

Governor's Keynote Address at the the Asian Banker Summit 2003, “Post-Asian Financial Crisis: Securing Financial Stability”

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Ladies and gentlemen

As we advance into the 21st Century, sustainable performance demands resilience to the economic cycle, resilience to unstable market conditions and overall resilience in an environment of rapid change. To prosper in this new environment, we need to have the capacity to withstand the entire business cycle, to survive the increased volatility in the financial markets and to have the capacity and agility to adjust to the changes taking place. Sustainable performance is key in achieving long-term relevance and success. To achieve this, it is important to look beyond the short-term perspective and build the capacity and the resilience to meet the new challenges that are emerging in this new environment.

It is my honour and pleasure to be invited to this Asian Banker's Summit 2003. Let me join the organisers in welcoming you to Kuala Lumpur. It was exactly five years since the countries in East Asia have emerged from the financial crisis, when stability in the financial markets was restored and the economic recovery resumed. Asia has now emerged as the fastest growing region. Despite a more difficult external environment, the Asian region has demonstrated resilience. The new trends emerging in Asia point to significant transformation taking place in the economies in Asia. These trends have contributed toward increasing the growth prospects for the region.

Today, my remarks will focus on these fundamental trends that have emerged in Asia and the promise that they hold for the prospects for this region. I would also like to take this opportunity to share with you the implications of these trends for Malaysia and the strategies and responses that we have adopted in addressing the challenges that we are faced with in this more difficult environment.

Emerging Trends in Asia: Economic Transformation in Asia

Asia's resilience can be traced to several important trends which have contributed to the economic and financial transformation of the region. The dynamic transformations taking place in our region are significant and varied. The region accounts for more than half the world's population and 23% of the world economy. The growth for the region as a whole is forecast to be one and half times higher than the global average.

Of significance, is the trend towards greater integration in the region on several fronts. Intra-regional trade in Asia has increased significantly in recent years. Intra-regional exports account for about one third of total exports of the region. Intra-regional trade within ASEAN has increased significantly to account for about 24% of the region's total trade, exceeding ASEAN's trade with the United States. Trade with China, India and Korea has increased dramatically. Since 1993, China's role in the region has reversed from that of a net exporter to a net importer. The share of East Asian exports to China has doubled in the recent decade.

Previously, the high economic performance in Asia was driven by the export orientation and investment driven growth. In the recent decade, greater focus has been accorded to domestic sources of growth. Increased emphasis has been accorded to promoting the role of consumption demand in the growth process. Traditionally, the countries in the region have high savings, relative to other regions. ASEAN's saving rate of 35% is nearly double that of NAFTA and one and a half times higher than the EU's. There, therefore, remains significant potential for high rates of consumption without resulting in risks to our system. The increased consumption demand has been a factor that has reinforced the trend toward greater intra-regional trade in Asia.

There has also been a trend towards greater intra-Asian investment flows in the region. This includes increased reinvestment of the surplus funds back into the region, both in the form of foreign direct investment and portfolio capital flows. The recent establishment of the Asian Bond Fund is a step in this direction. Initiatives are in progress to promote the development of regional capital markets. The initiative to develop an Asian Bond Market will contribute towards recycling part of the high savings to finance productive activity within the region.

While the Asian regional economies have common threads that prevail across the region, the economies are generally diverse in their economic activities. While there are areas of competition, there are trends towards increasing specialisation and complementarities. These structural shifts arose from new technologies, new demand patterns and new production organisation structures. In essence, there is a movement from bilateral inter-regional trade flows to a more fully developed intra-regional division of labour incorporating all phases of production and markets. This has led to greater optimising of the comparative advantage of the region.

Finally, there has been an intensification of regional co-operation in the aftermath of the Asian financial crisis. There has been a high level of financial co-operation among the Asian economies. Co-operation has been in the area of enhanced regional surveillance, standardisation of systems and documentation, regional capacity building programmes and regional swap facilities. This strengthened co-operation enhances the foundations for realising the potential that the region possesses.

Ladies and gentlemen,

In a world where uncertainty has become a permanent feature of the environment, the challenge before us is to be able to increase our tolerance level to the shocks and changes that may occur. Building tolerance levels involves enhancing our capacity, strength and resilience to cope with the changed environment. Precautionary measures can be taken to reduce the risks and vulnerabilities. Despite uncertainties and unstable conditions, initiatives can be taken to achieve sustainable performance.

In the current environment, the pressure is for greater market orientation and liberalisation on the premise that competition would lead to pricing that would facilitate a more efficient allocation of resources. This, however, is not the only objective that is to be achieved. Consideration needs to be given to the objective of promoting growth, financial stability and social stability. Some of these objectives are conflicting and need to be carefully balanced, taking into account the trade offs.

Increasing the Tolerance Level Amidst a Volatile Environment

The pursuit of efficiency and competition has to be balanced with the objective of attaining soundness and preserving stability. Given the unique characteristics and peculiarities of emerging economies, the transition to a more liberalised environment would demand appropriate sequencing of measures to be taken.

Factors commonly ascribed as key in achieving and safeguarding financial stability include sound macro-economic management, effective regulatory and supervisory framework, greater transparency and disclosure of information, increased market discipline, dynamic accounting and auditing standards as well as the existence of strong corporate governance. For emerging economies, the requirements extend beyond these factors to include other areas, namely the development of the necessary financial infrastructure that supports a strong foundation that is able to provide depth and breadth to the financial system and economy as a whole. Of equal importance, is the need to develop alternative sources of funding, such as the equity and bond markets, not simply to ensure a more balanced allocation of financial and economic resources within an economy but more importantly to attain greater diversification within the financial system, hence ensuring the efficient distribution of risks within the system. In addition, the integrity and credibility of the payments system and effectiveness of regulation and supervision would require the support of a comprehensive set of legislations, one that would need to evolve in tandem with the developments that are taking place in the financial landscape.

It is also recognised that good corporate governance reinforces sound regulation and supervision. It contributes towards maintaining market confidence, and strengthens transparency and accountability. For corporate governance to work, good corporate practices need to be instilled and embedded in all aspects of the operations and at all levels within the organisation. To succeed in the new environment, institutions will

require qualified board members and management teams that exhibit a high degree of professionalism.

In addition, transparency and disclosure is essential, particularly in a rapidly changing environment and greater attention is being accorded to make banking systems more transparent. While the comprehensive and timely availability of financial information will enhance market discipline in emerging market economies, the disclosure of information must be complemented with the ability of the market players to analyse, digest and appropriately interpret the information to achieve the desired results.

Closely related to this is the need to strengthen the framework for consumer protection to provide an avenue for redress in cases where consumers are placed in a disadvantaged or unfair position resulting from financial transactions taken due to lack of transparency and understanding. The move towards the adoption of the supervised market approach requires continuous efforts to enhance product disclosures and to elevate the level of financial literacy of consumers. Dealing with consumer awareness and education require considerable time and commitment.

While recognising the potential benefits of liberalisation to the domestic financial system, the need to ensure the proper sequencing, and to manage the liberalisation process must be accorded importance. Financial systems in emerging economies have and are expected to continue to play a significant role in the economy. As such, the process of international integration of the domestic financial system has to be paced with developments in the domestic system so as to ensure that the system is adequately prepared to cope with the challenges arising from the liberalisation process without destabilising effects on the domestic economy.

The liberalisation process must be managed with respect to identifying the potential sources of risks to the system. Experience has shown that the timing for opening up of the financial system will need to be sequenced and guided by the objectives to develop a more diversified economy where the respective sub-sectors and segments of society have access to adequate financial services; and to ensure the enhanced and meaningful contribution by domestic financial institutions to the economic growth and transformation process through capacity building. In achieving these objectives, a key trade off is between the need to enhance institutional capacity and the need to phase in competitive forces through the appropriate sequencing of market liberalisation.

It is therefore, important that the liberalisation process is sequenced and managed effectively, according to the stages of development of the domestic financial system, the inherent risks and the strength of the social safety net as well as the tolerance level of the financial system. Successful implementation of this process, including evaluation of the trade-offs involved, will at the same time enable the emerging economies to achieve the overall national objectives.

It must be emphasised that the tolerance level for the system as a whole will only be as strong as the strength of its components. Having robust financial institutions that are able to withstand any potential shocks and that have the agility and adaptability to embrace the future challenges are key to ensuring long-term sustainability and survival in the competitive future as well as the maintenance of financial stability.

One of the most important aspects in enhancing the tolerance level involves building the capacity and institutional development.

Wide-ranging strategies have included consolidation, reengineering of business processes and reassessment of business models to fit the new financial landscape. Leveraging on advancements in information and communication technology is important to improve business automation and efficiency levels.

To achieve a higher level of operational efficiency, rationalisation of business networks and outsourcing are gaining greater significance. The journey is however never-ending, to adapt to the changing needs of the market, and at the same time, taking into account all the potential risks.

The need to enhance the capacity at the firm level is not limited to improving the way business is conducted and the level of efficiency in doing business. The financial institution, as a service provider, relies heavily on human intellectual capital which contributes to the innovativeness and competitiveness of the institution. Thus, human capital has been constantly sharpened through continuous development programmes and challenged to maximise its full potential. Towards this end, Bank Negara Malaysia has established the International Centre for Leadership in Finance to provide an avenue for the development of industry leaders especially in this region.

In the wake of the growth in the volume and complexity of financial transactions, and worldwide integration of financial markets, risk management has increasingly become a key concern. Sound risk management practices will minimise adverse consequences faced by financial institutions during periods of uncertainty. Effective risk management systems facilitate the measurement and management of risk exposures, thus minimising potential future losses. In addition, robust internal controls which are designed to provide qualitative standards are also necessary to complement the quantitative analysis of risk and provide a check and balance in the overall risk management practices.

The Malaysian Experience

Let me now take the opportunity to share with you Malaysia's experience in addressing some of these issues. The blue print for the development of the financial sector in Malaysia is outlined in Financial Sector Masterplan that was released about

three years ago. The Masterplan is all about determining the future directions of the financial system and to define the financial structure that is most appropriate to our requirements as our economy moves to the next stage of development. It therefore provides the direction and common purpose for all the relevant parties in the financial sector, the industry, the market participants, the regulators, and the government. In emerging economies, the role of the government and the regulator is important in particular to prioritise policy goals, build the infrastructure, provide the legal and supervisory framework, and in addressing market failures. The key emphasis of the plan is to move toward a more diversified and balanced financial structure with a strengthened institutional framework, enhanced market infrastructure and practices, and an appropriate regulatory environment in line with the transformation that has taken place.

The Asian crisis highlighted the vulnerability associated with fragmented financial systems and the risk of excessive reliance on the banking sector. Strategies therefore focused on introducing reform measures to strengthen the banking sector and develop and enhance alternative sources of financing. The objective is to develop an intermediation structure that will facilitate an economic transformation toward a more diversified economy, namely:

Develop the domestic bond market;

Develop venture capital industry to support new growth areas such as the ICT and bio-technology sectors;

Enhance the framework for financing the small and medium-sized enterprises or SMEs;

Develop micro finance services especially micro credit for micro enterprises; and

Strengthen the development financial institutions to ensure more effective use of public sector resources in achieving socio-economic objectives and greater complementarities with the banking sector.

Following the successful financial restructuring and consolidation of the banking sector, efforts have shifted to building the domestic financial infrastructure. The industry-wide consolidation exercise for the domestic banking institutions after the crisis saw the 71 banking institutions pre-crisis being consolidated into 10 domestic banking groups. The consolidation exercise was a major structural enhancement of the financial system. Banking institutions have now attained a minimum capital size that is able to benefit from economies of scale and undertake the necessary investment in technology important to the industry.

A major transformation of the structure of financial intermediation can be seen in terms of the deepening and broadening of the private debt securities market. Efforts were directed to promote a robust domestic bond market to provide a competitive source of long-term debt funding and viable investment alternatives for investors. The trading and information infrastructure was enhanced with the introduction of the Fully Automated System for Tendering, Bond Information and Dissemination System and real-time gross settlement system. The regular issuance of MGS with various

maturities along the active benchmark yield curve has facilitated the evolution of a benchmark yield curve. The introduction of new instruments such as asset-backed securities and MGS futures were facilitated, and liquidity in the market was improved by enlarging the size of MGS issues and widening the institutional investor base. The introduction of the Principal Dealer (PD) system promoted an active market-making mechanism for both Government and selected securities in the bond market.

In terms of magnitude, the bond market (including both public and private sector bonds), tripled in size from 44.7% of GDP in 1996 to 80.6% of GDP as at end-June 2003. The private debt securities market accounted for 54% of bonds outstanding and 43.6% of GDP as at end-June 2003 compared to 13.5% of GDP in 1996. Funds raised by the private sector through the bond market increased to 16% of the total private sector debt financing (as at end-June 2003) from 9.3% in 1996.

Another development in our financial landscape is the growing significance of Islamic banking and finance in the financial system. Islamic banking has strongly emerged as an efficient and effective financial intermediation channel, forming an integral part of the overall Malaysian financial system. Today, we have developed a comprehensive Islamic financial system covering banking, Islamic insurance, the money market and capital market, that operates in parallel with the conventional system. Islamic banking now accounts for 10 percent of the market share of the total banking system.

There has been a rapid expansion in the development of Islamic financial instruments. At the global front, Malaysia was the first country to issue a sovereign Islamic financial instrument launched in the international financial markets. The capacity of the Islamic banking institutions to arrange and offer products with attractive features and competitive pricing, which are comparable to the conventional products has been enhanced. While Islamic finance was first introduced to meet the needs of the Muslim community, today, the Islamic financial products and services have wide appeal to both Muslim and non-Muslim customers.

The Malaysian Islamic banking institutions operate under a robust regulatory and supervisory framework at par with the conventional banking institutions to ensure the soundness and stability of the system. At the international level, the establishment of the Islamic Financial Services Board will further harmonise the international prudential and regulatory standards for the Islamic financial institutions on a global basis.

The development of the venture capital industry, a better framework for SME financing and the provision of micro financing continue to be important priorities to ensure that credit is made available to all segments of the economy, as well as to support the growth of new areas and industries. Increased focus on developing these financing modes has been supported with higher public sector budget allocations for the venture capital industry and for specific development financial institutions to

channel micro-credit to small micro-enterprises.

Priority has also been accorded to investment in information and communications technology by the banking sector. With the completion of the consolidation exercise, domestic banking institutions have actively embarked on upgrading their systems, including in product delivery, risk management and information systems. The adoption of technology in the Malaysian banking system has predominantly been to automate business processes. However, more recently technology has been used as a tool to assess and drive business performance. With competition in the market becoming increasingly intense, the ability to understand the drivers of performance and the ability to make prompt response is vital to remain competitive.

Business delivery channels and business processes have also been reviewed to enhance efficiency levels and service quality to the customers. Many have formed strategic alliances with partners to enrich their value proposition to their customers through cross-selling of products and services. Indeed, the Malaysian banking industry has now become more consumer-centric. Several banking institutions have embarked on customer relationship management systems to better understand the needs of their customers in order to provide better levels of service and to gain a better understanding of their drivers of profitability.

In the area of corporate governance, the hybrid approach adopted by Malaysia includes legal reform, self-regulation as well as measures to encourage market-based regulation. New measures were introduced to further improve the level of governance among banking institutions. This includes limiting the number of directorships of chief executive officers, reviewing the responsibility and accountability of the board and management as well as requiring for the setting up of various board committees.

Emphasis on improved corporate governance goes hand in hand with the call for improvements in risk management standards. Arising from the experience during the Asian financial crisis, greater emphasis has been placed on enhancing the credit skills and to create a more robust credit culture. An accreditation process was introduced, aimed at better equipping credit officers with the required skills. Efforts are also on-going to prepare the industry for an enhanced risk management regime under Basel II and to continuously provide the relevant input towards the development of the framework, particularly from the perspective of emerging market economies.

A comprehensive 10-year consumer education programme was also introduced early this year. This is to raise consumer awareness and understanding on banking products and services and to educate the public on their rights and responsibilities in their relationship with a financial institution. The transparency and disclosure standards on banking products and services are also currently being enhanced to equip consumers with the ability to make informed financial decisions. It is envisaged that consumers will play a bigger role in instilling market discipline amongst financial players.

A deliberate reform of our payment system has also been undertaken to ensure that the payment system is stable and efficient. In July 1999, Bank Negara Malaysia implemented a Real Time Gross Settlement System known as RENTAS for inter-bank funds transfer to reduce the credit and settlement risk in the financial system. The RENTAS system also handles scripless debt securities trading, processing and settlement system on a real time Delivery versus Payment model that reduces counterparty risk substantially. In addition, a range of retail payment systems has also been implemented to further increase payment system efficiency through electronic channels, which include the introduction of Inter-bank Giro, Internet banking, mobile banking and the electronic purse.

Cards have also rapidly become an important payment instrument in Malaysia. In maintaining public confidence in using payment cards, Malaysia has taken steps to combat credit and ATM card fraud. Malaysia is the first country in the Asia Pacific region that had mandated the migration of ATM cards to chip based cards and the second country after Taiwan to implement the migration to EMV chip based credit cards, targeted to be completed by end-December 2005. The recent enactment of the Payment Systems Act 2003 is also a testimony to the Bank's commitment for greater payment system oversight, and to provide legal certainty to the finality of payment instructions carried out through major payment systems.

Social Responsibility of Banking Institutions

Sustaining growth in emerging economies requires stability to be preserved in the macroeconomic environment, the financial system and markets as well as social environment. The responsibility of achieving social stability and development should no longer be the exclusive domain of the government. The focus on short-term returns should not be at the expense of long-term sustainability. It is increasingly being advocated that corporate social responsibility is an important part of the business environment. Corporate social responsibility refers to operating business in a manner will also contribute to economic development while improving the quality of life of the workforce and local community and society at large.

The banking institutions, being the main provider of financing in the economy, need to assume a much greater role in contributing towards the long-term development of the small and medium-sized enterprises (SMEs). In developing the SME industry into strong and resilient enterprises, banking institutions need to reassess their relationships with the SMEs as financing alone will not guarantee the long-term success of the SMEs. The traditional relationship between creditor and debtor has to evolve into a business partnership whereby banking institutions are expected to play a more participative role in identifying gaps in processes, skills and expertise as well as usage of technology. Gains can be reaped as the SMEs grow in significance in the economy.

Positioning the Central Bank to Meet the Challenges Ahead

My presentation on institutional development and capacity enhancement would not be complete if it did not include the Central Bank. The new environment in which central banks are operating has also changed dramatically. Central Banks are continually being confronted with the need to balance between conflicting objectives, and conflicting means to achieve the objectives. To stay at the forefront in dealing with the new challenges that we are faced with, our own efforts have also been focused on strengthening our capacities and capabilities. This includes measures to continually review our strategic orientation and key priorities and the necessary changes that need to be made so that we are positioned to effectively deal with new challenges and changes taking place.

Central Banks in emerging market economies have a much broader mandate than our counterparts in the more advanced and mature economies. Of importance, is our developmental role in charting the development of the financial system, institutional development and the overall economic management. To achieve our strategic intent and build the infrastructure to support our strategies, investment in technology and the appropriate skills, and the transformation of our organisation into a knowledge-based organisation were among some of the major initiatives made.

Conclusion

To conclude, the East Asian region has, since the financial crisis, experienced pronounced economic and financial transformations. Our experience in Malaysia shows that a more diversified and sound financial sector, a more efficient and competitive financial industry and all the structural enhancements made, have evolved a more effective and resilient financial system. This has enhanced the tolerance level to withstand the more difficult and challenging environment.

Such fundamental changes, however, cannot be expected to be achieved within a short period of time. Enhancing the tolerance level in the financial sector of the East Asian economies is one of the important elements in strengthening the growth prospects for the region. The overall economic and financial transformation that has occurred has resulted in an Asia that is a mutually reinforcing region of growth; an Asia that has an increasing role in the creation of wealth; and an Asia that will be an important region in promoting and supporting global stability and global growth.

Source: <http://www.bnm.gov.my/> 09/16/2003 Malaysia