

Zeti Akhtar Aziz: Metamorphosis into an international Islamic banking and financial hub

Special address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the ASLI's World Islamic Economic Forum, Kuala Lumpur, 1 October 2005.

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Distinguished guests, Ladies and gentlemen,

I am honoured to deliver this luncheon address on the occasion of the inaugural World Islamic Economic Forum organised by the Asian Strategy & Leadership Institute (ASLI). Allow me to take this opportunity to share with you Malaysia's experience in evolving a comprehensive domestic Islamic financial system that has now become an increasingly more internationally-integrated financial system, thereby strengthening our economic and financial inter-linkages with the rest of the world.

In evolving the Islamic financial system, important considerations include the development of a system that is able to meet the changing requirements of the consumer and business community, that is efficient and competitive, that is safe and sound and that is robust and resilient and able to withstand a more challenging and uncertain world environment. These considerations are vital to ensure the sustainability of the system not only as a form of financial intermediation in the domestic economy but also as an integral component of the international financial system.

Evolving a robust Islamic financial system

Malaysia has adopted a holistic approach in developing its Islamic financial system. Our initial focus was to develop a comprehensive domestic Islamic financial system. The strategy has been to institute the entire financial system chain to ensure its smooth functioning thereby contributing to a balanced allocation of financial and economic resources within the economy, and a greater diversification of risks within the system, and thus achieving overall stability of the Islamic financial system. The initiatives taken include building the required financial institutions, robust regulatory and supervisory framework, effective legal and Shariah framework, the financial markets, effective payment and settlement system, reinforced by the development of the skill talents, and putting in place the mechanism for the operation of the Central Bank. The development of this chain has promoted greater linkages and integration within the domestic Islamic financial system.

Attention has therefore been given to the development of the key structural components of the system, comprising the Islamic banking industry, the takaful industry, the non-banking institutions and the Islamic interbank and capital markets. These respective components of the Islamic financial system have now become highly integrated and interdependent. This more diversified financial infrastructure has also enhanced the efficiency in the functioning of the overall financial system.

The development of the Islamic financial system in Malaysia started with the establishment of Tabung Haji in 1969 as the first Islamic savings institution. This was followed by the establishment of full-fledged Islamic banking and non-banking institutions. A year after the establishment of the first Islamic Bank in 1983, a takaful or Islamic insurance company was established under the Takaful Act. These developments were subsequently expanded with the introduction of Islamic windows by conventional banking institutions where Islamic products and services could be offered by these banking institutions. At the same time, adequate firewalls have been instituted to ensure absolute separation of banking operations to avoid co-mingling between the Islamic and conventional funds so as to ensure the integrity of the Islamic banking operations.

More recently, this structure has been strengthened. Conventional banking institutions that have achieved a critical mass in their Islamic finance operations have the option to transform their operations into a dedicated Islamic subsidiary. Within this framework, Islamic finance in Malaysia has proven to be resilient and able to function effectively and efficiently alongside the conventional financial system. The ability of the Islamic banking institutions to arrange and offer products with attractive and innovative features at competitive prices has appealed to both Muslim and non-Muslim customers, reflecting the competitiveness of Islamic finance as a form of financial intermediation. Since 2000, the domestic Islamic banking industry has been growing at an average of 18% per annum in terms of assets, while growth in the takaful industry was at an average of 28% per annum, with an increasingly more important role in supporting the growth and development process of the country.

Attention has also been given to develop both the Malaysian Islamic money market and capital market. A wide range of instruments has been developed to facilitate the effective management of liquidity and funding by the Islamic financial institutions. This has facilitated the smooth flow of funds in the Islamic financial system. With the development of the bond market in Malaysia which now accounts for 81% of GDP, the Islamic private debt securities account for about 44% of the total outstanding amount of private debt securities in the market, while the monthly traded volume of the Islamic money market is now about RM30 to RM40 billion. The money market also effectively serves as a channel for the conduct of liquidity operations by Bank Negara Malaysia as part of its monetary policy.

The rapid expansion of the Islamic financial services industry in Malaysia is also supported by a conducive legal and Shariah framework. In terms of the legal infrastructure, the Islamic Banking Act 1983 and Takaful Act 1984 governs the conduct of the Islamic banking institutions and takaful operators respectively. There is also the Government Funding Act which governs the issuance of government Islamic instruments. A dedicated High Court judge has also been assigned to preside over cases relating to Islamic banking and finance. An arbitration centre is also available to deal with disputes. The Central Bank Act has also been amended to provide for the establishment of a Shariah Advisory Council at the Central Bank as the sole authority and reference on all Shariah matters. The treatment of tax neutrality has also been accorded to Islamic financial transactions.

To ensure the soundness and stability of the Islamic financial system the regulatory and supervisory framework has also been improved for the Islamic financial institutions, with the incorporation of stronger standards for corporate governance, transparency, disclosure, accountability, market discipline, risk management and customer protection. In addition, the payment system has also been continually upgraded to ensure efficient and effective clearing and settlement of payments. It is now highly automated with the ability to handle scriptless debt securities trading, processing and settlement. By providing a real time settlement system for inter-bank fund transfers, the credit and settlement risk in the Islamic financial system has been minimised.

Attention has also been given to human talent management to create a sufficient pool of competent bankers essential to spearhead innovation in Islamic financial products and services. To meet the increasing manpower requirements, institutions of higher learning and the Islamic banking and finance institutes have also initiated new programmes on Islamic finance.

Leading initiatives in the global integration

Islamic finance in Malaysia has now taken on a new dimension to become more internationally integrated. This is part of the strategy to evolve Malaysia as an integrated international Islamic financial hub that will have a greater role in facilitating international economic and financial flows.

The liberalisation of the Islamic financial system in Malaysia commenced in 2004 with the issuance of three new Islamic bank licences to foreign Islamic financial institutions. These new entrants with distinct capabilities and strengths will not only participate in the growing domestic Islamic banking industry, but will also be able to tap new markets in the region. This initiative will also promote healthy competition, thereby contributing to elevate the domestic industry to new levels of dynamism. In addition to this initiative, up to 49% foreign interest is permitted in the Islamic subsidiaries of the conventional banking institutions and in the takaful companies. The increased international integration is also reinforced by our own institutions venturing beyond our domestic borders, in particular to the Asian region and to the Middle East. This international integration would contribute towards facilitating greater cross-border flows in terms of increased trade and investment transactions, thereby strengthening the global economic and financial inter-linkages.

Apart from banking, Malaysia is also initiating efforts to promote takaful internationally. This is being done in close coordination with the Islamic Development Bank where a taskforce has been established to spearhead, among others, the development and promotion of trade, investment, Islamic banking as well as takaful and retakaful industries among OIC member countries. Among the main initiatives to be undertaken under a Memorandum of Understanding signed between Malaysia and the Islamic Development Bank is to specifically promote and expand takaful and retakaful businesses in the member countries.

A further initiative by Malaysia was to access the international capital market with the issuance of global Islamic financial instruments. The Government of Malaysia made this inaugural primary issuance of a globally-accepted sovereign Islamic sukuk in 2002. Since then, there have been several other issues by other countries. To-date, the total issuance of the four global sovereign sukuk has exceeded USD3.5 billion. The sukuk has broadened the investor base by creating a new asset class for both Islamic and conventional investors. This has also been followed by the issuance of global corporate sukuk, which now amounts to USD12 billion. Several of these products are listed on the Labuan international financial exchange.

In 2004, Malaysia liberalised the foreign exchange administrative rules to allow Multilateral Development Banks and multinational corporations to raise ringgit-denominated instruments in the Malaysian capital market. Towards this end, two institutions, the International Finance Corporation and the World Bank, have issued ringgit-denominated instruments based on Islamic principles in our market. This has contributed to enhancing the depth of the market.

At the international level, Malaysia has also participated actively in initiatives to develop the supporting international Islamic financial architecture. The formation of the Islamic Financial Services Board (IFSB) in 2002 is one of the most important achievements in this development to set the international prudential standards for Islamic finance. To-date, the IFSB has made commendable progress, and this includes the issuance of two exposure drafts on capital adequacy and on risk management. Work is in progress for three other standards that relate to corporate governance, transparency and market discipline, and the supervisory review process. The IFSB has also played a catalytic role in expanding its membership and outreach, thereby contributing further to the global recognition of the Islamic financial system. Today, the IFSB has 78 members from all over the world. This will contribute towards the standardisation of the prudential rules and more importantly contribute to the soundness and stability of the Islamic financial system.

The International Islamic Financial Market, or the IIFM, which is another leading international initiative, will also contribute towards promoting the development of both the primary and secondary international Islamic financial market. IIFM provides the environment to link all the financial centres around the world that participate in Islamic finance, thereby encouraging active participation by both Islamic and non-Islamic financial institutions in the secondary market for Islamic financial instruments. As the volume increases, it would strengthen the inter-linkages and integration amongst the Islamic financial centres.

In the area of Shariah, Bank Negara Malaysia is currently promoting intellectual discourse on Shariah issues. Our own Shariah scholars have contributed towards the rapid growth of the Islamic financial products. Earlier this year in conjunction with the IDB Annual General Meeting that was held in Putrajaya, the opportunity was taken to bring the international Shariah scholars together to deliberate the issues and to foster greater understanding and convergence of the practices of Shariah. Bank Negara Malaysia has established a RM200 million dedicated endowment fund to facilitate regular dialogues among the Shariah scholars, to finance research and scholarships, and to facilitate enhanced interaction between the Shariah scholars and the industry practitioners.

Malaysia will continue to initiate international endeavours and collaborate closely with the Islamic financial community on developing the global Islamic financial system by dedicating our resources and commitment.

Key challenges moving forward

One of the key challenges in promoting greater linkages within the domestic Islamic financial system and integration with the international financial system is having the pool of talent and professional skills. Talents are an important pre-requisite for the national and global development of the Islamic financial system. They are important assets that will drive innovation in the Islamic financial business and sustain its competitive strength.

As the industry moves forward, the need to develop the range of products and services including risk mitigating products intensifies. These products are a necessity for the Islamic financial industry not only to meet the new and changing requirements of the domestic and international economy but also to allow for hedging against potential adverse events and uncertainties. This is important to strengthen the resilience and risk management framework of the Islamic financial industry amidst the increasingly more challenging and competitive global financial environment.

To fast track the creation of a pool of talents and skill set to meet the increasing manpower requirements, Malaysia is currently undertaking an initiative to establish an international centre for education in Islamic finance. It will be designed to act as a professional certification body and a training institute for post-graduates. In addition, Malaysia established the International Centre for Leadership in Finance (ICLIF) in 2003 to also provide leadership development and management training for the Islamic financial institutions.

Closely linked to having the talent is the need to have strong and well established Islamic financial institutions. This presents another challenge for the Islamic financial industry as there are currently not many large Islamic financial institutions. Many of the players are not large enough globally to finance large development projects, particularly in Muslim countries and are not strong enough to underwrite the needs of the Islamic financial community on a large scale. Currently, some of the project financing in Muslim nations are undertaken by large conventional banks because of the under capitalisation of the Islamic financial institutions. We therefore need to have strong and highly capitalised Islamic financial institutions that are able to offer the comprehensive and complete range of Islamic financial products and services.

Besides having large Islamic financial players with the required pool of expertise, the integration of the Islamic financial system with the international financial system needs to be supported by the development of a full Islamic financial system at the national level, thereby increasing the potential to effectively participate in a more liberalised and globalised environment.

Towards this end, Malaysia together with other OIC countries, are collaborating with the IDB and IFSB to formulate a ten-year master plan for the future global development of the Islamic financial services industry. The Master Plan will provide a road map to achieve a

convergence towards the common vision among countries in the development of an Islamic financial system.

Conclusion

In developing and strengthening our Islamic banking and financial system to become more integrated with the international financial system, Malaysia is positioning itself as an Islamic financial gateway to the East Asian region. In emerging on the radar screen of international investors, Malaysia thus not only offering financial communities that want to deal in Islamic financial transactions, but also the international investment community at large, the potential for further opportunities for financing and investment in productive activities.

In closing, I wish to say that our mission is for the development of an increasingly international integrated Islamic financial system. I am confident that in taking this approach, it would contribute towards facilitating increased trade and investment transactions, strengthening the global economic and financial inter-linkages, and thereby raising the prospects for more balanced global growth and shared prosperity among the Ummah, InsyAllah.

Thank you.