Zeti Akhtar Aziz: Malaysia's fast-changing financial landscape

Speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the 26th Annual Dinner 2005 of The Association of Merchant Banks, Kuala Lumpur, 3 December 2005.

*   *   *

I am pleased to be here tonight on this special occasion of the 26th Annual Dinner of the Association of Merchant Banks in Malaysia.

The year 2005 is a particularly significant year for the merchant banking industry in particular and for the financial sector more generally. While this decade has seen significant changes taking place in our financial landscape that followed from the restructuring, consolidation, greater investment in technology, deregulation, liberalisation and changes in the regulatory environment, the year 2005 has seen an intensification of the pace of change in the financial sector. Let me take this opportunity to discuss the macroeconomic environment which these changes are occurring, and discuss further some of the more recent changes that are taking place in the financial system.

Our economy has been able to continue to benefit from the favourable external environment as the global economy demonstrates its robustness in an environment of high oil prices and rising global interest rates. On the domestic front, our overall performance was further reinforced with the expanding domestic demand. Latest indicators suggest that the growth momentum remains firmly on track, with an improved growth of 5.3% in the third quarter. The outturn for the year as a whole is now expected to be in the range of 5 - 6%. There is also greater optimism now that the prospects for this growth momentum will be sustained in 2006.

Of significance is the continued strength of private sector activity. Household consumption increased by 10.4%, while real gross fixed capital formation increased by 9.6% in the third quarter. Reflecting Malaysia's structural transformation toward a skilled- and knowledge-based economy, the services sector has become increasingly important, now accounting for 58% of GDP, compared to only 47% in 1990. Indeed, more than 50% of the growth in the third quarter emanated from the services sector. Growth has remained strong in both the traditional services sub-sectors as well as in new growth areas such as shared services and the information and communication technology industry. This structural transformation of the economy has also been reflected in the pattern and the quality of foreign direct investment, with a shift away from capital- and labour-intensive projects towards the higher value added, skills and knowledge-intensive services industries.

In the manufacturing sector, the electronics industry is expected to benefit from the uptrend in the global electronics cycle, while commodity prices are forecast to remain high, supporting export growth as well as private consumption. Sustained demand for new uses for palm oil, in particular for bio-diesel production is a positive development. Private investment is expected to also increase substantially in 2006, driven by high levels of capacity utilization and strong revenue and earnings growth.

The year 2006 will witness the release of two important policy documents: the Ninth Malaysia Plan and the Third Industrial Masterplan. The Plans will outline the key policy directions over the next several years to enhance Malaysia's long-term growth prospects, including: (i) the role of agriculture and the nascent biotechnology industry; (ii) moving up the value chain in the manufacturing sector; (iii) the increasing importance of services, especially business and shared services, including outsourcing; and (iv) the importance of education in developing the human resources needed to achieve the development objectives.

An important strength of our economy for several decades now, is its flexibility, that is the ability for resources to shift to new areas of comparative advantage in response to changing conditions and new opportunities in the global economy. In particular, there is a high degree of labour and capital mobility. Significant investments in training and education have allowed labour to adjust and become more mobile. This has played a large part in enabling rapid industrialisation and in shifting to higher value added activities. Capital has also shown greater mobility, expanding the potential for the economy to adjust. Malaysia has also actively identified and develop new sources of growth, leveraging on its resource advantages and new technologies to move up the value chain. There have also been greater moves toward removing rigidities and transitioning toward greater market orientation and competition.

Turning now to monetary policy, Bank Negara Malaysia's determination of interest rate policy is based on the requirements of the domestic economy. Specifically, monetary policy seeks to balance the risks between economic growth and inflation over the medium-term. As the risk of slower growth has now diminished, while the rate of inflation is expected to remain at current levels for some time, this has prompted a monetary policy response. The Overnight Policy Rate was increased by 30 basis points to 3% on 30 November. In our monetary policy statement, it was indicated that at the new level, the Overnight Policy Rate is still below its neutral level, meaning that monetary policy is still supportive of economic activity. It is not indicative of any plans for further increases in the interest rates. Any further changes in the Policy Rate would be determined by our assessment on the balance of risks between growth and inflation, going forward.

Let me now turn to the financial sector. The financial sector in general, and the banking industry in particular, have an important role to play to ensure that our economy continues to have this flexibility by providing the enabling environment and facilitating the process. This requires a financial sector that has its own dynamism and agility to proactively respond to the changing requirements of the economy.

The Malaysian financial sector continues to evolve progressively in response to developments in both the domestic and external environment. As we transition from the first phase of the Financial Sector Masterplan into the second phase of the plan, significant developments have already taken place. In this year in particular, we are seeing a strengthening of the international dimension of our financial sector. This essentially serves to strengthen our economic and financial inter-linkages with the global economy.

Some notable developments in this direction include the liberalisation of the foreign exchange administration rules earlier this year to allow for greater flexibility and efficiency in foreign exchange transactions as well as to increase foreign participation in issuing ringgit papers in our bond market and thus contribute to contribute toward enhancing the depth of the market. Another major development this year was the move to a managed float exchange rate regime for the ringgit. This is essentially to better position the nation to respond and benefit from the structural changes occurring in the region and the global economy.

Other further developments to strengthen our international integration include the increase in foreign participation in our domestic financial system. This includes the issuance of new licences for foreign Islamic banks to operate in Malaysia, the issuance of new stock-broking licences to foreign players as well as increases in the permitted foreign interest in our Islamic subsidiaries and investment banks. All this will serve to enhance the international integration of the domestic financial system. The launch of the ABF Malaysian Bond Index Fund is also aimed at promoting greater integration among the regional bond markets.

On the domestic front, the year 2005 marks a significant milestone for the merchant banking industry. In March this year, the new framework for investment banking was unveiled, paving the way for the further rationalisation of domestic capital market intermediaries. As you may recall, the objectives of the framework are twofold: to facilitate internal rationalisation of the merchant bank, stockbroking company and discount house within the same financial group; and to promote the rationalisation of the discount house and universal broker industries. This integration is expected to promote a more competitive and dynamic financial system, enhance efficiency and strengthen the potential to capitalise on expanded business opportunities, both locally and abroad, thereby strengthening the competitive position of the new entity. Foreign equity participation in investment banks has also been liberalised, from 30% to 49%, as part of the overall efforts to strengthen their linkages globally and to enhance the transfer of specialised skills and expertise in the investment banking industry.

Moving forward, the competitive pressures are expected to intensify in the investment banking industry. With the extension of the investment bank framework to universal brokers, 17 investment banks may emerge from the rationalisation exercise. Amid this more competitive and challenging environment, the ability of the investment banks to thrive will no longer depend on factors such as asset and capitalization levels, but on their capacity and capability to manage and utilise their resources in the most efficient and effective manner.

Of importance is the need for merchant banks to continuously review their comparative advantage, business focus and organisational structure to strengthen their strategic and operational agility to respond proactively to the competition and maintain their market niche. In this regard, investment in human capital and expertise is essential to deliver customised and unique value propositions. With the entry of new players into the industry, it is expected that staff mobility within the industry could increase. The challenge for merchant banks will be to continuously train and retain their pool of expertise.

The transformation of merchant banks into investment banks will also bring about new risks as well as a multitude of new opportunities. The placement of banking and capital market activities under one roof entails wider risks which need to be addressed to ensure that they do not pose undue risks to safety and soundness. Safeguards and Chinese walls are essential to manage conflict of interest situations within the investment banks.

As capital market intermediaries, investment banks would also need to carefully manage issues on investor protection and the need to promote fair, efficient and transparent markets. The principles of fair market practice to promote investor confidence and ensure the protection of their interests need to be embodied in investment banking operations. Reputation and trust are indeed valued assets and the cornerstone of banking business. As investment banks originate more complex financial solutions to meet the needs of the more discerning and sophisticated wholesale customers, they also need to be mindful of the importance of preserving trust and personal reputation in business practices. In this regard, focus will be accorded to strengthen the overall market conduct of investment banks, as any lapses in market conduct can have widespread implications on their reputation. The emphasis will be on promoting greater market discipline to drive the performance of investment banks. Disclosure-based initiatives will be continued to ensure that consumers and investors have access to appropriate information to allow them to make well-informed investment decisions.

The changes in the merchant banking landscape will also bring a host of new opportunities. In this regard, offshoring represents an important avenue for merchant banks to diversify their business potential and income stream. The strengthened capacity of merchant banks arising from the transformation process will open new lucrative business opportunities, especially abroad. Merchant banks would need to capitalise on these opportunities to strengthen their presence beyond the domestic borders, particularly in areas where they have the niche and capabilities to compete with their counterparts abroad. Cross-border deals are no longer the exception but the norm. This is especially so with the liberalisation of the foreign exchange administration rules which provides broader opportunities for corporations to invest abroad. A greater degree of awareness of global developments and adoption of international best practices will thus enhance the capacity and capabilities of merchant banks to excel in their ventures abroad.

At the same time, the liberalisation of foreign equity participation in investment banks opens opportunities for investment banks to explore tie-ups and joint ventures with foreign parties to leverage on their expertise and distribution network to help Malaysian investment banks leapfrog in their areas of competitive advantage. Given the intensity of the competitive pressures, investment banks may not have the luxury to grow organically. The onset of increased competition will determine the pace of enhancements that investment banks must make to remain relevant and compete meaningfully in a more challenging operating environment.

Finally, let me also mention a further area in the financial sector that is experiencing significant change, namely, the profound global growth in Islamic banking and finance. Islamic finance is practised in over 60 countries across the world. Assets of Islamic banks and Islamic assets of window-based conventional banks gross to over USD400 billion. Islamic mutual funds exceed USD300 billion. Islamic sovereign and corporate sukuk has breached the USD15 billion mark. The issuance of Islamic bonds or sukuk is expected to top USD10 billion for this year alone. The global market capitalisation of Dow Jones Islamic index is well over USD10 trillion. Most of this growth was experienced in the recent decade with the demand for Islamic financial assets continuing to increase. Also in demand are Shariah compliant hedging instruments to meet the needs of both investors and issuers.

The expansion of Islamic finance and demand for Islamic financial assets promise exciting opportunities for innovative and enterprising merchant bankers. Such opportunities are available not only in Malaysia but also in the region and globally. The time is opportune for tapping into the Islamic finance market.

Malaysia has had a head start in Islamic banking and finance. While we have the largest Islamic banking market in the world, the largest Islamic capital market and largest takaful market, still the potential generated by the unprecedented growth in the global Islamic finance industry is yet to be fully harnessed by the players in the Malaysian financial sector. As Islamic financial products increase in sophistication, a higher level of competencies, skills and structuring abilities of the merchant banking community would be needed. If Malaysia could emerge as a supplier of these high-end services, the nature of merchant banking would change significantly.

On the part of the Government, major initiatives have been taken to create the enabling environment and create resources for the next phase of development of Islamic banking and finance. These include our efforts to build Shariah expertise, promotion of convergence of Shariah understanding, promoting and hosting IFSB, the international Islamic standard setting body and more recently work is being undertaken to streamline the regulatory regime for Islamic banking and Takaful. These cumulative efforts are aimed at promoting a more conducive environment for enhancing Malaysia's position as a hub for Islamic finance. Law reform work on these matters has already begun and is expected to be completed by next year. Work is also already underway to establish an international centre for education in Islamic finance to produce the professionals and expertise that is vital for the global development of Islamic finance.

Conclusion

The year has therefore been marked by significant developments on several fronts. Going forward, we need to build on the successes to fully maximise the potential benefits. In this dynamic environment, it is the cumulative efforts of the industry that will allow this hard-earned progress to yield sustainable results. We now stand at the threshold of the development of the financial sector. The merchant banking industry will need to confront the emerging challenges squarely and seize the new opportunities that will emerge with its new intermediation structure. There will also be an important need to stay alert on the emerging domestic and global trends and to be aligned to be well positioned to respond to the new emerging environment and thus sustain the effectiveness of the performance and contribution of the sector to the economy.

On that note, let me take this opportunity to wish you all a very happy new year, and a productive and successful year ahead.