Frankfurt European Banking Congress 2005
18 November 2005, Frankfurt

Session III: Financial Markets – Shared Responsibility

Intervention by
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Reference has already been made by previous speakers to the increased risks that the current prevailing global imbalances impose on the international financial system. The specific issue for this panel - "Financial markets: Shared Responsibility" suggests that a global solution is needed to address the problem of global imbalances, and that the burden of adjustment needs to be a shared responsibility.

There is already a general consensus on the necessary structural adjustments that need to be made by the respective regions, namely, the United States, Europe and Asia. By the very nature of structural adjustments, it involves structural reforms, institutional developments and shifts in the relative significance of economic segments and structures. These adjustments and reforms cannot be expected to occur within a short period of time. While there is concern whether there will be the commitment, the political will and the discipline to undertake these reforms and changes, the more immediate concern is that during the transition, sudden and abrupt adjustments may take place in the financial markets, with adverse implications on the world economy.

I would like to take this opportunity to discuss these issues from the perspective of Asia in general and emerging market economies in particular. More specifically, what might be the role that Asia could have in the adjustment process? Several issues have already been cited as constraints to the process of adjustment. The relative lack of strength in domestic demand outside the US; the large gap between saving and investment in major regions of the world; and the fragmented structure of global capital intermediation that hinders surplus regions from financing productive investments within their region. On all these fronts, significant initiatives are underway in the Asian region to address these issues and substantive progress has already been achieved in contributing to the global adjustment process.

Asia, with more than half the world's population and a growth performance that has been, on average, one-and-a-half times higher than the global average, is becoming increasingly more important in the world economy. While Asian economies have many common characteristics, they are less homogeneous compared to the European economies. The main common feature of Asian economies is its high degree of

openness and export orientation. On average, total trade as a percentage of GDP is 95%. A more recent emerging phenomenon is the growing significance of intra-regional trade. Intra-regional trade now accounts for more than 50% of Asia's total trade. A second distinctive and important feature of most Asian economies is the high degree of flexibility of the economies in adjusting to changing global conditions and in dealing with external shocks. This high degree of economic flexibility has been an important factor in sustaining the region's growth performance and in facilitating rapid recovery from shocks, including from the 1997-98 financial crisis.

While in the past, high economic performance of Asia was driven by the export orientation growth, greater focus is now being accorded in the recent decade to strategies geared toward building the capacity of domestic demand. In particular, increased emphasis has been placed on promoting the role of consumption. Reflecting the success of this policy, the savings rate that exceeded 40% of GDP in several of the Asian economies in the 1990s, (in Malaysia the rate was 42% of GDP) has now trended towards 30%. Private consumption as a percentage of domestic demand has increased from 77% in 1995 to 85% currently. It is projected that by 2010, this will reach 90%. In most economies, fiscal consolidation has also continued, thus reducing the budgetary deficits and the level of public indebtedness, while enhancing the role of the private sector in the economy.

Significant initiatives are also underway to increase the contribution of private investment to growth and to secure new areas of growth. Reforms have been undertaken to boost the investment climate by reducing the cost of doing business and improving the supporting infrastructure. These initiatives will continue to be on-going priorities in the region.

These trends have increased the potential for Asia to contribute to the rebalancing of global growth and thus towards the global adjustment process. This process has been strengthened by several factors. Firstly, the conscious policy measures that have been implemented to promote domestic consumption and investment. Secondly, the cumulative domestic demand of the regional economies in an environment of rising incomes has represented a significant regional market that has fuelled the expansion of intra-regional trade which has, in turn, resulted in a mutually reinforcing process that has strengthened further the regional growth. While the measures to spur regional demand are also being forged though various regional free trade agreements (ASEAN FTA; ASEAN-China FTA and ASEAN-India FTA), the region is also outward looking to strengthen its relations with other parts of the world. The series of reforms being pursued are thus aimed at strengthening the capacity of the region to emerge as a stronger source of global demand.

A further reinforcing factor for Asia to emerge as a stronger source of global demand is the favourable demographic structure in Asia. Asia has the largest share of the world's population, coupled with a young demographic structure, thereby providing a

future source of domestic demand. With the growing income levels, the middle-income groups in China, India, Korea and ASEAN have been increasing and will position Asia as one of the largest markets in the world going forward.

In many respects, the rising trend in intra-regional trade in Asia mirrors developments in Europe. Intra-regional trade in Europe has always been significant, and became increasingly important in the 1990s, rising from 53% in 1985 to surpass 60% in 2004. Since the 1970s, a central feature of Europe's cooperative efforts in the context of increased economic interdependence within the region was exchange rate stability. Exchange rates in Europe evolved, beginning with a fixed parity arrangement among European currencies, within the broader framework of a free float against the other international currencies. The evolution of the exchange rate arrangement has culminated in a common currency in the European Union.

While a single currency is a remote possibility for Asia, exchange rate stability in relation to the currencies of its major trading partners is even more important to Asian economies because of its higher degree of openness both in terms of trade and financial flows and also in view of the relatively smaller size of several of the Asian economies. On account of these factors, the region is rendered more vulnerable to sudden and large swings in exchange rates. While progress has already been made to strengthen the financial markets in the Asian region, Asia still needs to develop the capacity to manage the volatile financial flows and the consequent large swings in the exchange rate.

This brings us to the call being made for Asia to adopt more flexible exchange rate regimes, with the suggestion that the exchange rate should be allowed to appreciate and thus contribute towards reducing the global imbalances. It needs to be recognised that Asia's comparative advantage is not derived from the exchange rate. Wages, prices and other costs are significantly lower in Asia. It is precisely for this reason that multinationals have relocated their operations to Asia. Furthermore, studies have in fact shown that Asian currencies would have to appreciate by 50 to 60% to have any discernible impact in reducing the global imbalances. Any such adjustment within a short period of time would not only lead to significant economic dislocation in Asia, but also precipitate unstable financial market conditions. Given the increased international integration of Asia with the rest of the world, the destabilising financial market conditions would not be contained within the region but can be expected to have its contagion effect on the international financial markets.

What has been important is that while external price stability has been pursued in Asia has, it been accompanied by internal flexibility to adjust to changing conditions. In fact, Asia's strong performance has been due in part to its economic flexibility - the ability for resources to shift to new areas of comparative advantage in response to changing conditions and new opportunities in the global economy. In particular, there is a high degree of labour and capital mobility.

Significant investments in training and education have allowed labour to adjust and become more mobile. This has played a large part in enabling rapid industrialisation and in shifting to higher value added activities. Capital has also shown greater mobility, expanding the potential for the economies to adjust. Many of the Asian countries have actively identified and developed new sources of growth, leveraging on their respective resource advantages and new technologies to move up the value chain. There have also been greater moves toward removing rigidities and transitioning toward greater market orientation and competition.

On the financial front, significant progress has been made in Asia in strengthening the financial sectors (banking system and capital markets). This increases the region's capacity to intermediate funds within the region. The regional banking systems as a whole have increased their resilience and ability to manage risks as reflected in the indicators of profitability, asset quality and capital adequacy, all which have generally strengthened. The renewed strength in the banking systems is mainly underpinned by the recapitalisation programmes; consolidation through mergers; and improvements in banking supervision and regulation. Similarly, in the capital markets, initiatives have been taken to improve the standards of corporate governance and the development of the necessary infrastructure to promote the capital markets.

In this respect, regional financial ties underpin the reforms particularly in the intermediation of capital and for rechanelling for productive investment within the region. The implementation of the Asian Bond Funds (ABF1 and ABF2) marks a significant step in future financial integration as part of the foreign reserves are invested in Asian sovereign bonds. The introduction of ABF2 Funds as a new asset class in Asia, together with infrastructural improvements and tax and regulatory reforms, can be expected to contribute towards the broadening and deepening the bond markets in the region over time. A further step towards increasing market integration within the region, especially in the context of equity markets, has been the recent launch of the FTSE/ ASEAN – 40 Index. These market driven cooperative efforts are also expected to contribute to more efficient financial intermediation in the region over the long-term. Also, as most regional members' markets are small, building a region-wide financial market would increase the potential for the region to become more attractive to both global and regional investors.

Finally, a further issue raised for this session relates to the sustainability of the financing of the current account deficits, particularly in the United States. It has been maintained that Asia as a region that has surplus savings and more recently the Middle East, have engaged in such financing. The concern is if this trend should reverse. In the current environment, the US financial markets are the largest financial markets in the world. It allows for large transactions to occur with minimal impact on market stability. The numbers of players, turnover, and frequency of issues are unmatched in any market. It also has greater diversity of investment

opportunities in the different asset classes. This is a major reason prompting investment in these markets. The further development of non-dollar markets are therefore necessary to facilitate more balanced global investment activities and thus reduce the potential for any concentrated buildups that would be prone to risks of instability should reversals occur. Indeed, Europe can contribute significantly in this area.

More recently, successive upward adjustments in interest rates in the United States have in fact caused the dollar to strengthen significantly. Further increases in interest rates will continue to reinforce this trend as the interest rate differential between dollar and non-dollar-denominated assets widens. As to the direction of financial flows, in the final analysis, it will be the policies and developments in the economies receiving such financial flows that would be important in determining the investment climate and in preserving the stability of its financial markets.

The problem of global imbalances, by its very nature, requires a global solution, and a shared responsibility to ensure its orderly resolution. A gradual and co-ordinated global approach is necessary to avoid destabilizing adjustments. The Asian region recognizes its role in this adjustment process, and policy measures have been introduced to facilitate the adjustment, by enhancing domestic demand-led growth and strengthening the financial systems in Asia. At the same time, strategies aimed at reducing vulnerability and strengthening resilience have also been important so as to manage the emerging risks arising from the process of adjustment. This combination of actions would enhance the prospects of stability in financial markets.

The bull had the benefit of more than half a century to achieve the level of economic and financial development and integration today. The tiger should also be allowed some time to achieve this and assume its place in the global economy.

Regional Conference on Investment Climate and Competitiveness in East Asia
21 - 23 November 2005, Kuala Lumpur

"Financial Reforms and Investment Climate"

Address by
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It is my pleasure to be here today to speak at this Regional Conference on Investment Climate and Competitiveness, co-organised by the World Bank and the Economic Planning Unit of Malaysia. This subject on investment and competitiveness is of particular significance to Asia in the current environment when the world economy is confronted with the problem of unsustainable global imbalances that has brought with it, risks to the global growth prospects. While the resolution to this problem is seen as a shared responsibility by the respective regions in the world economy, Asia is seen as having a particularly major role in the adjustment process.

Among the issues that have been cited as constraints to the adjustment process are the relative lack of strength in domestic demand outside the United States; the large gap between savings and investment in major regions of the world; and the fragmented structure of global capital intermediation that hinders surplus regions from financing productive investments within their own region. An important role for Asia in the adjustment process is to contribute towards the rebalancing of global growth. This is not only in terms of strengthening regional consumption demand but also increasing the home bias for investments by channelling an increased part of the surplus savings into productive investment in the region.

The investment climate and competitiveness in Asia will therefore be important in determining the extent of the role that Asia might have in contributing towards the orderly adjustment process of unwinding the global imbalances.

The investment climate and competitiveness of an economy is shaped by a wide range of factors. These include the economic stability, monetary and financial stability and what is equally important is that it is supported by social and political stability. My remarks this morning will focus on financial reforms and the investment climate.

The financial sector has a major role in facilitating the overall functioning of the economy. It represents the nerve centre of the economy. The financial sector represents the means by which funds are intermediated through which the mobilisation and allocation of funds to productive investments are

undertaken. The greater the financialisation of savings, the greater will be the potential for the channelling of savings to productive activities through the formal financial sector. The financial sector also facilitates the means for payments and the transmission of monetary policy. The effectiveness of the financial sector in performing its functions depends on its ability to meet the changing requirements of the economy and the ability to withstand the economic cycle. The financial sector is also an important factor in facilitating greater economic flexibility and thus in driving the economic transformation process. In order to contribute to the low cost of doing business, the financial sector also needs to be efficient and competitive. This includes being able to meet the economy's financial requirements at the best possible values.

The Asian region has seen significant transformation of its financial landscape driven by the globalisation process, the shift towards greater market orientation and the advances in technology. Emerging market economies in particular need to focus on capacity building and financial infrastructure development. This includes strengthening the financial institutions, developing the domestic financial markets and putting in place the legal, regulatory and supervisory framework that will ensure the soundness and stability of the financial system.

This decade has also seen wide-ranging financial reforms taking place, including reforms relating to greater market orientation to achieve enhanced operational efficiency, productivity and innovation and the strengthening of standards of risk management, corporate governance and transparency. Initiatives have also been undertaken to restructure, rationalise and consolidate the industry to strengthen capacity and address areas of weakness, risks and vulnerability. These initiatives include the establishment of institutional arrangements for restructuring and rehabilitation to be undertaken. The liberalisation process in a number of countries has been intensified to include the liberalisation of foreign ownership limits in domestic institutions to the issuance of new licences and relaxation of rules for foreign transactions. This has been for the most part to enhance inter-regional and global linkages and to facilitate greater trade and investment across borders.

These reforms have brought with them new risks that need to be managed to ensure the maximum benefits of more competitive pricing, higher quality of product offerings and greater innovation in the range of products and services offered. The argument has always been made that the deregulation, removal of controls and liberalisation would produce a more optimal allocation of resources which would lower the cost of capital and thus enhance the investment climate and the overall growth prospects of the economy. The experience has shown that the lack of preparedness has often resulted in marginalisation and destabilising consequences. Appropriate strategies therefore need to be adopted to manage this globalisation process. Of importance, is the need to understand the implications of the changes, build the capacity to deal with the implications of such changes, have mechanisms to conduct surveillance to

monitor developments and finally, to have at the disposal of the monetary authorities, the capacity for policy response to manage the financial developments in the new environment.

In the final part of my presentation, let me share with you Malaysia's experience on the financial dimension in influencing the investment climate, particularly on the financial reforms that Malaysia has implemented as part of our efforts and commitment to continuously enhance the investment climate. The objectives of these efforts are to enhance the flexibility of the economy, strengthen its competitiveness, soundness and investor confidence in the economy.

The financial system in Malaysia has played an important role in providing a stable and positive environment while facilitating diversification of the economy - allowing for focus on the areas of comparative advantage, including new areas of growth that have higher value added potential. Most important is that it provides a supportive environment for private enterprise. Not only has it provided a supportive enabling environment for private sector activity and kept the cost of doing business low, but it has also increased resilience and enhanced stability. It has also been important in making Malaysia an attractive destination for investment. Between 1988 and 1997, Malaysia received foreign direct investment (FDI) averaging 7.7% of Gross Domestic Product (GDP) annually, one of the higher ratios in the world. Even during the period 1998-2004, notwithstanding the shift in global patterns of FDI flows, Malaysia continued to receive FDI amounting to 6% of GDP.

The financial system in Malaysia has had an instrumental and complementary role in creating a sound investment climate. While the economic, political and regulatory elements provide the underlying investment-conducive environment, the financial system provides the link for financial services and the infrastructure for investments to function efficiently in the economy.

Malaysia has undertaken a proactive approach in formulating the financial reforms and in the development of the domestic financial infrastructure, taking into account the stage of development of the financial sector and the context of the prevailing and prospective environment to ensure that the stability of the financial sector in particular, and the economy in general is not destabilised. The objective is to build a resilient, efficient and effective financial sector that is able to meet the changing needs of the domestic environment and provide a catalytic role in the transformation of the economy. Careful considerations were also given to the trades-offs of the conflicting objectives to promote efficiency and innovation within the financial sector whilst maintaining financial system stability and ensuring that the system has the capacity to adapt to changes in an orderly manner. Another important consideration in designing and implementing financial reforms is to also take into account the socio-economic agenda of the nation. As central banks of emerging economies, consideration also needs to be given to develop a financial system that is inclusive, that allows for all

segments, target groups and the different activities to have access to financial services so that balanced growth can be achieved.

Malaysia has also adopted a gradual approach to liberalisation of the financial sector. The process is sequenced, taking into consideration a number of factors. The overriding objective is preserving financial stability. It is important that the domestic banking institutions are ready and have the ability to adapt and respond positively to the dynamics of liberalisation so that the maximum benefits from this process can be realised. As part of this process, lead time has been given for domestic banking institutions to enhance their efficiency and capabilities to strengthen their capacity to operate in a more competitive environment and to elevate themselves and gravitate to benchmarks achieved by international players. This pre-condition is important prior to liberalisation so as to avoid any destabilising implications on financial stability, which may in turn adversely affect the investment climate of the country.

Our Financial Sector Masterplan that was launched in 2001 outlines our strategy on financial sector development and the approach towards liberalisation. The Masterplan provides the blueprint for the medium and long-term development of the financial sector and the integral steps that need to be taken to achieve the objective of creating a financial sector that is resilient and competitive and that is able to contribute more meaningfully to the economic growth and development process. In the first phase of the Masterplan, focus is accorded to nurture a core of strong and forward looking domestic financial institutions that are more efficient, competitive and technology-driven and that are able to face the challenges of liberalisation and globalisation.

The focus of the first phase was essentially on enhancing capacity of domestic institutions and building and enhancing the domestic financial infrastructure. Following the first phase, greater deregulation and liberalisation can be expected to increase the level of competition. These measures will be implemented gradually, taking into consideration the ability of the financial system to absorb the changes. The final phase of the Plan will involve gradual assimilation into the international financial system with possible introduction of new foreign competition. This phase will also see greater participation of domestic banking institutions in the global financial system.

It has been close to five years since the introduction of the Masterplan. Significant progress in building the capacity and capability of the domestic financial institutions and the establishment of the necessary financial infrastructure to provide the foundation for growth of the financial sector, has been achieved. The strengthening of the financial sector has also been driven by the restructuring, reengineering, rationalisation and consolidation efforts that have been undertaken during this period. This has also been reinforced by strengthened risk management practices and infrastructure and the adoption of high governance standards and best practices. The banking sector, in particular, is now anchored by a core group of domestic banking institutions that are well-

capitalised, benefiting from the industry-wide consolidation programme that was completed in 2002. The capitalisation of the banking system is strong, with a risk-weighted capital ratio sustained at high levels of more than 13%, whilst the asset quality has improved significantly. The banking system has also continued to record strong profits amidst greater diversification in their income sources and continuous improvement in their operational efficiency.

The financial sector is also supported by a thriving and evolving Islamic financial system which provides a comprehensive range of products and services based on Syariah principles. Significant milestones have been achieved thus far in terms of the development of the financial infrastructure, and the regulatory framework for Islamic banking. Complementing the developments in the banking sector and Islamic financial sector, the insurance and takaful sectors have also made marked contributions in supporting the economic transformation process. Premiums and contributions of these sectors have continued to expand at double digit growth rates in the first half of 2005. The underlying fundamentals for sustainable expansion have also strengthened, with stronger solvency positions, continued profitability and improved underwriting discipline. In tandem with the holistic development of the financial sector, focus has also been accorded to develop the capital market, in particular, the bond market and the venture capital industries towards achieving the objective of building a strong, vibrant and diversified financial sector. The corporate sector, including foreign multinational corporations and multilateral agencies are now able to access our domestic bond market.

Financial institutions have now also embraced higher levels of technology and improved business processes that enable them to capitalise on larger business opportunities and reap benefits from economies of scale and cross-selling of products and services. Significant milestones have also been achieved in the delivery of personalised and customised financial solutions to meet the increasingly complex needs of consumers. Utilisation of new delivery channels through innovative technology-based mechanisms has also increased, leading to more effective and efficient distribution of products and services to customers. The continuous ability of the financial sector to meet the increasingly diversified and discerning needs and preferences of the various segments of customers with greater product differentiation and value added services are strengthening their competitive advantage and contributing towards enhancing the investment climate for investors.

In tandem with these efforts, internal reorganisation and reengineering of processes to achieve higher levels of operational efficiency have also been emphasized. By December 2005, all finance companies would have successfully merged with their respective commercial bank. Also, the framework on investment banks will pave the way for rationalisation of the merchant banking, stockbroking, discount house and universal broking industry. The creation of

investment banks is envisaged to enhance the capacity and capabilities of domestic capital market players to compete meaningfully in an increasingly challenging environment, hence contributing to the development of a dynamic and vibrant capital market that effectively supports the growth and transformation process of the economy.

Efforts to develop the financial sector have also been complemented by efforts to develop the financial and consumer protection infrastructure. Efforts are being directed to evolve an efficient and effective payments system that has the agility to take advantage of the new technologies that have emerged. We have also embarked on a ten-year comprehensive consumer education programme to elevate the financial literacy of consumers and promote consumer activism as a means to promote greater inclusion and also to drive performance of the financial sector. Continuous enhancements are also underway to strengthen the consumer protection framework. The establishment of a deposit insurance system in Malaysia recently represents one of the initiatives that has now been implemented.

In terms of the regulatory approach, we have evolved from a "rule-based" approach to a more flexible approach, that is "principle-based". This aims to promote competition and innovation whilst maintaining sufficient regulations to ensure financial prudence and stability in the financial system. Emphasis is also given towards developing broad prudential guidelines and principles, with enhanced focus on identifying risks at the system level and ensuring that individual financial institutions have the necessary systems to undertake and manage risks. Within this context, the financial players have the flexibility to design their own strategies and market niches. The supervisory process has also been strengthened and more rigorous surveillance mechanisms at both individual institution and system levels have been instituted.

Given the now strengthened position of the financial sector, several liberalisation measures have been accelerated ahead of the schedule in the Masterplan. A series of measures that were brought forward include the liberalisation of the provision of internet banking by foreign banks in January 2002, and the removal of the 50:50 quota on credit granted to non-resident controlled companies between foreign and domestic banks in April 2003. Three new full-fledged Islamic banking licences to foreign financial institutions were also issued, ahead of the original plan to do so in the third phase of the Masterplan. Other measures that have been accelerated include the increase in the foreign equity participation limit in investment banks and Islamic subsidiaries to 49%, and the flexibility for commercial banks, including the foreign commercial banks to provide factoring services as part of commercial banking business or through a separate legal entity. Other initiatives include the operational flexibility to the locally-incorporated foreign banks to increase the number of their branches. These liberalisation measures which will be done in stages, reflect Malaysia's commitment to undertake liberalisation at a pace that provides a mutually beneficial situation in the domestic economy.

To conclude, the strong and stable financial system, supported by a comprehensive legal and regulatory and supervisory framework, has been a positive factor supporting Malaysia's growth potential. It has provided investors with a safe and stable environment that is conducive for sustainable performance. Efforts will continue to ensuring that the financial sector continues to perform its role in the economy, responding to its needs and functioning efficiently. Skills and expertise in the financial sector will continuously be enhanced so as to create a pool of expertise that can contribute effectively to this process. Areas that will receive special attention will be to develop Malaysia as an Islamic banking and financial hub and to enhance our competitive advantage as a business process outsourcing centre. Amidst all these efforts, Malaysia will continue to strengthen our global linkages through trade, investment, financial flows, strategic alliances, cross-border mergers and acquisitions, internationalisation of businesses, mobility of the workforce as well as regional and international cooperation. This will enable Malaysia to participate particularly with regional economies to strengthen further the mutually reinforcing growth potential of the region.

Payment Systems Forum and Exhibition 2005
28 November 2005, Kuala Lumpur

Keynote Address by
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The theme of this inaugural Payment Systems Forum and Exhibition 2005 is the "Migration to E-Payments" with a focus on the issues and challenges in the transition from paper-based payments to electronic payments in Malaysia. The issues that need to be addressed for a nation to effectively migrate from paper-based payment instruments to electronic means of payments are multi-faceted. This will require changes in the infrastructure and business processes, developing and sustaining users' confidence and inculcating a change among all the relevant stakeholders, including the service providers and the customers.

Our objective is to transform the payments system into one that is competitively leveraged on a modern market-based system. Indeed, this will need to be achieved by the cumulative efforts of all parties involved, including the industry and the authorities. This forum and exhibition has, therefore been organised to provide a platform to discuss the range of significant issues and challenges in achieving the common vision of migrating to e-payments in Malaysia and to increase public awareness of the various payment channels available in the market today, as well as to discuss views on the development of services and infrastructure for the next generation of systems. The forum is designed to encourage active dialogue and deliberations from the different perspectives, notably between the service providers and the users. The dialogue will also serve as a platform to discuss how the industry may effectively operate in the context of the prevailing regulatory environment, policies and practices. From the regulators' perspective, the aim is to develop an enabling environment to facilitate and foster greater use of more efficient payment mechanisms in Malaysia.

An efficient, reliable and secure electronic payment system is critical to the soundness of the financial system, the efficiency of the financial markets and the economic growth and development process. With the rapid technological advancements and increasing consumer demands for more efficient delivery services, the Malaysian financial landscape has continued to transition towards the increased significance of an electronic payment systems and channels. Despite the progress that has been achieved, Malaysians however, remain high users of currency notes and coins, with the currency-in-circulation amounting to about 6.4% of GDP. In contrast, the average ratio for high users of electronic payments such as in the Scandinavian economies is only 2.9%. The use of cheques is also dominant in our financial system, accounting for 96% of the

total value of non-cash payment instruments. These indicators suggest that measures to encourage more active use of e-payments would need to go beyond building the electronic payment infrastructure. It needs to address the broader issues revolving around building public awareness and confidence, promoting greater convenience; reviewing business and operating practices and finally, addressing the commercial interfaces between the customers and the service providers.

E-payment increases operational efficiency and improves productivity levels through expedient payments and receipts of funds as well as through the reduction or redeployment of resources used for handling cash and cheques. Whilst the migration to e-payment may require considerable investment and effort to provide the enabling infrastructure, the use of e-payments provide consumers with greater convenience and security that would result in cost savings in the long run. In this regard, it is important for the financial institutions and payment service providers to provide more widespread access points for electronic payment services via multiple channels, including the automated teller machines, the point-of-sale terminals, the gated toll and parking gantries and through the network channels and devices, such as the Internet and the mobile phones. Needless to say, the payment products and services need to be continuously enhanced to meet the changing needs of the consumers.

In addition, the efforts to increase the use of e-payments will not only hinge on the capacity of the service providers to ensure that e-payment services are convenient, but also secure. In the area of fraud prevention, the industry would need to be constantly vigilant to maintain consumers'confidence. Robust technology and strong internal controls must be in place to protect and preserve the integrity of the financial system.

In line with this objective, our banking institutions have successfully replaced the magnetic stripe ATM and credit cards with chip-based cards to ensure a more secure environment for payment cards. This move has effectively eliminated counterfeiting and fraud involving ATM and credit cards in Malaysia. This has provided Malaysia with the platform to further enhance payment card services by maximising the chip infrastructure. The conclusion of this year will see the completion of the industry-wide migration to Europay-MasterCard-Visa (EMV) standards with all of the point-of-sales terminals being fully EMV-compliant. With this, Malaysia will become the first country in the Asia-Pacific region to successfully migrate on a national scale from the magnetic stripe environment to the EMV chip-based credit card infrastructure.

For Malaysia to fully adopt e-payments, the task ahead requires great determination and commitment from all sectors. From the Central Bank's perspective, a strong motivation for promoting e-payments is in the eventual savings from the reduction of paper processing and printing, and the more efficient distribution of money in electronic form in the financial system that generates immediate economic value. Research studies have shown that shifting from an all paper-

based to an electronic-based payment system will generate annual savings of about 1% of the GDP. All stakeholders, including the financial institutions, payment system providers, the authorities, the corporate sector, and the consumers, have their respective roles to play to support this national agenda to reduce the use of paper-based payment instruments, particularly cheques, in Malaysia.

In this regard, the Government had recently announced in the 2006 Budget its intent to increase the acceptance of electronic means of payment with the Government and to promote the use of e-payments nationwide. This should provide a catalyst for the adoption of e-payments on a national scale, as most individuals and businesses have payment transactions with the Government. Key to making this a success is the need to review the business and operating practices and address any impediments that may hinder the use of e-payments. These practices ranges from the inability to store and collect bank account numbers, acknowledging electronic payment and receipt notices, instructing payments electronically, and many more that may be identified during the discussions at this forum. All corporations and institutions that are present at this forum should consider undertaking a business process reengineering in your own organisation to fully use the e-payment channels that are being offered by the service providers and the financial institutions. As a national agenda, I would like to propose that this forum debates and considers the feasibility of setting a realistic target date, perhaps by the year 2010, for a full implementation of a national e-payment roadmap that specifically outlines the strategies and realignments of the business processes and operating practices, for the nation to be fully engaged in making the migration a success.

Let me now move on to the third key point mentioned earlier on the commercial interfaces, whereby the underlying business models and pricing mechanisms for electronic payments, should take into account the need for an incentive structure that promotes the increased use of e-payments. In recent years, several notable developments in e-payments in Malaysia have taken place. Following its introduction in 2000, the Inter-Bank GIRO system, an electronic credit transfer system, had recorded on annual average increase in transactions of 160% in terms of volume and nearly 200% in terms of value between 2003 and 2004. The credit card is also becoming a popular means of payment card, with the total value and volume of increasing annually by 15 and 20 percent respectively. The growing acceptance of Internet banking as a convenient delivery channel for accessing banking services has translated into a significant growth of Internet banking subscribers, which today comprise two thirds of the total internet subscribers. The latest mode of electronic payments channel is the mobile banking services that provide convenience to consumers to access a range of payment services such as funds transfers, bill payments and credit card services through mobile phones. In addition, the establishment of an Internet-based multi-bank payment system in Malaysia, the Financial Process Exchange in October 2004, would facilitate

online payments for a variety of payments by providing convenience and an efficient channel for businesses and consumers to undertake their payment transactions through the internet.

While these positive developments will support the attainment of the objective of migration to e-payments, the commercial issues between the consumers and the service providers have often times inhibited growth in the volume of the e-payments. The business and pricing models have at times inadvertently promoted a less efficient system, such as in the case of the low price that customers pay for using cheques compared to the Inter-Bank GIRO payments, and the popularity of the credit card against debit card, which is a more efficient system that carries less risk. In addition, service providers have also had difficulties in agreeing on a common business platform, due to their own competitive positioning strategies. Such differences have contributed to containing the increased acceptance of e-payments, which is further reinforced by the consumers'need to see a wide spread acceptance by merchants before deciding to use the e-payment mode, while the merchant needs to see a critical mass of consumers before putting in place the required infrastructure. In this regard, a comprehensive review of the industry-wide related issues involving payment instruments and systems needs to be undertaken to make Malaysia more competitive, with a view to promoting the more efficient payment systems and addressing the commercial hurdles. In order to further improve the growth and promote the e-payments, the payments industry may wish to consider establishing a Payment System Association to deal with the industry-wide issues involving electronic payments. A Payment System Association would be able to address the lack of common technology standards between service providers to promote interoperability, and the lack of a collective forum to identify, understand and manage the spectrum of stakeholders' interests and expectations. I should add that this idea is not new, as payment associations are already in existence in several other countries.

The future landscape of the payment industry is one that will continuously evolve with market innovations, resulting in enhanced services that offer improvement in efficiency and cost savings compared to traditional payment methods. Bank Negara Malaysia will continue to play the role of a facilitator to spearhead the development and improvement of the payments system infrastructure and to promote a conducive enabling environment for such developments to take place. In this respect, Bank Negara Malaysia has taken several initiatives to promote greater use of electronic payments by the public sector and in bringing about a mindset change amongst the users. Several taskforces have been established, involving users and service providers to promote the sharing of information and cooperation amongst the players, to develop industry-wide best practices and security standards, and to collaborate with relevant agencies to promptly deal with security infringement issues. Bank Negara Malaysia is also currently undertaking a series of measures to increase the efficiency and reduce risks in the payment

systems, and facilitate a progressive transformation and migration of the payment systems infrastructure. In this regard, a cross-border link between the Ringgit and the USD settlement systems in Hong Kong, that is the RENTAS and USD CHATS in Hong Kong, will be established to reduce foreign exchange settlement risk via a simultaneous payment versus payment mechanism between Ringgit and USD in the same time zone. A cheque truncation system is also being developed to improve operational efficiencies through the elimination of the physical movement of cheques with the use of electronic images and data.

Bank Negara Malaysia also aims to provide a conducive regulatory framework that is supportive of market-based innovation and ensuring transparency for the benefit of consumers. In this regard, I certainly hope that the results of your deliberations in this Payment Systems Forum and Exhibition 2005 will provide valuable input for the formulation of strategies and modalities for both the industry and authorities to accelerate the migration to e-payments in Malaysia. It is also hoped that the exhibition will heighten public awareness of the various payments products and services available in Malaysia, as well as globally.

Third International Forum on Financial Consumer Protection and Education
14 December 2005, Kuala Lumpur

"Fostering Greater Consumer Protection and Education"

Keynote Address by
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Promoting a sound and progressive financial system is a vital and key pre-requisite to achieving sustainable economic growth and development. This recent decade has seen a significant transformation of the financial landscape shaped by the forces of globalisation, advances in technology, the trend towards greater market orientation and financial innovation. In this more dynamic environment, the maintenance of financial stability has become increasingly more complex and challenging. The requirements and expectations of consumers are also changing rapidly in tandem with the increased education levels, growing wealth and greater affluence. Following these developments, consumers have become more discerning and demand for better product choices, more efficient delivery channels and more customer centric practices from financial institutions. These trends have also become important in reinforcing an increasingly more competitive environment in the financial services sector. A comprehensive approach thus needs to be adopted to address all the key elements of the financial system so as to form a solid foundation on which the soundness and stability of the system can be achieved. A major strategy that has been adopted has been the strengthening of the prudential regulatory and supervisory framework. The safety and soundness of the banking system however has to extend beyond prudential regulation and supervision. Maintaining financial stability of the financial system also requires the development of the financial infrastructure, in particular, the financial markets; building the capacity of financial institutions and finally to have in place an adequate consumer protection framework.

Consumer protection and education initiatives empower consumers to be better positioned to take responsibility for their own well-being. It allows consumers to assume a more important role in exerting market discipline on service providers to drive greater efficiency, competition and innovation in the market place. In the design of a consumer protection framework, it needs to be recognised that financial products and services differ significantly from most other goods and services. Specifically there is asymmetry in the access to information and bargaining power between the consumers and financial service providers. These imbalances can be addressed by three mutually reinforcing strategies. Firstly, promoting stronger transparency and disclosure standards in financial institutions; secondly

strengthening the mechanisms for consumer protection; and thirdly enhancing consumer education. An increasing number of countries have undertaken this more comprehensive approach in order to give greater focus to consumer protection issues for ensuring the soundness of financial service providers and ultimately to the stability of the financial system. This will also in turn promote more effective consumer participation in the economy, thus contributing more significantly to the economic growth and development process.

The approach and mechanisms adopted to protect consumers in individual jurisdictions will vary from one country to another, given the unique characteristics prevailing in the different respective economies and financial systems. Consideration of country-specific circumstances and contextualisation is important to evolve relevant and effective consumer protection and education infrastructures. Individual countries need to customise the consumer protection and education framework to their environment, taking into account factors such as the stage of economic and regulatory development, the structure of the financial system and the level of consumer sophistication.

Prudential safety and soundness, competition and consumer protection need to co-exist to effectively serve the various stakeholders' interests. Hence, implementing an effective consumer protection and education framework involves achieving an appropriate balance between providing adequate safety for consumers while promoting competition and financial innovation. In formulating policies to safeguard consumers' interests, adequate consideration needs to be given to ensure the appropriate level of consumer regulation without imposing excessive regulatory costs and burden on both financial institutions and consumers, and thus avoid compromising the benefits that the policies are designed to achieve. In this process, ethics and integrity cannot be legislated. Regulators, therefore, need to consider other approaches in preventing market abuses or misconduct and in promoting consumer confidence. Of importance is to evolve an appropriate incentive structure for financial institutions so that they recognise that it is in their best interests to foster fair and equitable business practices as part of good governance, corporate social responsibility and brand building. Good business practices need to be instilled and embedded in all aspects of the operations and at all levels within the institutions.

On consumer education, it is recognised that with more well-informed and financially astute consumers making better financial decisions, competition is promoted among the financial service providers. Moreover, market efficiency would improve with the creation of new products and services that are more responsive to the requirements of consumers. In relation to this, financial literacy has become a vital skill in this increasingly more complex financial world, characterised by increasingly sophisticated financial products and services and growing diversity in financial service providers and distribution channels. While the overarching

objective of consumer education is to impart knowledge that will improve consumers' financial decisions, it cannot be assumed that equipping consumers with more information will automatically lead to improved financial behaviour. Research has shown that consumer decisions may not always be made based on sound advice and knowledge, but are at times made on impulsive intuition. The key challenge lies in determining how behavioural factors and other factors such as socio-economic and cultural backgrounds, life events and skill levels influence rational decision-making. The wide variation in information needs that arise from differences in prior experience, language and cultural background, current financial situation, and competing demands for consumers' time all pose challenges in the development and delivery of relevant information to consumers. In particular, the most effective means of engaging consumers that have a low level of interest in financial planning needs to be determined.

In relation to this, financial service providers need to provide consumers with information that accurately represents the features, risks and returns associated with their products and services and demonstrate integrity and good faith by offering products and services that are appropriate to the customers' financial needs and circumstances. The issue is how a consistent and comprehensive disclosure regime could be established, with the flexibility to apply differentiated rules in response to different situations and circumstances. Finally, disclosure as a consumer protection tool will only serve its purpose if consumers are able to understand the information provided. The challenge is to get the right balance between providing sufficient information to consumers to make informed choices, with the information being clear, concise and effective.

The increase in the number of delivery channels has not resulted in an equitable expansion in the access to financial services. Even in developed countries, there remains minorities that have limited access to basic financial services. For instance, a study conducted in the United Kingdom for the period 2002-2003 found that 2.8 million adults in households had no access to a bank account. In relation to this, regulators have to balance between the need for financial institutions to operate efficiently and the need to ensure access to basic financial services for both individuals and small businesses. In addition, rural communities have also tended to be underserved. The challenge confronting regulators is to ensure that all communities have access to financial services. This greater inclusion is vital to bring the lower income groups into the economic mainstream.

An important aspect in the development of a consumer protection framework is to ensure that the framework remains relevant despite changes in economic and financial environment. Changes in the profile of consumers following changes in the demographic structure for example needs to be taken into account. In most communities, the ratio of retired population relative to working adults is expected to rise more steeply in the next decade. In countries with growing ageing populations, there is an

increasing demand for financial planning, life insurance, wealth management and mutual fund investment services. Consumers' interests in these areas would need to be adequately safeguarded while financial literacy among the various target groups need to be actively promoted.

While regulators have an important role in promoting consumer protection and education, it is equally important to galvanise support and collaboration from all market participants - financial service providers, government agencies, educators and consumer associations and community-based organisations, toward effective implementation of the initiatives.

Let me take this opportunity to share with you the experience of Malaysia in promoting consumer protection and education. The Malaysian economy has transitioned from a production-based economy towards a knowledge-driven economy, with small and medium sized enterprises (SMEs) assuming an increasingly significant role in the economy. The financial sector has also evolved accordingly to facilitate this economic transformation process, with a growing trend towards greater deregulation and market orientation. To achieve a more efficient, competitive and resilient financial system, Malaysia has formulated a blueprint that outlines the roadmap for the development of the financial sector. The Financial Sector Master Plan which was issued in 2001 outlines the key strategies for the development of the financial sector. Amongst the important strategies implemented has been the development of the consumer protection framework and the enabling infrastructure to protect consumers' interests while at the same time to enhance their financial capability to participate effectively in the financial system.

Bank Negara Malaysia has adopted a multi-pronged approach in empowering consumers. As a central bank in an emerging market economy, our mandate is broader than our counterparts in the more advanced and mature economies. We have the important role of developing the financial sectors. In the area of strengthening the consumer protection infrastructure, the agenda covers a wide spectrum of initiatives involving infrastructure and institutional capacity development that includes financial education, advisory services, distress management, rehabilitation and putting in place avenues for redress.

Recent initiatives include evolving a more effective Financial Mediation Bureau (FMB) to ensure that consumers of all financial service providers under the purview of the Central Bank have recourse to an independent, fair and impartial dispute resolution mechanism. Earlier this year a deposit insurance scheme was introduced to further strengthen incentives for financial institutions to adopt sound financial and business practices and enhance public confidence in the financial system by providing explicit protection on deposits. Bank Negara Malaysia is also currently finalising the details for the establishment of a credit counselling and debt management agency to be introduced early next year, with the aim of providing individuals with credit counselling and assistance in restructuring of their debts.

To promote financial education at an early age, Bank Negara Malaysia embarked on an education programme in schools on basic financial knowledge in partnership with the Education Ministry since 1997. Further, in collaboration with the financial industry's associations, Bank Negara Malaysia launched a ten year Consumer Education Programme (CEP) for the banking and insurance sectors. We are now in the fifth year of this programme. Extensive information is being disseminated via the spectrum of distribution channels including newspapers, radio, websites, branches of financial institutions and outreach programmes.

The consumer education efforts are also complemented by initiatives to promote a higher level of disclosure and transparency so as to ensure that consumers have access to relevant, comparable and timely information on products and services. A significant focus has been on the insurance sector, given that a significant segment of the Malaysian consumers do not have good understanding of insurance products. In particular, guidelines on medical and health insurance and the requirements for marketing of life insurance policies, have been strengthened while rules for independent financial advisers have been introduced.

In meeting socio-economic objectives, there is also a need to ensure that the welfare and interests of all segments of society are protected and that no target group is excluded or marginalised. Indeed, an important component of our consumer protection framework is to ensure that all consumers continue to have access to basic banking services at reasonable costs. In this connection, a more interventionist approach has been pursued to require banking institutions to offer a list of basic banking services to all Malaysians and to set guiding principles for the imposition of fees and charges for these retail products and services for individuals and small and medium sized enterprises.

Efforts have also been taken by the Central Bank in collaboration with the financial services industry to enhance the integrity of the payments systems and instruments, aimed at promoting confidence and ensuring that consumers' interests are safeguarded. Specific measures include upgrading the funds transfer systems, migrating all magnetic stripe for ATM card and credit card infrastructure to a chip-enabled environment, and introducing payment platforms that leverages on the Internet to promote users' confidence and safeguard consumers' interests. Malaysia is the first country in the Asia Pacific region that has mandated the migration of ATM cards to chip based cards and has also been the first to complete the implementation of a national migration to EMV chip based credit cards. This is essentially to combat fraud in payment instruments. A number of other initiatives have also been put in place to create greater awareness among the public regarding counterfeit banknotes and to promote increased consumer understanding on credit card usage and protection.

As we advance forward, changes in the financial landscape will continue to be dynamic and the level of complexity and

sophistication in the financial markets will further intensify. While considerable efforts have been undertaken to empower consumers through financial education and enhance protection for consumers, much remains to be done in fostering the commitment of financial service providers to sound business practices and promoting fair and equitable treatment of consumers. Given the global dimension of financial services and the increasing interdependence of financial markets, efforts by individual countries to strengthen consumer protection need to be matched by efforts to enhance safeguards at the international level. Forums like this one provide a good opportunity for regulators to share information and insights, to discuss the issues and challenges at hand, explore potential areas for cooperation and lay the groundwork for future partnerships. Drawing on the experience and expertise of various countries, this forum provide a platform for participants to work together towards developing global best practice standards on consumer protection and education issues. I look forward to the outcome of your deliberations in fostering greater consumer protection and education.