

Zeti Akhtar Aziz: Current challenges confronting central banks

Opening and keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the SEACEN-BNM Banking and Financial Law School 2009 "Current Challenges in Central Banking – Legal Perspective", Lanai Kijang, 24 September 2009.

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It is my great pleasure to speak at the 5th Banking and Financial Law School 2009, jointly organized by the South East Asian Central Banks (SEACEN) Research and Training Centre, the Institute of Bankers Malaysia and Bank Negara Malaysia. The theme for this year's Banking and Financial Law School on "the legal perspective of the current challenges in Central Banking" has particular relevance in the present environment. Indeed, global attention is now focussed on an overhaul of the financial architecture in the efforts to address the fundamental weaknesses that have surfaced in this recent global financial crisis.

The current policy debates cover a wide ranging set of issues that include far-reaching regulatory reforms to strengthen the foundations for financial stability, institutional arrangements to achieve more efficient functioning of financial markets, effective coordination of financial stability measures and greater clarity of central bank mandates in promoting monetary and financial stability. The theme of this conference also has special relevance to us at Bank Negara Malaysia, as our new Central Bank of Malaysia Act 2009 will come into force later this year. We are very honoured to host the conference for this year and are pleased to welcome so many distinguished members of the legal fraternity, in particular, from other parts of the world to join us at this forum.

My remarks today will focus on three key challenges confronting Central Banks, and how the legal aspects impact the effectiveness of Central Banks. The first relates to building the capacity to manage the increasing uncertainties generated by financial innovation, the increasing prominence of the non-regulated sector and the increasing interconnectedness between financial institutions and markets. Such developments have not only resulted in the emergence of new risks to the financial system but have also changed the dynamics of how risks in the financial system are transmitted to the real economy. In this environment, it is vital to have **a legal and regulatory framework that is robust and dynamic** enough to enable the central bank to respond to these developments.

The second challenge concerns the effective implementation of **financial safety nets** and the effective coordination of the different components of the safety net to maintain public confidence and to support continuous financial intermediation. Appropriate legislation and regulations that ensure credibility and integrity of the safety nets are an essential part of maintaining financial stability.

The third relates to the increasingly and highly **complex financial and economic integration associated with globalisation. This has resulted in a significant expansion in cross-border financial activities** and introduced new sources of risks to domestic financial systems. The recent crisis raised many issues for which clear solutions, or even consensus, have yet to emerge, including on the propensity for home bias in the policy responses, suitable approaches to cross-border resolutions, and the significant challenge of coordinating policies across different legal and institutional frameworks. This is an area where the legal framework remains highly fragmented. A sustainable solution will require legal reforms in particular, to provide certainty and clarity in dealing with crises.

As events in the current global environment have demonstrated, central banking has become significantly more challenging. The issues confronting central banks today are far more diverse and complex, prompting the re-examination of the role of central banks, the capacity to manage and contain risks to monetary and financial stability, and the governance

arrangements and the policy instruments that are needed to support the effectiveness of central banks.

The new Central Bank of Malaysia Act 2009 which was passed by Parliament in July this year represents the culmination of more than two years work to address the issues and challenges that are confronting Central Banks in this rapidly changing environment. The Act elaborates extensively giving greater clarity on the mandates for which we are accountable and providing enhanced powers to undertake these mandates. In the principal objective of promoting monetary stability, it is recognised that price stability is to be achieved in an environment of sustainable growth of the economy. Consideration is thus given to the sustained implications of monetary stability measures on the real economy. The law therefore requires the Bank to take a balanced view to avoid the adoption of rigid frameworks that may result in strong biases that would lead to a fundamental and sustained damage to the economy. This balance is also extended to the explicit role of the Bank in developing an inclusive financial system in its responsibility to develop a sound and progressive financial system. These considerations are particularly important for emerging market economies so as to ensure balanced economic progress and development.

The new Central Bank of Malaysia Act 2009 also institutionalises the autonomy for the formulation of monetary policy, thus providing for the integrity and credibility of the decisions made. It also provides for greater flexibility in monetary policy implementation, allowing for a diversified range of instruments that can now be deployed for the implementation of monetary policy. As financial markets trend towards greater sophistication and demonstrate periods of extreme volatility, central banks must have commensurate capabilities to conduct monetary policy operations in order to maintain price stability. Equally important is the mandate to provide oversight over the money and foreign exchange market to ensure the orderly development and functioning of the markets. These necessary powers are however, combined with a system of checks and balances to enable the Bank to act decisively, but yet having in place safeguards so as to enhance transparency and accountability.

More extensive powers to achieve financial stability

In the area of financial stability, our new Central Bank Act incorporates an explicit mandate of the Central Bank for financial stability. This mandate is articulated in terms of the risks to financial stability that includes risks that disrupts the financial intermediation process (including the orderly functioning of the financial markets), or which affects public confidence. The Act also provides comprehensive provisions for heightened surveillance, pre-emptive actions and expanded resolution powers to facilitate the swift and orderly resolution of financial crises. The Bank may also take appropriate intervention actions to avert risks that stem from unregulated entities.

The Act further acknowledges the importance of coordinated policy measures across different agencies whose actions can affect financial stability. Accordingly, the new Act provides for cooperation arrangements with other supervisory authorities and the ability of the Central Bank to make recommendations to such authorities on measures or safeguards for promoting financial stability. These new powers are complemented by strengthened institutional arrangements in the form of the establishment of a Financial Stability Executive Committee that will be formed to ensure the effective coordination of regulatory authorities in financial resolution.

Enhanced governance and accountability framework

With these enhanced powers, the governance and accountability framework in the Act has also been strengthened considerably. This relates to the enhanced role of the Board of Directors' in the oversight of the management of the Bank. In providing enhanced powers to the Central Bank to address financial stability issues and the strengthening of the oversight

function of the Bank, correspondingly, focus has also been given to governance, internal controls and risk management by the Bank. For this purpose, the Central Bank of Malaysia Act 2009 empowers the Board to establish three specific committees, namely the Board Governance Committee, Board Audit Committee and Board Risk Committee that are chaired by a non-executive director, to ensure the independence of the oversight on the functioning of the Bank.

A comprehensive financial system safety net

Let me now turn to the second key area confronting central banks, namely the need to have in place an effective financial safety net. The global experience in these recent two decades has shown that crises have continued to plague the world and have resulted in massive costs to the economy. Financial safety nets serve two primary purposes, that is to avert risks to financial stability and to reduce the costs to the financial system and economy in the event of a crisis. They also serve an important social purpose of protecting savers and investors.

The first component of the financial safety net is the existence of an effective regulatory and supervisory system to ensure the sound management of financial institutions and the ability to deal with problems affecting financial stability. This includes adequate powers and instruments to mitigate losses to the system in the event of a crisis, restore stability and ensure the continuity of the financial intermediation process. The second is the lender of last resort facility that is provided by central banks to address liquidity stresses faced by financial institutions. Thirdly, is the deposit insurance scheme that provides a guarantee on deposits to protect the savings of small depositors and reduce the prospects for disruptions that could threaten the stability of the financial system.

The effectiveness of the financial safety net depends on several factors. They include the capacity of central banks and supervisory authorities to assess risks, the effective coordination between the different components of the safety net, clear communication strategies and a strong and comprehensive legal framework that supports the operation of the safety net. In Malaysia, the Malaysia Deposit Insurance Corporation Act (MDIC Act) which establishes the Malaysian Deposit Insurance Corporation (MDIC) provides comprehensive intervention powers for the protection of depositors. This is complemented by an extensive operating framework developed between the Central Bank and the MDIC which clearly sets out the responsibilities and obligations of both agencies in promoting financial stability and in financial resolution. In the area of consumer protection, amendments to Malaysia's financial services legislation are also being put in place to provide for the establishment, roles and functions of a financial ombudsman to deal expediently and efficiently with disputes concerning financial services between consumers and the financial institutions.

Let me now turn to the challenges arising from greater financial globalisation and the growing importance of international cooperation in ensuring sustainable economic and financial integration across national borders. In this environment regulators are confronted with the challenge of adapting regulatory and legal norms from a nation-centric system to norms that are more reflective of international business and finance. The issue is how to complement the domestic agenda and the international agenda. Regulatory problems arise not only because of the need for domestic regulators – operating within diverse national regulatory norms and cultures – to cooperate and coordinate in the domestic environment but also across jurisdictions.

Operational and legal issues in cross-border resolution arise where the regulatory frameworks of different countries do not provide for a common solution in areas such as the unwinding of financial transactions and the enforceability of secured parties' rights to collateral in the foreign jurisdiction. Failure to address such resolution issues promptly, generally within a matter of days, can lead to increased uncertainty and potential cross-border conflicts. Authorities must also have access to information that is not regularly

exchanged in the normal course of supervisory cooperation. This needs to be supported by consistent requirements for the coordinated execution of regulatory actions. Equally important is an effective legal infrastructure for the mediation of claims against insolvent institutions with international operations

Concurrence among regulatory authorities on key elements of effective resolutions would be an important step forward. Greater harmonization and clarity about the triggers for action, the tools to return insured funds quickly to depositors, the authority to implement a quick resolution, and the legal powers to restructure and continue key banking functions would allow for more effective crisis management. Hence, it is not just about opening our borders; we need to examine how our domestic regulatory framework interfaces with that of other countries.

International cooperation

The regional cooperation among central banks in East Asia have advanced significantly in this recent decade in the aftermath of the Asian Financial crisis. The focus of cooperation has been in the areas of financial stability, financial markets and payment and settlement systems. The participation in the working, technical and high level committees have contributed towards efforts to facilitate the adoption of international standards for banking supervision and financial stability taking into consideration the regional perspective. It has also contributed towards identifying supervisory priorities and areas of concern that will have an impact on financial stability, and towards improving techniques relating to supervision and surveillance. Challenges pertaining to cross-border issues such as regulatory arbitrage, competition laws, regulatory harmonisation are, however, yet to be fully resolved.

The new Central Bank of Malaysia Act 2009 gives Bank Negara additional flexibility and the mandate to engage in international cooperation. The Act allows for the Bank to engage with foreign supervisory authorities to coordinate and cooperate on financial stability measures. The new constituent law also incorporates a specific provision for the Bank to participate and provide appropriate resources in arrangements, schemes, programmes, or initiatives with any other central banks or international financial institutions or authorities to promote bilateral, regional and international monetary, financial or economic co-operation.

Conclusion

In conclusion, the supporting legal framework for central banking and the financial system is a key element to addressing the challenges faced by central banks. I have highlighted three areas which are currently very relevant in the current global financial system. Central banks in the advanced financial systems have resorted to unorthodox measures to prevent a systemic collapse of the global financial system. While action has been based on the sense of urgency and to avoid a total collapse of the system, in the aftermath of the crisis, an extensive review of the legislation needs to be made. The more challenging part is to effectively address cross-border issues facing national financial systems. Regardless of whether we are in a state of crisis, these challenges will continue to be relevant given that conditions will continue to be dynamic and the trend towards a more globalised world will not reverse.

On this highly complex subject, this two day conference will likely generate highly engaging discussions. I wish the Banking and Financial Law School a highly productive outcome and hope that your stay in Malaysia will be enjoyable and memorable.