Muhammad bin Ibrahim: "State of the Industry Address"

Remarks by Mr Muhammad bin Ibrahim, Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the Asian Strategy & Leadership Institute's (ASLI) 21st Malaysian Banking Summit, Kula Lumpur, 25 May 2017.

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Thank you for the opportunity to speak again at the ASLI Malaysian Banking Summit.

Around this time last year, I recall delivering the keynote address at this Summit after assuming the office of the Governor.

A year has passed, and it was indeed an eventful year. In the past year, we witnessed major forces that shaped the world. Some improbable, others familiar. Some transformative, others polarising. Some deep-seated, others fleeting.

In short, it has been a year of contrasts. In more ways than one, our perception of reality is also changing dramatically. The human brain can now communicate directly with computers, from powering prosthetic limbs to flying drones. Months ago, both Uber and Airbus unveiled separate plans for flying cars. Additionally, just earlier this week, artificial intelligence surpassed the world's best player in Go, believed to be the most complex strategy game, with more possibilities than atoms in the visible universe.

On many levels, these developments contrast starkly with conventional wisdom and the traditional state of play in respective industries. Yet, they are also driving thought leadership and genuine innovation. This theme of contrasts will underpin my observations today on the economy and the banking industry.

A World of Contrasts: Synchronous Recovery Amid Uneven Risk Profiles

Since the Global Financial Crisis almost nine years ago, the pursuit of a sustained global economic expansion has eluded policymakers. Global growth has been slow, fraught with risks and shrouded by uncertainties. There have been several false starts, with uneven and sometimes divergent growth momentum among regions. In fact, 2016 marked the slowest global GDP growth recorded since the crisis.

Positive developments have, however, recently emerged. A pick-up in industrial activity and trade, along with the increase in commodity prices, points to a quickening in growth momentum. Significantly, this growth upturn is characterised by a synchronised expansion in both the advanced and emerging countries. This has given policy makers some cautious optimism for a sustained recovery of global growth and international trade.

In particular, the improvement in advanced economies is encouraging as it is led by recovery in investment activity. Emerging economies are benefiting from external demand, aided by the improvements in commodity prices.

Our assessment is that the global economy will continue to gradually improve. Nevertheless, many developments around globe warrant a very close surveillance. It is still too early to declare a definitive revival in the global economy. In fact, at this point, despite the emergence of a few positive developments, the overall risks remain tilted to the downside.

Major events that could shape global growth in the near term include uncertainties in policy and political spheres, especially in major economies; the potential retreat arising from backlash against globalisation; the rise in trade protectionism; and the volatilities of global commodity prices. Financial markets have in recent months remained eerily calm. However volatility may reignite if risks re-emerge, whether real or perceived.

Beyond these short-term risks, structural changes are also afoot. The ageing population, income inequality and youth unemployment are slow-churning yet potent structural changes that require policy prescriptions. Changes in policy *today* are needed to secure future prospects for growth.

In Malaysia, the economy has been boosted by the expansion in global demand. The strongest export growth in 28 quarters has provided additional impetus to our domestic demand. Consequently, the Malaysian economy started 2017 with a robust growth of 5.6% in the first quarter. We are on track for a better economic growth compared to last year. Nevertheless as an open economy with sizable and globally connected financial markets, Malaysia cannot neglect the risks dominating the global environment. We are certainly not immune from events unfolding around us.

Some say central bankers are paid to worry. In good times and even more so, the bad. However I am comforted that earlier reforms have accorded the country with strong macroeconomic fundamentals and resilience to weather these still-challenging times. However, we cannot afford to rest on our laurels. New risks and challenges continue to emerge and confront us. An important lesson is to continue to strengthen our resilience and buffers, especially during the good times.

A World of Contrasts: Bankers as Active Stakeholders, Not Passive Bystanders

The banking sector has been a central pillar of strength for the Malaysian economy. The industry can play a more positive role by engaging positively in conversations on economic and financial issues confronting the country. As I have experienced in the last one year, the chamber of conversation on the economy could be further expanded. Narratives on the economy and the industry continue to be shaped by external parties, drowning out the occasional whispers from the banking industry.

Given the central role of banks in the economy, bankers have the equivalent of a box seat to provide an informed view on developments in the economy and financial system. Rather than being onlookers, the banking industry should weigh in on domestic economic discourse. From sectoral issues to macro trends, bankers' perspectives would provide additional viewpoints and enrich assessments by the public and financial community, and help address gaps between reality and perception that have too often dominated the public conversation.

It is therefore timely for our bankers to participate more actively in the economic discourse to shape a more balanced narrative. Bankers should be proactively offering solutions to some of the pressing economic and financial issues facing the country. A positive voice for socioeconomic change can help instill greater public trust in the role of the banking sector in nation building.

A current issue that has disproportionately drawn attention to banks is the affordable housing issue. Bank Negara Malaysia recently featured a box article on this subject in 2016 Annual Report. The public debate largely continues to misdiagnose or ignore the root cause of the problem, that is, affordability and accessibility, rooted by low incomes and compounded by the huge mismatch between demand and supply of affordable houses.

The popular myth, is that it is all about access to financing. I am perplexed. Actual data is self-evident. It shows the continued strength in bank financing to households for the purchase of affordable homes, with four in five new housing loans extended for houses priced below RM500,000. Yet banks have done little to educate and inform the public on this financing trend. The industry ought to be at the forefront in explaining the real situation and where possible, offering suggestions to help address this issue.

Affordable housing is not a problem that is unique to Malaysia. Policymakers around the world, including in developed countries, continue to look for creative solutions to this delicate socio-economic challenge. A common thread across these solutions is their multi-faceted dimensions.

The solution for Malaysia has to involve rebalancing the supply of housing towards the affordable segments. We require a bold and pragmatic solution. We estimate a shortage of 960,000 units of affordable housing. This is projected to reach 1 million units by 2020. A central authority and a national repository can significantly improve the ability to better distribute, monitor and manage the supply-demand imbalances. Developing a thriving rental market should also be on the agenda to temper the nation's fixation on home ownership.

Another issue that banks should be concerned with is the sizable surplus in commercial property. In contrast to affordable housing, the office and retail markets are in oversupply.

In 2016, the vacancy rate for prime office space in the Klang Valley stood at 21.8%, outstripping the regional average of 6.2%[1]. Monthly rentals of prime office space in Kuala Lumpur are the lowest among regional cities. Over the next few years, the significant incoming supply of large projects is likely to aggravate supply conditions in this segment.

Signs of oversupply are also emerging in the retail segment in major urban centres in Malaysia. This can be traced to the abundance of shopping malls. You may be surprised to learn that there are as many as *twenty* shopping malls just along the 40km stretch of the LDP highway. It is equally astonishing that the prime retail space per capita in cities like Johor, Penang and Kuala Lumpur is actually *higher* than regional megacities such as Shanghai and Beijing, and also higher income cities such as Singapore and Hong Kong.

A significant increase in vacancy rates, and the ensuing price corrections, are risks that the Bank has highlighted as far back as 2013. The concerns are not limited to effects within the commercial property sector, but have broader spillovers to other economic sectors. During the Global Financial Crisis, commercial property was a major driver of loan losses in Australia, France, Ireland and New Zealand, despite generally accounting for a much smaller share of banks' loan books, compared to residential property. This was attributable to a sharper pace of contraction in commercial property prices, compared to house prices.

Banks are key stakeholders in this conversation. Data available within banks can be a harbinger of turns in the property cycle, and used more effectively in combination with other sources of market data, to smooth out adjustments between demand and supply.

Furthermore, in the same way that reporting standards are starting to move away from provisioning practices that were "too little too late", there is merit in in taking a closer look at current valuation practices that contribute to property boom-bust cycles. It may well be time to consider how we might correct practices that are encouraging banks to lend "too much too early" in specific property segments, before demand drivers are firmly entrenched.

At a more fundamental level, we should explore ways to moderate the lending bias towards real estate. Instead, banks should be providing more financing to new productive investments that are essential to support the transformation of our economy. As we progress, the industry has to be more innovative in product offerings to meet the demands of the new economy.

These examples illustrate the significant scope for the banking industry to organise itself more effectively to weigh, expand, and ultimately galvanise action in response to emerging issues that concern our economy and society. There are other matters as well. Education in long-term financial planning among Malaysians, the impact of financial technology, expanded inclusion to financial services, income and productivity gaps, and labour market developments, are just some of the issues where banks ought to be much more active participants in the policy dialogue and debate.

The Financial Markets Committee stands out as a forum that serves as a focal point for industry and external stakeholders on recent measures taken in the domestic financial markets. Likewise, similar initiatives can be mobilised to provide a more organised stage for the banking industry to lend its voice on a range of issues and contribute to more informed public opinion.

It is time for the industry to be active stakeholders, rather than just passive participants.

A World of Contrasts: Long-Term Interests Versus Myopic Gains

Extending the theme of contrasts further, regulatory measures introduced in the past year have been the subject of much scrutiny. In many quarters, regulation is still widely perceived as an unnecessary constraint on markets. In reality, it is a means to safeguard longer-term public well-being against parochial interests. The intention behind regulatory measures may at times appear contrary to popular wisdom. Nonetheless, viewed through a broader lens, this is motivated by policymakers' duty to preserve macroeconomic and financial stability. In discharging this responsibility, policymakers must consider macro perspectives, be able to look further afield, evaluate risks, and take timely actions to manage these risks.

The Global Financial Crisis provides a stark reminder that markets cannot be exclusively relied on to rein in excesses. Left to the market, there is always a tendency to overshoot. Market forces can at times deviate significantly from public interest.

This is where policymakers step in to moderate these effects and steer markets back onto a sustainable path. This is infamously described as, central banks 'taking away the punch bowl, just as the party gets going[2]'.

One 'party' we saw developing was the imbalance in the foreign exchange market, more specifically in the ringgit non-deliverable forward (NDF) market.

Measures taken by the Bank in December last year were aimed at further developing the onshore financial markets and limiting the influence of speculative pricing of the ringgit in the offshore market which had undermined the stability of the domestic foreign exchange market. Since the implementation of these measures, the exchange rate stabilised, with the 1-month implied volatility recording a lower average of 4.5%, against 9.9% before the measures were put in place. The average intraday movement recorded a daily average of 76 points while the bid-ask spread recorded an average of 25.0 basis points since end-February 2017. Of importance, the onshore foreign exchange market continues to record a healthy daily average volume of USD10 billion. Prior to the measures, the daily volume was around USD8 billion.

The Malaysian bond market remains resilient. The last two primary auctions of government bonds recorded a healthy bid-to-cover ratio of more than two times. Following higher market demand, MGS benchmark yields have eased lower between 8 – 32 bps across the yield curve. Non-resident holdings of government papers have also been pared down from a peak of 34.7% to 25.3% as at end April 2017.

More importantly, our surveillance indicates that the composition of stable and long-term investors is now much higher, with previous outflows mainly due to short-term speculative positions exiting the market. This is definitely a positive development.

Malaysia remains a highly open economy and will continue to welcome the participation of long-term investors. Indeed, we remain a highly attractive destination for foreign direct investment. Returns on Malaysia's FDI assets have averaged 12.9% per annum between 2010 to 2016, higher than nominal GDP growth of 7.7% over the same period[3]. Payoffs from investing in the real economy are one of the highest in the region, making Malaysia an important profit centre for investors.

In the next seven months, the Bank will introduce further regulatory measures to strengthen the foundations for a strong and resilient banking system.

- First, we will implement a mandatory employment reference check for financial industry employees which is aimed at removing employee information asymmetries during job transitions.
- Second, we will share with the industry proposed revisions to the outsourcing policy to improve the governance and supervision of financial institutions, especially involving cross-border arrangements. The revisions also aim to better support the development of domestic expertise and capacity in core functions of the banking industry.
- Third, a shared security operations centre for the financial industry (FINSOC) will be established in coordination with the industry to support the continuous and proactive monitoring of cyber threats.
- Finally, by 2018, we hope to operationalise an industry-wide implementation of e-KYC for the on-boarding of customers.

Further progress has also been made on the development of the policy framework for domestic systemically important banks (D-SIBs). Survey results collected from banking institutions and financial holding companies earlier this year are currently being analysed and will facilitate further refinements to the assessment methodology to identify D-SIBs. This will form part of the D-SIB policy framework which will be released later this year for industry consultation.

Beyond the immediate term, the Bank is also looking at introducing enhanced standards on measuring capital requirements and outline expectations on recovery planning, in line with global reforms. In doing so, we will engage the industry on the potential domestic implications, and make adjustments where necessary to ensure that these standards are phased-in seamlessly.

A World of Contrasts: Shifting From Macro Masterplans to Micro-Cellular Transformation

Malaysia’s transition to a high-income economy will require careful attention to the context in which policies are developed and pursued. In particular, behavioral changes shape the way people live and work.

Thanks to globalisation and digitalisation, individuals are much freer to dictate their living, working and financing arrangements. Traditional institutions and conventional policy-making have less influence than before. This calls for a new approach to governing and policy making, one that combines high-level strategic clarity with experimentation and dynamic implementation at a micro level.

Since 2000, the Government has produced 39 blueprints, roadmaps and master plans, including the Financial Sector Blueprint. This is more than double the number of master plans introduced between 1970 to 1999.

From a different perspective, over the last 17 years, the country introduced two blueprints a year, compared to only one plan in every two years during the period 1970 to 1990.

There is no denying that the plans have laid a great foundation for the nation to move forward. Indeed, the Economic Transformation Plan played a catalytic role in spurring, what we at the Bank like to refer to, as the Investment Renaissance period between 2011 and 2014.

Going forward, there is a critical need to overlay these existing master plans and blueprints with micro-cellular transformations. We have been advocating this approach at every opportunity available. It is just as relevant for industry, including the banking sector. Very often, implementation pitfalls caused the failure of the strategic vision of leaders. I believe this gap can be bridged if each component, layer, and *cell*, within the ecosystem, whether at an institution or industry level, is empowered to support and even lead transformation.

This micro transformation involves three elements: first, solving locally-nominated and defined problems; second, employing nudges or smart incentives to induce desired behavior; and third, experimenting on specific markets, groups or products before a broad roll-out. I must admit that these are hardly unfamiliar concepts in business. Yet few businesses have gone further to integrate these elements within broader transformation strategies.

This has increasingly been the approach taken by the Bank, in facilitating initiatives such as the FinTech innovations in the financial sector. The Regulatory Sandbox introduced last year allows for the experimentation of potentially beneficial FinTech innovations that may seem inherently risky at inception, but properly harnessed could be a game changer. By providing a "safe" or "contained" space for testing, the risk effects can be comfortably observed, controlled and calibrated. Wider applications of this approach by institutions will go a long way to cultivate a balanced banking culture of innovation and resilience.

Such applications are also not confined to the area of technology. It can span across a bank's decision to enter a new market, reform incentive structures, disrupt outdated internal processes and provoke changes in management paradigms. The possibilities are limited only by our attitude to change, our ability to adapt, and our willingness to pursue creative solutions within acceptable risk limits.

Banks that will remain relevant in the future are those that have a deep understanding of the shifts in the economy and the consumer. This requires banks to have a finger on the pulse of the economy, to closely observe the micro transformations that are taking place, and to keep abreast of future financing opportunities, particularly in new areas of growth. To this end, banks will need to think ahead and begin to invest in developing the organisational capacity to study, distill and generate innovative solutions to effectively and efficiently meet new financing needs.

With the development of alternative financing such as crowd funding, P2P, private equity, venture capital, factoring and leasing, it will be imperative for banks to consider how they can complement and support these arrangements more effectively.

We are living in interesting times, shaped by forces that bring to the fore contrasts in economic and financial developments. These developments have important implications on how we govern, do business and engage externally. It has never been more important for the banking industry to be more engaged, agile and responsive.

I do believe that our banks are well-placed to adapt to changes going forward. It is incumbent on the banking industry to continue to strengthen its foundations and address gaps that may appear through business and economic cycles. Banks cannot be oblivious to the changing tide. Our economic prosperity is very much influenced by the ability of the industry to play its intermediating role effectively.

Bank Negara Malaysia

25 May 2017

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[1] Regional average prime office vacancy rate is based on 2015 data

[2] Attributed to William McChesney Martin Jr., the ninth Chairman of the United States Federal Reserve Bank

[3] Return on investment: measured as FDI profit over FDI stock