Nor Shamsiah Mohd Yunus: DFIs of the future - maximising development impact

Welcome remarks by Ms Nor Shamsiah Mohd Yunus, Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the World Bank and Bank Negara Malaysia Forum on Performance Measurement for DFIs "DFIs of the Future: Maximising Development Impact", Kuala Lumpur, 9 August 2018.

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I would like to thank the World Bank for collaborating with Bank Negara Malaysia to organise this important event as we think deeply about the future of development finance, especially on how we can elevate the role of development financial institutions in Malaysia to achieve greater development impact. This is timely as the country is charting its future direction.

History tells us that economic development is a collective responsibility. The success story of Malaysia's development journey over the past six decades is a testament to this. Our goal has always been to achieve sustainable and inclusive growth, consistent with the 2030 Agenda for Sustainable Development advocated by the United Nations. Thus, the development priorities of the nation and the materialisation of the 17 United Nation's Sustainable Development Goals (SDGs) will be key for us over the next few years.

To this end, development financial institutions or DFIs in short, play a very crucial role. The first DFIs in Malaysia were established in the 1960s and 1970s as specialised financial institutions with specific mandates to develop strategic sectors, spanning agriculture, infrastructure, small and medium enterprises, export-oriented and high-technology industries.

Since then, DFIs have contributed to the economic transformation of Malaysia and helped to reduce inequality. For example, through them, the unserved and underserved segments of society have increased access to financial services. Rural communities have benefitted from microfinance initiatives and agent banking services. Last but not least, DFIs have contributed to macro-economic stability through the provision of counter-cyclical financing during periods of financial instability.

The strategic role of DFIs make them well placed to contribute to the development priorities of the nation, and assist in the materialisation of the SDGs. Specifically, DFIs can play an important role in contributing to the advancement of the following SDGs: no poverty, zero hunger, good health and well-being, quality education, clean water and sanitation, affordable and clean energy, industry, innovation and infrastructure, reduced inequality, sustainable cities and communities and climate action, amongst others. Thus, as institutions designed with developmental mandates in mind, DFIs are primed to serve the greater good. For Malaysia, the developmental story is not over as we seek to transform our economy into a high income nation while ensuring no one is left behind. The task ahead of us is challenging, but it is not insurmountable.

As such, the stakes are higher than ever. In this environment, it is important for DFIs to ensure that they remain relevant. The urgency for change remains high, as shifts in the global economic and social landscape continue to create risks and unforeseen externalities that may dampen growth. Thus, the focus on building resilience, creating building blocks to address financial instability, boosting national competitiveness, strengthening human capital, inculcating sustainable consumption and increasing productivity, will be paramount in shaping our success ahead.

With all these in mind, I will put forward three points in my remarks today, relating to the business models, performance and regulatory framework for DFIs.

Key Message 1 – Re-engineer business models of DFIs

First and foremost, for DFIs to contribute effectively to the development priorities of the nation, it is important for each DFI to ensure their long term financial sustainability. Without this foundation of continued financial health and strength, DFIs will not be able to contribute meaningfully as there will be constraints and limitations in executing their objectives. As policymakers, Bank Negara Malaysia envisions an environment where DFIs are financially independent from the Government with enduring business models that can continue to deliver positive benefits to the economy and broader society. Over the long-term, DFIs should not be dependent on fiscal support to deliver their mandates and hence, will need to diversify their sources of funding to be sustainable in the long run. What we should seek is not short-term fixes but enduring business models that will deliver positive impacts to the economy and society as the economic landscape changes.

At the same time, business models for DFIs should be firmly grounded on strong governance and a culture of professional management. Good governance underpins any successful business model and it is of utmost importance that DFIs follow best practices that promote integrity, transparency and accountability. To achieve this, DFIs should strive to strengthen behaviour and risk culture within the organisation. Strong governance entails crafting well-defined mandates that will insulate the organisation from undue external interference. Focus should also be given to foster a culture that welcomes active debates and critical thinking at all levels of the organisation to guard against groupthink. Last but not least, to sustain effective and high performance, continuous upskilling of the board, senior management and staff is crucial to be able to seize opportunities and overcome challenges as they arise.

While the DFIs of today have grown in size and outreach, there remain opportunities for them to maximise their full potential. Innovation is lacking in developing diversified financial products that are tailored to meet the specific needs of targeted sectors. This is compounded by their limited capacity and capability to manage the potential risks arising from financing high risk sectors due to information asymmetries.

DFIs should aim to become the centre of reference for new growth sectors and emerging markets and develop expertise in risk assessment and management of high risk projects in those sectors. Underlying the strategies for a good business model is the need for DFIs to strengthen research and analytical capabilities to address their lending capacity by developing innovative solutions. Given the digitalisation of finance and proliferation of technology in financial services, DFIs need to remain at the frontier of these developments. This could include leveraging on big data and forging partnerships with technology firms to develop digital solutions at lower cost and increased efficiency.

At the broader level, the development finance architecture should also shift to be more effective in channelling resources and catalysing private investment to developmental oriented projects and initiatives. Whilst most DFIs have been self-sustainable for the past few years, DFIs will need to diversify their sources of funding and ensure that the structure of liabilities is appropriate for the assets that they hold to be sustainable in the long run. DFIs cannot be dependent on fiscal support to carry out their mandates. DFIs should aim to have strong competitive position on new growth sectors supported by a sustainable strategy and management execution capabilities. Last but not least, DFIs are required to continuously review their institutional fit and business models to increase their development impact while remaining financially sustainable. Effective DFIs should also be able to act as catalysts to promote private sector investments and support economic growth.

One example of a financially sustainable business model is demonstrated by the experience of Nacional Financiera (NAFIN) as an enabler to Mexico's aspiration to combat climate change through the Renewable Energy Financing Facility, or REFF. As REFF provides risk mitigation mechanisms such as guarantee and insurance in addition to financing, it has attracted the private sector as co-investors and guided the financial institutions to develop capacity in risk management of renewable energy projects. This demonstrates that with in-depth understanding of the sectors they are serving, DFIs can design solutions which achieve the desired impact, whilst crowding in private capital.

Key Message 2 – Performance measurement framework anchored on developmental objectives will ensure alignment of business strategies to deliver the highest value

My second point relates to adopting a performance measurement framework for DFIs that is anchored on development objectives. This is to ensure alignment of business strategies to deliver the highest value to society.

DFIs play an important role in bridging financing gaps by participating in markets not adequately served by the private sector. These are often developing sectors and markets which are characterised by high risks and uncertainties. Therefore, by extension, we cannot evaluate DFIs using mere financial indicators as they are not adequate to capture the contributions of DFIs to the wider economy and growth of the nation. DFIs must also be measured by the additionalities they create.

In my view, a DFI can be deemed to be successful when its participation addresses market failures and brings high value addition by:

(a) Influencing project design and delivery in a way that will generate employment, increase income levels and welfare of targeted sectors, expand tax revenues and multiply economic spill-overs;

(b) Crowding in or attracting private investments or financing in new growth sectors/markets through innovative financial structures; and

(c) Creating an enabling environment for economic segments to flourish by actively contributing to the sound design and implementation of public policies.

The difference in measuring the success of the DFIs means that it is important to have a structured and comprehensive performance measurement framework. This framework must be anchored on developmental outcomes to create strong incentives for strategic alignment to achieve greater development impact.

For example, the BancoEstado of Chile has for the past 4 years published integrated reports which are called the "Social Footprint of BancoEstado". They showcase the achievements of the Bank's development impact in terms of meeting the SDG agenda. BancoEstado embeds relevant SDGs and developmental KPIs in their performance measurement framework. They are then hardwired into key decision making processes to ensure productive and effective allocation and distribution of resources aimed at meeting the development objectives. Similarly, performance measurement of development impact is the backbone of FinDev Canada, where their success is not only measured by financial sustainability but whether they also improve the lives of those impacted by the businesses they support.

On this note, I would also like to mention that sustainable and impactful financial solutions are not reserved exclusively for DFIs. The whole financial sector has a professional and civic responsibility to advance the sustainability and inclusion agenda. This responsibility includes upholding the fiduciary duty of financial institutions to preserve the trust, integrity and confidence in the financial system. By being responsible citizens, financial institutions will go a long way to repair the trust deficit between the industry and the public brought about by bank failures and the numerous cases of market misconduct, manipulation and scandals.

To this end, Bank Negara Malaysia has pioneered the measurement of development impact to complement financial performance by implementing the Value-based Intermediation (VBI) Scorecard with selected banks. The VBI scorecard contains components of qualitative and quantitative measures of impact to cultivate an impact-driven mindset and drive improvement within the banking industry. We hope that this will be a stepping stone to enhance the contribution of the financial sector to public welfare.

In summary, as the old adage correctly points out, "If you can't measure it, you can't improve it." Hence, the accountability and effectiveness of DFIs need to be measured through a robust, structured and comprehensive performance framework. This two-day Forum is dedicated towards realising this outcome. Challenges in measuring performance and collecting credible data that will best quantify the development impact will be discussed to identify workable solutions drawing from the experience of other leading international DFIs.

Key Message 3 – Enabling regulatory and policy environment to support DFIs in realising their full potential

My third and last point relates to the regulatory framework to support DFIs in realising their full potential. An appropriate regulatory and policy ecosystem is crucial to nurture a culture of innovation that will support the achievement of development impact within the DFIs.

Bank Negara Malaysia is committed to cultivate this through the application of proportionality in our regulations. The concept of proportionality is related to the application of differentiated prudential requirements for institutions of varying sizes, systemic impact and complexity in order to avoid excessive compliance costs. These costs may be burdensome and disproportionately high to smaller institutions. The application of proportionality can take the form of reduced reporting burdens or simplified rules for some institutions. Proportionality however, does not necessarily mean less stringent regulations. For some institutions, it may mean lower leverage, additional safeguards and prudential measures. Thus, proportionality entails an adjustment to the complexity of the rules taking into account the risks and externalities posed by financial institutions. It is important to understand that this does not necessarily result in a lower degree of stringency.

This practice is not entirely new as we have been practising proportionality in regulating DFIs. This is reflected in prudential regulations on capital and liquidity which are applied to DFIs as well as corporate governance and financial reporting requirements.

Moving forward, this application of proportionality will be further enhanced to reflect developmental outcomes. The Bank is refining its methodology for DFIs to support greater differentiation at the individual institution level based on the nature, size, complexity and most importantly, the unique roles and mandates of each DFI. Prudential and conduct standards applicable to DFIs will also continue to be renewed and adapted where relevant. The balance that we aim to strike can only be achieved if DFIs also lift their game to ensure strong internal controls and risk and performance management.

In addition to proportionality, a related issue is the need to review the overall DFI landscape in a holistic manner. An important step towards steering the DFIs forward will be to conduct a review on the mandates of the DFIs. Since the establishment of the DFIs in Malaysia more than four decades ago, their mandates have remained largely unchanged.

Periodic mandate reviews are important especially in a country like Malaysia where there is rapid economic growth and structural change as the country moves from one stage of growth to another. Mandate reviews will not only identify gaps within the economy that DFIs can play a meaningful role, but to reduce areas which overlap with each other and other players in the financial sector. For the immediate future, there are pockets of financing gaps particularly in the new and emerging sectors that the DFIs could support. Examples of these areas are: the high-end services and advanced manufacturing sectors, as well as knowledge or technology-based sectors including green-tech and biotech industries. These are key drivers that will accelerate the transformation of Malaysia into a high-income economy in a sustainable and inclusive way.

Last but not least, as part of the holistic review, we should be prepared that some DFIs may have to “graduate” into the mainstream legal and regulatory landscape of the Malaysian financial system. This would mean that they may no longer be placed under the Development Financial Institutions Act. This is a positive development as it reflects the maturity and success of the institution in delivering on its developmental mandates.

In conclusion, the progress of the nation is a collective responsibility. All of us have our own part to play. Our roles may be different but we share a common vision towards a shared, inclusive and sustainable prosperity for all.

For all of us gathered here today, this outcome is crystallised in the vision for DFIs to lift the growth and development of Malaysia. For this to happen, DFIs need to ensure that they are financially sustainable, possess the agility to support the existing and new economic drivers, and constantly measure their performance and contribution in an appropriate performance management framework.

As DFIs will continue to be at the forefront of efforts to meet the SDG goals, I hope that the next two days will sow the seeds for individual and collective actions that will both transform DFIs and increase their development impact.

With this, I wish all of you a productive forum.