Zeti Akhtar Aziz: Ensuring stability in the Islamic financial system

Speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the 3rd Annual Islamic Finance Summit, London, 13 January 2004.

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I. Introduction

"In its nascent history spanning three decades, Islamic banking and finance has undergone rapid growth and transformation. From an industry striving to fulfil the religious obligations of the Muslim community, it is now a multi-billion dollar industry driven by well-defined business considerations and profit optimisation, whilst steadfastly upholding the Islamic principles. Indeed, this progress has been achieved against a challenging global financial and economic environment. The further development of Islamic finance requires for it to be endowed with the right pre-requisites that will ensure the evolution of an intermediation system that is viable, resilient and sustainable. Of essence, is the timeliness to develop an Islamic financial industry that is comprehensive and sound, that promotes financial stability and growth through the robustness of its regulatory framework, the dynamism of its inter-connected markets, the strength of its financial infrastructure and the responsiveness and sophistication of its products and services."

It is my honour to be invited to speak before this distinguished audience at this 3rd Annual Islamic Finance Summit organized by Euromoney. In the development of the Islamic financial system, significant attention has been given to ensuring financial stability. Several initiatives have been taken to promote financial stability in the Islamic financial system and thereby strengthen its foundations. My address this morning will focus on these initiatives. Allow me to also take this opportunity to share with you Malaysia's experience in this endeavor.

II. Current trends in the international financial landscape

The international financial landscape is constantly being reshaped and transformed by the rapid pace of globalisation, financial liberalisation and the advances in technology. Globalisation has manifested itself with the geographic expansion and consolidation of financial establishments beyond national boundaries and the massive flow of financial resources across borders. This has unleashed a greater volume of resources through the financial system, increasing the importance of the financial sector. These trends have been reinforced by the advances in technology, which has radically changed the way we do business and the structure of markets and their dynamics in the national and global economy. This has resulted in an environment in which businesses, markets and economies are becoming internationally more integrated and inter-dependent.

Financial liberalisation and deregulation of the financial services industry has also resulted in increased competition and the proliferation of new financial products and services. Also, the business operations of global financial conglomerates now span over multiple jurisdictions. Against these developments, regulators have reassessed existing prudential rules and have adopted a consolidated supervision framework to prevent regulatory gaps that could become a source of systemic concern.

While deregulation of the financial sector has expanded the range of opportunities, it has also increased the incidence of instability in the financial markets. Heightened uncertainties and greater volatility in financial markets have required greater attention on building more robust risk management capabilities. Greater investments have gone towards refining risk quantification techniques to enhance the overall risk management framework. There is also greater emphasis on risk management in the new international regulations such as in the Basel II capital framework. Maintaining relevant financial data and information has also become more important, and has resulted in large investments to enhance data mining and IT capability.

While the global financial markets have become increasingly sophisticated, unstable market conditions and the failure of large financial institutions have prompted more stringent regulatory requirements and increased transparency. The message is that integrity and transparency is critical for financial institutions to gain public and investor confidence. In response to a number of high-profile corporate failures, there has also been a review of international accounting standards and practices to address inadequacies in the existing standards. In some countries, independent oversight committees/public boards have been formed to establish auditing standards and to impose new rules on auditing quality control and auditor independence. The trend is, therefore, towards improving the value of financial reporting and increasing the overall level of transparency.

The 1997 Asian financial crisis also resulted in a reexamination of policies and practices. This has prompted extensive financial restructuring and reform to strengthen domestic financial systems. Five years after the crisis, the financial systems in East Asia have emerged significantly strengthened and demonstrated greater resilience.

III. Pre-requisites to a stable Islamic financial system

Despite a more challenging environment, the development of Islamic finance as a viable form of financial intermediation has moved forward. It is while Islamic finance is still at its early stage of development that the opportunity has been taken to strengthen its foundations and put in place the pre-requisites that will pave the way for its development and safeguard the stability of the system.

Not only has closer attention been given to the supervisory, regulatory and legal dimension but also to the development of the financial infrastructure and the markets as well to institutional development. In essence, the prudential regulatory design has been complemented by concurrent efforts to develop Islamic financial markets, the Islamic institutions and the financial instruments. Allow me to highlight the key areas that are important to this objective.

First, effective regulatory and supervisory framework

The hallmark of a well-developed financial infrastructure is an effective legal, regulatory and supervisory framework which would underpin the stability of the financial system. The regulatory and supervisory function is an indispensable and vital component of the financial infrastructure. For the Islamic financial system, this framework also needs to be consistent with the requirements of the Shariah principles, including the establishment of a Shariah council, which provide assurance that the strategic direction, the formulation of policies and the conduct of financial transactions are in compliance with the Shariah principles. This would need to be supported by an efficient court system that can effectively deal with all Islamic banking and finance cases, whose decisions are enforceable over the range of financial issues such as contracts, bankruptcy, collateral and loan recovery all of which are essential for businesses to operate. The legal framework should also deal with supervisory issues, including the relevant regulatory agencies involved in the supervision of Islamic financial institutions and encompass the licensing and conduct of Islamic banking business. The relevant agencies should have clear responsibilities and objectives to ensure effective financial supervision.

While the conventional banking system is guided by the Basel core principles which outlines the minimum requirements for the supervisory regime, these principles need to be reviewed from the perspective of Islamic banking, taking into account the unique characteristics and risks involved in Islamic banking and its products and services.

A fundamental issue is the setting of prudent and appropriate minimum capital adequacy requirements for Islamic banks. Such requirements need to reflect the risks that the banks undertake. The framework devised would need to incorporate fundamental Islamic concepts. The principle of Mudharabah, for example, creates a class of depositors that can also be construed as quasi-shareholders. Similarly, risk weights assigned to individual asset components need to reflect the nature of inherent risks involved. It is not as straightforward as a debtor-creditor relationship in conventional banking but also needs to include other inherent risks arising from the investor-entrepreneur relationship that is inherent in Islamic banking.

Islamic banking operations therefore need to be governed by its own standards and best practices in parallel with the international best practice. The establishment of the Islamic Financial Services Board (IFSB) in 2002 as an international prudential standard-setting body to promulgate the international regulatory and supervisory standards for Islamic financial institutions is aimed towards achieving this objective. In this regard, the IFSB has already made progress in developing the prudential standards on the capital adequacy and risk management framework. These standards are expected to be completed in 2005. In addition, the IFSB will commence work on developing standards on corporate governance.

At present, some countries have adopted the Basle Accord standards in their regulatory and supervisory framework for their Islamic banking industry. However, these standards do not adequately address the requirements of Islamic banking operations and transactions, resulting in gaps in the standards. Therefore, these gaps will be taken into account with respect to the capital treatment and risk associated for the different types of Islamic financial contracts to truly reflect their features and characteristics.

While certain products in Islamic finance by their nature may not attract capital, the Islamic financial institutions need to have a more rigorous risk management systems in managing the funds placed under this arrangement. In this regard, the risk management standard needs to specifically address this concern. The Islamic financial institutions can expect to be better regulated and supervised following the adoption of the standards to be issued by the IFSB. The IFSB will also have a prominent role in facilitating the streamlining of the standards covering the cross-border supervision issues including the home-host supervisor issue.

Since its establishment just over a year ago, the IFSB has attracted a wide participation. To-date, there are 13 full members, 3 associate members and 20 observers in the IFSB. This encouraging development demonstrates the keen interest towards the orderly and sound development of Islamic banking and finance. The wider participation which also includes several international and regional multi-lateral agencies will facilitate the consultation process and the adoption of these standards. Another important role to be played by IFSB is in the harmonization of the different Shariah interpretations towards a more universally accepted practice. These positive developments are expected to bring about a more robust regulatory and supervisory framework for the Islamic financial institutions to promote financial stability in the system.

Second, existence of strong corporate governance

It is also recognised that good corporate governance reinforces sound regulation and supervision. It contributes towards maintaining market confidence, and strengthening transparency and accountability. Its emphasis is to be value-oriented and promote fairness and justice with respect to all stakeholders of the banking institution. For corporate governance to work, good corporate practices need to be instilled and embedded in all aspects of the operations and at all levels within the organisation.

Indeed, Islam strongly advocates all forms of positive governance. These values and ethical conduct have already been in built and are inherent in the community. Islamic corporate governance serves through its underlying principles of economic well-being of the Ummah, universal brotherhood, justice, accountabilities and equitable distribution of income. Therefore, while the virtues of Islam have always advocated good corporate governance, the challenge to us lies in its application. For Islamic banking institutions, good corporate governance should have already been embedded in all aspects of their operations.

Closely linked to the corporate governance issue is the role of market discipline. Central to the effectiveness of the corporate governance arrangements is the empowerment of shareholders. This would mean providing the conditions under which shareholders have both the incentive and the means to act to discipline Management. The market for corporate control is an important way in which shareholders exercise, in effect, an ultimate discipline over bank Management on the premise of allocating capital where sound management is practised.

Third, greater transparency and disclosure of information

Transparency and disclosure is essential particularly in a rapidly changing environment. While the comprehensive and timely availability of financial information will increase market discipline, the disclosure of information needs to be complemented with the ability of the market players to analyse, and appropriately interpret the information.

Closely related to this issue is the need to strengthen the framework for consumer protection to provide an avenue for redress due to lack of transparency. This is even more relevant in the multi-facet role played by the Islamic financial institutions in dealing with Islamic banking customers as the Islamic financial transaction is not merely based on the lender and borrower relationship as is the case in conventional banking. The move towards the adoption of the supervised market approach requires continuous efforts to enhance product disclosures and to elevate the level of financial literacy of consumers.

To further enhance transparency in the conduct of banking institutions, proper accounting standards need to be in place to reflect the true and fair value of banking operations that would lead to greater accountability and responsibility on the part of the banking institution. Accurate financial reporting requires a body of financial accountants that are well-versed in Shariah principles to ensure that the accounts are not only drawn in accordance with the international accounting standards but are also in line with Islamic principles. This is to enable the investors and supervisors to obtain the true and fair assessment of the Islamic institution's financial condition and the profitability of the business. Transparency and disclosure is even more crucial in Islamic banking where the concept of mudharabah (profit-sharing) entails an investor-entrepreneur relationship and is a significant element in sourcing of funds.

The establishment of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has made a significant contribution in formulating and issuing accounting and auditing standards for Islamic financial institutions. The standards issued by AAOIFI have contributed towards improved quality of financial statements and reporting methodology of Islamic financial institutions. AAOIFI has also issued standards on the role of the Shariah committee as well as the code of ethics that should govern the accountants and auditors of Islamic financial institutions. Efforts by AAOIFI have also accelerated the pace of transparency and corporate governance of Islamic financial institutions.

Fourth, risk management framework

Emphasis on improved corporate governance goes hand in hand with the need for improvements in risk management standards. Sound risk management practices will minimise adverse consequences faced by financial institutions during periods of uncertainty. Robust internal controls to provide qualitative standards are also necessary to complement the quantitative analysis of risk to provide a check and balance in the overall risk management practices.

Effective risk management systems is central to supervisory efforts. The risk management system in Islamic institutions need to be able to address the unique characteristics and attributes associated with Islamic financing operations involving financial contracts and instruments which may give rise to other risks besides credit risk. The risk management infrastructure needs to be in place to facilitate the identification, measurement, monitoring and control of all inherent risks present in all the various types of financing so that the specific risks involved may be 'unbundled'. The complexities of the respective risks in the Islamic financial instruments therefore need to be fully explored and quantified to provide for their effective assessment and management.

In the area of Islamic banking, the requirement to manage the risks becomes more important because of the unique peculiarities in the contracts. Basel II has, to a certain extent, incorporated some aspects in the identification of risks, in particular the credit, market and operational risks that can be assimilated by the Islamic banks in terms of its product offering. However, further refinement will have to be done by the Islamic financial specialists to assess the appropriateness of the capital definition in particular as outlined by the Basel committee. One of the considerations that need to be addressed in assessing the risks associated with the Islamic bank is with regard to the capital charge on its investment accounts. Basel II does not address this unique feature in its framework. Assets that are funded by monies in the investment account may not require the capital charge for the purpose of capital adequacy measurement except in the case of misconduct and negligence. Similarly, if the Islamic banking institutions were to be more engaged in the profit-sharing arrangement in its balance-sheets, it will require the Islamic bank to have a more rigorous risk management assessment and monitoring mechanism. This is an area that is being addressed by the Islamic Financial Services Board in the drafting of the standard on the overall risk management framework for the Islamic financial community that takes into account this unique requirement of Islamic banking.

While risk mitigation is desirable in Islamic finance, further improvements need to be made to the existing risk management framework. New hedging products which are scarce in the market need to be developed in the quest to seek for compatible risk mitigating products. In accordance with the principles Islamic the Shariah has allowed the Ummah to undertake juristic reasoning based on contemporary analysis and logical inference. Indeed, the development of new hedging products is something that the Islamic financial community can look forward to. In conventional banking, these instruments are used to mitigate risk. Indeed the Islamic financial community will soon develop such products for this purpose.

Fifth, effective and dynamic Shariah framework

One of the central issues towards developing a dynamic Islamic financial industry is the Shariah. The Shariah should always be viewed as an enabler to innovation and creativity, rather than a constraint. Efforts, therefore, need to be enhanced to fully appreciate and maximise the true potential and wisdom of the Shariah. The collaboration among the Shariah scholars, practitioners, researchers and regulators to undertake in-depth studies and research to create new products will provide the fundamental foundation towards the development of a dynamic Islamic financial system.

Sixth, development of comprehensive legal infrastructure

Another important pre-condition to sustain the continued growth of Islamic banking and finance is a comprehensive legal infrastructure for legal redress arising from Islamic financial transactions. The legal infrastructure needs to comprise both effective regulatory and substantive laws as weIl as appropriate adjudicative fora for parties to resolve disputes relating to Islamic financial transactions. To address this, efforts are needed to develop a sufficient number of competent lawyers and judges that are equipped with sound knowledge and expertise in both Shariah and civil laws to deal with such matters.

Seventh, development of vibrant Islamic financial markets

In the more developed financial centers, the development of inter-related financial markets has contributed towards the stability in the financial system. This is an area of priority for the Islamic financial industry. In this regard, the development of a comprehensive Islamic financial system including the various components of the financial markets would meet the requirements of the various differentiated groups. The challenge in the Islamic banking industry is, therefore, to steer the development of an Islamic financial system towards one which is more dynamic and responsive. The development of an Islamic financial system should include the key components comprising the Islamic money market and the Islamic equity and debt capital market, given the strong linkages, inter-dependence and synergies among these components in the system. Of importance is the Islamic money market to act as a platform to provide a ready source of short-term funding and investment. Financial instruments and interbank investment will allow surplus banks to channel funds to the deficit banks, thereby maintaining the funding mechanism necessary to promote stability in the system. The Islamic money market will also facilitate the conduct of monetary policy.

The Islamic financial system also needs to include the capital market to provide an alternative source of financing, as well as to create broader and more diverse Islamic financial instruments for investors. The equity and bond markets will provide a more balanced allocation of financial and economic resources. This would result in a more efficient distribution of risks within the system, thus creating stability in the system. The equity and bond markets would also provide an avenue for raising long-term capital. With a wider spectrum of instruments in the market, fund managers would be able to manage their portfolios better and spread their risk according to their desired risk tolerance, thereby contributing toward greater stability.

Complementing these financial markets is the development of non-bank Islamic financial institutions. Takaful, or Islamic insurance, provides the risk protection to its policyholders and serves as an important mobiliser of long-term funds. In addition, development financial institutions, savings institutions and housing credit institutions need to be developed to meet the diversified customer demands. These specialised institutions will meet the different requirements of the economy.

IV. Malaysia’s experience in the development and management of the Islamic finance

The strategy adopted by Malaysia has been to develop a comprehensive Islamic financial system. Malaysia started with the establishment of one Islamic bank to spearhead the introduction of Islamic banking products and services, and at the same time, identified the relevant financial segments that were required to support the expansion of Islamic banking activities. The Islamic financial system in Malaysia operates in parallel with the conventional system.

Following the establishment of Islamic banking was the establishment of takaful or Islamic insurance to provide the coverage for Islamic housing mortgages. As these two segments progressed, Malaysia expanded its implementation approach by allowing the conventional banking institutions to offer Islamic banking products and services on a window basis. To preserve the integrity of the system, firewalls between the conventional and Islamic funds were put in place. It was made mandatory for the Islamic banking operations in these institutions to be separated from the conventional banking operations, either electronically or through other designated means. This move created more players in the Islamic financial system and provided the platform for the establishment of a vibrant Islamic money market. The Islamic money market served as a platform for the Islamic financial institutions to manage their short-term portfolio adjustments. Recognising the importance of the capital market, Malaysia initiated the development of a private Islamic financial securities market in the early nineties.

The Islamic financial system today has emerged as an important component of the overall Malaysian financial system that contributes to the growth and development of the Malaysian economy.

Malaysia has also adopted legal reform, self-regulation and measures to encourage market-based regulation. New measures have been introduced to further improve the level of governance among banking institutions. This includes reviewing the responsibility and accountability of the Board and Management as well as requiring for the setting up of various Board committees. In the case of Malaysia, the High Court of Malaysia has dedicated high court judges to preside on litigated cases over matters relating to Islamic banking and finance. To undertake a holistic legal review, the Central Bank of Malaysia has set up a Law Review Committee to review the common law-based domestic legislations to assimilate the Shariah principles with the aim of removing any impediments to ensure the unhindered and efficient functioning of the Islamic banking and financial system. The Central Bank Act has also been amended to provide for the establishment of a Shariah Advisory Council at the Central Bank as the sole authority and reference on all Shariah matters pertaining to Islamic banking and finance.

The successful integration of these core components to become a comprehensive Islamic financial system has contributed towards a more active domestic Islamic financial intermediation process. To-date, Islamic banking has mobilised assets amounting to RM76 billion or 10 percent of the market size, of which approximately 70 percent of the Islamic banking assets were generated by the conventional banks with Islamic windows. In the takaful sector, the four takaful operators registered a total of RM4 billion in terms of assets. Significant progress was achieved in the area of Islamic money and capital market where the volume traded in the Islamic money market reached RM340 billion, while the outstanding amount of Islamic private securities was amounted to RM75 billion or 44 percent of the total outstanding private securities. In the stock market, more than 80 percent of the counters in the Kuala Lumpur Stock Exchange are Shariah-permissible counters. This year the Islamic banking sector will be liberalised to include up to three foreign Islamic banking institutions as the system becomes more integrated with the global financial system.

V. Positioning the Central Bank to meet the challenges ahead

My remarks on pre-requisites to a stable and comprehensive financial system would not be complete without a few words on the role of the central bank. To stay at the forefront in dealing with the new challenges and to effectively perform our responsibilities, the Central Bank’s efforts have also been focused on strengthening its capacities and capabilities.

Central Banks in emerging market economies have a much broader mandate than our counterparts in the more advanced and mature economies. Of importance, is our developmental role in charting the development of the financial system, institutional development and the overall economic management. This is over and above the objectives of achieving monetary and financial stability and ensuring the sound and efficient functioning of the payments system. The Central Bank also has the important role of developing the financial infrastructure, developing the financial markets, the legal framework and driving the institutional development. In Malaysia, our vision of the development of the financial sector over the next ten years is outlined in our Financial Sector Masterplan. The plan includes the strategic direction and strategies for the development of the Islamic financial sector.

Finally, greater cooperation among the regulators is necessary in order to ensure that the Islamic financial system is not subject to vulnerabilities and abuses. In this respect, sharing of information among the regulators including across borders is important especially in a more globalised and liberalised environment where financial transactions and activities have become more complex and globalised. In this regard, there is a greater need for regulators to continuously exchange views and share information on key issues and developments faced in their own financial jurisdictions.

Another important aspect is in regard to the development of the international Islamic financial market. Although this market is to be driven by the market players, a greater role is expected from the regulators and central banks to support its expansion. In this respect, the encouraging support shown by various regulators and central banks in making the launching and issuance of the sovereign sukuk papers a success represents an important progress that has been achieved. These initiatives will bring about a more coordinated effort in achieving market development and stability.

VI. Conclusion

Our quest to develop a dynamic Islamic financial system is to achieve the ultimate objective for Islamic finance that contributes significantly toward the overall development of our economies. This is achieved through the intermediation process to facilitate trade, business and investment. This will facilitate the integration of the Islamic financial system as a viable component of the global financial system.

It is the ability of the Islamic financial industry to build institutional capacity, intensify the collaborative efforts to strengthen the effectiveness of the Islamic financial infrastructure, and the acceleration of its global integration that 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 greater global financial stability and enhance the prospects for a more balanced global growth.