

Zeti Akhtar Aziz: Building a comprehensive Islamic financial system - new financial opportunities

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Institute of Islamic Banking and Insurance's International Conference on Islamic Insurance, London, 26 September 2003.

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"Islamic banking and finance initially evolved as a form of financial intermediation for the Islamic community to conduct financial transactions that conform to Islamic tenets. Today, the Islamic financial industry has gained wider acceptance and appreciation and has expanded beyond the traditional borders of the Muslim-based economies into the major industrial economies to become an integral component of the global financial system. In a global environment that has become increasingly challenging, an environment that is subject to the powerful forces of change, and that is characterized by volatile and unstable market conditions, Islamic finance has emerged as a competitive and resilient form of intermediation. Although Islamic finance is still at the early stage of development, it has experienced rapid expansion and is fast emerging as a viable and robust form of financial intermediation with significant potential."

It is indeed an honour for me to be here today before a distinguished gathering of scholars, researchers and practitioners of the takaful industry. I wish to take this opportunity to congratulate the Institute of Islamic Banking and Insurance for their efforts in organizing this international conference on Islamic insurance or takaful. The takaful industry represents an important component in the overall Islamic financial system given its role in the mobilisation of long-term funds, its role in providing risk protection, its role in the development of the Islamic capital market and as an important institutional investor, as well as its role in supporting the overall economic growth and development. Our challenge is thus to evolve a dynamic and vibrant takaful industry within the Islamic financial system. Of importance is the development of an Islamic financial system that is dynamic, responsive and sustainable.

The development of an Islamic financial system needs to include the respective components comprising the Islamic banking industry, the takaful industry, the Islamic capital and money markets, given the strong linkages, interdependence and synergies among these components in the system. The spectrum of participants and the diversity of instruments are among the key attributes in creating the enabling environment for a dynamic Islamic financial system. This has been the approach adopted by Malaysia at the very onset of our journey in the development of a comprehensive Islamic financial system that is progressive and sustainable.

In the initial stage during the early years of the development of the Islamic financial system, our focus of attention was on the development of the Islamic banking system and to expand the number of players and volume of activity. Following the introduction of the dual banking system, the pace of expansion increased significantly. In two decades, the total assets of the Islamic banking industry have increased from USD97 million at the outset to USD20 billion as at end-June 2003. Similar expansion also took place in the takaful industry whereby the assets have increased significantly from less than USD30 million in 1993 to USD1 billion in June 2003. The Islamic capital market in Malaysia also recorded significant growth whereby the outstanding Islamic private debt securities accounted for USD17.8 billion, or 65% of the total outstanding private debt market while the new issuance of Islamic private debt securities in the first eight months of 2003 amounted to USD1.7 billion. What is more encouraging is that more than one third of the new issuance of Islamic debt securities were issued by companies owned by non-Muslims, some of which includes multinational companies.

The evolution of an appropriate financial structure would need to take into account the role of the financial system in the economy and the objectives that need to be achieved. In the context of an emerging market economy, the financial system is a means to an end. The appropriate financial structure, particularly in emerging market economies, need to be designed to meet the requirements of the economy. The financial system needs to be in a position to support the real sector, changing and evolving with the changing needs of the economy. The strategy adopted in Malaysia is to develop a comprehensive Islamic financial system that is able to operate in parallel with the conventional financial system.

The key constituents within the Islamic financial system, which includes the Islamic financial institutions as well as the capital and money markets need to be firmly reinforced by the legal and regulatory framework that adequately address the unique characteristics of the industry. These intra-dependent key components ultimately form the enabling environment for the Islamic financial services industry to effectively play its role as an efficient conduit for mobilising resources and channelling them to productive purposes. The absence of any one of the components could reduce the effectiveness and efficiency and could affect the viability and sustainability of the system.

While the Islamic banking system plays an important role in mobilizing deposits and providing financing, the development of the capital market allows the corporate sector to source their long-term financing needs based on Islamic principles. In addition, it would increase the range of Islamic financial instruments available to meet the demand of the Islamic investors. In the absence of a comprehensive Islamic financial system with financial services based on Shariah principles, the development of Islamic banking and finance would be hindered.

The government would need to assume an important role in the development of the Islamic financial system. The role of the government is, amongst others to provide the enabling environment and put in place from the outset, the necessary infrastructure through the formulation of a comprehensive set of legal and regulatory framework for Islamic banking and finance. In addition, this framework needs to be reinforced by a Shariah framework to ensure that all financial transactions are Shariah-compliant. Islamic financial operations would thus need to be based not only on best practices, but also satisfy the tenets of the Shariah.

For Islamic banking and finance to be sustainable, compliance with Shariah principles alone is not sufficient. Over the long run, customers and businesses demand for quality in the products and services that Islamic finance offers. This is the challenge for Islamic banking and finance, to be able to provide a comprehensive range of Islamic financial products and services that are not only innovative and competitive but Shariah compliant.

Let me now turn to the development of the takaful industry. Takaful as a system of Islamic insurance, is based on co-operation and mutual help for the good of the society at large. Although takaful has been in the market for more than 20 years, it has yet to make significant inroads. It should however, be noted that although the conventional insurance market is deeply entrenched in several of the Muslim countries, the percentage of the Muslim population that are insured is relatively low. The market penetration level is very low, notably less than 5 per cent in many Muslim countries. In Malaysia, the level of market penetration in terms of takaful certificates in force over the total population is only 3.8 per cent compared to a market penetration for conventional insurance of 34.7 per cent. It therefore represents an enormous potential market that remains yet untapped.

Takaful operators assume an important role as economic or financial agents as they essentially mobilise long-term funds in the form of contributions and invest them in the available Islamic investment avenues. As custodians of public funds, takaful operators must ensure that the takaful funds are invested in compliance with Shariah and are soundly managed to instil public confidence.

For the takaful industry to be developed into a viable alternative to the more entrenched conventional insurance industry, the need for it to be supported by the core components of a comprehensive Islamic financial system cannot be over-emphasised. As takaful operators are both mobilizers of long-term funds and fund managers to the policy holders, their ability to generate returns to fulfil the obligation to the policy holders depends very much on the range of financial instruments available in the market place.

Without an effective financial system, takaful operators may not be able to perform as effectively and as efficiently in terms of delivering their promise on the profit sharing basis and to be able to keep pace with their conventional counterparts in the area of fund performance. In the absence of a viable Islamic capital market, there would not be an adequate supply of quality financial instruments for which the takaful funds can invest. It may have to depend on low yielding returns from bank deposits. In addition, it will not be able to offer innovative products like investment linked products, which can further diversify their investment portfolio as these products are gaining popularity among conventional insurance companies. In the absence of an Islamic banking system, takaful operators would not be able to synergise and utilise the network of the banking system through bancassurance which can not only be an effective distribution channel but also serve to drive down operating costs.

The development of a comprehensive Islamic financial infrastructure in Malaysia that includes Islamic banking, the money and capital markets has reinforced the development of the takaful business.

Today, the takaful industry in Malaysia has emerged as a fast growing industry within the insurance sector since its introduction in 1985, 18 years ago. From total assets amounting to only USD0.5 million in 1986, it has reached more than USD900 million in 2002, constituting 5.2 per cent of the total assets of the insurance sector. In the same period, the takaful operators have offered a wide range of family and general takaful products.

The Malaysian Financial Sector Master Plan represents the blueprint for the development of the financial sector over a 10-year period. The plan, which was launched in 2001, places importance on the development of Islamic banking and takaful sector as an important component in the financial system. To achieve this objective, emphasis is being given to financial infrastructure and institutional development, aimed at enhancing efficiency of the system and building the internal resilience and competitive position of the takaful operators, while meeting the needs of the nation. This includes providing the foundations for the development of the financial markets and strengthening the institutional development. As part of this process, the benchmarking exercise is an important tool to enhance performance and to guide the takaful operators on improvement of their business strategies. To reinforce this, a service quality index has also been initiated to promote the development of world-class products and services. This is also complemented with a comprehensive consumer education programme so as to promote product transparency and increase accountability. The introduction of financial advisers is also a further element to facilitate consumer access to a wider range of financial products.

Amongst the most imminent challenges is the creation of the critical mass in the market to allow for meaningful cross-border alliances at the regional and global level. The establishment of an adequate number of takaful operators in the market is also crucial to provide the groundwork for the setting-up of more retakaful operators, in terms of sustaining business support and providing the economies of scale in order for the retakaful industry to develop.

Currently there is still a dearth in the number of players providing the retakaful facility, resulting in takaful operators ceding to conventional reinsurers. While this has become a common practice, ideally more competitive retakaful operators who provide reinsurance in accordance with Shariah principles need to be established so that the takaful industry would not be dependent indefinitely on conventional reinsurance as the conduit to which they can mitigate risk. More importantly, retakaful operators ultimately serve to strengthen and enhance the financial capacity of the takaful industry, and the synergistic by-products emanating from the interactive business alliances would contribute towards the overall betterment and robustness of the Islamic financial system. Indeed, there is much to be gained by the takaful operators in particular, and the Islamic financial industry in general, by having access to an adequate and competitive market of the retakaful facility. It is therefore important to increase the collaborative efforts and examine plausible ways to address this gap in the takaful industry.

Our quest to create a dynamic Islamic financial system is to achieve the ultimate objectives of developing an Islamic financial system that will be able to contribute significantly to the overall development of our economy through the intermediation process. Thus, Islamic banking and finance industry needs to extend its agenda towards the development of a comprehensive Islamic financial system. The Islamic banking and finance should strive to add value towards enhancing greater integration to the economy and the financial system. To harness the potential fully, genuine endeavours to develop and innovate Islamic financial instruments and activities that are able to fulfil the changing requirements of the economy and the emerging needs of the contemporary global marketplace need to be continuously pursued. Conferences such as this can contribute invaluable ideas to foster new initiatives towards the development of the Islamic financial system. With the acceleration of its global integration, it will provide the synergies and opportunities for the Islamic financial industry to evolve into an important component of the international financial system that can contribute to enhance prospects for balanced global growth and an enhanced shared prosperity.

On that note, I wish you a successful Conference. Thank you.