Zeti Akhtar Aziz: Opportunities and collaboration in Islamic finance

Address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Malaysia-UK Islamic Finance Forum, Kuala Lumpur, 8 July 2009.

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It is my pleasure to be here today to address the Malaysia-United Kingdom Islamic Finance Forum organised in collaboration with the Commonwealth Business Council. Allow me to take this opportunity to welcome The Right Honorouble Lord Mayor and distinguished guests from the United Kingdom today that are joining this dialogue with the Malaysian financial community to discuss the opportunities and areas of collaboration in Islamic finance – an important potential avenue for strengthening financial and economic linkages not only between our economies but with other parts of the world.

A global shift is currently taking place in the international environment that is dramatically altering the configuration of the global economy. It is resulting in an increasingly multi-polar world. In this new phase of globalisation, the concentration of economic power will become more dispersed. Strengthening strategic economic and financial linkages across jurisdictions will become a key feature in this environment. It is very much Malaysia's intention to be part of this new future as we consciously build our capacity to enhance our international economic and financial linkages.

Building effective partnership between UK and Malaysia

The United Kingdom and Malaysia has one of the oldest relationships. This relationship has been dynamic, evolving in the rapidly changing international environment. The strong and close bond has continued to evolve in the areas of trade, investment, education and finance.

While the bilateral trade in goods between the United Kingdom and Malaysia only accounts for 1.4% of our total trade, Malaysia's bilateral trade in services with Britain accounts for 6.3% of our trade in services in 2008. While the balance of trade is in our favour, the balance in the services account is in the favour of the United Kingdom amounting to RM2.3 billion. In the area of mobility of people between our two countries, there continues to be a significant two-way flow relating to employment, education and tourism. Tourists from Britain represent the largest group of visitors from the European market. In the area of education, there are a great number of Malaysian students studying in the United Kingdom. This has been reinforced by the twinning programmes. In addition, British education for Malaysians has been strengthened by the branch campuses in Malaysia.

More recently, the relationship building has extended into the area of Islamic finance. This relationship was cemented with the signing of a Memorandum of Understanding between the UK Trade and Investment and Bank Negara Malaysia.

The early development of Islamic finance was very much domestic-centric. This recent decade has seen the internationalization of Islamic finance. This has increased the potential for strategic partnerships between international financial centres that will bring with it mutually reinforcing benefits.

Malaysia has developed a comprehensive Islamic finance industry founded on a strong legal and regulatory framework, with a diversified number of Islamic banking and takaful institutions and a well-developed Islamic money and capital market. Today, Islamic financial assets comprise 17 per cent of the total assets of the banking system in Malaysia and the daily average volume transacted in our Islamic money market is RM6 billion. The sukuk market which has been expanding at an average annual rate of 22%, now accounts for more than 50% of our bond market.

With this financial infrastructure in place, Malaysia has recently intensified its pace of liberalisation. In April, the government announced further liberalisation measures that included new licences to be offered in Islamic banking and takaful. More specifically, up to two new mega Islamic banking licences will be issued to foreign players with minimum paid up capital of USD1 billion to enhance global interlinkages and leverage on global developments in Islamic finance. Existing domestic Islamic banks that wish to scale up their operations and expand into global markets are also given greater flexibility to enter into strategic partnerships with foreign players to raise their capitalization to USD1 billion with a higher foreign equity limit of up to 70%.

In addition, up to two new family takaful licences will be issued in 2009 to players that can offer significant value propositions to Malaysia to spur the development of the takaful industry. Takaful companies will also be given the flexibility to enter into strategic tie-ups with foreign partners through higher foreign equity limit of up to 70%, to further strengthen resilience and competitiveness. In addition, international Islamic financial institutions can be established to offer the full range of Islamic financial services to residents and non-residents in international currencies.

Another further measure announced is the liberalization of legal profession to allow up to five top international law firms with expertise in international Islamic finance to offer legal services in international Islamic finance in Malaysia.

Internationalisation of Islamic finance

Several factors are important in sustaining the internationalisation of Islamic finance.

Firstly, is the development of international Islamic financial markets to enhance the liquidity of the instruments and the risk management capacity of the players. This is important to promoting the efficient functioning of the markets and thus facilitate cross border capital flows thereby strengthening global financial integration. However, it can be observed that in most jurisdictions that have Islamic financial institutions, Islamic money and capital markets remain relatively less developed. Consequently, Islamic banking institutions face the challenge in their day to day management of cash, arising from the lack of a comprehensive Islamic inter-bank market with highly rated short-term tradable instruments. Without access to such a market, it is difficult for these institutions to manage their short-term liquidity needs in an efficient and effective manner. This would in turn require them to maintain a larger amount of liquidity compared to their conventional counterparts. In Malaysia , such markets exist and have been key to facilitating liquidity management.

Coordinated initiatives across jurisdictions can be taken to foster the development of an efficient and vibrant international Islamic financial market. The IFSB Task Force on Liquidity Management reflects a concerted effort to explore measures needed to develop the liquidity management infrastructure and framework for the Islamic financial institutions. Notwithstanding the effort by the Task Force to look into the pertinent issues, Islamic financial institutions are encouraged to promote innovation in the development of a broader range of Islamic financial market instruments. These include instruments with equity ownership features, Islamic asset-backed securities, the inclusion of permissible forms of credit enhancements as well as Shariah-compliant risk mitigating instruments.

It is also essential that there should be sufficient availability of liquidity to support the intermediation of funds in the Islamic financial system. Central banks must therefore have sufficient Islamic financial instruments at their disposal to manage the liquidity conditions in the Islamic financial system.

Secondly, is the international cooperation to ensure financial stability of the international Islamic financial system. This will also involve partnerships between international financial centres in promoting financial stability. A **robust and effective regulation and supervision of Islamic financial institutions** is key to preserving financial stability. The current ongoing global financial and economic crisis has highlighted the structural weaknesses in the global financial regulatory and supervisory framework. Co-operation between regulators across jurisdictions is vital in containing potential systemic risks that have extended beyond the national and regional boundaries.

In the case of Islamic finance, a rigorous and well developed legal, regulatory and Shariah framework is being put in place. Such a regulatory framework also needs to govern market practices by the Islamic financial institutions. This will involve the implementation of the prudential standards that have been issued by the Islamic Financial Services Board, the IFSB. The IFSB also has an important role in the harmonisation of prudential standards, in addition to contributing towards the consistent development of Islamic finance across different jurisdictions. Several parts of the world, including Malaysia , have implemented the prudential standards issued by the IFSB. These prudential standards which have been designed to take into account the unique features specific to Islamic finance will contribute towards ensuring its soundness and stability. British financial regulators are therefore encouraged to be members of the IFSB.

Early this year, the IFSB in collaboration with the Islamic Development Bank (IDB) established a task force on Islamic Finance and Global Financial Stability. The task force is responsible to examine the resilience of Islamic finance in the current challenging global financial environment and to examine further the building blocks that need to be put in place to develop the international financial architecture to strengthen further the resilience of Islamic finance. The task force will provide recommendations including on developing the framework for prevention and management of crisis taking into account the lessons for reform of the international financial system.

Thirdly, and importantly is that international integration of Islamic finance would be facilitated by **the mutual recognition of financial standards and products across jurisdictions**. In the area of Shariah, there has already been the progressive convergence of Shariah views and rulings, and the mutual recognition of financial standards and products across jurisdictions. As this continues to occur, it would be a major driver towards greater international financial integration. This convergence and harmonisation is taking place with the greater engagement among the regulators, practitioners and scholars in Islamic finance across jurisdictions.

To promote greater mutual recognition of products, Bank Negara Malaysia has embarked on the initiative to develop the Shariah Parameters to promote more consistent application of Islamic financial contracts. This initiative aims to determine the essential features of Islamic financial products derived from underlying key Shariah principles. This is also to provide greater clarity to the international community thereby facilitating greater cross border transactions. An International Shariah Research Academy for Islamic Finance (ISRA) has also been established in 2008 to promote greater engagement among Shariah scholars from around the world and to undertake research activities and contribute towards a greater understanding and international convergence. In this respect, we welcome relevant British institutions to collaborate with I SRA to advance this endeavour.

Development of human capital in Islamic finance is also important to ensure an adequate supply of talent pool of experts and high calibre professionals. The investment in human capital development is therefore crucial to support the global development of Islamic financial services industry. Bank Negara Malaysia is committed towards promoting human capital development. Dedicated ancillary institutions such as INCEIF, IBFIM and ISRA have been established to focus on training, education and research. There has also been a higher degree of strategic alliance with British education and training institutions with our Malaysian institutions to advance the talent development for the Islamic financial services industry. In this respect, I am pleased to note that we will today witness the signing of a number of strategic collaboration between leading British institutions and Malaysian education and training institutions.

Let me conclude my remarks. The increasing awareness and appreciation of the inherent strengths of Islamic finance and its tremendous potential for advancement have ignited interests amongst the global financial community to venture into this new sphere of finance. Taking advantage of the increasing role of Islamic finance in bringing together different parts of the world with surplus funds in search of investment opportunities, with those that have financing needs, will increase these mutually reinforcing prospects. We look forward to London's participation in this new financial evolution.