Datuk Zamani Abdul Ghani: Role of development financial institutions in the financial system

Speech by Datuk Zamani Abdul Ghani, Deputy Governor of the Central Bank of Malaysia, at the International CEO Forum of the Development Finance Institutions 2005, Kuala Lumpur, 12 September 2005.

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I would like first of all to express my sincere appreciation to the Association of Development Finance Institutions of Malaysia for inviting me to say a few words this morning on "The Role of Development Financial Institutions (or DFIs) in the Financial System". It is indeed an honour to address such a distinguished gathering of CEOs and senior officials of DFIs from many parts of the world. Before going further into the subject at hand, allow me to congratulate the organisers for jointly putting up this international forum. This forum provides a platform for CEOs and senior officials to exchange views and ideas on SME development and just as important, the roles of DFIs in this endeavour. I would also like to specifically welcome the foreign participants to Malaysia and wish that you will have a pleasant and enjoyable stay in Kuala Lumpur.

My remarks this morning will consist of three parts. The first provides an overall perspective on the universal establishment of DFIs in many parts of the world; the second will look at the prospects and some of the challenges for DFIs in carrying out their roles; and the final part will provide an insight into the roles of DFIs from the Malaysian perspective.

There are at present approximately 550 DFIs worldwide. These are special financial institutions established and mostly owned by governments aimed at promoting and supporting national economic development agenda. Indeed, o ver the years, history has shown, and reinforced the view, that DFIs do have an important role to play in a country's socio-economic development. For instance, in Europe, the advent of development banking can be traced back to the mid-nineteenth century, and was established to meet the increased demand for medium to long-term capital by new and emerging enterprises during the industrial revolution. The years following World War II saw the establishment of DFIs in many developing countries to provide, in particular, medium and long-term financing that was identified to be so critical in supporting the economic development agenda of these countries.

In a laissez-faire economy, an efficient financial intermediation system mobilises and allocates scarce resources towards activities that would optimise the rates of return. On this basis, the commercially-driven and profit-maximising banking institutions would often tend to take a short-term view and consider solely the private benefit of a project, at the expense of the potential long-term social benefit that could be derived from financing a particular project. This has, therefore, created a gap in the market place whereby certain segments of the economy have been underserved by the banking system. These include development projects which involve high potential risk and long gestation period, but yet have significant long-term benefits to the overall economic development of a country. Similarly, there are also some sectors or groups of businesses which, due to their business characteristics and lack of track record, limited credit history and inadequate collateral, do not have adequate access to financing from the banking system. These are clearly instances of market failure, and the establishment of the DFIs is indeed an attempt to rectify this shortcoming.

In this regard, in achieving national policies for economic and social development, the DFIs are established as a strategic conduit to bridge the gaps in the supply of financial services, by channelling the resources and funds in the financial system to areas and sectors that are deemed as strategic for long-term economic development purposes. In essence, the DFIs are complementing the banking institutions in meeting the financing requirements of the economy, particularly in supporting the economic and social development of a nation. The establishment of DFIs is part of the national development plan itself.

As policy-based financial institutions, the DFIs have roles and mandates which are linked closely to the country's national development objectives. This is evidenced from the establishment of DFIs with specific purposes to promote development of identified sectors, ranging from industrial and agriculture sectors to areas such as export promotion, infrastructure development as well as the small and medium enterprises (SMEs).

It is notable that the roles of DFIs have evolved in the course of a country's economic development and transformation. This is important in ensuring that the DFIs remain relevant to support the changing financing needs of the economy. In some instances, the DFIs have widened and diversified their scope of activities, to cater to the financial needs of new growth areas, such as information and communication technology (ICT), and biotechnology. Many of them have expanded their financial products to include providing short-term working capital loans, equity participation and investment banking. While operating with the widened scope of activities, it is observed that the majority of DFIs continue to maintain the provision of medium to long-term finance and project finance as the core of their activities. At the same time, the DFIs still fundamentally remain complementary, especially in supporting strategic sectors such as the SMEs and agriculture.

As reflected by the term, "development financial institution", DFIs are not only expected to provide development finance for nation building, but also to undertake a higher degree of developmental role to nurture and develop the targeted sectors. With regard to this, the DFIs have been demonstrating outstanding performance in their developmental role. For instance, the KfW Mittelstandbank, a prominent DFI in fostering SME development in Germany, is providing credit facilities to not only the established SMEs but also the new start-ups. Another example is the Organisation for SMEs and Regional Innovation of Japan which focuses on providing advisory and consultancy services, and training to nurture and develop the SMEs.

Let's now look at the prospects and challenges for DFIs, i.e., the second part of this presentation.

With the growing and changing global economy, I have no doubt that DFIs will remain important and relevant to meet the increasing developmental needs of their respective countries. This development, indeed, presents both opportunities and challenges to the DFIs in the way forward. While the expanding economies, both in the developed and developing countries, would create greater business activities for the DFIs, this also means that they have to remain innovative in their products and services by exploring new ways of doing business, to be able to respond effectively to the different financing and developmental requirements. DFIs must continuously evolve and review their areas of comparative advantage in order to remain relevant, effective and strategic.

To drive performance, one important aspect is to clearly identify key performance indicators for the DFIs, in order to measure efficiency and effectiveness in performing their mandated roles. Recognising DFIs' developmental role, the performance measurement of a DFI should go beyond the standard financial measurement to encompass quantitative and qualitative non-financial indicators that evaluate the economic and social contribution of DFIs, consistent with their objectives of establishment. For DFIs that are involved in SME development, the key performance indicators should include the number of new start-ups financed, the extent of borrowers receiving advisory services and the number of SMEs that have "graduated" from the DFIs.

An important aspect to highlight is the need for DFIs to be financially sound and sustainable in their operations. This is critical so that the DFIs could fulfill their roles without continuously drawing resources from the government and the public sector. It is indeed heartening to note that many DFIs have been successful in balancing the challenge to fulfill developmental roles, while ensuring that their operations are financially sustainable. For instance, the

Development Bank of Japan, which is focusing on the provision of supplement long-term funding to qualified infrastructure projects, has shown favourable financial performance with a return on equity of 6.5% in 2004. Similarly, the Business Development Bank of Canada, a leading SME development bank in the country, has also recorded encouraging performance with an average return on equity of 7.1% in the past five years.

The experiences of these DFIs have proven that despite the specific mandates to finance development activities, business operations of DFIs can be financially sustainable. These success stories essentially share several key factors, including a high focus on their mandates; dynamic leadership and proper accountability within the DFIs; continuous development of human resource capability; intensive use of information technology to improve efficiency; and last, but not least, the adoption of sound and prudent financial principles as well as best practices in their operations.

At the same time, given their relatively limited access to funds, it is recognised that financial support from the Government is important to enable the DFIs to play their role on a sustainable basis. This, however, does not mean that DFIs should solely rely on government funding. In order to remain relevant and effective in meeting the growing financial needs of an expanding economy, DFIs need to increasingly draw funds from alternative sources, such as the capital market. Sourcing funds directly from the market would also help instil certain form of discipline on the operations of the DFIs.

Allow me this opportunity to now share with you an overview on the roles and developments of DFIs in Malaysia. There are currently 14 DFIs in Malaysia. Like those found in other countries, the DFIs were established and funded by the Government to develop and promote identified strategic sectors, in line with the overall industrialisation and economic development objectives of Malaysia. The first DFI was the Malaysian Industrial Development Finance Berhad (MIDF), which was established in 1960, to provide medium to long-term financing to promote the development of private industrial enterprises. Subsequently, several major DFIs were established, including Bank Pertanian Malaysia (or the Agriculture Bank of Malaysia) to promote agricultural development, Bank Pembangunan Malaysia Berhad (or the Development Bank of Malaysia) to promote Bumiputera indigenous community development in commerce and industry, Bank Industri Malaysia Berhad (or the Industrial Bank of Malaysia) to support development in the industrial and manufacturing sectors, as well as the Export-Import Bank of Malaysia (EXIM Bank) and the Malaysia Export Credit Insurance Berhad (MECIB) to promote international trade and support export diversification and expansion, especially to the non-traditional markets.

Over the years, the DFIs in Malaysia have evolved in tandem with the country's economic transformation, especially to support developments in the strategic and new growth areas such as high technology, infrastructure, SME development and micro finance. Bank Pembangunan was entrusted by the Government to support infrastructure development in expediting economic recovery following the financial crisis in 1997. Likewise, in line with the strategy to promote capital-intensive and high technology industries, Bank Industri was entrusted with the task of supporting advanced industrial development, such as engineering activities and computer software development.

In the Malaysian financial system, the banking institutions form the largest component of the financial system, constituting about 51% and 78%, respectively, of the total assets and loans of the financial system. In contrast , the total assets and loans of DFIs as a group, respectively accounts for about 5% of the financial system. Nevertheless, these DFIs have been instrumental in providing the complementary financial services needed to support development of the targeted sectors and activities.

One particular notable development is the support provided by the DFIs for SMEs. Like many other economies, in Malaysia, the SMEs form the backbone of the economy with high potential in fostering the forward and backward linkages of activities along the value chain. While SMEs constitute about 90% of total establishments in the manufacturing sector, at the moment they only provide about 30% of employment in the sector and contribute about 6% to Malaysia's GDP. Clearly, there is room to further unlock the potential of SMEs in Malaysia.

While the banking system remains the main provider of funds to support the activities of the SMEs, there is the tendency for this system to focus on the more established SMEs. It can also be argued that the banking institutions also lack the appropriate skills and experience to develop and nurture the SMEs. This is where the presence of DFIs is so critical, that is to provide the complementary services, both financial and non-financial, particularly to support viable but smaller SMEs which are unable to obtain financing from the banking institutions.

In Malaysia, there are at present two major DFIs specialising in supporting the development of the SMEs. These are Bank Pembangunan dan Infrastruktur Malaysia Berhad and the Credit Guarantee Corporation (CGC). Each of these DFIs has been assigned the specified mandated roles in assisting the SMEs in Malaysia. Bank Pembangunan is entrusted with the mandate of promoting entrepreneurial development by not only providing financial services to the SMEs, but also assume the nurturing and developmental role through the provision of advisory and consultancy services to this targeted group.

Meanwhile, the CGC is mandated to assist the SMEs that lack track record and collateral to have access to financing, by providing credit guarantees to enhance the SMEs' accessibility to credit facilities. To supplement its guarantee schemes, the CGC, under its Business Advisory Service Entity programme, has identified and engaged a panel of consultants to assist the SMEs, particularly in drawing up business plans and other financial documents.

Bank Negara Malaysia recognises the important complementary role of DFIs in the financial system and their developmental role in supporting the national socio-economic agenda. As such, Bank Negara Malaysia in its Financial Sector Masterplan (FSMP) has drawn out the roadmap on the development of the DFIs, with the objective of developing a group of DFIs that are able to perform their mandates in an effective and efficient manner at minimal cost to the Government. In order to achieve this objective, three broad development thrusts have been outlined for the DFIs, namely, strengthening of the regulatory and supervisory framework of the DFIs, capacity and capability building as well as institutional efficiency enhancement of DFIs. A total of eight recommendations have been formulated premised on these development thrusts.

One of the significant milestones in the strategies to strengthen the DFIs is the enactment of the Development Financial Institutions Act 2002 (DFIA). The Act provides a comprehensive regulatory and supervisory framework for DFIs, with the primary objective of ensuring that the DFIs perform their mandated roles and that their activities are carried out prudently, effectively and efficiently. Bank Negara Malaysia was appointed as the single regulatory and supervisory body for DFIs under the Act. In carrying out the regulatory and supervisory function, the Central Bank's focus is primarily to promote the development of sound and robust DFIs capable of performing their mandated roles effectively. Seven DFIs are currently placed under the purview of the Act.

Recognising the unique characteristics of each DFI, regulations and policies have largely been tailored-made to suit the different roles and functions of each DFI with the view of facilitating and strengthening their operations. In general, the DFIs are required to ensure that their operations and activities are in line with their mandated roles, underpinned by good corporate governance and best practices. They are required t o operate with transparency, especially with regard to information disclosure on their corporate performance, in order to enhance credibility and to harness greater confidence from the public that they serve as well as from the Government.

Strategies formulated have also been focussed on enhancing the clarity in the roles and functions of the DFIs, with a view of minimising the overlapping of functions and increasing DFIs' effectiveness in serving the targeted sectors. This has led to a number of initiatives to realign and enhance the strategic focus through the restructuring of selected DFIs. One is the merger of the EXIM Bank and MECIB to enhance their synergy in export promotion. The other important initiative is the rationalisation of Bank Pembangunan and Bank Industri, which will result in the establishment of an SME Bank. The SME Bank, a specialised agency dedicated to the promotion of SME development, will commence operations in October 2005 and is envisaged to better serve the needs of SMEs through the provision of a comprehensive range of financial and non-financial services. In particular, the SME Bank will focus on nurturing the SMEs and promoting entrepreneural development, through the provision of financial and business advisory services, including financial management, business diagnosis and marketing support.

Recognising the importance of human resource development as part of the capacity and capability enhancement strategy, several initiatives have also been undertaken to enhance the skills of DFIs, particulary in the provision of advisory services and micro financing. In collaboration with the Japan International Cooperation Agency, Bank Negara Malaysia is currently embarking on a project to enhance the capabilities of DFIs in providing advisory services to the SMEs. It is envisaged that the provision of quality advisory support can be used to supplement the financial services of DFIs, in order to enhance their effectiveness in supporting the development of the SMEs. In addition, Bank Negara Malaysia has developed and distributed a set of micro finance manuals to DFIs engaging in the provision of micro finance, for use as reference to acquire the knowledge of micro finance principles and best practices. This is to ensure a sustainable provision of micro finance by these DFIs.

Going forward, the role of DFIs would not diminish, but continue to remain important and relevant, providing greater complementary and developmental role in addressing the nation's development strategies. Nevertheless, it is envisaged that the DFIs are expected to evolve from being the direct financiers to function as a strategic conduit to facilitate financing by the banking system, especially through the provision of credit enhancement. In addition, the DFIs would also increasingly become specialised institutions to render advisory and business support services, in order to increase their effectiveness in meeting the financing and developmental needs.

At the same time, the need for DFIs to remain financially sustainable while performing their mandated roles cannot be over-emphasised. This would require continuous capacity and capability enhancement of the DFIs, especially the strengthening of human capital skills and institutional efficiency, together with the adoption of good corporate governance and best practices by the DFIs. In addition, to ensure that available resources are channeled adequately and appropriately to support the targeted sectors, DFIs would need to strategically reduce the channeling of funds to the sectors and businesses that have matured and, on their own, would be able to obtain financial resources from the banking institutions or the capital market.

In conclusion, I must say that the theme for today's forum on "Revving up the SMEs as the engine of growth" is both timely and appropriate given the importance and potential economic contributions of SMEs, particularly in the developing countries. Therefore, it is important that the SME sector continues to receive adequate and appropriate financial and ancillary support to ensure their sustainable development towards meeting a nation's development objectives. In this regard, the DFIs play an important role in providing the necessary financial and developmental support to complement the banking institutions in the promotion of SME development.

I am pleased to note that we have distinguished speakers and panellist here to share their views on various issues relating to DFIs and their roles in SME financing. I am confident that your endeavour to learn and share, as well as to exchange views on areas that are of particular interests and benefits to you, will, in the final analysis, be very rewarding.