Zeti Akhtar Aziz: The Malaysian banking industry reinvention and transformation

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the 11th Malaysian Banking Summit "The Malaysian Banking Industry Reinvention and Transformation", Kuala Lumpur, 19 July 2007.

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In this recent decade, the Malaysian banking sector has been significantly transformed and reinvented. The restructuring, consolidation and rationalisation efforts that were undertaken in the banking sector have placed the financial sector on a stronger foundation. This decade has also been a period of favourable performance and increased resilience. This has been achieved with the successful integration of business processes and the redeployment of resources to support new areas of growth. Financial reforms have also changed the environment. Progressive deregulation and liberalization have increased the flexibility to financial institutions, while also resulting in new business opportunities and increased competition. These developments have also further strengthened the incentives for improved performance. Significant structural changes during this period have also reshaped the landscape. The introduction of capital market intermediaries, investment banks, an increasing presence of new international players in Islamic finance, and a significantly more developed bond market, has resulted in a significantly more diversified financial system.

The resulting payoffs for the financial system, and the economy generally, have clearly been positive. Today, the financial sector has evolved from being an enabler of growth to become an important source of growth in its own right. The sector, in the banking and insurance industries, now provides employment to more than 123,000 Malaysians. Despite conditions that have remained challenging for a large part of the decade, the banking system remained consistently on solid financial ground with a risk-weighted capital ratio of over 13%, low NPL ratios, and continued profitability for eight consecutive years. Substantial progress has been made towards consumer retail finance and access to banking services. Such consumer lending has increased from RM134 billion to RM343 billion while loans disbursed to small and medium enterprises have increased from RM71 billion in 2000 to RM108 billion in 2007. Domestic banking institutions are also building on their strong domestic performance to expand beyond Malaysian borders. Today, six domestic banks have presence in 10 countries around the region.

The current encouraging state of the banking system, however, should not make us complacent on the need to continually transform and reinvent. The road in front of us is likely to be significantly different from the one we have traveled on. As our previous experience has shown, we need to constantly recognize that strategies that serve well in today's environment would not necessarily be a formula for success in tomorrow's environment.

In looking at the future terrain of the financial sector in Malaysia, six trends are particularly important – **first,** the changing configuration of the global economy and global financial markets; **second**, regional economic and financial integration; **third,** financial sector development amidst increased liberalisation in the Asian region; **fourth**, increased role of domestic demand in the Asian economies; **fifth**, growing significance of Islamic finance in the international financial system; and **finally**, developments in the regulatory structures and approaches. It can be expected that all these trends will have a significant bearing on the future of the banking industry.

First, the global economic configuration has been altered by the emergence of several large emerging economies into the global economy. This is especially evident in Asia, where the rise of China , India and the South East Asian economies have increased Asia's global role. As a result, Asia today features four[1] of the world's twelve largest economies and several of the fastest-growing economies. Collectively as a region, Asia contributes about 40% of global output[2] and one-fourth of world trade. The region is also a significant net exporter of capital, holding two-thirds of the world's foreign exchange reserves and is the largest holder of the developed economies' sovereign bonds. One-quarter of Fortune's top 500 global companies are Asian corporations. This opens up tremendous business opportunities for Malaysia as a part of this dynamic growth region.

Accompanying these changes has been the prevalence of abundant liquidity in the global financial markets, resulting in an intensified search for higher yields. These trends are encouraging flows into the capital markets of emerging economies, presenting new opportunities for wholesale banking and capital market related financial services. These flows, however, also pose potential risks of reversals in financial market conditions. This increases the need to ensure that we have the capacity to absorb or adjust to changing financial flows.

A **second** significant trend shaping the future financial landscape is the intensification of regional economic and financial integration. Economic integration through trade is already well-advanced in Asia, with the share of intra-regional trade already more than half of the total trade in Asia . More recently, however, greater financial integration at the regional level has been an important development, bringing complementary and mutually-reinforcing benefits to the economies in the region. Intra-regional investments among the Asian economies have increased with an accompanying rise in cross-border financing activities. There has already been an increase in cross-border mergers and acquisition activity among Asian financial institutions in order to reap emerging opportunities. The transformation in the financial landscape in the current environment has not been confined to the Asian region but has also involved growing ties with other emerging regions. Of significance is the rising trend of trade and financial linkages between Asia and the Middle East and other parts of the world. Malaysian banks now have the capacity to take advantage of these trends.

The trends towards regional financial integration also present significant opportunities to tap into the enlarged pool of savings in Asia . Besides institutional pools of wealth, the rapidly expanding middle class has been a key factor sustaining the high savings rate. In Asia alone, we now have more than 2.6 million high net worth individuals who collectively control an estimated USD8.4 trillion in financial assets. These trends underpin the increasing demand for more sophisticated consumer finance and wealth management products. There is also potential to tap the appetite for growing international diversification among the more developed economies in Asia , to meet the rising demand for regional financial assets. Furthermore, the continued growth momentum in the region has created demand for infrastructure. It is estimated that Asia needs USD 1 trillion worth of infrastructure investment over the next 5 years, offering huge potential for financing opportunities.

Third, reinforcing the move towards regional financial integration, authorities across the region have encouraged greater financial sector development and progressively liberalised their capital accounts. Many regional countries are moving beyond financial restructuring to promote more diversified and vibrant financial systems that embrace a broad range of service providers and asset classes, including private equity, hedge funds, structured products and Islamic finance.

In Malaysia, the gradual but progressive liberalization of foreign exchange administration rules undertaken since 2003 has led to significant benefits in terms of providing enhanced

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[1] Refers to Japan (rank: 2), China (4), India (10) and Korea (12) based on 2005 nominal GDP in USD terms.

[2] GDP based on purchasing power parity (PPP).

flexibility of the financial sector, contributing to reducing the cost of doing business as well as expanding the scope of activities of the financial sector. In April this year, several liberalization measures were implemented to further increase international investors' participation in the Malaysian capital market, provide greater flexibility for resident investors to diversify into non-ringgit investments in Malaysia and overseas, and to facilitate the expansion of the domestic banks' foreign currency business.

Fourth, the trend for the growing significance of domestic demand has also become more pronounced and is expected to continue going forward. Supported by rising incomes, firm labour market conditions and a young demographic profile, private consumption activity has moved towards income-sensitive goods and lifestyle services for which the retail banking sector should be well-positioned to offer a wider range of innovative products and services to meet the requirements of increasingly more sophisticated consumers.

The change in demographic structure of the population will also have an indirect impact on the domestic financial landscape. While Malaysia's population is still relatively young, an increasing segment of the population is in the group aged 64 and above. This development will have implications for human capital, business and product strategies of banking institutions in terms of savings behaviour and demand for different types of products.

Fifth, a new area of growing significance in the international financial system is Islamic Finance as a viable and competitive form of financial intermediation. The Malaysia International Islamic Financial Centre, or MIFC, initiative, launched in August 2006, has taken Malaysia's liberalisation strategies to a new level with the aim of positioning Malaysia strategically in this new growth area. Islamic banking institutions are allowed to undertake a broader array of Islamic financial activities that include commercial banking, consumer banking, investment banking as well as international currency business under the MIFC initiative. Financial institutions need to consider their own competitive positioning in this area and to have the appropriate strategies to participate in this dynamic growth sector.

Finally, the regulatory and supervisory paradigm will also continue to evolve. Indeed, we have over the recent decade witnessed significant global shifts in the approaches to regulation and supervision across many countries. These have ranged from radical policy responses in some countries that led to the introduction of costly regulatory systems to address the problems have emerged, to bold deregulatory measures pursued in other countries, especially during times of exuberance and strong market conditions. A convergence towards the middle ground between these two extremes now seems to be emerging.

Two dimensions of regulatory change will be relevant to the context of the new environment. First, the emphasis on creating a strong risk management culture that is fundamental to sound banking operations will become significantly more pronounced. T he transition to Basel II and the implementation of the risk-based supervisory regime are important elements of this change.

Second, regulations will continue to focus more on facilitating market-led adjustments that will allow the industry to evolve in response to market developments, while maintaining a sufficient degree of regulatory oversight to maintain financial stability and public confidence. This includes the adoption of principles-based regulations and an increased focus on harnessing market forces and discipline, as well as internal oversight functions, to reinforce prudential regulation and supervision. The aim is to promote a more efficient and responsive financial system.

In this connection, Bank Negara will soon introduce a more facilitative process for product innovations with revisions to the new product approval framework. The changes are aimed at improving time to market for the introduction of new products by financial institutions, while ensuring that institutions put in place a sound product management programme within their respective institutions. The new framework will provide for more simplified regulatory processes and allow greater flexibility for well- managed banks and insurers to introduce new products more quickly in the market. Qualifying banks and insurers are expected to exercise this flexibility responsibly and in particular, with due regard to the interests of consumers.

The realignment of the regulatory and supervisory structures within the Central Bank in November 2006 has marked a significant turning point in consolidating these regulatory changes. As a result of the realignment, the Bank is better positioned to conduct effective surveillance of the financial system; to address regulatory overlaps and duplication within the system; to deal more strategically with the weight of multiple objectives and range of issues confronting the financial system, and more importantly, to preserve regulatory neutrality in the management of similar risks between different financial service providers.

Ladies and gentlemen,

These emerging trends in the international and regional environment will have an important bearing on the changing climate shaping the banking sector. While it brings new opportunities, it will also bring challenges. Let me return to the theme of this summit – the continued reinvention and transformation that needs to be considered for the industry going forward. I would like to focus on three main areas.

The **first** concerns human capital development. This is vitally important for the future development and growth of the financial sector. Going forward into the future this will become the pivotal factor determining the capacity to reinvent and transform. Financial institutions have two broad options. One would be to “buy talent”. This remains a viable option as long as productivity growth remains aligned with wage increases. Banks, however, need to be wary of bidding up wages without commensurate efficiency improvements or increases in value-add. This would not be sustainable and given the prevailing competitive market conditions, such a strategy will eventually erode the banks' competitiveness resulting from the additional costs.

The other option is to “build talent”. This can be achieved through strategic partnerships with training providers, actively contributing towards industry-wide efforts to support the training agenda and continuous improvements to internal learning programmes.

This is also the option that is by far more challenging, but ultimately the one that provides the optimal payoff for individual institutions, for our financial sector, and the economy. The magnitude of the task, however, demands our collective efforts to secure a sustainable pool of talent that will serve both the present as well as future needs of the industry. The industry also needs to participate in the formal learning programmes by the institutions of higher learning. It is encouraging to note that several have volunteered following the recent dialogue earlier this year organised by Bank Negara Malaysia and the Ministry of Higher Education . By contributing towards positive reforms in the academic curriculum and providing other forms of practical support, the industry is making an important investment in its own future.

To take this effort further forward, Bank Negara Malaysia is initiating an extensive programme to train and prepare at least 1,000 deserving graduates for immediate placements in banking and insurance institutions. This effort will be undertaken in collaboration with the industry and training institutes and is aimed at boosting the supply of well-trained and competent personnel for the financial services industry. The selection process will be rigorous, and the training programme will be designed to produce first grade candidates for employment at the management trainee level. It is also hoped that foreign financial institutions will draw on their extensive global network to support the programme. I urge the industry to lend its full support to this effort which will ultimately benefit the industry.

Collectively, these efforts will go a long way towards preparing students well for productive careers in the financial services industry and to provide a strong foundation for the development of the future generation of leaders and captains of industry.

The **second** area relates to financial inclusion. Strategies that are aimed towards consumer outreach and promoting financial inclusion will serve to increase access to financial services for all segments of society, promote more balanced growth, while at the same time, providing new sources of revenue for the financial industry. Significant efforts have been taken to strengthen the elements that support financial inclusion. This includes various outreach initiatives, including the consumer education programme, development of small and medium enterprises, increased public accessibility to financial information and greater access to advice and assistance.

Part of this effort is the development of a sustainable and commercially-driven microfinance industry in Malaysia . In Malaysia, there are at least 435,000 micro enterprises, but only 13% rely on financial institutions for funding. Of importance is promoting *commercially viable* microfinance ventures. In this connection, greater flexibility has been provided for foreign banks to enhance their presence in non-urban areas. Given the objectives of financial inclusion, it is hoped that foreign banks support this initiative given the flexibility that is being accorded to widen the outreach to segments of the economy which are currently underserved. Also embedded within the financial inclusion agenda is the responsibility that banking institutions have towards their customers, and to ensure that adequate information is provided to consumers and investors to make informed judgments.

In the area of product development, both the interest of consumers and businesses will be taken into account. Financial institutions that demonstrate their ability to act responsibly can look forward to greater business flexibility to innovate. Financial institutions that uphold the necessary principles in their business strategies stand to reap long-term gains from enhanced franchise value, a strong reputation and positive association with socially responsible values that will engender public trust and confidence.

The **third** area relates to the need for banking institutions to enlarge their sphere of influence going forward given the changing environment. Banks will increasingly be exposed to external developments and the forces of market discipline. There are several particular areas in which banking institutions can take strategic positions to influence such developments. First is to leverage on the "network economy" through strategic alliances. With global integration deepening further at the same time that competitive forces are exerting pressures on margins, the way forward would be to build on strategic alliances to increase capacity and expand reach, while containing costs. Strategic alliances with third parties, including those within and outside Malaysia, provides efficient opportunities to capitalize on the strengths of each partner and in the process promote development, the transfer of skills and improvement of best practices and pave the way for successful cross-border ventures.

The second relates to the area of international standard setting. With the gaining momentum of international standards in such important and pervasive areas such as capital adequacy standards, financial reporting and cross-border activities, it is important for financial institutions to participate more constructively in the standard setting process together with the regulatory community in order for such developments to take into account domestic circumstances and risks.

The third is in the area of ongoing negotiations on trade agreements. Banking institutions need to follow these developments and negotiations closely to consider implications it would have to their organisations and future business strategies.

The last area of influence relates to communication strategies. With increasing market discipline, effective communications has become more critical. Institutions will need to be more active in responding to consumer and business expectations and the building of long term customer relationships in order to be able to implement longer term business strategies. This is a significant challenge which demands deliberate, planned and well-designed communication strategies and resources dedicated for this effort.

Conclusion

Ladies and gentlemen,

This decade has demonstrated the capacity of the banking sector to reinvent and transform. Going forward, the changes in the global economy and international financial landscape will continue to accelerate beyond expectations. The ability of financial institutions to remain relevant in the future will depend on the actions that are taken now in the current environment. The leadership of the industry will be instrumental in charting the future growth path and cultivating a performance culture that will steer financial institutions towards continued success.

There therefore needs to be an awareness of the emerging cyclical and structural forces that will impact the economy as well as their linkages with the banking industry , to anticipate new developments and opportunities, and most importantly, to be equipped to respond to the new opportunities and to remain competitive and relevant. The challenge for banking institutions is in being able to balance between demands of the immediate term with a longer term outlook and how this would feed into the organisation's continuous renewal and transformation process.

On that note, I wish you a successful Seminar.