Zeti Akhtar Aziz: Strengthening the banking sector for further competition

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the dialogue session with banking institutions, Kuala Lumpur, 17 February 2005.

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Bismillahirrahmanirahim

Distinguished Guests,
Ladies and Gentlemen,

Economic transformation, a more competitive environment, advances in technology, strengthening international linkages, and more discerning customers will be the important forces that will drive changes in the domestic financial landscape in the years ahead. Economic transformation can be expected to be more pronounced as efforts intensify to shift resources to new areas of growth. A more competitive environment will emerge from increased deregulation and further liberalisation. Advances in technology will continue to increase the potential for creating new instruments, new business processes and enhance the ability to measure and manage risks. Strengthening international linkages will come as foreign presence and participation in the domestic financial system increases and as initiatives are taken by domestic groups to operate beyond domestic borders. Against this background, more demanding customers with higher expectations will see greater consumer activism exerting their influence on the financial landscape. These developments will indeed present a dynamic environment with new challenges for the banking industry.

Ladies and Gentlemen,

It is my pleasure to welcome you to the dialogue session between Bank Negara Malaysia and banking industry. This dialogue will provide an opportunity for the industry to discuss with the Central Bank these developments and their implications, important issues that have emerged and the Central Bank's policy initiatives. As the year 2005 unfolds, it is important for us to reflect on our progress achieved, the new challenges that have emerged and the actions that need to be taken to drive performance in the period ahead. The banking system in Malaysia today is vibrant, strong and profitable. In fact, the banking system is at its strongest position since the financial crisis. The high level of capital, improving asset quality and strong profitability have also been reinforced by substantial enhancements in the areas of corporate governance and risk management standards. Large investment has also been made to strengthen internal systems and processes, to improve delivery channels and to acquire talent. Cumulatively, these enhancements have enabled the banking institutions, particularly the domestic banking institutions, to remain competitive and to offer differentiated products and value-added services. Undoubtedly, the competitive environment has also driven domestic banking institutions to strive for greater efficiency as well as to venture into new areas of businesses, tapping new sources of income and entering into alliances with regional banking institutions.

Most of all, these advancements have enabled the banking institutions to assume an important role in facilitating the increased role of the private sector in the economic growth process.

The foundations for strong performance have now been well established for the domestic banks. As we advance into the second phase of our Financial Sector Masterplan, the policy of gradually deregulating and liberalising the banking system will be complemented with the objectives of bringing increased benefits to the overall economy. While foreign banks will benefit from this process, it becomes equally important that there is reciprocity in the relationship. It is acknowledged that foreign banks have contributed to the development and vibrancy of our financial sector. They have made large capital investments and facilitated transfer of skills and technology to Malaysia. But the foreign banks have in turn benefited and flourished in the stable economic environment and significant economic growth Malaysia has achieved. Therefore, while greater operational flexibility will be accorded to the existing foreign banks so that they can better serve the needs of the growing economy, foreign banks will also need to become more integrated into the domestic economy. This includes ensuring affordable access to banking products and services by all segments of the society and not to focus only on specific locations. Therefore, the potential to establish additional branches will be balanced with the requirement to distribute the branch network to include non-urban areas. While the focus of foreign banks have been for the most part in urban areas, it should be noted that the record has shown that domestic banking institutions with large presence in the non-urban areas have been among those institutions that have sustained strong performance.

Ladies and Gentlemen,

The economic prospects for 2005 will continue to be favourable. Despite some signs of slower global growth, this has not become a cause for concern as the underlying conditions in the global environment continue to remain supportive of growth. Positive developments are that income growth and job creation in the world's largest economy, the United States, has improved while growth in the Asian region also continues to be strong and mutually reinforcing. Despite higher commodity prices, inflationary pressures in the major economies remain moderate. While some countries have begun to raise interest rates, the environment has allowed the upward adjustments to be gradual and supportive of growth. Therefore, although the pace of world growth may moderate, global growth in 2005 will remain strong.

The current global environment is however, affected by uncertainty arising from the global imbalances. The United States continues to record large deficits in the current and fiscal accounts. There has been extensive discussion by the global community on the nature of the adjustment that should take place. Currently, the discussion on the measures to address the existing imbalances appears to be skewed toward pressures for a realignment of exchange rates. Ultimately, these structural imbalances would have to be addressed by the countries where these imbalances exist. Exchange rates may be part of the solution but even so, they are only a small part of the solution. The issue of competitiveness however, requires more than just adjustments in exchange rates. It requires fundamental structural changes in the countries concerned. The appreciation of regional currencies is not likely to eliminate these imbalances. In fact, excessive focus on the exchange rates as corrective mechanisms for these imbalances has led to speculative capital inflows into Asian economies. This has required policy makers to intervene to avoid a sharp appreciation of their currencies, thus accumulating large reserve holdings. Clearly, at best, exchange rates offer only a partial solution and excessive focus on this area could in fact be counter productive. It risks sharp movements in exchange rates which at the extreme would be highly destabilising to the global currency, capital and commodity markets.

The long-term solution would be for the US to increase its savings and moderate its import demand and for the rest of the world to increase its demand and imports. Such a transformation will eventually occur but it is unlikely to occur overnight. In the transition there could be some economic dislocation. However, with its young workforce and with the growing productivity, competitive and dynamic economies, there is great potential for the Asian economies to become the growth dynamo for the region and the world. With rising income levels in regional economies, particularly among the growing middle income group in China, India and the ASEAN economies, there is potential for an intrinsic source of demand within the region. This rebalancing of demand across the world will eventually reduce the prevailing imbalances.

In 2004, the Malaysian economy experienced strong growth. Going forward, the economy will continue to be well supported by both domestic and external demand. The strength of domestic demand, in particular, private expenditure, together with sustained exports, is expected to continue to support growth in 2005. This will be reinforced by sound domestic economic fundamentals as well as strong corporate and financial sectors. Private investment is likely to remain on an upward trend as companies upgrade facilities and install new capacity in response to strong domestic and external demand. The strength of the economy, the highly diversified economic structure and the strong fundamentals increase Malaysia's potential to absorb and respond to the challenging external environment.

Bank Negara's monetary policy has played a supportive role to the economy throughout 2004. Going forward, this stance will be maintained. Inflation has risen from the earlier low levels but it is expected to remain relatively low in 2005 despite the US dollar depreciation and the higher international price of oil. Temporary increases in the inflation rate caused by one-off supply shocks or price adjustments do not warrant a monetary policy response. The focus of monetary policy is to continue to support further expansion in business investment activity to enhance the long-term growth potential of the Malaysian economy. During 2004, Bank Negara Malaysia also implemented a number of measures to enhance the operational efficiency and transparency of its monetary policy. In particular, almost one year after its introduction, the new interest rate framework is operating well, with the Overnight Policy Rate providing the signal to the market on the stance of monetary policy. Combined with the quarterly Monetary Policy Statement issued by the Central Bank, the market is provided with regular information on current and expected monetary conditions. The deregulation of pricing under the new interest rate framework has also acted as a catalyst for more efficient pricing in the financial system.

Against volatile world currency markets, the pegged exchange rate regime continues to accord significant benefits to the Malaysian economy by providing greater predictability and stability for international trade and investment. From time to time, isolated developments or rumours have prompted market speculation on the need to review the pegged exchange rate. Bank Negara Malaysia has consistently maintained that the exchange rate regime would not be reviewed unless the Ringgit is expected to be fundamentally misaligned or if the regime is no longer consistent with economic fundamentals arising from major structural changes within the international and regional financial systems. It should be noted that while the Ringgit has declined with the US dollar, its depreciation against Malaysia's trading partners' currencies as a group has been relatively small. Given the small degree of undervaluation, the inflation pass-through arising from the weakness in the US dollar is also likely to be small, and consequently, the potential for misalignment is correspondingly small. Therefore, the peg exchange rate regime remains fundamentally sound and we expect that it would continue to serve the economy well. Any change in the exchange rate regime would be on the basis of longer-term structural considerations and not on account of short-term movements in capital flows and transient shifts in exchange rate expectations.

Ladies and Gentlemen,

In spearheading the development of the financial sector, Bank Negara Malaysia's objective is to develop a dynamic, competitive and resilient financial sector. In the year 2005, focus will be accorded to strengthen the effectiveness of the banking sector in meeting the new requirements of the economy, enhance competition and hence efficiency and to strengthen the infrastructure for consumer protection. These initiatives would be taken in the context of preserving the soundness and stability of the financial system.

An important component of a strong financial sector is the institution of a robust regulatory and supervisory framework. Two main principles will be taken into consideration in the formulation and implementation of prudential policies. First, is the creation of a regulatory environment that fosters innovation and competition, while promoting best practices to preserve financial stability. Policies will therefore balance the need to attain efficiency whilst preserving stability. Second, regulations will increasingly be "principle-based". Regulations will focus on identifying parameters within which banking institutions must operate, whilst retaining sufficient flexibility to allow institutions to determine their own individual strategies and approaches within these parameters. This is in the light of the improved corporate governance and risk management practices within banking institutions. The Board and management will be accountable for strengthening individual institutions.

The success of the principle-based approach to regulation will depend on the ability of banking institutions, individually and collectively as an industry, to make use of the flexibilities given without giving rise to excessive risk taking, overpricing, credit rationing and other actions that could threaten stability in the financial system and overall economic well-being of the nation. The key is for banking institutions to act responsibly, as the actions of banking institutions would have implications on all segments of the economy. Due attention must be given to ensure that all segments of the society have access to banking services at reasonable cost and no groups should be marginalised in this process. In this respect, while we advocate a principle-based regulatory framework, Bank Negara Malaysia will closely monitor the performance and actions of banking institutions, and would intervene and prescribe specific regulations in the event that actions by banking institutions could jeopardise financial stability and public confidence in the financial system.

As a custodian of public funds, and as a service-oriented industry, the banking sector must continuously strive to maintain public confidence in the system and deliver high standards of services. Maintaining public confidence entails efforts beyond maintaining strong financial results and having a wide range of products and services for customers. As customers become more financially savvy and better informed of their rights, the conduct and practices of banking institutions will increasingly be scrutinised by the public. Fraud, unethical practices, and monopolistic and unfair practices would, if left unchecked, adversely affect public opinion and confidence in the banking system, with consequences on the financial performance of individual institutions. Indeed, in order to preserve corporate reputation and sustain public confidence, banking institutions must be sensitive to the impact of their policies and practices on their customers and other stakeholders. It is, therefore, in the interest of the industry to collectively ensure that public confidence in the system is maintained at all times.

Ladies and Gentlemen,

The recent issue on the fees and charges imposed by the banking institutions received significant attention by the public. Bank Negara Malaysia's policy has been to gradually deregulate the rules on fees and charges, as a way to drive improvement in the performance of banking institutions and promote innovation. Nevertheless, the flexibility given needs to be judiciously enforced so as not to result in any erosion of public confidence in the banking sector. To protect consumer interest, Bank Negara Malaysia will balance the competing expectations of banking institutions and consumers. While it is recognised that enhancements to products and delivery channels involve substantial investments, any realignment to the pricing structures on products and services need to be supported by the adequate costing and justification that also takes into account cost savings. More importantly, it must be accompanied by improvements in service quality.

While Bank Negara Malaysia will continue to strengthen the consumer protection framework through enhanced disclosure standards, effective dispute resolution mechanisms, and promotion of fair practices, banking institutions must also play their role. An important aspect is to ensure that consumers are adequately equipped with the relevant information to minimise the risks of poor financial decisions and their consequences. Market practices and disclosure standards must be fair and comprehensive so as to ensure that consumers are treated equitably and have access to adequate and timely information to facilitate effective decision-making.

Ladies and Gentlemen,

In this recent year, Bank Negara Malaysia has put in place two important infrastructures within the banking sector, the first being the framework for the establishment of Islamic subsidiaries, and secondly, the merger of commercial banks and finance companies within the same banking groups. These frameworks have paved the way for banking institutions to further rationalise their operations and improve efficiency. Both allow for the operations to be now undertaken within a new structure where the operations will be able to leverage on the group infrastructure, including the branch network and the support functions, to maximise cost efficiency and reap the benefits of group synergies. A number of banking institutions have already capitalised on the opportunities provided by these frameworks.

Going forward in 2005, Bank Negara Malaysia will finalise a number of key regulations for the banking system. These regulations will focus on enhancing Bank Negara Malaysia's overall oversight on banking institutions, whilst according greater flexibility for the Boards and management of the banking institutions to chart business strategies within the parameters set by the regulations.

Ladies and Gentlemen,

In an environment where group structures are becoming more complex, prudential regulation and surveillance over diversified financial conglomerates will be further strengthened. In this regard, Bank Negara Malaysia will finalise the Framework for Consolidated Supervision of Financial Conglomerates in 2005. The first Concept Paper that was issued in December 2003 has received positive feedback from the industry. On the group structure, there has been wide acceptance of the proposal for all financial groups to be headed by financial holding companies. The essence of having the financial holding company is to allow banking institutions within the financial group to rely on the holding company as a source of financial strength. Flexibility will, however, be given for commercial banks to remain at the apex of the financial groups. Nevertheless, safeguards will be introduced to ensure that the commercial banks exhibit higher standards of risk management practices and oversight to manage the higher risks arising from such structures.

A further issue is the scope and nature of activities that would be permissible within the financial holding company structure. The principle for defining financial activities or activities that are incidental to financial activities will be clearly outlined to facilitate any likely restructuring that will be required as a result of the new policy. Work is also ongoing to define the appropriate corporate governance and prudential standards to be applied at the financial holding company level. With regard to capital requirements, whether there should be a standard capital rule for all financial holding companies is currently being reviewed. The more important consideration is to minimise excessive leveraging and ensure that the financial holding company has the necessary infrastructure to have an overall view of the risk taking activities within the group.

Ladies and Gentlemen,

It is envisaged that in a more liberalised financial system, market discipline will play a greater role in driving performance in banking institutions. In this regard, shareholders are expected to be more involved in overseeing the performance of banking institutions and the effectiveness of the board of directors and management. The policy on shareholding will therefore be enhanced to promote greater shareholder activism within banking institutions. Shareholders need to be concerned with the practices of banking institutions, particularly those which can have adverse implications on depositors' interests and on financial stability.

Similarly, given the increasingly competitive environment, advancement in risk management practices and the strengthened corporate governance framework, a more flexible policy framework on lending to connected parties will be put in place. However, to prevent abuses of such flexibilities, there will be safeguards and conditions that need to be observed by banking institutions.

Ladies and Gentlemen,

The adoption of a principle-based regulatory approach will provide banking institutions with greater flexibility in deciding on strategic options in a more competitive environment. As the banking industry grows at an accelerating pace, there are common areas where collective efforts by the industry will not only bring benefits to the financial sector but also to the overall economy. In this regard, there is an increasing trend among developed countries such as the United Kingdom, Canada, and Australia, where the bankers associations have an important role in spearheading initiatives to promote high standards of ethical code of market conduct to meet consumers' rising expectations and demands. The bankers associations have increasingly assumed the role as a focal point for consultation with not only the regulatory authorities, but also by the other stakeholders on policies affecting the financial sector. In this respect, such associations have played an important complementary role to the regulatory authorities' efforts in promoting a more progressive, dynamic and resilient banking system. In addition, banking associations in these countries have also acted as the voice for the industry in articulating the position of their members to promote the interests of the industry. In Malaysia, there are several areas of common interest to the industry which the associations can spearhead. It is, therefore, to the benefit of the industry to reassess the role of the associations with respect to taking forward common initiatives and interests of the industry.

Ladies and Gentlemen,

Moving forward, consumer and SME financing will continue to be two important areas of growth. The overall macroeconomic and interest rate environment would continue to be supportive of growth in these two sectors. The challenge for banking institutions is to ensure that consumers and the businesses have access to a wide range of products, while at the same time ensuring that the necessary infrastructure is in place to manage risks arising from these businesses. This is to ensure that lending to these sectors would be sustainable and avoid the risks that have recently been experienced in a number of other countries in this region.

While focusing on consumer and SME financing, banking institutions should also recognise the emergence of a number of new growth sectors in the economy, including activities in the services sector, and the agriculture and agro-based industries. These areas represent opportunities that can be capitalised upon by the banking institutions. While these may be viewed as non-traditional areas, banking institutions that introduce new lending models and products to cater to the financial requirements of these areas would have the early advantage in capitalising the potential of these new markets.

In this regard, the main theme of this year's dialogue, is "Tapping Opportunities in the New Growth Areas - Fostering Best Lending Practices", for discussion by the banking community. We are very pleased to have four distinguished speakers to share with us their expertise and experiences in building successful and sustainable portfolios in consumer lending, SME financing, microcredit and agriculture financing. Following their presentations, there will be break-up sessions in these four areas where bankers are encouraged to actively discuss the issues relating to these respective areas. Each group will be invited to present the results of their deliberations tomorrow morning. It is hoped that this will be a constructive process that will contribute towards elevating the level of performance and value added in these areas.

Ladies and Gentlemen,

On this note, I wish you productive discussions this afternoon. I look forward to hear the outcome of your deliberations tomorrow morning.

Thank you.