

## **Zeti Akhtar Aziz: Islamic finance – a central bank's perspective**

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Seminar on Islamic Finance "Islamic Finance: A Central Bank's Perspective", Bank of Italy, Rome, 11 November 2009.

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While not being here in person, most certainly I am here in the commitment to this conference on Islamic finance, organised by Banca d'Italia, to speak on the subject of Islamic finance from the perspective of a Central Bank. As the international financial markets and the global economy recover from the repercussions of the financial disruptions and dislocations that have occurred in the major financial systems, there have been wide ranging proposals to strengthen the foundations for financial stability, and reviews of the existing institutional arrangements in the international financial system.

Despite this more challenging environment, the expansion of Islamic finance as a viable form of financial intermediation has gained momentum demonstrating its viability and resilience. The rapid growth and development of Islamic finance essentially reflects its ability to meet the changing pattern of demand by consumers and businesses, its ability to remain competitive and its ability to withstand a more challenging environment.

More recently, the international dimension of Islamic finance has gained significance as it transitions from being domestic centric to becoming increasingly more internationalised. There is now increased international participation in Islamic financial markets in the different jurisdictions and more Islamic financial institutions are having presence or strategic interests in several jurisdictions. This trend has resulted in increased cross border financial flows.

My remarks this morning will focus on three aspects of Islamic finance that is of interest to Central Banks. The first relates to the financial stability of the Islamic financial system and to highlight the sources of stability that is derived from the inherent elements of Islamic finance and the regulatory and supervisory framework that has been developed to deal with emerging risks that are specific to the Islamic financial system. The second relates to the role of the Central Bank in developing the Islamic financial infrastructure, including the international Islamic financial architecture.

The third aspect concerns the implications of the increased internationalisation of Islamic finance and the potential for greater interdependence thus requiring more effective surveillance and cross border coordination to ensure financial stability across jurisdictions.

### **Intrinsic value propositions of Islamic finance**

The strengths in Islamic finance are derived from the principles of Shariah that require financial transactions be accompanied by an underlying productive economic activity thus resulting in a close link between financial and productive flows. This requirement reduces the prospect for over-exposure to risks associated with excessive leverage and imprudent risk taking.

Fundamental to Islamic finance is the profit and risk sharing which explicitly requires the appropriate due diligence and ensures that the profit is commensurate with the risks. The risk associated with the real investment activity is therefore explicitly integrated into the financial transaction. There is thus an explicit emphasis on the economic viability of the underlying assets and on good governance, ethics and transparency. It is these very elements of Islamic finance that provides an in-built mechanism that enhances the prospects for its soundness and stability.

As Islamic finance evolves to meet the changing requirements of businesses and consumers, innovation is integral to the development of new Islamic financial products and services. It is recognised, however, that unfettered financial innovation can become a major source of instability. In Islamic finance, innovation must be tested against the objectives of the Shariah, where the primary objective is the realisation of benefit to the people. This demands the internalisation of Shariah principles in Islamic financial transactions, both in form and substance. Indeed, Shariah-based innovation brings with it a Shariah-compliant culture in the Islamic financial institutions that serves to ensure that the product development process incorporates ethical value propositions.

### **A central bank's perspective**

From a Central Bank's perspective, ensuring financial stability of the Islamic financial system is the paramount objective. Integral to the efforts in the development of Islamic finance, is therefore, the strengthening of the regulatory and supervisory framework. The Islamic Financial Services Board (IFSB) which was established in 2002 has been instrumental in developing and issuing global prudential standards and guiding principles for the industry. This has included capital adequacy requirements, to governance and risk management standards. The IFSB has also contributed to the harmonisation in the development of Islamic finance across different jurisdictions.

While the basic legal, regulatory and supervisory framework that takes into account the distinctive features of Islamic finance are already in place, efforts are now underway to put in place a comprehensive infrastructure to deal with the new challenges confronting the international financial system. Looking beyond the current crisis, an integrated crisis management framework will be part of this infrastructure. It is recognised that a more facilitative and modernised legal framework is also required and that the boundaries of the regulatory framework for Islamic finance would also have to be regularly adapted to keep pace with the evolution and transformation of the financial system. Finally, the supervisory framework for Islamic finance is also being reinforced by a financial safety net framework that comprises the lender of last resort facility and a deposit insurance system. These financial arrangements are now in place in Malaysia.

Also important are the institutional arrangements for resolution of troubled Islamic financial institutions. In Malaysia, we have in place a mandated resolution mechanism to provide for expedient, effective and cost efficient resolution of Islamic financial institutions. Yet to be put in place however, is a mechanism for cooperation between regulators within and across jurisdictions for resolution to contain potential systemic risks beyond the national boundaries. In 2008, the Taskforce on "Islamic Finance and Global Financial Stability" was formed by the Islamic Development Bank (IDB) and the IFSB, together with the industry leaders and international expertise to examine further the building blocks in the Islamic financial infrastructure that need to be put in place to ensure financial stability.

Among the areas covered by the report are for the effective implementation and enforcement of the prudential standards and the supervisory framework, and the recommendation for the establishment of a Financial Stability Forum to address issues of financial stability in the Islamic financial system.

In Malaysia, the Islamic financial system operates in parallel with the conventional financial system. In such a dual system attention needs to be given to avoid the potential for regulatory arbitrage that may result in distortions that undermines the environment of a level playing field between conventional finance and Islamic finance. The development of the legal and regulatory framework for Islamic financial services industry is therefore grounded on the principle of neutrality in ensuring no worse off treatment when compared to conventional finance in terms of the taxation, laws and regulations.

Equally important in the building of the financial infrastructure is the development of the Islamic financial markets. Malaysia has now developed a comprehensive Islamic financial system that includes the banking and takaful industry, other specialised financial institutions and the Islamic money and capital markets. The supporting financial infrastructure includes a robust regulatory and supervisory framework reinforced by the legal and Shariah framework, the payment and settlement systems, the development of the pool of expertise and talent to support the industry.

The sukuk market that is, the Islamic bond market is fast emerging as the most significant form of financing that continues to receive strong interest as a means for raising funds and for investment. The global sukuk market has been increasing at an average annual rate of 40 percent, with 90 percent of the issuances by the corporate sector. In Malaysia, the issuance of sukuk has now surpassed the issuance of conventional bonds. Strong demand for sukuks have also come from the high savings economies including from Asia and the Middle East. As a new asset class, it has generated demand from both conventional as well as Islamic financial investors. The sukuk is therefore not only an attractive instrument for investment but it is also a competitive means for raising long term funding needs.

### **Strengthening synergies between financial centres**

Two important trends have increased the integration of Islamic finance into the international financial system – the accelerated development of the Islamic financial markets and increased liberalisation. The development in the Islamic financial markets has contributed to the availability of a wide spectrum of Islamic financial instruments that has ranged from instruments to manage liquidity, to structures for financing of mega investments. The higher level of foreign participation in the Islamic financial markets which has resulted in the increase in cross border flows in the international Islamic financial system thereby, enhancing international financial linkages between financial systems. Liberalisation has also brought greater foreign institutional presence in Islamic financial systems resulting in greater diversity of players and strengthening further the international financial linkages.

Malaysia has very much been part of this process. In 2003, the Islamic financial system was liberalised to allow for increased foreign presence. In 2007, the sukuk market was liberalised to allow the raising of funds by eligible corporates from any part of the world in any currency. And this year, the first foreign currency sukuk of USD1.5 billion was successfully issued by our petroleum corporation with a significant over subscription by investors from Europe, Middle East and Asia.

As the international dimension of Islamic finance gains momentum, it is necessary to facilitate the potential for liquidity management across borders. As part of an international collaborative effort, a Task Force on Liquidity Management was set up by the IFSB and the IDB early this year to develop solutions to enhance the efficiency of Islamic financial institutions in managing liquidity at both the national and international levels.

A further area of international collaboration is towards promoting value-added investment in human capital building as a long term solution to sustainable growth of the Islamic financial industry. The establishment of talent development and research institutions in Islamic finance are now increasingly wide spread in several jurisdictions with several strategic alliances across borders being entered into. The International Centre for Education in Islamic Finance (INCEIF) in Malaysia was set up by the Central Bank with programmes for practitioners and post-graduate studies to ensure the continuous supply of talent in Islamic finance. The current enrollment in INCEIF are from more than 60 countries attracting students including from the UK, Canada, France and Japan and Korea and the Middle East.

Equally important to innovative development is a deeper understanding of Shariah and knowledge of Islamic finance and for a greater convergence in the theoretical understanding and practical considerations in resolving the contemporary issues faced by Islamic financial

industry players. In this regard, a platform has been established for active engagement and intellectual dialogue among global Shariah scholars, practitioners, regulators and academicians. As the global economy becomes a more interconnected and interdependent, the process of greater convergence of financial standards and mutual recognition of products is also facilitating the international integration of Islamic finance across different jurisdictions.

### **Concluding remarks**

Let me conclude my remarks. While the inherent strengths of Islamic finance have contributed to its viability and resilience, going forward the foundations for its sustainability as a competitive form of financial intermediation continues to be strengthened. Concerted efforts are underway focusing on the further development of the Islamic financial markets, the financial infrastructure, the investment in research and development to support innovation, and enhancing further the legal, regulatory and supervisory framework.

An important part of the developments will be to facilitate a more inclusive arrangement that would allow for greater interface and inter-linkages across jurisdictions, in particular from emerging economies. As part of this process, building and strengthening linkages between financial systems will contribute to this process. Indeed, participation with the European financial systems will form an important linkage between the East and the West. In our pursuit and commitment to strengthening the resilience of Islamic financial industry and to enhance these linkages would not only have the potential to contribute towards global financial stability but also to the prospects for global growth.

Thank you.