

Zeti Akhtar Aziz: Legal issues in the Islamic financial services industry

Speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the 4th IFSB Seminar on Legal Issues in the Islamic Financial Services Industry, Kuala Lumpur, 28 September 2009.

* * *

It is my great pleasure to speak at this 4th IFSB Seminar on Legal Issues in the Islamic Financial Services Industry that has brought together so many international experts and industry practitioners to discuss legal issues in Islamic Finance. Such dialogue is important to achieving a common understanding and solutions to issues in Islamic finance, thus contributing to its overall development.

Islamic finance has continued to expand and demonstrate its resilience in the current more challenging international financial environment. This advancement has been in terms of the increased range of Islamic financial products and services, the development of the Islamic financial infrastructure and institutions, the greater maturity of the Islamic financial markets and the more comprehensive supporting legal and regulatory framework. More recently, the international dimension of Islamic finance has gained significance with the move to further liberalise domestic Islamic financial system and the strengthening of the international Islamic financial architecture.

In Malaysia, Islamic banking assets at the end of the second quarter of this year, now constitutes close to 19% of total banking assets. Total financing now amounts to RM118 billion and accounts for 20.1% of the total financing portfolio of the banking industry. Net non-performing financing remains low at 2.4%. Islamic securities has also maintained its dominance in the Malaysian bond market, accounting for 58% of total bond market. And almost two thirds of the equity market comprises Shariah compliant securities. Growth has also been experienced in the takaful sector in which the funds asset has registered an increase by 8.2%. This recent decade has also seen the increase in number of Islamic financial institutions including full-fledged Islamic banks, development financial institutions that engage in Islamic banking, takaful, re-takaful and capital market intermediaries. Several of these players have strategic partnerships with foreign players. In April this year, as part of the liberalization initiatives announced, new mega Islamic banking licenses and up to two family takaful licenses will be issued this year. On the global front, Islamic financial assets are projected to grow to **USD1.6 trillion** by 2012 while the global sukuk outstanding valued to date at approximately **USD152.8 billion**.

In the third series of this seminar in 2007, the vital role of a strong legal and Shariah framework in the sustainable development of Islamic finance was extensively discussed. It is key to providing certainty and predictability to financial transactions. The current international financial crisis has demonstrated the importance of recognizing that the rapid transformation of the functioning of the international financial system had to be accompanied by the need to ensure that regulatory and legal framework was aligned with these developments. The relevance of legal framework is essential to providing certainty and predictability to the financial transactions and to the innovative products, thus promoting public confidence in the financial system. This is equally important for the Islamic financial services industry in which this recent decade has seen a rapid evolution in terms of the innovation and in terms of its expansion.

Indeed, a robust legal framework in Islamic finance instills public confidence in the Islamic financial system, provides an enabling platform for practitioners to develop more innovative and complex financial products to meet the increasingly multifaceted consumer demands. In addition, it provides the mechanism for dispute settlement that takes into account the distinct features of Islamic financial transactions. This is where the legal services industry has a vital

role in providing sound legal solutions in Islamic finance. It therefore provides an important "bridge" between Shariah and legal parameters, thus enabling the operationalisation of Shariah principles into legally enforceable Islamic finance practices. In addition, by ensuring that the legal parameters are in compliance with Shariah parameters and the regulations, it also becomes a risk mitigator.

The legal aspects in Islamic finance represents an important "bridge" between the governing Shariah principles and the practice of Islamic finance. The application of Shariah principles in the light of the governing laws and regulations in each Islamic financial transaction are interpreted through legal advice, in legal documentation of the financial transactions, and dealing with disputes. In documenting financial transactions based on specific Shariah principles that underlie a financial product, the legal documentation reflects the tenets of Shariah and that it is in full compliance with the laws and regulations governing the financial transactions. Varying interpretations of Shariah in particular between countries adds to the complexity when cross-border transactions are involved.

From a domestic perspective, more jurisdictions are considering a central Shariah Council as the ultimate decision making body on Shariah matters. Across jurisdictions, there has been greater engagement thus bringing about increased convergence. Mutual recognition of the interpretation of Shariah principles across countries will contribute to the sustained growth of Islamic finance.

To promote consistent application of Islamic financial contracts in Malaysia, Bank Negara Malaysia has issued "Shariah Parameters" aimed at promulgating a standard point of reference on Shariah for Islamic finance practitioners. The Shariah Parameters outline the main Shariah requirements in the contracts and provides examples, methods and models for practical application of such contracts. The first Shariah Parameter on Murabahah that was recently issued aimed to promote consistent interpretation and application of Shariah views and opinions on Murabahah contracts.

In providing legal services, the industry has an important role of bridging the Shariah parameter with the legal parameters of the Islamic financial contracts. This is in particular important in preparing the legal documentation of Islamic financial transactions so as to avoid ambiguity, inconsistency and to avoid the risk that the legal document be considered void by a court of law on the grounds of contravention with Shariah.

Islamic financial transactions have their own unique risk characteristics that need to be managed. Risk areas that are unique to Islamic finance transactions include the legal risk of losses due in the event of lawsuits and non-compliance with relevant laws, the risks associated with non-compliance of Shariah principles and the fiduciary risk arising from failure to perform contractual obligations based on the underlying Shariah principles. The introduction of new, more innovative and complex products and financial transactions enables the disaggregation and repackaging of risks in ways that has not been explored. Shariah advisors would require the collective expertise including legal practitioners, to identify and understand the permissibility of a given structure. Islamic financial institutions in turn would need to address the attendant implications.

In view of the importance for Islamic finance to be supported by a robust legislative framework, the new Central Bank of Malaysia Act 2009 explicitly codifies the duality of the Malaysian financial system which shall consist of the Islamic financial system and the conventional financial system. This statement of law is supported by a comprehensive legal framework already put in place for the regulation of Islamic finance in Malaysia, encompassing the banking, takaful (Islamic insurance) and Islamic capital market industries. The legal recognition of the distinct features of Islamic financial transactions and the availability of a dispute settlement mechanism capable of applying these distinctive features reduces the legal risks as well as risk of non-compliance with Shariah principles.

Institutional structure that is determined by the legal and administrative framework is the first pillar of competitiveness. The ability to execute financial transactions efficiently, with

sufficient certainty and enforceability, and a clear process for resolving ambiguities and possible breaches of the contract will enhance competitiveness, both at the institutional level as well as for the financial system as a whole. In Malaysia, Islamic finance disputes are adjudicated in civil courts and not the Shariah courts where the jurisdiction is limited to matters relating to Muslim individuals. If the dispute concerns a point on the ascertainment of Shariah, the courts and arbitrators are required to refer to the Shariah Council at Bank Negara Malaysia to facilitate the ruling. The Shariah Council's authority is the ultimate body responsible for Shariah in banking and financial matters that is within the purview of Bank Negara Malaysia. This referral system provides an enabling platform for preserving consistency and predictability in interpretation and application of Shariah principles for financial transaction in Malaysia.

Concluding remarks

Allow me to now conclude my remarks. The inherent strengths of Islamic finance amid the global financial crisis has heightened interest in Islamic finance across the world. The level of innovation, scale and complexity of Islamic financial transactions is also increasing at a tremendous pace. Going forward, it is envisaged that the legal services in Islamic finance will become even more significant in the continued advancement and efficiency of Islamic finance.

In this regard, your thought leadership in addressing the legal issues embedded in Islamic finance holds important element in the continued growth of the Islamic financial services industry. Here, I would like to take this opportunity to congratulate the Islamic Financial Services Board for organizing this timely seminar. I trust it will continue to be a constructive platform for the legal and industry practitioners to deliberate on effective and pragmatic solutions to the legal issues in Islamic finance. On this note, I wish all of you a productive and successful seminar.