Zeti Akhtar Aziz: Strengthening linkages in the Islamic financial markets

Speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the seminar on Derivatives in Islamic Finance, "Strengthening Linkages in the Islamic Financial Markets", Kuala Lumpur, 24 June 2005.

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Distinguished Guests,
Ladies and Gentlemen,

"Islamic finance in Malaysia today has become increasingly more entrenched and integrated both on the domestic and international fronts. The successful integration has contributed to its rapid growth in assets and created a more robust and resilient Islamic financial system. The challenge now is to further strengthen the linkages in the respective components of the Islamic financial system, in particular, the Islamic financial markets. "

It is my pleasure to welcome you to this seminar on Derivatives in Islamic Finance jointly organised by Bank Negara Malaysia and the Financial Market Association of Malaysia. During this recent two days, we have organized the Investors Conference, the seminar on the 10-year Masterplan on Islamic Finance and the dialogue among Shariah scholars which have gathered an extensive participation, from policy makers, investors, industry players and Shariah scholars. Today's event is another important initiative which brings together financial experts to deliberate on a vital aspect in the development of Islamic finance.

Ladies and Gentlemen,

The successful development of a robust and resilient Islamic financial system depends on the ability to integrate the various components of the Islamic financial system that includes the Islamic banking industry, takaful and the money and capital markets. Of equal importance is also to integrate the domestic Islamic financial system with the international financial system. For more than two decades, we have witnessed the success of the development of each of these respective components that has contributed to the rapid expansion in Malaysia's Islamic financial services industry. Indeed, we have seen the development of a comprehensive Islamic financial system. This has placed the Malaysian Islamic financial system at the forefront of the global Islamic financial system. Notwithstanding this, there have been imbalances in the pace of the growth of the components of the financial system. While Islamic banking, being the core component, has recorded significant progress, more efforts need to be directed to promote the growth of takaful and the financial markets.

My remarks today will focus on measures to accelerate the growth of the Islamic financial markets by strengthening its required linkages. Of most importance is the development of a wider range of Islamic financial instruments, developing the relevant indicators to support benchmarking and an efficient pricing mechanism as well as to actively promote the role of the market players.

Development of a wider range of Islamic financial instruments

For Islamic financial institutions to effectively manage its funds, there is a need to have diversity in the type and the maturity of the Islamic financial instruments. This is one area in Islamic finance that offers formidable challenges and opportunities to market participants in Malaysia. A broader range of products and services is vital in this fast changing global financial landscape. In today's marketplace, there are only a number of Islamic financial instruments that have been developed to cater for this need which for the most part constitutes straight private and government Islamic papers. In a bid to deepen and broaden the Islamic bond market, the government has been regularly issuing Islamic and conventional securities with different maturities, enabling the creation of a benchmark yield curve. This was further enhanced with the introduction of an Auction Calender in the year 2000. In the 2000, Government Investment Issues or GIIs were introduced, followed by Islamic negotiable notes, private debt securities, Treasury Bills and sukuk. Furthermore, following the amendment to the Government Investment Act in year 2005, the Government has started issuing shorter-term Islamic Treasury Bills and longer-term sukuk or Islamic bonds with a maturity of 10 years in order to further diversify the Islamic financial instruments available for investors. Under the Act, the Government is able to issue Islamic instruments under various Shariah principles and for different tenures; short and long term, to meet the varying needs of investors. Islamic private debt securities (PDS) too have been fast growing in importance and size, accounting for 50% of the total PDS market in 2004.

Despite these developments, there has been an inadequate supply of short-term Islamic instruments thereby providing less flexibility to the institutions in managing their asset and liability profiles. This is important as the Islamic banking institution has, to a large extent of its portfolio, long-term assets that include long-term Islamic housing mortgages and long-term Islamic financial instruments. These two asset classes constitute approximately 80% of their portfolio. This over-concentration warrants the need to have effective risk mitigating techniques and instruments as to avoid any potential adverse consequences that could occur in volatile market conditions. On major importance is the elimination of uncertainties from a particular transaction. The need for Islamic hedging instruments in the Islamic financial services industry has therefore become increasingly important. Thus far, significant progress in this area has yet to be made. It is hoped that this seminar will be able to generate new ideas that can be implemented to support the requirements of the Islamic financial services industry players.

Ladies and Gentlemen,

As the Islamic finance is undergoing transformation, the financial infrastructure and product development must be complemented by the ability to manage risks by market participants. This becomes particularly important as the growing and changing needs and expectations of consumers occurs as a result of increased education levels and growing wealth. Corporate customers have become more performance-oriented and are demanding both competitively financial products and world-class financial advisory services. Consumers too are becoming increasingly discerning and have become more involved in their financial decisions, demanding a broader range of products and services at more competitive prices through more efficient and convenient channels. In this environment, product innovation needs to be escalated accordingly in particular, to respond to the growing need for managing risks to realign the risk-return profile of assets and liabilities for financial institutions and investors in reaction to fast changing economic variables. This is made more pronounced by the fact that increasingly, with the unprecedented economic integration, financial markets across the globe are not immune to financial volatilities. Therefore, it is crucial that market participants have the necessary tools to manage financial risks prudently and this is where derivatives can be applied.

Application of derivatives will yield benefits to the general public as spread of risk among economic agents will mitigate risk of financial shocks to the financial markets at the macro level and individual institutions at the micro level. As a result, the financial system becomes more robust, stable and resilient to extreme volatilities in the financial markets. The introduction of derivatives in the Islamic finance with adequate legal, regulatory and corporate governance framework will enhance the development of the functioning of the Islamic financial system.

Developing the relevant indicators

The pricing mechanism for the Islamic financial instruments has so far been based on the prevailing interest rate framework. There appears to be no real difference in both the conventional and Islamic instrument. In order for the Islamic financial instrument to be efficiently priced, it needs to have its own indicator. As an example, for an instrument issued based on Ijarah principle using the property as its underlying asset, the actual rate of rental can be used to determine the rate of return on this instrument. The indicator of the rate of rental will fluctuate based on the demand and supply of the said property. By having its own indicator, it will give a true reflection of the price of the underlying property asset as opposed to being linked to the KLIBOR which has no direct correlation with the changes in the rental rate.

Actively promote the role of the market players

The Islamic financial services industry is expected to benefit from the recent increase in the number of players following the launching of Islamic subsidiaries, the issuance of foreign Islamic banking licences and the measures to issue additional takaful licences. The entrance of these players will contribute to an active participation in both the primary and secondary markets for Islamic financial instruments.

Ladies and Gentlemen,

I hope this seminar will crystallize positive ideas to pave the way and contribute towards the development of a more vibrant and dynamic Islamic financial system. I wish to take this opportunity to thank the speakers for accepting our invitation to share their invaluable knowledge and experiences in this Seminar. The participation by researchers and practitioners in the Islamic financial system is also important. On this note, I wish you all a successful seminar.