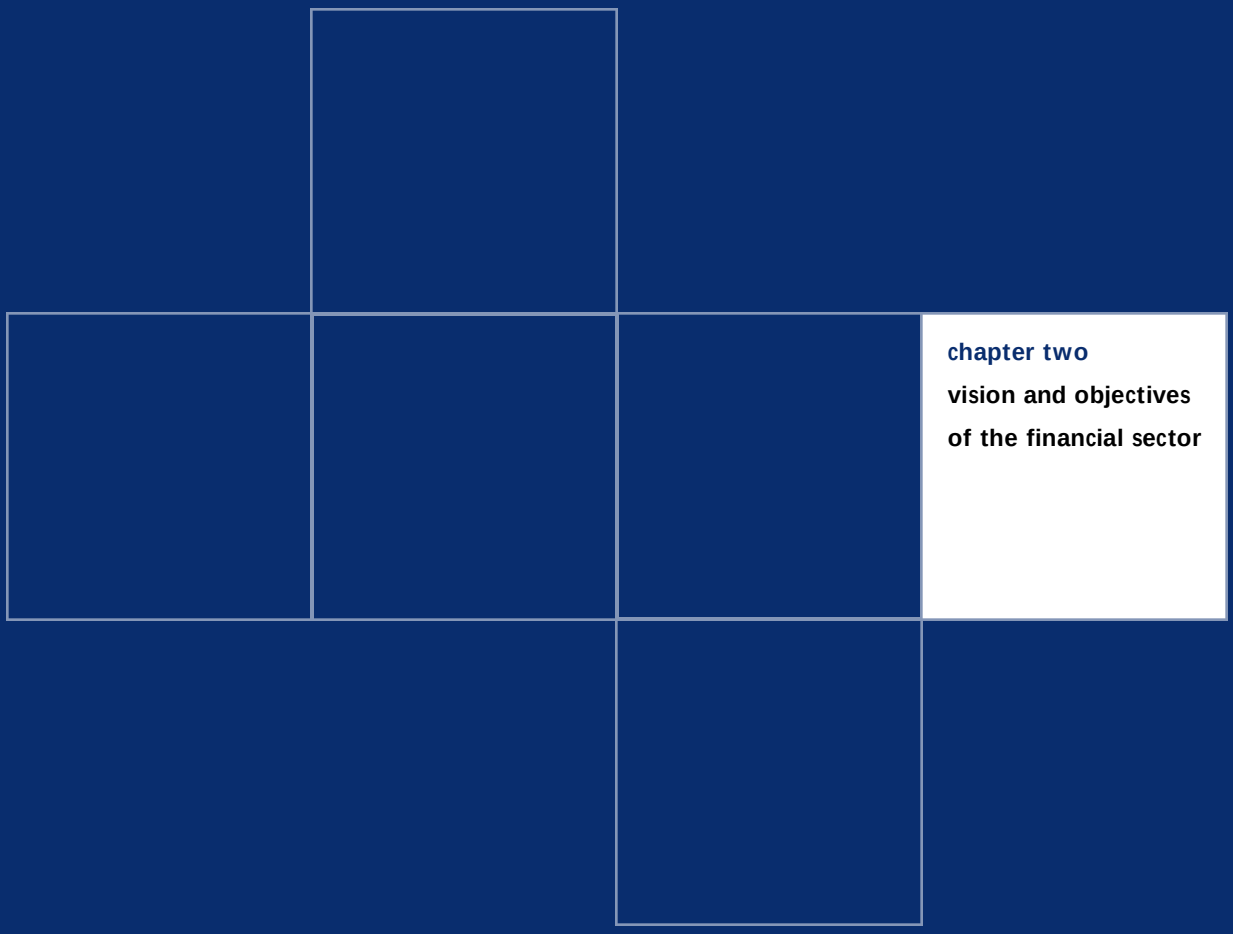

chapter two

vision and objectives of the financial sector

Introduction

The Malaysian economy has recorded strong growth that has been sustained over several decades. During this period, growth has averaged 7% and inflation has remained low in the region of 2%-3%. This growth process has also been accompanied by changes in the economic structure as the economy has become increasingly more diversified. The financial sector has had a pivotal role in facilitating and supporting this process. The financial system that has experienced phases of dynamic growth also evolved to become more diversified. During the recent financial crisis in 1997-1998, we have seen the stability of the financial system seriously challenged. Prompt measures were taken. Institutional arrangements to deal with the emerging problems were put in place and approriate policies implemented to mitigate the impact of the crisis and to maintain financial stability.

The Malaysian response to the Asian financial crisis has produced results earlier and better than initially expected. With stability restored, and the growth process resumed, the opportunity is now taken to be forward looking, to build the necessary foundation so that the financial sector continues to play its important role in the economy and continues to be strong and resilient in facing the future challenges.

Efforts to strengthen and develop the financial system require an assessment of the financial services required as Malaysia moves towards the new economy as well as an assessment of the implications of the forces of change in the global and domestic environment. The future landscape of the Malaysian financial system will be developed against the backdrop of an increasingly global and integrated economic environment and financial markets. The purpose of the FSMP is to set out the plan to chart future direction of the financial system over the next 10 years that will ensure its continued effectiveness, competitiveness and resilience.

Vision and Objectives

A well-diversified and competitive financial system is vital for the long-term economic growth and development to ensure that risks in the economy are well distributed among the various sub-sectors. In the new millennium, the future of the financial system lies in its ability to create a dynamic set of financial players, which are able to provide the support to the domestic economy, and more importantly, that are increasingly more efficient, competitive, sound and stable that would facilitate the economic transformation process. The objective of the FSMP is therefore 'to develop a more resilient, competitive and dynamic financial system with best practices, that supports and contributes positively to the growth of the economy through the economic cycle, and has a core of strong and forward looking domestic financial institutions that are more technology driven and ready to face the challenges of liberalisation and globalisation'. While opportunities have emerged in this new environment, threats of the global marketplace are becoming more intensive, as global players and technology advancements are having an unprecedented impact on the approach of banking and financial businesses. Against this background, it is vital for the financial system, particularly the domestic financial institutions to be resilient and efficient if Malaysia is to ensure that its financial sector remains effective and responsive in the face of a more globalised, liberalised and a more complex domestic economy.

In the new environment, the ability of the financial institutions to deliver products and services in the most efficient and effective manner will be the key to determining performance and relevance. The soundness of individual institutions will be a key factor in order to maintain the stability of the overall financial system. In the banking sector, despite the achievements of the domestic banking system that has been secured thus far, the Malaysian banking institutions need to strive to enhance their capacity and capability so that they will be at par with global players in terms of efficiency, effectiveness and financial soundness. Against the backdrop of socioeconomic objectives of the country, the vision is for the development of a well-diversified financial sector that is defined based on five main characteristics, namely:

Efficiency

The range of financial products and services should be offered at the lowest cost to both institutional and individual consumers, namely, borrowers, investors, depositors and risk managers. In this regard, improvement in productivity and higher returns on assets for the financial institutions will need to be realised through greater penetration of efficient and low cost delivery channels, access to scale advantages in processing, procurement and other back-office functions, and leveraging on world-class skills. This operational efficiency can be achieved through greater investment in technology and skill enhancements.

Effectiveness

The availability of a broad range of products and services is essential to meet the needs of customers that can be expected to be increasingly more demanding and sophisticated. The degree of

innovation of the financial institutions will determine the range of products and delivery channels offered. While Malaysian institutions do offer basic banking and insurance products, there is significant room for advancement in meeting the new requirements of the new economy, in particular, highly differentiated financial products which are tailored to meet specific demands of the consumers and the corporate sector. In an increasingly competitive market, innovation and improved services will be introduced through the existence of innovative players and a more conducive operational environment.

Stability

A safe, sound and stable financial system that is able to withstand sudden adverse economic and financial shocks that emanate from within and outside the system without significantly disrupting the intermediary function and the functioning of the economy. To have a stable system, there must be efficient, effective and robust financial institutions, strong prudential regulations and supervision, and efficient and reliable infrastructure.

Robust financial institutions that would have strong risk management capabilities and credit skills as well as sound corporate governance. Improvements in credit skills and risk management among financial institutions would be demonstrated among others by the greater use of financial models and application of risk management framework that is more comprehensive. Corporate governance could be enhanced through improving the quality and accountability of the board of directors and management of financial institutions.

Prudential regulations

While the foundation of a strong financial system is the implementation of effective prudential regulations and supervision, this needs to be balanced with the need to provide an environment which is conducive to the development of an efficient and innovative financial system.

Infrastructure

The availability of strong infrastructure is crucial to ensure overall stability of the financial system, with a core of strong domestic institutions and an efficient and stable payments system forming the backbone of the financial system. This is to ensure domestic institutions will continue to have a prominent role in the financial system. This will be achieved through institutional development and capacity building, increasing the competitive environment, the continuous improvement in the existing payments and financial markets infrastructure, and instituting a more market-driven consumer protection framework (including deposit protection).

Against the above objectives, the FSMP outlines the strategies for the Malaysian financial sector to progressively develop to achieve the objectives in meeting the requirements of the real economy and to adapting and adjusting to the forces of change in the domestic and international environment. Of importance, the FSMP seeks to identify strategies to generate flexibility, adaptability and innovation to ensure the financial sector continues to play an effective role in a more dynamic and competitive economic and financial environment.

The Financial Sector Landscape in 2010

While it may not be possible to project accurately how Malaysia's financial sector will be structured in 10 years time, taking into account the forces at work

and how the challenges facing the industry are being met, the future financial landscape can be expected to be characterised by the following:

- An increasingly more diversified financial sector meeting the requirements of a more diversified economic structure;

- The competitive environment in the banking sector is likely to result in institutions with differentiated strategies based on their strengths and market niches. This implies that:
  - Fewer large, broad based institutions will thrive, exploiting their privileged relationships with retail customers and mid-market corporates to provide a full range of financial services to market segments that value banking relationships and/or convenience.
  - The successful institutions will be those who continue to leverage on the advancements made in technology, in reengineering work processes and delivery modes, and offering state-of-the-art products and services that serve as complete financial solution for varying types of consumers.
  - Employing and retaining highly skilled workers and the reskilling of existing work forces and promoting a culture of continuous learning will be continuously pursued as human factor becomes a defining characteristic of a successful banking institution.
  - Specialist providers will emerge:
    - Some competing to provide specialised products such as mortgages and credit cards on the basis of lower costs or better marketing. These players are likely to be regional or global in scale;
    - Some competing only in particular segments of the business system, while outsourcing all other functions (such as mortgage originators, credit card processors or custodial service providers); and
    - Some dominating certain customer niches, such as the SMIs or high net worth individuals, by providing specifically tailored services beyond traditional banking offerings to satisfy the needs of customers they understand better than a more generalist competitor.
  - New service providers will emerge with the advent of new technologies and increased popularity of the internet. This may include telecommunications and other utility companies providing bill payment services, and supermarkets and other retailers providing basic lending services.
- The insurance industry will be more dynamic and increase in size:
  - The new economy will exert pressure on the industry to become more competitive with

increasing demands for general insurance protection in various sectors. Increasing wealth amongst the population will increase the demand for life insurance products, and institutions will be differentiated by their ability to introduce insurance products that serve the needs of the nation.

- Competition will be greater among the domestic and foreign insurance companies, bringing down costs and premium, and sizeable increase in business volume.
- The professionalism of the industry, particularly the agents and the financial advisors, will be enhanced through competition as a result of increasingly complex demands of the consumers and the need to continue to conform with the industry rules and regulations derived from international best practices.
- Consolidation of the insurance sector will be inevitable as size and scale would be a key factor to adequately insure the risks within the domestic economy.

- Islamic banking and takaful industry will be more significant, larger and sizeable. New players will join the industry and market operational framework will be increasingly more global;
- Development financial institutions will be strengthened through formulation of common rules and regulations, as well as having strategic business focus and employment of prudent principles;
- The payments infrastructure will be redefined as a result of significant innovation in technologies. An efficient and stable payments system will be developed through the adoption of a flexible, proactive and effective regulatory framework;
- Capital market and technology will disintermediate banks, brokers and traditional exchanges:
  - Banks will provide their traditional customers with access to market-based savings products as well as capital market instruments instead of just deposits and bank loans.
  - Investors and issuers will increasingly lend funds, raise funds and trade directly in the market, relying on financial advice from financial institutions, rather than on their executional capabilities.
  - Specialised domestic institutions, with a deeper understanding of domestic market segment needs and/or privileged relationships with local customers, are expected to develop profitable niches. Successful fund managers, local or global, are expected to set new benchmarks for the performance of existing domestic institutional investors and contributing to the development of the venture capital industry.
- Labuan International Offshore Financial Centre (IOFC) will thrive on Islamic finance and insurance activities, and business generated through the Labuan International Financial Exchange, such as trading of financial and non-financial products, in addition to the traditional and other peripheral activities. Policy convergence with the onshore regulations is expected as offshore institutions are continuously encroaching into the domestic businesses, providing greater competition and innovation in the financial system; and
- Regulators, which include BNM, Labuan Offshore Financial Services Authority (LOFSA) and the Securities Commission (SC), will work closely to keep abreast with the convergence (blurring of

boundaries) between the financial service providers. The focus will now be more on preserving system stability and market integrity through a coordinated supervision given that the pace of innovation will be far too rapid for more interventionist approach.

The Economy in 2010 and the Role of Financial Institutions

The financing needs for the real economy over the next 10 years can be expected to increase significantly and become increasingly complex and diversified. Public and private investments are expected to grow by 5.4% and 17.5% a year respectively during this decade. In the period from 2001 to 2010, the combined total of both public and private investments is expected to amount to RM2,231 billion compared with RM790.9 billion in 1991-2000. The structure of the economy is also expected to change significantly to become increasingly diversified, with greater emphasis on small and medium-sized businesses in the technology and services sectors, and continued growth of skilled knowledge workers as a percentage of total population. While banking institutions will continue to be the backbone of the financial system, insurance and other specialised institutions and the capital market will increase in importance. New growth areas, the increased importance of SMIs and the need to be innovative in product offering as the more sophisticated and technologically literate population will demand a wider range of specialised products and services.

More domestic corporates will be expanding regionally and globally, and will require capital investment in technology to increase their productivity as labour costs rise. To do so, there will be the need for increased access to long-term fixed rate financing and more sophisticated risk management advisory services and products from domestic banking institutions, insurance companies and offshore financial institutions.

To underpin this, Malaysia will continue to invest significantly in developing and upgrading the infrastructure, to be developed in part by the private sector. Therefore, continuing efficient mobilisation of domestic savings and foreign investment will remain important. Infrastructure companies and Government will have to tap domestic and international capital markets, and local institutions will have to build the placement capacity – through alliances and technology – to serve these needs.

Finally, as in all developed and developing economies, there will remain segments of the population requiring special attention to ensure access to basic financial services, and segments of the economy requiring special support. The financial system will continue to have a role in the socioeconomic development of Malaysia. The financial system as a whole will consist of a set of robust and efficient financial institutions, whereby financing needs will be met at appropriate costs and structures, through capital or debt obligations. Similarly, the development financial institutions will continue to be relied upon as providers of funds. New growth industry will be supported by venture initiatives – capital generated by business angels or Government-sponsored venture funds.

The challenges facing the financial sector are broad and seamless, requiring efforts to be addressed on all fronts. The FSMP will deal with the broad spectrum of these issues. The recommendations in the report would focus especially in building the capabilities of domestic financial institutions, maintenance of financial stability, providing the framework for

consumer protection and improving the financial landscape consisting of banking institutions, insurance companies, Islamic financial institutions, venture capitalists, offshore financial institutions and specialised financial institutions.

The Financial Sector as an Enabler of Economic Growth

The financial sector will continue to be an important determinant of economic performance and thereby the quality of life of the people. In response to changes in the global and domestic economic environment over several decades, the Malaysian economy has experienced waves of economic transformation from primary product producer to a significant manufacturing base and to now an even more diversified economic structure in which greater importance will be accorded to the development of the services sectors, including the financial services sector, agriculture and the technology and knowledge-based activities.

Financial sector has thus far been evolving with the changing profile of the domestic economy. The growth of international trade and cross border activities has resulted in the increase of the provision of trade financing facilities as well as international banking. Similarly, the need to invest in the massive physical infrastructure and other identified priority sectors had led to the setting up of development financial institutions to cater for this purpose. The need for lower cost of funds in the long term from domestic sources by large corporates has aided the development of the domestic capital market.

Given the gradual process of economic transformation and the economic opportunities that have yet to unfold, the long-term objectives for the domestic financial sector will continue to take into account the needs and vision of the economy. The objectives for the financial sector for an emerging economy such as Malaysia is therefore not necessarily similar to those systems that aim to develop as an international financial centre where rapid deregulation and liberalisation is a key part of the process, relatively independent of developments in the real sector. In an emerging economy, the financial system has a pivotal role in facilitating the growth process. Careful consideration therefore has to be given to both the objectives of efficiency and stability and that of the social agenda.

To become an efficient and effective enabler of growth, the financing capability of the financial sector will need to recognise the importance of the new areas to growth and the other alternative modes of financing, suitable for the risk of the specific economic sub-sectors. Financial institutions will therefore need to be prepared and proactive in providing services to such new industries and businesses, recognising the need for diversified economic structure and a balanced growth, with the objective being to achieve sustainable growth and development, as well as overall prosperity.

Adapting and Responding to Forces at Work

Going forward, global forces at work and the advances in technology is likely to have a significant

impact on the financial system and can be expected to potentially create significant performance gaps between Malaysian institutions and the world best practices. The rapid technological change is constantly improving efficiency and effectiveness in the global financial services industry. The ramifications of technological advances will extend beyond the technology itself. Financial institutions will need to recognise the forces of change and be positioned to adapt to the new forces at work in the financial industry. These include the following:

A. Greater competition driven by deregulation, consolidation, new entrants and greater price transparency

The global trend, including in Asia, deregulation, consolidation, the entry of non-traditional players and the emergence of virtual marketplaces are intensifying competition. In some Asian economies, foreign ownership limits have been raised significantly with most no longer having foreign ownership limits, deregulating price controls, issuing new licences or allowing universal banking. The issue of the move to higher market orientation and the pace of liberalisation and greater international integration will be addressed in this FSMP.

B. Growing capital market will increasingly result in disintermediation

As the domestic capital market deepens, there will also be a shift from bank lending to the capital market. Large domestic corporates will also seek to list their shares on foreign stock exchanges in order to have access to global equity market. With increasingly open economies, companies will be faced with increased competitive pressure for both their outputs and inputs (such as human talent). As such, to be competitive, firms will need to tap the lowest cost and most stable funds.

C. Financial institutions are becoming increasingly global and specialised

The new competitive environment is driven by the revolution in communication technology, which has become an important means to drive competitive advantage through access to economies of scale and more global outlook. This process is also driven by increasing demand among high-end customers for international standard investment options and financial solutions.

D. Financial institutions are using new organisational structures and more aggressive compensation models, and relying much more on alliances and third party relationships

In an ever-growing, fast-changing business, the value of good ideas is correspondingly multiplied, and the value of top talent increases accordingly. The best talent, and the technology and strategy that come with it, are increasingly unaffordable and have to be accessed externally. As a result, the use of new compensation structure as well as outsourcing and alliances by financial institutions are becoming widespread.

E. Financial institutions are investing more in technology

Investment in technology is soaring in order to improve key capabilities such as marketing (achieve better results through data mining), credit risk management (control risks better), pricing (price products based on segmentation and credit history) and delivery channels (develop phone, internet and electronic banking). This is happening not only in the U.S. and Europe, but also in Asia.

Future Technological Developments - Facing the Uncertainty

Modern technology will continue to be a key driver that shape future development and competition in financial services in the new millennium. Information and communication technology (ICT) is affecting every aspect of banking in unprecedented ways. It is facilitating radical change in the operations and structure of financial markets, in roles and relationship among service providers, intermediaries and investors, as well as regulators.

In the light of fast ICT development, speed, reliability and the availability of multiple delivery channels have become important prerequisite in order to remain relevant. Traditional brick and mortar financial institutions are already confronted with new types of players, such as 'aggregators' that threaten to take away their businesses through the introduction of more innovative solutions, and more efficient delivery channels. In facing these challenges, a natural response of traditional players would be to invest in developing an ICT platform that would be robust enough to allow internal efficiency to be achieved and at the same time enable the financial institutions to reach larger pool of customers.

Another distinct characteristic of modern technology is the degree to which it empowers consumers to make their choices. Through one-stop financial portals, consumers are connected online to multiple providers. The ability of consumers to control their own transactions and their ability to access huge amounts of financial information will allow and encourage direct participation of retail investors into the market.

In the light of the changing role of consumers and the financial freedom made available by market liberalisation, the function of managing consumer relationships becomes more daunting. Financial institutions will have to learn to rely less on consumer loyalty, but more on its own creativity and competitiveness. A key ingredient to remain competitive is to maintain close relationship with customers. Databases that contain consumer information that could be easily dissected are powerful tools that allow financial institutions understand their customers better and become more proactive in reaching out to them.

Product developments have also been assisted by modern technology. Sophisticated products using derivatives such as hedging tools have enabled banking institutions to implement better risk management. Insurance companies can leverage on sophisticated actuarial models for risk assessment. Similarly, the bundling of products from different providers has increased emphasis on product specific branding and reduced the significance of institutional branding. The strength of technology indeed lies in its capability to enable financial institutions to structure innovative products in the most efficient ways. The ultimate challenge to financial institutions in the future is to identify and optimise on these capabilities.

Technological development can be so dynamic, even in a short time frame, that future directions become highly unpredictable. As financial markets become more electronic-based and interconnected, the nature of business transactions conducted through these markets becomes increasingly blurred and complex. Electronic communication networks are also disintermediating traditional players. In such an environment, the effectiveness of the implementation and enforcement of traditional rules and regulations would be questioned. The lack of

physical location, the different legal jurisdiction for different business functions, limited ability to restrict access to markets, and over-dependence on technology, are among the myriad of issues that have to be addressed by regulators.

Managing the implications of technology on systemic stability and encouraging innovation and efficiency will involve a careful balance. In responding to these challenges, BNM will adopt a proactive approach and seek to ensure that the regulatory framework will cater for the development of a financial system that can support the new economy driven by modern technology. While some of these issues can be addressed at the domestic level, it is recognised that there needs to be discussion and coordination at regional as well as international level. A coordinated and proactive approach is necessary to ensure that the potential destabilisation and disruptive consequences of an uncertain future and disruptive consequences can be minimised.

Promoting Shareholders' and Consumers' Activism

Shareholders' and consumers' activism is an important element that would drive performance in banking institutions and the desired efficiency and effectiveness in a market driven environment. Over the longer term, more avenues for activism, such as for minority shareholders will be identified to ensure that shareholders continue to exert pressure for performance. Shareholders' activism will also be improved if shareholders better understand their banking institutions' performance and strategic issues. As for consumer protection, an active consumerism is healthy in creating a dynamic and responsive banking system. Consumers shall be given the opportunity to play an effective role in determining the quality of banking products and services they are getting. This shall be done through improvement in transparency of product offerings as well as the financial performance of banking institutions to generate better-informed consumers. The regulatory framework would be enhanced to provide necessary infrastructure for better consumer protection, while at the same time, consumer education will be focused towards promoting greater awareness on consumers' rights with regard to banking products and services.

Public Policy in the New Environment

In achieving the long-term objectives of developing a more efficient, effective and stable financial system, policy implementation will need to be formulated within the broad public policy objectives, that cuts across all economic sub-sectors. Policy decision-making will involve the need to maintain certain key policies while priorities would need to be attached to others depending on prevailing circumstances. While the objectives of most public policies will provide the strategic focus, the approaches perhaps require flexibility. The responsibility of meeting the socioeconomic objectives, needs to be achieved in the most efficient and effective manner.

Regulatory control

An important element in achieving an efficient and innovative market is for BNM to move from the traditional 'regulator knows best' approach to a 'supervised market approach'. As BNM moves towards a supervised market approach, it will be

essential for banking institutions to understand the regulatory philosophy of 'what is not forbidden is allowed'. There will be a move away from 'micro-managing'. Efforts will be directed to ensure that changes in regulatory directions and approaches are well communicated and understood by the industry as well as the consumers. This will create an environment for innovation and creativity to be further encouraged. Market forces, rather than regulations, will play an increasingly important role in determining the future landscape of domestic competition. In order to achieve this, BNM will focus on greater supervision of market integrity with minimal regulation imposed on business decisions.

Priority sector financing

The availability of financing to specific priority sectors such as the SMIs continues to remain vital to ensure that these sectors grow providing an economic structure that has greater agility. As the banking sector continues to become the main source of financing in the economy, their roles in financing the priority sector will remain significant. While policy will continue to focus on ensuring access to such activities, there would be a move from imposing lending targets on banking institutions to a new framework that would increase the effectiveness and efficiency in providing access to these sectors. Such framework will involve the Credit Guarantee Corporation and securitisation agencies. At the same time, the role of the development financial institutions will be enhanced in these areas. An active venture capital industry will also mobilise funding to ensure adequate financing to the specialised sectors.