Seminar on Islamic Finance: During and After the Global Financial Crisis - "Islamic Finance and Global Financial Stability" Istanbul, Turkey, 5 October 2009

Keynote Address by

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The unfolding events during this global financial crisis have brought to the forefront the issues concerning the stability of financial systems and the robustness and resilience of the international financial architecture. At the heart of the crisis is the breakdown of the functioning of the financial intermediation process and the loss of confidence in the financial system. As the world continues to struggle with the consequent global economic recession and the continued fragile financial system, it has intensified the search for solutions. Indeed, wide ranging reforms are now currently being discussed. The future financial landscape in the aftermath of this crisis is, therefore, likely to be significantly different from the present. In the search for the appropriate reforms, there is a general consensus that we need to return banking to its basic functions - to provide financial services that adds value to the real economy. This in fact represents the very essence of Islamic finance. These are the very elements that are espoused in the Shariah principles that underpin Islamic finance and which explains its resilience during this international financial crisis. As the role and relevance of Islamic finance in the global financial system gains significance, it will not only increase its potential to contribute to global financial stability but also towards strengthening global growth."

It is my honour to be invited to speak at this **Seminar on Islamic Finance: During and After the Global Financial Crisis**, jointly organised by the World Bank, the Islamic Financial Services Board (IFSB), the Islamic Development Bank (IDB) and the Institute of International Finance (IIF). This seminar takes place at a time in world history thatis characterised by an unprecedented global financial instability, that has now precipitated a synchronised global economic recession.

Although signs of an impending recovery in the world economy have appeared in the horizon, the pervasively virulent and far reaching repercussions unleashed by the crisis has shaken the foundations of the global financial system. This damage has yet to be repaired and rebuilt. This has sparked the international call for the reform of the financial architecture to one that will best serve the world economy, to one that is more resilient to shocks and to one that would reduce the prospect for future financial crises.

History has shown that there have been more than a hundred distinct banking crises in this recent three decades. There is therefore an even more urgent need to find an enduring solution to ensure the stability of financial systems. The challenge before us is to build a new financial architecture that would allow for the more efficient functioning of not only financial intermediation within national economies but also across borders. Islamic finance, with its emphasis on a strong linkage to productive economic activity, its inbuilt check and balances and its high level of disclosure and transparency offers this prospect. Indeed, inherent in Islamic finance is the explicit elements that address several of the issues that have surfaced in the conventional financial system during the current crisis.

Given the global dimension of the current crisis, the accelerated pace at which it has spread and the severity of its repercussions, it has called for a higher degree of collective determination by the international community to work together towards developing a global strategy that will evolve a financial system that is stable and sustainable over the entire business cycle. As Islamic finance continues to become an integral part of the global financial system, it will increasingly be exposed to risks of financial

stress arising from global financial instability and global economic activity. This necessitates a greater global engagement between those that are driving the reform agenda given that it will result in new structures, standards and regulatory regimes for the industry. This is particularly important when such standards become the basis on which assessments are made by multilateral agencies, rating agencies and the market at large. Such engagement also facilitates cooperation and collaboration in achieving our shared interest of preserving global financial stability.

The combination of indiscriminate lending, excessive risk-taking and overzealous financial innovation were at the root of the current financial crisis. The financial turmoil that first originated in the mortgage market in a number of the advanced economies triggered a broad-based meltdown and subsequent breakdown in the functioning of the financial markets. Despite these developments, the Islamic financial industry has been able to weather this first wave of the global financial crisis, demonstrating its robustness as a stable form of financial intermediation.

The resilience of the Islamic financial institutions during this crisis epitomises the intrinsic strengths embedded in Islamic finance that are underpinned by forces of the Shariah principles. This arises from two essential requirements of Islamic finance - firstly, that the financial transaction must be accompanied by an underlying productive economic activity that will generate legitimate income and wealth, thereby establishing a close link between the financial transactions and productive flows. Thus, in the Islamic finance business model, financing or equity participation can only be extended to activities in the real sector that have economic values. Hence, Islamic financial assets are expected to grow in tandem with the growth of underlying economic activities.

Secondly, that it is based on profit sharing in which there is a mutual risk sharing. Islamic finance, therefore, impels the Islamic financial institutions to undertake the appropriate due diligence on the viability of business proposals and by enforcing the requirement for transparency and disclosure. The role of the Shariah board in ensuring that all aspects of business operation of Islamic financial institutions are in accordance with the Shariah principles, adds another level of oversight which inherently safeguards against irresponsible practices. Embraced in its entirety, these in-built dimensions of governance and risk management contributes to safeguarding Islamic finance from the potential risks of financial stress arising from excessive leverage or speculative activities.

Despite the uncertainties and challenging environment posed by the current crisis, the expansion and development of Islamic financial services industry in global financial system have continued unabated. The dynamic nature of the Islamic financial system is reflected by its solid growth, the increased range of financial products and services and the establishment of new Islamic financial service providers from the different parts of the world including from the non-Muslim world. This increased participation is particularly pronounced in the sukuk market whereby funds have been raised by issuers from various parts of the world. Recent sukuk issuances both in domestic and in foreign currency have attracted interest from a wide investor base from Asia, Europe and the Middle East. These positive developments have been achieved despite the more challenging global financial market environment.

As Islamic finance evolves to meet the changing requirements of businesses and consumers, innovation is integral to the development of new Islamic financial products and services. It is also recognised, however, that unfettered financial innovation can become a major source of instability in the financial system. In Islamic finance, financial innovation must be tested against the 'Maqasid al-Shariah' (objectives of the Shariah), where the primary objective is the realisation of benefit to the people. This demands the internalisation of Shariah principles in Islamic financial transactions, both in form and substance. Indeed, the move to embrace Shariah-based innovation brings with it a strong Shariah-compliant culture in Islamic financial institutions. This in turn serves to ensure that the product development process in Islamic finance is grounded within Shariah injunctions which also incorporates ethical value propositions.

Financial innovation also needs to be supported by robust risk management and strong governance practices. It is recognised that sophisticated and complex financial structures very often result in the failure of consumers, investors and even regulators to understand the risks and leverages embedded in the instruments which in turn results in the lack of transparency and inadequate risk management. In Islamic finance, a prerequisite under the risk-sharing arrangements is having the necessary information to understand the risks that are to be borne by Islamic financial institutions. The explicit risk sharing element between the financier and customer in Islamic finance obligates its participants to evaluate risk profile of the product or investment proposition, the underlying trends in earnings and cash flows, and its income-producing potential. This process also allows the pricing of funds to be adjusted accordingly.

Equally important is the risk management capability of the Islamic financial institution to manage the risks that are peculiar to Islamic financial transactions. Additional capital is for example required to cushion the inventory risks of underlying assets and equity positions that are embedded in partnership contracts, therefore bringing the capital requirements closer to the true economic risks in portfolio of the financial institutions. To manage depositors' expectations and sustaining market confidence, Islamic banks are also permitted to set aside a portion of income derived from assets funded under Mudarabah contracts, in the form of profit equalisation reserves (PER), as a mechanism to address the impact of pro-cyclicality of their returns. This is reinforced by a combination of stronger governance and enhanced transparency to address the trust-based relationships which is a fundamental hallmark of Islamic finance.

With increased globalisation and greater integration of Islamic finance with the international financial system, the higher will be the risk of the contagion effects from other markets and jurisdictions. In addition, Islamic finance will also be affected by the second round effects arising from slower economic growth and the reduction in global liquidity. An essential infrastructure in this environment is a well functioning liquidity management infrastructure to enhance the capacity of Islamic financial institutions to effectively manage their liquidity positions. Of importance, is the wide availability of Shariah-based Islamic financial market instruments to facilitate liquidity management. Such facilities for adjusting portfolio balances in a Shariah compliant manner ensure that the liquidity risks can be effectively managed.

As part of the global collaborative efforts to enhance the efficiency of Islamic financial institutions in managing liquidity at both national and across borders, a Liquidity Management Task Force has been established by the IFSB and the IDB early this year. This work is being further supplemented by ongoing market initiatives by the International Islamic Financial Market (IIFM) which focus in the advancement and the standardisation for Islamic financial instruments for the Islamic capital and money markets. More recently, Malaysia established the Bursa Suq Al-Sila' under the concept of commodity murabahah. This multi-currency and multi-commodity is an electronic exchange traded platform to facilitate the trading and settlement of commodity using crude palm oil (CPO) for liquidity management between Islamic financial centres. Although Malaysia already has a well functioning Islamic inter-bank money market, this platform provides a further alternative for liquidity management, through which global interlinkages in the international Islamic financial system can also be further enhanced.

Integral to the efforts in the development of Islamic finance has been the strengthening of the regulatory and supervisory framework for Islamic finance. In the area of international prudential standards for Islamic finance, the IFSB that was established in 2002 has developed a number of standards ranging from capital adequacy requirements to governance and risk management to assist the Islamic financial institutions in adopting international best practices and standards.

While the basic legal, regulatory and supervisory framework that takes into account the distinctive features of Islamic finance are already in place, there is a need to have a

more comprehensive infrastructure to meet the present challenges. Looking beyond the current crisis, there needs to be an integrated crisis management framework as part of this infrastructure to ensure that any emerging crisis in the Islamic financial system will be promptly and efficiently managed. More facilitative and modernised legal framework is also required to make business more conducive for Islamic finance. In addition, the boundaries of the regulatory framework for Islamic finance would also have to be regularly adapted to keep pace with the evolution and transformation of the financial system. In the case of Malaysia, the comprehensive legal, regulatory and supervisory framework for Islamic finance is further supported by a financial safety net framework that encompasses the lender of last resort facility and a deposit insurance system.

Moving forward, in the aftermath of this global financial crisis there is also a need to have in place the institutional arrangements for resolution of troubled international Islamic financial institutions. In Malaysia, we have also in place a mandated resolution mechanism to provide for expedient, effective and cost efficient resolution of Islamic financial institutions. The current crisis, however, has highlighted the need to have in place a mechanism for cooperation between regulators across jurisdictions for resolution and for containing potential systemic risks beyond the national boundaries. To promote global financial stability in the Islamic financial system, the Taskforce on “Islamic Finance and Global Financial Stability” was established in 2008 by the IDB in collaboration with the IFSB, together with the participation of industry leaders and international experts to examine the development of further building blocks in Islamic financial infrastructure to strengthen its resilience and ability to meet future challenges. Substantive progress has been achieved by the Taskforce and a report including major recommendations is planned for submission to the IFSB Council in November this year. Among the areas covered by the report include the effective implementation and enforcement of the prudential standards, the supervisory framework, the strengthening of the financial safety net mechanisms and the development of an effective crisis management and resolution framework. Among the recommendations in the report will be the establishment of a Financial Stability Forum to address issues of financial stability in the Islamic financial system.

The internationalization of Islamic finance requires the industry to progress into the next stage of international acceptance, with mutual recognition of financial standards and products across jurisdictions. Indeed in the area of Shariah, there has already been progressive convergence of Shariah views and rulings, and the mutual recognition of financial standards and products across jurisdictions. As this continues to occur, it would be a major driver towards greater convergence and harmonization. This has been facilitated through greater engagement among the regulators, practitioners and scholars in Islamic finance across jurisdictions. This interface is important given the common interest of global financial stability.

The announcements following the recent G20 Summit and the associated announcements of the Financial Stability Board reflect the international economic regulatory cooperation that will set the agenda for the conventional standard setting bodies to put in place a framework to strengthen the international regulatory standards. It will also form the basis by which assessments will be made by multilateral agencies such as the IMF. It is therefore important for there to be engagement with the prudential standard setting entities for Islamic finance, not only to raise awareness of whether the new standards being introduced can be applied to Islamic finance and whether modifications need to be made but there could also be possible consequences that are unintended. Equally important is for there to be recognition of the standards that have been issued for Islamic finance specifically by the Islamic Financial Services Board. As a growing component of the international financial system, it becomes important for the interface and engagement with the international standard setting entities to take place given the common interest of global financial stability.

Let me conclude my remarks. While the inherent strengths of Islamic finance have contributed to its viability and resilience,

going forward into the future, the foundations for its sustainability as a competitive form of financial intermediation will continue to be strengthened. Concerted efforts are underway focusing on the further development of the Islamic financial markets, the financial infrastructure, the investment in research and development to support innovation, and enhancing further the legal, regulatory and supervisory framework. Tapping on the advances in technology and the development of human capital are also an important part of the development of Islamic finance.

Finally, with greater liberalisation, effective infrastructure is also being put in place for enhancing interlinkages across jurisdictions. An important part of these developments will be for a more inclusive arrangement that would allow for greater interface with the current reform efforts being undertaken in the international financial system. Our vigorous pursuit and commitment to strengthening the resilience of Islamic financial industry would enhance the potential to contribute towards global financial stability and in turn enhance the prospects for global growth.

ASEM Conference - "Asia's New Development Strategy: Where Now?" Kuala Lumpur, 19 October 2009

Keynote Address by

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The experience of economic development in Asia - home to more than half of the world population and one of the most diverse regions - for more than half a century has been remarkable. Despite being interrupted by turbulence from time to time, Asia has, in general, attained and sustained high growth rates during this period, experienced rapid structural economic transformation and shifted from economies based on agriculture to capital-intensive production of modern goods and services. From a mix of poor and less developed economies after the Second World War, Asia today features five of the twenty largest economies in the world and several of the fastest-growing economies, contributing around one-third of global output and world trade.

The objective of economic development is, however, not solely based on trade, finance or even wealth. Economic development is fundamentally about the welfare of people, where growth is but a means to achieve continued improvements in the standards of living. Viewed within this context, Asia has achieved significant progress too. Asia's rapid development has led to a more than four fold increase in average per capita income, lifting more than 500 million people out of poverty and destitution since the 1980s. The poverty rate in Asia has markedly declined from 80% in 1981 to 16% of the total population in 2005. Beyond dramatically improving basic social conditions, significant strides have also been made in the provision and access to quality healthcare and education. Whilst Asia's urban population has increased by more than six fold, average life expectancy has risen by 25 years to 72 years and average literacy rate to above 90%. What makes these considerable improvements remarkable is that they were all achieved in a relatively short span of less than two generations.

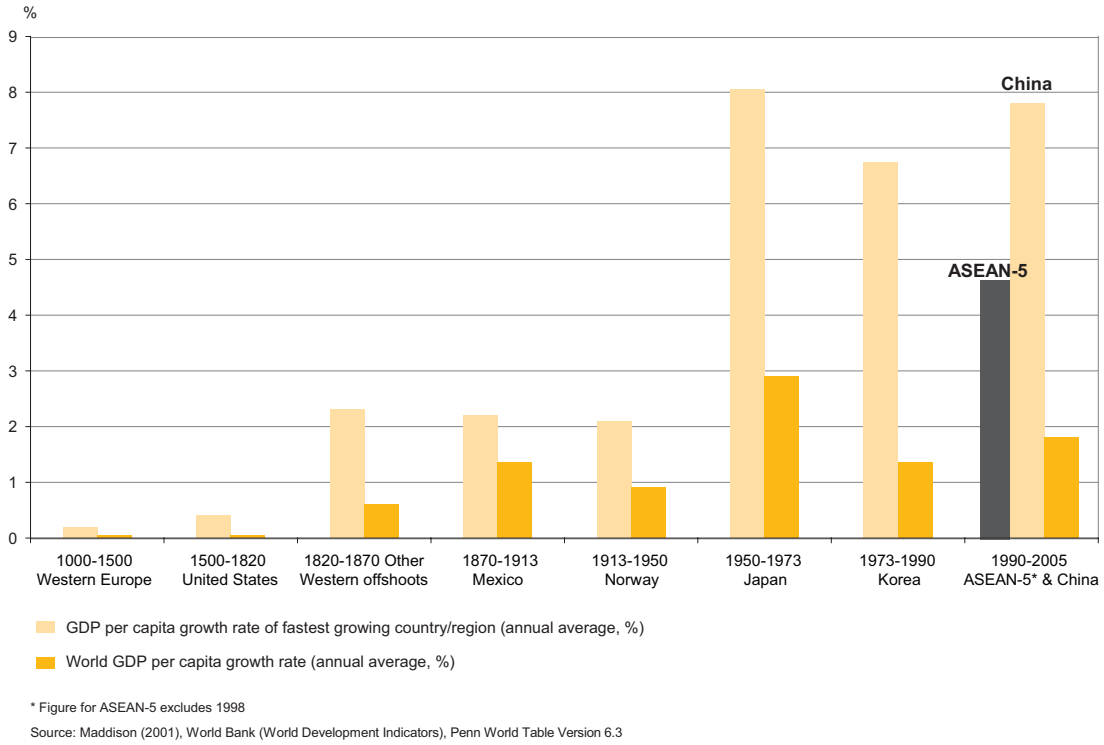
This paper consists of two parts. The first explores the development strategies that have contributed to Asia's successful economic transformation in the post-World War II period, with particular emphasis on the recent decade after the Asian financial crisis. The paper then discusses broadly how Asia's development strategies need to be adapted going forward, especially in light of the current global crisis which has brought significant changes to the global economic and financial environment.

ASIA'S DEVELOPMENT STRATEGY OVER THE LAST 50 YEARS

Asia in the Post-World War II Period

What is exceptional about the performance of Asia is the relatively high growth rates achieved by the best performing Asian economies when compared to the champions of earlier eras (Figure 1). The rapid transformation of Asia was led by three global growth leaders over the past 50 years, beginning with Japan in the 1950-70s, South Korea from the 1970s and currently, China. Their average annual per capita growth rates of 6-8% are historically unprecedented and greatly exceed those attained by the present advanced economies at their earlier stage of economic development by at least three folds. Similarly, ASEAN-5 experienced growth rates of more than doubled that of world average during the past two decades. Nevertheless, Asia's growth path is no different from those of the other economies. Asia too follows a similar industrialisation process of moving from traditional to modern activity, from the production of low value-added goods to incrementally higher value-added products to eventually the services sector. What makes Asia different, however, is that this process has been considerably accelerated.

Figure 1
Asia IS different - Historical experience with growth



* Figure for ASEAN-5 excludes 1998

Source: Maddison (2001), World Bank (World Development Indicators), Penn World Table Version 6.3

The success of Asia has not been a result of one single factor, but instead, a confluence of factors that has promoted, facilitated and driven economic development. Given the immense diversity of the continent, it would not be possible to draw on exact and specific development strategies that have contributed to the rapid economic progress and transformation. Nevertheless, four general but salient features have been critical in the development strategies of most of the Asian economies.

First, sustained economic growth has always been given a steadfast priority in the Asian economies. The governments in most South-East Asian and East Asian countries have focused on institution-building and promoting industrialisation. Institutions have been established to plan, drive and monitor the laying of necessary economic foundations, including enabling infrastructure, in the broader economy, while potential impediments have been addressed. These institutions in effect aim to promote an environment that is conducive for growth. Equally vital are the institutions to maintain macroeconomic and financial stability, as well as to promote inclusion and socio-economic stability. To accelerate the movement of resources from traditional to modern activity in the new industrialised economies in Asia (South Korea, Chinese Taipei, Hong Kong and Singapore), industrial policies have been targeted at enhancing efficiency, higher-productivity and competitiveness. Incentives and some domestic protectionism had an important role at the initial stage of the industrialisation process to advance the industrialisation process. These features are exemplified in the experiences of Japan and the newly industrialised Asian economies, as well as later, in the other Asian economies such as ASEAN and China.

Although the Asian Governments participate directly in economic development, the emphasis is on the private sector leading growth, particularly after industrial and infrastructure

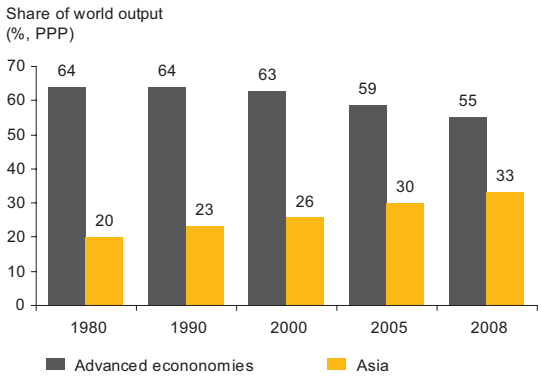
foundations have been laid. The role of the Government has been to support the private sector through developing an environment for the private sector to undertake higher productivity activity, with the actual production of goods and services ultimately driven by the private sector. Governments, together with the established institutions, draw up industrial plans and set targets to guide the industrialisation process for the private sector to embark to realise these goals.

The second salient feature is Asia's high rate of savings, exceeding 30% of gross national product (GNP) in most Asian economies, which have enabled the private and public sectors to fund capital accumulation from domestic sources. While the private sector focuses on investing in physical capital and adopting new technologies to raise productive efficiency, governments across Asia place commensurate emphasis on developing infrastructure, such as roads, ports and utilities, as well as on healthcare and education. The combination of efficient capital and productive labour in turn generates more highervalue-added activity, thereby accelerating economic growth.

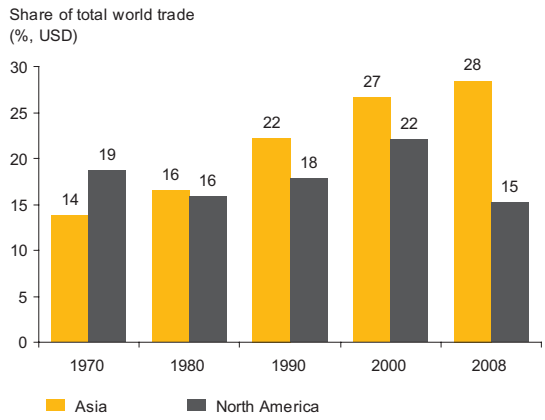
Third, the Asian economies have adopted an outward-oriented development path, rather than depended only on domestic demand, to expand industrial production. Just five decades ago, Asia was amongst the world's poorest regions. Asia recognised that its development process would be slow and marginal should low-income-driven domestic demand be relied upon to incrementally stimulate industrial activity. It accelerated the movement of resources from low-productivity traditional activity to high-productivity modern activity. Most of Asia, early among the developing economies, has been very open to international trade and foreign direct investment (FDI), resulting in Asia to be rapidly integrated with the global economy. The trade volume of Asia as a share of total world trade increased from 14% in 1970 to 22% in 1990, and subsequently to 28% in 2008. Furthermore, Asia has also been a major recipient of FDI, with FDI flows into Asia increasing from 7% of total global FDI to 20% in 2007.

Figure 2
Growing importance of Asia in the world economy

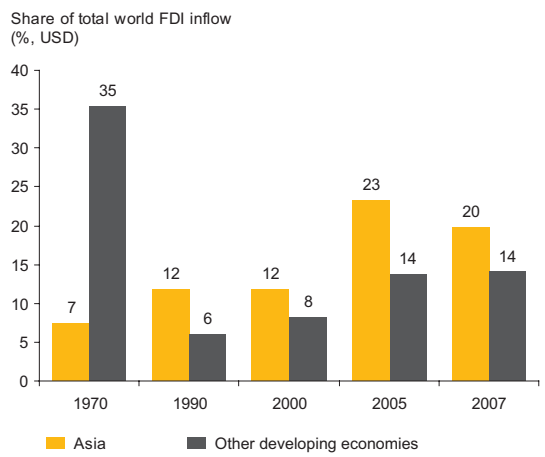
Gross Domestic Product



International Trade



Foreign Direct Investment



Source: IMF, WTO and UNCTAD

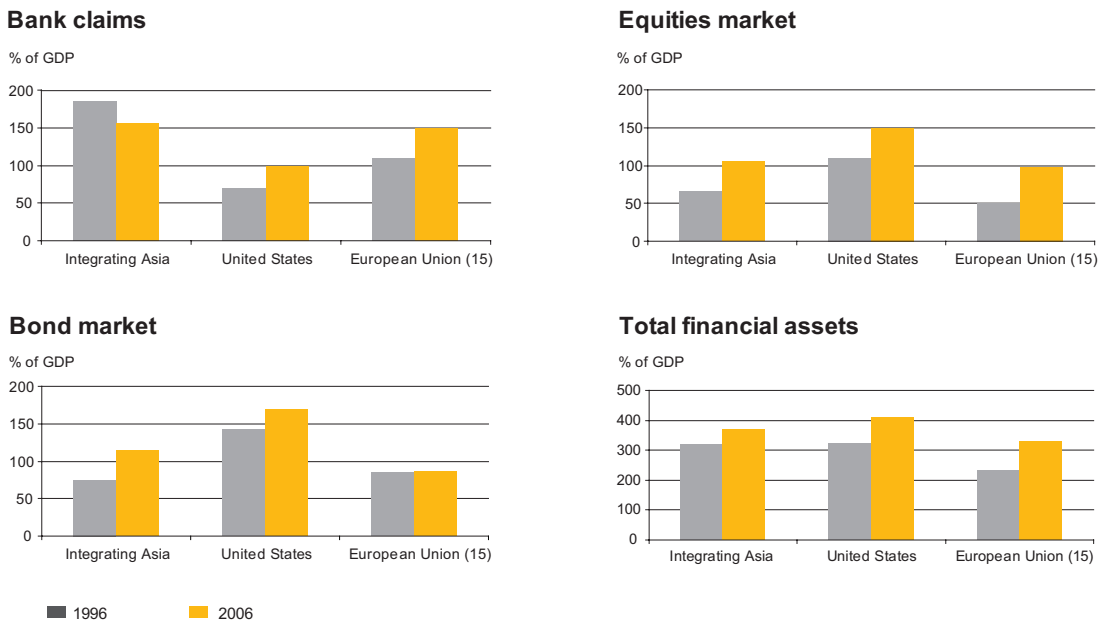
Fourth, the immense heterogeneity and diversity of the Asian economies have not been a restraint on progress, but have complemented and facilitated the region's economic development. The vast differences in the stage of development of the individual economies, such as from the advanced Japan to emerging China to developing Vietnam, together with the rich variety of natural resources and endowments throughout the region, have enabled Asia to capitalise on a multitude of strengths and comparative advantages. In particular, there are the region's different development levels and consequent technological capabilities, known commonly as the 'Flying Geese Model'. Such specialised division of labour is evident in the 1970s when Japan relocated the more labour-intensive stages of production processes to the newly industrialised Asian economies, such as South Korea and Singapore, and subsequently in the 1980s, to emerging Asia, including Malaysia, Indonesia and Thailand. The emergence of China in the recent decade has further provided significant impetus to this pattern of vertical specialisation, which has effectively resulted in a globalisation of the production chain across the network of regional economies. Whilst Asia's fragmented industrialisation has led to a considerable strengthening of trade links within the region, the transfer of capital, knowledge and technologies that are crucial for strengthening industrial capabilities have also been enhanced.

Asia after the Asian Financial Crisis

The 1997-98 Asian financial crisis represents a significant juncture in the history of Asia. The crisis exposed several structural weaknesses both in the domestic economies of Asia and in the global financial architecture. Recognising the growing interlinkages and risks, a range of new initiatives both nationally and regionally, together with the parallel development of sound institutions and good governance, were introduced post-crisis to strengthen the resilience of the Asian economies and minimise regional systemic risks in order to ensure a more sustainable economic development. In retrospect, the Asian crisis marked not a halt, but the start of an even greater presence of Asia in the global landscape.

Following the crisis, Asia has undertaken wide-ranging financial reforms, aimed at developing more stable, resilient and efficient financial systems. This included restructuring as well as institutional development to strengthen the resilience of the financial sector. Amongst others, sound regulatory regimes have been established, prudential regulations strengthened, corporate governance and financial disclosure improved, and deposit insurance introduced. As the domestic financial systems strengthened, the environment for the banking sector has become increasingly more competitive through gradual deregulation and liberalisation. In addition, efforts have also been focused on developing the capital markets, in particular the bond market, which has also reduced over-reliance on the banking sector as a source of financing for large businesses. This has prompted the banking sector to broaden access to credit to other economic agents. Overall, what were once bank-dominated financial systems has become more diversified and competitive with strengthened governance, disclosure and regulation. Asian financial deepening has been faster than in the EU or US, while it starts from a lower base. The Asian bond market today, as a share of GDP, is higher than the EU.

Figure 3
Faster financial deeping in Asia than in the US or EU



Source: Source: Asian Development Bank (2008)

Note: Integrating Asia refers to the 11 economies for which data on financial markets are available: P. R. China; Hong Kong, China; India; Indonesia; Japan; South Korea; Malaysia; Philippines; Singapore; Chinese Taipei and Thailand. European Union refers to its first 15 members.

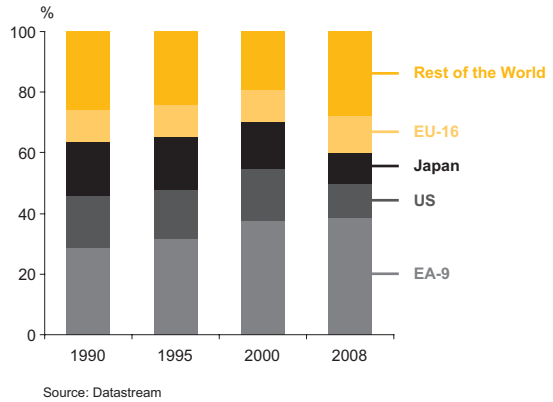
On the regional level, several initiatives have been undertaken to promote intra-regional trade and investment since as early as the 1990s. For example, in 1992, an ASEAN Free Trade Area (AFTA) was launched for intra-ASEAN tariffs to be lowered to 0-5% under the Common Effective Preferential Tariff (CEPT), with a target of establishing a tariff-free free trade area by 2015. Also, an ASEAN Framework Agreement on Services (AFAS) was signed in 1995 to eliminate intra-ASEAN restrictions to trade in services and facilitate free flow of services by 2015. Furthermore, in 1998, an ASEAN Investment Area (AIA) was adopted to promote greater flows of capital, skilled labour, professional expertise and technology within the region. These various initiatives have been further accelerated post-Asian crisis, with various free trade agreements (FTA) rapidly emerging between ASEAN and the North East Asian economies, namely China, Japan and South Korea. Recently in April this year, the FTA between ASEAN and China was broadened to encompass the removal of investment barriers from just restrictions in trade-in-goods since 2004 and in services since 2007, thereby creating the world's largest free trade area with a population of 1.8 billion and gross domestic product of USD2 trillion. In addition, negotiations on an FTA between ASEAN and Japan, South Korea, as well as India, Australia and New Zealand have been initiated.

Given these regional initiatives in trade and investment, Asia's export market has become increasingly diversified with intra-regional trade gaining a greater importance. Intra-regional trade in South, East and South-East Asia as a share of total trade of all three regions has risen from 25% in 1980 to 44% in 2006. More specifically, growth in intra-regional trade of East Asia-9 (EA-9) has been higher at 17% than that of total regional trade (15%) and world trade (12%) for the period of 1999-2008.

Whilst EA-9's trade to the US as a share of the region's total trade has declined from 17% in 1990 to 11% in 2008, intra-regional trade rose from 28% to 39% during the same period. Overall, intra-regional trade in South-East Asia and East Asia has about the same volume as intra-regional trade in Europe and North America, which is significantly more than either regions at the outset of their integration efforts. These developments reflect the deeper and considerably strengthened trade and investment linkages within the Asian region.

Figure 4
Asian intra-regional export share has been increasing

Intra-regional trade as a share of total trade of the region



Source: Datastream

Of greater significance in this recent decade is that regional efforts have transcended trade and investment areas toward an intensification of financial cooperation. The importance of regional financial collaboration was recognised, not only to provide a platform for regional development through channelling part of the high savings in Asia to be invested in Asia, but also as a safeguard against the vagaries of global markets. Extensive efforts have now been put in place in the areas of surveillance, liquidity support arrangements, crisis management framework, the development of financial markets and other financial infrastructure, capital account liberalisation, financial services liberalisation, development of regional payment and settlement systems, as well as training and capacity-building.

Broadly, economic and financial surveillance, aimed at identifying regional risk sources and vulnerabilities have been undertaken to enhance vigilance as prevention to potential financial crises and enable prompt corrective actions. Several forums, including the Executives' Meeting of East Asia and Pacific Central Banks (EMEAP), ASEAN and ASEAN+3, undertake extensive discussions on these issues. An integrated regional crisis containment, management and resolution framework has also been established, which is also complemented with mutual support arrangements and liquidity support mechanisms, such as the Chiang Mai Initiative (CMI) launched in 2000. The CMI, comprising of the ASEAN Swap Arrangement and a network of bilateral swap arrangements among the ASEAN+3 countries, makes available financial resources in a timely manner to members facing temporary balance of payments and short-term liquidity constraints. It was first agreed in 2005 that the CMI would be multilateralised in all main components of the arrangement, and more recently in 2009, the total size of the facility has been increased to USD120 billion.

Considerable efforts have also been placed in regional financial market development, especially for a deeper and more liquid secondary bond market. On the supply side, the Asian Bond Market Initiatives (ABMI) seeks to develop deeper and more liquid capital markets that facilitate the channelling of the large pool of savings in the region to fund productive investments, thereby enabling further regional economic development. Recently, the establishment of a Credit Guarantee and Investment Mechanism by ASEAN+3 to support the issuance of local currency-denominated corporate bonds, with an initial capital of USD500 million, was announced. Meanwhile, the Asian Bond Fund (ABF) Initiative focuses on addressing demand-side issues by broadening and deepening domestic and regional bond markets through pooling reserves for investments into regional bond markets. Two funds, totalling USD3 billion, have been established to catalyse market development.

Regional financial integration has accelerated in this decade. A more diversified financial system, together with strengthened

financial infrastructure and capital account liberalisation, has seen the share of intra-regional portfolio investment, in both debt and equity, as a share of total portfolio investment increase to 24% in 2007 from 15% in 2001. Mergers and acquisitions (M&A) have also been growing, with intra-regional M&A as a share of total M&A in the region rising to 47% in 2006 from 32% in 2004. Most of the investments were into the services sector, such as financial services and real estate. However, despite the considerable progress in financial integration in Asia, it is still low compared to the European Union-16 (2007: 56% as a share of total portfolio investment).

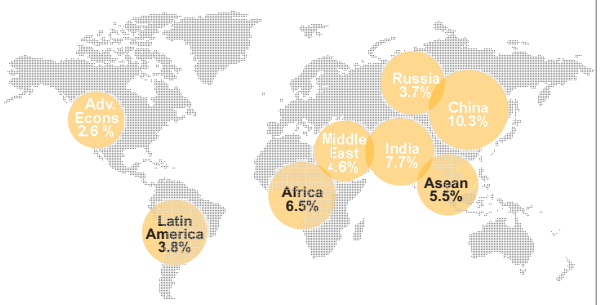
ASIA GOING FORWARD

The current global crisis, considered to be the most severe in the post-World War II period, has revealed weaknesses to the current global system. In the aftermath of the crisis, the global economic and financial landscapes are expected to change significantly. While signs of stabilisation are now emerging, prospects for recovery in the advanced economies are expected to be gradual. The general consensus is that the emerging economies in Asia, in particular China and India, will lead the global recovery moving forward. Several structural factors will support growth in Asia, including the growth-enhancing reforms and greater regional integration that have been undertaken in the recent decade. In addition, Asia's relatively strong and resilient financial systems, which have remained relatively unaffected in this current global financial crisis, are in a sound position to provide financing to support domestic economic activity. Indeed, this trend will accelerate the formation of more multi-polar global landscape in the future.

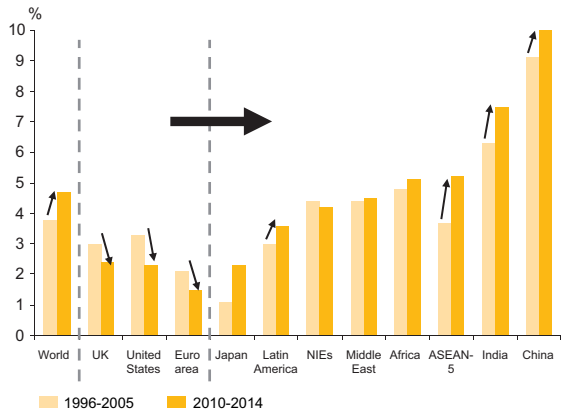
For continued progress and development, the strategies for Asia are adapting to the changing landscape; leveraging on regional strengths and addressing current weaknesses and future risks. Two key principles have contributed to Asia's earlier success, namely the regional and global integration of the economy and inclusive development. Asia has always embraced openness. While greater integration beyond national borders will likely continue, the pattern of integration will change. It will become increasingly diversified among emerging economies, in particular within Asia. Similarly, to ensure sustainability of economic growth, it requires consideration of inclusion.

Figure 5
Towards an increasingly multi-polar global landscape

Growth projections for the period 2011-2014



Average annual change in growth, %



Source: International Monetary Fund (World Economic Outlook 2009)

Three Key Strategies for Asia

Going forward, three areas are critical for Asia. The current crisis demonstrated the effects of Asia's reliance on trade and final demand from the advanced economies. While domestic demand and intra-regional trade has started to increase, it still shows the region's continued close trade connections with the global community. Exports performance in the Asian economies was dramatically adversely affected, causing the more open economies in the region to slip into recession, while other Asian economies experienced slowing economic growth. The decline in world trade followed the reduced final demand from the advanced economies. The outward-oriented policy across Asia and the internationalisation and vertical integration of manufacturing supply chains amplified the magnitude and speed of trade contraction in the Asian economies. An important strategy for Asia going forward is, therefore, to **intensify the balance of the outward-oriented development strategy with efforts to promote the greater role of domestic demand**. This economic diversification will provide increased resilience in the face of external shocks and will enhance the overall growth prospects for Asia.

Several preconditions are already in place to support domestic demand in Asia going forward. The first is the favourable demographic structures, fast-rising income levels, broadening affluence and the growing middle income class across most of the Asian economies. Estimates suggest that both China and India have large and growing domestic middle-class markets - estimated to be about USD1 trillion per year in China and USD250 billion annually in India. This trend is expected to continue given an increasing young population in Asia with new spending patterns, threreby leading to the rise of a modern retail sector across the region. In China, organised retail trade as a share of total retail trade has increased from 5% a decade ago to an estimated 17%, while in India, the retail market is growing by 7% per annum. The second factor is the relatively sound financial position of households in Asia, with high saving rates that exceed 30% of GNP in most countries and relatively low debt levels, thus providing the potential for rising consumption to be sustained. This is further supported by the ability of the financial sector to provide financing to support consumption. In this regard, Malaysia is an example, with household debt at 66.8% of GDP as at end-July 2009, while the growth of credit to the household sector has continued to increase in this recent decade. Of significance the level of non-performing loans, a measure of asset quality remains low.

The second strategy is the **further diversification of the external markets, in particular, to accelerate the efforts to foster greater regional trade ties, for Asia**. It would also shift the composition of intra-regional trade from intermediate inputs for the production of goods for final demand to the traditional markets, to a more balanced composition with increased share to meet final demand within Asia. First, as the emerging economies, in particular Asia, gain importance as growth centres, the cumulative markets of Asia as export destinations will expand over time. The rapidly rising Asian middle income class will increase final demand for goods and services. Second, Asia can leverage on its immense diversity as a source of economic complementarities. The 'Flying Geese Model' illustrates how Asia had, in the past, harness the diversity of the region. Going forward, similar emphasis can be adapted beyond merely for the production of goods for final demand outside Asia.

Financial integration as a third strategy

The third strategy is the **promotion of deeper financial integration**. This is important for further advancing the economic development of the region. Financial integration is generally associated with capital mobility and refers to the extent to which an economy's financial system is interconnected with other financial markets. A fully integrated financial system will be one in which potential market participants, both in the banking sector and financial markets, adopt a single set of rules, have equal access and are treated equally. This would in turn be reflected in an international convergence in the prices of financial products and assets, with low transaction costs that encourage the institutions, issuers and investors to venture beyond the domestic markets into foreign

markets. Essentially, the end goal of financial integration is to establish a free flow of finance and capital, akin to trade integration which aims for the unrestricted mobility of goods and services. Deeper financial integration would further enhance the competitiveness and dynamism of Asia.

Broadly, greater financial integration would bring about three key benefits. First, financial integration fosters greater competition and economies of scale in the financial system, thereby improving the efficiency in the allocation of capital within the region and thus increase the capacity of the financial system to meet the differentiated and growing demands of investors. While the individual Asian financial markets, on their own, are small in size and fragmented, an integrated market would raise Asia's attractiveness to both regional and global investors. Second, financial integration would facilitate a more efficient transfer of surplus funds for investments within the region, with lower intermediation costs and thus more optimal returns. Through the greater opportunity for risk-sharing and diversification across a wider geographical area, country-specific shocks and financial vulnerabilities would be reduced, thus contributing towards enhanced regional financial stability. Third, financial integration enables countries to build on the complementarities between countries. Individually, different financial systems can leverage on the comparative advantages of the different markets that exist in the region. Thus, with greater integration, countries in the Asian region can expand on financial products and services.

Regional financial integration is particularly important at this stage of Asia's economic development. Indeed, a more integrated financial market within the region would lead Asia to a higher stage of economic development. First, while many of the Asian economies have large surplus funds, there also exists many development needs across the Asian economies, including more advanced infrastructure development including transportation, healthcare and education, which require substantial financing. However, cases of mismatched funding needs are not uncommon. In this regard, a more integrated regional financial system would enable for a **better matching of saving and investment in the region, thus effectively channelling Asia's large pool of savings into productive uses within the region** that would support growth and development in the region.

Second, the large and growing trade sector in Asia provides an expanding market for financial services. The ease of obtaining access to credit through financial integration, specialisation and exploitation of economies of scale would support the increasing trade and investment activities. Furthermore, the regional development of capital markets, both in bonds and equities, provides greater opportunity for firms to raise capital needed for future industrial expansion. More importantly, higher value-added goods and services tend to require more credit for more advanced production equipment and technology. As a result, the role of external finance becomes increasingly more important to facilitate regional trade and investment as economies move towards higher stages of development. Thus, deeper regional financial integration would **facilitate Asia's growing intra-regional trade and investment trends**. Third, Asia is home to more than half of the world population, with a growing middle income and young population in the region. This represents **a massive potential market for financial products and services. The high rate of savings also provides a large local investor base**.

Whilst extensive regional cooperation have been initiated and undertaken in the liberalisation of the Asian financial systems and in the development of financial infrastructure, there still exist several areas where efforts need to be further strengthened to deepen financial integration in Asia. The important four areas include financial sector liberalisation, capital account liberalisation, regional payments and settlements systems, and cooperation among regulators and central banks. These priorities would, however, need to take into account the diversity of the various economies within the Asian region, in terms of the level of development of both the financial system and broader economy. Therefore, reforms need to be sequenced and aligned to the heterogeneities of the various economies. First is the further liberalisation of financial services undertaken to allow for the greater

presence of regional institutions in the individual domestic markets, which would further facilitate trade and investment flows within the region. Beyond the General Agreement on Trade in Services (GATS) commitments, limits on licenses, branch networks, ownership share and voting rights still remain in most Asian financial sectors today. Gradually removing these restrictions to facilitate a greater presence of Asian financial institutions and investors in each other's economies would facilitate the integration process.

Second, the policies of gradually liberalising the capital account of the balance of payments would facilitate greater cross-border investment and capital flows. This would enable firms and investors to better tap the regional financial markets to find the lowest cost of funding and highest risk-adjusted return. Equally important is the appropriate prudential safeguards to manage short-term flows and for the liberalisation process to be appropriately sequenced and based on a well-functioning, well-regulated and adequately developed domestic financial systems.

Third, as payment and settlement systems are relatively well-developed in most of the Asian markets, the increased linkages of the national payments systems would enhance the efficiency and reduce the cost of financial transactions within the region. Several efforts have been initiated in this area. The Executive' Meeting of the East Asia and Pacific Central Banks (EMEAP) Working Group on Payment and Settlement Systems (WGPSS) - Working Group on Financial Markets (WGFM) Joint Taskforce has embarked on a cross-border collateral arrangement initiative to support and improve the liquidity management of internationally active financial institutions in the region. Second, the AseanPay Initiative of 2004 has led to a link-up of ATM networks across the region, allowing for convenient cash withdrawal to support Asia's increasing tourism activity. With wide participation by banking institutions in Malaysia, Indonesia, Thailand and Singapore, such infrastructure can be extended to enhance the efficiency and cost-effectiveness of intra-region card electronic payments and remittances. The Real Time Gross Settlement (RTGS) systems of Bank Negara Malaysia (RENTAS) and the Hong Kong Monetary Authority, have been linked to facilitate faster and more efficient forms of payments. Further linkages could be pursued among the broader Asian community to link more RTGS systems, thereby facilitating faster and more efficient forms of payments.

Fourth, while greater financial integration brings about many benefits, its associated risks have to be anticipated and managed. In relation to this, cooperation among the region's financial regulators and central banks need to be further strengthened. There is already extensive cooperation and collaborative mechanisms in place. More specifically, there is improved regional surveillance that facilitates early detection of emerging risks and potential contagion at the regional level. In addition, institutional arrangements and a framework for financial crisis containment, management and resolution is now being put in place. These have been reinforced by infrastructure development in the areas of financial markets, payments systems, and regulatory framework. With significant strides already accomplished, a key challenge for Asia will be in intensifying this positive momentum for cooperation and collaboration. Over the next few years, the focus will be on the implementation of the next set of recommendations that are embodied in the region's road map produced in 2006, which outlines the strategic direction of regional cooperation. These include the development of a vibrant and efficient foreign exchange market, a deeper and more liquid secondary bond market, the further strengthening of the mutual support arrangements and liquidity support mechanisms to deal with crises, as well as the intensification of capacity and capability in reserve management and the overall capacity building. The institutional arrangements that are now established to deal with financial stresses and crises must be complemented with collaborative arrangements and frameworks to deal with an economic crisis within and of the region. Given the growing depth and magnitude of economic and trade interlinkages within Asia, this will be fundamental towards preserving the overall macroeconomic, financial and social stability of the region.

Deeper financial integration within Asia will also facilitate in advancing the strategic positioning of the region in the global financial landscape. In addition, Asia is now having a voice in shaping the direction of international financial reforms and setting of international standards. This represents a positive development and presents the opportunity for the interests of emerging economies, in particular Asia, so that more balanced and comprehensive solutions that will strengthen global financial stability will be achieved. The expanded Asian membership in the international financial institutions would open doors for a more inclusive process in international standard setting and decision making. To support this process, the role of existing Asian collaborative platforms has been strengthened to consolidate Asia's position in providing responses to global issues that reflect Asia's concerns and perspectives.

CONCLUSION

In a short span of just fifty years, Asia, with its vast diversity in population, ethnicity, social structure and political regime, has made remarkable progress throughout the region. Despite broad and different challenges from urbanisation and rising income inequality to economic crises and social instabilities, Asia has time and time again risen to the occasion and resumed economic progress. The 'Asian miracle' was achieved not by chance, but by pragmatic policies, ensuring sound economic fundamentals and strong institutions.

Today, a global shift, triggered by a severe global economic and financial crisis is resulting in an increasingly multi-polar world. In this new phase of globalisation, the concentration of economic power in the global economy will become more dispersed. Asia will very much be a part of this new emerging future. With growth in the advanced economies expected to remain slow and with the emerging economies increasingly becoming the growth centres in the global economy, Asia must review and accordingly change its existing development in this new environment. Of significance, strengthening of the domestic Asian economies supported by the necessary institutions, the further development of the financial markets, and greater regional financial integration that is reinforced with overall regional cooperation. As these trends become more pronounced, it will not only contribute towards unlocking Asia's full potential, but it will also contribute towards a more balanced growth in the global economy.

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Financial Industry Conference 2009
Kuala Lumpur, 17 November 2009

Opening Remarks by

Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz
Governor, Bank Negara Malaysia

It is my great pleasure to welcome you to our financial industry conference for this year. This conference takes place at a time when the global financial landscape is experiencing fundamental change. Even as we meet, events continue to unfold in directions that are likely to fundamentally alter the way in which financial institutions conduct their business. Reforms to strengthen the foundations of financial stability are wide-ranging to improve the supervision and regulation of financial institutions, and the institutional arrangements for coordination and cooperation in the area of surveillance and crisis management within and across jurisdictions. This Conference is organised by Bank Negara Malaysia to engage in constructive dialogue with the industry on developments affecting the international and domestic financial industry, focusing in particular on implications for financial institutions in Malaysia.

Economic Developments and Outlook

After a challenging beginning to this year, Malaysia is now gradually moving on a path of recovery supported by strong macroeconomic fundamentals and a sound financial sector. Economic activity has continued to show a marked improvement in the third quarter, with positive growth expected in the fourth quarter. This improvement has been underpinned by a recovery in domestic demand, particularly in consumption, supported by better employment conditions, the accelerated implementation of fiscal measures, the accommodative monetary environment and the continued access to financing. In 2010, the Malaysian economy is expected to sustain the growth momentum, driven by domestic economic activity and reinforced by improvements of growth of our major trading partners.

The role of the domestic sector in driving growth is not new. Domestic demand has in fact been the main source of growth for the overall economy since 2003, complementing our large external sector. This trend highlights the fact that our economy is evolving towards a balanced growth model, deriving advantages from our economic linkages with the global economy while at the same time strengthening the domestic sources of growth.

While growth in domestic consumption has been encouraging, the next step towards further rebalancing the sources of growth will be to increase the contribution from investment. A higher level of private investment would further improve our productive capacity and increase the potential for higher growth. In this, many new areas of growth would benefit from higher investment, including in the services sector, as well as in the development of enabling infrastructure for modern economies such as in broadband and green technology.

Rising Above the Economic Challenges

While economic prospects have improved, the road to economic recovery will not be without challenges. Firstly, the better economic prospects for recovery in Asia, and the expectations that Asia will lead in the emergence from the global recession could draw large capital inflows into the region. Such flows would not only lead to more volatile exchange rates, but also to increases in asset prices. Increases in commodity prices could also potentially feed into inflation and affect the economic recovery process. Most economies in Asia, including the policy makers, the financial industry and the private sector, have however, the capacity to manage these challenges. Stronger financial positions, low levels of leverage and buffers built during the good times have rendered the potential to manage the more challenging environment. The role of the financial sector is particularly important in ensuring the flow of financing to productive economic activity is not disrupted, while exercising prudential restraint in an environment of excess liquidity.

Towards the medium term, significant uncertainties remain for the outlook of the global economy. Overall global growth is expected to remain weak over the medium term with structural weaknesses in the advanced economies weighing down the overall economic growth in these economies. Being highly integrated with the global economy, the continued weakness of the advanced economies could present a challenge for overall economic growth for most emerging economies in the medium term. Therefore, it is crucial for the external sector of Malaysia to evolve into a more diversified structure to increase resilience and rely less on the traditional markets for growth. It is encouraging to note that this is already happening. Since 2000, our share of exports to emerging economies has increased from 53% to 66% in 2008. This represents an important trend towards a more broad-based economic integration with the global economy, through increased trade and investment.

Going forward in 2010, to enhance the growth prospects in this more challenging environment is through increasing productivity whereby the same levels of investment generates higher output. Focus also needs to be on high impact investments that will have a higher multiplier impact on the economy. Attracting foreign direct investments through liberalisation and strategic alliances would also contribute to this process. To raise the level of economic performance, it is not only important to invest right, but equally important is to have the enabling environment to maximise the return on investment. The efficiency of financial intermediation is a vital part to the success of this strategy.

International Regulatory Reforms

Let me now turn to the international regulatory reforms. This global financial crisis has resulted in the world experiencing the worst recession in modern history. This has prompted the world to come together with wide ranging proposals to strengthen the foundations for financial stability and to address weaknesses in the international financial system. A fundamental issue being deliberated is the determination of the balance between private decision-making, the market system and Government intervention. While at one end of the spectrum, the case is being made that there is no other alternative to the market to generate an efficient functioning financial system, at the other end of the spectrum the call is for a more interventionist regime. The solution lies in a balance between these, and the avoidance of an over reaction in addressing weaknesses and excesses that have been built over an extended period of time.

Equally important is to recognise that for markets to function efficiently, institutional and market infrastructure need to be well developed. The incentive structure, the rules of the game, the transparency and the levels of financial literacy also needs to be in place. When these elements are still yet to be developed, as in many emerging economies, it increases the risk to financial stability. For advanced financial systems, however, when the institutional structures and rules became deficient and less relevant, it is necessary for them to be changed. In essence, the environment has become highly dynamic requiring regular regulatory reinvention.

Let me turn to the approach adopted by Bank Negara Malaysia. The recent global developments will not fundamentally alter the main tenets of our approach to the regulation and supervision of financial institutions in Malaysia. It will continue to be a balance between rules-based and principles-based regulation. The principles-based approach is more likely to produce more efficient market outcomes, better risk-alignment and socially responsible behaviour. The approach will also continue to be risk-based, in which the expectations in governance and risk management are higher for the larger and more complex financial institutions, and when these expectations are not met, the Bank will respond with supervisory actions. The Bank will continue to act pre-emptively to deal with the risks, at the institutional and system levels. Judgements will be applied based on a broad range of information available on the potential build-up of risks.

The regulatory framework adopted will continue to be consistent and aligned to international standards to safeguard the stability of the financial system. In this regard, Bank Negara Malaysia will implement the changes by the Basel Committee to improve the risk capture of Basel II for trading book, securitisation

and counterparty credit risk exposures. We will also positively consider developments by the International Association of Insurance Supervisors to achieve internationally consistent capital standards for insurance companies. We will be introducing changes to improve the liquidity framework and strengthen the quality of capital, focusing in particular on equity as the predominant form of capital. We also support the global initiatives that are aimed at reducing the complexity of products, strengthening transparency and improving incentive structures.

An area of current international deliberation which will have a significant implication on the domestic regulatory and supervisory environment is the increased emphasis on the macro-prudential dimension of regulation and supervision. A key lesson drawn from the crisis has been the inadequacy of supervision that was primarily focused on individual institutions. Even before the build-up of financial imbalances, the underpricing of risk and increased leverage in the financial system had been identified as sources of potential instability well before the eruption of the crisis. The warnings that were issued by central banks and international institutions were largely ignored and failed to result in appropriate responses either by market participants or by the authorities responsible for the oversight of individual financial institutions or the specific market segments.

This has led to calls to regulate such market excesses through counter-cyclical or macro-prudential measures such as increasing capital buffers in good times which could be drawn upon under stress conditions, the implementation of a leverage ratio to supplement risk-based capital requirements and through-the-cycle provisioning standards. There is also a call for systemically important institutions to be required to meet higher regulatory standards that are reflective of the risks that they pose to the system, rather than a consideration only of their institutional risk profile. The international reactions to these measures have been mixed, mainly because they are extremely difficult to calibrate in a way that will not unduly constrain output potential in good times, while avoiding significant demands for more capital and a confidence crisis during bad times. The Bank will carefully assess the details of these measures as they are released, and we will do so taking into account the regulatory and supervisory regime in Malaysia.

Bank Negara Malaysia has already for some time now, put in place a framework in which the supervision of individual institutions is complemented with macro-prudential assessments. Risks identified at the macro-level provide important inputs to supervisory assessments of individual institutions, while the collective behaviours of individual institutions provide information on the build up of risks in the system. Financial institutions would already be familiar with this through the Financial Stability Report of the Bank and with the stress testing parameters.

The ability of the Bank to undertake surveillance and act pre-emptively to avert risks to financial stability will also be further enhanced when the new Central Bank of Malaysia Act 2009 comes into force on 25 November 2009. This includes the expanded powers for the Bank to undertake surveillance and prompt resolution on financial institutions including on non-regulated institutions that are systemically important. As we continue to refine our approaches, and develop a better understanding of market behaviours, financial institutions will also need to better integrate institutional risk assessments with macro-economic developments.

International reforms have also focused on delivering fair outcomes for consumers. In relation to this, the Bank will continue to ensure that financial innovations are developed to meet the real needs of consumers and businesses, and do not expose the system to excessive risks. Ongoing efforts to strengthen avenues for consumer redress will continue through the establishment of a financial ombudsman and improved product transparency, particularly in the area of pricing, commissions, fees and charges so as to support more informed consumer decisions. Timelines for some of these measures have already been announced. These reforms will be reinforced by strengthening further the current consumer protection framework to address mis-selling practices and facilitating a more effective enforcement of business conduct regulations.

Strengthening the Domestic Infrastructure for Financial Stability

An important part of the efforts to strengthen the domestic infrastructure for financial stability is legislative reform. The Bank is in the process of drafting a new legislation that will amalgamate existing legislations governing financial institutions and intermediaries in Malaysia that are administered by the Central Bank. Provisions in the current banking, insurance and takaful laws will be updated to support a more differentiated regulation and supervision according to risk. It will also reinforce the emphasis placed on effective board oversight and enable pre-emptive supervisory and enforcement actions by the Bank. This will include the introduction of a broader and more flexible enforcement framework, with consideration to civil and administrative penalties to deal with different types of offences. Proposed legislative changes also include the introduction of a more comprehensive insurance compensation system for the protection of policyholders. The draft legislation is expected to be completed in 2010.

Progressive Liberalisation of the Financial Sector

This year marks the ninth year into the implementation of the Financial Sector Masterplan. Following the release of the Plan in 2001, more than 90% of the recommendations in the Plan have been implemented. Collectively, these measures have contributed towards achieving a more efficient, effective, stable and resilient financial sector as was envisioned in the Masterplan. This is evidenced by the significant transformation of the financial system that is now more diversified with well developed financial markets and broadened product offerings, that is more competitive with home-grown regional players, that is more inclusive with higher levels of banking and insurance penetration, and with improved financial strength indicators as financial institutions are better supported by strengthened governance and risk management standards and practices.

The development of Islamic finance has also made significant strides both in the domestic and international front as Malaysia evolves as an international Islamic financial hub. Enhancements to the payment infrastructure have also supported the increased use of e-payment channels. With these building blocks in place, the financial system has also been progressively deregulated and liberalised. The more recent liberalisation to allow for greater foreign participation in the domestic financial markets and increased foreign presence will enhance further our financial and economic international linkages.

As we move into the final phase of the Masterplan, we are confident of the strength and resilience of the domestic financial sector to face greater competition and benefit from the liberalisation measures recently announced. We have received strong interest in the new licences from Asia, the Middle East, Europe and the United Kingdom that bring with them strong value propositions that will add significantly to the depth and breadth of the financial sector in Malaysia.

In the insurance sector, greater competition will emerge from the progressive deregulation of product rates. The current reforms in the motor insurance sector will introduce far-reaching changes in a key segment of the industry, with significant implications for the business strategies of insurers and their approaches to risk management. With the introduction of a new scheme for basic motor insurance cover, pricing for non-statutory motor insurance will be gradually liberalised, thus removing price distortions. This will allow rates to adjust to underlying risk factors. This will also be accompanied by a holistic review of motor insurance practices and the supporting infrastructure to enable more scientific underwriting and improve claims management. Industry groups have been formed to study these issues and make recommendations for the smooth transition to this new and more competitive environment, while at the same time improving practices across the entire value chain of the motor insurance sector. The groups have made good progress and the recommendations are expected to be finalised for implementation in the second half of 2010.

A New Blueprint for the Financial Sector

Beyond this international financial crisis and economic recovery, a global shift is taking place that is resulting in an increasingly multi-polar world. In this new phase of globalisation, the concentration of economic power in the global economy will become more dispersed. Asia will be very much part of this new future that is emerging. As Asia's importance as a growth centre in the world economy increases, three major trends can be expected to intensify going forward. First, domestic demand, supported by the large and fast-growing middle income and young population in the region, will increasingly have a greater role in driving economic growth in Asia. This would contribute towards a greater balance between domestic and external sources of growth. Second, the diversification of external markets will accelerate, towards greater economic inter-linkages with emerging economies in other parts of the world. Part of this trend includes the creation of the ASEAN Economic Community by 2015 in which ASEAN will transform into a single market with free movement of goods and services. This will include the lifting of restrictions to the flow of capital in the region. And third, is the greater financial integration within Asia that will result in an increased part of the savings in Asia being reinvested in Asia.

The new spending patterns as incomes rise in the region will drive the modernisation of the retail sector across the region. Financial services to the household sector will become increasingly important in this new environment. Reforms to pensions and retirement benefit systems will be key to providing a more comprehensive social safety net, thus reducing the need for high precautionary savings and encouraging consumption. In addition, the large trade sector in Asia and large capital investments required to move towards higher value-added activity will also provide an expanding market for financial services. The more regionally integrated financial system will allow firms and investors increased options in the regional financial markets for financing and investment. These trends are being further supported by enhanced linkages in the payment systems to facilitate the intermediation of funds in the region.

The economic transformation of Malaysia will move us to the next level of development. Malaysia has been a middle income country for almost three decades, having benefited considerably from rapid industrialisation and integration with the global economy. Moving into the next stage of economic development, the domestic economy will change to a productive structure that is more innovation-driven and knowledge-intensive, with the services sector assuming an increasingly dominant role in the economy. In this next decade, the services sector is expected to account for about two thirds of the economy, with growth focused on higher value added activities.

To support and drive this transformation, a new blueprint for the financial services sector is being developed by Bank Negara Malaysia. The blueprint will chart the next phase of the evolution of the financial sector, with the aim of positioning the financial sector, including Islamic finance, not only to become a catalyst to the transformation process, but also having the flexibility to respond to the key trends that are emerging. In essence, we need to evolve a financial system that best serves Malaysians in this new environment.

As the global financial services industry going forward strives to regain thrust and confidence, the starting point in Asia is to build on the solid foundations put in place during the decade following the Asian financial crisis. Asia is seeing the payoffs from the financial reforms, institutional development and the strengthening of the financial infrastructure. While financial markets have become more volatile, financial intermediation has not been interrupted.

While our starting point is from a position of strength, we must nevertheless draw upon the lessons from the current crisis. The lessons from the crisis must not be lost. This crisis offers Malaysia and other emerging markets an opportunity to steer the future path of development of the financial sector to a stronger and more sustainable path one which avoids the trappings of greed and reckless behaviour that have significantly set back the financial sector in many advanced economies. It would be foolish of us not to take heed of these lessons and leverage on the opportunity to leap forward on a more solid foundation.

Despite these developments, going forward, the trend for liberalization will continue as financial integration in the region will intensify. This will mean greater foreign participation in terms of new institutional presence, strategic alliances and greater participation in our financial markets. Efforts to develop further our foreign exchange market will be intensified. Our financial links will also need to extend beyond the region to facilitate economic links with other emerging economies.

On the domestic front, financial services to SMEs need to evolve from transactional and lending-based business to a full-service, relationship-based business. The household sector, already an important segment being served by the industry, will see further transformation with the continuing evolution of multi-channel distributions with online channels becoming more popular and increased customer demands for product transparency and overall service levels. We expect to see a re-orientation of processes and incentives towards value over volume, further differentiation in the management of customer-relationships and an increasing focus on technology-driven transformations that are more aligned with business strategies. The outgrowth of these strategies will include an accelerated shift in product offerings towards more comprehensive end-to-end financial solutions and further changes in the traditional roles of physical branches and intermediaries, with greater use of more efficient direct channels and strategic alliances to widen the outreach of financial products and services. In the area of e-payments, the creation of a mobile ecosystem is envisaged, to provide an open and inter-operable platform for all financial institutions, mobile network operators and services providers to offer highly automated and cost-effective mobile payment services.

Going forward in this new financial system, the role of boards of financial institutions in determining the risk appetite of their institution, in ensuring that strategies are consistent with that appetite and in overseeing risk management systems will become increasingly critical. Shortcomings in how boards discharged their roles in a number of major international financial institutions were a material contributor to the global financial crisis. Boards must be relentless in pursuing the effective governance of risk, continuously develop their capacity to do so, and insist on strengthening processes, systems and structures as appropriate to effectively monitor and control risk.

Conclusion

Let me conclude my remarks. We need to prepare ourselves for a future in which we can prosper. We have every potential to do so. The authorities have great determination to provide the enabling environment for this to happen. Financial institutions need to decide on their own strategy and the business model to not only perform but also survive in this more challenging environment. The demands are for world class service and real value added to the economy. For the Central Bank, as the supervisory authority, our role will be to push the frontier of the financial infrastructure with its international inter-linkages, while not losing sight of ensuring overall financial stability.

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Governor Dr. Zeti, in her keynote address at the Seminar on Islamic Finance in Istanbul, said that fundamental Shariah principles set out a resilient strategy for risk management that have the potential to safeguard Islamic finance from the worst of the financial crisis. She noted that two elements in particular had enabled Islamic finance to weather the storm. The first was the requirement that all financial transactions must be underpinned by productive activity that will generate legitimate income, thus establishing a close relationship between transaction and productive flows. The second was the connection between profit and risk sharing, which drives financial institutions to employ due diligence when undertaking businesses.

18-20 October 2009

The Bank, the European Commission and the Asian Development Bank jointly organised the Asia-Europe Meeting (ASEM) conference in Kuala Lumpur. The theme of the Conference was "Beyond the Global Crisis: A New Asian Growth Model?" Officials from the finance and economic ministries and central banks from 43 ASEM countries, as well as academicians, business leaders and media representatives from domestic and international communities participated in the Conference. The Conference provided opportunities for the participants to discuss key economic and financial issues affecting Asia and the EU, and assess Asia's growth strategies amidst the changing global economic and financial landscape.

28 October 2009

The Bank's Monetary Policy Committee (MPC) decided to leave the Overnight Policy Rate (OPR) unchanged at 2 percent. The MPC stated that conditions in the domestic economy are improving and a recovery in economic activity is gaining some strength. These improvements are reflected in stronger labour market conditions, consumer and business sentiments, industrial production, financing activity and external trade. These positive developments are expected to continue into 2010, with growth in the domestic economy expected to continue, supported by existing policy measures and the growing confidence in the private sector. At its subsequent meeting on 24 November, the MPC kept the rate at the same level, citing that the current monetary policy stance is appropriate and will continue to provide support for economic activity.

11 November 2009

The Bank and the China Banking Regulatory Commission signed a Memorandum of Understanding (MoU) to forge deeper cooperation between the two regulatory authorities on banking supervision, including sharing of information and promoting regional financial integration. The MoU is a continuation of the Joint Acton Plan on Malaysia – China Strategic Cooperation between the Government of Malaysia and the Government of the People's Republic of China that was signed on 3 June 2009. The MoU signifies the strengthening collaborative partnership between the Government of the People's Republic of China and the Government of Malaysia and marks an important milestone in enhancing the regulatory cooperation and the economic and financial linkages between the People's Republic of China and Malaysia.

17-18 November 2009

The Bank organised the Financial Industry Conference 2009 for leaders of the banking, insurance and takaful industries. The Conference provided a platform for high level dialogue with the industry on global economic and financial developments, including international regulatory reforms and their implications for the domestic industry. The industry discussions centred on the need to further strengthen risk management capabilities in the light of the increasing complexity and interconnectedness of the financial system, the need to better align incentive structures, the more pronounced emphasis on product transparency, as well as on the need for a balanced response to risks confronting the financial system.

19 November 2009

The Bank announced the appointment of Puan Norzila Abdul Aziz as Assistant Governor effective 1 November 2009. Her portfolio includes the Investment Operations and Financial Market Department and the Foreign Exchange Administration Department.

20 November 2009

The Bank announced that the Malaysian economy registered a smaller contraction of 1.2% in the third quarter of 2009 (2Q 09: -3.9%) amidst positive growth in domestic demand and stabilisation of external demand. The better performance was mainly supported by domestic demand due to stronger private consumption and higher public sector spending. Improvements in the global economy, particularly the regional economies, helped to stabilise the external sector. On the supply side, all economic sectors, except agriculture, recorded improved performance. Going forward, the pace of economic recovery is expected to gain momentum, as business and consumer sentiment improve further in an environment of continued implementation of fiscal measures, accommodative monetary policy and continued access to financing. The gradual improvement in the global economy will also continue to contribute positively to the recovery of the domestic economy.

On the same day, the Minister of Finance approved the issuance of a commercial bank licence to Industrial and Commercial Bank of China Limited (ICBC), the largest commercial bank in the People's Republic of China. This licence follows a bilateral arrangement between the China Banking Regulatory Commission and the Bank, and between the Government of Malaysia and the People's Republic of China in the earlier part of the year.

25 November 2009

The Bank announced that the Central Bank of Malaysia Act 2009 (The Act) has come into force. With this, the Central Bank of Malaysia Act 1958 is repealed. The Act provides greater clarity on the Central Bank's mandate and vests it with the necessary powers and instruments to achieve the mandate of promoting monetary and financial stability. Incorporated in the Act is a more robust governance framework that provides for a high degree of accountability and transparency of the Central Bank's operations. The Act institutionalises the good practices that have been put in place over the recent decade and takes into consideration the needs for enhanced regulatory and supervisory mandates required as a result of the recent global financial crisis.

2-3 December 2009

The Bank, in collaboration with the Consultative Group to Assist the Poor (CGAP), a microfinance group based at the World Bank and the Alliance for Financial Inclusion (AFI), organised the Microfinance Policymakers Forum 2009. Themed 'Scaling Up Financial Inclusion through Branchless Banking', the Forum aimed to promote branchless banking, which is the delivery of financial services outside conventional bank branches using information and communications technologies and non-bank retail agents. Discussions of the workshop focused on key considerations and recent developments in institutional structures, as well as regulatory and supervisory requirements necessary for effective adoption and application of branchless banking.

23 December 2009

The Bank announced that effective 1 January 2010, travellers entering or leaving Malaysia with cash and/or negotiable bearer instruments (eg travellers cheques, bearer cheques) exceeding amount equivalent to USD10,000 must make a customs declaration at the entry or exit points. This requirement is in line with the international practice to combat money laundering and terrorism financing.

28 December 2009

The Bank and the Ministry of Finance Malaysia announced the signing of the Chiang Mai Initiative Multilateralisation (CMIM) Agreement by the ASEAN Members, China, Japan and Korea (ASEAN+3) and the Hong Kong Monetary Authority. The main objectives of the CMIM are to address balance-of-payments and short-term liquidity difficulties in the region and to supplement the existing international financial arrangements. Participating countries facing liquidity difficulties is entitled to receive financial support through currency swap transactions provided by the CMIM.

31 December 2009

The Bank announced that more than 9,000 SMEs have benefited from the RM2 billion SME Assistance Guarantee Scheme launched on 3 February 2009. The scheme was established to ensure that viable SMEs affected by the economic slowdown will continue to have access to financing and sustain their business operations.