Zeti Akhtar Aziz: Current issues and developments in Islamic banking and finance

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the ASLI's Conference on Developing Islamic Banking and Capital Market: "New Opportunities, New Market and New Frontier in Islamic Banking and Finance", Kuala Lumpur, 25 August 2004.

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Islamic banking and finance has emerged as a financial intermediation process that is competitive and resilient and that contributes to the overall wealth creation, growth and development of our nation. Amidst an increasingly challenging and competitive financial environment, the evolution of a comprehensive Islamic financial system seeks to meet the range of requirements of a rapidly changing economic environment, with its soundness and stability secured through the robustness of its regulatory framework supported by the strength of its financial infrastructure and the sophistication of its products and services. Indeed, the strength of the respective components of the system and the interconnections of its markets will open new frontiers in Islamic banking and finance and will maximize the potential and opportunities that it accords.

Distinguished guests,

It is my pleasure to be here today at this conference organised by ASLI to speak on the current issues and developments in Islamic banking and finance.

The Islamic financial system in Malaysia has evolved as a viable and competitive component of the overall financial system, complementing the conventional financial system as a driver of economic growth and development. The rapid progress of the domestic Islamic financial system, reinforced by significant developments in the Islamic financial infrastructure, including the legal and Shariah infrastructure and the regulatory and supervisory framework, has strengthened the position of the Islamic financial system as an increasingly important component in meeting the changing requirements of the new economy. The Financial Sector Masterplan launched three years ago provides the strategic direction envisioned for the development of the Islamic financial sector looking beyond the near term and taking a longer-term perspective into the needs and requirements of the future. The strategies outlined in the Plan have emphasized the development of the respective building blocks of the various parts of the financial sector that need to be put in place to form the solid foundation on which sustainable future progress can be achieved. The expansion of the Islamic financial system in Malaysia has therefore taken place with attention given for the development of a comprehensive system.

Towards a more diversified Islamic financial system

At the onset of our journey in the development of a comprehensive Islamic financial system that is progressive, efficient, dynamic and sustainable, due attention was thus given to the development of the key structural components of the Islamic financial system, comprising the Islamic banking industry, the takaful industry and the Islamic money and capital markets. The intra-dependency of these key components creates the enabling environment for the Islamic financial system to effectively perform its role as an efficient conduit for mobilizing resources and channeling the funds to finance productive economic activity. The absence of any particular component could reduce the effectiveness and efficiency and thus affect the viability and sustainability of the system. While the Islamic banking system has an important role in mobilizing deposits and providing financing, the Islamic capital market has an equally important role in providing a stable source of long-term funds for financing large investments and development projects as well as for capital and business expansion. The development of the Islamic capital market not only allows for a more balanced allocation of financial and economic resources within an economy but more importantly, ensures greater diversification of risks within the Islamic financial system. This enhances the resilience and robustness of the Islamic financial system to withstand financial shocks and contributes to the overall stability of the Islamic financial system.

In terms of the development of our Islamic financial system, as at June 2004, the assets mobilized by the Islamic banking sector have increased to RM89.1 billion, accounting for a market share of about 10% of the banking system. At the same time, deposits have also increased to RM64 billion, constituting a market share of 10.4% while financing mobilized amounted to RM54 billion to garner 11% of the market share. Product offerings have also increased in sophistication from the deposit products to hybrid products that are able to enhance returns to depositors. A further advancement was made with the introduction of the Islamic variable rate financing mechanism that provides an alternative to the fixed-rate financing. This will assist the Islamic banking institutions in mitigating part of the risks emanating from asset and liability mismatches.

The Islamic capital market, in particular, the Islamic debt market, has also experienced rapid growth since its emergence in the 1990s. The issuance of Islamic bonds has expanded steadily at an average growth rate of 33.7% since 1995. In 2003, the total funds raised via the issuance of Islamic bonds amounted to RM8.1 billion, constituting 19% of the total funds raised in the bond market. New innovative Islamic financial instruments such as Islamic asset-backed securities have also emerged and the financial structures underlying Islamic securities have become more diversified. The number of Shariah-based unit trust funds has also grown consistently over the years to reach 55 in 2003 with a net asset value of RM4.75 billion, constituting a market share of 6.8%. The rapid growth of Islamic unit trusts comprising a variety of bond funds, equity funds and balanced funds increases the efficiency and potential of the Islamic financial system as an intermediation channel by providing investors access to professional asset management that is based on their distinct risk tolerance levels.

The development of a vibrant, efficient and effective Islamic capital market requires the creation of a broad spectrum of innovative Islamic financial instruments and the infrastructure to promote active trading so as to enhance the breadth and depth of the market. In the development of Islamic financial instruments, the challenge is to develop innovative and more diverse Islamic financial structures that are not only able to accord flexibility to issuers in managing their distinct financing requirements but also able to meet investor’s demand in accordance with their risk and return preferences.

At the international level, the successful issuance of the first sovereign global Islamic sukuk by the Government of Malaysia which attracted significant interest from a wide international investor base, acted as a catalyst for other countries and corporations to tap the international Islamic financial market and provided the impetus to the development of the International Islamic Financial Market (IIFM). The IIFM is entrusted with the task of creating an enabling environment that will encourage active participation by both Islamic and non-Islamic financial institutions in the secondary market for Islamic financial instruments. Strategic alliances such as those forged between IIFM, the Labuan International Financial Exchange and the Bahrain Stock Exchange will further pave the way for cross-border listing and trading of Islamic financial products. This will increase international investors’ access to Islamic financial instruments, enhance liquidity and spur the development of an Islamic capital market with greater global reach.

Strengthening the foundations for the development of a sound, progressive and sustainable Islamic financial system

The strengthening of the financial infrastructure is a key pre-requisite for the development of a dynamic and progressive Islamic financial system. An important feature of a comprehensive and well-developed financial infrastructure is the diversity of the players and institutions in the system that have been developed based on their distinctive capabilities and competitive advantage thus raising their performance level, valued added and contribution to overall growth and development. In addition, as part of the strategy to enhance our integration with the international financial system and to strengthen our inter-linkages with other economies, the liberalization of the Islamic banking industry has been brought forward to take place in 2004. The issuance of new Islamic banking licences to qualified foreign financial institutions will allow for the presence of foreign Islamic banking players to act as a bridge between Malaysia and other global Islamic financial markets and increase the potential to tap new markets and growth opportunities. It will also contribute to spur financial innovation as well as facilitate international trade and investment flows between Malaysia and the rest of the world.

An important dimension of the financial infrastructure is a comprehensive and effective legal infrastructure for legal redress arising from Islamic financial transactions. The legal infrastructure needs to comprise both effective regulatory and substantive laws as well as appropriate adjudicative fora for parties to resolve disputes relating to Islamic financial transactions. This will instill confidence and promote the sound expansion of the Islamic financial industry. Towards meeting this objective, the

High Court of Malaysia has assigned a dedicated High Court to preside over litigated cases on matters relating to Islamic banking and finance. To complement the court system, disputes may also be referred to the arbitration centre for resolution. In this regard, the Kuala Lumpur Regional Centre for Arbitration will be enhanced to serve as a platform to deal with dispute cases on Islamic banking and finance, and to extend these services beyond our borders. In addition to the dispute resolution mechanisms, the Central Bank has formed the Law Review Committee to review the common law-based domestic legislations to assimilate Shariah principles with the aim of removing any impediments to ensure the unhindered and efficient functioning of the Islamic banking and financial system. This review covers tax and stamp duty laws, company laws, land laws and procedural laws.

An important consideration in the development of an effective legal framework for Islamic banking and finance is the need to ensure enforceability of Islamic financial contracts in accordance with Shariah principles. In this regard, the Central Bank of Malaysia Act 1958 was amended to position the Shariah Advisory Council of Bank Negara Malaysia as the sole authority on Shariah matters pertaining to Islamic banking and finance that fall under the purview of the Central Bank. With this stature, the Shariah Advisory Council will therefore serve as the reference point for the court or arbitrator in dispute resolution that involves Shariah issues in Islamic banking and finance cases.

To further strengthen the Shariah infrastructure, guidelines will be issued to define the new structure, roles and functions of the Shariah Committees of the Islamic banks, the Islamic Banking Scheme banks and the takaful operators. The guidelines would specify among others, the requirements for the appointment of the Shariah Committee members and the duties and responsibilities of Islamic financial institutions to facilitate the effective functioning of the Shariah Committee. In the Islamic capital market, the establishment of a strong Shariah infrastructure is equally pertinent to ensure that the structuring of Islamic capital market instruments, the construction of Islamic investment funds and the execution of Islamic investment fund strategies are Shariah-compliant. This is important to preserve the integrity of the Islamic financial system and promote confidence that Islamic banking and financial operations do not deviate from the dictates of the Shariah.

The hallmark of a well-developed financial infrastructure is an effective regulatory and supervisory framework which underpins the stability of the financial system. The regulatory and supervisory function is an indispensable and vital component of the financial infrastructure. In a dual financial environment, the prudential regulatory design needs to take into account the unique characteristics peculiar to Islamic banking and finance as well as provide a level playing field in relation to conventional banking and finance so as to ensure that Islamic financial institutions and transactions are not at a comparative disadvantage. It also needs to assess and mitigate any potential regulatory arbitrage practices between the conventional and Islamic financial system that could undermine the stability of the overall financial system. While conventional banking is primarily premised on an interest-based debtor-creditor relationship, Islamic banking transactions are relatively more complex arising from the diverse contractual relationships between the Islamic financial institutions and their customers, ranging from the low risk sales and lease-based modes of finance to the higher risk equity-based modes. Each of these modes of finance has a distinct intrinsic characteristic dictated by its underlying Shariah principles and thus, entails different risk profiles. Therefore, the risk management infrastructure in Islamic financial institutions must be in place to identify, unbundle, measure, monitor and manage all the specific risks in Islamic financial transactions and instruments to provide for their effective quantification and management.

The establishment of the Islamic Financial Services Board (IFSB) in 2002 marks an important milestone in the development of internationally accepted prudential regulatory standards and best practices for the Islamic financial services industry. Since its establishment, the IFSB has attracted wide participation. To date, there are 13 full members, 4 associate members and 35 observer members in the IFSB. The technical committee of the IFSB is now in the final stages of the formulation of the prudential standards on capital adequacy and risk management. The IFSB has also commenced work on standards for corporate governance.

Whilst appropriate regulations and standards are vital to mitigate the risks involved, of equal importance is the oversight and monitoring of the Islamic financial institutions through effective supervision by the regulatory authority to ensure that the prudential requirements are observed. Lack of oversight, inadequate check and balances, and over exposure to risks are amongst the factors that may result in vulnerabilities to the system. The best of regulations and financial safety nets would not be able to avoid vulnerabilities if early warning systems are not in place. To effectively perform the supervisory function it is important to not only identify the risks involved in the various Islamic financial transactions but also to be able to detect any contravention of Shariah principles in financial transactions and operations.

A central feature of the regulatory framework for Islamic financial institutions is financial transparency and disclosure. This is particularly pertinent for Islamic financial transactions. For example, investment depositors in the Islamic banking institutions have the role of quasi shareholders that are not only entitled to share the profits of the Islamic banking business but are also exposed to the risks of losing their capital in the event of losses. In this connection, the issuance of a standard framework for the derivation of the rate of return in Islamic banking business has an important role in addressing the information asymmetry between the Islamic banking institutions and the depositors so as to ensure depositors receive their appropriate share of returns on the investment. In addition, the issuance of the guidelines on the model financial statement for Islamic banks will provide for greater disclosure on the risk and return profiles of the different categories of deposits. This will enable depositors to obtain the true and fair assessment of the Islamic banks' financial performance and hence, promote confidence and strengthen the competitiveness of the Islamic financial industry.

Enhanced financial disclosure needs to be complemented by customer education and awareness programmes to elevate the level of financial literacy of consumers and businesses to be able to make informed financial decisions and instill market discipline amongst financial players. The launching of the Consumer Education Programme and the organization of the Islamic Banking and Takaful Week are aimed at achieving these objectives. These programmes have contributed to enhance the understanding and appreciation of the unique characteristics of Islamic banking and finance, Islamic financial products and services and their underlying Shariah principles and concepts. Enhanced awareness on the manner in which Islamic financial transactions are being conducted and Islamic financial contracts are being executed will not only strengthen the role of market discipline in driving Islamic financial institutions towards ensuring Shariah compliance in the operations, but also contribute towards improving operational efficiency, strengthening risk management infrastructures and instituting sound and dynamic risk management practices.

Conclusion

To harness the full potential of the Islamic financial system, genuine endeavors to strengthen further the Islamic financial infrastructure, to develop the Islamic financial markets and to innovate Islamic financial instruments and activities that are able to meet the changing requirements of the new economy and the contemporary global marketplace need to be continuously pursued. With the acceleration of the global integration of Islamic finance, 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 the prospects for a more balanced global growth and global financial stability.

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