Zeti Akhtar Aziz: Building a robust Islamic financial system

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the 2nd International Conference on Islamic Banking, Kuala Lumpur, 7 February 2006.

* * *

Let me first of all extend a warm welcome to the participants of this Second International Conference on Islamic Banking: Risk Management, Regulation and Supervision, jointly organized by the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank and the Islamic Financial Services Board (IFSB). This forum has an important role of not only fostering the dissemination of knowledge and exchange of experiences on the subject of risk management, regulation and supervision, in facilitating a better understanding on the issues confronting us, and thus contribute towards advancing forward the development of the industry. Effective risk management capabilities is particularly important in this more challenging global financial environment of heightened uncertainties and increased potential for financial vulnerabilities. And an effective regulation and supervision will ensure the soundness and stability of the system.

In the recent decade, the Islamic financial system has experienced remarkable growth and transformation, demonstrating its potential as a competitive form of financial intermediation. Today, Islamic finance represents a multi-billion dollar industry with a comprehensive range of products and services, serving a broad spectrum of consumers and businesses that extends beyond the Muslim world.

In developing the Islamic financial system, it is important to focus on the appropriate pre-requisites that will facilitate its efficient evolution. Fundamental to this is the development of the institutions, the markets, the range of financial products and services and having in place the accounting, legal, regulatory, supervisory and shariah frameworks, as well as, for the monetary authority to have the capacity to manage its financial policies within this context.

With the development of these respective components having made significant progress, we are now seeing the Islamic financial services industry enter a new phase of development. Following increased liberalisation, the progress in the development of the international financial architecture for Islamic finance and the increased innovation resulting in the development of new products and services, the international dimension of Islamic finance is becoming increasingly more significant.

Islamic financial institutions are now also venturing their operations beyond their domestic borders. Islamic-based papers are also being issued in international financial markets, generating significant interest from global investors. The international financial architecture for the development of Islamic finance has also been strengthened with the establishment of the international boards to set the accounting and prudential standards. These developments have cumulatively evolved the Islamic financial system to increasingly become an integral component of the international financial system.

The Malaysian experience has been to evolve a comprehensive domestic Islamic financial system that is diversified in terms of its institutions, markets and players. The strategy has been to institute the entire financial system chain to ensure the efficient functioning of the system. The initiatives include establishing the required financial institutions including, the Islamic banking institutions, takaful companies, the non-banking institutions and developing the Islamic money and capital markets. These respective components have recently been progressively liberalized in terms of allowing for the entry of new foreign players and in terms of increasing the potential for foreign participation in the domestic financial markets. In addition, both these domestic and foreign operations have been encouraged to tap on regional and international business opportunities. As a result, this has strengthened the cross-border financial inter-linkages, prompting greater international integration. To ensure the robust functioning of the system, these developments are supported by a strong regulatory and supervisory framework reinforced by the legal and Shariah framework and the payment and settlement systems.

While the positive growth and developments in the Islamic financial system have brought about expanded opportunities, the financial liberalization and technological advancement have brought about increased competition and greater innovation in the development of products and services, operational processes and delivery channels. These developments have contributed to increasing the risk profile of the institutions. These new risks are generally more complex and have more profound systemic implications to the financial system. This has increased the need for strengthened risk management capabilities by the industry and for greater attention to this aspect by regulators and supervisors in promoting the stability and integrity of the financial system. Of importance is to ensure an understanding and awareness of the risks inherent in Islamic banking activities. The challenge is to ensure that each component that supports the risk mitigation requirements, comprising the framework and institutional infrastructures, legal, regulatory, supervisory as well as the Shariah infrastructures are in place.

My remarks this morning will focus on the challenges of risk management in Islamic financial institutions, and the roles of effective regulation and supervision in this context as part of the efforts to promote the development of a robust and sound Islamic financial system.

In Islamic banking, the management of risks becomes more challenging due to its peculiar risk characteristics and the requirement for compliance to Shariah principles. While the Basel II initiatives on the identification of credit, market and operational risks can be assimilated into Islamic banking, the initiatives have to be complemented with consideration of the other dimensions of risks that are inherent in the Islamic financial transactions. The risk management infrastructure in Islamic financial institutions needs to identify, unbundle, measure, control and monitor all the specific risks in the Islamic financial transactions and instruments. This is to ensure that the systems and controls will be effective in the quantification and management of the risks arising from the operations.

New innovations in technology would be particularly important to enhance the potential to manage risks. In addition, as the returns in Islamic banking are uncertain and can only be ascertained on an ex-post basis, well-developed IT systems would be necessary to enable Islamic banking institutions to make projections on future returns so as to reduce the degree of uncertainty in the returns to be paid to the depositors. This would also strengthen the potential competitiveness of the Islamic financial services industry.

Another facet to risk management is the need for the Islamic banking industry to develop a derivatives market. In the current increasingly uncertain global financial environment, investors need to be in a position to mitigate and manage these emerging new risks. Islamic banking institutions, in particular, have to a large extent long-term assets which include long-term Islamic housing mortgages and Islamic financial instruments, that are funded by short-term deposits, thus giving rise to a maturity mismatch between the assets and liabilities. There is therefore a need for the development of a broader range of Islamic financial market instruments to provide the industry with effective risk mitigating instruments.

In addition to the derivatives market, the Islamic financial system also needs deeper and more efficient money and capital markets to facilitate sound asset and liability, and liquidity management by Islamic financial institutions. In this regard, Bank Negara Malaysia will issue Sukuk al-Ijarah, to meet the requirements of participants in the Islamic money market.

At the core of a strong Islamic financial system in any jurisdiction, there needs to be a strong regulatory framework which enforces the standards for capital adequacy, ensures effective risk management practices, financial disclosure and governance, reinforced by a strong Shariah and legal framework. Shariah principles serve as a self-regulating mechanism that protects Islamic financial institutions from unproductive, speculative and unethical activities, given the prohibition of interest or usury in banking business, and the requirement that all financial transactions are to be accompanied by genuine trade and business-related transactions and the prohibition from the involvement in illegal and unethical activities. The regulatory framework in which Islamic banking operates is thus able to draw on the strength of the Shariah injunctions, to reinforce financial soundness and stability of the Islamic banking system.

In Malaysia, Islamic banking institutions are required to have a Shariah Committee council within their respective institutions to ensure that products and services to be introduced are Shariah-compliant. In addition, emphasis is also placed on the internal audit function to ensure that all transactions undertaken by Islamic banking institutions are in compliance with the Shariah principles.

In designing and implementing financial regulation and supervision for Islamic banking institutions, the challenge is to enforce a framework that takes into account the unique characteristics of Islamic banking business, without being a regulatory burden and restricting its growth potential or providing arbitrage opportunities between the conventional and Islamic financial systems. This is important to ensure the stability of the overall financial system.

In building a sound prudential framework for Islamic banking, aligning the regulatory capital requirements to the underlying risks, requires dichotomization of the risk intricacies in the Islamic banking asset portfolio, given the asset structure of Islamic banking institutions, such as the diverse spectrum of Islamic financing structures, which range from low-risk sales and lease-based modes to the higher risk equity-based modes of finance. The intricacy in profiling the risk in Islamic banking is further increased as the risks may transform from one type of risk to another at the various stages of the contract. For example, in the diminishing Mu-sya-ra-kah contract, the Islamic financial institution initially acts as a joint-owner of the asset, but the asset ownership will be transferred fully to the customer at the conclusion of the contract. In this regard, the Islamic financial institution is exposed to higher market and impairment risks at the initial part of the transactions initially compared with the exposure during the later stage of the contract. At the same time, the amount of repayment by customers represents the credit risk to the Islamic financial institution. As each of these respective parts of the transaction has a distinct intrinsic characteristic, it would entail different degrees of credit, market and operational risks. In this regard, in formulating prudential standards for Islamic banking institutions, there is a need to have an accurate assessment of the various risk variants underlying the alternative parts of the transaction to determine the capital adequacy requirement.

Similarly, the liability structure of the Islamic banks is characterized by two distinct categories of deposits: the demand deposits which are not subject to the risk associated with the banking business and for which the principal is guaranteed, and the investment deposits which involve risks and hence, eligible to share the profits earned from the banking business. Given that the returns are not pre-determined, profit-sharing depositors of Islamic banking institutions, as the capital provider will have to bear any of the losses. This places a higher degree of fiduciary risk on the Islamic financial institutions in ensuring that the investment deposits funds are managed in the most effective and efficient manner. This is further compounded by competition in managing the liquidity in the system. The profit share distributed needs to be competitive relative to that earned and paid by the conventional banks. This is important to avoid a shift of deposits and to retain the funds in the system.

A central feature of the regulatory framework for Islamic financial institutions is financial transparency and disclosure. Market conduct disclosure and customer relationship management form the core of these principles. Addressing the information asymmetry between Islamic banking institutions and the depositors is of vital importance. Under the Mu-da-ra-bah principles, there is a need for disclosure by Islamic financial institutions to investors on how the funds are being managed so as to provide the assurance that the underlying business operations, the risk profile and the risk control mechanisms are in place. In Malaysia, this has been addressed through the establishment of an effective rate of return framework, which provides a standard methodology for deriving the rate of return on deposits. The Profit Equalisation Reserve has been provided in the rate of return framework for Islamic financial institutions, which serves as a mechanism to mitigate the impact of the fluctuations in the rates of return. The reserve is appropriated from the gross income and is shared by both the depositors and the banking institution. Given the dual banking environment, as the one in Malaysia, the ability to maximize risk-adjusted returns on investment and sustain stable and competitive returns is an important element in ensuring the competitiveness of the Islamic banking system. From the regulatory perspective, the rate of return framework provides a means of assessing the efficiency of Islamic banking institutions, its profitability, management competency and fairness. To further protect Islamic depositors, the Malaysia Deposit Insurance Corporation has established a separate deposit insurance scheme based on Islamic principles.

Disclosure of the true and fair value of the Islamic banking operations in the financial statements is also essential for depositors to undertake a true and fair assessment of the bank's performance. The enhanced financial disclosures need to be complemented with customer education and awareness programs to elevate the level of financial literacy among the consumers and businesses. Towards achieving this objective, consumer education programs have been conducted, providing information among others, on the unique characteristics of Islamic banking and finance, Islamic financial products and services and the underlying Shariah principles and concepts. Enhanced consumer awareness is expected to strengthen the role of market discipline in driving the Islamic financial institutions towards strict Shariah compliance, enhanced operational efficiency, and strengthened risk management infrastructures and practices.

In Malaysia, Islamic banks and conventional banks with Islamic banking windows observe similar prudential standards as imposed on conventional banks such as the minimum risk weighted capital ratio (RWCR), standards for corporate governance and risk management, financial disclosures and know your customer policy. The principles of prudent management and enhanced operational efficiency are inculcated through the minimum risk weighted capital adequacy requirement. Corporate governance standards have been enforced through specific guidelines on the code of conduct for directors, officers and employees of the banking institutions and guidelines on the directorship and prohibition of loans to directors, staff and their selected corporations. In addition, strict compliance with the tenets of Shariah would also ensure that the Islamic financial institutions are managed on the basis of a high degree of prudence, ethics and integrity.

The Basel Committee on Banking Supervision has enhanced its capital regulation to include operational risk in the computation of capital adequacy, in addition to credit and market risks. The task of formulating a framework that addresses the peculiar risks associated with Islamic banking is being undertaken by the Islamic Financial Services Board (IFSB), which serves as an international standard-setting body for regulatory and supervisory agencies. Its mandate is to develop prudential, regulatory and disclosure standards for Islamic finance, and promote uniformity in the best practices on the governance of Islamic financial institutions worldwide. In this respect, the IFSB has recently issued two prudential standards on risk management and capital adequacy for institutions offering Islamic financial services, which are recommended for implementation in 2007. The IFSB has also made progress in developing three other standards on corporate governance, transparency and market discipline, and the supervisory review process to be released in due course.

A key challenge in managing operational risk in Islamic banking is ensuring Shariah compliance. Bank supervisors in their assessment would need to give due attention to the adequacy of the financial institutions' board and management oversight, policies, procedures and limits, risk measurement, monitoring and management information systems, and internal controls. The risk management standards issued by the IFSB would serve as a guide to bank supervisors in this regard.

Notwithstanding the significant progress made so far, there are still outstanding issues confronting the Islamic financial system today, particularly the different interpretations of the Shariah injunctions. Internationally, there continue to be debates among Shariah scholars on the compliance to the Shariah principles. In Malaysia, the National Shariah Council on Islamic Banking and Takaful has invited prominent international Shariah scholars to participate in the deliberations as its members. The move is expected to help bridge the gaps in the interpretations of Shariah injunctions in relation to the conduct of Islamic banking business among the Shariah scholars in different parts of the world. Another forum through which the differences in the interpretations is being addressed is regular and continuous dialogue sessions by the scholars. A RM200 million endowment fund has been established by Malaysia to support the role of the international community of Shariah scholars in developing global Islamic banking and finance.

The development of a vibrant Islamic banking sector cannot be achieved without the support of appropriate human capital development. Underpinning the success of Islamic banking system is the strengthening of research and intellectual capacity in the sphere of finance and Shariah. The Islamic banking industry needs to be equipped with a new breed of innovators, risk managers, regulators and supervisors who have the right blend of knowledge of finance and the understanding of the Shariah. For this purpose, Malaysia has established the International Centre for Education in Islamic Finance (INCEIF), which will commence operations in March 2006, aimed at developing talents in Islamic finance. INCEIF will offer professional certification programs in Islamic finance and will forge strategic alliances with domestic and foreign institutions of higher education to offer Masters and PhD. programs in Islamic finance in specific areas of specialisation.

As we advance forward, changes in the financial landscape will continue to accelerate and the level of complexity and sophistication in the financial markets will further intensify. Islamic banking institutions will need to reinvent themselves to meet the emerging issues, challenges and opportunities. The regulatory and supervisory approach and the methodologies to be applied must continue to evolve in order to remain effective and relevant. In addition, given the global dimension of the Islamic financial products and services, and the increasing interdependence of financial markets, efforts by individual countries to strengthen risk management practices needs to be matched by efforts to enhance the safeguards at the international level.

The future prospect of the Islamic banking industry thus depends on the combined cumulative efforts by the industry, regulators, the market participants and the international community. The collective efforts needs to be coordinated to maximise the potential of the industry. Setting shared vision and common goals to be achieved would be an important first step. Of greater importance are the actions that needs to be taken to realise these goals. It will be the actions and initiatives which we take today that will contribute towards achieving the future that we aspire.

On this note, I wish you a successful and productive conference.

Thank you.