

Banking Industry Seminar: Enhancing SMEs' Awareness on Access to Financing Kuala Lumpur, 9 July 2008

Keynote Address by

Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz
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It is my pleasure to be here this morning to speak at this seminar, to enhance greater SME awareness on access to financing organised by the Association of Banks in Malaysia. The development of a strong and dynamic SME sector is a priority on the national agenda. It is part of the efforts towards creating sustainable and balanced economic growth. The reasons for this are clear. SMEs account for 99% of the total business establishments in Malaysia and for 56% of total employment and contribute about 32% to gross domestic product and 19% of total exports of the nation.

Over the recent five years, SMEs have also increased their contribution to growth. In several developed countries, SMEs contribute at least half of the gross domestic product. Taking SMEs in these economies as a benchmark, there is clearly significant potential for SMEs in Malaysia to increase their contribution to the economy.

My remarks today will focus on three areas. Firstly, the implications of global economic and financial developments on the Malaysian economy, and in particular on businesses and SMEs. Secondly, on the strategy adopted by the Government and Bank Negara Malaysia to develop the potential of the SME sector as a source of economic growth. And finally, the further measures that need to be implemented by the banking institutions and the SMEs in a more challenging environment of rising costs.

Economic and Financial Developments

Going forward, the international economic and financial environment is expected to remain challenging with slower global growth and continued uncertainties in the international financial markets. The moderation in global

growth is also occurring in an environment of increasing inflation arising from the higher energy and commodity prices.

The Malaysian economy has been on a steady growth path averaging about 6% in the recent three years. In 2007, the economy expanded by 6.3% and has continued to register a strong growth in the first half of 2008. This stronger growth has been achieved despite the more challenging external environment and increased uncertainties in the international financial markets.

One of the important contributing factors has been the successful transformation of the Malaysian economy in this recent decade which has resulted in a more balanced and diversified growth, in which the services and agriculture sectors have become increasingly more important drivers of growth. In addition, domestic demand has a more significant role in driving the growth. The stronger domestic demand and growth in the services and agriculture sectors have benefited the SME sector since the majority of the SMEs are operating in these sectors.

However, the rising international prices of energy and commodities have confronted economies globally with rising costs and intensifying inflationary pressures. This has prompted several emerging economies to restructure their fuel subsidies in an effort to create more efficient economies and to achieve more sustainable fiscal positions. This has been followed by the consequent adjustments in consumer prices as the gap between international market prices and domestic prices narrow. In Malaysia, petrol prices were adjusted by 40.6% while diesel prices by 63.3%. This adjustment would be reflected in

the consumer price inflation in June, which is expected to exceed 6%. Beginning 1 July, electricity tariffs have also been raised by up to 18% for households and an average of 26% for some commercial and industry users. While domestic inflation is expected to remain elevated for the remaining part of this year and early next year, it is expected to moderate in the second half of 2009.

In the current international environment, the policy response needs to be contextualised to the conditions prevailing in each individual economy. In those economies that are experiencing overheating and strong demand conditions, there is greater clarity in terms of the need for policy to rein in demand. However, for economies that are experiencing moderating growth, the risks to growth and inflation need to be carefully evaluated. In addition, consideration needs to be given to the deflationary impact of the fuel price increases on consumption. Trends in consumption and the conditions in the labour market will provide signs of potential second round effects following rising costs and the extent to which a generalised price increases are occurring.

In such an environment, SMEs need to consider repositioning of business strategies and to find new markets and avenues of growth. Reengineering of processes would also be required to better manage the higher cost conditions. The key is for the SMEs to use their inherent flexibility and agility to create new products and reorient the business. Given that the current inflationary pressures is a global phenomenon, with many of our trading partners and neighbors having similar or higher inflation rates, the inflation is unlikely to erode Malaysia's comparative advantage.

In this more challenging economic environment, sustaining growth will also require concerted efforts by the public and private sectors to reduce costs and become more efficient and more productive. To assist SME businesses in this environment, the Government has recently established a Special Committee to recommend potential measures to reduce the impact of rising costs on SMEs. The measures to be announced

later this month are aimed at enhancing efficiency and productivity of SMEs, reducing the cost of doing business and ensuring that SMEs have sustainable access to financing.

The SME Development Agenda

In view of the important role of SMEs in the economy, the Government has accorded significant emphasis on the development and strengthening the SME sector. Culminating from the recommendations of the National SME Steering Committee, the Government took a landmark decision in June 2004 to establish the National SME Development Council. The Council, chaired by the Prime Minister and supported by Bank Negara Malaysia as the Secretariat, provides policy direction for the programmes to support the development of SMEs, and to ensure the effective coordination and implementation of these programmes. Currently, members of the Council comprise of the Prime Minister, 15 Ministers and four Heads of Agencies, that are involved in SME development.

Since the establishment of the Council in 2004, the national SME strategy has focused on the development of high performing and resilient SMEs by capacity building and providing an enabling environment for the SMEs. The measures undertaken have been clustered under three broad strategic thrusts, namely, strengthening the enabling infrastructure; enhancing the capacity and capability of SMEs; and enhancing access to financing. The basic principle adopted has been to help SMEs to help themselves.

An annual SME Blueprint Management Framework has been implemented to ensure more focused, holistic and effective SME development programmes with greater collaboration between the Ministries and Agencies involved. In 2007, more than 286,000 SMEs received assistance through the implementation of 189 key development programmes, involving expenditure of RM4.9 billion. For 2008, 198 key programmes are being implemented, involving an expenditure of RM3.2 billion.

With the foundations now in place, on 2 June 2008 the Council announced the formation of the SME Central Coordinating Agency to further build on the successes that have been achieved and to take the SME sector to the next stage of development. This dedicated SME Agency represents a major structural enhancement in the SME development agenda and marks another milestone for SME development in Malaysia. The Small and Medium Industries Development Corporation or SMIDEC, will be transformed and repositioned to undertake this role. This new entity, that will be known as the SME Corporation Malaysia or SME Corp, will be a one-stop agency that undertakes the overall coordination of SME policy formulation and assessment of the SME development programmes. The SME Corp will serve as the central point of information, reference and advisory services for SMEs for all sectors and will assume the role of Secretariat to the Council, a role which has until now been undertaken by Bank Negara Malaysia.

Increasing SME Access to Financing

Bank Negara Malaysia's own efforts have been focused on ensuring that SMEs, at different stages of the business life cycle, have adequate access to financing. The initiatives have been directed at four broad areas. Firstly, the strengthening of financial service providers. This has involved strengthening the role of the banking institutions in providing financing to SMEs. This recent five years have seen the financial institutions accord greater focus to the SME sector. We have also seen a paradigm shift in the approach by financial institutions in the business of SME financing. Increasingly, banks have introduced strategies for interfacing with SME customers, evolving new business cultures for the SME segment and enhancing the financial products and services offered to the SME industry. The share of SME financing has increased from 30% of the total business financing of banking institutions in 1999 to 44% at end-May 2008.

In addition, a sustainable and comprehensive Microfinance Institutional Framework was implemented in 2006. Since its implementation, there has been considerable progress in the participation of financial institutions in providing microfinance. Currently, nine financial institutions have launched microfinance products, which has helped to increase access to financing to micro-enterprises. The outstanding micro-financing now amount to RM325 million with more than 31,000 customers.

In addition, the financial service providers such as the Credit Guarantee Corporation and Bank Pertanian Malaysia, now known as Agrobank, have been transformed into institutions that are more effective, efficient and financially sustainable. In relation to this, the SME Credit Bureau, a key initiative under the transformation plan of the CGC has officially commenced operations on 1 July 2008. The Bureau serves as a source of reliable credit information for both the SMEs and their potential financiers. The Bureau will assist SMEs to build a track record and thereby enhance access to financing on more favourable terms, leading to faster decisions on loan applications, and providing a balanced profile of the credit standing of the SMEs. This will also promote a better understanding by SMEs of their financial conditions, drawn from the analysis provided through the Bureau reports.

Initiatives have been taken to continuously develop new financing products that meet the evolving needs of SMEs in various segments and stages of growth. This includes the introduction of the new CGC guarantee scheme to assist start-up SMEs that have insufficient collateral and insufficient financial track record to obtain bank financing.

Finally, to complement the financial infrastructure, initiatives have been taken to develop comprehensive financial advisory services. Bank Negara Malaysia's Laman Informasi Nasihat dan Khidmat or BNMLINK, and BNMTLELINK, which is a dedicated Contact Centre, provide financial advisory services to the SMEs. In addition,

Bank Negara has also established the Small Debt Resolution Scheme where viable SMEs that are constrained by non-performing loans are assisted through loan restructuring and the provision of additional funding.

Today, SME financing has become robust with financial institutions being the main provider of SME financing. In 2007, banking institutions approved RM55 billion in new financing to more than 109,000 SME accounts. For the first five months of 2008 alone, a total of RM22.7 billion in new financing was approved to more than 55,800 SME accounts. As at end-May 2008, outstanding SME financing by banking institutions amounted to RM120.3 billion. In 2008, banking institutions are projected to approve RM61 billion of financing to more than 115,000 SME accounts, increasing at an annual growth rate of 10%.

Over the years, SME customers have gained a more prominent standing in the books of banking institutions in Malaysia. Consequently, it is in the banking institutions' best interest to meet the requirements of viable SME customers, which may face difficulties in the current challenging environment. Banking institutions need to engage and regularly interface with the various associations that represent SMEs to ascertain and formulate solutions to address issues confronting the SMEs while also communicating the requirements expected of the SMEs. Banks also need to provide greater flexibility in structuring the financing facility including customisation of the repayment periods within acceptable risk management levels. Banks may also expand the provision of advisory services to SMEs and proactively seek out SME customers that may be facing stress in this difficult business environment well before their conditions deteriorate. Adequate advice on financial management could pre-empt and avoid problems with respect to the financing facility.

Bank Negara Malaysia has also advocated for the migration to electronic payments as a measure to improve efficiency levels. This cannot be overemphasised in the current environment. The adoption of electronic

means of payments would result in greater business efficiency in addition to reducing the cost of doing business. It is important for the businesses including the SMEs to place high priority on the adoption of more expedient and efficient means of payments. In facilitating this transition, Bank Negara Malaysia is reducing transaction fees for the RENTAS system (the real time gross settlement system operated by Bank Negara Malaysia) for payments made by financial institutions on behalf of their customers. With effect from 15 July 2008, the RENTAS transaction fee imposed on the member banks will be reduced by RM1.00, from RM2.50 to RM1.50. This reduction in fees will result in a corresponding reduction in bank charges imposed by member banks on their customers for RENTAS payments with effect from the same date. In addition, the banking industry will be reviewing the fee structure for fund transfers to apply a fixed fee instead of the existing Inland Exchange Commission of 0.03%.

In this environment, the SMEs also need to initiate their own measures to complement those undertaken by the Government and the banks. Achieving cost efficiency and productivity improvements needs to be a priority for SMEs. SMEs should look at every facet of their business operations to identify ways to streamline processes, eliminate waste, consolidate activities and adopt new technology and energy-efficient processes. SMEs that operate in common geographical locations and that have similar production inputs, should also consider pooling their purchase requirements to benefit from bulk discounts by suppliers, in addition to sharing common costs such as transportation. In this regard, the Chambers of Commercences and industry associations can have a key role. They can facilitate the bulk purchase of raw materials for their members. Experience-sharing sessions can also be organized for successful members to share their experiences in achieving cost efficiency and productivity improvements.

As important as achieving cost efficiency is the need to raise the level of value creation and to find new areas of growth. This will require shifting resources to new areas of competitive advantage. In striving towards

long-term competitiveness, SMEs should adopt best practices in their governance and risk management processes. An aptitude for hard work and prudent practices, the agility to adapt to changing conditions, perseverance and entrepreneurial skills and the ability for reinvention - these are the qualities that will enable SMEs to ride through the near term challenges and allow them to grow and enhance their contribution to our economy.

Today's seminar provides a platform for SMEs to widen their knowledge on the numerous financing arrangements offered by the banking institutions. Take advantage and benefit from this opportunity. On this note, I would like to congratulate the Association of Banks in Malaysia for organising this important seminar on "Enhancing SME Awareness on Access to Financing". I wish you a productive and successful seminar.

**Malaysian Islamic Finance 2008 Issuers and Investors Forum
(Launch of the MIFC Global Communications campaign)
Kuala Lumpur, 11 August 2008**

Keynote Address by

Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz
Chairman of the MIFC Executive Committee and Governor of Bank Negara Malaysia

It is my pleasure to be here this morning at this third Malaysian Islamic Finance (MIF) 2008 Issuers and Investors Forum. It was at the first MIF Forum in August 2006 that the Malaysia International Islamic Financial Centre or MIFC initiative was launched. This was part of our efforts to strengthen further our economic and financial linkages with the rest of the world. It is our firm conviction that as an international Islamic financial hub this will be an important element facilitating the realisation of this aspiration. Since our launch, other traditional financial centres such as Hong Kong, Singapore, Dubai and London have also intensified their participation in the Islamic financial system.

As one of the fastest growing segments in the international financial system, there is a growing number of Islamic financial institutions and an increasing range of innovative Islamic financial products. Of importance is that this progress has been supported by a rigorous and well developed legal, regulatory and Shariah framework, thereby ensuring its stability and sustainability.

The Operating Environment for Islamic Finance

With the internationalisation of Islamic finance and the rapidly changing international Islamic financial landscape, Islamic finance is becoming increasingly integrated to the international financial system. This development has taken place in all segments of the Islamic financial system including the Islamic banking and takaful industry, and in the Islamic money and capital markets.

There are now a large number of diverse players and institutions in the Islamic financial

system. There has also been a growing range of products and services being offered. The pace of product innovation has intensified with more sophisticated Islamic financial products including the structured and investment-linked products. These products have become competitive both in terms of product structure and pricing. There has also been enhanced depth of the Islamic financial markets. This has increased the attractiveness of the Islamic financial instruments as an asset class for investment.

The Prudential standards are developed by the Islamic Financial Services Board (IFSB) to govern the operations of Islamic financial institutions. The IFSB has, not only, an important role in the harmonisation of prudential standards, but also contributes towards the consistent development of Islamic finance across different jurisdictions. Several parts of the world, including in Malaysia, have implemented the prudential standards issued by the IFSB. These prudential standards which have been designed to take into account the unique features specific to Islamic finance will contribute towards ensuring its soundness and stability.

Developments in the Sukuk Markets

The year 2007 saw an exceptional growth of the global sukuk market which expanded by more than 70 percent during the year. New issues during the year reached a record high to about USD47 billion and the outstanding global sukuk market has now surpassed the USD100 billion mark. Despite the more challenging international financial environment arising from the financial crisis that has occurred in a number of the advanced economies in the recent twelve months, the sukuk market while also affected, it has been to a lesser extent. Up until June 2008, it has held its ground with a total global

issuance now exceeding USD10 billion. With greater recognition of the sukuk market as a competitive and attractive form of financing, the global sukuk market is expected to continue its growth going forward.

The International Islamic financial hub evolving in Malaysia is supported by five pillars.

Pillar 1: Sukuk Origination

Following the first ever sukuk in the world that was issued in Malaysia in 1990, Malaysia has now developed a deep, liquid and vibrant sukuk market. Recently, the largest sukuk ever was raised in the Malaysian sukuk market in 2007. The magnitude was approximately RM15 billion or about USD5 billion equivalent. Despite being issued during the height of the sub-prime crisis, it attracted huge demand and was oversubscribed by more than two times. Sukuk origination has thus been identified as one of the important pillars of the Malaysian Islamic financial system. As of the end of 2007, more than 60 percent of the outstanding global sukuk originated from Malaysia. It has been increasing by an annual rate of about 20 percent and it accounts for about 56 percent of the outstanding bond market in Malaysia.

Several foreign multilateral development banks, quasi sovereign agencies and MNCs have received the approval of the authorities for the issuance of sukuk in our domestic sukuk market. The Malaysian foreign exchange administration rules have been extensively liberalised to enable non-resident corporations to raise ringgit and foreign currency denominated funds from our market. International issuers may thus issue multi-currency sukuk in addition to having the flexibility to swap domestic currency funding into other currencies.

Pillar 2: Islamic Fund and Wealth Management

The sukuk market has been an important source of financing for productive investment activities, while for investors it provides potential for diversification into new asset classes. The second pillar in the Malaysia Islamic financial

hub is the Islamic fund and wealth management industry. Malaysia is centrally located in the ASEAN region that has a population of 570 million. It is also positioned centrally between the major Asian economies of India, China, Japan and Korea. Malaysia has always been a highly open economy in trade and investment activities and has been a major recipient of foreign direct investment for more than a hundred years.

As a destination for financial investment, the Malaysian capital market offers a wide range of world class financial products. More than 85 percent of the listed companies in the equity market are Shariah compliant, representing about 60 percent of total market capitalisation. Other investment opportunities include in Shariah-compliant real estate investment trusts (REIT), in unit trusts and in the Islamic exchange traded fund (ETF). The capital market intermediaries in Malaysia, that is, the investment banks and Islamic fund management companies have had a key role in supporting the development of this industry. Both retail and wholesale products are being offered in ringgit and non-ringgit currencies. There is also no restriction in investing 100 per cent of the funds abroad. The foreign exchange administration rules now allow for the free mobility of inward and outward movement of funds.

Pillar 3: International Islamic Banking

The Islamic financial system has also been extensively liberalised to allow for the entry of foreign Islamic financial institutions that offer both domestic and international banking business. In addition, the foreign equity ceiling in Islamic financial institutions has been raised to a maximum of 49 percent as part of the effort to promote strategic alliances. The Islamic banking business in foreign currencies can be conducted by the international currency business units (ICBUs) that may be set up within existing financial institutions and the international Islamic banks. Such international Islamic banks may be established as either a branch or a subsidiary. Currently, about 16 percent of total assets in the Malaysian banking system is Shariah compliant.

Pillar 4: International Takaful Business

The fourth pillar is takaful and retakaful business. There are now eight takaful operators, several of which are joint ventures with foreign shareholding that conduct both domestic and international takaful business. In addition, licences have been granted to three reinsurance players to undertake retakaful business in Malaysia. Several existing takaful operators have set up international currency business units (ICBUs) and one new international takaful company has been licensed as an international takaful operator to conduct foreign currency takaful business.

Pillar 5: Human Capital and Thought Leadership

The fifth pillar is human capital and thought leadership. Several important human capital development projects have been implemented to foster Islamic finance thought leadership and to create a supply of talent for the Islamic finance industry. Having a sufficient pool of the talent and expertise has been key to the development of the Islamic financial hub in Malaysia. The International Centre for Education in Islamic Finance (INCEIF) which has an international faculty and students from more than 40 countries, is focused on programmes for Islamic finance professionals and specialists to meet the human capital requirements of the global Islamic financial services industry. The first group of students for the Chartered Islamic Finance Professional, or CIFP, offered by INCEIF is expected to graduate at the end of this year after completing a three year programme that includes an internship with an Islamic financial institution.

Strengthening the MIFC Initiative

Let me turn to today's event. Malaysia's Islamic financial hub has been built on the foundation of a comprehensive and progressive Islamic financial system that has been developed in the recent three decades. Activity in the Islamic financial system has become vibrant, in particular, in the sukuk market and in the other wholesale Islamic financial transactions. Going forward, Malaysia will collaborate with other financial centres with the aim of strengthening the international interlinkages in the global Islamic financial system.

Today, Malaysia is taking another step forward and launching a global communication campaign to the world. The campaign is part of our efforts to strengthen our connectivity with the rest of the world. The MIFC global communication campaign highlights the opportunities and offerings – here in Malaysia – for investors, issuers, industries in the economic sectors and for professionals and practitioners with interest in the Islamic financial services industry. Malaysia presents itself as a meeting place for those with surplus funds and those who seek to raise funds from any part of the world. As an Islamic financial hub, the Islamic financial intermediaries are supported by institutions of learning for human capital development in Islamic finance.

It is Malaysia's aspiration to participate in this exciting journey at the frontier of Islamic finance as it progresses as the fastest growing segment in the global financial industry today. In conjunction with the opening session of the MIF 2008, it gives me great pleasure to launch the MIFC Global Communication Campaign. To all the participants, I wish you a successful and productive conference. Thank you.

**4th SEACEN/ABAC/ABA/PECC Public-Private Dialogue for the Asia Pacific Region
'Basel II Implementation and the Development of Asia's Financial System:
Experiences, Challenges and Regional Cooperation'
Kuala Lumpur, 18 August 2008**

Keynote Address by

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

It is my pleasure to be here today, to speak on the occasion of this Public-Private Dialogue organised by the SEACEN Centre in collaboration with the APEC Business Advisory Council (ABAC), the Asian Bankers Association (ABA) and the Pacific Economic Cooperation Council (PECC) on the development of Asia's financial systems and the implementation of Basel II.

The implementation of Basel II across the Asia Pacific region is occurring at a time of heightened risks, during a time in which our economies and financial systems are confronted with significant challenges and increased uncertainties. As the underpinnings of Basel II are concerned with enhancing the responsiveness to risk by banking institutions, there are enormous expectations that Basel II will stand up to the test of capturing the complexities and the more uncertain direction of risk in the current environment. There is also enormous interest in assessing the pre-emptive capabilities of the framework to anticipate the direction of risk and thus ensure the provision of adequate capital buffers for such risk. The sharing of experience on the implementation of Basel II in this region and the greater engagement between the supervisory and financial communities will provide further insights to these issues. The ultimate objective of Basel II is to achieve more resilient banks, and thus preserve the broader financial stability.

In the Asia Pacific region, thirteen countries have adopted the standardized approaches under Basel II for credit and operational risks. A number of countries have also either

already adopted or announced plans to adopt the more advanced approaches by 2010 or earlier. Malaysia adopted the standardised approach this year and has recently issued a concept paper detailing the parameters for the implementation of the more advanced approach to be adopted in 2010.

The global economy has entered a period of greater uncertainty, with a number of developments that are taking place in some of the developed economies having destabilising implications on the global economy. The international financial markets continue to be in turmoil, triggered by the developments in the subprime market in the United States and resulting in the tightening of liquidity in the credit markets. The impact of these developments on the financial position of financial institutions has affected the functioning of the financial markets and the financial intermediation process. This has required interventionist policies to contain its systemic implication. In addition, the global economy has been through a period of high commodity and energy prices which has not only translated into higher inflation but has also contributed to dampening economic growth.

While the Asian region has experienced robust growth in the first half of 2008, the regional economies will be affected by these developments. Although growth is expected to moderate, most economies will continue to see a reasonable growth performance. The region will, however, continue to face inflationary pressures arising from high commodity and energy prices. This is however, expected to recede with the substantial correction that has recently taken place following the slower pace of global growth.

The Asian region is expected to weather this challenging period with the growing intra-regional trade and the expansion of its economic links with Eastern Europe and Russia, the Middle East and Latin America. At the same time, increased infrastructure spending in several of the large economies will provide further support to domestic demand. In addition, the strengthened economic fundamentals of the Asian economies, including the high level of reserves, low external debt, strengthened financial systems and improved fiscal position, will allow the flexibility to better manage the risks to the economy and the financial systems.

In this environment, the implementation of Basel II presents a powerful lever for banks to significantly enhance both their long term resilience and their competitive advantage. It promises greater financial stability through the closer alignment of risk with capital. To realise the full benefits from the implementation of Basel II, its multi-faceted dimensions need to be well understood and well integrated with the financial structures, institutional practices, and supervisory systems. Emerging markets in particular will need to ensure that supervisory interpretations of the framework are contextualised to the local conditions, and the preconditions for its effective implementation are adequately developed to avoid the potential market distortions.

At the institutional level, Basel II provides a unique opportunity for banks to integrate risk considerations with their business strategies. Indeed, several leading financial institutions have successfully taken Basel II beyond the narrow and mechanistic risk applications to a more strategic implementation of the framework across the organisation. Such institutions have leveraged on the upgraded risk infrastructures that have been established for Basel II to create competitive advantages through the application of new business and management tools. This enables the risk function to have a central role in informing strategic moves into new markets or products. In the process, this will ensure that the strategies are aligned with the bank's risk appetite and policies.

The benefits of Basel II cannot be achieved with just a strict regulatory compliance approach. While Basel II serves as a powerful catalyst to reposition the role of, and the attention to, risk management in banking institutions, significant efforts need to be directed at strengthening the financial structure, corporate governance, risk management and data capabilities within the banking institutions. The approach adopted by Bank Negara Malaysia has been for these efforts to complement and reinforce the positive outcomes of Basel II. These are important preconditions for, and not automatic outcomes from the adoption of Basel II.

In the wake of the sub-prime mortgage crisis in the United States, several aspects of Basel II have attracted attention. Among them has been the use of ratings in the regulatory framework and whether this has unintentionally discouraged investors from performing their own due diligence. The underestimation of risk for structured credit securitisations has now come under greater scrutiny. There has also been increased debate over the cyclical impact of Basel II. The effectiveness of the supervisory review process in ensuring that additional capital buffers are provided by banks for risks not fully captured under Pillar 1 of the framework has also been the subject of this review by authorities.

The relative importance of these issues will be different for different countries, depending on the stage of development of the financial markets and the banking system, as well as the supervisory structure that is in place. Among Asia Pacific countries, experiences with the implementation of Basel II have been varied.

For emerging economies, Basel II has arguably a more far reaching impact. This is on account of several factors. Firstly, many emerging economies continue to depend heavily on the banking system to finance economic activity. With a few exceptions, commercial banks are the main providers of credit in most emerging economies, accounting for an average of 90% of total credit. This produces a higher correlation to the economic sectors where the

implications on the banking system could result in significant disruptions to credit supply which could in turn affect economic activity.

Secondly, the more advanced approaches of Basel II are calibrated to the environment of the G10 countries, with significant acceleration of capital charges as the probability of default ratings deteriorate. To the extent that this inappropriately amplifies economic cycles by inducing the systemic misperception of risk in emerging economies, this can exacerbate a credit crunch during periods of weak economic performance.

Thirdly, the anticipation of lower regulatory capital requirements and hence, a competitive cost advantage, provides a strong incentive for banks especially in the developed countries to move towards the more advanced approach under Basel II. This could result in an uneven competition between the domestic and international foreign banks operating in the domestic financial system. Capability gaps in the adoption of the more onerous approaches under Basel II may place domestic banks at a competitive disadvantage in such countries.

These considerations have meant that for many emerging economies, the translation of the Basel II framework to suit the local environment needs to be approached carefully. The Basel II text provides a range of options which can be considered by national supervisors to re-balance the calibration of Basel II to reflect the local environment. It is also important that Basel II is implemented as part, and not in isolation of, the overall financial sector development programme. This has been Malaysia's approach.

The highly fragmented banking system and relatively weak risk management systems within the domestic financial institutions which prevailed in Malaysia prior to the financial restructuring and reforms that were undertaken from 2001 would have rendered the implementation of Basel II extremely difficult, if not impossible to achieve without risking disruptions to the intermediation process. The financial reforms that were undertaken to

strengthen the underpinnings of our banking system are therefore instrumental in facilitating the smooth transition to the adoption of Basel II in Malaysia without adverse market outcomes.

In the more recent period, the Asian region as a whole has made significant strides towards strengthening market structures and institutional arrangements for financial stability. Two developments deserve mention, in view of their important contributions towards mitigating some of the concerns surrounding Basel II for emerging economies.

First, in the decade following the Asian crisis, the emerging economies in Asia have extensively developed their bond and equity markets. Measured in terms of market capitalisation, East Asia's equity markets have more than trebled since 1997. The bond markets in the East Asian region have also seen significant growth during this period with significantly improved liquidity conditions in these markets. There is therefore now a more diversified structure in the financial system.

Second, within Asia, the regional cooperative framework has been substantially strengthened to support financial sector development, surveillance, crisis management and capacity building. An important achievement within the EMEAP process has been the establishment of a Monetary and Financial Stability Committee, or MFSC, which is charged with the mandate of facilitating greater regional collaboration in preserving monetary and financial stability as well as in the development of regional financial markets. Since its establishment, the MFSC has exceeded expectations in terms of the commitment towards supporting regional monetary and financial surveillance, and in advancing efforts to institutionalize cross-border crisis management and resolution arrangements.

These developments will contribute towards reducing any procyclical impact of Basel II and facilitating over time, refinements to the risk parameters that are more appropriate to local and regional experiences. The continuation of such efforts at the national and regional

levels will reduce the prospects for potential disruptions in the regional financial systems.

One of the most important consequences of Basel II lies in the effect that it will have in sharpening the focus on corporate governance in banking institutions. While there has been considerable attention focused on the quantitative implications and operational aspects of the Basel II framework, there has been less attention given to the corporate governance dimensions associated with its implementation.

The expectations on the board and senior management oversight are significantly higher under Basel II. The board of directors is expected to ensure that a sufficiently strong risk control framework is in place before banks can adopt the more advanced approach. Boards and senior management must have a sound understanding of the risk profile of the respective banking institution and ensure that it holds sufficient capital that is commensurate with that profile. This is reinforced by the greater attention being accorded by supervisors to the risk management control functions within the banking institutions and how they are effectively governed. Improved market disclosures under the third pillar of the framework further subjects the banking institutions governance practices to closer market scrutiny.

These developments have challenged governance practices that may have been tolerated in the past, but which would be grossly inadequate to provide the oversight that is demanded in today's far more complex business environment. Such practices have included vague reporting of risks to the board, boards that are disengaged, and boards that have no or little expertise in risk and financial matters. Boards and supervisors need to confront these issues with firm resolve. This will entail the more rigorous scrutiny of board members and senior management, both prior to their appointments and on an ongoing basis. Boards need to also assert themselves more actively in advocating and driving risk reforms, and demanding the appropriate level and amount of information from management that would enable the oversight responsibility to be discharged effectively.

In many respects, Basel II remains a work in progress. As we continue to ponder its broad and complex dimensions, platforms such as this for open and active dialogue between public and private interest groups are important to provide further insights on the many issues that will provide the direction forward for the wider and effective global implementation of Basel II.

On that note, I wish you all productive and successful discussions. Thank you