

## **Zeti Akhtar Aziz: Islamic finance – new frontiers in financing the economy**

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the EU-Malaysia Chambers of Commerce and Industry's (EUMCCI) Quarterly Financial Panel Discussion 2012 "Islamic finance – new frontiers in financing the economy", Kuala Lumpur, 8 March 2012.

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In this new phase of globalisation in which economies and financial systems are increasingly becoming more interconnected, we are seeing the emergence of several new trends in trade and investment flows. While there has been a slower expansion in world trade and investment flows in the aftermath of the global financial crisis, cross-border trade and investment activities among emerging economies have been increasing significantly. Asia is very much part of this changing pattern in world trade and investment activity. In Asia, strong domestic demand, supported by resilient financial systems and well developed financial markets have well intermediated these international flows.

The most pressing challenge confronting the current global economy is to generate growth and employment. It is particularly important for the crisis-affected economies that growth resumes and is sustained, while addressing fiscal imbalances, public and private sector over-indebtedness and the financial sector impairment, the solutions to which will most likely result in slower growth. While supportive domestic policies will thus be necessary to support the growth, also important is the potential growth that can be gained from trade and investment with other parts of the world.

For the countries in the ASEAN region, the partnership with the EU region has expanded steadily over time, and has continued to evolve and strengthen. There is significant potential to expand such trade and investment links between both the EU and ASEAN regions. Global corporations, including the EU and ASEAN multinational corporations (MNCs), have contributed to maximising the mutual benefits from such relationships. In Malaysia there are currently more than a thousand multinational corporations from more than 30 countries. Many are from the EU region. Initiatives that continue to lower the barriers between our respective regions are also set to strengthen the growth of such strategic partnerships.

It is my pleasure to be here at this Quarterly Financial Panel Discussion, organised by the EU-Malaysia Chamber of Commerce and Industry, to speak on the role that Islamic finance might have on facilitating greater trade and investment between our regions. Islamic finance, which was previously domestic-centric, is now increasingly providing financial solutions for cross-border trade and investment. Progressive liberalisation has facilitated the internationalisation of Islamic finance. This has been reinforced by the dynamic pace of innovation in Islamic finance that has widened the range of financial products and services. Islamic finance has thus become an increasingly important channel for the efficient allocation of funds across borders and the diversification of risks.

### **Islamic finance: financial solutions for international business**

Despite an increasingly more challenging environment, Islamic finance has continued to expand its potential as a sustainable and stable form of financial intermediation. Its emphasis on the close link between financial transactions and economic activity has positioned Islamic finance to be well-anchored to serve the real economy. The adoption of profit- and risk-sharing, transparency and disclosure, and the universal ethical values of fairness which is implicitly embedded in the Islamic financial system provides the internal checks and

balances. Embraced in its entirety, it enhances the prospects for sustainable economic growth and financial stability.

The resilience of the Islamic financial system is also further strengthened by the international prudential standards and best practices that have now been introduced. These include the standards issued by the Islamic Financial Services Board since 2002 in the areas of capital adequacy, risk management, governance, and the conduct of business and supervisory process. The industry is also guided by international accounting standards that have been developed by the Accounting and Auditing Organisation for Islamic Financial Institutions since its establishment in 1990. In enhancing liquidity management in the Islamic financial system, the International Islamic Liquidity Management Corporation (IILM), which was established in 2010, is putting in place the mechanism that will facilitate effective liquidity management solutions through the periodic issuance of short-term Shariah-compliant financial instruments.

As the Islamic financial system transitions to becoming more diversified and comprehensive, it provides the spectrum of financial solutions that meet the different needs of the economy. Such financing products offered in Islamic finance also include syndicated financing, equity financing and venture capital. There are also a wide range of investment and treasury instruments, as well as fund and wealth management products for the management of portfolios of businesses. In terms of takaful, there is also a broad range of products, including takaful coverage for physical properties and assets of businesses, as well as protection for employees.

The growing significance of the international dimension of Islamic finance in this recent decade has witnessed its increasing role in bridging economies through the mobilisation and channelling of funds to productive investment activities across borders. Despite the challenging global environment and the increased uncertainties, the Islamic finance industry has continued to experience the double digit growth of 21 percent, and total Shariah-compliant assets have surpassed the USD1 trillion mark. There are now more than 600 Islamic financial institutions operating in more than 75 countries in both Muslim and non-Muslim jurisdictions. The emergence of new financial centres in Asia and the Middle East and their increased connectivity has strengthened the foundations for intra- and inter-regional linkages in trade and investments.

More recently, Islamic finance is also being introduced in the EU region. The establishment of Islamic finance in key financial centres, namely London and Luxembourg, presents opportunities for businesses in the EU to raise funds using Islamic financial instruments such as the sukuk, and to diversify investment portfolios with Islamic fund and wealth management products. The development of Islamic finance has also been initiated in several other European economies. Malaysia has entered into a number of collaborative arrangements in the areas of talent development and expertise, business linkages, and infrastructure development. To date, Malaysia has signed Memorandums of Understanding in the area of Islamic finance with the UK, France and Luxembourg.

The now well-developed existing Islamic financial markets, including the sukuk and Islamic money markets, have been particularly instrumental in intermediating funds in the Islamic financial system. It is fast becoming an important platform for international fund raising and investment activities that are generating increased cross-border flows. From an outstanding amount of USD33 billion in 2006, the sukuk market has expanded to USD180 billion as at end-2011.

The sukuk market brings with it many attractive value propositions for both issuers and investors. A central merit of the sukuk structure is that it is based on underlying assets that have an income stream. This therefore discourages over-exposure of the financing facility beyond the value of the underlying asset, given that the issuer cannot leverage in excess of the asset value. In addition, with the requirement that the financing must be channelled towards productive purposes, the risk exposure in sukuk is therefore to the project and not to

the uncertainties or activities that have no economic benefits. This element not only contributes towards financial stability, but also offers investors another asset class for investment.

The demand for sukuk currently exceeds the supply, as the high level of surplus savings in Asia and the Gulf region spurs the strong demand. Although the size of the market may seem modest by global standards, the sukuk market has been registering an average annual growth of 40 percent. The growth of the Islamic bond market in particular, in the current environment also reflects its cost effectiveness. An increasing number of multilateral agencies, Government agencies and the corporate sector including multinational corporations have relied on the sukuk market as a source for raising financing. In Malaysia, Shell MDS Sdn. Bhd. issued the world's first ringgit-denominated corporate sukuk in 1990, amounting to RM125 million. The issuance of a RM3.5 billion programme sukuk by TESCO Stores in 2007 witnessed the first sukuk issuance by a British owned MNC, while Toyota Capital Services, a Japanese MNC, issued a RM1 billion programme in 2008. There has also been a growing trend for multi-currency sukuk issuances in Asia, with the latest landmark issuance of the world's first renminbi sukuk issuance in 2011 being issued in the Malaysian market. These multi-currency issuances have attracted international investors to participate in this market.

As an asset class, there are now a wide range of structures, size and different maturities. Recent examples in Malaysia include the PLUS Berhad's issuance of a record size of RM30.6 billion or equivalent to USD9.7 billion programme, with maturities ranging from 5 to 27 years. This also facilitates the potential for diversification of portfolios. The Islamic capital market has also been an avenue for businesses to raise equity financing globally. Shariah-compliant corporations that are listed in major global Islamic stock market indices, such as the Dow Jones Islamic Market Indices and the FTSE Global Islamic Index, are able to enhance their profiles among the prospective investors, including those with inclination towards socially responsible investment. In Malaysia, similar listing opportunities are available through the FTSE Hijrah Shariah index and the FTSE Bursa Malaysia EMAS Shariah index for Shariah-compliant investment, that has been designed to provide a broad benchmark for investors that wished to invest in Shariah-compliant stocks.

Malaysia operates a dual financial system that comprises the conventional and the Islamic financial system. Businesses are able to select the financial offerings that best serve their requirements. While Malaysia has progressively liberalised our financial system, the liberalisation of the Islamic financial system has been at a more rapid pace. The motivation for this is to forge greater international economic and financial linkages. Liberalisation of the conventional sector has been more gradual and sequenced to ensure that the financial system promotes balanced growth while remaining stable and sustainable. The robust legal and regulatory framework, together with the availability of a large and diverse pool of talent and expertise in Islamic finance, forms the solid components in the system to meet the requirements of businesses.

There is also Shariah certainty in Islamic finance through a robust Shariah governance framework, which comprises Shariah committees at the industry level and the Shariah Advisory Council at the regulatory level. Malaysia's supportive framework and process for sukuk origination and sukuk listing also facilitates the issuance process of ringgit or non-ringgit denominated sukuk in our market. Efforts to deepen the sukuk market have provided significant opportunities for participation in this market, with the size of the Malaysian sovereign and corporate sukuk outstanding growing threefold from a total of RM120 billion in 2005 to RM353 billion as at end-2011. The market has also drawn the interest of foreign participation for their financing and investment activities. Key in the development of Islamic finance in Malaysia has been its progressive internationalisation and the introduction of more innovative Shariah-compliant financial solutions that meet the increasingly more complex and diverse international business requirements.

Let me conclude my remarks. In serving the needs of the real economy, Islamic finance offers a comprehensive and competitive solution in meeting funding and investment requirements of businesses. Given its international outreach and dimension, and ability to provide a total financial solution, Islamic finance is now at the frontier in which it presents new opportunities to support the economy and overall financial stability. Today's dialogue session would serve to provide a greater understanding and appreciation on Islamic finance and its potential for the intermediation of finances for international businesses.