Zeti Akhtar Aziz: Reflections on financial reform – Malaysia's experience

Speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the 2013 China Business News (CBN) Annual Meeting and Finance Summit "Reflections on financial reform – Malaysia's experience", Beijing, 8 December 2013.

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It is my honour and pleasure to be invited to speak at this 2013 China Business News Finance Summit. As the globalisation of finance intensifies, the world is becoming increasingly more inter-connected and integrated. This has largely been due to the trend towards increased financial liberalisation by most parts of the world. It has been maintained that such deregulation and liberalisation would facilitate the development of more efficient and robust financial systems and that it would result in a more efficient allocation of financial resources across borders. While such financial liberalisation may indeed bring such wide ranging benefits, it also brings with it increased risks that needs to be effectively managed.

It was for these reasons that Malaysia adopted a conscious effort to put in place the financial and economic pre-conditions so as to enable us to benefit from such financial reforms involving the deregulation and liberalisation of our financial system. Allow me to share our experience in pursuing this agenda. Following the Asian Financial Crisis, Malaysia embarked on strategies for an orderly development of the financial sector. Focus was first placed on strengthening the institutional capacity of the domestic financial intermediaries so as to narrow the performance gap between the domestic and international financial intermediaries. In parallel with this was the intense effort to develop the domestic bond market.

During this phase of the development of the financial system, significant advancement in the banking sector was made in terms of capitalisation, risk management and governance practices, delivery channels and in human capital development in the industry. This paved the way for the interest rate reform to move to greater market orientation, thereby supporting a more efficient pricing of financial products and services. The more competitive environment that it generated also became an important driver of productivity gains, customer centricity and innovation in the financial system.

Equally important, was the attention that was given to the development of a deep and vibrant domestic bond market as an alternative channel for the efficient raising of funds, particularly by the corporate sector. The development of the bond market has enabled better matching of long-term projects with long-term funds, and by reducing the over-reliance on the banking system, it has contributed significantly to financial stability. Among the institutions that was established to support the development of the domestic bond market was the establishment of the domestic rating agencies and Cagamas, the mortgage corporation. The Malaysian bond market has since evolved to become the largest in South East Asia to now account for 110% of GDP. This market has since been liberalised to allow foreign corporations to raise funding in both domestic and foreign currency. In these recent few years, there has been a number of successful Reminbi bond issuance from our market to finance investment opportunities in China.

Various other key financial infrastructures were also put in place to enhance the efficient functioning of the intermediation process of the overall financial system. This included the infrastructure to support robust payment and settlement systems. In 2012, we introduced onshore settlement of Reminbi transactions in our real time gross settlement system RENTAS via a local onshore settlement institution. As part of the development of our domestic financial infrastructure the Malaysia Deposit Insurance Corporation was establish to provide a comprehensive deposit insurance and insurance benefit system for the banking and insurance sector. This institution not only imposes discipline for risk management by the financial institutions through the imposition of differential premiums based on the risk profile of institutions, but it also is the resolution authority in the event of failure of a financial institution.

Underpinning the financial sector growth was also the development of a more robust surveillance, regulatory and supervisory framework. As the Malaysian financial system evolved to become more complex, sophisticated and diversified, the regulatory and supervisory approach has correspondingly evolved from detailed and prescriptive rules to a risk-based approach that combined greater supervisory judgment and intensity with high-level principles of sound practice. This is complemented with effective surveillance that is forward looking and focused on addressing the risks to overall financial stability.

This decade has also seen the modernisation of the legal framework, that has included the enactment of two comprehensive laws this year to govern the financial sector under a single legislative framework for the conventional and Islamic financial sectors. The implementation of these laws have strengthened Malaysia's financial sector by providing a consistent approach to regulation and supervision and enhancing the Central Bank's power to take timely intervention actions in relation to financial intermediation activities that occur outside the banking system. Following the global financial crisis, such shadow banking systems have come under greater regulatory scrutiny. Specifically, regulators have been concerned with the scope that exists for non-bank financial institutions to perform financial intermediation activities in a way that replicates the systemic risks associated with banking activities, without being subjected to the same rigor of regulation and supervision that is applied to banks.

In this recent decade, the strengthened institutional arrangements in Malaysia to promote financial stability have contributed towards addressing this important gap. They include the establishment of an oversight authority for credit cooperatives, and provisions for the Malaysia Deposit Insurance Corporation to extend temporary deposit insurance coverage to instruments of non-bank intermediaries that are similar in nature to deposits. Also important has been the significant strengthening of inter-agency coordination arrangements to address potential regulatory gaps. The new legislation has also improved the ability of the Bank to respond to financial stability risks that can originate from shadow banking activities, including to issue orders requiring such intermediaries to address any risk identified which could threaten financial stability. A Financial Stability Executive Committee chaired by the Governor, which includes the Treasury Secretary, heads of key regulatory authorities and independent parties as its members may impose macro-prudential measures on these non-bank financial institutions to prevent the build-up of financial imbalances from this sector.

With these necessary preconditions firmly in place, Malaysia embarked on a gradual and sequenced approach towards liberalisation and internationalisation. In 2005, Malaysia migrated to a flexible exchange rate regime at the very same moment that China did. It has provided Malaysia with greater flexibility to adjust to changing structural conditions in the region and the global economy. This has been reinforced by the progressive liberalisation of foreign exchange administration rules which have enhanced business competitiveness and facilitated larger volumes of trade and foreign direct investment flows. This has generated greater two way flows in the foreign exchange market and thus promoted orderly conditions in an environment of highly volatile capital flows. In the financial sector new licences and foreign equity interests in the banking and insurance sectors have now moved beyond the prescription of hard limits, to assessments based on the prudential and in the best interest of Malaysia criteria.

In building a stable and resilient financial system, the Central Bank has accorded greater emphasis on financial inclusion. This has included enhancing access to the unserved sectors as well as the introduction of highly innovative delivery channels such as retail outlets and post offices as third-party agents to widen the outreach of financial services. These have worked in tandem to ensure that all members of society, including the most vulnerable groups, have the opportunity to participate in the formal financial system. Concurrently, continuous efforts are being undertaken to promote consumer protection and education, in order to ensure fair and responsible market practices and conduct, and that consumers are better equipped with the necessary financial knowledge to make informed decisions.

Recognising that the development of the financial sector also depends on the availability of high quality and skilled talent, focus was accorded to the development of human capital through the introduction of institutional arrangements to provide comprehensive education and learning programmes for the financial services industry. Towards this objective, the Central Bank oversaw the establishment of differentiated platforms to meet the diverse needs of financial services professionals, from the entry to middle management, specialist and leadership levels. These include the setting up of programmes and institutions such as the Financial Sector Talent Enrichment Programme, the ICLIF Leadership and Governance Centre and INCEIF, the global university of Islamic finance.

Malaysia's imperatives for growth and stability moving forward

Our next phase of transformation will continue to promote inclusive access to financial services, encourage the development of the range of financial institutions, products and markets that will facilitate and drive the development of new domestic sources of growth, and accelerate Malaysia's regional and international connectivity. The use of technology will also be leveraged in this new environment, to enhance the efficiency of financial transactions through electronic means. The implementation of these strategies will also be accompanied by an effective regulatory and supervisory regime that is appropriate for a more regionally- and internationally-connected financial sector.

There has been tremendous payoffs from the development of our financial system, its restructuring, rationalisation, deregulation and subsequent liberalisation. During the recent global financial crisis our financial system has remained resilient. Credit flows to support the economy was never disrupted. Despite the massive and highly volatile capital flows, Malaysia was able to intermediate these flows. There continued to be orderly functioning of the financial markets and the overall financial system.

In conclusion, the outcome and success of any reform strategies will depend on the prevailing circumstances and the state of readiness of the financial system and the overall economy. As China undertakes its own reforms, it has every potential to emerge stronger and to continue its economic success that is now a well recognised milestone of this century and for the years to come.