

Zeti Akhtar Aziz: Islamic finance - dynamic industry in a rapidly changing global environment

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the 2nd International Islamic Finance Conference, Dubai, UAE, 22 September 2003.

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Bismillahirrahmanirrahim

“The Islamic financial industry is ascending to prominence in an environment that is highly competitive and constantly subject to the forces of change. The industry has made significant progress, with the essential fundamentals underpinning financial infrastructure to support its sound expansion in place. The challenge before us is to bring the industry to its next stage of development and reinforce the robustness of the industry in a more challenging environment. Of importance is the need to evolve the strategies that need to be adopted to build key strengths and enhance institutional capacity in the industry. Indeed, collaborative efforts need to be intensified on the global front and integration accelerated. As the decade unfolds, insha-Allah, the Islamic financial industry will evolve into an increasingly dynamic and vibrant industry”

It is my honour and pleasure to be here today at this Second International Islamic Finance Conference, organised by the Islamic Development Bank and the General Council of Islamic Banks and Financial Institutions.

Globalization and financial liberalization have brought profound changes to our domestic and international financial landscape. These changes have been accompanied by an accelerating pace of financial liberalisation, driven by advances in technology. The advancements in information and communication technology have removed barriers in the market place.

Against this backdrop, Islamic banking and finance, which is still at its infancy, needs to be ahead of these developments in order to remain a viable and competitive form of financial intermediation. The challenge, therefore, in the Islamic banking industry, is to evolve the development of an Islamic financial system, one which is dynamic, responsive and sustainable.

The development of an Islamic financial system, indeed would include the respective sets of the key components comprising the Islamic banking industry, the Islamic money and capital markets, and the takaful market, given the strong linkages, inter-dependence and synergies among these components in the system. In addition, the development of the non-bank financial intermediaries such as development financial institutions, savings institutions and housing credit institutions need to be developed to meet customer demands. These specialised institutions are important in meeting the requirements of the economy which are not met by the nascent Islamic banking institutions. Although the Islamic banking industry may be the core to an efficient Islamic financial system, it would need to have in place the supporting financial infrastructure. Of importance is the Islamic money market. Given the different needs of individual economies, the development of the structure of the Islamic financial system needs to include, at the early stage, the development of the Islamic capital market to provide an alternative source of financing, as well as to create broader and diverse Islamic financial instruments for investors. Complementing these three components is Islamic insurance or takaful, that provides the necessary risk protection to its policy holders and to serve as an efficient mobiliser of long-term funds.

The spectrum of participants and the diversity of instruments are among the key attributes in creating the enabling environment for a dynamic Islamic financial system. This has been the approach adopted by Malaysia at the very onset of our journey in the development of a comprehensive Islamic financial system that is sustainable and progressive. In the initial stage during the early years of the development of the Islamic financial system, the focus of attention was on the development of the Islamic banking system and to expand the number of players and the volume of banking activity. This has increased significantly when the dual banking system was introduced. This was subsequently expanded to the specialised non-bank institutions, including the development financial institutions, and the savings banks and housing credit institutions, where Islamic financial products and services are being offered. The other core components of the Islamic financial system comprised the Islamic money market, the Islamic capital market and the takaful market. Today, the Islamic money market has become an integral part of the Islamic financial system, with transactions of more than RM2 billion

a day and a broad spectrum of instruments, among which included the Government Investment Issues, Bank Negara Negotiable Notes, Islamic accepted bills and the Islamic private debt securities. New ancillary players such as money brokers have facilitated the development of this market.

Islamic finance as a sustainable intermediation process in this more challenging environment has been characterised by powerful forces of change that have brought significant implications on both the domestic and global financial systems, and marked by turbulent financial conditions. This requires the development of robust and resilient financial institutions. Institutional capacity enhancement is a central strategy towards this objective. This requires having a high calibre workforce and management teams with the required expertise, leveraging on the technology, strengthening research and development, and instituting risk management systems. A structured consumer education programme has increased awareness of the Islamic financial system and the advances it offers.

The Islamic capital market essentially comprises the equity market and the debt market. Phenomenal growth has been recorded in both these markets. In the debt market, the outstanding Islamic debt securities as at-end June 2003 were 45.5% or RM68.2 billion of the total outstanding private debt securities. In 2002, the new issuance of Islamic debt securities surpassed the conventional private debt securities amounting to RM13.8 billion. It is interesting to note that one-third of the issues have been by multinationals. In the equity market, more than 80% of the counters in the Kuala Lumpur Stock Exchange are Shariah-compliant. The takaful market has also shown impressive growth and the four takaful companies now offers a broad range of products in both family and general business which is comparable to the conventional counterparts.

The Islamic financial system that has developed in Malaysia over the last two decades has emerged as a comprehensive Islamic financial system that operates in parallel with, and is able to compete on an even keel with the more entrenched conventional financial system. The development of Islamic finance as an important niche activity in Malaysia's International Offshore Financial Centre in Labuan also complements the development of the domestic Islamic financial market.

To ensure the sound and stable development of the Islamic financial industry, it needs to be supported by a strong regulatory and supervisory framework. This is to ensure that the operations of the Islamic financial institutions are sound and not a source of vulnerability to the banking system. To a large extent, it has been governed by a regulatory framework that has been reinforced by the Shariah framework and the Islamic accounting standards.

The challenges facing the Islamic financial industry can be expected to be much more complex and demanding. This is because the regulatory framework in the Islamic financial industry needs to address the unique characteristics and attributes associated with Islamic banking operations and Islamic financial instruments. The complexities of the respective risks in the Islamic financial instruments need to be fully explored and quantified to provide for their effective assessment and management. With the advent of Basel II that advocates a higher degree of risk-focused regulatory approach would require the Islamic financial institutions to identify and "unbundle" the risks inherent in Islamic financial instruments. The players in the Islamic financial industry must therefore, have in place robust risk management practices and system.

In this regard, the establishment of the Islamic Financial Services Board has been timely. The IFSB has the important mandate of developing the prudential standards in accordance with the unique features of the Islamic financial institutions. Given that the IFSB and the existing standard setting body embraced common objectives, I do not see any difficulty in integrating the international standards with the Islamic prudential standards. This will contribute towards the development of a robust and resilient Islamic financial system that can effectively preserve financial stability and contribute to balanced growth and development. This will also facilitate the integration of the Islamic financial system as a viable component of the global financial system.

Over the years, the Islamic financial industry has adopted the adaptation approach in the formulation of Islamic financial products and services. Although there are Islamic financial instruments that are distinct from the conventional financial instruments, the numbers are still few. In most instances, the Islamic financial products are repackaged along the features of the conventional financial products, while eliminating the elements that are not in-compliance with the Shariah. While this adaptation can continue, the downside risk is that Islamic financial instruments will always have to "catch-up" with the pace of product development in the conventional system. Efforts should therefore be intensified to develop new financial products that embodied the virtues of Islamic banking. This would evolve Islamic financial instruments into distinct, innovative and cutting-edge products. Innovative instruments such as the sukuk have attracted interest from both the Islamic and conventional markets.

One of the central issues towards developing a dynamic Islamic financial industry is the Shariah. The Shariah should always be viewed as an enabler to innovation and creativity, rather than a constraint. On the contrary, innovation and creativity is strongly advocated. Efforts therefore, need to be enhanced to fully appreciate and maximise the true potential and wisdom of Shariah. Thus, there is a need for greater collaboration among the Shariah scholars, practitioners and researchers to undertake in-depth studies and research to originate products. This would provide the fundamental foundation towards developing a dynamic Islamic financial system.

An issue that needs to be addressed is the development of a pool of intellectual capital for Islamic finance. The investment in adequate expertise for the development of Islamic financial instruments and services need to be made. In this regard, there is a need for Islamic financial players to intensify efforts in the training and development of expertise in the various specialised areas. Such Islamic financial programmes would benefit from a comprehensive approach, encompassing both conventional banking and Islamic banking, complemented with Shariah. The dynamism of the Islamic financial industry can only be demonstrated through a pool of talent that possesses convictions and expertise in Islamic finance.

Our quest to create a dynamic Islamic financial system is to achieve the ultimate objective for Islamic finance that will contribute significantly toward the overall development of our economies, through the intermediation process to facilitate trade and investment. Moving forward, it is the ability of Islamic financial industry to build key strengths and enhance institutional capacity, intensify the collaborative efforts to strengthen the effectiveness of the Islamic financial infrastructure and the acceleration of its global integration that will provide the synergies and opportunities for the Islamic financial industry in the face of this more challenging environment. In doing so, Islamic finance can evolve into an important component of the international financial system that can contribute to enhance prospects for balanced global growth and shared prosperity.