Zeti Akhtar Aziz: Better supervision and better banking in a post crisis era

Welcoming address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Financial Stability Institute (FSI) – Executive Meeting of East Asia Pacific Central Banks (EMEAP) High Level Meeting Dinner, Kuala Lumpur, 16 January 2011.

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It is my pleasure to welcome you to this Financial Stability Institute (FSI) EMEAP high level meeting for Banking Supervisors. Bank Negara Malaysia is honoured to host this event that brings together senior officials from the regulatory community, as well as, the leadership from the banking industry from the Asian region to discuss Supervision and Banking in this post crisis era.

We are now in a period of profound and fundamental change for the industry and for regulators and supervisors. The issuance of the final reform package by the Basel Committee in December 2010 marks the completion of a key milestone in the international financial reform process that began in the aftermath of the global financial crisis. This process has been complex, involving multiple tracks of intense dialogue taking place, both at the international and regional levels. The journey towards building a more resilient international financial system, however, is far from over.

For this set of reforms that have been issued by the Basel Committee, the next phase involving the implementation will be equally challenging. There is already great anticipation on how the new standards would be phased in, and its impact on the financial sector landscape. Of importance, is ensuring that the implementation of the regulatory reforms does not impair the ongoing economic recovery process. Further, while major agreement has been reached on the key components concerning capital and liquidity, a number of other significant areas still remain largely work in progress. Against this backdrop, it is important that policy makers and the financial industry maintain a continued open and constructive dialogue on developments affecting the industry, in particular, to avoid any unintended consequences from these reforms.

Economic outlook

We are now entering the second year of global recovery. The rebound in 2010 has been largely led by the exceptional performance of the emerging economies, in particular, in Asia. Growth is expected to remain strong this year, although at a more moderate pace compared to 2010. Amid favourable growth prospects, Asia will however have to manage the impact of international developments given its high degree of economic and financial openness. The global attention is currently focused on the fiscal conditions of several of the advanced economies, the progress in the financial reforms and on the monetary and financial measures being implemented in the crisis affected economies. A major challenge for most emerging economies in 2011 will be the management of the highly volatile capital flows. The strong growth in Asia has and will continue to attract this massive increase in global liquidity in the form of capital inflows into the region. This calls for greater vigilance on the part of the policymakers in the region. Several regional economies have already implemented measures including macro prudential measures to preserve macroeconomic and financial stability.

Against the backdrop of continuing uncertainties, Asia is expected to continue to lead global growth, supported by strong macroeconomic fundamentals and sound financial systems. The revival of private sector economic activity has been an important factor in sustaining the strong growth prospects in Asia. On the domestic front, the Malaysian economy is set to register a growth in the region of 7% for 2010. While the external sector may be affected by the slower global growth, the growth momentum of domestic demand is projected to be sustained in 2011, supported by the continued firm expansion in private sector activity. Most encouraging is that private investment is expected to strengthen and become an important contributor to the growth.

Achieving financial stability objectives

Let me now turn to the efforts to achieve greater financial stability. While there is still much work to be accomplished at the international level, an immediate priority ahead is to achieve effective and well coordinated approaches to the implementation of the announced financial reforms. This is important given the greater inter linkages in the global economy. While the outcome of the quantitative impact studies have predicted that the long term benefits of the measures will outweigh the short term costs arising from the adjustments, actual experiences are likely to vary across different jurisdictions.

While individual jurisdictions may be confronted with specific challenges of implementation that may arise from differences in economic and market structures, there is also much in common, particularly among emerging economies, that can be shared among jurisdictions. The period of observation on some of the components of the reform package provided by the Basel Committee is welcomed. It will allow jurisdictions to consider appropriate actions needed to support the effective implementation of the reforms. At the same time, there is an expectation that there will be a willingness by the international standard setting community to adjust or otherwise supplement current prescriptions, frameworks or implementation strategies as more experience is gained under changing market conditions. The effective implementation would also require support for the implementation of the reforms, particularly in the area of capacity building, particularly in the emerging and developing world. Inclusive communication channels with the market and an inclusive process of global consultations will allow us to benefit from the experience of others and, more importantly, facilitate more coordinated policy responses and thus support the orderly adjustments to the new standards.

While the evolution of financial stability policies over the recent two years has seen clearer mandates being established for the regulatory authorities, the framework for financial stability both at the national and international levels continue to be a subject of intense discussion. The focus has been on the efficacy of policy instruments needed to preserve financial stability, the structure and design of decision making frameworks and the institutional arrangements and accountabilities in regard to financial stability policies. An important part of this is that, with the accountabilities, is the need to have broad range of instruments and the policy space and flexibilities to achieve the specific financial stability policy objectives. In addition to this, for many emerging economies, an important mandate is also to develop the financial system. For most Central Banks in emerging economies, this developmental role is integral to maintaining the orderly development of the financial system and hence financial stability over the longer term.

Intensified supervision and strengthened governance

The global financial crisis has also prompted a renewal and further strengthening of supervisory approaches, and intensified efforts to deepen supervisory cooperation across borders. This reflects the growing significance of internationally and regionally active financial institutions. Although the risk based supervisory approach is already adopted in many countries and provides the framework for enhanced risk assessments with more informed supervisory judgments, the methods used to determine supervisory intensity may need to be regularly re examined given the continuous pace of financial innovation and changing market conditions.

As more jurisdictions move to adopt more principle or outcome based approaches to regulation, ensuring rigorous and proportionate supervision, will become increasingly important to ensure prudent risk taking in the financial system. While compliance will remain important, the nature and intensity of supervisory relations with financial institutions are already seeing a more prominent shift towards more open and engaging interactions that allow both supervisors and financial institutions to develop a more complete understanding of risks confronting the institutions and industry as a whole. This also supports current efforts to strengthen the macro prudential orientation to risk management, both at the system and institution level whereby the assessment of institutional risks is complemented by considerations of macroeconomic developments and collective market behaviors that can have a significant impact on financial stability.

The reform measures to enhance the resilience of financial institutions and the supervisory capabilities to identify and assess risks at the macro level are also being reinforced with efforts to strengthen the caliber of the boards and senior management of the financial institutions. In Malaysia, our commitment towards enhancing the performance of boards of financial institution has not only been through the issuance of supervisory guidance, but also with the introduction of a rigorous Education Programme for Directors that was launched in 2008. Beginning this year, this programme is open to directors of financial institutions outside Malaysia. In drawing from the many lessons from the Asian financial crisis and this recent global financial crisis, nurturing of a strong risk culture and ethical workforce within the financial industry is absolutely fundamental to our efforts to promote financial stability and the need for this to start with the board and management of financial institutions.

In the wake of the crisis, greater expectations are being placed on the board and senior management to have more effective leadership and oversight roles. These expectations have in certain jurisdictions been translated into responses that have included intrusive approaches to appointments of directors and key personnel of financial institutions, while at the international level it has resulted in substantial enhancements to existing international supervisory standards on corporate governance. In the process, we are seeing renewed debate and dialogue on how fundamental precepts of governance should be best operationalised to achieve their substance over form, including the notion of separation between oversight and management, the determination of the relevant board competencies in today's environment and the appropriate role of the board, the management and the supervisor in reinforcing sound governance practices. It is thus important for a continuous process of renewal of established practices to preserve the foundation for financial stability.

Scope for greater collaboration

In a world that is highly interconnected, the scope for supervisory cooperation and collaboration for the effective conduct of financial stability policies is now already expanding. The regional cooperation among central banks and supervisory agencies in Asia itself has advanced in many areas, particularly in the aftermath of the Asian Financial crisis. The focus of cooperation has gone beyond the traditional areas of financial stability, financial markets and payment and settlement systems to cover the more technical policies and the forward looking issues. Despite this notable progress, there remains opportunities to leverage more on existing platforms to address more recent challenges pertaining to cross border issues such as regulatory arbitrage, facilitating financial integration, and establishing a more robust framework for regional macro surveillance and crisis management.

The global crisis experience also offers important insights that could further deepen our understanding and cement cooperation in the area of cross border resolution of problem institutions. The ongoing efforts in Europe to implement "living wills" would be of significant interest to this region, from the perspective of their construction as well as implementation. While these approaches are still untested, this exercise will make an important contribution to deepen our understanding on the relevance of business models and the different regulatory structures and legal systems that have an important bearing on the operations of significant institutions with cross border operations.

Moving forward, more experience is still to be gained in regard to effective financial stability communication strategy, an element that has not received much attention until the recent crisis. Credible financial stability communication strategies, particularly during periods of heightened uncertainties will require appropriate timing and delivery as well as effective coordination among relevant agencies. The effective coordination of announcements on the blanket government guarantee and liquidity measures in Malaysia, Singapore and Hong Kong during the recent crisis for instance, had helped sustained the overall confidence in our financial markets. Similarly, there are also lessons to be learned in regard to the experience in the communication of supervisory stress test results in Europe and the United States.

Conclusion

Given the dynamics of the financial markets today, more effective engagements between policy makers and the industry, both within and across borders have never been more important so as to bring about a greater awareness of key financial stability issues, to further sharpen supervisory and management judgements and to promote greater collaboration on multiple fronts. Enhanced prospects for greater global financial stability depend on a sustained commitment to these priorities. Ultimately, the goal is to strengthen our collective ability to anticipate and respond effectively to developments that affect financial stability, not just in these present challenging times, but through what will likely be an extended period of global adjustments going forward.