Muhammad bin Ibrahim: Future banking: reimagining banks – driving transformation and innovation

Keynote address by Mr Muhammad bin Ibrahim, Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the ASLI (Asian Strategy & Leadership Institute) 20th Malaysian Banking Summit, Kuala Lumpur, 26 May 2016.

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It is my pleasure to be here at ASLI's 20th Malaysian Banking Summit. The theme "Future Banking: Reimagining Banks – Driving Transformation and Innovation" is especially relevant in light of the significant changes taking place in the banking industry and wider economy.

The new world ahead

The financial crisis may have struck almost a decade ago, but has left in its wake a profoundly transformed landscape. With global economic growth remaining slow and uneven, it is increasingly clear that this is no mere downturn in the business cycle, but a realignment of the world economic order. Structural reforms continue to take place in many advanced and emerging economies albeit at varying pace across countries. Such reforms are critical as this will contribute towards enhancing future growth prospects. In an environment of weak growth, authorities face considerable challenges in managing the immediate effects of some of the reforms. The limits of monetary policy under unorthodox and unprecedented policies continue to be tested in a number of economies, with outcomes that still remain debatable.

Broader forces of change are also underway. Of significance is the accelerated pace of technological change, driven by increased processing power and connectivity. Across various sectors, disruptive technologies are rapidly expanding the horizon of economic opportunities while challenging existing business models. In the case of banking for instance, we have already seen greater competition from new entrants amid the emergence of fintech. Rapid urbanisation, which is more pronounced in emerging markets, and demographic changes such as an ageing population are other key trends which have major implications on economic and socio-political conditions. At the same time, there is a growing appreciation for the far-reaching impact of climate change, giving rise to calls for more sustainable growth models and innovation.

All these developments that are taking place in the banking industry today have created an environment much different from the one prior to the crisis. And together with the implementation of the post-crisis global regulatory reforms, which remains a key priority, their implications require careful and deep thinking as banks plan for the future.

Domestic policy continuity and priorities

Our banking industry is facing the current rapidly changing and challenging economic environment from a position of strength, following the successful reform measures that were implemented. Given the high degree of openness of the Malaysian economy and the increased integration with the international financial system, external developments have continuously affected our domestic economy. But the economy has been able to weather these challenges and have remained on a steady growth path of 4 to 6% over the past five years.

In recent quarters, economic growth, however, has moderated. This was attributable to a number of external and domestic shocks affecting the economy since late 2014. The major policy reforms such as the implementation of the GST also saw households and businesses adjusting their spending. As we move forward, these shocks will gradually dissipate and growth of the Malaysian economy will improve. Further support is also forthcoming in the form of Government measures to increase disposable income; thus, facilitating households and firms' on-going adjustments. The assessment is therefore for the economy to grow by 4 to 4.5% for 2016. Importantly, our financial system remains resilient and supportive of the economy. It is important to recognise the underlying reasons for the resilience of the Malaysia economy. This resiliency has been as a result of the continued strength of our fundamentals and the successful reforms and structural adjustments we have undertaken over the last decade.

Three changes to the economy have been particularly instrumental. Firstly, the structure of the economy has become more diversified and over-reliance on any particular industry has been mitigated. Secondly, growth has also become more balanced, driven by continued private sector activities with imbalances and excesses kept in check through keys measures implemented by the Government and Bank over several years. This has been complemented by crucial fiscal reforms that, while having short-term costs and being very unpopular, ultimately put the economy on a more sustainable growth path. Third, is the continued strength of our external position. This can be seen from our high level of international reserves, the manageable level of external indebtedness and the continued surplus in the current account balance.

Together with the greater flexibility of our exchange rate, this has strengthened the capacity of our economy to cope with external shocks and ensure that financing to the private sector is not interrupted.

Going forward, continuity in Bank Negara Malaysia's financial sector policies will be preserved. We will continue to strengthen our prudential regulatory framework in line with global standards, while introducing new developmental initiatives and maintaining a strong focus on the fair treatment of financial consumers. Following transformational measures taken in the past few decades to significantly strengthen the financial system, the banking industry in Malaysia is managing this transition from a position of strength. The capitalisation of the banking system is at its highest level of 16.5%. The combined excess capital of banks above the regulatory minimum level stands at over RM120 billion. The banking system Liquidity Coverage Ratio is also comfortably above 120% against the current regulatory minimum of 70%. This strong position has been an important element to facilitate orderly adjustments in transitioning towards global standards without disruptions to financial intermediation, thus ensuring the smooth flow of financing to the economy.

To enhance Malaysia's growth potential, several initiatives had been identified that will help boost productivity, improve the income-earning potential of Malaysians and expand opportunities in new markets. Building from Malaysia's leading position as an international Islamic finance centre, efforts to promote the sustainable growth of Islamic finance supported by a dynamic ecosystem will create opportunities for high income employment. At the same time, ASEAN integration remains high on Bank Negara Malaysia's agenda.

Meeting the e-payment targets that Bank Negara has set is also vital to enhance our economic efficiency, competitiveness and productivity. And we will continue to direct efforts at ensuring that all Malaysians can participate effectively in the financial system. Bank Negara will also continue to work with the Government on a range of economic priorities to sustain the Malaysian economy on a steady growth path. This includes the continued support and development of SMEs, and improvement in access to affordable housing. An area that demands greater attention and coordination going forward is the 'sharing economy'. We have already seen how the likes of Uber and AirBnB have changed the business model of the transport and hotel sectors, and enhanced the earning potential for asset owners, lower costs for users, and drive innovation and service quality improvements among incumbent providers. They can also bring important benefits for the environment through the reduction of wastage and control of over-consumption. Similar innovative trends are also emerging within the banking and finance sector. To reap the benefits of technological advancements, the Bank will work closely with relevant agencies and innovators in this space on new ways of delivering new products and services.

I would like to take the opportunity this morning to talk about some of the measures that Bank Negara Malaysia is taking to support growth in the financial services sector, encourage innovation and strengthen resilience. My remarks will touch on the areas of regional financial integration, fintech development, systemic focus on regulation, governance and the role of banks in ensuring an inclusive financial system.

Advancing regional financial integration

The ASEAN Banking Integration Framework (or ABIF) that was finalised last year was a significant milestone towards greater ASEAN integration. An agreement forged between 10 key economies at different stages of economic and financial systems development is in itself a remarkable achievement. This is in sharp contrast with recent global trends. In the decades leading up to the 2007 financial crisis, global financial integration took unprecedented strides forward as capital markets and banking systems expanded and diversified, increasing the mobility of capital. But of late, there has been a reversal of this trend. A recent study by McKinsey found that following the crisis, banks globally have shed $722 billion in assets and operations, of which almost half were foreign-based. Cross-border flows have also declined significantly, remaining at 60% of pre-crisis levels. To some extent, this is expected as markets undergo corrections and new regulations were introduced to address weaknesses in existing models for integration. The crisis has led to forces of change that are creating two diverging paths ahead: greater fragmentation of finance as operating structures adopt a narrower and more domestic focus, or a move towards alternative, more sustainable approaches to integration. ASEAN integration however, has adopted sustainable approaches to integration and continued to gain momentum. Importantly, this has been pursued in tandem with the need for greater private sector integration, thereby supporting a natural path of evolution for the region's financial sectors and overall economy.

As a whole, this has resulted in a measured approach to integration, mindful of different needs of member countries and supported by regional frameworks and bilateral arrangements. In doing so, risks are also better managed by preserving a strong focus on strengthening prudential frameworks and capacity developments and giving economies more time to adjust to new circumstances. With more than 600 million people, with a combined GDP of USD2.5 trillion and a burgeoning middle class, ASEAN holds enormous potential for economic growth for member countries. We expect that intra-regional trade will flourish and consequently sources of growth and trade will become much more diversified.

Since the finalisation of the ABIF, Bank Negara Malaysia has signed three Heads of Agreement (HOAs) with Indonesia, Thailand and the Philippines, paving the way for banks in the four economies to expand their presence and contribute towards regional growth. Bank Negara has also actively pursued initiatives to develop a viable regional cross currency market to support trade and investment by expanding the availability of multiple choices of currencies that businesses can use for trade and settlement. Malaysia and Thailand recently established the first cross-currency settlement and clearing arrangement between two ASEAN countries, following similar arrangements with China and South Korea. Moving forward, Malaysia remains committed to regional efforts to advance financial integration. This will be guided by the ASEAN Economic Community Blueprint 2025, which focuses on the three key pillars of financial integration, financial inclusion and financial stability in the region.

Facilitating fintech developments

I am pleased today to announce that Bank Negara will introduce a framework for fintech firms to test innovations in the financial services operational environment. Earlier this month at the Global Islamic Finance Forum, I spoke briefly about the work that Bank Negara Malaysia has undertaken with respect to fintech. Indeed, Bank Negara has long recognised the power of technology in driving the financial sector forward. Over the years, banks have harnessed the power of technology to reap significant benefits. Bank Negara has supported this development on many fronts including in the areas of payments, internet banking, agent banking, Islamic finance and money exchange and remittances. Fintech will be a new addition to the list.

Fintech developments such as blockchain, artificial intelligence and biometric applications are now expanding the frontiers of banking. Because of the profound implication of new technology, we require a re-think of the regulatory framework in addressing consumer protection and market conduct issues as well as the technological impact on the orderly functioning of financial markets. We expect that the framework would enable fintech firms to provide regulated financial services directly to the public, or in partnership with financial institutions, and to operate under more flexible regulatory arrangements. We take cognisance that some innovations cannot be achieved within existing regulatory parameters. Nonetheless, to protect the interests of consumers, this will be subject to certain safeguards. The innovation must provide a clear benefit to the general public or financial industry. A firm that operates within the framework must also commit to observe reasonable standards of service, transparency to customers, appropriate funding and reporting requirements. These are not meant to stifle the creative process at play, but rather facilitating an orderly process while protecting consumers interests and maintaining market confidence.

The Bank also expects the framework to deliver a number of key benefits. It will provide regulatory clarity for fintech start-ups, and for banks and consumers that use their services. It will also lower barriers to entry and accelerate the time-to-market for productive innovations. Our aim is therefore to support fintech firms that go on to upscale their activities, and aid fintech firms to better anticipate and adjust to appropriate regulatory expectations.

Strengthening the systemic focus of regulation

Bank Negara Malaysia's regulatory and supervisory framework will continue to reflect the increasing focus on systemic risks. This addresses a key lesson from global financial crisis – that greater attention needs to be directed at identifying and managing systemic risks that arise from interactions between financial institutions and markets, and their collective impact on the broader financial system.

As interlinkages within and beyond the Malaysian financial system deepen, the sources of potential vulnerabilities and shocks can be amplified, with larger and more complex institutions posing greater risks to system-wide stability. Bank Negara Malaysia's prudential standards and the intensity of our supervision will be more differentiated going forward to reflect these risks. In recent months, we have issued two standards on operational risk and compliance.

These standards reflect the differentiation by setting higher expectations for larger and systemically important financial institutions. Bank Negara is also assessing options to ensure that systemically important institutions have adequate capital buffers; that their capital is proportionate to the risks posed to the broader financial system and the possible costs of failure. In addition, we are progressing work in coordination with PIDM to develop an effective resolution and recovery framework. Banks are expected to continuously assess and identify critical functions from a systemic perspective within their operations, and prepare contingency and recovery plans to preserve those functions under a stress scenario. Bank Negara will engage the banking industry to share more information on this initiative, including our implementation approach. A concept paper on this will also be issued for comments.

Raising the bar on governance

Finally, we will continue to raise the bar on governance. The role played by governance failures in the recent crisis is well documented, particularly in respect of incentive systems, accountability structures and controls. More broadly, there is also a strengthened emphasis on the softer aspects of governance such as behavioural norms, corporate culture and ethics. We should not forget these lessons or else history will repeat itself.

Malaysian financial institutions should be the gold standard for good governance practices. Because of their important role within the economic system, banks have the added responsibility of maintaining public trust and confidence.

In addition, we also expect the banking industry to take the lead in promoting good governance practices more broadly across corporate Malaysia, through financing and investment activities, or professional advice to clients. An important regulatory priority for Bank Negara in this regard is to align incentives with a sound risk culture and ethical conduct, underpinned by effective independent oversight by the board. On this, Bank Negara recently published several proposals to enhance the corporate governance framework for financial institutions in Malaysia to address these issues. While proposals on board composition appear to have generated more attention in the media, the most significant enhancements actually relate to expectations for the board and senior management to set the right "tone from the top", and the explicit responsibilities placed on them to play a more critical role in shaping the core values and culture of the institution. This includes expanded requirements on compensation practices and disclosures to strengthen market discipline. Banks must also put in place a transparent whistleblowing policy that enables the escalation of concerns without the risk of reprisal.

Good governance is ultimately driven by a workforce that is committed to the highest standards of knowledge, competence and conduct. Competition for talent in the financial industry has intensified greatly, in an environment where public opinion of banks globally is also at an all-time low following the last crisis. Recent trends among graduates of leading business schools worldwide indicate a shift towards other well-paying alternatives to careers in banking, notably to technology and consulting firms. According to the Financial Times, the popularity of banking as a career has dropped 41% since 2008. Globally, banks' reputations have also been dented to varying degrees by poor quality of service, staggering control failures and misconduct.

The professionalisation of the banking industry is therefore critical to strengthen the talent pipeline, while restoring and maintaining public trust in the banking industry. An important step in this direction is the transformation of Institut Bank-Bank Malaysia (IBBM) into the Asian Institute of Chartered Bankers (AICB) as the professional body for bankers and the Asian Banking School as the education service provider. The AICB plays a key role in spearheading the vision of professionalising bankers through the development of professional qualifications, a specialised certification track to support continuing professional development and a membership framework that subjects members to a strict code of conduct, professionalism and ethics. The prestigious Chartered Banker qualification, for example, aims to provide comprehensive education on banking to support sound judgment and decision-making. The industry should therefore take full advantage of these opportunities to build a solid team of professional bankers that are able to perform effectively in a rapidly evolving landscape.

Fundamental role of banks to support inclusive financial participation for all

It is important to bear in mind that growth in financial services must also serve to enhance economic opportunity for all. Since the establishment of the Financial Inclusion Framework in 2011, major inroads have been made in widening the accessibility to financial services in Malaysia.

Agent banking has been a key strategy to improve access, particularly in the rural areas. 92% of our population has some form of access to financing. Moving forward, expanding public access to financial services will remain important for the remaining 8% of the unbanked population in Malaysia. There will also be greater emphasis on the quality of services provided.

The social impact of greater financial inclusion is significant as it helps improve people's lives. In this respect, banks have a critical role to play to make it easier for people to save, make payments and obtain affordable loans to improve standards of living and build more resilient communities. It would be a remiss to talk about the future of banking without embracing this very fundamental role of banks.

As our economy becomes even more financialised, it is important that banks strike a balance between legitimate profit-seeking goals, and their responsibility to provide the public with full and fair access to financial services. Some banks today are still falling short of expectations to offer basic banking services to the people who only need such services. We have observed poor communications by the front-line staff of such banks on the basic banking products which must be offered by *all* banks. In some cases, prohibitive conditions are attached to the opening of basic banking accounts in clear violation of Bank Negara Malaysia's requirements. This must change. In offering basic banking services, banks should also leverage on technological advancement that can support inclusive finance initiatives. These include adopting more innovative delivery channels, leveraging on big data to reach a wider community and to offer suitable products that are priced affordably.

Concluding remarks

The world as we know it is set to change dramatically just as it had over the last few decades, except that future changes will happen at a much more rapid pace, and in sectors where we least expect it. The ability of banks to adapt will be critical to its relevance. More likely than not, banks that are agile and have absolute clarity on their value proposition for their customer, society and wider economy, will be the ones that will endure. Banking as we know today will no doubt change in form as the future takes shape. What is more important that the core purpose of banking remains intact – that is to provide reliable passage for resources to move to productive use, including under the most challenging conditions.

I thought I would close these remarks by quoting Machiavelli 'There is nothing more difficult to take in hand, more perilous to conduct, or more uncertain in its success, than to take the lead in the introduction of a new order of things'.

Ladies and gentlemen, the future is about a new order of things.

Thank you.