Governor's Keynote Address at the 19th ASEAN Banking Conference 2012 - "ASEAN: Towards a More Integrated Market" Kuala Lumpur, 7 November 2012

Keynote Address by

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As we enter a new phase of globalisation, Asia's role in the world economy is being significantly transformed both in terms of its significance and influence. ASEAN economies are very much a part of this process. This trend has become more pronounced following the global financial crisis. Five years into the crisis, the world economy continues to be challenged to hold a sustained recovery. The financial sector restructuring and reforms, and the structural adjustments being undertaken by the crisis-affected economies will not only take time to produce results, but in the more immediate term, these efforts will involve costs to the economy.

While emerging markets such as those in the ASEAN region are not insulated from these developments, the region has displayed remarkable resilience during this period. The region has benefitted from the decade of restructuring and financial reforms following the Asian financial crisis. In addition, structural adjustments undertaken during this period and have resulted in more diversified economies, in which domestic sources have become increasingly important in sustaining growth performance. The region's more favourable growth prospects are also underpinned by the relatively sound fundamentals that include strong external and fiscal positions, stable macroeconomic conditions, low unemployment and resilient financial systems. This has also enabled the region to better manage the large and volatile capital flows that we are experiencing, thereby mitigating its destabilising effects on economic activity. These strong foundations have supported ASEAN economies through the challenging external developments that have taken place and have well positioned the region to realise its full potential as a dynamic growth centre.

It is my great pleasure to be here to speak at this 19th ASEAN Banking Conference, hosted this year by the Association of Banks in Malaysia (ABM) here in Kuala Lumpur. This Conference takes place at an important juncture for our region, as concrete plans are being advanced to achieve an ASEAN Economic Community (AEC) by 2015. The AEC Blueprint, adopted by ASEAN leaders in 2007, envisages ASEAN to become a single market and production base that is characterised by the free movement of goods, services, investment and skilled labour, and freer the flow of capital. Despite the recent global financial crisis, the drive for this vision to be realised remains resolute. This is well supported by the prevailing strong foundations and the tremendous growth prospects for ASEAN in the medium to longer term. My remarks today will focus on the elements of the prospects for the ASEAN economies, and the state of ASEAN financial integration and its importance in enhancing the regional growth potential. My remarks will conclude with some thoughts on imperatives for the banking sector going forward into the future.

Prospects for ASEAN Economies

ASEAN is currently one of the most dynamic and fastest-growing regions in the world economy. The region's GDP is expected to triple to USD3 trillion by 2017 relative to a decade ago. Economic expansion is expected to be sustained at a rate of 5.8% in the next five years, significantly outpacing global growth. In tandem with this, is the notable rise of the middle class population. The Asian Development Bank estimates that the share of ASEAN's middle class population is expected to increase to 65% by 2030, consequently contributing to altering the global consumer

landscape. With a sizeable population of 600 million people, this underscores the evolving role of ASEAN as a significant consumer market base with distinct needs and increasing purchasing power. Given that the share of the working population in ASEAN is estimated to reach 58% by 2050, ASEAN will benefit from its demographic dividend and abundant workforce.

An accompanying trend is the rise of entrepreneurship in the region. The emergence of home-grown businesses with prospects of becoming large national and multinational corporations has generated attention and priority to be accorded to supporting the development of small and medium scale enterprises (SMEs). Currently, SMEs account for 50% - 85% of domestic employment in ASEAN economies and 30-50% to GDP. Given the substantial contribution to income and employment generated by this sector, its development will be vital in creating employment and sustainable long-term growth in the ASEAN economies. On the corporate front, local corporations and businesses have fared well in establishing a stronger footprint in the region, as evidenced by their expanding regional presence and cross-border acquisition activity which has increased from USD10.9 billion during the first half of 2011 to USD26.2 billion for the same period in 2012. This vibrance of economic activity has been well supported by the continued access to financing by businesses in the region and resilient and strong ASEAN-based financial institutions.

Finally, ASEAN has also become an attractive foreign direct investment destination not only due to its stable macroeconomic environment but also due to its market size and the abundance of natural resources. ASEAN's proximity to major markets such as China and India reinforces its status as an important global value chain player and a preferred production base for many multinational corporations. In 2010, foreign direct investments into the region registered an impressive growth of more than 100% from the preceding year. The strong ties between the ASEAN economies are also underpinned by the continued growth of intra-regional trade, which now accounts for 25% of ASEAN's total trade. Going forward, this trend is set to continue. The growing consumer market and the expansion of production networks in Asia will continue to be a major driving force in promoting this increased intra-regional trade. In addition, the measures taken to boost investment, as well as infrastructure development will reinforce this trend.

Regional integration: the ASEAN model

We stand today on the brink of very exciting times for ASEAN as we draw closer to the vision of an ASEAN economic community in 2015. If the AEC vision was aspirational when it was first conceived, it is now clearly an imperative. This has prompted an increased momentum in efforts to realise an integrated ASEAN economic community, notably by achieving increased financial integration, higher levels of intra-regional trade and greater two-way cross-border investment flows. Like most regional blocs, the integration process for ASEAN seeks to promote greater regional connectivity which will in turn expand and reinforce the region's growth potential. The region's integration process however, has followed its own path. Given the diverse nature of our economies within ASEAN, the integration model adopted for ASEAN has been one that focuses on (i) strengthening preconditions through collective capacity building to promote more open market access among the economies in ASEAN; (ii) progressively reducing barriers to facilitate cross-border trade; (iii) developing the market infrastructure and enabling environment to promote efficient and effective intermediation of cross-border financial flows; and (iv) establishing the appropriate safeguards for financial system stability.

Progressive financial integration through this ASEAN model has been a strategy that has augured well for the region, allowing for the greater integration at a pace that is based on readiness and strength of the financial sector. Since 2007, ASEAN has achieved considerable progress in its efforts to deepen financial integration. ASEAN has undertaken gradual and sequenced liberalisation of identified financial services sub-sectors through the ASEAN Framework Agreement on Services (AFAS). Five rounds of negotiations have been concluded, with the sixth round of negotiations expected to be concluded by next year. In the area of financial markets, an Implementation Plan for an Integrated Capital Market has been

developed to enhance market access, linkages and liquidity. ASEAN has also made significant advancements in the areas of supporting financing for infrastructure development, as reflected by the establishment of the ASEAN Infrastructure Fund in 2011.

Notwithstanding these developments, a crucial driver for greater financial integration within the core of ASEAN financial systems is the banking sector. ASEAN banks have a significant role in supporting the financial integration process. Over the recent decade, we have witnessed the rising prominence of ASEAN financial institutions within the region, driven by the growing business fundamentals in the region and the strengthened capacity of the financial institutions. ASEAN commercial banks are predominant mobilisers of financial funds, as our experience shows, the banking sector is the most matured component in the financial sector of most jurisdictions. The banking sector therefore serves as an important conduit to increase connectivity among all ASEAN nations and in fostering financial integration.

Towards this end, the ASEAN central banks have endorsed the ASEAN Financial Integration Framework in 2011 and are in the final stages to launch the framework for banking sector integration. This will pave the way for a more meaningful presence of qualifying ASEAN banks within the region, while promoting regional financial stability. Recognising the diversity of ASEAN economies and the varying stages of financial sector development, the framework allows flexibility for ASEAN countries to participate in the integration process based on their readiness and willingness. Under the framework, qualifying ASEAN banks that have the capacity and that are well managed will serve as the regional standard bearers, and will be accorded more flexible access into regional markets. Greater flexibilities will also be given to facilitate the regional expansion plans of qualifying ASEAN banks to become important conduits of financial intermediation in the region. Tremendous opportunities can be harvested from this new framework. Hence, I welcome and look forward to the greater participation by financial institutions from all ASEAN countries in this process.

Imperatives for banking sector going forward

At this juncture, let me turn to imperatives for the banking sector going forward. There is a fundamental rethinking of banking by the international community in the aftermath of the recent global crisis. These are both driving and shaping the raft of reforms at the global level. I would like to touch briefly on four developments which could serve as a foundation for sustainable banking in the medium and longer-term. First, is for reduced complexity and increased transparency in the banking sector. Consistent with the more traditional banking models in this region, there are now increasing calls for a return to basic banking and its clear separation from higher risk-taking activities. This is part of the broader efforts to create a safer global financial system where markets and institutions are more transparent, less complex, and less leveraged than they are today.

While the banking sector in ASEAN has not reached the degree of complexity observed in the advanced economies, the region has to be mindful of the consequences as financial institutions evolve to become increasingly regional in orientation. Indeed, such growth must be commensurate with the capacity and capability of both the financial institutions and the regulators to manage and oversee the associated risks. Strengthened supervisory intensity and effectiveness, a core component of the financial sector reforms, is an essential pillar to check against unfettered innovation and risk-taking behaviours and promote strong incentives for prudent risk management. ASEAN will have to pursue an outcome that facilitates innovation and efficiency, without resulting in undue risks and unwanted costs on both the financial system and the overall economy.

Second, is the stronger focus on more responsible and sustainable financial business practices. Following the recent global financial crisis, there is a stronger international emphasis for appropriate risk-aligned mechanisms, particularly on compensation frameworks, which provide incentives for financial innovation and growth, while not compromising financial stability. This includes the increased pressure on financial institutions and regulators to have

incentive systems, governance, accountability and controls to address the issues of over-emphasis on short term performance, reckless risk-taking and the pervasive conflict of interests. In tandem with this, is the stronger focus to spur consumer activism as a means to encourage more responsible and sustainable business practices. It is in this area that financial institutions can have an important role in creating positive conduct and behaviours among financial participants in the industry, as well as contributing towards uplifting the state of financial education and consumer awareness.

Third, is the strengthening of boards' effectiveness and accountability, and sound governance of financial institutions. Following the crisis, i.e. the global financial crisis, corporate governance practices in the financial industry have come under significant scrutiny. There have been increased expectations on the management, boards of financial institutions and on regulators to significantly improve governance practices, particularly in the area of risk management policies and procedures. At the international level, substantial enhancements have been made to standards on corporate governance. The growing expansion of ASEAN banks in the region, must therefore be accompanied by an increased emphasis for the boards and senior management of financial institutions to provide the leadership and oversight of group-wide risks arising from cross-border operations. Greater diversity of boards to appreciate cultural nuances and competitive dynamics in different markets will hence be key to support sustainable cross-border operations of the institutions.

Fourthly, is reinforcing buffers to withstand future shocks. This is a key area of the international reform package that aims to significantly raise the resilience of the international financial system and to promote sound risk-taking activities. The standards will see financial institutions holding larger amounts of capital, including buffers which can be drawn down as losses occur. At the same time, the standards will also require banking institutions to significantly strengthen their liquidity and funding positions. Collectively, these standards aim to strengthen the banking institutions' ability to continue to support orderly credit intermediation, particularly during periods of instability. While carrying more equity entails greater costs of capital for banks especially in the short-term, this investment will support a more stable financial system and overall global economy as well as build the confidence of consumers and investors, particularly during periods of stress.

In view of these imperatives, this is a timely juncture for the industry to reflect and take charge of the efforts to rebuild and strengthen the foundations for more sustainable finance. Critical to this is the realisation that the creation of long-term shareholder value is consistent with, and not at odds with prudent risk taking and responsible business practices. Indeed, financial institutions with a regional footprint in ASEAN have the potential to contribute to the development of the financial systems in countries where they operate. There will be tremendous payoffs to be reaped from pursuing such sustainable strategies. Such long-term commitments to ASEAN will not only contribute to mutually reinforcing regional growth, but will become an important source of stability to the region.

Conclusion

Let me now conclude my remarks. There is less than three years to achieving the 2015 ASEAN aspirations. While many challenges remain, ASEAN is well positioned to collectively strive ahead towards the shared vision of a one ASEAN market. The financial industry has an important role in realising this vision, through its market conduct, business strategies and participation in domestic and regional collaborative initiatives. This conference provides an excellent strategic platform for the ASEAN industry to come together, share ideas and develop a greater understanding on the important issues towards building a stronger foundation for sustainable growth in ASEAN. On that note, I wish you an engaging and productive conference.

Governor's Speech at the Euromoney-Qatar Conference: "Global Financial Stability and the Internationalisation of Financial Systems in Emerging Economies" Qatar, 11 December 2012

Speech by

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It is my honour to be here in Doha to speak at this Euromoney-Qatar Conference on "Global Finance Re-designed". I wish to thank the Qatar Central Bank for the invitation to speak at this event. In this current global environment, the unprecedented and wide ranging global policy responses have yet to produce financial stability and a sustainable recovery of the global economy.

The intensification of the globalization of finance in this decade has resulted in an even more connected and interdependent world. While the financial systems and economies in most parts of the world felt the effects of the recent global financial crisis, it has not discouraged the pace of internationalization of financial systems, in particular, in emerging economies. My address this morning will be on financial stability and the internationalization of financial systems in emerging economies. My remarks will cover the benefits and challenges of such internationalization, the lessons that can be drawn from the recent global financial crisis, the Malaysian experience on the internationalization of our financial system.

Benefits and Challenges of Internationalisation of Financial Systems

While there are significant benefits from internationalization of financial systems, the resulting increased international financial integration brings with it new risks and challenges. The case for increased financial liberalization and internationalization maintains that it would foster the development of a more efficient and robust financial system. While the resulting more competitive financial system will enhance the efficiency in the financial intermediation process and contribute towards reducing the cost of intermediation, the supervisory oversight needs to ensure over competition does not result in the mispricing of risk with adverse consequences on financial stability.

Other benefits are the increased opportunities for technology transfer, new expertise and greater innovation and new product offerings. Increased foreign participation in the domestic financial markets would also contribute to increased liquidity and more competitive pricing in the domestic financial markets and encourage a more efficient allocation of capital within the economy. It is also maintained that it will contribute to the expansion and development of the domestic financial markets in particular, the capital market, proving an important access for financing of investment activity. With the more efficient functioning of domestic financial markets, it would also improve the transmission mechanism of monetary policy.

Meanwhile, the increased capital inflows following the capital account liberalization represents another source of financing that would contribute towards increased investment and growth. It will allow jurisdictions with surplus funds to be channelled to those regions with productive investment opportunities and thus contribute towards a more efficient allocation of funds across international borders. The stronger cross border financial linkages has the potential to enhance international trade and investment opportunities. It allows countries to leverage on the respective comparative advantage and complementarities to reinforce mutual growth. This would be important in the current environment to facilitate cross border economic activity.

The liberalisation of the capital account in the form of removing restrictions to foreign exchange transactions would also increase the flexibility of managing such foreign exchange transactions. This would increase the potential to better manage its associated risks, while the increased efficiency gains would also reduce the cost of doing business. Finally, it is also argued that in a more liberalised environment, there would be greater market discipline which would in turn promote financial stability in the domestic financial system. This however, relies on a sufficient level of disclosure and transparency to allow the efficient functioning of the markets.

The internationalization of financial systems is however, not without risks and challenges. The risk of contagion following from the increased connectivity increases significantly, in terms of the extent and speed. The contagion can result from external events and developments that can range from failure of large and important international financial institution to the eruption of wars or political incidents that have regional or global repercussions. Meanwhile, global developments including from global policy spillovers have also resulted in more volatile capital flows. The increased openness of the financial system also increases the vulnerability to economic cycles in other parts of the world. The increased interdependence of financial systems and economies and the contagion effects can be expected to be among the significant outcomes of financial internationalization.

Financial liberalization could for example amplify further the implications of financial stress from other parts of the world on the domestic financial system. It could also accentuate and amplify asset bubbles and boom bust cycles. Other implications are that it could contribute to the widening of income disparities and also to the marginalization of domestic financial institutions if they are not able to perform in a more competitive environment. Finally, volatile capital flows may not only affect the efficient functioning of the financial markets but could result in misaligned exchange rates that do not reflect underlying fundamentals. These potential risks and vulnerabilities continue to be a challenge not only to emerging economies but also to the more developed financial systems and economies.

Lessons from the Financial Crisis

While there are benefits to be gained from the internationalization of financial systems, the risks to financial stability have also increased immensely. The risks generally emanate from the greater prospects for contagion following the greater degree of interdependence. These risks would be even more pronounced in emerging economies in which financial systems have yet to become more developed and matured. To be better positioned to reap the benefits from internationalization of financial systems in emerging economies, the crisis provides us with several lessons. Firstly, is to recognize that the different parts of the domestic financial system is highly interconnected. This also includes those parts that may not be under the regulatory capture. Financial stress in a specific segment may no longer be confined to that segment but may rapidly be transmitted to the rest of the financial system. Thus, a piecemeal policy response would not be sufficient. It would require a comprehensive response to ensure that such stressed conditions does not evolve into a major financial crisis.

Secondly, the buildup of risks to financial stability need to be identified early. Preemptive action would reduce the cost of the crisis on the financial system and the economy. Third, the regulatory authorities need to be accorded the necessary powers to manage the risks to financial stability. Fourth, the optimal policy mix may not only include policy actions to address immediate term issues but would also need to simultaneously address the underlying structural problems. Fifth, is to give recognition to the importance of enabling conditions that will render the implemented policies to yield the desired outcomes. Finally, to facilitate effective policy decision making there needs to be a platform and governance process for policy coordination across agencies within an economy and for this to be extended for regional and international collective action.

Following the recent global financial crisis, the policy response at the national level has been extensive and on an unprecedented scale. While there has been wide ranging financial reforms at the international level to strengthen the resilience of the financial sector,

the cross border dimension of policy-making has not been as extensive. This is despite the swift spread of financial and economic shocks throughout the global economy and international financial system following the eruption of the financial crisis in 2008.

Despite these increased challenges, the institutional arrangements for policy cooperation and coordination have yet to reach the levels that are commensurate with the degree of global economic and financial integration. While the individual efforts by any single economy is vital, it can no longer guarantee global financial stability. Emerging economies that are more open and integrated with the global economy and international financial system are the most affected by these developments. The crisis has forcefully demonstrated the importance of the international dimension of policy.

Finally, a consequence of financial crisis that deserves increased attention is the widening of income disparities within economies. The recent crisis has worsened this trend given the conditions of high unemployment in many parts of the world. At the national level, the development of inclusive financial systems and the development of social safety nets will contribute to containing this trend.

Financial Internationalisation and the Malaysian Experience

In pursuing financial sector liberalisation to transition to a more internationalised financial system, Malaysia adopted a gradual and sequenced approach. This was to ensure that the necessary preconditions were in place so that the benefits of increased financial internationalisation would be realised, while ensuring that the associated risks inherent to a more open economy and internationally integrated financial system could be effectively managed.

Seven preconditions were identified as being important to this process. The first was to accord priority to building the capacity of the intermediaries in the financial sector, and to strengthen their resilience and competitiveness. At the time of the Asian financial crisis, Malaysia had a highly fragmented banking sector with more than seventy banking institutions, many of which were small and highly vulnerable. During the financial crisis, a major restructuring exercise was undertaken. This was followed by an industry-wide merger exercise, prompted by an increase of the capitalisation requirements. The restructuring strengthened the balance sheets of the banking institutions, while the consolidation produced larger and stronger financial groups.

The second was to undertake financial reforms which focused on the transition to a more market-oriented financial system. This involved interest rate reforms that would support the more efficient pricing of financial products and services. The more competitive environment that was generated became an important driver of efficiency gains and innovation in the financial system.

Equal attention was also given to the development of the financial infrastructure, in particular, the payment and settlement system and the modernization of the legal framework to give greater clarity to the legislation governing the financial sector. This involved seven new legislation that have been enacted in the areas of central banking, the payments system, money services, deposit insurance, and the regulation of the banking, insurance, Islamic finance, development financial institutions and cooperatives. This has given greater certainty and predictability in the functioning of the financial system.

Importance was also given to strengthening the surveillance capabilities of the Central Bank and the effectiveness of the regulatory and supervisory regime. This involved the transition from a rule-based regulation to an enhanced principle-based regulation regime with focus on governance practices and risk management. This was reinforced by the shift to a risk-based supervision. The supervisory oversight has however continued to remain intrusive, with a pre-emptive intervention framework to ensure that the potential risks to financial stability would continue to be addressed including in a more regionally and internationally connected financial sector.

In parallel with these efforts was the development of the securities market. From a financial system in which there was an over-reliance on the banking system for financing, the financial system has now become more diversified with greater access to financing from the bond and sukuk market. The domestic securities market has now evolved to become a vibrant part of the Malaysian financing ecosystem, and has served to disperse the concentration of risk in the financial system thereby contributing towards preserving financial stability. The Malaysian securities market has expanded significantly to become the largest in the ASEAN region.

Malaysia also made significant investments in talent development for the financial services sector. Given its significance in defining performance and resilience of the financial sector, comprehensive institutional arrangements have been put in place for all levels of the industry; at the entry point, at the working and specialist levels, at the professional level and at the leadership levels including for the boards of financial institutions.

Finally, as the financial system became more regionally and internationally more integrated, regional financial stability arrangements have also been established. These included advancing collective initiatives in the areas of regional surveillance, the development of regional financial markets and payments infrastructure, and cross-border supervision. Forums for assessment of risks to regional financial stability have also been initiated, and work on establishing an integrated crisis management and resolution framework for the region is in progress. As part of these initiatives, a regional support mechanism has also been established.

With these pre-conditions in place, Malaysia commenced initiatives to internationalise our financial system beginning 2003. The internationalisation of the financial sector entailed the advancement in two main areas; financial sector liberalisation and capital account liberalisation. In pursuing greater regional and international financial integration, the aim was to enhance the diversity of the financial system in terms of its product offerings, to improve further the competitiveness of the financial system and to strengthen our economic linkages with the region and other parts of the world.

The financial sector liberalisation involved increased foreign entry and participation in our financial system. New licences were issued to foreign conventional and Islamic banking institutions, while the minimum foreign strategic stakes in the insurance and takaful industry were increased. Increased operational flexibilities were also accorded to the existing foreign banking institutions in the financial system which now account for about 30% of the banking system. At the same time, the foreign participation in our securities market was liberalised in 2007 to allow foreign corporations to raise financing either in domestic or foreign currency.

The capital account liberalisation throughout the first decade in the 2000s has involved the progressive removal of restrictions on foreign exchange administration rules. This liberalisation was intensified after 2005, taking into account the state of readiness of the financial system and the economy to manage the consequential increased cross border financial flows. In July 2005, Malaysia migrated from a fixed exchange rate regime to a flexible exchange rate regime to accord greater flexibility to adjust to changing structural conditions in the region and the global economy. With the progressive dismantling of restrictions, businesses now had the flexibility to manage their financial exchange exposures. This encouraged two way capital flows and contributed towards stabilising the volatile capital flows to our economy.

Finally, in addition to being accorded with the necessary powers in the new legislations, the policy toolkit of the Central Bank has also been expanded to address the potential build-up of financial imbalances and its risks to financial stability following increased internationalisation. This includes macro-prudential and supervisory measures to collectively address the underlying causes of financial stability. A platform has also been established for the greater coordination among policy makers within the country, among the regulators and the public sector.

Conclusion

Let me now conclude my remarks. While many lessons can be drawn from the various episodes of financial crisis experienced by the world economy, there is no one approach to the liberalization and internationalization of financial systems. Its success depends on the prevailing circumstances and the state of readiness of financial systems and the economy and its capacity to manage its associated risks. Premature internationalization can result in highly destabilizing conditions. The liberalization process also needs to be pragmatic, taking into consideration the different objectives that need to be achieved. With sufficient development of the financial infrastructure, the safeguards and the buffers, emerging economies have every potential to participate in a more internationally integrated financial system that will facilitate mutually reinforcing global growth and development.

Governor's Speech at the Islamic Development Bank (IDB) Regional Lecture Series on Islamic Economics, Finance and Banking: "Finance and the Real Economy: Fostering Sustainability" Jakarta 19 December 2012

Speech Adress by

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I am most honoured to be invited to deliver this inaugural lecture of the Islamic Development Bank Regional Lecture Series. I am also most delighted to be back here in Jakarta. I would like to thank the Islamic Development Bank for the invitation, and Bank Indonesia for kindly hosting this event.

For more than three decades now, the Islamic Development Bank has had an important role in promoting economic growth and development in so many parts of the world, and associated with this, has been its role in fostering the development of Islamic finance. It has supported the building of key international financial infrastructure that has been important for the orderly global development of Islamic finance and for safeguarding financial stability. The Islamic Development Bank has also supported research and education efforts in this area, while its strategic interests in financial institutions in different jurisdictions have been an important catalyst for their establishment and expansion. In the current more uncertain environment, in the aftermath of the recent global financial crisis, the role of the Islamic Development Bank will continue to be important, given that the goal of sustainable growth and development in the world economy has now become even more challenging.

As the conventional financial system currently confronts what is perhaps its most defining period, several important lessons can be drawn for our collective efforts to build more resilient financial systems. Important considerations need to be accorded to the issues that have emerged, and on the policy directions affecting growth and stability. My address today will discuss several of these issues, and discuss how Islamic finance, given its nature and inherent features, can contribute to the process of enhancing the discipline that contributes to ensuring growth and financial stability.

At the core, the financial system needs to serve the real economy. The purpose of the financial system is intermediation - that is, to match savings and investments for the purpose of generating economic growth. Yet, in recent decades, a number of factors have contributed to the weakening of the link between financial intermediation and productive economic activity. Deregulation opened up new opportunities for financial institutions to enhance performance and expand the scope of their activities. Greater competition, reinforced by significant advances in technology, intensified the pace of innovation. And, the extended period of low inflation and low interest rates incentivised greater risk-taking. Cumulatively, these developments contributed to a dangerous build-up of financial imbalances.

This has prompted a rethinking of the issues related to the financial business and its models, and wide-ranging regulatory reforms by the international community. Related to these issues is the question on the "appropriate" size of the financial sector. As economies develop, the size of financial sector assets and, correspondingly, the value-added contribution of the financial sector, is expected to increase. However, while there is a fundamental relationship between the growth of the financial sector and the real economy, the relationship is not well-understood or captured in current macroeconomic models. This creates a potential challenge for policymakers to determine the point at which growth of the financial sector may be outstripping the demands and the potential of the real economy. This issue has become even more pronounced with greater

regional and global financial integration, and in countries that are also international financial centres. To the extent that corporate and personal income growth is driven by financial transactions rather than by an increase in production or employment growth, economies become potentially more vulnerable to the consequences of financial system stress.

The recent global financial crisis provides a distinct example of how excessive leverage and exponential growth in financial activities that are detached from the growth trajectory of the real economy can become a source of instability. Leverage increased sharply in the years leading to the crisis, buoyed by years of strong economic growth. In the advanced economies, bank balance sheets exploded, growing to multiples of annual GDP. For example, in the case of Iceland, the three largest banks that were nationalised in early October 2008 had seen their total assets expand from 100 percent of GDP in 2004, to more than 900 percent of GDP as at end-2007. Similarly in Ireland, assets in their financial institutions with substantial domestic businesses were more than 400 percent of GDP by 2008, while in the United Kingdom, bank assets were more than 500 percent of GDP prior to the global financial crisis. The sheer size, complexity and leverage in the banking system increased the fragility of financial institutions and limited their ability to absorb even small losses, thereby resulting in widespread and deep economic dislocations.

This expansion of financial activities was also in part due to the activities in the shadow banking system, which in the United States, grew to be even larger than the traditional banking sector in gross terms. At the height of the crisis, the size of gross amounts outstanding of over-the-counter (OTC) derivatives globally was estimated at over 614 trillion US dollars[1], more than ten times global GDP. Despite its size, the over-the-counter market was opaque and inadequately regulated, making it more difficult to quantify the risk that had been assumed by the financial institutions.

A further issue relates to financial innovation and for policy interventions not to stifle those innovations that are beneficial to society, while reining in those that are harmful. The current debate on the international financial reforms continues to reveal that this is a challenging task. While there is wide support for a return to basic banking, it is also acknowledged that financial innovations have been instrumental in improving financial access levels, by enabling financial institutions to manage risks in ways that have allowed for higher-risk economic activities to be undertaken. Contrary evidence, however, also exists. In the run-up to the crisis, derivatives were extensively used to arbitrage regulatory requirements and to extract excessive profits through opaque and complex transactions that resulted in the fundamental mispricing of risk. Current reform efforts are therefore confronted with the need to strike a balance between constraining harmful practices, without restricting innovation that is key to a progressive financial system.

Another issue relates to the prospect for aligning the expectations of capital providers with the imperatives of sustainable banking. In the years preceding the crisis, the growth of the financial system substantially exceeded that of the overall economy. Published data[2] indicates that the balance sheet of the world's largest 1000 banks increased by about 150 percent between 2001 and 2009. At its peak, the scale of the assets of the financial sector far exceeded those in other sectors, with record profits reported from year to year. In the current environment, banks continue to remain under considerable pressure to support activities that generate the kind of rates of return that capital providers have come to expect from the industry. This runs counter to expectations for banking to be returned to its fundamental role of supporting real economic activity. The extent to which these conflicting imperatives can be reconciled in a sustainable manner remains unclear.

A focal point of the reforms has been to protect retail banking from the vagaries of investment banking that often has involved higher risk-taking activities. In the United States, the Volcker Rule prohibits banks from carrying out certain types of investment banking activities if they wished to continue to rely on deposit funding. In a similar vein, in the United

[1] As at December 2009. BIS Quarterly Review Statistical Annex, June 2010, Table 19.
[2] The Banker publication

Kingdom, the adoption of the recommendations by the Independent Commission on Banking mandates banking groups to establish a separate subsidiary for their retail activities, and it prohibits the subsidiary from undertaking other businesses and risks. Solutions to these challenges are far from straightforward. While these and other reforms by the Basel Committee and the Financial Stability Board are expected to have far reaching implications for the landscape of the financial system as we know it today, they have yet to provide answers to many of the key questions that policymakers and the financial industry need to address in the pursuit of effective functioning and sound financial systems as we progress forward into the future.

Since the global financial crisis, significant attention has been directed at evolving an effective macro-prudential policy framework, which can serve to rein in excesses and strengthen the nexus between finance and the real economy. The concept of macro-prudential policies is hardly new and can be traced back to as early as the late 1970s, in reference to the macroeconomic and financial stability implications from the rapid pace of lending to developing economies[3]. Some emerging markets, including Asia, have, since the 1990s, deployed macro-prudential policy instruments to manage imbalances in the financial system and capital flows.

Following the recent global financial crisis, greater attention is now being focused on the role, scope, instruments and governance arrangements for macro-prudential policy to preserve financial stability. New or strengthened mandates for macro-prudential policies are being established in a growing number of jurisdictions, supported by wide-ranging changes to the legislative framework and institutional structures. Used effectively in combination with other policy tools, including micro-prudential measures and monetary and fiscal policy tools, macro-prudential policies have been demonstrated to significantly improve financial stability outcomes.

Effectively operationalising macro-prudential policy frameworks, however, remains a key challenge. By design, macro-prudential policies are intended to reduce the probability and severity of a future crisis. While further research will deepen our understanding of leading indicators and transmission channels, judgments will continue to have a key role. History has shown that political economic considerations have, at times, had an effect on the willingness of policymakers to act. Despite the high costs of crisis on the financial system on the economy and on the society, there is still an inherent bias towards inaction. This underscores the need for a stronger focus on creating an environment in which policymakers will have the confidence to act. This requires a strong mandate, sufficient policy instruments, and clear accountability structures.

While macro-prudential policy has a clear and important role in contributing towards financial stability moving forward, it does not however diminish the important role of micro-prudential supervision. Indeed, the notion that more developed macro-prudential policy frameworks can, over time, provide a credible alternative to the close supervision of systemic financial institutions - for example, through the development of better predictive macro indicators, or through reliance on recovery and resolution plans alone - is misplaced. There can be no substitute for the effective ongoing supervision of financial institutions, which relies on supervisory assessments and judgments, and enhances the understanding of firm behaviours in a manner that models and plans, no matter how sophisticated, will never be able to fully achieve. Efforts should therefore also be accorded towards further strengthening the conduct of micro-prudential supervision and promoting the complementarities between micro- and macro-prudential policies.

Let me now turn my remarks to the growing role and relevance of Islamic finance in contributing to the global agenda of fostering sustainable growth that is firmly anchored to the real economy.

[3] Based on the article entitled “The term ‘macro-prudential’: origins and evolution” published in the BIS Quarterly Review March 2010, which contains excerpt of the unpublished minutes of a meeting of the Cooke Committee (the precursor of the present Basel Committee on Banking Supervision)

The core proposition of Islamic finance draws from its inherent features and the values that it brings to the economy, and the tremendous potential that it offers in supporting sustainable economic growth and in safeguarding financial stability. These core propositions are derived from the Shariah, which dictates that Islamic financial transactions must be supported by underlying productive activities. This Shariah ruling ensures a close link between financial transactions and the real economy. Innovation and intermediation in Islamic finance are thus aligned to generating productive economic activities. There is also strong discouragement against excessive risk undertakings and a prohibition against speculative elements. These rulings also serve to insulate the Islamic financial system from excessive leverage, which in turn contributes towards promoting financial stability and its long-term sustainability. These fundamental elements resonate with the call for banking to focus on its core function of providing financial services that add value to the real economy.

This recent decade has also witnessed a dramatic transformation of the Islamic financial landscape. It has been marked by sustained rapid growth and the widening of its geographical reach, resulting in more diverse Islamic financial institutions and the generation of a wide spectrum of innovative products, particularly in the high-growth segment of the sukuk market. In this decade, Islamic finance has also evolved from being domestic-centric to become increasingly internationalised. In this dynamic environment, the scope of the Islamic finance business has expanded from simple retail and trade financing to include private equity, project finance, sukuk origination and issuance, as well as fund and wealth management products. Today, the total global size of the Islamic financial assets has surpassed more than 1 trillion US dollars. There are now more than 600 Islamic financial institutions operating in 75 countries.

The vision for the Islamic financial system in Malaysia was articulated in our first Financial Sector Masterplan that was launched in the year 2001, in which the plans for building the foundations for the Islamic financial system were outlined. This included strengthening and diversifying the financial intermediaries in the financial system, building and developing the financial markets, and enhancing the regulatory supervisory, Shariah and legal framework. Ten years later, in 2011, a new Financial Sector Blueprint was launched, charting the path for Islamic finance to transition to become increasingly internationalised, and thus to become more integrated into the mainstream of the global financial system.

Whilst Islamic finance has all the ingredients and the potential to meet the needs of the global economy, the channelling of funds to productive activities in Islamic finance today is still largely being carried out through non-participatory contracts, that includes the mark-up sale (Murabahah) and the lease-based (ijarah) structures, which continue to remain essential to cater for financing trade and the purchase of assets. Such contracts are similar to lending instruments which expose the Islamic financial institutions mostly to credit risk elements. Whilst non-risk-sharing contracts will continue to contribute to the future growth of Islamic finance, the wider use of risk-sharing transactions and undertakings under participatory finance models have significant scope in evolving a broader representation of Islamic financial products that will spur the next phase of industry growth and development. This includes participatory or equity-based contracts such as Mudarabah and Musharakah that support ventures involving entrepreneurship endeavours. Greater use of equity-based models in Islamic financial solutions has been observed in the more recent period. This has been most evident in the sukuk segment, with Shariah structures evolving from predominantly ijarah and murabahah structures to musharakah partnerships as well as convertible and exchangeable trusts.

The further development of participatory Islamic finance contracts on a broader scale offers particular potential in efforts to reinforce links between finance and the real economy. Several elements of risk- and profit-sharing participatory contracts support this. As profit-sharing and loss-bearing are clearly identified and agreed based on the contractual agreements between the financier and the entrepreneur, strong emphasis is placed on the value creation and

economic viability of productive efforts that create new wealth. In equity-based contracts, the financial intermediation is thus also directed towards promoting entrepreneurship, in that the clearly defined risk- and profit-sharing characteristics of the Islamic financial transaction provides strong incentives for both parties to contribute to the success of the investment. This also provides the foundation for a long-term trust-based relationship, and a clear interest for the financial institutions to undertake the appropriate due diligence to ensure that the returns are commensurate with the risks being assumed. Aspects of governance and risk management thus strongly underpin these contracts. In particular, such contracts demand higher standards of disclosure and transparency to be observed, which in turn act to strengthen market discipline.

The legal, regulatory and supervisory framework will need to be adjusted to accord greater clarity to the appropriate legal and regulatory treatment in order to foster the sound and orderly growth of risk-sharing structures and activities, both in terms of the funding and the assets-side of Islamic banks. In Malaysia, steps are currently being taken to provide a conducive enabling environment for this next phase of development that will spur more risk-sharing transactions though the formulation of new legislation for Islamic banking and takaful. This legislation is now at the final stages of the process of its enactment. This new law for the industry is aimed at promoting certainty to the legal and regulatory treatment of Islamic financial transactions by providing legal recognition to the contractual requirements in accordance with the Shariah. This provides a comprehensive legal environment under which effective risk and profit sharing activities can take place, encompassing all aspects of Islamic financial transactions, from its prudential and business conduct requirements to the legal treatment of Islamic banking assets upon its resolution, to be fully consistent with the distinctive elements of the respective Shariah contracts employed in these transactions.

This legal framework will also further enhance the capacity of the regulatory and supervisory framework for the Malaysian Islamic finance industry to evolve in greater alignment with the international regulatory and the supervisory standards and best practices issued by the Islamic Financial Services Board (IFSB) to govern the specificities of Islamic financial transactions. To complement the efforts to strengthen the regulatory law for Islamic finance, Malaysia has also established the Law Harmonisation Committee in 2010 to undertake objective reviews on other relevant laws and recommend legislative changes to ensure that the laws in the country would allow for Islamic financial transactions to take place effectively and efficiently.

Another important dimension in fostering the further development of risk and profit sharing instruments is the need to ensure the institutional soundness of the Islamic financial institutions and their enhanced ability to assess risks in the real sector. This underscores the imperative of robust risk management capabilities to manage new risks peculiar to risk and profit sharing contracts and the adoption of strong governance, transparency and disclosure practices within the Islamic financial institutions to meet the due diligence requirements for determining the viability of business and investment proposals.

Business risks of equity positions and ownership risks of underlying assets are, for example, embedded in these arrangements arising from the contractual relationships between the investors and entrepreneurs as well as the Islamic banking institutions as the intermediary of funds. Further in-depth applied research is also needed to develop more innovative financial products using risk and profit sharing structures with the corresponding development of risk management techniques. This also needs to be reinforced by enhanced consumer protection and education initiatives to deepen the understanding and awareness of consumers on the associated risks and rewards in the Islamic financial contracts, in particular for equity-based instruments.

Equally important in ensuring the institutional soundness of Islamic financial institutions is the need for robust liquidity management. Today, Islamic financial institutions operating in the different jurisdictions are still confronted with the challenge of managing their liquidity

positions effectively, given the limited supply of high quality Shariah-compliant liquid instruments being the reason most commonly cited. The lack of high quality liquidity instruments for Islamic finance is not only constraining effective liquidity management, but it is also affecting the efficient cross-border diversification of financial flows. It is therefore our hope that through the mandate of the International Islamic Liquidity Management Corporation (IILM) in issuing high-quality liquid sukuks, it will contribute to promoting more efficient cross-border liquidity management by Islamic financial institutions whilst facilitating Islamic financial institutions in meeting the international requirements on liquidity.

Let me conclude my remarks. Whilst the evolution of the global financial landscape is currently being shaped by the need to return finance to its basic functions of serving the real economy, several critical questions remain, the answers to which will continue to have an important bearing on the global agenda to build sound and resilient financial systems that promote sustainable growth. In particular, determining the appropriate size of a financial sector relative to its economy before it becomes a risk to overall financial system and economic stability; promoting conditions that ensure that financial innovation is beneficial to the economy; and enhancing prospects for aligning expectations of capital providers with more sustainable banking strategies present significant policy challenges that will continue to occupy the attention of policymakers going forward.

The global community has made some important strides, but more work remains to achieve an appropriate balance between preserving safety and soundness of the financial system and allowing financial institutions and markets to perform their intended functions. We are not without policy options. The role of macro-prudential policy and the developments in Islamic finance have gained greater prominence in terms of their potential to improve financial stability outcomes, and most notably by the vital contribution that they make towards restoring the foundations for finance that supports sustainable economic growth, and bringing with it immense benefits to the real economy and to the well-being of society.

CALENDAR OF EVENTS
October – December 2012

22 October 2012

The Bank announced the issuance of the Shariah Standard on Mudarabah to all Islamic financial institutions under its purview. The issuance of the Shariah Standard on Mudarabah marks an important milestone and is part of the Bank's continuous efforts to enhance the Shariah and regulatory framework in Malaysia. The standard would serve as guideline for the Islamic financial institutions in developing Islamic financial products and services based on Mudarabah. The Shariah Standard on Mudarabah is the second in the series of Shariah Standard (formerly known as Shariah Parameters), the first being the Shariah Standard on Murabahah.

30 October 2012

The Bank and the Securities Commission Malaysia (SC) signed a Memorandum of Understanding (MOU) to enhance joint regulatory oversight. This MOU builds on and further strengthens the MOUs signed by the Bank and the SC in 2002 and 2007 and it takes into account the changing financial landscape and the new international regulatory regime.

The MOU provides for an enhanced scope of collaboration and cooperation between the Bank and the SC, focusing on common areas of interest that are important to promote financial sector and capital market stability. These includes managing threats to financial stability and systemic risk, including supervision of financial groups, management of financial crisis, supervision of money markets and derivatives market, combating threats relating to money laundering and terrorism financing and supervision of auditors of financial institutions.

5 - 9 November 2012

The Bank and the International Finance Corporation (IFC) jointly organised the 4th Credit Reporting and Risk Management Training Workshop. More than 150 regulators, central bankers as well as credit reporting and finance professionals from around the world attended the workshop to promote best practices on credit reporting, scoring, modelling, risk management as well as reform of credit reporting systems.

The Bank shared its experience on the Central Credit Reference Information System (CCRIS) which has contributed towards greater responsible lending decisions, as reflected by Malaysia's number one ranking for five consecutive years in terms of Ease of Getting Credit, in the Doing Business Report, published jointly by the International Finance Corporation and the World Bank.

5 - 6 November 2012

The Bank and the Irving Fisher Committee on Central Bank Statistics jointly organised a two-day workshop on Financial Inclusion Indicators at Sasana Kijang, Bank Negara Malaysia. The workshop brought together financial inclusion policy makers and statisticians across the globe to attain greater convergence on issues related to measurements and indicators.

The workshop was also attended by representatives from International Monetary Fund, World Bank, Global Partnership for Financial Inclusion, Consultative Group to Assist the Poor, Alliance for Financial Inclusion and the International Finance Corporation where the role of financial institutions in overall economic development were deliberated.

This was followed by the National Statistics Conference (MyStats 2012) jointly organized by the Bank and the Department of Statistics Malaysia (DOSM). Entitled "Enhancing National Statistics to Meet Public and Private Sectors Needs during a Period of Transformation" it provided a platform for statisticians, analysts, economists, policy makers, academicians and the media to share, discuss and highlight statistical issues in analysis and policy formulation as well as challenges in the compilation and communication of statistics.

7 November 2012

In her keynote address at the 19th ASEAN Banking Conference 2012 at Kuala Lumpur, entitled "ASEAN: Towards a more integrated market", Governor Dr. Zeti highlighted the importance of the increased momentum to achieve an ASEAN Economic Community (AEC) by 2015, as we draw closer. This is notably by achieving increased financial integration, higher levels of intra-regional trade and greater two-way cross-border investment flows. She also emphasised on the role of banking sector as a crucial driver for greater financial integration within the core of ASEAN financial systems.

8 November 2012

At its final meeting for 2012, the Bank's Monetary Policy Committee (MPC) decided to maintain the Overnight Policy Rate (OPR) at 3.00 percent. In its assessment, the MPC stated that the global economy is expected to continue to experience slow growth with uncertainties surrounding the growth prospects of the advanced economies. However, despite the weaker external demand, growth in the regional economies remains supported by domestic demand.

On the Malaysian economy, the MPC added that domestic activity has offset the weakness in the external sector. While inflation may increase in 2013, it is expected to remain modest given the excess capacity in the economy with global energy and commodity prices also likely to be contained given the weak global conditions. Upside risks to inflation could, however, emerge in the event of supply disruptions that could result in higher global prices for commodities. The meeting also approved the schedule of MPC meetings for 2013.

12 November 2012

The Bank of Korea hosted the third meeting of the Financial Stability Board (FSB) Regional Consultative Group for Asia in Seoul, Korea, co-chaired by Governor Choongsoo Kim, Bank of Korea and Governor Zeti Akhtar Aziz, Bank Negara Malaysia.

The group deliberated on the short-term and long-term implications on financial stability and financial infrastructure in Asia following prolonged uncertainties in sovereign and financial sector issues in Europe and United States. The developments in macroprudential policy tools and potential challenges associated with their use in Asia were also discussed.

16 November 2012

During the press conference at the release of third quarter 2012 GDP, the Bank announced that the Malaysian economy grew by 5.2% in 3Q 2012 (2Q 2012: 5.6%), amid the challenging global economic conditions. Domestic demand continued to support growth, led by the favourable performance of private consumption and private and public investment. On the supply side, growth in services sector expanded further while manufacturing sector slowed and mining sector contracted. The headline inflation rate moderated to 1.4% in the third quarter (2Q 12:1.7%), reflecting lower inflation in the transport, recreation services and culture and miscellaneous goods and services categories.

11 December 2012

In her speech at the Euromoney-Qatar Conference, entitled “Global Financial Stability and the Internalisation of Financial Systems in Emerging Economies”, Governor Dr. Zeti highlighted the significant benefits from internationalization of financial systems while at the same time to be fully aware on the need to manage risks and challenges it entails.
In transition to a more internationalised financial system, she shared Malaysia’s gradual and sequenced approach. This was to ensure that the necessary preconditions were in place so that the benefits of increased financial internationalisation would be realised, while ensuring that the associated risks inherent to a more open economy and internationally integrated financial system could be effectively managed.

19 December 2012

In her speech at the Islamic Development Bank (IDB) Regional Lecture Series on Islamic Economies, Finance and Banking, entitled “Finance and the Real Economy: Fostering Sustainability” in Jakarta, Indonesia, Governor Dr. Zeti highlighted there has been weakening of the link between financial intermediation and productive economic activity in recent decades. Deregulation, innovation and extended period of low interest rates incentivized greater risk-taking, leading to dangerous build-up of financial imbalances.

She added this has prompted a rethinking of the issues related to the financial business and its models, and wide-ranging regulatory reforms by the international community. Significant attention has been directed at evolving an effective macro-prudential policy framework, which can serve to rein in excesses and strengthen the nexus between finance and the real economy. Finally, she emphasized on the growing role and relevance of Islamic finance in contributing to the global agenda of fostering sustainable growth that is firmly anchored to the real economy.

28 December 2012

The Bank announced, with effect from 1 January 2013, all commercial banking institutions are required to adopt standardised documentation for conventional housing loan and home financing agreements involving a principal sum of RM500,000 and below. The primary objective of this initiative is to enhance borrowers’ understanding and comparability of the key terms and conditions of the loan agreements, including the responsibilities and obligations of borrowers and financiers under such agreements.