Zamani Abdul Ghani: Sound risk management to boost bottom line and strengthen resilience

Keynote address, by Mr Zamani Abdul Ghani, Deputy Governor of the Central Bank of Malaysia, at the MII International Risks and Risk Management Conference (IRRMC) for Insurance Sector 2010, Kuala Lumpur, 1 June 2010.

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I am most pleased to be here today to officiate this International Risks and Risk Management Conference for Insurance Sector 2010. This conference is organized by the Malaysian Insurance Institute, with the theme “Sound Risk Management to Boost Bottom Line and Strengthen Resilience”. It surely provides an important platform to discuss emerging risks faced by the insurance industry and to share the latest developments in risk management standards and techniques in managing insurance business.

Global economic developments and outlook

The past two years have been a tumultuous journey for financial players in the global arena. The global financial crisis has tested the robustness and resilience of financial systems around the world, the after-effects of which are still being felt today. The implications of the financial crisis have shaken the foundations of the entire international financial system. Malaysia was most fortunate, however, to be mildly affected by the global financial and economic crisis. This is due to the swift and concerted policy responses by the Malaysian Government and the existence of a robust and resilient financial sector in the country. The dynamism and strong fundamentals of most Asian economies are also contributing factors. The Malaysian insurance sector is also fortunate that the global insurance sector has also, to a certain extent, been insulated from the worst aspects of the global crisis.

The above not withstanding, we must always bear in mind that as institutions grow bigger and become more complex, they are more vulnerable to contagion risks and spill-over effects. A pertinent example is that of the American International Group (AIG). AIG suffered a liquidity crisis when its credit ratings were downgraded due to the mounting losses arising from its Financial Products division during the sub-prime crisis beginning in 2008. More recently, the European Union faced one of its gravest crisis as Greece’s ballooning sovereign debts spiraled and threatened to unravel both the European Union and the Euro currency. What are the lessons from these examples? A fundamental point is to realize that the financial world is now a web of risks, with complex inter-linkages between different financial markets and sectors. The highly contagious effects of a failure of a single entity in one part of the world on all other connected parties illustrate the tremendous importance of sound and effective risk management in today’s financial world.

Due to the inter-connected economies around the world, Asia has not been isolated from the spill-over effects of the global financial crisis. The Western economies continued to be bogged down by slow and hesitant recovery with weak economic growth and high unemployment rates. Emerging economies, particularly in Asia, however, have been resilient through these financial challenges. This is attributable to various policies and practices adopted in the region following the lessons learned from the Asian financial crisis in 1997–98.

On the local front, Malaysia has been largely successful in dealing with the challenges brought about by the global crisis. The economy has recovered beginning from the fourth quarter of 2009. Prompt government responses and initiatives, as well as the existence of strong macroeconomic fundamentals and a sound financial system are the principal factors. In the first quarter of 2010, most Asian economies registered robust growth, with Malaysia recording a 10.1% real GDP growth. Another recent measure of Malaysia's resilience is its rating in the IMD World Competitiveness Yearbook 2010. Malaysia's global competitiveness ranking improved significantly from 18th place in 2009 to 10th place in 2010, out of 58 economies. Malaysia has successfully issued a US$1.25 billion sovereign Sukuk (Islamic bonds) last Friday with large international demand even during a period of volatile financial markets. This further attests to Malaysia's success as well as international acceptance of Malaysia's standing as a major international Islamic financial centre.

Although Malaysia fared relatively well during this crisis, we should not be complacent. We should leverage on the lessons learnt from this and the late 1990s crises to improve our resilience to any future shocks. There is at present obvious optimism among financial institutions following the improved economic outlook and market sentiment. It is crucial to ensure, however, that this does not result in unchecked increases in risk appetite or compromises the quality of risk management practices. What was once a "black swan" event has increasingly become more common due to the high inter-linkages between international economies. As such, we need to be vigilant and ensure all potential risks are addressed and comprehensive risk management measures are adopted, both at the macro and micro levels of the economy.

Regulatory reforms in line with risk management

Let me turn now to the regulatory reforms in line with the risk management practices. The global financial crisis has exposed weaknesses in the existing international financial architecture and highlighted the fragmentation of regulatory rules across different jurisdictions. It has been a wake-up call for the world to come together to implement regulatory reforms to strengthen the foundations of financial stability and address the issues in the international financial system. For Malaysia, the recent global developments will not alter much the fundamental tenets of Bank Negara Malaysia's approach to the regulation and supervision of the financial institutions. During the past decade, we have developed and implemented our Risk Based Supervisory Framework and our Risk Based Capital regime. Under these benchmarks, regulatory capital requirements and Bank Negara's expectations in terms of governance and risk management are already well aligned with the specific risk profiles of individual institutions. The risk assessment and supervision of individual institutions are also further complemented with macro-prudential assessments to monitor the aggregation of risks in the financial system.

In 2009, i.e., during the height of the global financial crisis, Bank Negara continued to focus on developing and consolidating a comprehensive set of standards on corporate governance and risk management practices. These standards encompass overarching principles on risk governance with more specific guidance on the management of market, credit, liquidity, operational and insurance risks. Further efforts of Bank Negara include organizing the Financial Industry Conference on risk management. This Conference has encouraged further dialogue on key risk challenges facing the financial institutions and how financial institutions can further enhance their resilience to these challenges. A major milestone was the enactment of the new Central Bank of Malaysia Act 2009. This Act, which came into force on 25 November 2009, has further strengthened the ability of Bank Negara to undertake surveillance and prompt resolution to avert risks to financial stability.

The existing Financial Sector Master Plan is currently in the final phase of its implementation. The measures under the Plan, which were undertaken during the past decade, have contributed towards achieving a more efficient, effective, stable and resilient financial sector. This has in turn resulted in more developed financial markets, broader and better product offerings, as well as higher levels of insurance and Takaful penetration. This trend of liberalization is expected to continue, whilst the banking and insurance sectors could possibly see further consolidation, convergence, and competition within the region.

Development of insurance sector in Malaysia

Despite the challenging external conditions posed by the global financial crisis, the Malaysian insurance industry has, on the whole, remained resilient. The industry-wide Capital Adequacy Ratio stood at 242% at the end of the first quarter of 2010, well above the benchmark supervisory target of 130% set under the RBC framework. Total net premiums and contributions for insurers and Takaful operators grew by 8.2% during 2009. This was driven by growth in the ordinary life segments of the life and family Takaful industry, and a broad-based demand in the general sector. Also of significance is that insurers in Malaysia have performed considerably well in managing and responding to the challenges of lower investment returns and the lower interest rate environment following the global financial crisis.

Also notable is the rapid progress of Malaysia's Islamic financial industry which has become a competitive sector and one of the key drivers of economic growth in the country. As Malaysia evolves and emerges as a major international Islamic financial hub, Bank Negara will continue to play an active role in promoting Islamic financial products and services, supporting the enhancement to the payment infrastructure and progressively deregulate and liberalize the financial system. More recently, the liberalization to allow for greater foreign participation in the domestic financial markets will create further international linkages for Malaysia's Islamic banking and Takaful industries.

As Malaysia moves into the next stage of economic development, by transforming from a mainly production-based economy to a more innovation-driven and knowledge-based economy, the financial services sector will play a prominent role in this evolution. In support of this transformation, Bank Negara Malaysia is developing a new blueprint for the financial services sector. This blueprint will chart the next phase of the development of the financial sector, position the financial sector as one of the main catalysts for the transformation of the Malaysian economy and ensure our economy remains robust and resilient to respond to any emerging risks.

Risk management for insurance institutions

It is expected that the financial sector in Malaysia will expand and become more complex and inter-connected over time. Therefore, the corporate governance and risk management practices in insurance institutions will also need to evolve to keep pace with the fast-changing environment. It is a fact that institutions which performed better during the crisis were consistently differentiated by more robust governance and risk management practices. According to a recent Towers Perrin survey of major U.S. corporations, failure in risk management has been cited to be the key characteristic of financial institutions that suffered large losses during the global financial crisis. Thus, improving risk management was the top priority of CFOs in reaction to the global financial crisis. Prioritizing risk management is even more important for insurance companies. This is due to the fact the core activity of insurance involves risk-taking and risk-transfer, and that insurance risks are usually long-tailed.

Under the Risk Based Supervisory Framework, corporate governance and risk management has always been an integral part of Bank Negara's supervisory assessment of insurance institutions. To form a supervisory view of an institution, Bank Negara evaluates how an institution manages the inherent risks within its significant areas of activity. The Bank also assesses the quality of the oversight and control functions and tests the resilience of the institutions to different risks under stress conditions. Therefore, it is critical for an insurance company's internal policies and control mechanisms to be effective in shaping the desired risk profile. This risk profile should commensurate with the level of capital and capabilities of the company.

The Bank also initiated, in 2008, the Financial Institutions Directors' Education (FIDE) program to promote good corporate governance and risk management practices. Feedback from the directors who attended the program revealed a deeper appreciation of the importance of sound corporate governance and active engagement of the Board in risk management and strategic issues. We have also observed that the practices of financial institutions in Malaysia showed evidence of strengthened risk governance culture. In particular, we observed higher commitment by Board members, strengthened authority of the Chief Risk Officer (CRO), and more comprehensive oversight of risks.

It is important to recognize that risk management should not be a “black-box” discussion that is confined to high level management. Risk management should be an enterprise-wide process involving all levels of business functions. The top level management is responsible for putting in place a well-defined risk governance framework and formulating the appropriate risk strategies. At the operational level, the roles of the business units are to ensure that key risks are appropriately identified, assessed and mitigated.

We are all aware, therefore, that risk management is a dynamic and iterative process. Risk management is not a one-off exercise. Instead, it is a continuous cycle. Hence, there should be genuine awareness, ownership and accountability of risks throughout the company. Every employee should see himself or herself as a risk manager!

It is exciting to see the breath of the topics for this Conference. And it is even more encouraging to see risk experts from different countries like the United Kingdom, Hong Kong, Singapore, Philippines and Malaysia coming together to exchange information and experience. I am also pleased to note that some of the discussions will cover the Takaful perspective. This will include discussions on the impact of Shariah requirements, as well as sessions on financial management and business continuity management for Takaful business.

In closing, let us remind ourselves again that risk management is a corporate culture and everyone plays a role in the process. Your roles are critical in ensuring that the key risks, both present and foreseeable, are identified and effectively mitigated. With concerted efforts from all parties, an effective risk management process will enable companies to minimise financial losses, and optimize business practices, in order to respond to the changing business environment.

I am very confident that this Conference will be a great platform to catalyze open discussions among market players on the key issues relating to risk management. It will also provide good opportunities for business networking. On this note, it is my pleasure to declare open the International Risks and Risk Management Conference for Insurance Sector 2010.