Zeti Akhtar Aziz: Extending the boundaries in the new financial landscape

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This decade has become one of the most dynamic periods in the development of our financial sector. We have seen the dramatic transformation of the financial structure to becoming increasingly more diversified, the industries becoming more consolidated and rationalized, and the system becoming more internationally integrated. We have also seen the financial system transition into a more competitive environment in which the institutional arrangements are more deregulated and liberalised. The financial infrastructure has also evolved with fundamental changes to support this transformation. Finally, the regulatory and supervisory approaches have also advanced to becoming more principled and risk-based to improve the functioning and stability of the financial system.

The financial transformation has taken place in an environment of economic stability. Malaysia 's economic performance has been characterized by sustained high quality growth and stable fundamentals. The underlying growth in the Malaysian economy has been solid. Malaysia has benefited from both the favourable external environment and the strong domestic demand. Malaysia has also benefited from the globalization of production with the geographical relocation of the production chain by an increasing number of both multi-national and local corporations across the Asian region. This trend has leveraged on the respective comparative advantages in countries of the region. Malaysia 's distinct capabilities in a wide number of areas has increased its participation in this process. In addition, increased economic integration following the rise of intra-regional trade and investment has brought mutually reinforcing benefits in terms of the expanding regional opportunities. The strengthened corporate sector has also led to increased direct investment abroad by Malaysian companies. Going forward, developments in the Malaysian economy will also benefit from the Ninth Malaysian Plan.

A major strength of the Malaysian economy has been its economic flexibility. Significant changes in the structure of the economy continues to take place. The manufacturing sector has continued to move up the value chain while the services sector has gained increasing prominence, with its share of GDP rising from 45% in 1995 to almost 60% today. The role of private consumption in the economy has also been enhanced, supported by steadily rising incomes, low unemployment, and access to the financial system. Of importance is the recovery of investment activity. In addition, the small and medium-sized enterprises (SMEs) have increased their role in the domestic economy. New areas of growth are also emerging, ranging from the shared services and outsourcing industry to agro-business, biotechnology and Islamic finance. The flexibility of the economy to continually adjust to new areas of activity has been an important factor contributing to the dynamism of the economy.

About a year ago, Malaysia took the opportunity to transition into a more flexible exchange rate regime. This has been achieved in an orderly manner. Of importance was that the preconditions had been put in place to ensure this orderly transition. The banking sector had been strengthened, the bond market had been developed, and the capital account had been sequentially liberalised. These developments were reinforced by the further deregulation and liberalization of the domestic financial system, thus creating a more competitive financial environment. The successful transition to the new regime following these developments has seen a two-way movement in the exchange rate that reflects the underlying economy and the market conditions.

Monetary policy in this environment will continue to be conducted in a manner that will ensure that the long-term growth prospects of the economy is achieved with price stability. As a small, open economy, Malaysia is not insulated from the inflationary forces being felt globally. In this regard, decisions on monetary policy will be determined by the Bank's assessment of a broad range of indicators of the domestic economy. The Overnight Policy Rate (OPR) remains the signalling mechanism to achieve the policy objectives. Interest rates, therefore, is not an instrument to influence capital flows or the exchange rate.

The Bank continues to undertake initiatives to enhance communication to promote greater understanding of the objectives, processes and conduct of monetary policy. Extensive deliberations in assessing the latest domestic and global economic, monetary and financial developments are conducted at the Monetary Policy Committee (MPC) meetings, which are held eight times a year. The Monetary Policy Statement (MPS) remains the key monetary policy communication tool of the central bank to provide the rationale for monetary policy decisions.

Given the pronounced changes in the economy and the significant changes taking place in the financial sector, the industry would essentially need to respond to the new challenges arising from:

i. Greater linkages, integration and interdependence between nations. This trend is likely to intensify as more countries embark on initiatives to promote closer regional economic and financial integration, to enhance their level of economic performance.

ii. The challenge of intensified competitive pressures, arising not only from changes in the financial environment, the technological advancements and financial reforms but also the entry of new players, including the non-traditional competitors such as non-financial services.

iii. Consumers are increasingly confronted with a wide range of new and innovative products and services that are delivered via new and more efficient delivery channels. As consumers are becoming increasingly demanding and financially sophisticated, greater emphasis needs to be given to the provision of the variety and quality products and services at competitive prices through the most effective channels. Banking institutions need to anticipate and rapidly respond to these new demands and expectations.

iv. Policymakers are also confronted by the challenge of maintaining overall financial stability whilst at the same time, promoting efficiency in the financial system. Balancing the trade-offs arising from meeting these objectives will be necessary to determine the best course of action. This needs to be achieved while developing the financial infrastructure, in addition, to allowing for the entry of new players into the system.

v. The emergence of international players that possess the competitive advantage of being more technologically advanced with greater capability and capacity to offer more innovative products and services through new delivery channels will further intensify the competitive environment.

Despite its challenges, the changing economic and financial landscape also offers many opportunities;

i. New growth areas present new opportunities and financial institutions need to take advantage not only of the potential return but also the options for further diversifying the sources of income.

ii. Alternative sources of financing from the capital market, development financial institutions, as well as from non-bank sources such as venture capital funds, have increased significantly in recent years. Financial institutions need to develop new products and services that reinforce these developments and meet the new requirements of corporate consumers. This includes providing world-class financial advisory services and wealth management services.

iii. The emergence of new delivery channels such as the Internet and mobile phones have significantly altered the traditional banking-customer relationship. Business can be conducted seamlessly across borders. Technological developments have also transformed the payment systems industry, with the introduction of new payment instruments and entry of non-banks into payment services, facilitating the migration to e-payments. Market leaders can capitalise on these developments in providing products and services to customers and businesses.

The changing economic and financial landscape also brings about many opportunities for trade and investment. With the accelerating pace of regional integration, financial institutions are presented the opportunities to broaden beyond domestic borders to capture opportunities for the regional markets.

It has been more than 5 years since the Financial Sector Master Pan was launched. The strategic focus has allowed us to promptly emerge from the crisis management mode and moved full steam ahead towards developing the financial system, The initiatives undertaken have now laid a strong foundation for the development of a strong and diversified financial system. Significant progress has been achieved in building the capacity and capability of the financial sector and in putting in place the necessary financial infrastructure including the supporting legislation and the domestic financial markets.

The financial landscape and operating environment that is envisaged in Phase 2, where domestic banking institutions would have built greater capacity and capability to compete, is also progressing as planned. The level of competition in the financial system has increased significantly, fuelled by greater expectations from customers and facilitated by a more flexible regulatory framework and increased deregulation and liberalisation. This has resulted in improvements in the delivery of financial services and more efficient pricing and risk management, all of which contribute towards raising the level of economic performance.

The wide range of measures to improve efficiency and effectiveness of the financial institutions, include initiatives on improving risk management practices, further developing the human capital and building talents for the financial sector, as well as measures to elevate the level of consumer awareness. These efforts have further enhanced the ability of the financial system to respond to the changes that have occurred.

The banking sector recorded improvements on all fronts, enhancing the ability to compete effectively and strengthening the resilience to weather any potential adverse developments in particular, any external shocks to the system. The level of capitalisation remained consistently strong with the risk-weighted capital ratio of the banking system above 13% for the period concerned with quality of portfolio continuing to improve further amidst sustained economic performance.

The banking sector also continued to record strong profitability performance despite the increasingly competitive operating environment. In 2005, the banking system as a whole registered a pre-tax profit level of RM12.4 billion with a higher component of the revenue originating from service related activities such as the sale of wealth management products and remittance services, as well as from trading and investment activities. With this stronger performance and enhanced capability to manage risk exposures, several banking institutions have also taken the next step and moved forward to expand in the regional market to reach new sources of business opportunities. On the domestic front, there has been a narrowing of the gap as compared with the foreign banks.

Further initiatives undertaken include enhancing the operational aspects and delivery of services to banking consumers through the rationalisation of the configuration within respective banking groups. This has resulted in leaner and more effective entities where common functions and capabilities have been pooled leading to more cost-efficient entities as well as allowing for greater focus in the marketing and customer management. Following this rationalisation, the cost to income ratio of the domestic banks have improved from 55% in 2003 to 51% in the first quarter of this year.

On the aspect of improving customer interface and improving time taken to conduct banking transactions, branches have been redesigned with new business models. With this move, branch staff now have greater opportunity to provide value-added consultations and interface with clients. Increased investments have also been made to improve information systems - to be better positioned to understand customers' profiles and needs, as well as enhance overall risk management. Technologies such as data warehousing are now readily available to aid banking institutions to be more customer-centric and thus be more focused in their approach. As a result, more institutions have undertaken to offer greater product differentiation and value added services.

The robust growth in the Malaysian economy has also contributed to an increased demand for life insurance coverage. The growth in premium income has continued to outpace economic growth. Over the period 2000-2004, the market penetration rate increased from 31% in 2000 to 39% in 2005. The per capita spending on life insurance products also increased at an average annual rate of 10% over the same period. Notwithstanding this wider reach, life insurance coverage has remained relatively low compared with the more developed markets in the region such as the Republic of Korea, Singapore and Japan which reported penetration rates of more than 80%. Given the vast untapped market potential and the increased product innovation and new distribution channels, the life insurance penetration in Malaysia is expected to strengthen.

Demographic changes leading to a growing ageing population has been a growing concern in many countries. Given the trends in rising life expectancy and falling birth rates, responding to the increased challenges of retirement financing has been high on the nation's socio-economic development agenda. Going forward, there will be greater interest in private pension schemes representing an are of significant growth opportunities for life insurers.

The financial performance of the Malaysian insurance industry has also continued to be impressive during the 2000 and 2005 despite the challenging underwriting and investment conditions, with growth primarily driven by the life sector. Total insurance fund assets of the industry grew at an average annual rate of 13.8%. The insurance industry also increased in importance as a component of the economy and financial system. The ratio of total industry assets to nominal GNP rose from 16.1% in 2000 to 20.4% in 2005, while the ratio to total assets of the financial system continued on an upward trend from 4.0% in 2000 to 5.1% in 2005.

Moving forward, the Bank will step up its vigilance of the industry's state of readiness to cope with the changing environment. An orderly transition of the market-led adjustments is vital to ensure that the adjustments does not destabilize the market or undermine public confidence. To this end, efforts will continue to be directed towards building institutional capabilities and putting in place the necessary supporting financial infrastructure to provide a firm foundation for orderly change. Initiatives in the area of financial education for consumers will be intensified to further expand the coverage as well as to promote the fair treatment of consumers.

With a strong foundation in place to meet increased competition, further deregulatory and liberalisation measures will be introduced. This will include greater flexibility accorded to foreign insurers to establish branch offices, the progressive deregulation of pricing for tariff-rated insurance products, greater investment management flexibility and removal of limits on management expenses and continuing improvements in disclosure standards to promote greater market discipline in the more deregulated environment. On-going deregulatory measures will also further enhance the ability of insurers to respond more proactively and speedily to changes in consumer demands and market conditions. The prudential framework will also continue to be adjusted to establish principles of sound financial and business practices in the changing environment, with a significantly stronger emphasis on risk-based supervision and effective board and management oversight.

Further advancement towards greater international integration will be considered to provide Malaysian consumers with greater access to world-class products and services, while further catalysing the development of the domestic industry towards meeting international best practices and standards. This will include the issuance of new licences in specialized lines and greater opportunities for internationally-reputed insurers to acquire equity interests in, or forge strategic alliances with domestic players, both in the direct insurance as well as re-insurance sectors. The progression towards further deregulation and liberalisation will continue to be managed at an appropriate pace, taking into account the development of the supporting infrastructure and the level of substantive progress achieved by domestic institutions, in order to ensure market stability.

Next on the agenda in the development of the domestic financial system is the formation of investment banks. This is aimed at further enhancing the delivery of financial services to the wholesale and corporate sector. With this rationalisation, the business community will have a more streamlined access to banking services to fulfil their wider range of requirements. Comprehensive changes to the organisational structure of the development financial institutions have also been undertaken to provide a clearer scope and focus to service the needs of targeted sectors. At the same time, measures were also instituted to expand the role of the credit guarantee agency to further facilitate the development of the small and medium enterprises, a critical component of the nation's economy.

On the regulatory front, a series of enhancements to the risk management regulatory framework has been introduced with the aim of promoting a more robust and comprehensive risk management practices within banking institutions. In addition, significant effort has also been put in place to prepare the industry towards the implementation of Basel II, which is targeted for January 2008 for the standardised approach and January 2010 for the IRB approach. The industry has responded well - with various improvement measures that have been instituted, and investments made to enhance their systems and approaches to elevate their capability to manage risk exposures. This will contribute towards enhancing further overall financial stability, and towards the development of new products with better pricing of the financial services.

The Islamic banking and *takaful* industries have been among the most dynamic in the sector. In terms of assets, the annual growth rate of Islamic banking and *takaful* averaged 19 percent and 25 percent respectively. In 2005, profitability of Islamic banking surpassed the RM1 billion mark for the first time, while its assets breached the RM100 billion threshold. As of end-March, the Islamic banking assets accounted for almost 12% of the total assets of the entire banking system. The *takaful* industry's assets stood at about 6% of the industry total.

The Islamic banking industry has begun to maximise the competitive advantages of the Islamic banking concept of profit and risk sharing. We are seeing this concept more keenly being exploited in profit and risk sharing ventures, and Islamic fund and wealth management which are emerging as rewarding banking activities. Developing a pool of the required skills and talent, and putting in place of proper risk management systems and good corporate governance practices becomes vital to sustain the growth momentum of the industry.

As we move towards the final phase of the Master Plan and into a more competitive landscape, we require robust financial institutions that are resilient, effective, efficient and well placed to serve the nation, and thus support sustainable economic growth and transformation. In the area of Islamic banking and finance, our aim is to be a leading international Islamic financial centre. To achieve this, we have to strengthen our position and focus our resources on achieving two broad aims. The first is to become an international leader in the origination, issuance as well as trading of Islamic capital market and treasury instruments, fund and wealth management services, offshore Islamic financial services, and *takaful* and re *takaful* . As a services sector, the robustness of the industry is a direct function of the calibre of the workforce in the industry. As such, our second goal is to position Malaysia as a centre of excellence for Islamic banking and finance education, training, consultancy and research. Not only will this provide a deep pool of highly trained and capable employees, it will also further promote the innovation of Islamic financial products and services.

In a dual financial environment, neutrality in treatment between Islamic and conventional financial products is important in order to create a level playing field. It also sets the stage for greater innovation to take place to support the development of the Islamic financial services industry going forward. With the strengthened and robust Islamic financial infrastructure firmly achieved in the first two phases of the FSMP, the Islamic financial services industry is poised to tap new growth opportunities and grow to its full potential. This will inevitably increase the breadth and depth of the Islamic financial market and, more importantly, strengthen Malaysia 's position as an attractive and dynamic international Islamic financial centre.

In preparing for the pressures of liberalisation and increased competition, continuous review of the regulatory framework and their implications on the efficiency and an environment conducive for innovation is taken into consideration. The cost and benefits of regulations are carefully weighed to ensure a well-balanced regulatory framework that meets prudential objectives yet remaining relevant and adaptable to the changing environment. Premised on this, the prudential framework is evolving towards a predominantly principle-based regulatory approach.

The underlying flexibility inherent in the principle-based approach would involve a regulatory framework that relies more on market discipline, where the market will be entrusted to allocate resources and risks, with greater reward for prudent practices. The emphasis is on self-regulation, where stronger corporate governance, integrity and transparency are critical for banking institutions to achieve investor confidence and public trust. Moving forward, as market discipline improves and both banking institutions and insurance companies are better positioned to undergo self-regulation, further deregulation can be expected. A differentiated regulatory approach will increasingly be adopted, where banking institutions and insurance companies that exhibit strong corporate governance and risk management practices will be given greater regulatory flexibility.

Whilst it is recognised that the regulatory framework should foster efficiency and competition, this has to be balanced with the objective of attaining soundness and preserving the stability of the financial system through the promotion of sound risk management practices. Commensurate with the diversity and complexity of products and services, the financial landscape of the future will require the continuous upgrade of the risk management practices with improvements in the governance standards and enhancing of information management systems. The rationalisation exercises aimed at maximising cost efficiency and reaping benefits of group synergies has led to the emergence of more complex group structures of more diversified financial conglomerates. In relation to this, a holistic and integrated regulatory approach is being adopted to ensure that the activities of these financial conglomerates do not introduce excessive risks to the financial system. Risk management standards are applied across the group and safeguards have been introduced to ensure risks are efficiently managed with necessary infrastructure for an overall view of the risk exposures within the group.

Fostering a customer-centric culture encompasses fair and equitable dealings with customers to engender greater trust and loyalty among customers and serving customers in good faith by extending products and services that are appropriate to their financial requirements and circumstances. Greater innovation must therefore be complemented by higher levels of service quality. Greater attention on excellence in customer service requires continuous investment in staff development, which will be a vital part of the process. Harnessing the technology to deliver distinctive customer experience that combines the right mix of convenience and value is also an essential part of the process. In addition, adequate emphasis and resources need to be accorded to protecting customers' privacy and safeguarding their interests.

In order to make a quantum leap forward, it is vital to continuously invest in human intellectual capital so as to create a pool of talent, skill and expertise that will drive the performance of the financial system. Skilled individuals are needed to be able to deliver high value-added products and services, adopt advanced business practices and have the necessary competence to build confidence in the financial market and trust of the consumer. Initiatives have been taken for putting in place specialised training organisations as part of the infrastructure for the development of highly skilled workforce for the financial sector. The International Centre for Leadership in Finance is now in its 3 rd year of operations and more recently the International Centre for Education in Islamic Finance was established to meet the increased demands of Islamic finance professionals, both in the domestic and international markets. The programmes carried out by the Institut Bank-bank Malaysia and Malaysian Insurance Institute has also been reviewed to meet the demands of the financial sector.

Ladies and Gentlemen,

While Malaysia has approached liberalisation in a gradual manner, our track record has shown that the process is accelerated when it brings benefits to the country. Financial liberalisation has on several occasions been brought forward. In particular, liberalisation has been focused on the new areas of growth that is, in the insurance sector, in Islamic finance and in investment banking. New licences in Islamic banking to foreign financial institutions and larger foreign equity participation in both Islamic banking subsidiaries and *takaful* operators, and in investment banking of up to 49% is aimed at achieving a more internationally integrated financial system. While liberalisation in the traditional sector will continue, its already highly liberalised status and its higher level of capacity relative to the economy does not introduce urgency to the liberalisation compared to the new growth areas. These traditional sectors may lead to overcrowding. The focus of a more rapid liberalisation is where significant market development are likely to take place. Emphasis would be towards attracting foreign players who are recognised as specialist in a specific segment. This would also include new growth areas such as micro-financing or agricultural lending. The aim is to produce niche players delivering specialized value added products and services that will be able to cater towards specific segments of the market and over time, and thus develop a more comprehensive financial system that would contribute towards the development of a more diversified economy.

Given the background of emerging economies, the transition to a more liberalised environment would indeed demand appropriate sequencing of measures and careful management of the liberalisation process that are guided by broad principles that would ensure that there are benefits and opportunities brought about by the liberalisation process. The financial sector is an important and strategic sector that has a significant role in supporting the economic growth and transformation. Liberalisation needs to commensurate with the pace of economic development and strength of the regulatory structure to avoid destabilising effects on the stability of the financial sector and the overall economy.

Key considerations for the strategic opening up of the financial sector would be to steer the financial sector towards increased competition whilst ensuring domestic financial institutions are not marginalised by the liberalisation process. Liberalisation should instead serve as a catalyst for domestic banks to further improve their performance and enhance efficiency and capabilities in order to sharpen their competitive edge and elevate themselves to a level that is at par with the international players. Benefits of foreign direct investment are manifold ranging from efficiency gains brought about by new technologies to the introduction of innovative products and management techniques. Further, more advanced research and development facilities and adoption of best practices from more matured financial markets will contribute to the transfer of skills and knowledge, adoption of sound risk management culture, technology and ideas in the domestic financial system.

Another consideration in the liberalisation process is that of promoting financial inclusion, where all segments of society will have access to adequate financial services. The wide branch network of domestic banking institutions has ensured that non-urban areas have access to banking services, thereby eliminating the use of informal financial services. Domestic banking institutions with large presence in the non-urban areas, some as high as 20% of total branches, have succeeded in achieving sustainable performance while meeting this objective. Locally incorporated foreign banks are however located mainly in major cities and serve only certain segments of the banking public. A wider dispersion of branches of locally-incorporated foreign banks across the country would contribute towards achieving greater financial inclusion. For further expansion outside major cities to be a commercially viable proposition, it is recognised that the attainment of critical mass is essential. In this regard, in addition to the flexibility accorded to establish up to four new branches, consideration will be given to allow for greater presence in the non-urban areas and to serve the segments of the economy which are currently underserved.

The banking sector is now in a prime position for the next step in evolution. The foundation for the development of a more efficient, effective and stable financial system has been laid. The task is now for the industry to move forward and undertake the necessary actions towards realising goals as envisaged in the FSMP. Nevertheless, this journey does not end in 2010. We should also look forward towards what lies beyond 2010. As an open economy, we should also be cognisant with the developments that take place around us. I believe that the Malaysian financial services industry is ready to take on this challenge to elevate the performance and standards of the sector. With this, I wish you a productive summit.