate that the real issues in enhancing the industry's level of performance goes beyond this, towards developing a stronger customer-centric orientation. The findings provide a discernable indication of the differences in customer needs and requirements, and identify specific areas where customer-orientation issues tend to arise.

Let me briefly share some of the key findings of the survey. The findings reveal that while the general level of customers' satisfaction is favourable, the relationship between customers and the banking institutions needs to be improved. While one in three customers is satisfied with the banking relationship, it did not imply loyalty.

The survey also identified factors that customers are looking for in their banking relationship. Among the primary needs are the quality of interface with bank staff; and the effectiveness and efficiency of delivery channels, in particular branch banking and ability to deliver effective service in transacting and the efficiency in application processing.

Secondary requirements represent potential leverage factors which can be used to substantially improve overall customer relationship. These include product innovativeness with value-added features and electronic banking including internet banking. These secondary core needs would become primary drivers and important elements in banking relationship.

Additionally, the survey indicated that younger and middle-income individuals, a growing customer segment, prefer to use ATMs and electronic channels. Another growing segment is the "Older Affluent", in the middle and higher income levels. Given the growing size of this customer segment and their higher income level, they require a wider range of innovative investment products that offer safe and steady returns as well as personalised financial advisory services.

The challenge therefore is for the industry to pro-actively respond to these customer priorities now rather than waiting for increased customer churning. Fundamental to achieving greater customer-centricity is to ensure that the staff, processes and orientations are aligned towards fulfilling customers' expectations and delivering superior customer's experience. Of importance is to have clarity of purpose that is communicated, shared and understood by all levels of staff, especially the front-office staff. Having a culture that is built around such commonality of purpose will ensure consistent service performance. Another further aspect is the design of the operational processes with customers' perspective in mind to ensure easy access, speedy and accurate execution of transactions that are responsive to many facets of customers' demands. To facilitate this, it is essential that banking institutions embrace the relevant technology to support business processes, enhance risk management capabilities while at the same time provide seamless access to customers through a wider range of delivery channels. All these need to be supported with an effective human resource management framework that ensures the availability of best talent and the right skills.

As competition intensifies, banking institutions increasingly must be able to deliver personalised and customised financial solutions. Therefore, it is important for institutions to understand the dynamics of customer segmentation, build customer relationship and address requirements and preferences of specific segments. Understanding specific segments requires banking institutions to understand complex intangibles such as customer behaviour, motivation and life events. Sustainable growth will be very much dependent on the ability to develop lasting and profitable relationships with customers.

Investing in new products in meeting the complex customer needs and demands is important. Equally important is the need to develop an effective communication plan or strategy as a package to product delivery. Even the best of products would not have a good chance of success without a well-conceived communication strategy. This goes beyond marketing and advertisement. It would include educating customers to adapt to the new ways of doing banking transactions or changes being introduced and to use the innovative products being offered. It is also interesting to note that the survey findings clearly indicated the importance of quality interface between customers and banks. As such, numerous interface points need to be reengineered to ensure the right mix of the virtual and physical environment. New branch models have emerged, incorporating features from both virtual and physical environment, to fulfil the varying needs of different localities and market segments.

Conclusion

Ladies and Gentlemen:

While the new emerging trends in both the domestic and global economy will have significant implications on the domestic financial landscape, each banking institution will need to be able to formulate differentiated strategies to effectively respond to these forces in a strategic manner. Thus, the ability to precisely assess the institutions individual capabilities and strengths as well as opportunities in this changing environment is key to facilitate effective strategic management at the organisational level. Through this process, I envisage that the domestic financial landscape will evolve into a banking environment characterised by three types of banking institutions that will emerge to meet the future demands of the economy.

a. First, large Malaysian banks with nationwide and regional and international presence that are able to compete with global financial players;

b. Second, banking institutions with nationwide presence that are able to offer a broad range of financial products and services; and

c. Third, specialist niche players delivering specialised value added products and services for specific segments of the market.

Ladies and Gentlemen:

The financial services industry has evolved considerably over the recent period. New emerging trends have provided us with new opportunities in our quest to create a dynamic financial system that will best serve our economy. In striving towards high performance and world-class standards in the industry, we look forward to working with you in this dynamic and challenging environment to achieve this common goal. Let me now conclude and wish you a most productive Summit.