Zamani Abdul Ghan: Creating a competitive banking system - towards the enhancement of quality and efficiency in Malaysian banks

Speech by Mr Zamani Abdul Ghan, Deputy Governor of the Central Bank of Malaysia, at the 9th Malaysian Banking Summit 2005 - “Enhancing Competitiveness to Meet Strategic Challenges”, Kuala Lumpur, 10 May 2005.

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Your Excellency

Distinguished Guests
Ladies and Gentlemen

Assalamualaikum warahmatullah and Good Morning

On behalf of Bank Negara Malaysia, thank you for the invitation to officiate at this year's Banking Summit organised by ASLI. It is indeed a great pleasure to be here today at this important forum. The theme chosen for this year's Summit is most relevant as it provides an opportunity to deliberate on the challenges ahead and the strategic initiatives needed to realise our common goal of a progressive and competitive banking system that will facilitate and drive our economic transformation.

Ladies and Gentlemen,

The financial landscape is undergoing transformation, driven by financial liberalisation and consolidation, economic transformation, and more discerning consumers. These developments have been reinforced by technological advancements, which have allowed the developments of new and more efficient delivery and processing channels as well as more innovative products and services. Against this backdrop, a number of challenges have emerged. Foremost amongst these is intensified competitive pressures, spurred by financial liberalisation and technological revolution. Banking institutions are facing competition not only from each other but also from non-traditional competitors such as non-bank financial intermediaries as well as from alternative sources of financing, such as the capital markets. Indeed, the Malaysian capital markets have broadened and deepened, and are now playing a more pronounced role than before in the financial intermediation process. In this respect, the challenges to the banking sector are manifold. On the funding side, consumers' continued interest in diversifying their investments in search of higher returns, have seen funds flowing directly into the financial markets instead of going into banking institutions' deposits. At the same time, companies are increasingly meeting their financing needs in the equity and bond markets, thereby reducing their reliance on banking institutions. This is evidenced by the growth of outstanding private debt securities or PDS in the market by 10.7% to RM160 billion as at end of 2004, accounting for approximately 25% of the total financing channeled to the economy. The challenge to banking institutions is to enhance their competitive edge by being cost efficient without compromising on the quality of their services. On the other hand, the disintermediation process also offers opportunities to banking institutions. In particular, they can enhance their income by cross-selling mutual funds products and increasing their role as advisors, arrangers, underwriters and brokers for corporate financing arrangements. There is also bancassurance and bancatakaful in the area of cross-selling.

On the Islamic banking front, new foreign Islamic banking players and the transformation of Islamic windows into Islamic subsidiaries of a banking group present new challenges to the Islamic banking scene where competition is expected to intensify. In line with the government's strategic direction, initiatives are being taken to encourage strong and capable Islamic financial players to venture abroad to explore new markets. In the years to come, it is envisaged that corporations and multilateral institutions will increasingly use Malaysia as a launching pad to raise Shariah-compliant long-term capital and issue sukuks, while investors look to Malaysia for investment in Islamic financial instruments. This is not merely a national vision, but actually a national target. The key challenge is to ensure that the financial infrastructure is well in place and that our banking institutions are well equipped with distinct capabilities to enable Malaysia to compete regionally and internationally as a leading Islamic financial centre.

Ladies and Gentlemen,

As competition intensifies with the entry of foreign players and non-bank financial intermediaries, another challenge confronting banking institutions is to find new markets or growth areas to tap new sources of income and thereby diversify their income sources. Amongst the growth areas is financing to small and medium enterprises (SMEs). SMEs play a very significant role in terms of generating employment and contribution to export earnings, and that SMEs can blossom and contribute significantly to the national economy in the future. Given the importance of SMEs to the economy, a number of initiatives are being taken to foster the development of SMEs and improve their access to financing. In this respect, banking institutions have provided considerable support in terms of financing to the SME sector. Moving forward, the banking industry is expected to play a greater role in the development of SMEs, such as by offering a complete financial services solution as part of and in conjunction with their financing programs. Aside from the SME sector, banking institutions should explore other potential growth areas such as microcredit and agro-based financing, which are generally perceived as riskier and more costly than lending to larger firms. The challenge is for banking institutions to innovate and develop new form of financing arrangements and business models to exploit the opportunities offered by these market sectors. Strategic opportunities are also available from a larger marketplace as economic integration and regional linkages of markets in the East Asian region gather pace, driven by increasing regional trades and investment flows. In this regard, banking institutions should broaden their strategic outlook and expand their presence in the region to support Malaysian businesses and investors as they venture into new activities and expand their geographical profiles.

Another strategic challenge facing banking institutions today is the growing and changing needs and expectations of consumers in tandem with increased education levels and growing wealth. Consumers are becoming increasingly discerning and have become more involved in their financial decisions. For this reason, they are demanding a broader range of products and services at more competitive prices through more efficient and convenient channels. Corporate customers have also become more performance-oriented and are demanding both competitively priced credit facilities and world-class financial advisory services. In this environment, the challenge is for banking institutions to anticipate and respond quickly to the differentiated demands and expectations of customers to sustain their competitive advantage. With growing customer expectations for continuous availability of services, the ability to continue to provide critical banking services at all times will also be crucial in the pursuit of building and maintaining their competitive edge. In conjunction with this, banking institutions must be able to quickly recover mission critical functions and assets during a major interruption to ensure efficient and reliable services to their customers.

Technological advancement, which has increased the complexity of banking business and which has led to the emergence of increasingly innovative products and distribution channels, also presents opportunities for the banking sector. With ICT, financial services are being delivered to places and markets without requiring physical branch networks through a growing array of alternative delivery channels, including Internet, ATMs, and even mobile phones. The challenge to banking institutions is to effectively leverage on the opportunities offered by technology to innovate products and services aimed at attaining greater efficiency, reliability and competitiveness. While the efficiency of electronic means of doing banking is acknowledged, banking institutions should recognise the need for them to meet customer expectations for more personalised and quality services. Additionally, the potential benefits from electronic delivery channels need to be exploited without undermining the security and confidence of the banking public. The growing incidences of e-banking scams globally present banking institutions with the challenge of being one step ahead by deploying security measures that will provide customers with the highest level of confidence.

Technological development has also redefined the landscape of the payment systems industry with the introduction of new payment instruments and new delivery channels, as well as the entry of non-banks into payment services once thought to be the domain of banking institutions. While a vast array of electronic payment systems and instruments have been introduced against a background of more flexible regulatory policies, the use of cheques remains pervasive, accounting for more than 90% of the non-cash retail payments in Malaysia. Significant development efforts and initiatives have been taken aimed at increasing the safety and efficiency of payment systems infrastructure, including upgrading funds transfer systems, migrating all magnetic stripe ATM and credit card infrastructure to a chip-enabled environment, and introducing payment platforms that leveraged on the Internet. These trends underpin the challenge for banking institutions to accelerate the adoption of electronic payment instruments and channels amongst consumers to gradually replace paper based payment instruments.

While significant investments have been made to develop the network infrastructure, banking institutions should capitalise on the opportunity to further drive cost reductions and reap efficiency gains. There should be industry-wide participation in the e-payment infrastructure to attain critical mass in a much faster time frame and drive the unit cost of production lower. Accessibility of payment services should be made more convenient by leveraging on existing network infrastructure, such as facilitating inter-bank funds transfers via the ATMs. Further, industry standards on common payment value dates, payment references and notifications would entice consumers to use the more reliable e-payment channel. To encourage the use of e-payments, consumers should also be provided with the right pricing incentives. In this regard, banking institutions should price their payment services according to their production costs to encourage the use of the more cost effective and efficient payment modes.

Ladies and Gentlemen,

The Malaysian economy has registered a robust growth of 7.1% in 2004, the fastest growth since 2000. The economic prospects for 2005 will continue to be favourable as the economy enters the year from a position of strength. Growth is expected to be sustained at 5-6% as underlying conditions in the domestic economy remain strong, with robust private consumption and investment activities. The sustained global growth as well as relatively favourable prices for primary commodities would ensure that the external environment would remain supportive of growth.

The banking sector also enjoyed a very good year in 2004, a year in which strong performance was recorded, and this positive trend has continued into the first quarter of 2005. Buoyed by favourable economic and financial market conditions, 2004 marked another year of strong profitability performance by the banking system where the combined pre-tax profits rose by 16.1% to RM11.8 billion. Banking institutions have diversified their revenue source by venturing into a broader range of fee-related activities, which yielded a strong growth of 17% for the banking sector as a whole. This shift in the sources of revenue has been gradually taking place over the past few years as banking institutions seek to lessen their dependence on interest-based activities as their main source of revenue. With the growth in the middle-income group in Malaysia, banking institutions are poised to provide value-added services to this increasingly affluent group including wealth management services and sale of unit trusts and bancassurance.

Perhaps the biggest contributor to strong earnings has been the steady improvement in asset quality, consistent with a gradually improving economy. The net non-performing loans have declined to a record low of 5.4% as at end-March this year, the lowest level since the Asian financial crisis. Improvement in economic conditions is a key reason for the sustained decline and credit quality is on track to improve further, more so as the economy improves. The underlying strength of the Malaysian banking system is also confirmed by trends in capital adequacy. The banking sector continued to exhibit strong risk-weighted capital ratio where the level has remained above 13% for 33 consecutive months and continues to improve.

For Islamic banking, the sector has registered a strong growth of 19% per annum from 2000 to 2004. While the Islamic assets accounted for almost RM95 billion or 10.5% of total assets of the banking system as at end-2004, market shares of Islamic deposits and financing increased to 11.2% and 11.3% of the banking system respectively. The capital position of the Islamic banking sector remained strong during 2004, registering an increase of 14.7% to RM7.8 billion. The risk-weighted capital ratio and core capital ratio were sustained above 12% and 10% respectively.

Ladies and Gentlemen,

While our banking sector has made progress, as financial liberalisation and consolidation gather pace, greater competition in the banking sector is likely to ensue. As such, the need to enhance the competitiveness of the banking sector to withstand forces of change and compete in this more liberalised environment becomes even more pressing. Successful institutions will be the ones with the agility to adapt swiftly and respond to the changing market needs through - innovative and differentiated product offerings; excellent service quality; and superior level of efficiency. With growing competition in traditional banking products and services, banking institutions need to continually strive for excellence in product development capabilities with a greater focus on customised and higher value-added services. In this respect, banking institutions should capitalise on the opportunities presented by the emergence of new growth areas as well as rising households' wealth by strengthening their capabilities in the areas of wealth management, financial advisory services and consumer banking. Product innovation must also be high on the agenda of Islamic banking institutions going forward. The move into niche markets will not only increase the potential to secure higher returns for shareholders and depositors but would also increase the diversity of new asset classes available for Islamic investment. Banking institutions are expected to maximise the full advantage of the universal Islamic banking licence issued, which allows a wide range of business to be undertaken ranging from retail and corporate banking to investment banking and fund management.

To meet the challenge from more discerning and demanding customers, it is equally important for banking institutions to complement the richer and more customised range of product offerings with higher levels of service performance. Of importance is the enhancement on customer relationship management and development of 'front-office' strategy that is aligned with the customer-centric value proposition to improve customer satisfaction and retention. Closely related to this is the need to promote a customer-centric culture and align the organisational structure and strategies towards supporting the strategic focus of building a lasting and profitable relationship with customers. In this regard, clear communication of business strategies to front-line staff is important to achieve excellence in service performance, particularly in complaint management and customer service. As service quality is the essence in banking business, the quality of manpower will increasingly be the defining factor of competitive advantage and long-term sustainability. As such, continuous investment in human intellectual capital must be made to ensure the availability of best talents at all levels of the institution. Most importantly, strategic leadership at top management level is required to chart the strategic course and drive the banking institution towards attaining the highest standards of performance.

The business environment remains dynamic, as such human resource management must adjust to support business strategies and realise improvements in business processes and systems by ensuring employees are equipped with the appropriate skills at all times. Such adjustment requires greater integration of personnel policies and practices with the corporate mission and goals, improvement in recruitment practices to attract the best talents and greater focus on human resource development. While qualification and skills of staff are critical elements, of greater importance is the ability to translate knowledge into enhancing the capabilities and excellence of the institution. Banking institutions will have to enhance the level of competencies and motivation on an ongoing basis, cultivate professionalism and the right attitude, and create and maintain a learning environment. For Islamic finance, the banking industry needs to continually promote human capital development and expertise to create a larger pool of experts and high calibre professionals in Islamic banking and finance. In particular, adequate resources should be allocated in building distinctive capabilities in the newly emerging areas such as private equity investments, real estate investments, private wealth and asset management.

Ladies and Gentlemen,

Another key aspect that drives higher standards of performance and competitiveness is the capabilities to deliver products and services in the most efficient and effective manner. To facilitate this, banking institutions should adopt the relevant technology to enhance their delivery capability to ensure speedy and seamless customers access to banking services through a wider range of delivery channels, aimed at reducing operating costs and providing greater convenience to customers. Information technology still has immense untapped potential in banking. For instance, technology could be harnessed as an enabler in building higher quality research, strengthen risk management capabilities, enhance market information gathering and analysis capacity to keep pace with the changing trends and demand patterns. While leveraging on technology may achieve improved efficiency, banking institutions should also ensure that the new banking technology does not lead to the emergence of a digital divide in the access to banking services. In this regard, banking institutions are expected to continue providing high standard of banking services to all consumers, regardless of their income and where they live, whether urban or rural.

With the growth in the diversity and complexity of products and services, risk profiles of banking institutions will change. Consequently, banking institutions should continuously upgrade their risk management framework by improving their governance standards, adopting global best practices and enhancing information management systems. Enhancing risk measurement and management systems would better prepare banking institutions in complying with the criteria required under the Basel II Capital Accord. In addition, with enhanced risk management capabilities, banking institutions will be better equipped to price products and services more competitively while ensuring that their risk exposures remained within manageable levels. Better insights into their risk profile also facilitate in their formulation of business strategies and enable the optimal use of their capital. In this context, banking institutions must be prepared to beef up their financial strength and capital level during the current favorable economic environment so that they could weather vulnerability during downturns and crisis situations.

Ladies and Gentlemen,

While the responsibility for strengthening competitiveness rest with the banking institutions, Bank Negara Malaysia plays an important role in spearheading the development of the banking sector. In realising the vision of a progressive and dynamic banking system, Bank Negara's policy initiatives aim at providing a more conducive environment that encourages innovation and competition, while maintaining the safety and soundness of our banking sector. In line with this, Bank Negara Malaysia will ensure its prudential framework is adaptable to changing market circumstances and business practices, and does not contain features that might inhibit banking institutions from upgrading their capabilities or delaying their response to changes. Our regulatory approach has shifted away from prescribing detailed rules towards "principle-based" regulations. There is now greater focus on providing "incentive compatible" parameters that encourage banking institutions to conduct their businesses prudently, whilst allowing them the flexibility to develop strategies within the broad principles. Over time, our regulatory and supervisory framework would rely more on market discipline through increased disclosure and transparency. In this respect, shareholders are expected to play a more active role in overseeing the performance of banking institutions and the effectiveness of management in conducting the business in an efficient and professional manner.

As we advance into the second phase of the FSMP or the Financial Sector Masterplan Plan, progressive liberalisation will take place to level the playing field for domestic and foreign banking institutions. To this end, greater operational flexibility will be accorded to the existing foreign banking institutions. Bank Negara Malaysia has, in addition, granted three new full-fledged Islamic banking licences to foreign financial institutions. Additionally, foreign direct investment of up to 49 per cent has been allowed in the equity holding of the Islamic subsidiary of a commercial bank. The overall market shares of local and foreign banking institutions have not changed drastically, but there has been qualitative improvements in operational efficiency, service levels, risk management and corporate governance standards. Over time, as the industry further evolves, Bank Negara Malaysia will reassess the environment before deciding on further liberalisation measures.

Ladies and Gentlemen,

Macroeconomic and financial conditions are evolving swiftly, posing more significant challenges and lending urgency to accelerating efforts towards realising our vision of a more progressive and dynamic financial system. Greater commitment towards enhancing strategic competence and organisational effectiveness are critical as we strive for higher standards of performance and greater efficiency in the banking system. To ensure that the financial system is well placed to serve the nation, on-going efforts will be directed towards enhancing the efficiency of financial infrastructure and strengthening the functioning of the markets as we advance forward. Our policy initiatives will continue to maintain a regulatory environment that encourages innovation and efficient competition towards evolving a more diversified banking sector, while at the same time maintaining high prudential standards to ensure the soundness and stability of the system. With strong concerted efforts between Bank Negara Malaysia and the industry, or continuous and honest dialogues in one form or another, we can look forward with confidence to continued strong performance from the banking sector to contribute significantly to the economic prosperity of the nation.

On this note, I wish you all an enjoyable and fruitful conference.

Assalamualaikum and thank you.