

Zeti Akhtar Aziz: The international dimension of Islamic finance

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the 2007 INCEIF Global Forum "Leadership in Global Finance – The Emerging Islamic Horizon", Kuala Lumpur, 30 August 2007.

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It is my honour and great pleasure to be here to speak at this first INCEIF Global Forum, which has drawn together a distinguished gathering of scholars, researchers and practitioners from the financial services industry. Let me focus on the international dimension of Islamic finance which has continued to gain significance. Islamic finance now extends beyond the traditional predominantly Muslim economies to become an increasingly important part of the international financial system. Total assets of the Islamic financial system are estimated to exceed one trillion US dollars. It is among the fastest growing financial segments in the international financial system with an estimated annual growth of 15 to 20 percent. There is now a growing demand for Islamic financial products in the global market, far exceeding the supply of financial products and services that is being offered by the Islamic financial institutions.

As we advance forward, the international environment in which we are operating is also rapidly evolving to become **more complex, competitive and challenging**. In the current environment it has become more volatile and uncertain. The challenge for Islamic finance is to evolve strategies that will ensure its competitiveness, dynamism and sustainability. An aspect in the contemporary global Islamic finance that is fundamental is the "principled centred" nature of Leadership in Islam, that involves "trust" (*amanah*), and with that comes "responsibility" (*taklif*) and "accountability" (*mas'-u-li-yah*¹). My remarks today will discuss the positive elements that Islamic finance brings to the global financial system, its prospects for enhancing international integration and the potential to strengthen the socio economic aspects of Islamic finance.

Optimizing benefits of Islamic finance

In evolving the international dimension of Islamic finance an important aspect is the optimization of the oasis of benefits and opportunities Islamic finance has the potential to provide. Islamic finance implicitly embraces strong core values and universally beneficial characters. The fundamental requirement of Islamic finance is that it confines its activities to that which is supported by an underlying economic transaction thereby avoiding emphasis on speculative purposes. The Islamic principles require that the financial transaction be accompanied by genuine trade and business related transactions. This provides for a high level of disclosure and transparency. This thus prohibits the commoditisation of risks, which effectively leads to its proliferation through multiple layers of leveraging and disproportionate distribution. It reduces the potential for information gaps and for mispricing of risks and thus avoids the elements that could contribute to uncertainty and disruptive market conditions.

The Islamic financial system derives its strength and stability from its faculty to uphold Shariah principles. The Islamic financial system thus has an in-built dimension that promotes financial soundness and stability, as it resides within a financial trajectory underpinned by the forces of Shariah injunctions. These Shariah injunctions interweave Islamic financial transactions with genuine productive activities and prohibit involvement in illegal and unethical activities. This intrinsic principle of governance contributes towards insulating the

¹ ICLIF Leadership Competency Model – Syed Naquib al-Attas & Wan Mohd Nor Wan Daud.

Islamic financial system from the potential risks of financial stress triggered by excessive leverage and speculative financial activities.

Equally important is that the key components of the Islamic financial system, comprising the financial institutions, the markets and the financial infrastructure, has demonstrated its viability and robustness as a form of financial intermediation, with a mutually reinforcing role in enhancing the overall stability of the financial system. Its growing role in mobilising and channeling the funds to productive investment activities across borders brings significant benefits to the global economy. Firstly, it has the potential to contribute global growth and contributing towards some rebalancing of the global growth given that it brings about a more inclusive financial integration. Secondly, the strengthened international financial linkages allows for the potential for greater diversification of risks. The increase in the Islamic financial products, the growing number of assets classes being offered, the increased cross ownership of assets have all expanded the possibilities for greater diversification of risks and the potential for return.

The intrinsic nature of Islamic finance encourages risk management and provides confidence through explicit disclosure and transparency of the roles and responsibilities defined in the contract. The transparent nature of the Islamic financial contracts and the need for underlying economic transaction reinforces the stability of the Islamic financial system.

A vital challenge going forward is however to build a stronger, competitive and dynamic Islamic financial system that better reflects the internalization of Shariah principles in financial transactions, in its form, spirit and substance. This epitomizes the objectives of the Shariah in promoting economic and social justice. While developing Islamic financial system with products and services mirroring the conventional counterpart is acceptable as a pragmatic approach, it needs to develop further on its own paths and merits so as to maximize the potential benefits of Islamic financial system. Key to this is having an appropriate pricing benchmark to be an indicator for Islamic securities to be efficiently priced and credible.

In addition, the role of Shariah scholars who have the full understanding of the mechanics of Islamic financial products and services, are key to ensuring its continued development. At the same time, Shariah decisions, when made, needs to be disclosed. This will allow others to appreciate the juristic reasoning, which in turn would lead to a wider acceptance of Shariah decisions, particularly if they have implications on cross-border transactions.

As the Islamic financial system becomes increasingly more internationally-integrated, it is important to recognize the different regional and institutional strengths and complementarities and the need to maximize synergies. Collaboration among regional centres and key players in Islamic finance will be an important part of the process that will contribute towards greater international financial integration. Constructive engagement in the form of strategic partnerships and collaboration, as well as in market access needs to be enhanced. Allowing greater market access among players in Islamic financial centres can be a catalyst for enhanced integration and innovative elements in the Islamic financial industry.

Malaysia's experience in strengthening the international dimension of the Islamic financial system has shown positive results. This has commenced in 2002 with the inaugural issuance of a global Sukuk to the liberalizing to allow for greater market access in Islamic banking and takaful initiatives by permitting entry of foreign players.

The third area of international integration is the liberalization of our financial markets to allow for greater foreign participation. In particular, in the sukuk market, foreign corporations, multinationals and multilateral agencies may raise ringgit and foreign currency denominated instruments in our market. Our private debt securities market is the largest in South East Asia. Malaysia also has highly liberalized exchange administration system that allows for the free inflow and outflow of funds. There is also no restriction on the utilization of the funds raised in our market. The funds may be utilized for investments outside the country.

Finally, our own financial institutions have ventured beyond our domestic borders. These cumulative developments have strengthened our linkages with other Islamic financial centres.

Another area important for Islamic finance is the investment in research and development (R&D). The promotion of international strategic alliances through smart partnerships can create greater synergy that will bring about new approaches, new technologies and new areas of specialization. Such collaborative efforts amongst Islamic financial institutions would strengthen the ability to leverage on the industry's expertise. The introduction of innovative Islamic financial products in a specific jurisdictions 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, collaboration between academic researchers and the practitioners will enable the practical application of such research findings.

In the area of education and training in Islamic finance, there is now a critical shortage of talent in the Islamic financial industry. Collaboration between training institutions is vital to developing the pool of expertise in Islamic finance that subscribes to common standards. Establishing a network of mutual co-operation and collaboration would strengthen the efforts among the institutions of higher learning across regions in the areas of curriculum development, research, training, exchange of ideas and information, and resources in Islamic finance. Such partnerships in connecting the knowledge communities between regions would facilitate this process.

In the area of Shariah, the progressive convergence of Shariah views and rulings, the mutual recognition of financial standards and products across jurisdictions would be major driver towards greater international financial integration. Such a convergence and harmonisation can only happen with greater engagement among the regulators, practitioners and scholars in Islamic finance in the international community.

Finally this integration process also requires greater cooperation among the regulators to ensure that the Islamic financial system is not subject to vulnerabilities and abuses and thus ensuring its soundness and stability. In this respect, the sharing of information among the regulators including across borders is important especially in a more globalised and liberalised environment where financial transactions and activities have become more complex and globalised. In this regard, there is a greater need for regulators to be continuously connected to share information on key issues and developments faced in their own financial jurisdictions. In this respect, the Islamic Financial Services Board has an important role to facilitate this process.

Closer financial linkages among Islamic financial institutions from different jurisdictions is essential to contribute towards accelerating the process and towards serving as a bridge to strengthen the relationship of the international Islamic financial markets as well as the investment and trade ties between regions. Such linkages within the industry could also lead to new product offerings and to co-arranging financing. There could also be mutual development of IT systems and other technologies including other research and development endeavours.

Finally, let me touch on the development of the socio-economic aspects of Islamic finance. While "profit motivated" Islamic financial institutions will continue to evolve and gain greater significance, this trend also needs to be complemented with similar evolution in the socio economic aspects of Islamic finance such as *waqf* and *zakat*. A stronger *zakat* and *waqf* system would not only complete the equation for a comprehensive Islamic financial system that supports a more equitable distribution of wealth to ensure fairness and equity, it will also become the user of the Islamic financial services particularly in the management and investment of the *zakat* and *waqf* funds. In addition, access to Islamic financial services to micro enterprises would bring such activities into the economic mainstream and improve their level of performance.

Conclusion

As Islamic finance advances forward to become an integral component of the international financial system, continuous efforts are needed to further develop the domestic financial system to meet the changing requirements of a highly dynamic and rapidly evolving environment. 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 economic activities, that conforms to the principles and values of Shariah. With this, the Islamic financial system will ultimately bring benefit not just among Muslims but with the rest of humanity, *Inshaallah*.

Thank you.