

Zeti Akhtar Aziz: Globalisation of Islamic finance services – opportunities and challenges

Speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Fifth IFSB Summit: Session 1: Globalisation of Islamic Finance Services – Opportunities and Challenges, Amman, Jordan, 13 May 2008.

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This decade has seen the financial globalisation of Islamic finance gain significant momentum. While the early development of Islamic finance was domestic centric, its internationalisation is now manifested by increased cross border flows, greater participation in international Islamic financial markets, the increased presence of Islamic financial institutions in new jurisdictions and more recently, the increased number of Islamic financial institutions which have shareholders from multiple jurisdictions. This trend has strengthened the international economic and financial interlinkages between nations bringing with it mutually reinforcing gains.

Financial globalisation has essentially been facilitated by the more rapid pace of liberalisation, the advancement in the information and communications technology, and the significant progress achieved in the development of the international financial infrastructure. This trend has also been reinforced by the search for higher returns and the need to diversify risks. In the current international financial environment of increased uncertainties, this trend has become even more pronounced prompting investors to venture into new asset classes and markets that provide stability.

The globalisation of Islamic financial services

With the increased significance of the international dimension of Islamic finance, the financial landscape has been dramatically transformed with more diverse players and a more competitive environment. This in turn has been a catalyst for increased financial innovation and resulted in a wider range of Islamic financial products and services. This has ignited interest from conventional global players from Non-Muslim countries largely in the form of increased participation in Islamic financial markets and in acquisition of strategic stakes in domestic Islamic financial institutions. With the opening of borders for banking institutions and other players, the Islamic financial system has become more diversified and the Islamic financial markets deepened. These developments have contributed to its rapid expansion across the globe, and Islamic finance has now emerged as among the fastest segments in the financial services industry.

The scope of Islamic finance business has thus expanded beyond retail and trade financing, to more sophisticated financial products in response to the changing global customer base. Such Shariah-compliant products include private equity, project finance, the origination and issuance of sukuk, as well as fund, asset and wealth management products. The sukuk market in particular, has become an important avenue for international fund raising and investment activities, has expanded by an annual growth rate of 40%. The vast potential in sukuk market in the international financial system indeed represents the crest of a new wave of innovation in Islamic finance and is very much part of the globalisation process in Islamic finance. Sukuk Musyarakah and Ijarah, which command the broader global acceptance, represents the majority of global sukuk issuances.

As part of the on going internationalisation of Islamic finance has been the development of the supporting international financial architecture. Of significance, is the establishment of the Islamic Financial Services Board (IFSB) in 2002 to set the prudential standards for Islamic finance, and the Accounting and Auditing Organization for Islamic Financial Institutions

(AAOIFI) that was established in 1990. The importance of these international standard setting institutions has been their role in the harmonisation of prudential and accounting standards across the different jurisdictions. More importantly is their role in instituting international best practices in the global development of Islamic finance. It is these concerted efforts to develop robust international best practices in the prudential and supervisory framework that will ensure the resilience and long term sustainability of the Islamic financial industry.

With globalisation also comes enhanced interdependence. While the strengthened interlinkages can be expected to bring about a more efficient allocation of capital across borders which in turn would result in lower the cost of capital, it has also resulted in the potential for the transfer of risks across different jurisdictions. This underscores the need to ensure the quality of financial globalisation. While the intrinsic nature of Islamic finance encourages risk management and provides confidence through explicit disclosure and transparency, the new risks resulting from globalisation needs to be taken into account. This is to ensure that the Islamic financial institutions have the capacity to manage the risks and that the regulatory authorities have the necessary instruments at its disposal to respond to any destabilising implications.

Emergence of new set of challenges

The enhanced international dimension of Islamic finance has thus brought about a new set of challenges. The emergence of more diverse Islamic financial institutions and the expanded development of Islamic financial markets have intensified the development of sophisticated Islamic banking, takaful and capital market intermediaries. This has also resulted in the creation of sophisticated and complex structured financial instruments including hybrids of debt-equity structures. The increased competition has not only intensified the pace of innovation in products and services, but also of the operational processes and delivery channels. These developments have contributed to the **increasing complexity of the risks** profiles of Islamic financial transactions.

Global strategic initiatives

Recognizing the importance of ensuring financial resilience of the Islamic financial services industry in this more challenging environment, collaborative international efforts have been undertaken.

Spearheading the strategic development of the industry is the **ten-year Master Plan** for the development of the global Islamic financial industry, a joint initiative by the Islamic Development Bank (IDB) and the IFSB. This strategic initiative provides a blueprint for the orderly development of Islamic financial system across jurisdictions to achieve the common goal of a vibrant, efficient and progressive Islamic financial services industry. This blueprint also outlines the broad strategies for the development of the key components of the various parts of the Islamic financial sector, including the guide for determining the best options for the different stages of development of the Islamic financial system so as to ensure that it would contribute to the growth and development of the economy and also become an integral component of the international financial system.

Of importance is that the master plan not only represents a blueprint for the development of a cohesive and a comprehensive Islamic financial system but also it promotes increased understanding and appreciation for those that wish to participate in the Islamic financial system, including providing information on the expected level of achievements that are required.

Another important global initiative in Islamic finance already mentioned is the promulgation of the **international prudential and supervisory standards** by the IFSB. The IFSB has fast-

tracked the development of these standards to address the unique and peculiar characteristic of risks of Islamic financial contracts. Fundamental to the implementation of the standards is the strengthening of the risk management capabilities of the financial institutions. In addition, the implementation of these standards needs to be complemented by the continuous surveillance so as to ensure the early identification of the new emerging risks and to ensure that the institutions undertake to manage the risks.

Resilience reinforced by the intrinsic features of Islamic finance

The intrinsic features of Islamic finance also contribute to its overall resilience. This is derived from the Shariah principles, the key pillar of Islamic finance. The Shariah injunctions require that Islamic financial transactions be accompanied by an underlying productive activity resulting in a close link between financial and productive flows. Under the risk sharing concept, there is an explicit risk sharing by the financier and the customer. In this arrangement, the real activity is expected to generate sufficient wealth to compensate for the risks. Parties to the transactions would thus be insulated from excessive risks exposure given that the Shariah prohibits the excess leverage and involvement in speculative financial activities. The intrinsic principle of profit and risk sharing thus provides an in-built check and balance to the Islamic financial transactions. A combination of these distinct features together with the implementation of prudential risk management standards and practices would contribute to the robustness and resilience of Islamic financial system.

Mutual respect on Shariah matters

This decade has thus been a phase of innovation in the global Islamic financial system with a number of breakthroughs and major milestones in innovative deals and structures. The advancement of sukuk, Islamic securitization, Islamic private equity, Islamic real estate investment fund and other financial instruments in terms of sophistication and product range has widened the international market reach of Islamic finance, particularly in the cross border transactions.

At the same time, this phase is also seeing a number of key issues being raised, particularly in respect of divergence of Shariah views underlying a number of the Islamic financial transactions. While such a divergence of opinions in Islamic financial transactions is not a new phenomenon, it has presented a new set of challenges in today's increasingly more globalized market. To forge closer linkages between the global Islamic financial markets would require a common understanding and acceptance on the applicable rules and standards. Indeed, cross border transactions would require the jurisdictions involved to **mutually recognise the validity of respective rules, practices and underlying Shariah interpretations**. This is key for the orderly development and for advancing the pace of progress of the international Islamic financial industry.

For this, it is important to have a concerted effort in providing greater clarity on the mutually acceptable strategy for the development of global Islamic finance. In the current globalised environment, the role of scholars needs to transcend beyond pure advisory or Shariah rule-making, to a more strategic role in charting industry development. This could be in part be achieved by having **global Shariah standards** for the Islamic financial industry. A mutually agreeable position could be achieved with the application of **mutually recognized principles and processes to deduce the Shariah rulings and views**.¹

¹ There are lessons to be drawn from the previous success stories in the history of Islamic jurisprudence whereby the strong sense of mutual respect prevailed among Muslim jurists with multiplicity of Shariah opinions. The jurists from different mazhab had high regard for differing views expressed by other jurists, even in ibadah matters.

In relation to this, Malaysia has taken a **three-prong strategic initiative** to promote greater mutual respect of the Shariah views. The first is to recognise the principle of mutual respect in Shariah opinions issued in other jurisdictions by a recognized Shariah committee for transactions undertaken in Malaysia. In addition to the key role of a centralized Shariah Advisory Council as the reference point for all Shariah matters in Islamic finance, Malaysia welcomes Shariah rulings by other Shariah committees that are deemed to be **deduced through generally accepted rigorous principles, processes and rules**.

The second initiative is to have **strong resource foundation** supported by a pool of qualified and competent Shariah talent, as well as to accord more emphasis on extensive Shariah research in Islamic finance. Given the rapid global growth of Islamic finance, there is an urgent need to meet the talent demand for Shariah scholars with strong interest in the strategic development of the Islamic finance industry. From the supply side, the International Centre for Education in Islamic Finance (INCEIF) established in 2006 has made significant progress with more than 1000 registered students in its professional Islamic finance certification. It also has 28 PhD students and has recently launched a Masters Programme in Islamic finance. The Islamic Banking and Finance Institute Malaysia (IBFIM) also offers a structured, modular training solutions for Shariah advisers focusing on practical and operational aspects of Islamic banking and takaful.²

Given the importance of the in depth of Shariah research in Islamic finance, the International Shariah Research Academy (ISRA) was recently established as part of INCEIF to conduct applied Shariah research on the contemporary Islamic finance issues. The third strategy is to provide a platform that promotes active engagement and dialogue among the relevant stakeholders. The annual Shariah dialogue at international and regional levels have contributed to increased understanding of different views on Islamic finance matters and enhanced mutual respect of Shariah opinions.

Closing

In conclusion, against a backdrop of an increasingly uncertain global environment, Islamic financial system is indeed well positioned, as a form of financial intermediation in this more challenging environment. In the coming years, it is important for adequate focus to be given on the implementation of international prudential standards and sound risk management practices in Islamic financial institutions to ensure the financial stability and integrity of the financial system. According greater mutual respect to global Shariah views for Islamic finance would also contribute to the orderly global development of Islamic finance, thus sustaining the overall viability and soundness of the Islamic financial system as it becomes an integral part of the international financial system.

² IBFIM's "Shariah Scholars Induction Programme".