Zeti Akhtar Aziz: The next wave for the financial system in Malaysia

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the 12th Malaysian Banking Summit organised by ASLI "Taking the Leap in Paradigm Shift of Banking – New Wave, New Ventures", Kuala Lumpur, 5 June 2008.

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In this recent decade we have seen a period of profound modernisation of the Malaysian banking sector. Today, the banking sector has evolved from facilitating and supporting the economic growth process to becoming a significant source of growth. Innovation and product pioneering has proliferated the diversity of products and services offered. The adoption of best business practices, the use of new technologies, systematic cross selling and the new means of interface with consumers have become more pervasive. The banking system is also significantly stronger, reinforced by strengthened institutional structures, enhanced financial safety nets and developed financial markets, that includes one of the most developed bond markets in this region. Progressive deregulation and liberalisation have increased the flexibilities for banking institutions to capitalise on new business opportunities, both onshore and overseas. The strengthened incentives and more competitive environment have also prompted continuous performance improvements. Indeed, these developments have well positioned the banking sector to take the next leap forward.

It is my pleasure to be here this morning to speak at this year's Malaysian Banking Summit which has focussed on the theme, the next wave for the banking system in Malaysia. My remarks today will focus on three areas – firstly, the outlook for the Malaysian economy as developments continue to unfold in the domestic and international economic environment. Secondly, I will discuss some of the key lessons that may be drawn from the recent credit turmoil and their implications for the Malaysian banking system. And finally, I will take the opportunity to share with you some thoughts on our vision for the financial sector beyond our current financial sector masterplan and the thrust of our strategies going forward.

The Malaysian economy enters this more challenging period following several consecutive years of solid growth that averaged 6%. The economy grew by 6.3% in 2007, the fastest pace in three years with the growth momentum being sustained in the first half of 2008. In the first quarter of this year, the economy expanded by 7.1%.

This stronger growth was achieved despite the more difficult environment with slower global growth and increased uncertainties in the international financial markets. The successful transformation of the Malaysian economy in this recent decade has been one of the important contributing factors. It has led to more diversified sources of growth resulting in a more balanced economy. While the external sector remains important, domestic demand now has a more significant role in driving the growth process. In addition, the services sector has become a more important source of growth. Moreover, the agriculture sector continues to expand as Malaysia benefits from the high commodities prices. These developments have continued to sustain our external balance with the current account of the balance of payments likely to continue to record large surpluses.

Going forward, in the next 12 to 18 months, several external and domestic developments need to be taken into account in the assessment of our economic outlook. First, the slowdown experienced in a number of the major economies is likely to extend into 2009. This more prolonged period of slowdown is likely to have spill over effects on other economies including emerging economies. Global financial markets are also expected to remain volatile as the financial stress experienced by financial institutions in these economies continue to have an impact on credit conditions, the housing market and their overall economy. These developments have resulted in a number of institutions scaling back their global operations. The disruptions in the credit markets have already exerted some restraint in economic activity. While the adjustments are still taking place, there remains uncertainty about the full magnitude of the losses and its consequent impact on financial stability and thus on their overall economy.

Despite these developments, indications are that growth remains resilient here in the Asian region, benefiting from the strengthened domestic demand and the increased trade activity within the region and with the non-traditional markets. The region however, still remains highly integrated to the global economy and international financial system and therefore will have to manage the risk of moderation in global growth in the event that a more pronounced slowdown occurs in the major developed economies.

This risk is compounded by the high and rising energy and commodity prices, which are impacting inflation in most countries today. Stronger demand for grains, the diversion of land used for food crops to biofuel crops, the higher transportation costs and adverse weather conditions are some of the factors driving the rise in food prices. As a consequence, rising cost pressures on inflation in the global economy can be expected to persist. Should global growth however, continue to moderate in the second-half of 2008, this can be expected to slow the pace of increase in energy and food prices, which in turn, will moderate the inflationary pressures that are currently being felt.

Several domestic factors have sustained the growth of the Malaysian economy indicating that external demand has thus far resulted in only a modest moderation in our overall growth as the underlying strength of the economy has been able to sustain the resilience of the growth process. This has been underpinned by the strong domestic demand which has become a key driver of growth. The strong growth that has been achieved so far is on account of the robust expansion in private consumption and investment expenditure.

Malaysia's economic structure has also become increasingly more diversified with increased contribution to growth from the services, agriculture and commodities sectors and the resource-based and knowledge-driven industries. Malaysia is also very much part of the regional integration that is taking place. Today, about 63% of our exports are to the countries in the Asian region. Efforts are also being put into forging stronger trade linkages with other non-traditional markets in West Asia and the Middle East and these efforts are now showing positive results. The trade links are also reinforced by increased investment flows within and between these regions. The inflow of foreign direct investment into Malaysia has remained steady while Malaysia's investments abroad, in particular, to this region are increasing.

Finally, an important factor supporting the resilience of the economy in this more challenging time is the sound macroeconomic fundamentals, the high international reserves and the capacity for policy stimulus to be undertaken to manage the risks to growth. The economy is also supported by the favourable financing conditions and strengthened banking system. Ample liquidity amidst a relatively low interest rate environment and declining non-performing loans have sustained private sector access to financing.

The urgent issue that may be raised today is to what extent will the price adjustments announced yesterday have an impact on the economy. Related to this is the extent to which inflation will increase and whether this would in turn affect the country's competitiveness. Key to dealing with these risks is the flexibility of the Malaysian economy. Malaysia has a proven track record over several decades in successfully dealing with difficult periods in our economic history. Each time, the flexibility of the economy, the agility of the private sector to adjust and reinforcement by the policy response, has allowed the economy to emerge stronger. This was demonstrated during the Asian crisis. Within a period of one year, our economy was able to resume growth, expanding by 6.1% in 1999 and by 8.9% in 2000.

The current conditions are by no means of such threatening proportions. If managed well by all parts of the economy, the economy will in fact emerge more competitive and stronger. This will require concerted efforts by the private and public sectors to become more efficient and thus reduce costs. This will also require shifting resources to new areas of activities where Malaysia has the competitive advantage. With the aptitude for hard work and prudent practices, and the ability for reinvention, this can be realised. To a great extent this has been achieved in the financial sector which has now emerged as an economic sector that generates income and employment and accounts for 11% of the economy, from only 4.5% in 1990.

The current increasing inflationary pressures is a global phenomenon, the result of rising international prices of energy and commodities prices. In Malaysia, domestic inflation has increased from less than 1% in April 2004 to 3% in April 2008, primarily reflecting higher food and energy prices. The Bank's preliminary assessment of the impact of the rationalisation of the domestic fuel and energy prices on inflation in 2008, is that it will rise to an average of 4.2% for the year. The initial price impact would be felt in June during which inflation is expected to be in the region of 5%. The increases in prices are expected to peak in the first quarter of 2009 before moderating to less than 3% in the fourth quarter.

As international prices of commodities are expected to continue to remain high and as direct influence over these prices is limited, efforts will have to be focussed on increasing efficiency and productivity to reduce cost and to shift resources to areas of comparative advantage. From the perspective of monetary policy, the concern would be on the potential second-round impact of these price increases, the extent to which they lead to more generalised price increases and whether they pose a serious risk to inflationary expectations.

It must be remembered that the current inflationary pressures is a global phenomenon, and that many of our trading partners and neighbours are having similar or higher inflation rates. Given this fact, the increase in inflation is unlikely to erode Malaysia's comparative advantages in global trade.

The experience during current international financial turmoil have demonstrated fragilities in financial systems even among the developed economies. These events have brought to the forefront key issues regarding financial intermediation, financial innovation and the corresponding regulatory and surveillance mechanisms that need to be put in place to provide the necessary oversight over such activities. Although our domestic financial system was not impacted by the sub-prime crisis, its underlying causes bear important lessons for Malaysia, and indeed, for other emerging economies, as the forces of globalisation continue to drive the modernisation of our financial systems.

Firstly, the combination of a misaligned incentive system, a favourable macroeconomic environment and heightened competition generated excessive risk-taking by financial institutions. Under these circumstances which prevailed prior to the current crisis, financial innovation occurred at a pace that outstripped the capacity of the financial system to manage the risks associated with such innovations. Indeed, one of the fundamental underlying weaknesses was the erosion of sound practices in the mortgage market segment, with banks compromising on sound underwriting standards and risk management practices in pursuit of short term gains and market share. While the banking institutions had increasingly employed sophisticated financial engineering techniques to repackage mortgages into complex structured securities, such financial innovation was not supported by commensurate enhancements to governance processes and the risk management infrastructure and practices. This resulted in a significant underestimation of the risks being borne by the financial institutions and to an overestimation of the capital buffers in the financial system.

Secondly, the events of the financial and credit market crisis have re-focused attention and debate on the susceptibility of the financial system to market failures. Indeed, the crisis unraveled significant gaps in the extent and manner of public disclosures that were made by financial institutions regarding their on- and off-balance sheet risk exposures. Investors on the other hand, were over-reliant on credit ratings which were based on methodologies which were not sufficiently robust, or lacked transparency about the rating parameters. As a result, the effects of market discipline did not occur as expected, while regulators which relied on market discipline to take effect, did not act pre-emptively to add discipline where it was needed.

Thirdly, developments in the regulatory, accounting and macro-surveillance frameworks had not anticipated, nor provided for, the complex inter-linkages of the modern financial system. The most significant evidence of this was when large scale downward valuations of assets due to accounting rules heightened risk aversion, which in turn further constricted market liquidity, thereby perpetuating a vicious cycle. Globally, episodes of financial crisis have again demonstrated that market, credit and operational risks are closely inter-linked.

These experiences have underscored the critical importance of good governance, sound risk management, rigorous supervision and a strengthened crisis management framework which is sufficiently robust to withstand extreme market conditions.

The Malaysian banking sector on the whole is sound. Domestic banking institutions, in particular, have benefited from the broad-based reforms and capacity building measures that had been undertaken following the Asian financial crisis. Notably, the consolidation of the banking sector, the strengthened board and senior management oversight functions within banks, and the more risk-sensitive capital and the stress-testing requirements have contributed towards reinforcing the core foundations for a more resilient banking system. Banking institutions have also made significant advances in the adoption of improved risk management infrastructure and practices.

Today, the payoffs from these efforts are evident. The banking sector has maintained a steady growth momentum since the Asian financial crisis, with profitability of the Malaysian banking system growing by 36.7% to record RM17.7 billion in 2007. The exposure of the Malaysian banking sector to the sub-prime market has been minimal amounting to only 0.3% of the capital base of the banking sector.

The Malaysian banking institutions are thus now on a stronger foundation to venture into new businesses, undertake more complex risks and withstand shocks. Their enhanced capabilities are backed by stronger balance sheets, with the risk-weighted capital ratio of the banking sector at 13.2% and net non-performing loans ratio of 3.0%.

On the regulatory front, Bank Negara Malaysia continues to direct significant effort and resources towards strengthening our surveillance capabilities to detect, monitor and to deal pre-emptively with emerging risks and vulnerabilities in the financial system. These efforts have also been reinforced by improvements in the surveillance tools and processes to enable pre-emptive action to be taken to avoid disruptions to the financial system. The supervisory processes have also been enhanced with more granular and holistic risk assessments of the financial institutions.

In terms of the regulatory framework, the Bank will be outlining the approach for the implementation of Pillar 2 of the Basel II Framework. The Bank is providing further guidance in the areas of liquidity and operational risk management, the maintenance of internal capital targets, market disclosures, and the valuation processes and controls – particularly for illiquid instruments. The guidance will also be issued to address the implementation of the internal capital adequacy assessment process within the institutions to complement the minimum regulatory standards under Pillar 1 and will also stipulate the minimum requirements for banks that are adopting the Internal Ratings-Based Approach. Details of the proposed capital framework for securitization will also be released during the year. In addition, the liquidity guidelines will be revised to strengthen the requirements in the management of foreign currency cash flow mismatches over different time horizons.

Corporate governance will remain an important priority of the regulatory framework in preserving a sound financial system. The progressive adoption of more principle-based regulations has placed greater reliance on the effective oversight by boards and the senior management to ensure that the regulatory flexibilities accorded to financial institutions are exercised in a judicious manner. A revised fit and proper standard for directors, senior management and controllers of financial institutions will be issued, complemented by an improved and coordinated strategy for the education of directors of financial institutions to strengthen their oversight responsibilities in a more complex financial landscape.

The recent crisis also brought to light the critical importance of coordinated and prompt response by regulators in dealing with crises, whether through market interventions or in the resolution of banking institutions that are experiencing difficulty. Coordinated actions by the Central Banks in Europe and the United States have relieved the liquidity tensions in the financial markets. However, national arrangements for dealing with problem banking institutions are being severely tested.

Decisive action is vital to ensure the continued intermediation process to stem the spread of the financial crisis within the financial system and to the real sector. Such early action will also reduce the cost of the crisis. For Malaysia the cost of the crisis ten years ago was less than 5% of GDP. Danamodal in fact recorded a pre-tax profit of RM200 million upon full repayment from the recapitalised institutions.

More recently, additional initiatives have been taken to strengthen the safety net, inter-agency coordination arrangements and the legal framework for interventions. Today, we have a holistic financial safety net framework in Malaysia which includes a lender of last resort framework and a comprehensive deposit insurance system. The regulatory and supervisory framework is also supported by enhanced intervention framework for dealing with banks under financial stress. The enhanced supervisory intervention powers is to be embodied in the amendments to the various legislations administered by the Central Bank.

The provision of liquidity support by Bank Negara Malaysia for financial institutions in distress is a key component of the safety net. In light of recent international experiences of bank failures, the traditional intervention criterion of lending to “solvent but illiquid” banks has been put to the test as it becomes increasingly difficult to determine the necessity for intervention as well as the method and timing of such measures. The extension of such support will therefore be based on a careful balance of various considerations, which include amongst others, its potential systemic implications, the cost of the intervention, the cost of failures, avoiding disruptions in the functioning of markets and finally its potential social implications. In order to avoid long term moral hazard, the lender of last resort is based on the rigorous application of viability tests and the “first loss principle”, where losses are borne by the shareholders of the financial institutions. The operational framework also needs sufficient flexibility, in terms of policy instruments, acceptable collateral and range of counterparties, to deal with exceptional market conditions.

Going forward, cooperation arrangements for dealing with crises will continue to be further enhanced. This includes further strengthening current cooperation arrangements among the various regulatory agencies in Malaysia, as well further advancing cross-border cooperation in the region. Indeed, significant strides have already been taken to strengthen the cooperative framework between central banks and supervisory agencies in the region to promote financial stability at the regional level. These have included the establishment of various regional mechanisms for cooperation and coordination in surveillance, information sharing and crisis management. These mechanisms will become increasingly important as regional integration continues to deepen and as more Malaysian financial institutions venture overseas.

The progress that has been achieved in the financial sector has surpassed the initial expectations outlined in the financial sector masterplan. The foundation of a vibrant, sound, stable and resilient financial sector accords the opportunity of advancing the sector to a new level where new opportunities with new formulas and strategies for success can be achieved. The financial sector has been key in supporting the transformation of the Malaysian economy, to increase its significance and to promote a more diversified economic structure. This has been achieved by the increased financing extended via the banking system and capital market. In particular, outstanding loans and private debt securities expanded by an average of 7.8% for the period 2001-2007. Malaysia is also ranked third in terms of access to credit amongst 175 countries surveyed by the World Bank in the Doing Business Report 2007. In an environment of rising incomes and expanding domestic demand, the further modernization of retail banking will be important going forward. With increasing financial literacy and growing consumer sophistication, product pioneering and cross-selling, the trend towards electronic financial transactions will gain significance.

Increasingly, loans to the corporate sector will become less dominant with an expanding and efficient functioning capital market. In particular, the bond market presents opportunities for increased corporate advisory and debt and equity underwriting business. Private debt securities now represent 45.5% of GDP. An increasing trend that will become even more important in the future are the SMEs. By 2010, it is expected that SMEs contribution to the economy will be 37%, and account for 22% of exports. Loans approved by the banking institutions and development financial institutions to SMEs have increased by 34.3% to RM63.2 billion in 2007. This trend is expected to accelerate in the future. Microfinancing is also important for micro-enterprises to accord to greater financial services and hence contribute towards balanced growth.

In the recent three years, the finance and insurance sector expanded by 8.3% per annum, outpacing the growth in real GDP of about 6%. The financial sector now accounts for 11.0% of GDP, with about 140,000 people employed in the industry. Reflecting the higher skilled positions in the industry, the average salary in the industry is 2.4 times the country's per capita income and is amongst the highest in the economy. The financial sector's high demand for skilled talent thus require significant investment.

As part of the strategic positioning of Malaysia to attain a developed economy status in 2020, the financial sector moving forward also has an important role as a catalyst of economic growth. Studies have shown that banks play an important role in promoting the creation of new industries as well as in generating spillover effects on other sectors of the economy. In developing the financial sector, it contributes substantially to the growth of the professional services sector, that includes the network of supporting services encompassing software development, telecommunications, shared services, and legal and accounting services. Often, the ability of the financial sector to play this catalyst role depends on the sector having sufficient critical mass. Such a financial sector is able to play an important role in mobilising talent and business linkages to strengthen research and development efforts and spur innovation in other economic sectors. Through the channeling of productivity, the financial sector can drive endogenous growth in other economic sectors.

Let me turn to two areas where Malaysia has strong competitive advantage. The first is in Islamic finance and the second is shared services and outsourcing (SSO). Malaysia is at the forefront in the development of Islamic finance, housing the world's largest sukuk market with 65.8% of the global outstanding sukuk as at end-March 2008. Building on our established foundation in Islamic finance in terms of experience, infrastructure and knowledge, the promotion of Malaysia as an international Islamic financial hub is expected to catalyse growth in other economic sectors. Positive effects are expected to spill over to the markets and related industries such as the property market and health, education and business services sectors, spreading the sector's growth momentum to the economy.

Similarly, there exists potential for a greater mutually reinforcing relationship between the financial sector and the SSO industry in Malaysia. The financial sector's participation in the SSO sector is expected to provide the impetus for growth in the information communication technology industry as more technology-driven hubs are established in Malaysia. Indeed, Malaysia is ranked as the third most attractive outsourcing centre globally, already housing 123 SSO centres which include leaders in the finance, technology and energy industries.

The liberalisation plan moving forward aims to reinforce the role of the Malaysian financial sector in the next phase of development, capitalising on core comparative advantages whilst reaping benefits from alliances and partnerships. The strategy will focus on the strategic positioning of the Malaysian financial sector, with differentiated strategies tailored towards different sub-sectors and markets. Malaysia will pursue more aggressive liberalisation strategies to maximise our potential in areas where there will be mutual benefits from such greater liberalisation. An area that will be pursued is increased strategic alliances with foreign partners and greater foreign participation in our financial markets. This will be key to enhancing our economic and financial interlinkages with other parts of the world.

In particular, initial advancements to support the ongoing efforts on integration with the other South East Asian nations through the ASEAN Economic Community (AEC) will facilitate broader and deeper economic cooperation in the region. It is evident from the recent ventures abroad by Malaysian banking institutions, that the prospects in the region are recognised. There is tremendous potential for Malaysian banks to reap greater benefits from increased regional integration through diversification of income streams and the fast-growing prosperity of the region. Such the expansion however, needs to commensurate with the institutional capacity. On reciprocal grounds, consideration will be granted towards enhancing the presence of ASEAN-origin financial institutions in Malaysia. Indeed, liberalisation including greater market access may be granted to countries where there are also reciprocal potential for Malaysian financial institutions to promote greater economic and financial integration in the region.

The operating landscape moving forward is going to be increasingly challenging. Competitive pressures and global developments will continue to shape the transformation process of the financial sector. While the growth prospects of the financial sector remain positive, with the financial sector having emerged stronger and more effective, it also has the prospects of staying ahead of the curve, break new grounds in the development and quality of banking services and delivery channels. The ability to compete will drive performance and innovation within the financial sector, raising the potential to contribute to the economy to make the leap towards realizing Vision 2020. There is a high degree of confidence that the Malaysian financial sector will rise to the challenge.

On that note, I wish you a productive and successful seminar.

Thank you.