Re-engineering the Malaysian financial system to promote sustainable growth

Abdul Ghani Zamani

Introduction

The Malaysian financial landscape has undergone continuous transformation in the last decade, driven by financial liberalisation and consolidation, economic transformation, technological advancements and more discerning consumers. The Asian financial crisis has also played a meaningful role in the process. As a result, the Malaysian financial system has emerged stronger and more diversified and competitive since the Asian financial crisis. The first part of this paper examines the Malaysian experience in restructuring and reorganising the domestic financial system in the aftermath of the Asian financial crisis. In the following section, the paper outlines Malaysia's approach towards post-crisis development of the financial system, highlighting the main changes that have taken place.

I. Successful financial restructuring since the Asian financial crisis: the Malaysian experience

The Malaysian economy was flourishing prior to the crisis, with strong broad-based economic growth amidst low and stable inflation. Growth in gross domestic product averaged 8% for eight consecutive years, with low unemployment and high domestic savings. Coupled with a strong fiscal surplus and low foreign indebtedness, Malaysia's economic fundamentals were relatively strong. The banking sector was also at its strongest position following periods of regulatory enhancements. At the time, Malaysia had already complied with 22 of the 25 Bank for International Settlements Core Principles. These developments attracted the influx of capital flows, prompting the government to introduce measures to prevent further overheating in the economy and address the vulnerabilities that emerged. Despite the strong fundamentals and responses of the government, the country was hit by the crisis through contagion.

As conditions in the domestic and regional economies worsened, the government took a bold approach by prohibiting the internationalisation of the ringgit and adopting a fixed exchange rate regime to insulate the economy from external uncertainties and further disruptions, hence enabling the government to pursue its domestic agenda. Strategies were targeted at both near-term recovery of the domestic economy and at addressing structural inefficiencies that had emerged in the banking system. On the banking system front, the approach was holistic. Three national agencies were formed to preserve the stability of the entire system. Pengurusan Danaharta Nasional Berhad (Danaharta), the national asset management company, was established in June 1998 to relieve financial institutions from the distraction of rising non-performing loans, enabling them to refocus on their financial intermediary role. Complementing its role, in July 1998, the Corporate Debt Restructuring Committee (CDRC) was formed to act as a platform for faster and more effective debt resolution between corporate borrowers and their creditors. Danamodal Nasional Berhad (Danamodal) was then established in August 1998 to recapitalise viable banking institutions. In 1999, the government embarked on a strategy that led to the consolidation of a highly fragmented domestic banking system, which comprised 71 institutions prior to the crisis, to 30 domestic banking institutions organised in 10 domestic banking groups by 2002.

The early and comprehensive intervention proved to be fruitful with the successful closures of the CDRC and Danamodal in 2002 and 2003 respectively. Danaharta also ceased operations by end-2005, thereby closing the final chapter of financial restructuring in Malaysia. All three agencies have achieved their mandates successfully, and the use of public funds was contained at below 5% of gross national product. The key to this success has been the timely, prompt and holistic approach adopted that prevented the adverse situation from worsening further. Good coordination between related parties in pursuing the crisis resolution measures, supported by strong and forward-looking leadership and dedicated political will, entailed positive results to the benefit of the nation. Faced with a changing operating environment amidst greater competitive pressures, the government then began to focus on medium- and long-term development of the financial system, which led to the production of two important blueprints in 2001, outlining broad strategies for the comprehensive development of the financial sector.

II. Re-engineering the Malaysian financial system: blueprints for development

The Financial Sector Masterplan (FSMP) sets the medium- and longer-term agenda to build a financial sector that is resilient, efficient and competitive, and responsive to the changing economic requirements. In realising the long-term agenda, emphasis was on putting in place the various critical components of the financial sector. By focusing on capacity building among the domestic financial institutions and on strengthening the regulatory and supervisory framework in the initial stage, Malaysia aims to lay a solid foundation on which financial institutions can strengthen and compete effectively amidst further liberalisation without accumulation of risk factors that may adversely affect financial stability and economic growth. In this context, the FSMP spans over three phases, to provide sufficient time for a gradual, sequenced and comprehensive development of the financial sector over the next 10 years, covering the banking sector, insurance sector, Islamic banking sector, development financial institutions, alternative modes of financing and the Labuan International Offshore Financial Centre.

Embedded in the Capital Market Masterplan (CMP) is the comprehensive plan for charting the strategic positioning and future direction of the Malaysian capital market for the next decade in supporting the needs and aspirations for national growth. Six key objectives have been identified and form the basis for the CMP's main strategic initiatives and specific recommendations: (i) transform the domestic capital market into the preferred fund-raising centre for Malaysian companies; (ii) promote an effective investment management industry and a more conducive environment for investors; (iii) enhance the competitive position and efficiency of market institutions; (iv) develop a strong and competitive environment for intermediation services; (v) ensure a stronger and more facilitative regulatory regime; and(vi) establish Malaysia as an international Islamic capital market centre.

III. Creating a progressive and dynamic financial system that promotes sustainable growth: Implementation of policy initiatives

This section elaborates on four key strategies that were implemented: (i) enhancing financial sector capability in meeting growing demands of the economy; (ii) strengthening the resilience of the financial system to withstand shocks; (iii) enhancing the capacity and efficiency of domestic financial institutions in an increasingly competitive environment; and (iv) enhancing market discipline through the promotion of consumer activism and protection. The final part of the section describes some of the main strategies and initiatives that have been undertaken in the creation of a robust Islamic financial system.

Enhancing financial sector capability in meeting growing demands of the economy

As the economy transitions into the next phase of development, the financial structure has to evolve accordingly to support the transformation. It is in this context that Malaysia aims to create a **diversified financial landscape** that is capable of sufficiently meeting the financial needs of various sectors within the growing economy. Sufficient diversification in the financial system will improve resource allocation and risk distribution within the economy. As financial institutions become more focused, this will **encourage greater specialisation** within the financial sector, which will facilitate the innovation and cost-effective prices needed by the economy.

In the area of **bond market development**, significant milestones have been achieved on many fronts, particularly in terms of market infrastructure, legal, regulatory and administrative frameworks, as well as development of capital market intermediaries. In the government securities market, reforms were introduced to achieve market-related pricing in primary issues and to facilitate secondary trading in government securities through enhancements to the principal dealer system, introduction of the *Real Time Electronic Transfer of Funds and Securities System*, which facilitates real time delivery against payment for electronic book-entry settlements, and issuance of the *Code of Conduct and Market Practices for Scripless Securities Market*. In the area of the private debt securities market, the *Fully Automated System for Tendering* was introduced to improve the efficiency of the tendering system, whilst the *Bond Information and Dissemination System* was established to provide comprehensive market information on domestic debt securities, thereby facilitating efficient trading and enhancing liquidity in the secondary market. Efforts were also focused on creating a reliable market-based benchmark yield curve, for both conventional and Islamic bond markets. Another development was the introduction of new asset classes following the issuance of ringgit bonds by two multilateral development banks and of residential mortgage-backed securities in 2004. Cumulatively, these reforms have enhanced the breadth and depth of the capital market, which accounted for 81% of GDP at end-2004. The range of capital market intermediaries is set to widen in the near future with the creation of **investment banks**. To pave the way for an accelerated creation of expertise and specialists, higher foreign ownership (of 49%) in the investment banks will be allowed.

Focus was also directed towards strengthening the **role of development financial institutions (DFIs)** in the economy, with special emphasis on strengthening strategic business focus and risk management practices, and formulating the regulatory and supervisory framework. The enactment of the Development Financial Institutions Act 2002 provides a comprehensive legislative framework for the regulation and supervision of DFIs. Today, a total of seven DFIs have come under the purview of Bank Negara Malaysia (BNM). In addition, a review was conducted on the existing mandates, roles and activities of the DFIs to identify gaps and overlaps in the mandated functions of individual DFIs, with a view to streamlining and rationalising these functions, as well as to determine the synergies among the DFIs in undertaking their activities.

An **efficient, reliable and secure payment system** is crucial to the soundness and stability of the financial system and the smooth functioning of the financial markets. In this regard, various efforts have been directed towards improving the efficiency and safety of payment systems. These include initiatives taken by the Bank to migrate users from paper-based to electronic payments; for example, spearheading the development of an Internet-based payment system (known as the Financial Process Exchange), facilitating the extensive deployment of card acceptance devices at government agencies and merchants, and promoting the use of more convenient delivery channels such as automated teller machines (ATM), the Internet and mobile phones in providing payment services. The integrity of the payment system was heightened, particularly with the introduction of chip-based ATM cards and EMV chip-based credit cards. These initiatives were complemented with awareness programmes on payment system issues and continuous efforts to strengthen the consumer protection framework.

Amidst increasing globalisation and in line with global efforts to enhance **anti-money laundering and counter-financing of terrorism** (AML/CFT) measures, the National Coordination Committee to Counter Money Laundering was set up to formulate AML/CFT measures. As secretariat to the Committee, BNM undertakes the co-ordination function for the implementation of the measures and ensures that national efforts are aligned with regional and international initiatives. Following the enactment of the Anti-Money Laundering Act 2001 (AMLA), BNM has been appointed as the competent authority under the AMLA, with effect from 15 January 2002. The Financial Intelligence Unit (FIU) was established within BNM to carry out the functions of the competent authority under the AMLA. The AMLA covers a wide scope of reporting institutions, both financial and those designated non-financial businesses and professions. The AMLA regulatory net will be extended incrementally to other classes in line with the Financial Action Task Force on Money Laundering's (FATF) 40 Recommendations. Under the AML/CFT framework, financial institutions are required to submit suspicious transactions reporting (STRs) through an online database, whereby financial intelligence on suspected offenses will be disseminated to the appropriate domestic enforcement agency and shared with foreign counterparts. In addition, a comprehensive AMLA compliance framework has been established, encompassing assessment of reporting institutions' AML/CFT infrastructure, compliance with own internal policies and procedures, adequacy of the "know-your-customer" policy, monitoring of transactions and record-keeping, and detection and reporting of STRs. In recognition of Malaysia's effective AML/CFT regime, regional bodies such as the Asia/Pacific Group on Money Laundering (APG) and the Asian Development Bank have requested that BNM provide technical assistance to countries in the region. BNM has also shared its experience in establishing the FIU with the State Bank of Pakistan, and has participated as a financial sector expert in various APG AML/CFT mutual evaluation exercises for member jurisdictions such as Macau, China, Fiji, the Philippines and Pakistan, and in the joint FATF/APG evaluation on the USA.

Strengthening the resilience of the financial system to withstand shocks

Maintenance of financial stability remains a key challenge for regulators. While efforts are geared towards achieving greater efficiency and competitiveness within the financial sector, this has to be balanced with the need for protection and stability. Towards this end, the approach to preserving financial stability has been holistic, encompassing micro and macro surveillance, risk-based supervisory frameworks, prudential standards and risk management principles that are aligned with international practices, and financial safety nets.

Within BNM, efforts have been focused at **enhancing the capacity and skills of personnel involved in regulatory and supervisory activities.** As the level of integration between the financial sector and domestic economy, as well as between financial markets, intensifies, the need for competent and skilled personnel becomes critical to not only enable a more effective identification of emerging vulnerabilities but also to ensure effective policy responses. From the surveillance perspective, development of forward-looking surveillance tools and enhancement of stress test methodology are underway to facilitate surveillance activities. A key challenge in the process is **access to timely, accurate and relevant data and information,** particularly in view of the structural transformation that has taken place in recent years. The emergence of complex structures and financial conglomerates as well as new products complicates the process further.

The regulatory approach has begun to evolve from predominantly "rule-based" **towards more "principle-based" regulations,** which are adaptive to changing market circumstances and business practices, reduce the regulatory burden and do not inhibit innovation and development. As the strength of individual institutions is often the first line of defence against any crisis, focus is increasingly on the need for banking institutions to adopt and promote **strong corporate governance, integrity, internal controls and risk management practices.** Greater regulatory scrutiny is also undertaken to ensure that the shareholders, boards of directors and management of banking institutions are "fit and proper" and have the capacity to discharge their responsibilities and accountabilities.

In line with the rapid structural and operating changes in the domestic financial system, the **supervisory approach has evolved significantly** to adapt to the increased complexities and enhance the effectiveness of supervision. Supervisory activities are now premised on a rigorous **risk-based framework** which provides for a structured and forward-looking approach in assessing banking institutions' risk profiles and the effectiveness of risk management systems. With this forward-looking methodology, Bank Negara Malaysia is able to allocate resources optimally in supervising the institutions, focusing on key risk areas. The increasingly complex group structures involving financial conglomerates have called for the development of **consolidated supervision** framework to ensure balance between allowing group synergy and efficiency, and ensuring that the financial conglomerates do not introduce excessive risks to the overall system. The proposed framework emphasises developing prudential guidelines and principles to ensure that the financial holding companies are financially strong and able to lend support to their subsidiaries. The framework focuses on five main areas; group structures, corporate governance, risk management, intra-group exposures and reporting requirements.

In coming years, due focus will continue to be placed on **aligning prudential regulations to international standards.** An example is the International Accounting Standards (IAS 39) which is set to be implemented in Malaysia as a **Financial Reporting Standards** (FRS 139) for financial institutions. Its implementation is, however, not without its challenges, given the intricacies involved, in which dedicated and experienced personnel are required to ensure a smooth and swift transition. In the context of emerging economies, issues relating to volatility in income statements arising from short-term market fluctuations, lack of data availability and integrity, as well as deep and liquid markets for accurate and reliable valuations, pose great challenges to the regulator and banking institutions. Therefore, the capabilities of regulators, supervisors and external auditors to assess the robustness of financial institutions' adopted methodologies and controls need to be enhanced to ensure that the use of fair value accounting will be managed, monitored and reported in a sound manner, and to enable effective assessment of financial institutions' risk management control and systems.

With regard to **Basel II**, Malaysia has specified two implementation dates: January 2008 for the Standardised Approach and January 2010 for the Internal Ratings Based (IRB) Approaches (for credit risks). Banking institutions implementing the standardised approach in January 2008 (for credit risks) would also be required to adopt the simpler approaches for operational risks, either the Basic Indicator Approach or the Standardised Approach. The implementation approach is based on four underlying implementation principles: (i) gradual enhancement to risk management standards within the industry; (ii) flexible timeframe to accommodate capacity building measures; (iii) the adoption of advanced approaches should not be mandated by BNM; and (iv) development of more effective and rigorous supervisory processes to support the implementation of advanced approaches. Whilst the adoption of advanced approaches under Basel II may take longer in most emerging markets, the emphasis on having robust internal credit rating systems will provide the basis for greater improvement in risk management standards over the long term, particularly in terms of product pricing, portfolio management and new business development, where decisions will have to be made based on risk-adjusted returns and capital considerations. This will ultimately promote greater convergence of regulatory and economic capital in the longer term.

Malaysia now has a **deposit insurance system** following the commencement of operations of the Perbadanan Insurans Deposit Malaysia (PIDM), an independent statutory body established to administer the deposit insurance system on 1 September 2005. The system is funded by annual premiums from member institutions, where a flat rate will be imposed for the initial two years of its implementation. Thereafter, a risk differential premium framework will be implemented, consistent with the mandate of PIDM to strengthen incentives for sound risk management of its member institutions.

Enhancing the capacity and efficiency of domestic financial institutions amidst intensifying competition

Conscious efforts were directed towards narrowing the performance gap between domestic and foreign financial institutions. The ability of domestic financial institutions to compete effectively on a level playing field with foreign players is a vital prerequisite for ensuring a smooth transition towards greater liberalisation in the financial sector without accumulation of risks that may undermine financial and economic stability.

The **industry-wide consolidation** exercise which was completed in 2002 provided the basic foundation for subsequent capacity building and efficiency improvement initiatives to allow the merged entities to strengthen capacities and benefit from **greater group synergies**. Measures were implemented to facilitate the rationalisation of common functions within the groups and the offering of various financial services under one common brand through cross-selling. Legislative changes were also instituted to allow the conduct of commercial banking and finance company operations under a single legal entity. Banking institutions were also allowed to **outsource non-core functions** to third-party service providers subject to certain prudential safeguards, hence freeing up resources for more efficient use.

As domestic banking groups have capitalised on the flexibility, new operating models have begun to emerge, with branch set-up reconfigured, leading to the creation of **specialised business centres** offering specialised and customised products and services to cater to the needs of specific market segments. Technological advancements have also facilitated **enhanced delivery channels** through increased usage of ATMs and other electronic tellers, as well as communications-based banking such as round-the-clock and more efficient banking services. As risk management and product development capabilities were enhanced amidst greater pricing flexibility, the market has now begun to see the proliferation of specialised and **new products** such as structured investments, micro-financing and more SME-related financing instruments.

In line with efforts to strengthen revenue capacity and promote business differentiation, banking institutions have formed **strategic alliances** with other types of financial institutions. This has resulted in the growth of bancassurance and asset and wealth management activities. Malaysian banking institutions have also undertaken steps to strengthen their commercial presence in the region either through **partnerships or alliances with foreign financial institutions** abroad to tap the greater opportunities arising from the growth in intra-regional trade. Currently, the domestic banking groups have presence, in the form of branches, representative offices, subsidiaries or joint ventures, in 19 countries.

The continuously evolving financial landscape requires the availability of highly skilled and agile senior management to drive the strategic direction and position their institutions to maximise the opportunities presented by the changing environment. This is more pronounced in the context of a developing economy where talent and skills are scarce resources. To accelerate the development of **intellectual capital and managerial capabilities** of senior management in the financial sector, the International Centre for Leadership in Finance (ICLIF) was established in 2003. Focusing on senior management capabilities, the ICLIF complements the technical training programmes undertaken by the Malaysian Banking Institute. Activities conducted by the ICLIF include forums, seminars, training and education programmes with strategic alliances and collaborative arrangements with renowned institutions of higher learning from abroad.

Enhancing market discipline through consumer and shareholder activism and consumer protection

Maintaining financial stability and development of the financial sector are shared responsibilities of all stakeholders. To facilitate the role of stakeholders in fulfilling their responsibilities and in making informed decisions, enhancements were instituted to improve the **transparency, comparability, relevance and timeliness of information** relating to financial institutions' operations and financial conditions and to strengthen corporate governance standards within the banking institutions. Meanwhile, continuous effort have been placed on educating shareholders about their roles and responsibilities whilst enhancing the effectiveness of the boards of directors and management beyond tactical performance.

The other powerful stakeholder that has a key role in fostering development, innovation and market discipline within the financial sector is the consumers. To empower them with greater responsibility, focus was accorded to elevate the level of education and financial literacy through a structured **consumer education programme**. Launched in 2003, the programme, known as BankingInfo, is aimed at promoting greater financial literacy among the public and enhancing their understanding of the roles and functions of the different segments in the financial system. Initiatives under the programme are undertaken through various channels, including information booklets in multiple languages (recognising the diversity of the population) and an information website which serves not only as a source of information but also facilitates comparison shopping by consumers. Although the empowerment will take some time before realising its full impact, today consumer demands have grown increasingly complex and sophisticated along with growing affluence.

BNM has also announced the establishment of the Credit Counselling and Debt Management (CCDM) agency, to be operational in 2006, which marks another milestone towards the development of a comprehensive **consumer protection infrastructure**. By providing credit counselling and debt management for individuals with difficulties meeting their financial commitments, the agency will also undertake activities to educate consumers on financial and money management. The institutional arrangement would provide prompt and cost-effective means of debt settlement for housing loans, hire purchase, credit card and personal loans through out-of-court procedures based on agreed repayment plans between creditors and debtors. In the long run, the agency will support the domestic-driven growth strategy pursued by the country.

While entrusting consumers with the larger role, equal emphasis was placed on ensuring they have access to **redress mechanisms** to preserve confidence. The Financial Mediation Bureau (FMB) was established in 2005 as a one-stop centre for formal and administrative redress relating to a broad range of retail consumer complaints against financial institutions under BNM's purview, i.e. banking institutions including Islamic banks, takaful (Islamic insurance) operators, development financial institutions, selected payment system operators, and non-bank issuers of credit and charge cards.

Evolving a robust Islamic financial system

In the early years, focus was placed on developing a **comprehensive domestic Islamic financial system** as a viable alternative to support economic growth. Initiatives were therefore directed towards developing the players and the key structural components in the system, comprising the Islamic banking industry, the takaful industry, and Islamic interbank and capital markets. Emphasis was also placed on building a robust financial infrastructure to support the progressive development of the Islamic financial system, which includes an effective legal and shariah framework, progressive and dynamic Islamic financial markets, effective and stable payment and settlement systems, and a robust regulatory and supervisory framework.

The rapid evolution of the domestic Islamic financial system has set the stage for its global integration. Strategies have now shifted towards developing **Malaysia as an international Islamic financial hub** that will have a greater role in facilitating international economic and financial flows. In 2004, the landscape for Islamic finance was broadened following issuance of three new Islamic banking licences to foreign Islamic financial institutions. In line with measures to promote foreign participation and the transfer of knowledge and expertise, foreign equity participation of up to 49% has been allowed in Islamic banking subsidiaries and new takaful companies in Malaysia. Initiating efforts were also undertaken in close coordination with the Islamic Development Bank to promote takaful and re-takaful businesses among member countries of the Organisation of the Islamic Conference. A further initiative by Malaysia to develop the international Islamic financial market was through the inaugural primary issuance of a global sovereign Islamic sukuk in 2002, which has broadened the investor base by creating a new asset class for both Islamic and conventional investors. Malaysia is also the host country for the Islamic Financial Services Board (IFSB), established in 2002, which was a milestone achieved in the development of international prudential standards for Islamic finance.

One of the key challenges faced in developing the domestic Islamic financial system is having a sufficiently large pool of talent and professional skills to drive innovation in products and services and sustain its competitive strength. In this regard, an industry-owned research and training institute in Islamic banking and finance, the Islamic Banking and Finance Institute Malaysia (IBFIM), was established to spearhead greater collaborative efforts with universities to undertake research in areas that are key for the progressive development of the Islamic financial industry. BNM has also strongly promoted intellectual discourse on Shariah issues to promote rapid growth of Islamic financial products and services. Moving forward, Malaysia and other OIC countries are collaborating with the IDB and the IFSB to formulate a 10-year masterplan to provide a road map for greater convergence towards the common vision among countries in the development of the international Islamic financial system.

IV. Moving forward: challenges facing BNM amidst greater financial development and integration

Like other emerging economies, Malaysia faces a multitude of challenges in its efforts to achieve a progressive and dynamic financial system. Balancing between financial stability on one side and monetary and economic stability on the other will become more challenging, particularly as the domestic economy becomes more interconnected and integrated with other economies and financial systems. In this environment, the responsibility of maintaining financial stability will become a collective effort extending beyond the national boundary, and require greater collaboration among countries.

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