Zeti Akhtar Aziz: The future prospects of the Islamic financial services industry

Speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the IFSB interactive session, Bali, 31 March 2004.

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Our endeavour is to develop an Islamic financial system as an intermediation process that will contribute to overall wealth creation, growth and development and a greater shared prosperity. As the pace of globalization and liberalization accelerates, securing financial stability and confidence have increased demands for more robust and resilient financial systems. The challenge is therefore to evolve strategies that will promote a competitive, dynamic and sustainable Islamic financial services industry. Central to this common vision, to create a comprehensive Islamic financial system that will be able to respond to meet the requirements of the domestic economies and also to become an integral component of the international financial system.

Distinguished guests,
Assalamu'alaikum Warahmatullahi Wabarakatuh,
It is my pleasure to be here today at this conference organised by the Islamic Financial Services Board to discuss the future prospects of the Islamic financial services industry.

Malaysia's experience in the development of our financial system is outlined in our ten year Financial Sector Masterplan. The Masterplan represents the blueprint that provides the strategic direction for the development of the sector that looks beyond the near term and takes a long-term perspective into the needs of the future. The aim of the plan is to provide clarity of the vision and objectives that are to be achieved in the context of a more challenging environment that is driven by rapid change in a world that is becoming increasingly more integrated and more technology and knowledge-based.

In the development of our Islamic financial system, a comprehensive approach has been adopted. Malaysia has given emphasis to the development of a comprehensive financial infrastructure that includes the Islamic financial markets, Islamic financial instruments, contract law and law enforcement procedures, Shariah governance framework, Islamic accounting practices and valuation standards, appropriate disclosure requirements as well as an efficient and secure payment and settlement system. Attention has also been directed to develop the prudential regulatory and supervisory framework that underpins the stability of the Islamic financial industry.

Today, my remarks will focus on three key areas in which greater attention is needed in order to secure a promising future for the Islamic financial services industry. These areas include accelerating the pace of financial innovation, strengthening risk management capabilities and leveraging on information technology.

Accelerating the pace of financial innovation

As we advance forward in the development of Islamic finance, innovation will be key in securing the competitive advantage. It will be vital to the future of Islamic finance. While the initial focus has been on institutional building and financial infrastructure development, greater attention needs to be given to increasing the range of products and services to meet the greater sophistication of consumers and the more complex requirements of today's businesses in addition to enhancing the overall efficiency at which such products and services are provided.

Several factors are important to provide an enabling environment that would encourage and promote innovation. Firstly, a highly qualified and skilled workforce in the industry is indispensable for innovation. Training is a major means for promoting innovation. Personnel development in the industry is therefore important. In addition, industry involvement and participation in university education through course development, teaching and internship will contribute to this process. In Malaysia, an industry-owned research and training institute in Islamic banking and finance known as the Islamic Banking and Finance Institute Malaysia or IBFIM has been established to spearhead greater collaborative efforts with universities to undertake research in areas that are vital for the progressive development of the Islamic financial industry.

Increasing the capacity to innovate and securing long term competitiveness also underscores the importance of developing strategic leaders for Islamic financial institutions, leaders who are able to reinvent themselves in this new environment. Recognising this, Malaysia has established the International Centre for Leadership in Finance (or ICLIF) as part of our commitment to spearhead the development of a new generation of world class leaders who can steer the financial services sector to high performance and excellence in the industry.

Secondly, significant investment in the infrastructure that supports research and development will enhance the capacity for innovation. Financial support for advanced research at universities and research institutes will increase research opportunities. In addition, increasing the workforce involved in research and development will also increase the potential for innovation.

Thirdly, extensive education of the consumer and business community would increase the outreach resulting in increasing demands for new and innovative products and approaches. Malaysia has implemented a ten year structured consumer education programme to increase the level of consumer awareness on the unique characteristics of Islamic financial products and the product choices offered by Islamic financial providers. Increased awareness will drive the demand for a broader range of Islamic products and services customized to their requirements at more competitive prices and through more convenient channels. The outreach has also been for small businesses on the Islamic products and services. This process prompts the financial industry to increase innovation to strengthen their competitive position. This can be reinforced by market research to enhance the understanding of customers' distinct financial needs and their risk tolerance and therefore enable the design of Islamic financial instruments that offer tangible benefits and value to customers.

In addition, as there is greater disclosure and transparency in the manner in which Islamic financial transactions are being conducted and Islamic financial contracts are being executed as well as on the risk and return profiles of Islamic financial products, this will strengthen the role of market discipline in driving Islamic financial institutions towards ensuring Shariah compliance in the operations, improving operational efficiency, strengthening risk management infrastructures and instituting sound and dynamic risk management practices.

These developments will create spin-off effects to increase innovation in developing hedging instruments that are Shariah compliant. While innovation in conventional banking has led to the development of a number of derivative instruments to hedge risks, there is still considerable debate amongst Islamic scholars about the acceptability of the various forms of derivative products from the perspective of Islamic jurisprudence. Towards this end, there is a need for more investment in intellectual capital and greater collaborative efforts among Shariah scholars, Islamic financial engineers and researchers to accelerate innovation that can integrate Shariah principles in the process of designing risk mitigation techniques and products. The Shariah should therefore be viewed as an enabler to innovation rather than a constraint. Leveraging on the true potential and wisdom of the Shariah would evolve Islamic financial instruments into distinct innovative and cutting-edge products.

Fourth, the environment and the incentive structure are also important in providing an enabling environment that promotes innovation. In particular, the regulatory framework and the tax structure are important to the innovation process. The regulatory framework should not be so onerous that it forms a high cost and a burden to businesses. Intrusive regulatory approaches on new products can become a disincentive. Tax structures can also be structured to support the innovation process. Within financial institutions, organisational structures can also create an environment for innovation by avoiding product-oriented structures and aligning instead to the organization's processes as well as implementing appropriate performance incentives.

Fifth, entering into strategic alliances with entities may bring new approaches, new technologies or specialisation in a new product. In addition, collaborative efforts amongst Islamic financial institutions would strengthen the ability to leverage on the industry's expertise. The introduction of innovative Islamic financial products in a specific jurisdiction can be expanded to other jurisdictions, which in turn, will contribute to broaden and deepen Islamic financial markets and thus strengthen the overall development of the Islamic financial industry. To facilitate the achievement of this objective, the sharing of information can be made on the product features and the Shariah methodology adopted in ascertaining the permissibility of the products in the various jurisdictions.

Strengthening risk management capabilities

While financial liberalization and innovation have expanded the range of opportunities, it has also led to heightened uncertainties, greater volatility and increased potential of financial vulnerabilities. These developments require financial institutions to move to a higher standard of risk awareness and management. Regulatory emphasis has shifted towards a more risk sensitive regulatory capital framework and the assessment of risk management systems and processes in financial institutions. Extensive investment has been made by the industry to adopt a comprehensive and robust internal risk management infrastructure.

In Islamic banking, the requirement to manage risks becomes more important due to the special nature of the financial intermediation process that is guided by the Shariah. Islamic financial institutions have a multi-facet role. On the asset side, Islamic financial institutions enter into diverse modes of Islamic financial contracts, each with its own peculiar risk characteristics. Basel II, has to a certain extent, incorporated the identification of credit, market and operational risks that can be assimilated by Islamic financial institutions. However, Islamic financial institutions need to be ahead in exploring other dimensions of risks in these Islamic financial contracts. The risk management infrastructure in Islamic financial institutions must therefore be in place to identify, unbundle, measure, monitor and control all the specific risks in Islamic financial transactions and instruments to provide for their effective quantification and management.

Strong risk management capabilities become more pertinent in view of the different contractual arrangements entered into by the Islamic financial institutions with the different classes of depositors. Demand deposits, under the guaranteed custody contract and investment deposits, under the Mudharabah contract, each has its own unique risk and return attributes. Islamic financial institutions must ensure that demand depositors are protected from the risks of Islamic banking business. In respect of the Mudharabah depositors, any adverse shock to the financial performance of the asset portfolio in the balance sheet will be directly transmitted to the liability side, resulting in an adverse impact on the returns to the investment depositors. Islamic financial institutions have a fiduciary accountability in ensuring that depositors' funds are prudently managed and that the risk-adjusted returns on investments are maximized. The ability to maximize risk-adjusted returns on investments and sustain stable and competitive returns to depositors will contribute to promoting confidence in the Islamic financial industry.

Leveraging on information technology

As we forge ahead, successful financial institutions will be those that are able to exploit the full potential and opportunities that arise from the IT revolution. In embracing new leading edge technology, the potential for the Islamic financial industry to provide new products and services will be enhanced. It also represents the potential to increase access to financial products through a wider range of new delivery channels. Greater application of IT in the industry can also enhance efficiency by driving down costs for consumers and businesses. Other areas include leveraging on IT in making strategic decisions in the alignment of business, in elevating institutional capacity and operational efficiency and strengthening risk management capabilities.

The advent of Basel II for conventional banking has compelled institutions to make strategic investments in technology and risk management systems to be equipped in making the required quantification of credit, market and operational risk. Enhancing the IT infrastructure has therefore become indispensable in view of the need to capture and maintain sufficient financial data and information for risk analysis.

In Islamic banking, IT applications in strengthening risk management capabilities are even more demanding in view of the risk intricacies in the different Islamic modes of finance. A financing facility for example that is extended to a client based on Murabahah, Ijarah, Istisna' and Musyarakah will all have its own unique risk exposures. The risk exposure is not only different across the different modes of finance but also across clients. In addition, different maturities of the Islamic financial contracts will have different implications for risk across modes and across clients. Islamic financial institutions need to have a robust internal rating system that can map all assets in the balance sheet in accordance with the risk characteristics of each asset. Comprehensive IT systems will be needed to capture and store long-term historical data so that expected probability of the return can be estimated and a risk weight can be quantified and assigned. Indeed, the heterogeneous modes of Islamic finance require an even more rigorous system for expected return calculation as compared to interest-based credit transactions.

The complex and volatile financial environment requires enhanced capacity of Islamic financial institutions in dealing with uncertainties and probabilities. This will enable Islamic financial institutions to strengthen tolerance levels to deal with financial vulnerabilities. Towards this end, well-developed internal risk management systems are required to identify any potential deterioration in the asset quality of the Islamic banking portfolio. This will allow Islamic financial institutions to be in a position to maintain adequate provisioning in a dynamic manner, forecast future earnings and apply Shariah-compliant risk mitigation techniques at an early stage so as to manage the volatility in returns to ensure stable and competitive income to depositors.

Similarly, applications of risk-based models allow Islamic financial institutions to conduct stress testing, sensitivity analysis and simulations based on multiple scenarios to take into account all possible potential outcomes that may occur. This will enhance the capacity of Islamic financial institutions to better anticipate the possible impact of financial shocks on future earnings and hence formulate contingency plans leading to a more effective and efficient asset and liability management.

In addition, IT-based risk management systems would strengthen the capacity of Islamic financial institutions to effectively manage the segregation of demand deposits, restricted and unrestricted investment accounts and shareholders funds in accordance with their distinct investment objectives and risk tolerance. The mapping of financial performance of assets with risk-adjusted returns to these specific classes of investors will lead to enhanced accuracy and transparency in the determination of returns. In addition, as returns in Islamic banking are uncertain and can only be ascertained on an ex-post basis, well-developed IT systems can equip Islamic financial institutions with the ability to make projections on future returns to reduce the degree of uncertainty in the returns to be paid to the depositors. This would enhance credibility and strengthen the competitiveness of the Islamic financial industry.

Conclusion

The future prospects of the Islamic financial services industry will be the result of the combined efforts of all the relevant entities in the financial sector - the industry, the regulators, the market participants and the international community. These collective efforts need to be galvanized as a coordinated and concerted effort to maximize the potential for the industry. Evolving the shared vision and common goal to be achieved will be an important first step. Of greater importance will be the actions that need to be taken to make this happen. It will be our actions and initiatives taken today that will contribute towards determining the future that we aspire.