Zeti Akhtar Aziz: Strategic positioning in a changing environment

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the 2006 Dialogue Session with Insurers and Takaful Operators, Kuala Lumpur, 22 August 2006.

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In a rapidly changing environment, rethinking the future and strategic repositioning needs to be a high priority agenda. Strategic positioning is not only necessary to deal with the new emerging challenges but more importantly, it needs to be part of the process that will shape the future.

The changes taking place are on several fronts.

- Nations are becoming increasingly inter-linked and integrated in a more globalised environment.
- The Malaysian economy continues to experience significant structural shifts into new areas of growth and comparative advantage.
- Consumers are becoming increasingly discerning in terms of the range and quality of financial products and services.
- The financial system is transitioning into a more competitive environment as institutional arrangements become increasingly more deregulated and liberalized.
- Technological advancement has enabled greater innovation in the development of financial products and services, operational processes and delivery channels.
- The regulatory and supervisory approaches to maintaining financial stability are becoming more principle and risk-based.

With these changes intensifying, it is timely to reflect on the emerging issues for the insurance and takaful industry.

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 the challenges and opportunities the changing environment presents. A year ago, the focus of the discussions was on the strategic issues facing the industry as we transitioned towards a more competitive market environment. The emphasis was on the expectations on the industry to deliver a fair proposition to consumers, its relevance in the changing environment and its readiness in terms of capacity, and to support and sustain a successful strategy for growth. While the theme for this dialogue is to focus on how the industry should position itself to meet the new challenges, it will specifically address the transition towards a risk-based and a more self-regulated market conduct regime, and the development of a dual financial system for the insurance and takaful industry.

This year, the dialogue has been jointly organised by the industry with the Bank. The industry's active involvement will be important in making this important event a success. This dialogue will provide an opportunity for deliberations on the strategic issues confronting the industry in the changing environment from the different perspectives between the industry and Bank Negara Malaysia . At this juncture, let me take this opportunity to share with you some of the recent economic and financial developments and the major policy initiatives by Bank Negara Malaysia .

The global economic performance for 2006 has so far been favourable with a more balanced growth among the major economies, including in Japan and Europe . The world economy is however, facing an extended period of high energy prices and its consequent effects on inflation. Following these developments, interest rates have been raised in most economies. While risks are now emerging for a slower growth in a number of the major economies, growth in the Asian economies have continued to remain robust and resilient. This trend has not only increased Asia 's relative significance in the world economy but it has also contributed to a more balanced global growth.

The Malaysian economy has benefited from this favourable external environment. Growth has been supported by both the strengthening exports performance that has be reinforced by strong domestic demand. Domestic demand also continues to be driven by the private sector as private consumption and investment have been an important source of growth. The continued expansion in private investment is particularly important in ensuring the long-term sustainability of the growth.

The focus of the monetary policy in this environment continues to be towards achieving macroeconomic stability. More recently, the higher energy costs have resulted in an increase in consumer prices. In this environment, interest rates have been raised three times. In May this year, a pause in this increase was announced. With limited evidence of demand induced inflation, the assessment is for inflation to moderate in the second half of this year. In addition, the extent to which the external environment will be affected by the higher energy prices and rising interest rates, and its implications on our domestic economy, will be important considerations in the future direction of interest rates. The risk to higher inflation and to the growth prospects will be carefully balanced. Monetary policy will continue to promote sustainable growth in an environment of price stability.

Since the dialogue a year ago, the financial landscape continues to be transformed. The domestic financial industry has seen further rationalisation and consolidation in the banking groups in retail banking and investment banking. While the rationalization in the retail banking industry would benefit from the economies of scale, reduce duplication of resources and promote cost efficiency, the new investment bank framework is expected to bring about the emergence of more effective, efficient and resilient capital market intermediaries. It will essentially result in the consolidation of 32 entities into 16 investment banks by the end of this year. Another significant development in 2005 was the establishment of the Malaysian Deposit Insurance Corporation which will further strengthen the domestic financial infrastructure by providing an explicit guarantee of deposits, while simultaneously reinforcing incentives for the improvement of risk management practices by banking institutions. To promote greater financial inclusion in our financial system, development financial institutions have also been strengthened to ensure that they are more focused and complementary in their objectives and business strategies. A major initiative during the year was to promote increased access to financing to the new areas of growth as well as to small and medium scale enterprises, including for micro enterprises. This aims to enhance the potential and capacity of domestic indigenous enterprises to grow and thus enhance their contribution to the economy.

In the area of Islamic banking and finance, policy initiatives have been implemented to position Malaysia to become a leading international Islamic financial centre. Earlier this month, the Malaysian Government had launched the Malaysia International Islamic Financial Centre or MIFC initiative. This initiative is aimed at building greater intermediation linkages between the East Asian, the West Asian and Middle East regions which will in turn, further expand inter-regional trade and cross border investment flows. This would also contribute towards a more efficient allocation of capital and thus enhance the prospects for mutually reinforcing intra-regional growth. In addition, the enhanced opportunities for raising financing offers would also facilitate greater risk diversification. To achieve this goal, efforts and resources are being directed towards achieving two broad objectives:

- First, to become an international leader in the origination, issuance as well as trading of Islamic capital market and treasury instruments, fund and wealth management services, offshore Islamic financial services, and takaful and retakaful.
- Second, to position Malaysia as a centre of excellence for Islamic banking and finance education, training, consultancy and research. This will not only provide an extensive pool of highly trained and capable expertise to spearhead future development, but will also promote greater innovation in Islamic financial products and services.

Given the functioning of Islamic finance in parallel with the conventional financial system in our financial environment, neutrality in treatment between Islamic and conventional finance products is important to ensure its viability and sustainability. This competitive environment would in fact encourage greater innovation to take place, thereby supporting the development of the Islamic financial services industry. With the much strengthened and more robust Islamic financial infrastructure that is now firmly in place, the Islamic financial services industry is well positioned to tap new growth opportunities to realize its full potential. This will inevitably increase the breadth and depth of the Islamic financial markets and, more importantly, strengthen Malaysia 's position as an attractive and dynamic international Islamic financial centre.

The Bank's regulatory orientation in this changing environment continues to evolve towards a more robust and flexible regime to effectively maintain financial stability. The regulation of the financial services industry in the changing environment will continue to focus on safeguarding the financial system against systemic risk, ensuring the reasonable protection of consumers in financial service dealings and enhancing the efficiency of the financial system. In addition, the regulatory function will also continue to facilitate the achievement of the socio-economic objectives, including increasing the insurance penetration, promoting adequate provision for retirement needs and supporting the growth of target sectors.

While these objectives will provide the basis and direction for regulation, it is recognized that the environment in which financial institutions operate has changed significantly. Accordingly, the regulatory practices have undergone significant change in recent years to ensure that they continue to be aligned with the underlying rationale for regulation. More specifically, the Bank's approach to regulation is increasingly characterised by:

- a heightened focus on, and alignment with, risk;
- anticipatory, rather than reactive interventions;
- greater use of incentives to achieve desired institutional behaviours and outcomes; and
- convergence with international best practices.

Efforts have also been directed at achieving regulation that is more proportionate in relation to its costs and benefits. This has resulted in an expanded regulatory toolkit that is now beyond prescriptive rules, but leveraged more extensively on inherent checks and balances within the system, and on the greater use of incentives to achieve desired institutional behaviours and outcomes. In addition, there has been an increased focus on market conduct and harnessing more active consumerism to reinforce prudential regulation and supervision.

To further reinforce these changes, the Bank has undertaken a holistic review of the regulatory and supervisory structures within the Bank. The internal organisational changes that are being made will result in a complete transition from the current approach to regulation on a sectoral basis, to one that will integrate the Bank's regulation of different financial institutions under its purview along functional lines. In effect, the existing regulatory departments will be transformed into new departments with respective responsibilities for financial sector development, prudential policy, consumer protection and market conduct, and financial surveillance across both the banking and insurance sectors. The supervisory functions will similarly be integrated for financial service groups that include both banks and insurance companies under their umbrella.

We believe this organisational change will deliver a more comprehensive overview and cohesive approach to the development of the financial system, while facilitating a clear distinction between the objectives of prudential regulation and financial stability, and the broader developmental objectives. It will also sharpen the regulatory focus on the management of risk in the financial system in a manner that will more effectively address the basic components of credit, market, operational and insurance risks. For the regulated institutions, this new structure is also intended to promote greater efficiency and competition in the financial system by:-

- minimising regulatory overlaps and duplication within the system;
- preserving regulatory neutrality in the management of similar risks between different financial service providers; and
- ensuring more efficient use of regulatory resources.

The Bank will be communicating the details of the new structure to the licensees in November and December this year. A smooth transition will be ensured to maintain continuity in the major ongoing regulatory initiatives currently being undertaken by the Bank, and clear arrangements will be made for dealings between licensees and the Central Bank during the transition.

Under the new regulatory landscape, the relationship between the Bank and the regulated entities, and thus, the supervisory expectations, will change, as the prudential framework evolves towards a predominantly principle-based and risk-based regulatory approach. There will be a greater emphasis on corporate governance, integrity and transparency as the foundations for industry players so as to maintain investor confidence and public trust. Under this environment, it is also envisaged that insurers, individually or collectively, will play a bigger role in developing market conduct standards, fostering fair market practices and improving financial literacy among consumers. Moving forward, as market discipline improves, and insurers and takaful operators are better positioned to implement self-regulation, further deregulation can be expected. A differentiated regulatory approach will increasingly be adopted, where companies that exhibit strong corporate governance and risk management practices will be given greater regulatory flexibility.

Commensurate with the diversity and complexity of products and services, the continuous upgrading of risk management practices, with improvements in governance standards and enhancements of information management systems will be critical. With the impending implementation of the risk-based capital framework, the responsibility for the implementation of sound risk management and market conduct governance, as well as assessment of risks and management of the financial condition of an insurer, will rest increasingly with the Board of Directors and Senior Management of the insurers.

Integral to the increased flexibility provided under the new regulatory landscape is the highest standards of integrity and ethics in the industry. Indeed, the very foundation of insurance is one that is based on a relationship of trust and integrity. Reputation and trust are indeed the valued assets of the insurance and takaful industries' business. Any lapses in market conduct will have widespread implications on the business and on the industry. Ensuring fair and equitable dealings with customers should also be a priority. In this environment where the industry originates more and more innovative and complex financial solutions, insurers and takaful operators therefore have a responsibility to ensure that: -

- consumers receive sufficient information to be able to make informed decisions;
- that they understand the key features of a policy, including any significant exclusions, before any purchase;
- that the recommended policies are suitable for their demands and needs; and
- that their claims are dealt with promptly and fairly.

The new environment of increased market discipline now places even greater emphasis on stronger corporate governance, integrity and transparency. High standards of integrity should also define the management of the institution's human and physical resources. In this respect, there can be no substitute for the commitment of an institution's leadership to uphold the highest standards of integrity in dealing with its human capital and corporate resources that are managed on behalf of shareholders and policyholders.

Achieving success in an environment of greater competition will hinge on the ability of the domestic industry to innovate and provide enhanced value propositions for consumers. This underscores the importance of capacity building by industry players in research and development, and re-engineering of business processes in search of operational excellence and enhanced customer service delivery. A strong culture of excellence is therefore vital: one that is embedded into all levels of the organization; one that fosters and rewards innovation and service quality.

Increasingly, highly-skilled individuals will be needed to be able to deliver high value-added products and services, adopt advanced business practices, and have the necessary competencies to build consumer confidence and trust. It is, therefore, crucial for the industry to continuously invest in human intellectual capital to create the pool of talent, skills and expertise that will drive the performance of the industry. To meet this demand, specialised training organisations have been established. They include the International Centre for Leadership in Finance (ICLIF), which is now in its 3 rd year of operation, and the recently-launched International Centre for Education in Islamic Finance (INCEIF). The programmes carried out by the Malaysian Insurance Institute (MII) have also been reviewed to meet the evolving demands of the financial sector.

As we move towards the final phase of the Financial Sector Master Plan and into a more competitive landscape, we require robust financial institutions that are resilient, effective and well positioned to serve the nation. In particular, to achieve a financial sector that will effectively facilitate and support sustainable economic growth and transformation. To complement the ongoing efforts to build the capacity of domestic insurers, the Bank will continue to leverage on strategic initiatives to achieve the desired financial landscape which will also be better able to contribute to the socio-economic objectives of the country, as well as to be better to withstand competitive pressures in the provision of insurance products and services.

Consolidation and fostering strategic alliances will have the potential to strengthen the position of the industry to compete more effectively as the market becomes increasingly deregulated and liberalised. In particular, in fostering strategic alliances within the industry, the foreign shareholding limit for new entries in direct insurers has been increased from 30% to 49% to harness the potential for financially strong and internationally known foreign players. This would contribute towards enhancing the development of domestic capabilities, particularly in the areas of technical expertise, innovation and improved operating processes. This will provide an additional avenue for potential foreign partners to participate more substantively in the domestic industry through a strategic equity interest in existing licensed insurers.

As part of efforts to promote good risk management practices in the financial system, the Bank will also consider introducing differentiated premium contributions to the insurance guarantee scheme fund, based on the risk profile of individual insurers. This is similar to that being adopted for the deposit insurance system in the banking sector. This will provide an incentive for insurers to strengthen their risk management practices in order to benefit from lower contributions to the insurance compensation scheme.

It is hoped that discussions at this dialogue will contribute towards providing greater clarity in the thinking on the future direction of corporate strategies as well as the regulatory responses to ensure the sound development of the insurance and takaful industry. On this note, I wish you a successful and productive dialogue.

Thank you.