

Zeti Akhtar Aziz: Islamic finance - promoting the competitive advantage

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Islamic Bankers' Forum 2005: Islamic Finance - Promoting The Competitive Advantage, Putrajaya, 21 June 2005.

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“Islamic finance has become a competitive form of financial intermediation that has been able to meet the differentiated requirements of our economies. In an environment of rapid change, a key factor that will influence the future prospects of the Islamic financial services industry will be the investments to build the foundations on which further progress can be achieved. Investing in the future, in research and development and in the development of talent and expertise will be the differentiating factor that will contribute to the effectiveness, resilience and competitiveness of the industry. This undertaking needs to be the joint responsibility of both the private and public sectors to mutually elevate the performance of the industry and thus increase its potential to contribute to wealth creation and prosperity of our nations.”

Your Excellencies,
Distinguished Guests,
Ladies and Gentlemen,

It is my honour to be invited to speak at this Islamic Banker's Forum organized by the General Council for Islamic Banks and Financial Institutions (CIBAFI) on the strategic approach in developing a progressive Islamic financial system. The occasion of this Forum is indeed an excellent opportunity for the industry practitioners, regulators and academia to deliberate on the key issues that are important to the future of the Islamic financial services industry. My remarks today will focus, in particular, on the issues relating to innovation, which is indeed derived from the investment in research and development, and from the investment in the workforce in the sector.

Innovation is key to sustaining growth and securing the competitive advantage. Innovation is about developing new Islamic financial products and services and increasing the range of products and services to meet the more sophisticated and complex requirements of today's consumers and businesses. It is also about improving the overall efficiency by which the products and services are being provided. Innovation will also involve the introduction of new structures that may contribute towards enhancing convenience for consumers and businesses. Finally, it may also contribute towards creating new markets or expand the existing markets for Islamic products and services. Industry practitioners thus have an important role to promote innovation. Financial institutions need to equip their business strategies with research and development to design new innovative products and services. Such innovative financial products and services which are credible, competitive and Shariah-compliant would indeed find a ready market. The introduction of the global sovereign sukuk more than two years ago was an important innovation that has since gained significant ground.

Innovation can also take the form of the application of technology to improve convenience for customers and reduce the cost of financial transactions. In embracing new leading-edge technology, the potential for the Islamic financial industry to provide new products and services will be enhanced. It also represents the potential to increase access to financial products through a wider range of new delivery channels. Greater application of IT in the industry can also enhance efficiency by driving down costs for consumers and businesses. Other areas include leveraging on IT in making strategic decisions in the alignment of business, in elevating institutional capacity and operational efficiency and strengthening risk management capabilities. Moving forward, the enhancement of technological capabilities becomes vital for the financial industry as it competes in an increasingly technology-driven environment.

The environment and the incentive structure is also important in providing an enabling environment that promotes innovation. In particular, the regulatory framework and the tax structure are important to the innovation process. The regulatory framework should not be so onerous as to impose a high cost and a regulatory burden on businesses. Intrusive regulatory approaches on new products can become a disincentive to innovation. Tax structures can also be designed to support the innovation process. Within financial institutions, organisational structures can also create an environment for innovation by aligning the organization's processes and implementing appropriate performance incentives.

The pace of innovation that has taken place in the Islamic financial services industry has contributed to the development of a broad and diversified range of Islamic financial products and services that has been able to effectively mobilize financial resources to meet the investment requirements of the economy. Notwithstanding this significant progress, the process of innovation in Islamic finance has generally been structured mainly along the adaptation approach. 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.

The Islamic financial services industry is now at the threshold of a new level of development. As we advance forward, the Islamic financial services industry can expect to have a different set of regulatory and supervisory standards which is conducive to its unique financial operations. There is also an increased awareness and understanding amongst the international financial community on the distinct nature of Islamic banking and financial operations. In addition, a higher degree of Shariah dynamism is evident in the evolution of sophisticated Islamic financial products that are being structured based on multiple Shariah concepts. Against these developments, it is timely to move away from “plain vanilla” innovation and to embrace a new wave of innovation that will evolve Islamic financial instruments into distinct products that will maximize the potential and wisdom of the Shariah and that meets the greater sophistication of consumers and the more complex requirements of today’s businesses. This paradigm of innovation in Islamic finance, which by itself shall accord Islamic financial institutions with the competitive advantage to forge ahead, entails substantial and continuous investments in research and development (R&D). R&D is indeed an essential aspect of modern industries and enterprises and is no less the case in the financial world. There are three important pre-requisites in strengthening research and development capabilities, namely, adequate allocation of resources for infrastructure development, forging strategic alliances through smart partnerships and developing the required pool of qualified and skilled talent.

Adequate allocation of resources for infrastructure development

Islamic financial institutions are continually being confronted with new challenges that need to be addressed. Their institutional capacities and capabilities need to be continuously strengthened. This includes attention to continually review their strategic orientation and key priorities and the necessary adjustments that need to be made to position the institutions to effectively respond to the new developments and challenges that have emerged.

In order to meet the increasing demands of a modern and sophisticated market, financial institutions must continually invest in the supporting infrastructure that promotes research and development. This will enhance the capacity for innovation. Attention also needs to be given to the applied approach to Islamic finance and its modern practice. Financial support for advanced research at universities and research institutes will increase research opportunities. Efforts to utilise and install strong technological capabilities will also contribute to enhance research and development. In embracing the new leading-edge technology, the potential for the Islamic financial industry to develop new products and services will also be enhanced.

Forging strategic alliances through smart partnerships

To further enhance research and development (R&D) activities, the promotion of strategic alliances through smart partnerships can play an important role. Entering into strategic alliances with other entities would create greater synergy, which may bring about new approaches, new technologies and new areas of specialization. Collaborative efforts amongst Islamic financial institutions in particular, would strengthen the ability to leverage on the industry’s expertise. The introduction of innovative Islamic financial products in a specific jurisdiction can be expanded to other jurisdictions, which in turn, will contribute to broaden and deepen Islamic financial markets and thus strengthen the overall development of the Islamic financial industry. In addition, active collaboration between academic researchers and the practitioners will enable the practical application of research findings. In Malaysia, an industry-owned research and training institute in Islamic banking and finance, the Islamic Banking and Finance Institute Malaysia (IBFIM) has been established to spearhead greater collaborative efforts with universities to undertake research in areas that are key for the progressive development of the Islamic financial industry.

A highly qualified and skilled pool of talent

The fast pace of innovation in global financial services in general and for the Islamic financial services sector in particular, will demand a rapid and continuous infusion and upgrading of skills. Developing a substantial pool of talent and expertise is indispensable for strengthening research capabilities. In this regard, there has to be a strong focus on human capital development through training and education. In today's competitive environment, intellectual capital is the major factor in determining the level of innovation and competitiveness of an institution or corporation. A key challenge for Islamic financial institutions is to attract a knowledge-based workforce with the skills required to enhance the potential for innovation, productivity and performance. The Islamic financial services industry needs to continually promote human capital development and expertise to create a larger pool of experts and high calibre professionals. This involves attracting and retaining the existing talent, and building a robust pipeline of skilled individuals for the future. In addition, specialists in Islamic finance would need to combine knowledge and understanding of the Shariah with the necessary skills in finance. The provision of training and career development will have a key role in the sector. Learning systems therefore need to be strengthened to meet the skills and talent requirements of the next decade.

Training is a joint responsibility between the industry, academia and Government. In Malaysia, the Government plans to establish an international financial training institute on Islamic finance. The ground work to establish this institute has already commenced. While this may meet some of the requirements, Islamic banking institutions are also encouraged to explore the feasibility of entering into collaborative arrangements with universities and other institutions locally and abroad, to identify and provide specialized training for the financial services industry. These would include training workshops and courses in new and emerging product lines which require specialised skills and expertise.

Education of graduates and other personnel entering the Islamic financial market is also important. Undergraduate opportunities to study Islamic finance or Shariah, either as a speciality or a major component of a business degree, should be readily available at local and foreign universities. The challenge is to provide programmes which keep pace with changes in financial innovation and technology. Meeting this need requires rigorous, extended programmes such as the post-graduate programmes in Islamic Finance and Financial Engineering with emphasis on Islamic banking principles. At the same time, relevant organizations can support such programmes by creating funds to sponsor promising students to pursue formal education, ranging from modular courses in Islamic finance to full post-graduate programmes. There is also a need to increase programmes and initiatives that provide education and training in Shariah. Islamic research organizations and financial institutions need to work towards developing a sufficient number of competent Shariah scholars who are equipped with sound knowledge and expertise in both Islamic jurisprudence and Islamic commercial laws to deal with innovative and cutting-edge products.

There is also the need for extensive education of the consumer and business community. This would increase the outreach resulting in increased demand for new and innovative products and approaches. Malaysia has implemented a 10-year structured consumer education programme to increase the level of consumer awareness on the unique characteristics of Islamic financial products and the product choices offered by Islamic financial service providers. Increased awareness will drive the demand for a broader range of Islamic products and services customized to their requirements at more competitive prices and through more convenient channels. The outreach has also been targeted at small and medium sized businesses. This process will also prompt the financial industry to increase innovation to strengthen their competitive position. This can be reinforced by market research to enhance the understanding of customers' distinct financial needs and their risk tolerance and therefore enable the design of Islamic financial instruments that offer tangible benefits and value to customers. In addition, with increased disclosure and transparency on the manner in which Islamic financial transactions are being conducted and on how Islamic financial contracts are being executed as well as on the risk and return profiles of financial products, this will further strengthen the role of competition.

In conclusion, the investment in the future needs to be undertaken by all the relevant entities in the Islamic financial sector - the industry, the regulators, the market participants, the academia and the international community. As a co-ordinated and concerted effort it will be mutually reinforcing in elevating the performance of Islamic finance. While the increasingly more competitive prevailing environment raises the pressures to produce immediate-term results, it is the investment in human capital and in research and development that will secure the long-term sustainability of the industry. It is these investments that will be the defining element of the future development of Islamic finance and its long-term success.