

Zeti Akhtar Aziz: The global Islamic financial market today – challenges and way forward

Luncheon address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the annual “The Asset Triple A Awards for Islamic Finance”, Kuala Lumpur, 6 July 2010.

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It is my great pleasure to be here this afternoon on this occasion of the Annual “The Asset Triple A Awards for Islamic Finance” by the Asset Publishing and Research, to deliver some remarks on the key challenges and way forward for Islamic finance in the international financial system. Islamic finance has experienced its most rapid pace of development in this decade demonstrating its competitiveness and resilience as a form of financial intermediation. While the Islamic assets are now more than US\$1 trillion, it is estimated that the global Islamic finance industry will reach the US\$2 trillion mark in the next three to five years.

The sukuk market has become the most significant and vibrant segment in the international Islamic financial system. Issuers are seeing the sukuk instrument as an attractive alternative means for raising capital, whilst investors are increasingly seeing it as a new asset class in their investment universe. This has generated significant cross-border flows as funds are raised from beyond domestic financial markets and as investors diversify their portfolios into assets from other jurisdictions. The sukuk market currently stands at almost US\$130 billion, with a growth rate of about 40 percent annually. Despite a challenging environment, new issuance of sukuk in the global sukuk market rose by 43 percent to US\$20 billion in 2009. However, developments in Europe resulted in a more cautious market and the global sukuk issuance declined by about 20 percent in the first half of this year. In the coming period, this trend is expected to improve as the Governments in Asia and the Middle East have already initiated the raising of funds for the implementation of infrastructure development and investment projects.

This extensive interest in Islamic finance from different parts of the world is driving the international dimension of Islamic finance. This has contributed to the strengthening of financial and economic linkages between the more established financial centres of the Western world and the newly emerging financial centres in Asia and the Middle East. This has thus contributed to the more efficient allocation of funds across borders from centres with surplus funds to regions with investment opportunities. It has also allowed for more inclusive participation regardless of size and stage of development. Islamic finance now provides the range of financial products and services to multinational corporations, to micro enterprises and to households while at the same time, facilitates financing of international trade and cross border investment activities.

This recent decade has also seen significant milestones being achieved in the area of international financial infrastructure that supports the development of Islamic finance. The Islamic Financial Services Board or IFSB, established in 2002 as an international prudential standard setting body for Islamic finance, now has a membership of 50 regulatory authorities. It has developed prudential standards ranging from capital adequacy requirements to standards for governance and risk management. There has also been the development of degree programmes and professional qualifications in Islamic finance that are now being offered by major institutions of higher learning and training organisations from around the world. More recently, conscious efforts to initiate platforms for greater engagement among practitioners, scholars and regulators have brought about greater convergence and standardisation of Shariah interpretations and thus enhancing the potential for product harmonisation which has in turn supported greater cross border transactions in Islamic finance.

Challenges faced by the Islamic financial industry

During this same decade, despite enjoying rapid growth, Islamic finance has also experienced its most challenging period. Today we face an environment of financial uncertainties and economic turmoil. The global economy and international financial system has been shaken by a series of unprecedented financial meltdowns in the international environment. Much has been said and documented about the financial mess that the crisis has created. Unprecedented policy responses were initiated to stabilise conditions. Now, significant steps are being taken by the international community to reform and strengthen the international financial system. The aim is to build the foundations for a stronger international financial system and global economy that is built on the premise of sustainable growth and a greater shared prosperity. This global resolve is in congruence with the role and relevance of Islamic finance on the global economic environment in this post-crisis era.

While the amount of funds managed in the Islamic financial system is still only a fraction of the total assets of the international financial system, it represents that portion of financial activities that is truly supported by underlying productive capacity that connects with the real economy. Despite the unprecedented disruptions in the international financial system, studies show that the Islamic financial industry has weathered the global financial crisis relatively well. The financial crisis has thus brought about a greater appreciation amongst the international financial community on the distinct nature and in-built strengths of Islamic finance. Based on the Shariah requirement that Islamic financial transactions needs to be supported by an underlying economic activity, its expansion contributes to income and wealth creation. In addition, the profit sharing and risk sharing characteristics in Islamic finance strengthen the incentives for the financial institutions to ensure the profits are commensurate with the risks being assumed. It is this form of finance that we would want to encourage.

With this underlying foundations, efforts are being directed to build the domestic financial infrastructure. A challenge that is being specifically addressed is the development of an active secondary global sukuk market. In this regard, there has been a lack of trading in the secondary market especially in the USD sukuk market as the investors tend to buy-and-hold the instruments until maturity. This is largely due to the scarcity of the instruments in the market. In Malaysia, the growing ringgit sukuk market has resulted in an active secondary market. This is largely due to the regular and varied issuances throughout the year. This is supported by the investment in research and development and in talent development to ensure the availability of expertise in the structuring of sukuk instruments and in sukuk documentation. Having the potential to innovate new instruments will depend on having the necessary talent. This is an area of focus in Malaysia to develop the skills, expertise and capability. The Islamic financial system in Malaysia now offers a wide range of financial products and services that are competitive and able to meet the changing requirements of the domestic and global economy.

Way forward for the global Islamic financial system

As we advance forward, we need to recognise the forces of change and the transformation taking place in the international financial system and global economy. Relentless efforts have been initiated to reform the international financial system by the international community to address the weaknesses that have contributed to the recent crisis. In this environment, Islamic finance needs to continue to evolve to remain effective and competitive.

The Islamic financial system does not exist in isolation and will continue to develop as an integral part of the global financial system. As part of efforts to ensure sustainability in this new and more challenging environment, a Task Force on Islamic Finance and Global Financial Stability was formed by the Islamic Development Bank (IDB) and the Islamic Financial Services Board (IFSB). The report, which was completed in April this year, sets out eight areas that need to be further strengthened to bring the Islamic financial system to a

higher level of performance in this new economic and financial order that is emerging. A recommendation of the report is the establishment of an Islamic Financial Stability Forum (IFSF) based at the IFSB as a strategic platform for productive dialogues to promote financial stability in Islamic financial system. The IFSF would also be a platform for the Islamic financial system to interface with the conventional system via the Financial Stability Board to facilitate the common objective of achieving global financial stability.

To enhance the efficiency of the Islamic financial institutions, a solution is currently being developed to facilitate liquidity management at both national and international level. A Liquidity Management Task Force was established by the IFSB and the IDB to develop this solution. This task force is expected to make key announcements later this year to facilitate cross border liquidity flows for efficient resource utilisation by Islamic financial institutions.

Islamic finance has come a long way and is set to continue its trajectory upwards and onwards. An important aspect of the recent developments to strengthen Islamic financial services industry is that this is being undertaken during the stable and good times. This will position Islamic finance to deal with future challenges. A clear indication of that is the growing relevance and importance of the sukuk market. This event in Kuala Lumpur is commemorating the talent, expertise and the successes of the Islamic financial community.