Muhammad Bin Ibrahim: Convergence and sustainable growth of Islamic finance in a dynamic environment

Keynote address by Mr Mohammad Bin Ibrahim, Deputy Governor of the Bank of Malaysia, at the Asia Islamic Banking Conference: "Convergence and sustainable growth of Islamic finance in a dynamic environment", Kuala Lumpur, 5 July 2010.

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I would like to thank the organisers for inviting me here today to give the opening address at this inaugural Asia Islamic Banking Conference themed "Convergence and sustainable growth of Islamic finance in a dynamic environment". This event is timely as the Islamic finance industry continues to grow and expand in several financial centres around the world. Since the first Islamic financial institution was established over four decades ago, Islamic finance has evolved into an industry that has now gained global recognition, transforming its role from an enabler to a driver of economic growth, offering consumers with diversity of financial solutions to meet not only the Shariah requirements but also financial needs. This evolution has been evidenced in many parts of the globe, originating in Asia and the Gulf Corporation Council (GCC) countries, and spreading to the centers in Europe and Africa.

In Malaysia when Islamic finance started three decades ago, the initiative offered simple banking solutions that encourage savings and financing. The products were structured in a manner that is in line with Shariah principles and easily understood by the public at large. Today, Islamic finance in Malaysia is a dynamic industry that is widely regarded as a competitive alternative to conventional financing solutions. There are now diverse local and foreign players in the market, showcasing their dynamism with a wide array of innovative financial products and services on offer. Islamic banking now comprises 20% of the total banking sector, complemented by a vibrant Islamic capital market, where 55% of outstanding domestic private debt papers are sukuk, representing the largest volume of sukuk issuances globally.

Dynamism is most evident in the Islamic capital market where now there are many varieties of sukuk being structured and issued, including exchangeable, convertible and hybrid sukuk. Recent developments have also seen Shariah compliant hedging instruments such as the Islamic profit rate swap being introduced in the market. These products are able to compete with conventional bonds by offering superior value proposition to their issuers and investors.

At the international level, we are also seeing significant progress being made in the development of Islamic finance. There are more and more institutions offering Shariah-based financial services being established today to tap on the opportunities in this fast-growing industry. This includes the participation from global conventional banking giants. The participation of established financial centers such as London and Hong Kong has further reinforced the trend of internationalisation in Islamic finance. Similarly, emerging new markets, from both Muslim and non-Muslim countries, have also identified Islamic finance as a key growth sector with the potential to contribute significantly to their respective economies, with some positioning to become established as new financial centres of the industry in their own right. All these developments are creating a dynamic environment for the global Islamic finance industry.

Despite the fact that there are now greater appreciation of Islamic finance leading to the heightening of global interest in the industry, owing to the strength of its embedded value proposition as demonstrated by the relatively resilient performance of Islamic financial institutions during the recent financial crisis, we must continue to take steps to reinforce the prospects for sustainability of the industry in this new development phase of global expansion and cross-border inter-linkages. Today, I would like to touch upon two key imperatives, firstly in promoting convergence and harmonisation, and secondly, the transition to a more industry-led development, and how these can be major drivers pushing the industry towards greater internationalisation and achieving sustainable growth and continued development of Islamic finance.

In offering Islamic financial services, institutions are bound by a common thread in Islamic finance, where all transactions must be in congruence with Shariah. However, differences in opinion on the application of Shariah in financial products across markets have often been pointed out to be a major issue which could hinder a more robust expansion of Islamic finance internationally. Notwithstanding the desire for more standardisation, we should be mindful not to suppress the generation of alternative point of views which could be the seeds to innovation and breakthroughs in the marketplace. We need to transform the differences of Shariah views into competitive strengths for the industry. History had shown that diversity in opinion had led to the great Islamic civilisation. We should take recognition of this lesson in history. I therefore would like to suggest that the international Islamic financial community to subscribe to the fundamental principle of unity in diversity. Healthy debate and dialogues amongst Shariah scholars must continue and prosper. However, we must always make a conscious effort to keep an open mind, a tradition that was even espoused and practised by the Prophet (s.a.w.), so that generation of good ideas would emerge from vigorous, even at times heated intellectual debates. Over and above this requirement for openness and dialogue, we should not lose sight of the greater themes that will unite rather than divide. We should be open enough to amplify agreements rather than divergences.

We can agree that complete convergence is neither practicable nor achievable, as Shariah also recognises differences in customs and cultural practices between various societies. Also, the use of *'urf*, the methodology through which customary practices are recognized, enables different societies to function smoothly and efficiently, provided they are not antithetical to the principles of Islamic law of transactions. *'Urf* in Islamic law refers to the general opinion or customs of a community, and forms the basis for rulings issued by a *mujtahid or a group of mujtahids*, who has attained the right to exercise *ijtihad*, which is an important part of the process of making a Shariah ruling.

Historically, *'urf* played a crucial part in business development in Islam during the time of the Prophet (s.a.w.). I shall briefly summarise the story on *salam* contract to illustrate this point. In the Islamic law of transactions, the general rule is that parties are not allowed to contract with each other where subject matter is non-existent to avoid anything that can lead to *gharar*, or uncertainty, which can result in one party benefiting at the expense of the other unfairly. This rule is based on a *sunnah* of the Prophet (s.a.w.) that states "Do not sell things that you do not own."

This was the practice adopted in Mecca, a city of trade where such contracts were not difficult to construct and physically tangible goods were plentiful in supply. Medina, though, was a city of agriculture where typically the produce would not always be available at the time of the contract. The practice called *salam*, a forward sales contract, was customarily used so that farmers could sell their produce to be delivered at an agreed later date in exchange for advanced payment which would be used as capital to cultivate land and grow crops. The Prophet (s.a.w.) recognised the need for this practice in the economy of Medina, and allowed the people to continue practising salam transactions. Today, *salam*, and by extension *istisna*', are important contracts in modern Islamic financial transactions and are now widely used in the structuring of financial products such as sukuk.

Clearly, there is wisdom in recognising *'urf* to accept the permissibility of various practices that may not be commonplace between different societies, but which are required to ensure that the livelihood of communities is not disrupted. Greater engagement and dialogues among Shariah scholars are therefore indispensible as platforms through which Shariah scholars can discuss differences in financial practices, legal frameworks, operational requirements, taxation, cultural differences and other issues pertinent in other jurisdictions. Through this process, scholars shall become more appreciative of the many differences in business and economic environments that might lead to different Shariah interpretations. A more thorough understanding of such matters will also lead to better co-operation between the scholars and industry practitioners and preserve the sanctity of the Shariah principles, resulting in more well-informed opinions and better quality financial products and services.

However, as the market continues to evolve, the need for market harmonisation will continue to grow. This is understandable as markets desire certainty and simplicity in engaging business. It is therefore encouraging to see that, based on recent developments, there appears to be an increasing movements towards combining efforts in establishing internationally acceptable standards. A commendable example of this concerted effort towards standardisation is the recent global master agreement on Islamic hedging, also known as the *tahawwut* agreement, launched in March 2010 by the International Islamic Financial Market (IIFM) and the International Swaps and Derivatives Association (ISDA). To pave the way towards greater standardisation in the marketplace, the Master *Wakala* Agreement For Deposit was recently signed by the Malaysian and UK Islamic banks in November 2009 to provide alternative tool for deposit placements and provide the industry with an increased choice in risk management instruments. Malaysia had also earlier launched the first global Islamic derivatives master agreement (IDMA) in 2007 to develop hedging tools for the Islamic financial markets to manage investment risks. This was followed by the Interbank *Murabahah* Master Agreement (IMMA), which was signed in August 2009 by Malaysian Islamic banks, designed to facilitate effective risk and liquidity management through Shariah-compliant deposit placements using the commodity *murabaha* concept.

Moving forward, recognising the need to introduce standards which are acceptable and applicable to the Islamic finance industry, Bank Negara Malaysia is committed to undertake research to develop Shariah Parameter References, which are aimed at achieving convergence and harmonisation of Islamic financial practices. These references are being developed together with local and international Shariah boards, industry practitioners, academicians and other relevant parties to ensure the completeness in the documentation. The first Shariah Parameter Reference on Murabahah contract was released in 2009, while several concept papers have been issued on Mudharabah, Ijarah and Musharakah before the final release of these references in the foreseeable future.

Such important efforts to generate greater harmonisation in Islamic finance will enhance market efficiency particularly in terms of accelerating the product development cycle and improving time to market, as well as to produce acceptable benchmarks of quality in terms of products, services, processes and practices against which Islamic financial institutions must aim to match or exceed. With this objective in mind, the overall Islamic finance industry stands to benefit from commonality of practices leading to lower operating costs and the potential set up of shared industry wide platforms, all of which are important considerations for Islamic financial institutions to achieve economies of scale and interoperabilities across institutions and national economies.

This brings me to my next point.

Ladies and gentlemen, the development of Islamic finance industry in many jurisdictions has thus far been largely led by governments and regulators. Whilst this is expected in the earlier phases of Islamic finance development, a pragmatic transition into the next phase of development in an increasingly globalised environment would require more corporate or private-led efforts amongst industry players, particularly in leading initiatives of promoting convergence and harmonisation of Islamic financial practices. In the case of Malaysia, initiatives by the government and regulators through more than three decades of development have already provided a comprehensive enabling environment for the Islamic financial institutions to now take the lead. In this time of globalization and greater liberalisation, Islamic financial institutions must be forward-thinking and leverage on their extensive experience to secure first-mover advantage in tapping into opportunities across borders, particularly in new markets seeking to develop Islamic finance. I believe that the future holds better prospects for Islamic finance with greater internationalisation of business beyond domestic centric operation.

Going forward, we can expect for more leadership from the Islamic financial institutions in making the paradigm shift to promote industry development initiatives and to become less government led and more market driven. This calls for more efforts among industry players to increase cooperation, establish more strategic alliances and build closer relationships across borders in various fields. For instance, Islamic financial institutions must come together and drive the initiative to develop the industry's own internationally acceptable code of conduct and standards of Islamic financial practices that should work to complement efforts by Bank Negara Malaysia in developing the Shariah Parameters References.

As Malaysia's Islamic finance industry continues to grow and expand beyond domestic boundaries, our Islamic financial institutions are well positioned to initiate and lead efforts in converging different organizations' financial practices to establish uniform standards or instruments that may be applied across borders. These areas span from accounting, legal and operational practices. Cross-border alliances by Islamic financial institutions in setting-up new business ventures would also facilitate knowledge sharing and the globalisation of Islamic business products and services. In this aspect financial market instruments that enable better allocation of resources in the international Islamic financial system need to be further enhanced and developed. This certainly needs to be supported by more international collaborative efforts in the area of research and development to provide the impetus for more innovation to take place and address global and contemporary issues of market and risk management practices. These initiatives are important for the industry to develop as it becomes more internationally integrated.

Conclusion

On that note, let me now conclude. Moving forward, converging Shariah views, where appropriate, and building greater linkages between industry players that are collectively driven by the private institutions are important to build on the momentum of industry development achieved thus far. The involvement of the private sector to drive development will lead to enhance the efficiency of Islamic finance and greater cross-border transactions. This would serve the aim to enhance international financial interlinkages and market participation between institutions and nations practising Islamic finance. In this endeavour, there is no doubt that it takes nothing less than steadfast commitment and collective will of all industry stakeholders. The time is now for us to take the leap to the next level of development. I hope that this conference will focus on specific initiatives that could lead to inter-market activities. Only when the various jurisdictions are linked as one, could we propel ourselves to the next phase of accelerated level of growth.