Zeti Akhtar Aziz: Building a progressive Islamic banking sector - charting the way forward

Speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Seminar on 10-Year Master Plan for Islamic Financial Services Industry, “Building a Progressive Islamic Banking Sector - Charting the Way Forward”, Putrajaya, 22 June 2005.

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"The Islamic financial services industry is now at the threshold of its next stage of development. This decade has seen significant progress being achieved. Islamic finance has now gained wide acceptance as a form of financial intermediation. The sustainability of this progress, however, demands due attention to the future - to look beyond the near term, and to take a longer-term perspective into the needs of the future and to evolve an Islamic financial system that will best serve these needs. An essential part of this process is the clarity of the vision and the objectives that are to be achieved. This provides the starting point for the formulation of a Master Plan which defines the blueprint for the future development of Islamic finance. While envisioning the future will provide the strategic focus and the common goal to be achieved, of greater importance will be the actions that need to be taken to make it happen."

Your Excellencies
Distinguished Guests,
Ladies & Gentlemen,

I am most honoured to be invited to speak at this Seminar on the Ten-Year Master Plan for the Islamic financial services industry organized by the Islamic Development Bank and the Islamic Financial Services Board to discuss the key issues and considerations in the formulation of a master plan for the development of Islamic banking and finance. Our goals are to develop an efficient, progressive and comprehensive Islamic financial system that is able to contribute to the overall growth process and development. In this first session on the banking sector, the focus of my address will be on the blueprint for building a progressive Islamic banking sector. This will include a discussion of the building blocks that are necessary to provide the foundations on which subsequent enhancements can be built. I will also take this opportunity to share with you Malaysia's experience in formulating a ten-year Financial Sector Master Plan which was launched in 2001, and our experience in the implementation of the Plan, in particular, for the development of the Islamic banking sector.

The need for a Master Plan

Islamic finance is now taking on a new dimension to meet the changing requirements of consumers and businesses; to participate in a more liberalized and globalised environment and to become increasingly more internationally integrated. The financial system is also operating in an era of change. Indeed, the national and international financial landscape is being shaped by powerful forces of change, creating an environment of increased uncertainty. However, with clarity of vision on the ultimate goals that the financial system aims to achieve, we can, by our actions and initiatives taken today, help realize our vision of the future.

The Master Plan in essence provides a common vision, and template for countries in developing the Islamic financial services industry. The vision and desired objective will to a large extent depend on the desired aspirations for the economy, expected the role of the financial sector in the economy, the stage of development of the economy and the financial sector and the degree of international integration with the rest of the world.

The Master Plan will also serve as a key reference document to guide countries in charting an orderly development of the Islamic financial system. The broad strategies and action plans, with the necessary milestones that need to be pursued over the medium to long term to develop an Islamic financial system can then be identified. Within the defined parameters, countries have distinct options in determining the best course of action to achieve the envisaged country vision. Experiences of other member countries can be compiled to serve as references.

It needs to be recognized however, while the Plan provides the strategic direction, the implementation needs to be managed with flexibility. The approach for the implementation of the action plans outlined in a Master Plan needs to be done in an iterative manner, taking into account the potential for change that may occur in both the domestic and external environment.

The Master Plan will also identify the building blocks of the various parts of the financial sector that need to be put in place to provide the foundation on which further progress can be built. The Financial Master Plan thus provides the sequencing of priorities and identifies the key financial infrastructure that needs to be put in place before advancing forward. In some areas, the implementation can be simultaneous, while in others a more direct route can be taken to enable a more rapid pace of development.

In designing and formulating the Master Plan, consideration needs to be given to the diversity of the member countries of the IDB. The member countries are at various stages of economic development, facing different economic and financial challenges, and with different development priorities. The Master Plan aims to highlight the approaches, templates and building blocks that can be adopted at the different stages in the development of a comprehensive Islamic financial system. A phased-approach would provide the Master Plan with the flexibility to take into account the different stages of economic development of respective countries. While the starting points may differ, countries may adapt the approaches to their requirements and that is commensurate with their stage of development. The Master Plan would allow countries the option to evolve the financial system sequentially, or alternatively the option to accelerate the process of development by providing countries the opportunity to develop the institutions and supporting infrastructure simultaneously.

Significance of banking system

At the outset, due attention needs to be given to promoting the development of a comprehensive Islamic financial system, involving the development of the key structural components of the system, comprising the Islamic banking industry, the takaful industry, the non-bank financial institutions, and the Islamic interbank and capital markets. The comprehensiveness of the system will allow for a more balanced allocation of financial and economic resources within an economy and ensure 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. The respective components of the Islamic financial system are also highly integrated and inter-dependent. A more diversified Islamic financial infrastructure will contribute to the more efficient functioning of the overall financial system.

Given its roles in the intermediation process and payments system, the Islamic banking system will continue to be at the core of the Islamic financial system. A well functioning and efficient banking system is vital for achieving robust economic performance. As financial intermediaries, banks are entrusted to safeguard their deposits and preserve the efficiency in the manner the funds are mobilised, while vigilantly channeling these savings to productive investments. Given these responsibilities, the banking institutions therefore need to play their role effectively and efficiently to contribute to the overall stability of the financial system, and the growth and development of the economy.

Visioning for the Islamic banking system

In charting the future development of the Islamic banking system, due consideration would therefore need to be given to the role of the banking system in the economy. The ultimate goal is to **enhance wealth creation, and promote sustainable and balanced economic growth**. The vision is, therefore, to develop a progressive and robust Islamic banking and financial system, rooted in the Islamic core values and principles, that best serves the needs of our economies.

By indicating the destination in the journey, to developing the Islamic banking industry, the Master Plan would provide a road map to drive convergence towards the common vision among countries in the development of an Islamic financial system. While collective efforts can be directed to achieve this common vision, consideration needs to be given to the stage of development of the respective economies. In particular, the expected role that the banking system needs to fulfill can be identified accordingly. This could range from the development of an Islamic banking system to efficiently intermediate funds in the economy, to having in place a sophisticated Islamic banking and financial system that is internationally integrated and that is in itself, an engine of growth.

Pre-requisites of the Islamic banking system

The development of a vibrant and dynamic Islamic banking system that has a meaningful role in a nation's future economic and social development requires well-defined strategies that focus on two main areas, **building institutional capacity** and the **development of the supporting financial infrastructure.** Allow me to highlight the key areas of the strategies.

The first task is to identify the nature of Islamic banking system that is appropriate for the country - whether to ultimately adopt a dual banking system where Islamic banks and conventional banks offering Islamic banking products operate in parallel with the conventional banking system, or alternatively to adopt a single banking system that fully accords the Shariah injunctions where all the banks are Islamic.

Second, measures need to be in place to ensure that the Islamic banks are well-capitalised and resilient. For Islamic banks that are already in existence, clear criteria need to be specified on the minimum capital size that would enable them to be significant players in the market, be able to gain from economies of scale, have a diversified earnings base and stronger market presence. Such minimum size can either be achieved through organic growth or merger with a partner bank which would bring about the desired outcome in a shorter period of time. Incentives can be provided to induce the banks to consolidate while guidelines on minimum capital size can be imposed to ensure that the banks either merge or undergo a recapitalisation exercise. In the case of countries that are just embarking on the introduction of Islamic banks, this could be achieved by the issue of new Islamic banking licences.

Third, for countries that have a dual banking system, where conventional banks are allowed to offer Islamic banking products, there must be adequate firewalls to ensure absolute separation of banking operations to avoid co-mingling between the Islamic and conventional funds. This is to ensure the integrity of Islamic banking operations and the sanctity of Islamic funds. The firewalls would need to include separate capital funds, cheque clearing systems, clearing accounts with the Central Bank, settlement accounts and reporting systems.

Fourth, regardless of the choice of system, it is important that the stakeholders of the institutions play their role effectively and efficiently to generate improvements in the entity. Of importance, is strong leadership in the management team that has a firm commitment toward performance and capacity enhancements. In addition, investments in the requisite talent and skills is essential to spearhead the development of Islamic financial products.

Fifth, is the need to put in place a comprehensive legal infrastructure. Enactment of an Islamic banking law is an important part of this process. For conventional banks offering Islamic banking products, amendments to the existing banking legislation may be necessary to allow such banks to undertake trade-related activities and other multi-faceted functions. The investment policy of the Government may need to be reviewed to provide for the issue of Islamic investment instruments to facilitate the liquidity operations of such banking institutions. In addition, a legal fraternity that is competent in both Shariah and civil laws is also important. Finally, in a dual banking system, the tax legislation should accord neutrality in treatment between Islamic and conventional banking products.

Sixth, the development of a comprehensive Shariah framework is a fundamental part of the process. Each institution offering Islamic products will need to establish a Shariah advisory committee to ensure that all Islamic transactions, products and operations are Shariah-compliant. Shariah decisions need to be made transparent to promote greater understanding and the acceptance of such decisions.

Seventh, the importance of a robust and effective regulatory and supervisory framework cannot be over-emphasised. While the financial regulation and supervision of Islamic banking institutions would be similar, the areas such as capital adequacy, the liquidity framework have to take into account the unique risk characteristics of the Islamic banking models that accord the Shariah requirements. Sound corporate governance, transparency, accountability, disclosure, market discipline, risk management and consumer protection are common issues that need to be addressed. In a dual banking system, it is important that opportunities for regulatory arbitrage in banking practices should be eliminated.

Eighth, research and development is important to incorporate core Islamic values into banking products and business models. Research and development, and leveraging on the advances in information and communication technology are also critical in ensuring performance and a more equitable distribution of profits and wealth among all stakeholders. In addition, robust financial models that leverage on the advances in information technology can be used to enhance product development and risk management.

Ninth, the development of the financial market infrastructure is equally important to ensure the sustainability of Islamic banking. The Islamic interbank and foreign exchange markets are integral to the efficient functioning of the Islamic banking system. They facilitate the liquidity operations of Islamic banks and promote financial stability. In addition, they serve as an important transmission channel for the implementation of monetary policy as well as the central bank's role as lender of last resort. The creation of a well-developed Islamic capital market is also important as it provides the users of capital with an alternative and cost-efficient source of longer-term financing, and accords investors with a wider range of financial instruments to suit their different risk profiles. And at the core of any financial system lies an efficient and robust payment system for the clearing and settlement of payments. Other financial infrastructure that provides support to the development of the Islamic banking sector includes the mortgage corporation to undertake the securitisation of house financing, a credit guarantee corporation to provide guarantee schemes to the SME industry, and a rating agency to rate the Islamic financial instruments and a deposit insurance scheme to provide the necessary safety net for depositors should also be developed. In addition, the auditing, tax and legal firms must have the right talents to provide their services to the Islamic financial institutions. These ancillary institutions must have the ability to provide their services that are in accordance with the Shariah principles.

Tenth, consumer education and awareness about Islamic banking is critical to its success and future development. A consumer education programme needs to be developed to enhance public awareness of the features of Islamic banking products and services.

Translating the action plan into reality

The appropriate Islamic banking system for a country would be largely based on the national agenda of the respective countries, the objectives that the system hopes to achieve and the available resources. For the adoption of a dual banking system, the conventional banks have the option of offering Islamic banking products on a window basis or via full-fledged Islamic branches or an Islamic subsidiary. Conventional bank may also be converted to operate as an Islamic bank. Alternatively, the Islamic banking system may only comprise Islamic banks newly created to operate in parallel with the conventional banking system.

In addition, the government can upgrade existing Islamic savings institutions to Islamic banks; license foreign Islamic banks as a consortium or on joint venture with local banks; or a combination of these options to achieve its objective. Alternatively, a country may wish to adopt a system-wide Islamic banking and finance, a single banking system that fully accords the Shariah framework.

Allow me to take the opportunity to present the Malaysian experience. The development of Islamic banking has transitioned through four distinct phases. The first phase involved the establishment of Islamic financial institutions. In the second phase, conventional banks with the appropriate firewalls in place were permitted to offer Islamic financial products and services. As this window operations achieved a critical mass, the option to transform these operations into Islamic subsidiaries represents the third phase of development. And finally as capacities were enhanced, liberalisation allowed for the international integration of our domestic Islamic banking system in the fourth phase of the development.

The first phase of development of Islamic finance in Malaysia started in 1969 with the establishment of an Islamic savings institution known as the Pilgrim Fund Board, or Tabung Haji, as the first Islamic financial institution in Malaysia. Its objective is to mobilise savings of Muslims intending to perform the pilgrimage and to channel the funds to permissible investments according to the Shariah principles. As awareness of Islamic finance increased, a full-fledged Islamic bank was established in 1983 when Bank Islam, the first Islamic bank was established under the Islamic Banking Act.

The Government Investment Act was also enacted in 1983 to allow for government investment certificates to be issued to facilitate the Bank's liquidity operations. As part of the long term objective of developing a comprehensive Islamic financial system operating side-by-side with the conventional banking system, a year after the establishment of Bank Islam, a takaful or Islamic insurance company was established under the Takaful Act to provide the coverage for Islamic financing.

In the second phase of the development of Islamic banking, conventional banking institutions were permitted to offer Islamic banking products and services on a window basis to leverage on the existing infrastructure, including staff and branch network, and achieve wider market and cost optimisation. This landmark policy was undertaken ten years after the establishment of the full Islamic bank to allow for its greater outreach. The window operations opened the door for the existing conventional banks to participate in the Islamic banking market for both the Muslim and non-Muslim communities.

Under a pilot programme, three conventional banks were initially allowed to offer Islamic banking products and services. Then in early 1994, together with the establishment of the Islamic interbank market, a dual banking system was created. The interbank market is integral to the smooth functioning of the Islamic banking system, and became the first of such models. Concurrently, firewalls between the conventional and Islamic funds were put in place, which included separation of capital funds, cheque clearing system, clearing account with the central bank, settlement account and reporting system. They were also required to establish Islamic banking units to be headed by a senior banker, create an Islamic banking fund with a minimum allocation, and appoint at least a Shariah consultant to advise on the day-to-day operations of the Islamic banking division. In the ensuing years, additional rules and regulations were made to strengthen such operations. Eventually, more players were granted approval to offer Islamic financial products and services. The move enhanced further the vibrancy of the Islamic interbank market.

The efficiency of the Islamic interbank market is enhanced by the Real Time Gross Settlement System (RENTAS) and the Fully Automated System for Tendering (FAST). RENTAS facilitates larger value interbank funds transfers and scriptless securities while FAST facilitates the tendering process for Islamic securities including government securities, commercial papers and private debt securities. Funds are raised to finance long-term infrastructure and development projects through the issuance of Islamic private debt securities.

Recognising the importance of the capital market, Malaysia initiated the development of a private Islamic financial securities market in the early nineties, about six years after the establishment of the Islamic bank, with the issuance of the first Islamic financial instrument. Subsequently, more instruments were issued and these created an investment environment conducive for investors, including banks. The introduction of the Islamic capital market has reduced the over-dependence on the Islamic banking system for long-term financing and allows Islamic banking institutions to diversify part of the risks emanating from asset and liability mismatches. The existence of the Islamic capital market plays an important role in reducing a potential source of financial vulnerabilities and enhances the robustness and resilience of the Islamic financial system, leading to greater financial stability.

A significant development in the domestic Islamic financial market was the recent issuance of ringgit-denominated Islamic debt securities by two multilateral financial institutions. This has heightened confidence in the Malaysian Islamic financial market. The issuance was made possible following the liberalisation to the foreign exchange administration rules to facilitate multilateral development banks, multilateral financial institutions and multinational corporations to raise ringgit-denominated bonds in the Malaysian capital market.

The Islamic banking system is currently represented by 30 Islamic banking institutions, comprising four Islamic banks and 26 conventional banking institutions, that is, eight commercial banks, four foreign banks, three finance companies, four merchant banks and seven discount houses. The ability of the Islamic banking institutions to arrange and offer products with attractive and innovative features at competitive prices vis-a-viz conventional banking products, has appealed to both Muslim and non-Muslim customers, reflecting the effectiveness and competitiveness of Islamic finance as a form of financial intermediation. The extensive distribution network of Islamic banking institutions, comprising 152 full-fledged Islamic banking branches and 2,065 Islamic banking counters, is also supported by an efficient and secure payment system.

The other institutions which have been established to ensure that the Islamic financial system remain sustainable and robust include the external credit rating agencies such as the Rating Agency Malaysia and Malaysian Rating Corporation Berhad, three more takaful players, five development financial institutions that offer Islamic financial products including a cooperative bank that has fully converted to operating as a full fledged Islamic financial institution and a national mortgage corporation, Cagamas Berhad, all of which offer Islamic financial products.

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. In the case of Malaysia, the High Court of Malaysia has dedicated high court judges to preside over litigation on 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. The aim is to remove any legal impediments and 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 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. Since 2000, the domestic Islamic banking industry has been growing at an average rate of 18% per annum in terms of assets. As at end-2004, total assets of the Islamic banking sector increased to RM94.6 billion, accounting for 10.5% of the total assets in the banking system. The market share of Islamic deposits and financing also increased to 11.2% and 11.3% respectively.

As the domestic Islamic banking industry progresses into a more advanced stage of development, significant developments are shaping the industry's financial regulatory infrastructure. The developments in the pipe-line include the unique set of prudential regulatory and supervisory standards for Islamic banking operations by the Islamic Financial Services Board, tailor-made set of accounting standards for Islamic financial business by the Malaysian Accounting Standards Board and introduction of the Deposit Insurance Scheme in Malaysia.

Having achieved the critical mass, Bank Negara Malaysia conducted a review in 2003 of the existing 'window' institutional structure of the banks to prepare an enabling structure that can assimilate future developments in the Islamic financial regulatory infrastructure over the longer term and thus strengthen the prudential regulatory and supervisory regime. This represents the third phase in the development of Islamic banking in Malaysia. The new institutional structure known as 'Islamic subsidiary' was introduced in 2004. It is envisaged that greater strategic focus and resources as well as higher autonomy and governance will be accorded to the Islamic banks. To-date, two Islamic subsidiaries of two banking groups have been set up.

Integrating with international financial system

Another significant milestone in the progress of Islamic banking and finance in the Malaysian banking system in its two decades of development is the issuance of three new Islamic bank licences to Islamic financial institutions from the Middle East. The new entrants with distinctive capabilities and strengths will have the opportunity to bridge the two regions, participate in the growing Islamic banking industry as well as tap new markets in Malaysia and in the region, and promote healthy competition thereby contributing to elevate the industry to new levels of dynamism. In addition, up to 49% foreign interest is permitted in the Islamic subsidiaries. This represents the fourth phase of development of our Islamic banking sector. The pace of the integration process of Islamic finance with the international financial system is dependent on the steps to enhance the robustness and resilience of the domestic Islamic financial system. It will promote increased competitiveness, resilience and sustainability of the Islamic financial system as a form of financial intermediation. The integration would greatly contribute towards facilitating greater cross border flows in terms of increased trade and investment transactions; thereby, strengthening the global economic and financial inter-linkages. As this international integration process intensifies, it will facilitate greater mobilisation and channelling of resources between countries to productive investments; hence, raising the prospects for more balanced global growth and shared prosperity among the Ummah. This would also allow for more diversification of risks to achieve global stability.

We are witnessing the beginning of this process through greater presence of Islamic banks in the markets of other Muslim and non-Muslim countries as well as ability to raise funds in each others' financial markets, particularly by traditional multilateral institutions. Subscription and trading of Islamic financial instruments by conventional financial institutions is already commonplace, which is undertaken using the existing systems for trading, the existing international exchanges for listing and the existing clearing houses for settlement purposes.

An important initiative in the development of the international Islamic financial architecture is the establishment of the Islamic Financial Services Board (IFSB) in 2002. It was established to promulgate the international regulatory and supervisory standards for Islamic financial institutions worldwide aimed at achieving harmonisation of Islamic banking practices, fostering best practices and securing soundness and stability in Islamic finance. Another initiative to accelerate the integration of Islamic finance was the setting up of the International Islamic Financial Market or IIFM in 2002. The IIFM provides the environment to link all the financial centres around the world that participate in Islamic finance, thereby encouraging active participation by both Islamic and non-Islamic financial institutions in the secondary market for Islamic financial instruments. As the volume increases, it would strengthen the inter-linkages and integration amongst the Islamic financial centres.

While having a Master Plan will provide a shared vision and a common goal, it needs to be recognised that the evolution of an Islamic financial system with all its component parts cannot be achieved within a short period of time. Having the medium and longer term goals outlined however, provides a basis to ensure the short term initiatives will be consistent and coherent with the long term objective. In other words, the construction of the building blocks must move in the right direction. As part of the process, each Islamic banking institution needs to formulate its own strategic plans and short-term action plans within this longer term perspective. With the foundations built and the plans in place, the future is by no means secure. It is only with the combined efforts and perseverance of all the stakeholders that the vision that is being envisaged for the future development of Islamic finance can yield the desired results. InsyaAllah'.

Thank you.