

Mohammad bin Ibrahim: Islamic finance and Malaysia's role

Luncheon address by Mr Mohammad bin Ibrahim, Deputy Governor of the Central Bank of Malaysia, at the 21st Conference of Presidents of Law Associations in Asia: "Islamic Finance and Malaysia's Role", Kuala Lumpur, 27 July 2010.

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Allow me to express my thanks to the organizers for inviting me to this 21st Conference of the Presidents of Law Associations in Asia. It is my pleasure to speak before such a distinguished gathering of legal practitioners from all over Asia on the topic of Islamic finance. The support provided by the legal fraternity has been important in the advancement and significant growth of the Islamic finance industry. The existence of appropriate laws and well-developed related institutional framework has been fundamental to the orderly and sound development of Islamic finance in Malaysia. And our legal community has been at the forefront of advancing the expertise in Islamic finance, enabling and contributing to the dynamism of our Islamic financial services industry. The contribution of the legal fraternity has been significant given that Islamic financial transactions are driven to some extent of the lawyers' ability to structure legal documentation to conform and consistent with the principles advocated by the Shariah.

It has now been more than three years since the world's financial systems were engulfed with a crisis of an unprecedented magnitude in modern history. Yet its far-reaching repercussions continue to reverberate around the world today. Whilst we in Asia, backed by the strong fundamentals of Asian economies and swift stimulus measures, were able to rebound quickly and lead the world into recovery thus far, recent developments surrounding the ongoing sovereign debt crisis in several advanced economies have sparked fresh concerns which could imperil global growth, derailing the road to a more robust global economic recovery. This unsettling financial environment prompts a reminder that fundamental changes are gravely needed in the global financial sector.

Much effort in making these changes are still taking place at various international fora, with most have largely centered on reforming financial regulation and supervision. Beyond regulatory and supervisory reforms, there is an increased global emphasis for effective, efficient and responsible financial intermediation that promotes economically, socially and environmentally sustainable development and long-term growth. It is now generally accepted that the overriding objective of global development must be founded on genuine and productive arrangements, leading to the path of sustainable growth and shared prosperity. Islamic finance is well positioned to meet this objective. Malaysia's long and experienced journey in Islamic finance and the various measures that were put in place attest to our commitment in pursuing well-rounded growth and development for the nation. Today, Islamic finance forms part of the overall financial services industry that has proven to be an instrumental engine for driving economic growth for our economy.

Let me now briefly recap the evolution of Islamic finance in Malaysia. Our journey officially began with the establishment of the first Islamic bank in 1983 and in the year that followed, the first Takaful operator. We have never looked back since then to evolve a comprehensive domestic Islamic financial system operating alongside the conventional financial system, comprising the Islamic banking institutions, the takaful industry, the Islamic money and capital markets. These respective components have been progressively liberalized over the years, allowing for more foreign presence in the market to become internationally more integrated. This has led to diversity in market players, and the increased competitive forces now provide the impetus for increased innovation in the market. The dynamism in the market has been supported by a robust regulatory and supervisory framework, reinforced by the legal and Shariah framework, the payment and settlement systems. Our Shariah framework in particular is distinctively robust, through the consultative role of the Shariah Advisory

Council of Bank Negara Malaysia and Securities Commission, complemented by the Shariah board of individual Islamic financial institutions. This strategy has served us well, as it had nurtured innovation whilst ensuring stability in the marketplace.

Collectively, the strategies that we had adopted have brought about significant progress on several fronts, in the areas of institutional structure, diversity of players, operational efficiency and the wide range of products and services. Several global players have chosen Malaysia as their regional base for Islamic finance. Our sukuk market in particular has come a long way since the issuance of the first global sovereign sukuk by Malaysian Government in 2002. Today, it has evolved into the world's largest Islamic bond market, accounting for more than fifty percent of global sukuk issuances in the first half of 2010. It has attracted the participation of various foreign corporations, multinational corporations and multilateral agencies in raising funds and investing in issuances out of Malaysia. In the latest development, Japan's biggest brokerage house has recently listed its first US Dollar sukuk on Bursa Malaysia. The strength and competitiveness of our sukuk market in bridging and strengthening financial linkages thus best encapsulates Malaysia's evolving role as an important international gateway in Islamic finance, particularly in linking the two most dynamic growth regions of South East Asia and the Middle East. Malaysia is committed to, and extensively engaged in, strengthening linkages across borders through Islamic finance. This emerging role is a natural progression of Malaysia's leadership evolution in driving growth and innovation in the industry.

Benefiting from our domestic experience, where we have come to recognize the strength and benefit of Islamic finance early on, Malaysia has taken a proactive role in supporting and contributing to the development of Islamic finance on the global front. We offer a well-developed and complete platform for the global financial community to participate in Islamic finance through the development of Malaysia as an international Islamic financial centre (MIFC). We also recognize the fact that the global business community of Islamic finance needs to grow in order for the broader global community to benefit from its value proposition, as only then can its growth potential be fully harnessed. With this in mind, Malaysia actively engages the global community to develop Islamic finance together by sharing our experience and providing the technical know-how on the industry. Deriving strength from our progress and achievement on the domestic front, Malaysia offers a workable model of development which can be deployed not only in other traditional Muslim countries, but also in other centres seeking to work together in developing a specific segment of the market. Indeed Islamic finance has now entered a new phase of development, where participants and businesses have become more internationalized.

Another priority in facilitating global integration of the Islamic financial system which is high on our agenda is in ensuring Malaysia's continued active and meaningful role in contributing to the development of supporting international Islamic financial infrastructure. Since Malaysia's involvement in the pioneering group of countries that led to the formation of the Islamic Financial Services Board (IFSB), the international prudential standard-setting body which Malaysia has the honour of hosting, we have continued to support the important work of the IFSB including through our active participation in its various projects. Our support continues through the work of the Taskforce on Islamic Finance and Global Financial Stability, jointly formed by the IFSB and the Islamic Development Bank (IDB), whose recently completed work has led to the establishment of the Islamic Financial Stability Forum (IFSF), which is yet another important international platform for the regulators around the world to deliberate and collaborate on initiatives towards maintaining financial stability in the Islamic financial system.

And last but not least, Malaysia has been at the forefront to support global growth and development of Islamic finance through capacity building endeavours, focusing on the two key areas of human capital development and catalysing greater harmonisation of Shariah interpretations. The availability of talents who are skilled in both the financial and Shariah fields have been essential in invigorating innovation and dynamism of Islamic finance in

Malaysia. This is reflective of our long-held conviction that sustainable growth of Islamic finance could not be achieved without adequate attention to the development of intellectual resources. It is out of this conviction that Malaysia has committed resources to support the broadening horizon of growth in country and beyond, through the deepening of knowledge and competence among financial practitioners and Shariah scholars within the industry. For this purpose, Malaysia has established the International Centre of Education in Islamic finance (INCEIF) to support advanced education in Islamic finance, while, the International Shariah Research Academy (ISRA) was founded to promote *research* and rigorous intellectual dialogue among Shariah scholars and practitioners on Islamic finance.

Let me now turn to the development of our legal framework, which has been one of the key factors contributing to the competitiveness of Islamic finance in Malaysia. Our legal infrastructure consists of effective regulatory and substantive laws, as well as dedicated adjudicative platforms to undertake legal redresses arising from disputes revolving around Islamic financial transactions. The legal infrastructure in Malaysia evolved in different phases over the years. Our initial focus was to establish dedicated enabling substantive laws for Islamic finance, such as the Islamic Banking Act 1983 and Takaful Act 1984. The enactment of these laws provided the platform for separate regulatory framework for the industry and importantly, established the foundation of the Shariah governance framework through two key provisions. These are the requirements imposed on Islamic banks and takaful operators to ensure that their business aims and operations are Shariah-compliant and the need to form separate Shariah board within their respective institutions. Our experience has shown that dedicated laws governing institutions authorised to conduct Islamic finance are critical elements in instilling and maintaining public confidence in the system.

After establishing the necessary legislative measures to establish a more conducive environment for Islamic finance to thrive, the next phase was aimed at creating the critical mass which was essential to develop Islamic finance in Malaysia. Amendments were made to the Banking and Financial Institutions Act 1989 to allow the conventional banks to operate Islamic windows which brought about new players in the industry. At this stage we also saw the establishment of the National Shariah Advisory Council (SAC), the highest authority on Shariah matters related to Islamic Finance. A tax neutrality policy was introduced for Islamic financial instruments and transactions which has benefited our players, consumers and the development of Islamic finance as a whole. The policy, which was later emulated by many countries around the world, ensures neutrality to tax treatment between Islamic and conventional financial products and services, a move which enhances the attractiveness of Islamic financial products as competitive alternative to conventional banking.

The most recent development of Malaysia's legal infrastructure for Islamic Finance was the enactment of the Central Bank of Malaysia Act 2009. Our Central Bank of Malaysia Act accords formal recognition to the dual financial system practised in Malaysia and our mandate to develop Malaysia as an international financial centre. The Act formally recognizes the SAC as being the highest authority on Shariah issues related to Islamic finance transactions, and the role of the SAC as a consultative body to the Malaysian judiciary system. Most critically, SAC's rulings are binding on the courts and arbitrators. This referral system preserves the sanctity of Shariah rulings and the consistency in the interpretation and application of Shariah principles for Islamic finance transactions in Malaysia.

For adjudication purposes, a dedicated judge in the commercial division of the High Court has been assigned to preside over litigated cases on matters relating to Islamic finance. Specific arbitration rules for Islamic banking and financial services have also been enacted to compliment the court system and enable disputes relating to Islamic finance to be dealt by the Kuala Lumpur Regional Centre for Arbitration. This infrastructure is unique to Malaysia and reflects the support and cooperation from the legal fraternity to keep up with the development of Islamic finance. Importantly, a supportive judicial system helps create an

environment where players and consumers are able to execute financial transactions efficiently, with sufficient certainty and enforceability.

In recent times, we have witnessed a number of legal disputes involving Islamic Financial transactions that have been brought to the common law courts for settlement. These recent cases tried in the English courts have highlighted the hesitancy on the part of the common law judges to deliberate on issues concerning Shariah principles in Islamic finance transactions. This is quite understandable given the lack of expertise on the matter. While evidence on Shariah matters can be admitted from subject matter experts but such evidence or advice is not binding. The scenario in Malaysia is different. We have a dedicated High Court for Islamic finance related cases and our judges shall refer to the SAC for questions or rulings relating to the Shariah and these rulings are binding. Malaysian courts, therefore are well equipped to uphold the sanctity of the Islamic financial contracts as they have the avenue to make references. They have the capability to preside over such cases and give firm, consistent decisions with the backing of SAC rulings.

As part of our collaborative effort to expand human capital development initiative, measures are being made to ensure that players within the industry including judges and lawyers are trained in Islamic finance. Moving forward, with the existence of a dedicated court, competent human capital and consistent legal precedents, our courts and arbitration centre are well qualified to serve as a platform for adjudication and dispute settlement.

The development of the requisite facilitative legal infrastructure is continuing. It is an ongoing and dynamic process. In the early phases of development, Malaysia had looked into the legal impediments that might hinder Islamic finance. What lies ahead is to harmonise existing laws such that it accommodates and facilitates Islamic finance in the most legally efficient way possible. These laws are not confined to those under financial services acts but to all Malaysian laws. As the future of Islamic finance depends on its agility and innovativeness in developing new products, our laws have to be facilitative and contemporary. Countries that intend to promote Islamic finance must also have laws that are clear and easily enforceable. In this respect, having common laws, or a reference point for laws on Islamic finance, would serve to benefit the industry worldwide.

To this end, we are pleased to announce the formation of a Law Harmonisation Committee. This committee comprised members from among key government stakeholders, including the Attorney General's Chambers as well as industry players and experienced Islamic finance legal practitioners. We are also pleased to announce the appointment of Tun Abdul Hamid bin Mohamad, the former Chief Justice who is also a member of our Shariah Advisory Council, to chair this committee. We will be engaging with the industry and general public for feedback on the laws which require harmonisation. Further details will be announced in due course. The underlying objective in having this Law Harmonisation Committee is to position and strengthen existing laws as the laws of choice for Islamic financial transactions. It is also consistent with our objectives to create an enabling environment that facilitates and accommodates the development of the industry, a clear and efficient system that preserves that enforceability of Islamic financial contracts and a credible and reliable forum for settlement of legal disputes arising from Islamic financial transactions.

The support provided by the legal fraternity to Islamic finance has been instrumental to the progress of the industry. Crafting legislation to facilitate the growth and development of Islamic finance requires dedication and skill, and the ties that have since developed between lawyers, regulators, Shariah scholars and industry practitioners, have inevitably blossomed into a strong relationship based on mutual understanding and close co-operation. Going forward, it remains crucial for this close collaboration to continue so that more pioneering progress can be achieved in paving the way towards greater international integration and expansion of the Islamic finance industry. Towards this end, the legal practitioners should work together to create a network to foster its development. This might involve the setting up

of a specific association of international groupings of Islamic finance legal practitioners working together towards harmonisation of practices at the international level.

Thank you.