Zeti Akhtar Aziz: Forces of change

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Financial Industry Conference 2010, Kuala Lumpur, 3 November 2010.

*   *   *

It is with great pleasure that I welcome you to this year's Financial Industry Conference. One year hence from our Conference in 2009, the world is still confronted with the same challenge – achieving a self-sustaining economic recovery. The encouraging signs of recovery that emerged a year ago have now given way to increasing uncertainties on the sustainability of this global recovery. Considerable uncertainty also remains on how the announced regulatory reforms will be implemented and on its consequential impact on growth and on the financial intermediation process. In addition, market conduct challenges, the uncertain outcomes of the unconventional and exceptional measures as well as the considerable pressure on the public finances have added to the rising uncertainties on the sustainability of global growth.

I. Economic outlook

As the effects of the massive policy support begins to wear off, growth in the advanced economies is slowing, weighed down both by crisis originated factors and structural issues. Unlike in the early part of the financial crisis, policymakers in the advanced economies now have limited policy flexibility to undertake further measures to support growth. Amid these increased uncertainties, there has been heightened volatility in the international financial markets, arising in part from increased sovereign credit risks and, more recently, the sharp movements in the major currencies in the foreign exchange markets.

In contrast, the recovery in the emerging market economies, in particular Asia, remains robust, with the potential for relatively strong growth to be sustained. While most Governments in Asia had an important role in stimulating the economic recovery, private sector activity has been revived and is now having a greater role in driving the economy. Also, with rising intra-regional trade, external demand from the region is providing additional support to growth. Amid this favourable growth prospects, the region however is also confronted by a number of challenges. As highly open economies, the weaker global environment will, and indeed, has already resulted in a moderation in external demand. In addition, the divergence in growth prospects between the advanced and emerging economies, has precipitated surges of capital inflows, in particular, to Asia. This could in turn lead to the risk in the build-up of destabilising imbalances in our economies.

Asia today, is however, in a better position to address these rising concerns. First, domestic demand has steadily increased in importance since the beginning of this decade and is contributing towards a more balanced growth. Second, is the diversification of Asia's export markets towards increased intra-regional trade which now accounts for more than 50% of the total trade in Asia. Third, the extensive financial reforms and development of the domestic financial markets since the Asian financial crisis have significantly strengthened Asia's financial systems to better manage the more volatile capital flows. In addition, rigorous surveillance is being undertaken. This has allowed several economies to introduce pre-emptive measures to preserve monetary and financial stability.

The near term outlook for emerging Asia going into 2011 remains positive. For Malaysia, despite slower external demand, the overall growth is expected to remain strong, supported by the continued expansion in private domestic demand. Favourable employment conditions, firm commodity prices and an accommodative policy environment will continue to underpin growth in private consumption. Meanwhile, the positive outlook on the domestic-oriented sectors and the recently announced economic transformation programme has improved the investment climate. Intra regional trade is also expected to continue to provide support to the growth and development process.

Transition to high value-added high income economy

Beyond the near term horizon, the Malaysian economy is currently at a significant juncture in its development. The economic future of our country depends on the success in our transition to becoming a high value-added economy. For more than five decades, Malaysia has demonstrated its economic flexibility to adjust to the changing environment and to continuously enter into new areas of competitive advantage. The ability to continue to do this as we advance forward into the future will however, become more challenging amidst the rapidly changing global environment, characterised by increased competition and a higher degree of global and regional economic and financial integration.

Fundamentally, the successful transition of Malaysia towards a high value-added, high income economy will depend on several critical factors. The first is to achieve an orderly shift ***towards new areas of growth and new areas of comparative advantage***. This transformation requires all sectors of the economy to be increasingly involved in higher value added economic activity. In the manufacturing sector, existing industries need to move up the value chain. This will be complemented by knowledge-intensive services sectors, such as information and communication technology (ICT), education and health. While multinationals and large domestic corporations will remain important in these sectors, the contribution of small and medium enterprises (SMEs) have an important role in supporting these new growth areas.

The second critical factor is that ***productivity improvements will become a critical determinant of our future growth prospects***. Continuous increases in productivity characterised by greater innovation and efficiency in production and business processes, are vital to achieve this transformation. Indeed, such productivity improvements are taking place in the financial sector. The comprehensive efforts in capacity building and institutional development in the early part of this decade have resulted in the opportunity to achieve scale, and thus allow for increased investment in technology and in people. Increased competition also facilitate this trend. The higher productivity levels and thus the value added to the economy by the financial sector has increased to 11.7% of GDP in 2009, compared to 9.2% in 2000. Commensurate with the higher value added by the financial sector is also reflected by the higher average wage in the sector which is about 70% higher than the national average. This trend towards higher productivity levels needs to be generalised throughout the economy.

For the successful shift to higher value added activities and for productivity to become an important driver of growth, new talents are required to achieve this. ***Human capital development is, at the heart of Malaysia's transition to become a high value-added economy***. Physical capital accumulation will no longer be sufficient for Malaysia to make the transition into a more innovative and entrepreneurial society. A fundamental rethinking of our education system is thus crucial for the effective development of talents with the necessary skills and competencies required to achieve this. The cultivation of continuous learning is needed for the constant upgrading of talents. In the financial sector, there is now a comprehensive institutional arrangement to generate the supply of the right kind of talent required by the industry – from pre-employment to leadership development not only to focusing on the development of technical skills but also on the capabilities that practitioners require in the context of an emerging economy.

The fourth critical factor is the ***extensive enabling infrastructure to facilitate private sector economic activity***. Malaysia already has in place high quality physical infrastructure but considerably more is needed. Steps already being taken include the development of an efficient urban public transportation system, reliable and seamless broadband connectivity and energy efficiency-related infrastructure. This also needs to be reinforced by the transformation of the Government machinery to support the transition to a high value added economy.

The final and fifth factor is the ability to effectively participate in the economic and financial integration with ***other emerging economies in particular with that of the region***. Asia, in particular, offers immense opportunities for increased participation by Malaysia. Indeed, there is already rising investment into the region by Malaysian companies and this trend can be expected to continue over the medium term. This is particularly pronounced in the financial sector, where Malaysia's domestic financial institutions are now increasingly having a greater presence in the region. Of importance, is that such ventures yield mutual benefit. There must also be value added to the countries concerned so as to ensure the sustainability of such ventures.

II. Financial stability and potential risks in the financial system

Let me now turn to the financial system and financial stability. The Malaysian financial system has continued to perform well throughout 2010, with a high degree of resilience and stability even under the more challenging conditions. The capital positions of both the banking and the insurance sectors have remained stable, well above the regulatory requirements. Asset quality in the banking sector have continued to improve, with the net impaired financing ratio as at end September 2010 at 2% while the loan loss coverage ratio is at 90%. The more favourable economic conditions and the positive outlook have also resulted in strong profits being recorded by the industry.

While these developments affirm the underlying strength of the financial sector, there needs to be greater vigilance on potential risks to the system. The ***first*** relates to the rising level of household sector indebtedness. Debt accumulation by the household sector has expanded rapidly, during the three year period leading up to 2009. Increasing at an annual rate of 9.3%, household debts now account for 73% of GDP. While the household balance sheets at the present remain healthy, household debt above prudent and sustainable levels would become an area of concern. In addition, history has shown that excessive risk-taking practices by banking institutions that involve indiscriminate lending practices with inadequate regard to the aggregate debt obligations of borrowers would contribute to financial instability with its consequences not only on the financial system but also on the economy.

This recent global financial crisis has shown that such irresponsible lending practices contributed to the build up of excessive leverage among households, and that this in turn sowed the seeds for negative consequences on both the financial system and real economy. Banks and insurers are, therefore, expected to observe prudent underwriting standards and responsible behaviours in their lending activities. Boards also need to be accountable and ensure that the risks associated with consumer financing are well understood and being effectively managed.

The ***second*** area that is being closely monitored is residential property prices. The aim is to ensure affordable housing for the population and that imprudent financing to this sector does not become a source of financial instability. Generally, the price levels of properties in Malaysia have remained relatively stable, recording an annual increase of 5.6% in the first quarter and 4.2% in the second quarter of this year. At the national level, residential property prices have increased steadily in tandem with economic development and the rise in household income levels. This aggregate growth trend of this sector has remained largely manageable and residential property prices have not deviated from the long term trend. In the more recent period, however, certain specific locations, particularly in the urban centres, have experienced faster growth, both in house prices and the number of transactions. Supporting this trend has been the increase in financing for multiple unit purchases by a single borrower. This suggests investment activity that is of a speculative nature.

While Malaysia is not experiencing a general property price bubble, targeted pre-emptive measures are appropriate to moderate the increases in property prices that are evident in select locations arising from purchases that are speculative in nature. These measures aims to support a stable and sustainable property market, and to ensure that prices of properties remain affordable for the general public. Thus, with immediate effect, Bank Negara Malaysia announces the imposition of a maximum loan-to-value (LTV) ratio of 70% that is applicable from the third house financing facility taken by a borrower. Financing facilities for purchase of the first and second homes will not be affected by this measure and borrowers will continue to be able to obtain financing for these purchases at the present prevailing LTV level applied by the individual banks based on their internal credit policies. This measure is expected to moderate excessive investment and speculative activity in the residential property market and to ensure affordability of homes for genuine house buyer. The objective of encouraging house ownership among Malaysians continues to be an important national agenda.

As part of its continuous efforts to raise the level of financial savvy and sophistication among Malaysians through the promotion of sound financial and debt management by individuals, Bank Negara Malaysia also wishes to announce the introduction of the Financial Capability Programme. This Programme will be offered by Agensi Kaunseling dan Pengurusan Kredit (AKPK) through its nationwide establishments and will commence from January 2011. The Programme is to equip individuals with practical knowledge and skills in money and debt management. This is aimed at promoting sound household financial debt management. Individuals, particularly new prospective borrowers and young adults, are strongly encouraged to participate in this specially designed programme. The Bank will also issue Guidelines on the Conduct of Business for Retail Financing for responsible practices in consumer lending. The aim of these combined measures is to reinforce the conditions for financial stability, promote a sustainable housing market and deliver socially desirable outcomes through responsible lending and borrowing behaviours.

III. Financial regulatory reforms

These measures foreshadow our broader plans and priorities in the area of financial regulatory reforms going forward. While banks and insurers in Malaysia have avoided the pitfalls that have set back some of the largest and most successful global financial institutions, our ambition to develop a dynamic and robust financial system demands that we remain firmly focused on continuously strengthening the foundations for financial stability. This will take into account our assessment of the domestic conditions, and the nature and direction of risks in the financial system. The regulatory regime will be based on the framework of international standards, specifically those set by the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors and the Islamic Financial Services Board.

Following the global financial crisis, the most profound changes in the international standards have been focused on the banking system. However, as a result of more prudent risk management, a rigorous stress testing discipline and being subject to close supervision by the Central Bank, banks in Malaysia are largely already operating at more conservative capital levels than is being suggested under Basel III. While it is recognized that the global reforms have been designed to address problems not faced in our financial system and are guided by different value and incentive systems, it is still important that we embrace initiatives that will enable us to avoid the same such mistakes. As more of our banks and insurers venture abroad into the regional markets, financial institutions will also be assessed by investors, analysts and market participants against these global standards.

Moving forward, after a consultative process with the industry, the following enhancements will be incorporated to the Risk Weighted Capital Adequacy Framework for banking institutions:

- higher capital requirements to support risks in trading activities, securitizations and counterparty credit exposures;
- strengthened definitions and criteria for the recognition of Tier 1 and Tier 2 capital; and
- higher levels of common equity, Tier 1 and total minimum capital requirements which also provide for capital conservations buffers.

The appropriate timing of transition to the new requirements, will be determined in 2011. While the Basel Committee has set a generous timeframe for implementation of the new requirements, we anticipate that given the current position of strength of our banking system and together with other jurisdictions, including those in this region, we are in a position to be on a faster track to adopt the new requirements. In this endeavour, an appropriate balance will be maintained between our priority to substantially strengthen the capacity of the banking system to absorb future shocks arising from financial and economic stresses, and avoiding material competitive distortions that can arise from uncoordinated moves between countries on specific elements of the framework.

Through the continued rigor of our stress testing requirements, the expectations are for banks and insurers to operate at levels that remain sound even under stressed conditions. This will be further reinforced with the implementation of Pillar 2 from 2011, which will accord greater focus on the individual banks' own internal capital adequacy assessment processes to determine the adequacy of capital against their specific risk profiles and capital management strategies.

With respect to liquidity, our existing Liquidity Framework will be enhanced in 2011 to bring it in line with the Basel III standard, while making appropriate customisations to take into account the specific structural characteristics of our market. We will also issue additional guidance to promote more stable funding structures that will increase the robustness of bank liquidity positions, particularly during periods of stress in funding markets. These quantitative liquidity standards will be further complemented by principles for sound and effective management of liquidity risk.

While major agreement has been reached on most areas concerning capital and liquidity, proposals in other areas including the non-risk-based leverage ratio, countercyclical capital buffers and the supervision of systemically important financial institutions continue to be a work in progress at the Basel Committee. It is important that bankers including board members remain current on all these developments and understand their implications on our domestic and regional financial landscape.

In the insurance and takaful industry, there have been continued improvements in corporate governance practices and further strengthening of the capital positions of individual institutions. These improvements have however, been uneven between institutions and overall progress can be further accelerated. We will monitor closely the implementation plans by insurers to meet and maintain internal capital targets that are above the regulatory minimum level. Given the increasingly more complex and competitive environment going forward, smaller insurers, particularly in the general insurance industry, need to strengthen their ability to comply with the higher prudential standards. The option for mergers to form stronger and more resilient institutions would accelerate this process.

In the critical area of corporate governance, we are well advanced in our concerted efforts to strengthen the Boards of Financial Institutions through the Financial Institutions Directors' Education (FIDE) programme which is now managed by the ICLIF Leadership and Governance Centre. More than 200 directors have completed the programme.

Bank Negara Malaysia is also reviewing the need for boards of insurance companies to be served by a dedicated head of risk to provide assurance to the board on the quality of risk management within the firm. This is to promote better risk management systems and processes among insurers and a more integrated approach to risk management and oversight within insurers. The Bank is also reviewing the role of signing actuaries of general insurers which may be expanded to support the more robust management of risks by insurers, particularly with respect to underwriting and solvency assessments. The regulatory framework for takaful operators will also be significantly strengthened with the issuance of the Takaful Operating Framework by the end of this year.

These developments will further strengthen the preconditions for the wider adoption of more principle-based regulations in the insurance and takaful sector. This will include our plans to proceed with the liberalisation of operating cost control limits as set out under our Financial Sector Masterplan. This move will usher in a more competitive environment within a stronger framework of governance, market transparency and prudential safeguards that has already been put in place.

Finally, the work on amagalmating and modernizing the existing legislation governing financial institutions and intermediaries under the purview of the Central Bank is now in its final stages. A key extension of the proposed new legislation involves putting in place a more comprehensive framework for the effective regulation and supervision of financial conglomerates. This will include proposals to cover financial holding companies under an appropriate prudential regulatory and supervisory regime to ensure that the evolution of such complex financial groups does not, over time, pose a threat to financial stability and the safety and soundness of regulated institutions. The proposed new legislation will also provide strengthened legal powers to support more effective market conduct regulation and supervision.

IV. The financial sector blueprint

Let me now turn to our progress on the financial sector blueprint. While the fundamental objective of this blueprint is to achieve a financial system that best serves our country as it transitions to becoming a developed economy in 2020, the formulation of the plan has also drawn from the important lessons of the recent global financial crisis. Most important, is that growth of the financial system should ultimately be anchored to the growth in the real sector.

Based on the rate of growth of the economy projected for the next decade, the financial sector is envisaged to increase in significance from 4.6 times of GDP currently, to between 5 to 6 times of GDP by 2020. Meanwhile, the contribution of the financial services sector to GDP is expected to increase from 11.7% in 2009 to 14% by 2020. Following the increased liberalisation in this decade, this expansion will be based on both domestic and foreign financial business activity.

Also important, will be the changing structure of the financial system. Going forward, the financial markets are expected to have a greater role in the intermediation of funds. Hence, it is envisioned that there will be further deepening and increased liquidity in financial markets as new players and a wider range of financial instruments combine to increase the efficiency of the financial markets. Of increasing importance will be the intermediation of long-term savings, such as insurance and pension funds, and long-term investments such as investments in economic and social infrastructure.

The composition of financial institutions will also show much greater diversity: with banks, insurers and takaful operators offering higher value-added services to serve the more sophisticated customers, with more developed venture capital industry and angel funds providing risk capital for innovative firms, and with development financial institutions stepping up to widen the base of financial services to all Malaysians. In addition, new and existing forms of financing that have thus far remained at the fringes of the financial system such as factoring, leasing and credit companies are expected to become more significant. Spurred by new technologies, such as greater adoption of electronic invoicing and receivables exchanges, it will generate more competition to the traditional players while enriching the product offering, particularly to the SME segment.

The evolution of the financial sector will also focus on the new growth areas that will catalyse Malaysia's transition to a higher value added economy. These include areas of financing such as for green technology, infrastructure development, education, and entrepreneurship and innovation. These are key focal points that will yield increased national productivity, drive innovation and stimulate the formation of businesses. It is anticipated that a significant portion of new frontier industries will be spearheaded by young, innovative SMEs that would require substantial investments in research and development, and for the commercialisation of the research and development. To support these endeavours, a more diversified financial structure, involving new financing modalities will be essential. The new funding ecosystem will thus need to provide comprehensive and flexible financial solutions to Malaysian consumers and businesses.

Recognising the importance of having a payment system that is comprehensive and efficient to support the needs of the consumers and businesses in a high-income economy, the payment system infrastructure would be enhanced and more inclusive, capitalising on the advancements in technology as well as the high number of banking accounts and mobile phone penetration in the country. The focus will be on infrastructure developments necessary to provide the speed and efficiency while offering convenience to consumers and businesses. Electronic payments should be the preferred medium for all economic transactions. This includes having the infrastructure necessary for industry-wide mobile banking and payment ecosystem, including an extensive outreach of the point-of-sale terminal facilities. The pricing structure and a comprehensive awareness programme to steer desirable payment behaviour are also key areas that will be addressed in our next phase of the development of our financial system.

The blueprint will also seek to extend the reach to the potential untapped market represented by the latent demand for financial services among the non-urban population and urban residents in the lower income group. The blueprint will endeavour to develop a conducive environment for the design of financial products and services and the utilisation of delivery channels will effectively overcome the barriers to financial access, particularly cost restrictions and physical accessibility. With greater regional integration, we also see significant potential to leverage domestic strategies to create a strong regional footprint in the provision of affordable and commercially viable financial products and services.

Beyond domestic borders, Asia's continued growth and prosperity offers significant opportunities for the provision of financial services and productive investment prospects. An important thrust of the blueprint will therefore be to develop the financial infrastructure to enhance the linkages within the region. This will be facilitated through the continued process of financial integration and increased connectivity within the region, with greater liberalisation of the financial sector, the integration of payment and settlement systems, and greater cross-border cooperation in maintaining regional financial stability.

Central to the development strategies for the next decade is the consolidation of Malaysia's position as a leading international Islamic financial centre. Malaysia already has a strong brand affirmed by the growing importance of our sukuk market and the higher level of foreign participation in our Islamic financial markets. This is reinforced by the diversity of market players and a comprehensive institutional framework for Islamic finance. Two landmark initiatives achieved this year is the establishment of the Islamic Financial Stability Forum (IFSF) and the International Islamic Liquidity Management Corporation (IILM). Moving forward, Islamic finance is expected to further accelerate its pace of global expansion, having a more significant role in facilitating the intermediation of international financial flows.

A critical factor that will determine the success of the financial services industry is the talents in the industry. With increased international mobility of talent, the global war for talent will intensify. Successful financial institutions will be those that are able to develop, attract and retain talent. Financial services professionals also need to be regionally oriented and able to integrate cross-border businesses effectively. The blueprint will also address this issue to ensure that the sector will be well supported.

In charting the future for the industry, the foundation for financial stability will be strengthened. The focus will be on addressing systemic risks and strengthening crisis management capability. Regulatory cooperation will be enhanced in surveillance and in capacity building for effective cross border resolution of problem institutions. Domestically, significant supervisory attention will be directed towards achieving regulatory consistency in respect to risk assessment for financial groups taking into account the trade-offs and the need for safeguards.

Underpinning the more competitive and dynamic financial sector will also be a deep-seated core value system, with financial service providers operating responsibly, with integrity and offering financial products and services with dignity. More specific institutional arrangements will be considered for market conduct and consumer protection.

In realizing this shared vision for the financial sector, of critical importance is the cumulative participation of the public sector and the industry in the development of the Plan and its implementation. This combined effort will ensure that the new blueprint is comprehensive, relevant and realistic.

V. Conclusion

Let me conclude: Considerable uncertainty remains in the outlook for the global economy and we must thus remain vigilant to emerging risks. Second, in a more complex and interconnected environment, broader prudential and economic considerations must factor more prominently in financial institutions' management of risks. Third, while we believe our regulatory and supervisory system has served us well, we are not complacent and will continue to work hard to place the financial sector on firmer ground so that our ability to manage future shocks will be further improved. And finally, we are confident that with a clear vision, focus and effective implementation, our strategies to bring the financial sector to a new level in this next decade will deliver better outcomes for our financial system and our overall economy.

Thank you.