

## **Zeti Akhtar Aziz: Towards creating an Islamic Financial System as an integral part of the International Financial System - strategies and challenges**

Speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Asian Islamic Banking & Finance Summit, Kuala Lumpur, 21 September 2004.

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*“The integration of Islamic finance with international financial markets and institutions has demonstrated its viability, competitiveness, resilience and sustainability as a form of financial intermediation. This trend has contributed towards facilitating greater cross border flows in terms of increased trade and investment transactions thereby strengthening the global economic and financial linkages. As this international integration process intensifies, it not only raises the prospects for more balanced global growth but also allows for greater diversification of risks thus contributing towards greater global stability. At the core of this financial globalisation process is the robustness and resilience of the domestic Islamic financial system. The development of a sustainable Islamic financial system that is able to withstand the challenges of the uncertainties and instabilities inherent in the global financial system, thus not only requires an effective global financial architecture but a system that is also supported by an appropriate, comprehensive and sound domestic financial infrastructure. These mutually reinforcing structures would not only accentuate wealth creation and foster greater potential for trade but would also promote global financial stability and breakthroughs in new business relationships”.*

Distinguished Guests,

It is my honour to be invited to address this distinguished audience at this ‘Asian Islamic Banking & Finance Summit - Developing a Comprehensive Islamic Financial System’, organised by the Euromoney Seminars for the Asian region. While the overall development of Islamic banking and finance for more than three decades has been evolutionary, the pace has intensified in recent years. Islamic financial concepts have been incorporated into many financial products to meet the changing needs of consumers, businesses and investors. New Islamic financial institutions are being established ranging from the traditional banking institutions to more specialised financial institutions. This Islamic financial landscape has been supported by a well-developed regulatory, prudential, legal, accounting, framework and reinforced by the necessary research and development. Initiatives to promote greater awareness and education amongst Muslims and non-Muslims have also been intensified.

In this recent decade, we have seen the financial globalisation of Islamic finance with the participation of both the authorities and the private sector. In the case of the former, attention has been given to developing the financial infrastructure, including the financial markets, institutions and agencies as well as establishing the necessary prudential and accounting standards. While the latter has included the borrowers, investors and institutions that participate in the process. Sovereigns, corporations and multinational and multilateral entities have accessed the international markets while the institutions and investors have been a source of financing. Indeed, these funds are either raised directly from international banking institutions or through bonds and equity issues in international markets. It has not only expanded the investor base, but reduced the cost of capital and enhanced its liquidity. By operating beyond their domestic borders, financial institutions also provide their services from different geographical locations. There has also been greater use of international financial institutions by corporations, households and funds to increase their ability to diversify their risks. Investments in the domestic economies have also been financed by foreign capital. International firms have also participated in local markets through Islamic based financial structures. With increased liberalization, there is also increased foreign presence in terms of foreign entry into the domestic financial system. This is an area where Malaysia is taking a step forward during the course of this year. The globalisation process has also taken place in terms of participation by firms in international capital markets through cross listings. My remarks today will focus on the strategies on the approach to accelerate the transition of Islamic finance towards being an integral part of the international financial system in terms of both the international financial architecture of the Islamic financial system and the development of a comprehensive domestic financial infrastructure.

The establishment of the Islamic Financial Services Board (IFSB) has been an important initiative in the development of the international Islamic financial architecture. It has been established to

promulgate the international regulatory and supervisory standards for Islamic financial institutions aimed at achieving best practices and to secure soundness and financial stability in Islamic finance. In this regard, the IFSB has already made progress in developing the prudential standards on the capital adequacy and risk management framework, and has commenced work on developing standards on corporate governance.

Appropriate accounting standards have also been put in place to reflect the true and fair value of banking operations that would lead to greater accountability and responsibility on the part of financial institutions. While the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has made a significant contribution in formulating and issuing accounting and auditing standards for Islamic financial institutions, efforts need to be intensified to promote the adoption of these standards.

The International Islamic Financial Market (IIFM) further provides the environment that will encourage active participation by both Islamic and non-Islamic financial institutions in the secondary market for Islamic financial instruments. Several global sovereign sukuk have been issued in the international market that has attracted wide interest, both by Muslim and non-Muslim investors. The next phase in this development is the raising of funds from this market by multinational corporations and multilateral institutions. As the volume increases, it would strengthen the inter-linkages and integration amongst the Islamic financial centres. In addition to structuring a variety of attractive off-the-shelf instruments, efforts need to be intensified to create a benchmark curve for future issues. With a well-developed system, the trading of instruments would encourage the free flow of capital movements and would in turn facilitate greater Islamic fund management activities.

As a platform to promote greater cooperation among Muslim countries and further promote IIFM, a proposal that can be explored is the creation of an Islamic universal bond, structured similar to the universally-accepted asset-backed Ijarah sukuk. Under this proposal, interested countries and selected organisations could be invited, where each country sells its assets to an SPV, which in turn would lease back the assets to the country. Proceeds could then be transferred to the participating country for the general purpose of socio-economic development. This could be an avenue for countries that have not secured stronger ratings to get more competitive funding. Indeed regional and multilateral entities would be well positioned to explore the viability of this proposal.

The role of Shariah is one of the key elements that can spur the innovation process and enhance the global integration of the Islamic financial system. To effectively enhance Shariah governance, the understanding of the mechanics of finance by the Shariah experts is imperative to assist in the deliberation process in deriving a sound Shariah decision. The Shariah decision should then be made transparent. With such disclosure, the ability for others to appreciate the juristic reasoning based on contemporary analysis and logical inference of process could lead to wider acceptance of a Shariah decision, especially if it has implications on cross-border transactions.

With better understanding, the likelihood of a Shariah convergence is higher and this will enable the creation and trading of Islamic financial instruments at the international arena to be more universally accepted, as interpretations will be uniform and consistent. Harmonisation of the differing views among the scholars from different schools of thought is necessary to enhance the global development of Islamic banking and finance. I believe, at this juncture, the right approach is to advocate mutual respect in any Shariah discourse where there are differences in opinions, interpretations and practices.

To complement the efforts to create a sustainable and comprehensive Islamic financial system, consumer education and awareness on Islamic banking and finance should be extensively undertaken. Concerted efforts between the governments and Islamic financial fraternities should be engaged to develop such a consumer education programme. Such programmes would increase transparency on the virtues and availability of Islamic financial instruments offered by the Islamic financial institutions. How consumers can expect to benefit will depend on how well informed they are about the financial services being provided. Barriers across geographical boundaries can be removed by leveraging upon the advances on Information Communication Technology to create an integrated internet platform as means for the knowledge sharing on research findings, conference discussions, Shariah rulings and other vital information on Islamic banking and finance. Improvements can be made to the existing internet portals to be more comprehensive with linkages to other useful information providers.

Equally important is the consumer protection infrastructure. An international financial information dissemination body should be set up to disseminate the development of Islamic banking and finance

worldwide. In addition, with greater disclosure and transparency on the manner in which Islamic financial transactions are being conducted and the risk and return profiles of the products, the role of market discipline in driving Islamic financial institutions towards ensuring Shariah compliance will be strengthened. This will ensure operational efficiency, strengthen risk management infrastructures and institute sound and dynamic risk management practices.

As part of the process of enhancing inter-linkages with the rest of the world in the area of Islamic finance, Malaysia is also encouraging the domestic Islamic financial institutions to be more global by expanding beyond the domestic shores. With the experience that has been acquired in Islamic banking and finance that has been accumulated over more than three decades now, it is timely and desirable to extend this experience beyond our own borders. The domestic Islamic financial institutions would need to undertake feasibility studies and in-depth groundwork to identify new markets to expand their business operations, in particular with economies in which there is potential for greater economic linkages and integration.

As the pace of globalisation and liberalisation accelerates, securing financial stability and confidence has increased demands for more robust and resilient financial systems. While affected by some market instability and uncertainties, it has not, however, undermined the development of the global Islamic financial system that has now become an increasingly integral component of the international financial system.

The approach to building a sustainable and progressive domestic Islamic financial system involves the creation of the key components comprising the Islamic banking industry, Islamic financial markets, the Islamic insurance or *takaful* market, and fund management industry given the strong linkages, inter-dependence and synergies among these components in the system. In addition, to the financial intermediaries and fund managers, other institutional players such as brokers, specialists and corporate treasurers also have important roles to play.

Another area of focus is the growth of non-bank Islamic Financial institutions. In Malaysia, the first included Tabung Haji, the Pilgrim Fund Board. Other components include institutions such as *waqaf*, corporate *zakat*, investment trusts, mutual funds and inheritance management. This is part of wealth management that will become more significant as the domestic economy enters into its next level of development and as savings across borders becomes more institutionalized. This will become an important source of funding for productive investment, in particular for large-scale investments. New forms of financial structures may be developed for this purpose.

In promoting Islamic finance in the Labuan offshore financial center, emphasis is being given to several of these areas, in particular, to promote the fund management industry including via the Labuan International Financial Exchange (LFX). Labuan will also be promoted as a center for *waqaf* administration. It will also promote the development and market acceptance of IIFM. In the LFX, dual listing and trading of capital market instruments are being undertaken, for both Islamic and conventional papers. This includes equities, debt instruments, bonds (*sukuks*), asset back securities and mutual funds. In addition, the Islamic capital market will be expanded through IIFM and strategic alliances with other stock exchanges. These offshore activities will thus complement the onshore activities.

Not only has attention to be given to the financial infrastructure, the financial markets and to institutional development, but also to the regulatory, Shariah and legal dimension. The hallmark of a well-developed financial infrastructure is an effective legal, regulatory and supervisory framework which underpins the stability of the financial system. For the Islamic financial system, this framework also needs to be consistent with the requirements of the Shariah.

It is also recognised that good corporate governance reinforces sound regulation and supervision. This contributes towards maintaining market confidence, and strengthening transparency and accountability that is implicit in Islamic finance. Its emphasis is value-oriented and to promote fairness and justice with respect to all stakeholders of the financial institution. Transparency and disclosure is essential to this process. While the comprehensive and timely availability of financial information will increase market discipline, it also needs to be complemented with the ability of the market players to analyse, and appropriately interpret the information. Closely related to this issue is the need to strengthen the framework for consumer protection to provide an avenue for redress in the event of disputes.

Emphasis on improved corporate governance goes hand in hand with the need for improvements in risk management standards. Sound risk management practices will minimise adverse consequences

faced by financial institutions during periods of uncertainty. Robust internal controls to provide qualitative standards are also necessary to complement the quantitative analysis of risk to provide the necessary checks and balances. In the area of Islamic banking, the requirement to manage the risks becomes more important because of the unique peculiarities in the contracts. Basel II has, to a certain extent, incorporated some aspects in the identification of risks, in particular the credit, market and operational risks that can be assimilated by the Islamic banks in terms of its product offering.

Another important pre-condition to sustain the continued growth of Islamic banking and finance is a comprehensive legal infrastructure for legal redress arising from disputes in Islamic financial transactions. The legal infrastructure needs to comprise both effective regulatory and substantive laws as well as appropriate adjudicative fora to resolve disputes relating to Islamic financial transactions. To address this, efforts are needed to develop a sufficient number of competent lawyers and judges that are equipped with sound knowledge and expertise in both Shariah and civil laws to deal with such matters. This would need to be supported by an efficient court system that can effectively deal with all Islamic banking and finance cases, whose decisions are enforceable over the range of financial issues. Above all, these pre-conditions have to be in conformity with the Shariah framework.

Whilst it is necessary to have in place the market infrastructure, institutional players and the regulatory, Shariah and legal framework, it is still not sufficient in sustaining the robustness and dynamism of an Islamic financial system. To achieve this, the strong linkages and synergies especially among the components in the financial markets, namely, the money market, foreign exchange market and the capital market, have to be extensively capitalised. The Islamic money and foreign exchange markets are integral to the functioning of the Islamic banking system, firstly, in providing the Islamic financial institutions with the facility for funding and adjusting portfolios over the short-term and thus the necessary liquidity mechanism to promote stability, and secondly, serving as a channel for the transmission of monetary policy.

The inter-linkages in the functioning of the Islamic financial markets have brought about a natural environment for innovation of Islamic financial instruments. A broad spectrum of instruments, such as Government papers including bonds and treasury bills, Central Bank notes and Islamic accepted bills, can be structured on a Shariah-compliant basis to meet the needs of these markets. In addition, instruments for a risk mitigating mechanism for hedging or value protection need to be developed. While risk mitigation is desirable in Islamic finance, innovations need to be made for this purpose.

To aid the process of developing the financial markets, Bank Negara Malaysia has recently developed a website on the Islamic money market as a source of information on domestic Islamic financial instruments and to facilitate investment decisions and secure public confidence in their investment. The website aims to effectively meet the needs of bankers, financiers, statisticians, economists and prospective investors as well as increase awareness of the users - domestic and foreign. Moving forward, the website will be linked with other markets to serve as a platform for exchanging information and knowledge beyond our borders.

The existence of a well-developed capital market is also important to provide users of capital with an alternative and cost efficient source of medium and long-term financing. It would also provide investors and savers with a wider range of financial instruments to suit their individual return and risk profiles as well as allow for better diversification of risks in the financial system. One of the linkages in this market is asset securitisation. Mortgage financing is an example of where the asset liability mismatch can be addressed. This would substantially improve the liquidity and quality of assets of the banking institutions, while at the same time contribute towards promoting the development of the capital market and secondary trading of instruments through the issuance mortgage-backed private debt securities. Over the years, the scope of securitisation activities can evolve and expand with the introduction of securitisation of Islamic hire and purchase or leased assets ending with ownership, and other types of leased financing.

At the core of a financial system of any country must lie an efficient and effective payment system as a means for clearing and settling payments. In modern economies, this function is already highly mechanised to support a sound and stable financial sector. It is vital that a real time settlement system for inter-bank funds transfer be implemented to reduce the credit and settlement risk in the financial system. It must be able to handle scripless debt securities trading, processing and settlement on a model that reduces counterparty risk.

## **Conclusion**

As Islamic finance advances forward to become an important integral component of the international financial system, efforts need to continue to strengthen further both the international architecture and to enhance international cooperation and collaboration as well as to develop the domestic financial system to meet the changing requirements of a highly dynamic and rapidly evolving environment. Malaysia will continue to play an active role in this process. In our quest to build a viable and sustainable Islamic financial system, the aim is to contribute to the channeling of capital flows to productive investments, create wealth and promote trading activities, with the activities undertaken not just among Muslims but with the rest of humanity, Inshaallah.

On that note, I wish you a successful conference. Thank you.