Zeti Akhtar Aziz: Moving towards a more competitive market

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the 2005 dialogue session with insurers and takaful operators, Kuala Lumpur, 9 August 2005.

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The annual Dialogue between Bank Negara Malaysia with insurers and takaful operators is held to discuss issues confronting the insurance and takaful industries, major policy initiatives by Bank Negara Malaysia as well as current economic and financial developments affecting the industry. This year's dialogue is being held on 9 and 10 August and attended by the Chairmen, members of the Board and Chief Executive Officers of insurers, takaful operators and bank holding companies.

Themed "Moving Towards a More Competitive Market", the dialogue this year will provide a platform for insurers and takaful operators to discuss strategic issues relating to the challenges of the more competitive and rapidly changing financial landscape. The keynote address delivered by the Governor, Bank Negara Malaysia at the opening of the Dialogue session is attached.

The Malaysian economic and financial landscape continues to be dramatically transformed. As this transition process gains momentum, the key issues confronting the insurance and takaful industries today are: defining effective growth strategies in an increasingly borderless world; sustaining confidence in the face of increased demands for greater transparency; responding to the challenges of regulatory and accounting changes; and managing risk in an increasingly complex and volatile environment. These challenges have spawned multi-faceted reforms, involving changes in business models, risk orientations, operating practices and in the interface with customers. It is this modernisation process of the insurance and takaful industries that will take it to new heights, bringing with it widespread and far reaching implications on the overall financial system and the economy.

It is my pleasure to welcome you to this year's dialogue session between Bank Negara Malaysia and the insurance and takaful industries to discuss these issues in greater depth within our domestic context, and to consider the necessary actions that need to be taken under increasingly more challenging conditions. The theme for this year's dialogue: "Moving Towards a More Competitive Market", will focus on the challenges of pricing deregulation, product transparency, operating cost efficiencies and commission disclosures. The issues revolving around operating practices and the interface with customers also needs to be viewed in terms of the broader dimensions of public confidence, transparency and risk management.

The dialogue this year is also based on a new format focused on issues with long-term strategic implications that need to be addressed in the current environment. It is designed to encourage deliberations from the different perspectives between industry participants and Bank Negara Malaysia. The dialogue will also serve as a platform to reflect on recent economic and financial developments and the major policy initiatives by Bank Negara Malaysia. Allow me to take this opportunity to share some thoughts with you in these areas.

The outlook for the Malaysian economy continues to remain favourable, despite some signs of moderating growth in the global economy arising from the higher oil prices. Malaysia has had a track record of solid and steady growth for a number of years now. The diversified economic structure and sound macroeconomic fundamentals have been important in supporting this trend. Of importance is that this growth is private sector driven. While price pressures have been contained by improvements in labour productivity and capacity expansion, domestic inflation has begun to edge upwards, largely due to cost-related factors. In balancing these trends, monetary policy has continued to remain supportive of growth. Growth in Asia has also remained strong with mutually reinforcing effects for regional economies, including Malaysia, as regional integration continues to intensify.

The global environment, however, is clouded by uncertainties amid the persistence of global imbalances. The United States continues to record large deficits in its external accounts. There is significant discussion in the global community on how these imbalances may be unwound. The consensus, however, is clear that the adjustment should be orderly. There has however, been an over focus on realignment of exchange rates to facilitate this adjustment. But this may risk destabilizing adjustments. Ultimately, the structural imbalances have to be addressed by some combination of adjustments in demand, prices and exchange rates. In particular, the rebalancing of global growth can be expected to be a major factor contributing to an orderly adjustment to these imbalances. Indeed, it would require more than just adjustments in exchange rates. The nature and breadth of the adjustments will be important to achieve a long-term solution.

With its young workforce, growing productivity, competitive and dynamic economies, there is great potential for the Asian economies to contribute towards the re-balancing of global growth. 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 expansion of demand within the region. The rebalancing of global growth across the world will eventually contribute towards reducing the prevailing imbalances. Malaysia's own agility to absorb and respond to the external and domestic challenges has allowed us to efficiently shift resources to new areas of growth, to new areas of comparative advantage and thus, sustain our long-term prospects. Going forward, Malaysia's economic policy will therefore continue to focus on ensuring that the economy's flexibility and resilience is sustained.

With the strengthening of the economy, the financial system and our fundamentals, the opportunity has been taken to deregulate and liberalise the environment further. The most recent policy initiative in this direction has been the shift in the exchange rate regime to a managed float. Under this regime, exchange rate stability will continue to be a primary objective of exchange rate policy. Malaysia is a trading economy that is highly integrated with the world economy, and in this context, a stable exchange rate environment continues to be important. With changes in the international economic and financial environment, the move towards a managed float was important to enable Malaysia to maintain a stable exchange rate against its major trading partners. Under this arrangement, Bank Negara Malaysia will now monitor the exchange rate against a currency basket to ensure it remains close to fair value. The transition to the new system has been orderly, with transactions mainly reflecting trade and foreign direct investment as well as portfolio investment activities.

As providers of long-term capital and efficient risk transfer solutions for productive economic activity, the insurance and takaful sectors play an important role in supporting the economic transformation process. Over the years, that role has increased in prominence with the impressive growth achieved by the industry. In 2005, the insurance and takaful industries have continued to demonstrate resilience and strong performance despite challenging investment and underwriting conditions. Premiums and contributions have continued to expand at double digit growth rates in the first half of 2005, with the general sector rebounding strongly after two consecutive years of slow growth. The underlying fundamentals for sustainable growth have also strengthened with stronger solvency positions reported by the majority of players, continued profitability and improved underwriting discipline.

The growth has also been accompanied by enhancements to the competitive structure, improvements in innovation and a greater degree of differentiation in the market, offering consumers a wider range of products and services. In particular, the advent of bancassurance and bancatakaful has seen more players packaging life insurance and family takaful with innovative investment options that incorporate banking product features. Today, bancassurance and bancatakaful constitutes a significant feature of Malaysia's financial landscape, and continues to develop rapidly in terms of market reach and operational sophistication.

The recent passage of the Insurance (Amendment) Bill on Financial Advisers marks yet another important milestone in ongoing efforts to achieve a more diversified market structure. With the legislative framework now in place, I am pleased to announce that Bank Negara Malaysia will soon be issuing licences for financial advisers. The introduction of financial advisers in the Malaysian insurance industry will further diversify the distribution system for life insurance. Corporate bodies with a minimum paid-up capital of RM100,000 will be eligible to apply for a financial adviser's licence. Similar amendments to the Takaful Act 1984 will be undertaken in the near future within the context of more substantive and wide-ranging changes to the current legislation.

Our foundations for financial stability will also continue to be strengthened with the ongoing evolution of a more diversified and balanced financial structure. Today, Malaysia stands at the forefront in the provision of comprehensive Islamic financial services covering banking, takaful, and the capital and money markets. In the area of takaful, Bank Negara Malaysia continues to undertake initiatives aimed at developing significant market players that are able to compete effectively and efficiently.

Although the organic growth of the existing takaful operators may meet the current demand for takaful products and services, it is envisaged that players with strong capabilities in operational and risk management, and product development would hasten the further expansion of the takaful industry. In May this year, the Bank announced the issuance of up to four new licences for takaful operators. The additional takaful licences are offered to sound financial institutions, with priority accorded to those with experience in Islamic banking, takaful or insurance business. It could also include joint ventures or consortiums of financial institutions, which includes at least a banking group. Such joint ventures or consortiums would enable the new takaful operators to leverage on the expertise, experience and infrastructure of their partner financial institutions. In line with the liberalisation in the Islamic banking industry, foreign equity interest of up to 49% will be allowed in the takaful entity to secure strong shareholders, and foster meaningful strategic alliances.

For insurers, the potential to participate with strong local and foreign partners in the new takaful operators will open up significant opportunities to expand their product offerings to include a comprehensive range of insurance and takaful products. Existing takaful operators will therefore need to review their business and management strategies in response to the increased competitive elements that are set to shape the takaful industry.

Malaysia has also moved strategically to establish closer economic linkages and integration with our neighbours to enable Malaysian businesses to tap the vast commercial opportunities present in Asia. The Government has already started negotiations on a number of free trade agreements that will open doors to greater market access in the growth economies within the region. These negotiations are currently now at various stages. We remain confident of achieving a positive outcome that will be balanced and mutually beneficial. Specific opportunities for expansion abroad by Islamic financial institutions, in particular, are also being further enhanced through various bilateral and multilateral arrangements. This includes the signing of a memorandum of understanding between Malaysia and the Islamic Development Bank in 2004 to enhance cooperation among member countries of the Organisation of Islamic Conference, or OIC, in the areas of trade, investment, islamic finance and ICT development. These initiatives will pave the way for Malaysian takaful operators to promote and expand takaful and retakaful business to key target markets abroad, in particular, within the OIC.

The net benefits that will ultimately accrue to Malaysia will depend on the ability of Malaysian institutions to develop targeted globalisation strategies that will position them to gain from the first-mover advantages where they arise. This needs to be reinforced with research into the new growth markets, and exploring opportunities for strategic alliances or joint ventures in these markets. At the same time, the growth strategies must also accord an equal *inward* focus on reinforcing financial strength and resilience, human capital development, a strong business reputation and high standards of service and professionalism all of which are the critical success factors for effective strategies abroad.

Maintaining financial stability remains a primary mandate of the Central Bank. In response to the constantly changing financial landscape, Bank Negara Malaysia's approach to the regulation and supervision of the insurance and takaful sectors has evolved to achieve a more robust regime that emphasises three key dimensions: **first**, creating a strong risk management culture that overlays the operations of insurers and takaful operators; **second**, facilitating market-led adjustments that will allow the industry to evolve in response to market, technological and demographic developments, while maintaining sufficient regulatory oversight to maintain financial stability and public confidence; and third , ensuring mutually consistent policies for the banking and insurance sectors.

Two fundamental changes underpinning the Bank's current approach to regulation and supervision are the shift towards "principle-based" regulations and the implementation of a risk-based regulatory and supervisory regime. Increasingly, regulations have focused less on prescriptive rules, and more on establishing the broad parameters for sound financial and business practices that provide substantial flexibility for insurers and takaful operators to apply the principles in the manner most appropriate to their specific circumstances. Under this approach, greater attention is also being given to the creation of appropriate incentives within the system to achieve the desired outcomes.

The adoption of "principle-based" regulations is complemented by an increased focus on risk management in the capital and supervisory framework. On this front, I am encouraged by the industry's positive response to the new risk-based supervisory framework implemented for the insurance and takaful industries since August 2004. The new approach amplifies the focus on institution-specific risks in the supervisory assessment and rating process. Importantly, the framework serves to mutually enhance understanding by the institutions and the Central Bank of the inherent risks faced by the respective institutions, and thereby establish the common expectations regarding the management and control of those risks, taking into account the nature, scope, complexity and risk profile of the institution. This process, in turn, facilitates appropriate supervisory and institutional responses that are *proportionate* to the risk assessments of individual institutions and their systemic impact.

Similarly, the implementation of the risk-based capital framework for insurers will further reinforce the regulatory focus on risk. The adjustments to this framework will take into account the feedback received from the industry on the concept paper released by Bank Negara Malaysia in December last year, as well as the results of the impact study that was concurrently carried out to assess the potential capital adjustments required by insurers. Specifically, the adjustments to the framework are being made to achieve greater consistency between the valuation bases for assets and liabilities, and to fine-tune the asset risk charges. A second consultation paper, incorporating these changes, will be released for further industry comments later this year.

Insurers will no doubt welcome the greater degree of investment flexibility that will be allowed under the risk-based capital framework. It is an important improvement over the current "admitted assets" framework, and one that is also expected to significantly raise the profile of the investment management function within the industry. As the scope for differentiation between institutions increases under the risk-based regime, it will become more critical for insurers to attract, develop and retain the right human capital resources. With the liberalisation of financial markets and the rapid pace of financial convergence, the investment management function within insurers needs to be flexible, risk-focused, and equipped with professionals who are able to respond to the exigencies of the marketplace.

An important component of the new risk-based capital and supervisory framework is the notion of supervisory target capital levels which insurers will be required to maintain under the risk-based framework. This is new to our environment, and has been a matter of some concern to insurers which may view it as an additional capital burden. Although the risk-based capital regime will more closely align economic capital with regulatory capital, it is important to recognize that it necessarily derives its application from industry-wide tests which cannot fully address risks that are specific to an individual institution. The supervisory capital target therefore serves to provide an early signal of emerging difficulties so that appropriate intervention measures can be taken to prevent a further deterioration of conditions which would warrant more drastic and costly actions. For insurers that already adopt robust internal approaches to capital management, the introduction of the supervisory target level *in itself* should not significantly alter existing capital management strategies. Insurers that *do not* yet have such systems in place, will be encouraged to develop them, and thereby enhance their own resilience to adverse changes in business conditions.

The Bank is mindful that developments internationally on this front remain extremely fluid. Work is still in progress on the International Financial Reporting Standard for Insurance Contracts, the Solvency II initiative in the European Union, and the development of cornerstones for solvency assessments by the International Association of Insurance Supervisors. The Bank will therefore continue to maintain an open consultative approach in proceeding with this initiative to preserve our ability to respond appropriately and to ensure its smooth implementation.

Going forward, greater attention will be given to market conduct issues, which recent experience in other markets has shown to be an increasingly important factor in promoting confidence in the insurance and takaful industries. Financial markets cannot operate efficiently and effectively unless market participants act with integrity. This needs to be reinforced with adequate information to consumers and investors to make informed decisions. In today's information era, the business environment has changed dramatically, and with it, the expectations of consumers and investors have also increased. The industry needs to adapt accordingly.

Policy initiatives by Bank Negara Malaysia in the area of market conduct will continue to focus on achieving complete, true and plain disclosures to consumers, thereby equipping consumers to make informed decisions essentially through consumer education initiatives, and ultimately, promoting the fair treatment of policyholders. In this connection, I am pleased to announce that after more than two years of extensive discussions with the industry, the revised Guidelines on Medical and Health Insurance Business have now been finalized. The Guidelines will be released to the industry this month for implementation early next year. This is an important strategic development, both from the public policy and consumer perspectives. Today, medical insurance business accounts for the largest share[1] of non-tariff general insurance premiums in the market, with premiums exceeding RM1.3 billion in 2004. The revised Guidelines have retained a significant degree of product flexibility, and enhanced disclosure requirements to promote increased competition while more clearly defined rules governing

[1] 10,5% of total general gross direct premiums, third (in terms of market share) only to motor and fire business.

minimum policy terms and conditions will be put in place to deliver a reasonable level of protection to policyholders. These requirements will also promote more consistent treatment of consumers in the provision of core benefits under medical insurance policies.

Where regulatory intervention remains necessary, the Bank will continue to balance the business interests of industry participants with that of consumers, to ensure that the costs of regulation are commensurate with its perceived benefits to consumers. In the long term, however, reliance on regulation and supervisory oversight alone is not a sustainable solution to the market conduct and broader confidence issues that confront the industry. The desired outcome should be one where freedom of action is accompanied by an appropriate degree of moral restraint on the part of the market. This requires compatible incentives in the system and a strong ethical foundation built within institutions which will ensure that insurers and takaful operators act responsibly within an environment that allows greater business flexibility.

The strategic issues before us today concern the industry's responsibility to deliver a fair proposition to consumers, its relevance in the changing environment and its readiness in terms of capacity and infrastructure to support and sustain a successful strategy for growth.

It is hoped that discussions at this dialogue will contribute towards the thinking on future corporate strategies as well as on the regulatory responses to ensure sound development. This will be an opportunity to engage actively in the discussions on these keys issues confronting the industry in moving forward. I wish you a successful and productive dialogue.

Thank you.