Muhammad bin Ibrahim: Developing Malaysia's financial sector for the future

Keynote address by Mr Muhammad bin Ibrahim, Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the Future Finance Conference 2016, Kuala Lumpur, 23 September 2016.

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This conference gathers the leaders of the industry to discuss opportunities and develop substantive ideas for the development of our financial sector relevant to Malaysia's future. In the weeks leading up to today, some ideas have been exchanged among us and further refined. It is our intention that the industry can come to an understanding on implementing substantive and collective solutions to the four subjects that we had identified: going beyond access to promote financial inclusion, creating opportunities for underprivileged children, financing the new economy and improving insurance penetration. We will also have the opportunity to hear from international speakers and financial technology (fintech) companies on how the world around us is changing, and how the financial industry will need to evolve with it.

Part I: Progress and achievements so far

Five years have now passed since the Financial Sector Blueprint was released in 2011, with the clear vision of creating a financial system that can navigate Malaysia's transformation into a high-value added, high-income economy.

As the title of the Blueprint "Strengthening the Future" suggests, the goal was to move the financial system towards higher levels of stability, efficiency and competitiveness in the financial sector to power the economy of tomorrow. Judging by the financial data, we are pleased to note that the financial sector is steadily advancing towards these goals.

We have significantly strengthened our legal and regulatory foundations for a safe and stronger financial system with the enactment of the Central Bank of Malaysia Act 2009, and the Financial Services and Islamic Financial Services Acts of 2013. We have continued to update our prudential guidelines in line with international standards, a contributory factor in supporting the regional and global expansion of our financial institutions. The changes that we had made also ensured a highly resilient banking and insurance sector amid much more challenging conditions. The capital buffers of banks and insurers today collectively stand in excess of over RM140 billion above the regulatory minimum levels.

Ongoing efforts of financial institutions to strengthen risk management, governance structure and a strong focus on effective supervision further reinforce the strength of our financial system. Collaborative efforts between the industry and the Bank had resulted in significant investments to build a strong talent pipeline for the financial services sector, including the transformation of the key industry professional bodies and training institutes.

At the same time, the financial sector has continued to play its intermediary role in financing the economy, in particular the SMEs. As at end July 2016, financing by the banking system to businesses and SMEs stood at RM533 billion, growing at an average annual rate of 9.9% between 2011 and 2015. Banks remain the largest financiers to SMEs, and this relationship is expected to remain, thanks to the high approval rates of close to 80%.

In Islamic finance, the introduction of investment accounts and the subsequent operationalisation of the Islamic bank-backed Investment Account Platform (IAP) will further expand access to financing for a wider cross-section of businesses with different profiles and at different stages of development. The industry is making encouraging headway in introducing more diverse products and services in the financial system. For example, the successful migration of deposit products into investment account which now constitute 10% of all Islamic funding in just over a year since Islamic banks were required to clearly distinguish between principal guaranteed and investment accounts consistent with Shariah principles.

Also important has been the development of a stronger consumer protection framework and more inclusive financial system. Earlier this week, over 500 policymakers and industry participants from 30 countries were in this building to address the immense challenge of reaching more than 2 billion adults worldwide who remain excluded from the formal financial system. At that forum, a point was made that, it is an important moral obligation for all of us to do more, to help the millions who are still living in abject poverty or those who are highly vulnerable to financial hardship, with no means or opportunity to change their circumstances.

Financial inclusion has also received greater attention by global leaders, including the international standard setting bodies which has considered the important characteristics of financial inclusion in formulating global standards. Malaysia continues to play an active role in this aspect.

We have achieved important strides since the release of the Financial Inclusion Framework in 2011 which outlined strategies to promote greater financial inclusion over the coming decade. The level of financial inclusion in Malaysia as measured by the Financial Inclusion Index has risen significantly from 0.77 to 0.90. Today 97.4% of mukims in Malaysia have financial access points, reaching out to 99% of Malaysia's population. Agent banking in particular, has been a highly effective game changing initiative in expanding financial accessibility while protecting the integrity of financial transactions.

In the insurance and takaful sector, we have also carefully laid the ground for wide-ranging reforms that are ultimately aimed at increasing insurance penetration and reducing the protection gap among Malaysians. The detariffing exercise is set to fundamentally change the general insurance business in Malaysia. In our effort to chart the growth and development of the industry over the next 10 years, we have established an Insurance Development Department that will serve as the primary reference for the insurance industry.

I also wish to highlight the important role played by development financial institutions in contributing to the inclusion agenda, which includes participation as agent banks as well as supporting the development of SMEs, the agricultural sector and co-operatives.

To further improve the operational efficiency and resilience of these institutions, amendments to the Development Financial Institutions Act were made and came into effect in January 2016. The amendments further strengthen important areas such as governance and consumer protection. The strengthened legislation will ensure that development financial institutions can better contribute to the next phase of Malaysia's socio-economic developments, building on achievements over the past decade.

Finally, the Malaysian financial system has become more regionally integrated to support stronger economic and financial linkages with our strategic trading partners. This has been characterised by the push for regional economic and financial integration in ASEAN, which includes the continuing proliferation of local currency settlement arrangements with banks serving as key enablers in these mechanism, and the deepening of regional financial markets.

Greater banking integration within the ASEAN region is gaining traction under the ASEAN Banking Integration Framework, with attention now turning to the formulation of a similar framework for insurance integration. Malaysia's commitment to support multilateral-cooperation and development is also reflected in the international organisations that have chosen to base their headquarters or offices in Malaysia, including the World Bank, the Alliance for Financial Inclusion and the Islamic Financial Services Board.

This will benefit the country, by enriching the domestic talent pool, building intellectual capacity, and originating research and policy recommendations, that address today's key financial and economic challenges, and placing Malaysia as a centre of excellence for training and capacity development. It would also benefit many countries where member countries will be able to share experiences in developing their economy.

Part II: Reassessing our position – are we heading in the right direction?

These developments that I outlined above have enhanced the breadth, depth and resilience of our financial system. It is important that we continue to stay the course to reinforce these core strengths of our financial system. More work still lies ahead to achieve specific outcomes that were envisioned in the Blueprint. In Islamic finance, encouraging greater product diversity supported by strong institutional capacity remains critical to increase the share of Islamic banking assets to 40% of the banking system by 2020. Similarly, insurance and takaful penetration, currently around 5% of GDP, remains low. This is compounded by an enormous protection gap ranging between RM550,000 to RM723,000 per household. A focus on consumer education, product development and underwriting capabilities, alternative delivery channels and service quality remains important to increase penetration.

The Malaysian financial sector has achieved a significant milestone in facilitating the country's cross-border linkages with other economies. Yet, there remains vast potential for our onshore financial institutions to support the growing financing needs of domestic and foreign corporates operating in Malaysia.

For example, over the last five years, offshore corporate borrowings have risen to RM233 billion or 19.7% of GDP. From a macroeconomic perspective, total offshore corporate borrowing remains lower relative to the position observed during the Asian Financial Crisis at 47.1% of GDP. Furthermore, these borrowings were largely hedged, either naturally through foreign currency earnings or through the use of financial instruments. The bulk of these borrowings reflected intercompany loans extended by the parent of multinational companies operating in Malaysia, which tends to be more favourable in their terms and are more flexible on requirements for collateral and borrowing tenures. In sum, the macroeconomic prognosis of our offshore corporate borrowings suggests that they are manageable and within prudent levels.

On the other hand, when viewed from the perspective of banking and financial opportunities, onshore banks and financial institutions could do more to tap this opportunity. Onshore banks would need to increase competitiveness by increasing its skill and strengthening capacity and offering innovative and tailored financing solutions, while at the same time play an important role in helping businesses manage the attendant risks from these transactions. This requires more discerning credit assessments of prospective borrowers and competitive financial solutions.

By itself, the banking sector will however not be able to cater for all the increasing and expanding needs of the economy of the future. This is precisely why we need to develop the role of market-based financing institutions as a new source of funding.

Niche institutions such as factoring and leasing companies, angel funds and alternative credit providers of various industries such as motor, housing and consumer retail sector can play an important role in contributing towards providing consumers with greater funding choices. There, however exist a high bar and strict preconditions that must be met before this funding model can take root and flourish. The presence of a strong regulator, a sound and resilient supervisory and regulatory framework as well as robust consumer protection statute are some of the critical foundation required to ensure these institutions 'clear the hurdle' to become a viable source or financing and benefit our economy. The ultimate aim remains in protecting consumers' interests, preventing predatory practices, managing debt levels, including high household debt, and preventing borrowers from falling into financial hardship due to inability to service debt.

At the same time, we must not ignore important changes in the global and domestic financial landscape that will affect current and future priorities to deliver a financial system that effectively serves our economy. One of the most significant changes has been the commoditisation of financial services. This has been largely driven by technological advancements, enabling financial products and services to be delivered by a broader set of institutions while driving lower margins for traditional providers such as banks and insurance companies. These “disruptions’ introduce new ways of interacting with consumers as well as changes to the nature of financial intermediation itself. The implications are far reaching and call for a re-thinking of business models and growth strategies, regulatory frameworks and customer relationships.

The global economy and financial systems have also become more interconnected. While this development augers well for businesses and trade, it also dramatically compounds the economic and social costs of financial failures. At a macro level, low to stagnant economic growth has become a ‘new normal’. Growth in the developed economy is still anaemic and below pre-recession levels. Depressed long-term interest rates have impacted net interest margins for banks and investment income for insurers. With projections for a sustained period of low growth, traditional growth models and strategies are coming under increasing pressure, with focus turning to new engines of growth.

Bank Negara Malaysia is moving on a number of fronts in response to these developments. To support financial innovations and new business and growth models of financial institutions, we have recently introduced a discussion paper on the regulatory sandbox that provides a collaborative opportunity for fintech firms, financial institutions and the Bank to evolve responsible innovations and sensible regulation. The final policy document on the regulatory sandbox is targeted to be issued by early October 2016. Later today, you will also have the opportunity to see some of these solutions and consider how they can complement your own businesses.

We are also working with the Government to introduce consumer credit legislation that will provide consistent protection to businesses and households that deal with financial intermediaries that are not licensed financial institutions. Appropriate arrangements are also being considered to drive and support the development of alternative financing vehicles to serve the financing needs of small businesses.

To address an increasingly interconnected domestic and global financial system, we are coordinating the development of a recovery and resolution framework with Perbadanan Insurans Deposit Malaysia (PIDM). This is a multi-year project and an important priority of the Bank to ensure that financial institutions are well prepared to manage potential stress, and to preserve the broadest options for managing any failure of a financial institution with minimal impact on financial stability. The Bank and PIDM will be initiating a series of engagement sessions with the industry from early next year to share more details on this work and how it will affect your institutions.

Part III: Reinventing the future – financing growth and innovation

We are entering a new era of economic development of unprecedented nature, one of the most important roles of the financial sector will be financing innovation and supporting businesses in managing the associated risks. Competing objectives and the obligations of financial institutions to depositors and policyholders have suggested that this role is likely to be more limited for traditional financial institutions. However, there are growing prospects for financial institutions to support innovation without compromising the overriding obligations to safeguard deposits and claims by policyholders. Two notable developments have supported this.

The first is the evolution of a more comprehensive ecosystem for innovation. This includes incubator programmes that are proving to be highly successful in helping entrepreneurs commercialise ideas and scale up companies.

Such programmes can significantly reduce the cost of innovation for firms, and risks for financiers and risk managers such as insurance providers. Malaysia also has in place well-developed institutions that can play a key role in partnership with financial institutions to support innovative financing solutions. These include the Credit Guarantee Corporation, Cagamas and SME Corporation.

Second is the increasing opportunities presented for financial institutions to develop models to evaluate risks associated with innovative ventures by making use of technology and big data. This needs to be further complemented by broader efforts to develop valuation standards and strong protections for intellectual property.

The financial industry should organise itself to advance such efforts in coordination with professional bodies and authorities to open up wider avenues for financing innovative businesses in Malaysia.

In the final analysis however, a larger role for financial institutions in financing growth and innovation demands a clear, strategic focus on enhancing the organisational capacity to promote innovation. It cannot be achieved with incidental measures and half steps. Financial institutions must be able to effectively mainstream innovation into their operations – across all parts of business, from developing innovative financial and risk management solutions, strengthening learning on innovation within the organisation and reviewing operational models and policies to support responsible practices that promote innovation. As earlier alluded to, the industry must also take a more active role in creating the conditions for innovative finance and insurance to be viable, working with legislators, policymakers, valuers and incubators. It is high time that the industry associations devote a sustained focus with dedicated resources to lead this effort.

Innovations must be firmly anchored in a mentality that has the public interest in mind, and customers at the core. Just as innovation propels the financial sector forward, as custodians of public funds, it is trust and integrity that prevents a gulf from forming between finance and real value creation. This not only serves to build public confidence in the financial system, but places finance firmly back in service of society. We ought to aspire for the banking and insurance industry to be the pride of Malaysian, for its professionalism and integrity.

If innovation is the source of future prosperity, then financial solutions that promote innovation must surely be its cradle. Over 120 years ago, Thomas Edison banked on his famous invention, the incandescent light bulb, to obtain financing for his start-up, General Electric, which went on to become one of the most enduring and successful global conglomerates of our time. More currently, 18 banks and fund managers have invested USD170 million in Symphony, a secure messaging platform which is being touted as the "Whatsapp" of the financial world. Innovation such as this might or might not work but experimenting new solutions always involve risks and we have learnt that it is an imperative for any economy to grow to the next level of progress. Many other examples of our era exist – each one illustrating the promise of innovative industries that have the potential to create high-skill jobs and new economic opportunities that contribute to growth and development.

Let this future finance conference serve as an opportunity for us to critically reflect on the actions that we can take individually and collectively to reinforce existing foundations, and build new ones for sustainable growth in the new economy. The future is in our hands, let us shape it to the advantage of the industry and the nation.