Zeti Akhtar Aziz: Innovative financing for transformation

Speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Langkawi International Dialogue 2011: Innovative Financing for Transformation, Putrajaya, 19 June 2011.

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The world is transforming. Our motivation for accelerating our own pace of transformation is to ensure that we will be able to effectively participate in this new economic and financial environment, and in the process, maximize our potential performance. Central to this is having a well functioning financial system and the right financial policies. The recent financial crisis in the developed world has shown that when things have gone wrong in the financial system, the consequences have been catastrophic. Instead of creating wealth – it destroys wealth, instead of generating employment – it results in job losses, instead of facilitating economic progress – it derails growth and development.

It is my great honour and pleasure to speak at this 2011 Langkawi International Dialogue on Innovative Financing for Transformation. The overarching objectives of economic transformation is surely to generate sustainable and balanced growth, to improve living standards, to create employment opportunities and to achieve a more inclusive development. This decade has however seen how innovative financing in several of the developed economies have fuelled excessive levels of leverage that have resulted in deeply indebted private and public sectors, which in turn have become highly destabilizing to their financial systems and to their economies. The challenge before us is how then should the financial system be developed and regulated so that these pitfalls will be avoided while at the same time remaining dynamic and innovative so that we can push our frontiers and gain the progress that we aspire.

While innovation remains essential to economic progress, it needs to be within the context of stronger governance and sound risk management practices. Positive innovation can make enormous contributions to economic performance. The financial system has to deliver the essential financial services that would cater to the financial needs of all sectors of the economy – from households, small and medium enterprises, including to micro enterprises and to the corporate sector. The financial system also has to take into account the fundamental changes taking place in the global economy and the growing participation of emerging economies in the global economy. As we become more interlinked, financial systems also need to become more internationalized to facilitate and reinforce this trend.

The role of the financial system is essentially to effectively intermediate and to meaningfully mobilize funds including from across borders to be channeled to productive economic activity. Such intermediation must be firmly anchored and aligned to the objective of generating sustainable and balanced growth, raising the standards of living, creating employment and promoting development. With clarity in the role of the financial system and the importance of its link to the economy, the range of the financial solutions offered needs to meet these highly differentiated and changing requirements.

For the households, the financial system provides a means to optimally spread their income and consumption over their life cycle. Accumulating wealth via saving, investment and borrowing in the initial years, and de-accumulating of the wealth during the later years, such as through pension products and annuity schemes during retirement. This is particularly important as a population matures. The absence of these products will impose tremendous burdens to the government fiscal position and the overall standards of living.

The Malaysian experience has been to encourage diversity of financial product offerings to ensure that the needs of all segments of the population are met. This includes, from having basic banking products at negligible cost for lower income groups, to the wider range of savings, investment and protection products for the middle income groups and for the higher income groups, wealth management and comprehensive advisory services.

In the area of financing, a key priority for any country is financing to promote home ownership. This is to meet an important basic need of society and to encourage wealth accumulation among households. Malaysia approached this by initially establishing Cagamas, a national mortgage corporation, which enables banks to source long-term funding to match long-term housing loans. The national mortgage corporation has continued to evolve to promote the secondary market for housing loans via securitization and mitigating risks in mortgage financing through the provision of mortgage insurance. A recent innovative arrangement introduced this year is the risk-sharing arrangements between the government and banks to provide opportunities for the lower income and younger segments of the population to own homes and thus accumulate wealth at an earlier age.

Another important form of wealth accumulation is the collective investment schemes such as unit trusts. The pooling of savings provides economies of scale, access to professional investment managers, as well as a diversified investment portfolio. In Malaysia, this was initially promoted through the establishment of government sponsored national savings scheme (Amanah Saham Nasional). Participation of the average household has now paved the way for the growth in the private unit trust industry. The formation of such national savings schemes has also contributed to the development of an institutional investor base in Malaysia that has been able to mobilize substantial volumes of savings. The mobilization of these funds provides the potential for funding of businesses and the corporate sector and for project financing including for infrastructure development.

As SMEs and micro enterprises form the majority of business enterprises in most countries, and as they contribute significantly to GDP, employment and wealth creation, efficient access to finance is critical. The Malaysian experience to address this has been the establishment of the Credit Guarantee Corporation to assist viable SMEs with inadequate track record to access financing by providing guarantees and credit enhancements for SME financing. The credit evaluation is carried out by banks, and by the CGC. For countries where SME-credit evaluation skills are scarce, the centralisation of expertise using such an arrangement would be able to facilitate this as banks build their capacity. There have also been a wide range of innovative financial products and services to support this agenda.

A highly successful programme in Malaysia has been the RM2 billion SME Assistance Guarantee Scheme which was established in February 2009 to ensure that viable SMEs adversely impacted by the economic slowdown would have continued access to financing. Under this scheme, SMEs are able to obtain financing with an 80% guarantee cover provided by the Credit Guarantee Corporation. The cost of the guarantee was borne by the Central Bank. This scheme has assisted about 10,000 SMEs from all sectors of the economy in sustaining their businesses and preserving employment.

Venture capital and private equity funds are required to provide early stage financing for innovative SMEs. Due to the highly specialised focus of such funds, it is common for fund-of-funds to be established as a pooling mechanism for the purpose of risk diversification. However, the success of these forms of financing depend very much on the enabling environment in terms of availability of talent as well as deep and relatively well developed equity market for early stage investors to “exit”.

Finally, micro financing is important to provide access to funding for micro enterprises. There are now many highly innovative schemes to achieve outreach, including by mobile banking and agent banking. Critical to the success of such financing is pricing and accessibility. The world has seen different degrees of success of such financing. Critical to their success is the enabling environment of which equal attention has to be accorded. This includes the institutional arrangements, the business model for such financing, the regulation and policies and the supervisory oversight. This will ensure its sustainability as a form of financing.

Another important segment of businesses is the corporate sector. Established corporates will require efficient sources of financing for expansion as well as advisory services to maximise enterprise value. A deep and liquid bond market with good information flow and modern infrastructure will allow for efficient pricing of corporate issuances – from short term commercial papers to support liquidity and working capital, to longer term bonds for project financing. Treasury services are also important to manage the funds of larger corporations to achieve higher returns as well as access to risk management and hedging instruments to manage foreign exchange, commodity price and other forms of market risk.

As economies develop, governments will need to increasingly shift from being a driver of growth towards having a facilitating role and to promote the private sector as the driver of growth. Malaysia has leveraged on the comparative advantage of the public and private sectors through Public Private Partnerships for infrastructure projects. The objective is to optimise on the cost efficiency and sustainability of the financing model, so as to enhance the financial viability of the infrastructure project. This is achieved as risks are transferred to parties that can best manage those risks. Hence, the public sector can provide the regulatory risk guarantees and incentives to ensure adequate demand, whilst the private sector will raise financing as well as technical expertise. This model was successfully implemented for the biggest highway concessionaire in Malaysia. PLUS operates and maintains 973km of expressways in Peninsular Malaysia, stretching from the border of Thailand to Singapore and linking all major cities on the west coast of Peninsular Malaysia.

Financing for infrastructure development is equally important as this has implications on the fiscal position. To structure the most competitive and efficient financing for each stage of the infrastructure project schedule, several options can be considered – including direct funding from the budget, the issuance of long-term Government bonds, the issuance of long-term Government-guaranteed bonds, the securitization of works completed, and the issuance of long-term bonds backed by the Government's undertaking to make deferred payments. The actual funding mix adopted needs to be based on the Government's fiscal position and on economic conditions. By adopting a mix of strategies over the overall duration of the project, the Government can optimise on the funding costs.

Another major area of financing that has been a challenge both in the developed and emerging economies is for health care. The structure of healthcare provision requires a balanced socialised element to avoid both the market failure of a largely privately driven system (e.g. as experienced in US) and the inefficiencies of fully public systems (e.g. several European countries). Social health insurance schemes based on earnings contributions is a means by which such funding sources can become a complementary source of funding to public sector. Such an institutional arrangement should provide high quality basic healthcare for the population whilst private health insurance can have a complementary role in providing higher level care for those that have the means to absorb these costs.

In developing a financial sector that will deliver innovative financing for economic transformation throughout the different phases of development requires several supporting elements. These include:

a. Having strong financial institutions that are resilient to withstand the economic cycle;

b. Establishment of a credit information system;

c. Development of a domestic bond market for financing large investments for both the public and private sectors. This includes the necessary infrastructure to facilitate the functioning of the bond market;

d. Having the talent pool in the financial services industry;

e. Financial literacy has to be advanced aggressively;

f. Effective structure to ensure sufficient supervisory oversight to ensure soundness and stability of the financial system;

g. Mechanism for resolution of debt problems including for public and private sector;

h. Potential to leverage on technology. This in particular enhances distribution channel and outreach;

i. Consumer protection framework needs to be in place; and

j. Surveillance mechanism needs to be in place.

Finally, I would like to discuss the importance of Islamic finance as an important mode for financing economic transformation. Islamic finance requires financial transactions to be supported by an underlying productive economic activity that will generate legitimate income and wealth. This gives rise to a close link between financial transactions and productive flows. Therefore, the growth in Islamic financial assets is generally in line with the growth of underlying economic activities, thereby ensuring that the financial system is always grounded to the real economy. Other inherent features arising from risk sharing also contribute to the stability and integrity of Islamic finance. Thus, Islamic finance, embraced in its entirety, is supportive of sustainable economic growth.

Islamic finance offers an extensive range of innovative financial products and services from consumer financing, asset and wealth management to Islamic insurance and capital markets. The sukuk market has become a highly competitive fundraising option for large scale projects and infrastructure development. With an annual growth rate of 40 percent, sukuk instruments are fast emerging as an attractive new asset class for investors, while evolving to become a preferred financing and capital raising option for issuers. In Malaysia, the sukuk market now accounts for more than fifty percent of our bond market, drawing the participation of not only our own corporates but also a wide range of international corporations and multilateral agencies. In Malaysia, a comprehensive Islamic financial system operates in parallel to the conventional financial system. This is now internationalized to enhance our interlinkages with other emerging economies and traditional markets.

The emerging economies will be the key drivers of economic transformation over the next decades, both within and across borders resulting in a more integrated global economy. It is therefore imperative that efforts are increased in ensuring collaboration and sharing of experience for the common good. The Langkawi International Dialogue continues to be an important platform for such exchanges and it is a great honour for me to have this opportunity to be here today.

Thank You.