Zeti Akhtar Aziz: Key issues confronting the financial sector in Malaysia

Keynote address by Mrs Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Financial Industry Conference 2009, Kuala Lumpur, 17 November 2009.

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It is my great pleasure to welcome you to our financial industry conference for this year. This conference takes place at a time when the global financial landscape is experiencing fundamental change. Even as we meet, events continue to unfold in directions that are likely to fundamentally alter the way in which financial institutions conduct their business. Reforms to strengthen the foundations of financial stability are wide-ranging to improve the supervision and regulation of financial institutions, and the institutional arrangements for coordination and cooperation in the area of surveillance and crisis management within and across jurisdictions. This Conference is organised by Bank Negara Malaysia to engage in constructive dialogue with the industry on developments affecting the international and domestic financial industry, focusing in particular on implications for financial institutions in Malaysia.

Economic developments and outlook

After a challenging beginning to this year, Malaysia is now gradually moving on a path of recovery supported by strong macroeconomic fundamentals and a sound financial sector. Economic activity has continued to show a marked improvement in the third quarter, with positive growth expected in the fourth quarter. This improvement has been underpinned by a recovery in domestic demand, particularly in consumption, supported by better employment conditions, the accelerated implementation of fiscal measures, the accommodative monetary environment and the continued access to financing. In 2010, the Malaysian economy is expected to sustain the growth momentum, driven by domestic economic activity and reinforced by improvements of growth of our major trading partners.

The role of the domestic sector in driving growth is not new. Domestic demand has in fact been the main source of growth for the overall economy since 2003, complementing our large external sector. This trend highlights the fact that our economy is evolving towards a balanced growth model, deriving advantages from our economic linkages with the global economy while at the same time strengthening the domestic sources of growth.

While growth in domestic consumption has been encouraging, the next step towards further rebalancing the sources of growth will be to increase the contribution from investment. A higher level of private investment would further improve our productive capacity and increase the potential for higher growth. In this, many new areas of growth would benefit from higher investment, including in the services sector, as well as in the development of enabling infrastructure for modern economies such as in broadband and green technology.

Rising above the economic challenges

While economic prospects have improved, the road to economic recovery will not be without challenges. Firstly, the better economic prospects for recovery in Asia, and the expectations that Asia will lead in the emergence from the global recession could draw large capital inflows into the region. Such flows would not only lead to more volatile exchange rates, but also to increases in asset prices. Increases in commodity prices could also potentially feed into inflation and affect the economic recovery process. Most economies in Asia, including the policy makers, the financial industry and the private sector, have however, the capacity to manage these challenges. Stronger financial positions, low levels of leverage and buffers built during the good times have rendered the potential to manage the more challenging environment. The role of the financial sector is particularly important in ensuring the flow of financing to productive economic activity is not disrupted, while exercising prudential restraint in an environment of excess liquidity.

Towards the medium term, significant uncertainties remain for the outlook of the global economy. Overall global growth is expected to remain weak over the medium term with structural weaknesses in the advanced economies weighing down the overall economic growth in these economies. Being highly integrated with the global economy, the continued weakness of the advanced economies could present a challenge for overall economic growth for most emerging economies in the medium term. Therefore, it is crucial for the external sector of Malaysia to evolve into a more diversified structure to increase resilience and rely less on the traditional markets for growth. It is encouraging to note that this is already happening. Since 2000, our share of exports to emerging economies has increased from 53% to 66% in 2008. This represents an important trend towards a more broad-based economic integration with the global economy, through increased trade and investment.

Going forward in 2010, to enhance the growth prospects in this more challenging environment is through increasing productivity whereby the same levels of investment generates higher output. Focus also needs to be on high impact investments that will have a higher multiplier impact on the economy. Attracting foreign direct investments through liberalisation and strategic alliances would also contribute to this process. To raise the level of economic performance, it is not only important to invest right, but equally important is to have the enabling environment to maximise the return on investment. The efficiency of financial intermediation is a vital part to the success of this strategy.

International regulatory reforms

Let me now turn to the international regulatory reforms. This global financial crisis has resulted in the world experiencing the worst recession in modern history. This has prompted the world to come together with wide ranging proposals to strengthen the foundations for financial stability and to address weaknesses in the international financial system. A fundamental issue being deliberated is the determination of the balance between private decision-making, the market system and Government intervention. While at one end of the spectrum, the case is being made that there is no other alternative to the market to generate an efficient functioning financial system, at the other end of the spectrum the call is for a more interventionist regime. The solution lies in a balance between these, and the avoidance of an over reaction in addressing weaknesses and excesses that have been built over an extended period of time.

Equally important is to recognise that for markets to function efficiently, institutional and market infrastructure need to be well developed. The incentive structure, the rules of the game, the transparency and the levels of financial literacy also needs to be in place. When these elements are still yet to be developed, as in many emerging economies, it increases the risk to financial stability. For advanced financial systems, however, when the institutional structures and rules became deficient and less relevant, it is necessary for them to be changed. In essence, the environment has become highly dynamic requiring regular regulatory reinvention.

Let me turn to the approach adopted by Bank Negara Malaysia. The recent global developments will not fundamentally alter the main tenets of our approach to the regulation and supervision of financial institutions in Malaysia. It will continue to be a balance between rules-based and principles-based regulation. The principles-based approach is more likely to produce more efficient market outcomes, better risk-alignment and socially responsible behaviour. The approach will also continue to be risk-based, in which the expectations in governance and risk management are higher for the larger and more complex financial institutions, and when these expectations are not met, the Bank will respond with supervisory actions. The Bank will continue to act pre-emptively to deal with the risks, at the institutional and system levels. Judgements will be applied based on a broad range of information available on the potential build-up of risks.

The regulatory framework adopted will continue to be consistent and aligned to international standards to safeguard the stability of the financial system. In this regard, Bank Negara Malaysia will implement the changes by the Basel Committee to improve the risk capture of Basel II for trading book, securitisation and counterparty credit risk exposures. We will also positively consider developments by the International Association of Insurance Supervisors to achieve internationally consistent capital standards for insurance companies. We will be introducing changes to improve the liquidity framework and strengthen the quality of capital, focusing in particular on equity as the predominant form of capital. We also support the global initiatives that are aimed at reducing the complexity of products, strengthening transparency and improving incentive structures.

An area of current international deliberation which will have a significant implication on the domestic regulatory and supervisory environment is the increased emphasis on the macro-prudential dimension of regulation and supervision. A key lesson drawn from the crisis has been the inadequacy of supervision that was primarily focused on individual institutions. Even before the build-up of financial imbalances, the underpricing of risk and increased leverage in the financial system had been identified as sources of potential instability well before the eruption of the crisis. The warnings that were issued by central banks and international institutions were largely ignored and failed to result in appropriate responses either by market participants or by the authorities responsible for the oversight of individual financial institutions or the specific market segments.

This has led to calls to regulate such market excesses through counter-cyclical or macro-prudential measures such as increasing capital buffers in good times which could be drawn upon under stress conditions, the implementation of a leverage ratio to supplement risk-based capital requirements and through-the-cycle provisioning standards. There is also a call for systemically important institutions to be required to meet higher regulatory standards that are reflective of the risks that they pose to the system, rather than a consideration only of their institutional risk profile. The international reactions to these measures have been mixed, mainly because they are extremely difficult to calibrate in a way that will not unduly constrain output potential in good times, while avoiding significant demands for more capital and a confidence crisis during bad times. The Bank will carefully assess the details of these measures as they are released, and we will do so taking into account the regulatory and supervisory regime in Malaysia.

Bank Negara Malaysia has already for some time now, put in place a framework in which the supervision of individual institutions is complemented with macro-prudential assessments. Risks identified at the macro-level provide important inputs to supervisory assessments of individual institutions, while the collective behaviours of individual institutions provide information on the build up of risks in the system. Financial institutions would already be familiar with this through the Financial Stability Report of the Bank and with the stress testing parameters.

The ability of the Bank to undertake surveillance and act pre-emptively to avert risks to financial stability will also be further enhanced when the new Central Bank of Malaysia Act 2009 comes into force on 25 November 2009. This includes the expanded powers for the Bank to undertake surveillance and prompt resolution on financial institutions including on non-regulated institutions that are systemically important. As we continue to refine our approaches, and develop a better understanding of market behaviours, financial institutions will also need to better integrate institutional risk assessments with macro-economic developments.

International reforms have also focused on delivering fair outcomes for consumers. In relation to this, the Bank will continue to ensure that financial innovations are developed to meet the real needs of consumers and businesses, and do not expose the system to excessive risks. Ongoing efforts to strengthen avenues for consumer redress will continue through the establishment of a financial ombudsman and improved product transparency, particularly in the area of pricing, commissions, fees and charges so as to support more informed consumer decisions. Timelines for some of these measures have already been announced. These reforms will be reinforced by strengthening further the current consumer protection framework to address mis-selling practices and facilitating a more effective enforcement of business conduct regulations.

Strengthening the domestic infrastructure for financial stability

An important part of the efforts to strengthen the domestic infrastructure for financial stability is legislative reform. The Bank is in the process of drafting a new legislation that will amalgamate existing legislations governing financial institutions and intermediaries in Malaysia that are administered by the Central Bank. Provisions in the current banking, insurance and takaful laws will be updated to support a more differentiated regulation and supervision according to risk. It will also reinforce the emphasis placed on effective board oversight and enable pre-emptive supervisory and enforcement actions by the Bank. This will include the introduction of a broader and more flexible enforcement framework, with consideration to civil and administrative penalties to deal with different types of offences. Proposed legislative changes also include the introduction of a more comprehensive insurance compensation system for the protection of policyholders. The draft legislation is expected to be completed in 2010.

Progressive liberalisation of the financial sector

This year marks the ninth year into the implementation of the Financial Sector Masterplan. Following the release of the Plan in 2001, more than 90% of the recommendations in the Plan have been implemented. Collectively, these measures have contributed towards achieving a more efficient, effective, stable and resilient financial sector as was envisioned in the Masterplan. This is evidenced by the significant transformation of the financial system that is now more diversified with well developed financial markets and broadened product offerings, that is more competitive with home-grown regional players, that is more inclusive with higher levels of banking and insurance penetration, and with improved financial strength indicators as financial institutions are better supported by strengthened governance and risk management standards and practices.

The development of Islamic finance has also made significant strides both in the domestic and international front as Malaysia evolves as an international Islamic financial hub. Enhancements to the payment infrastructure have also supported the increased use of e-payment channels. With these building blocks in place, the financial system has also been progressively deregulated and liberalised. The more recent liberalisation to allow for greater foreign participation in the domestic financial markets and increased foreign presence will enhance further our financial and economic international linkages.

As we move into the final phase of the Masterplan, we are confident of the strength and resilience of the domestic financial sector to face greater competition and benefit from the liberalisation measures recently announced. We have received strong interest in the new licences from Asia, the Middle East, Europe and the United Kingdom that bring with them strong value propositions that will add significantly to the depth and breadth of the financial sector in Malaysia.

In the insurance sector, greater competition will emerge from the progressive deregulation of product rates. The current reforms in the motor insurance sector will introduce far-reaching changes in a key segment of the industry, with significant implications for the business strategies of insurers and their approaches to risk management. With the introduction of a new scheme for basic motor insurance cover, pricing for non-statutory motor insurance will be gradually liberalised, thus removing price distortions. This will allow rates to adjust to underlying risk factors. This will also be accompanied by a holistic review of motor insurance practices and the supporting infrastructure to enable more scientific underwriting and improve claims management. Industry groups have been formed to study these issues and make recommendations for the smooth transition to this new and more competitive environment, while at the same time improving practices across the entire value chain of the motor insurance sector. The groups have made good progress and the recommendations are expected to be finalised for implementation in the second half of 2010.

A new blueprint for the financial sector

Beyond this international financial crisis and economic recovery, a global shift is taking place that is resulting in an increasingly multi-polar world. In this new phase of globalisation, the concentration of economic power in the global economy will become more dispersed. Asia will be very much part of this new future that is emerging. As Asia's importance as a growth centre in the world economy increases, three major trends can be expected to intensify going forward. First, domestic demand, supported by the large and fast-growing middle income and young population in the region, will increasingly have a greater role in driving economic growth in Asia. This would contribute towards a greater balance between domestic and external sources of growth. Second, the diversification of external markets will accelerate, towards greater economic inter-linkages with emerging economies in other parts of the world. Part of this trend includes the creation of the ASEAN Economic Community by 2015 in which ASEAN will transform into a single market with free movement of goods and services. This will include the lifting of restrictions to the flow of capital in the region. And third, is the greater financial integration within Asia that will result in an increased part of the savings in Asia being reinvested in Asia.

The new spending patterns as incomes rise in the region will drive the modernisation of the retail sector across the region. Financial services to the household sector will become increasingly important in this new environment. Reforms to pensions and retirement benefit systems will be key to providing a more comprehensive social safety net, thus reducing the need for high precautionary savings and encouraging consumption. In addition, the large trade sector in Asia and large capital investments required to move towards higher value-added activity will also provide an expanding market for financial services. The more regionally integrated financial system will allow firms and investors increased options in the regional financial markets for financing and investment. These trends are being further supported by enhanced linkages in the payment systems to facilitate the intermediation of funds in the region.

The economic transformation of Malaysia will move us to the next level of development. Malaysia has been a middle income country for almost three decades, having benefited considerably from rapid industrialisation and integration with the global economy. Moving into the next stage of economic development, the domestic economy will change to a productive structure that is more innovation-driven and knowledge-intensive, with the services sector assuming an increasingly dominant role in the economy. In this next decade, the services sector is expected to account for about two thirds of the economy, with growth focused on higher value added activities.

To support and drive this transformation, a new blueprint for the financial services sector is being developed by Bank Negara Malaysia. The blueprint will chart the next phase of the evolution of the financial sector, with the aim of positioning the financial sector, including Islamic finance, not only to become a catalyst to the transformation process, but also having the flexibility to respond to the key trends that are emerging. In essence, we need to evolve a financial system that best serves Malaysians in this new environment.

As the global financial services industry going forward strives to regain thrust and confidence, the starting point in Asia is to build on the solid foundations put in place during the decade following the Asian financial crisis. Asia is seeing the payoffs from the financial reforms, institutional development and the strengthening of the financial infrastructure. While financial markets have become more volatile, financial intermediation has not been interrupted.

While our starting point is from a position of strength, we must nevertheless draw upon the lessons from the current crisis. The lessons from the crisis must not be lost. This crisis offers Malaysia and other emerging markets an opportunity to steer the future path of development of the financial sector to a stronger and more sustainable path one which avoids the trappings of greed and reckless behaviour that have significantly set back the financial sector in many advanced economies. It would be foolish of us not to take heed of these lessons and leverage on the opportunity to leap forward on a more solid foundation.

Despite these developments, going forward, the trend for liberalization will continue as financial integration in the region will intensify. This will mean greater foreign participation in terms of new institutional presence, strategic alliances and greater participation in our financial markets. Efforts to develop further our foreign exchange market will be intensified. Our financial links will also need to extend beyond the region to facilitate economic links with other emerging economies.

On the domestic front, financial services to SMEs need to evolve from transactional and lending-based business to a full-service, relationship-based business. The household sector, already an important segment being served by the industry, will see further transformation with the continuing evolution of multi-channel distributions with online channels becoming more popular and increased customer demands for product transparency and overall service levels. We expect to see a re-orientation of processes and incentives towards value over volume, further differentiation in the management of customer-relationships and an increasing focus on technology-driven transformations that are more aligned with business strategies. The outgrowth of these strategies will include an accelerated shift in product offerings towards more comprehensive end-to-end financial solutions and further changes in the traditional roles of physical branches and intermediaries, with greater use of more efficient direct channels and strategic alliances to widen the outreach of financial products and services. In the area of e-payments, the creation of a mobile ecosystem is envisaged, to provide an open and inter-operable platform for all financial institutions, mobile network operators and services providers to offer highly automated and cost-effective mobile payment services.

Going forward in this new financial system, the role of boards of financial institutions in determining the risk appetite of their institution, in ensuring that strategies are consistent with that appetite and in overseeing risk management systems will become increasingly critical. Shortcomings in how boards discharged their roles in a number of major international financial institutions were a material contributor to the global financial crisis. Boards must be relentless in pursuing the effective governance of risk, continuously develop their capacity to do so, and insist on strengthening processes, systems and structures as appropriate to effectively monitor and control risk.

Conclusion

Let me conclude my remarks. We need to prepare ourselves for a future in which we can prosper. We have every potential to do so. The authorities have great determination to provide the enabling environment for this to happen. Financial institutions need to decide on their own strategy and the business model to not only perform but also survive in this more challenging environment. The demands are for world class service and real value added to the economy. For the Central Bank, as the supervisory authority, our role will be to push the frontier of the financial infrastructure with its international inter-linkages, while not losing sight of ensuring overall financial stability.

On that note, I look forward to productive discussions during these next two days on the key issues confronting the financial sector.