

Zeti Akhtar Aziz: Towards the positioning of Islamic finance as an integrated component of the International Financial System

Opening speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the 5th Annual Islamic Finance Summit, London, 24 January 2006.

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It is my great pleasure to be here in London to speak at this 5th Annual Islamic Finance Summit organised by Euromoney. Islamic finance has made significant breakthroughs to now gain a place in today's challenging global environment with its international dimension now becoming increasingly more significant. It has now evolved to become an integral part of the international financial system. As this international financial integration process intensifies, it will not only increase the potential for Islamic finance to contribute towards enhancing the prospects for more balanced global growth through fostering greater trade and wealth creation, but also through facilitating greater diversification of risks, it will contribute towards increased global financial stability.

Rapid Evolution of the Global Islamic Financial Services Industry

As recent as five years ago, the development of Islamic finance was still regarded as an infant industry striving to prove its viability and competitiveness in the global financial environment. At that time, the growth of Islamic finance was mainly organic and largely concentrated in countries where the Muslim population was significant. Islamic finance was also for the most part governed by conventional regulatory and accounting standards. In addition, the divergence of views on some of the outstanding issues called for greater harmonization. Indeed, there was also some apprehension amongst the regulatory authorities, consumers, business communities and investors on the future potential of Islamic finance.

Notwithstanding this, over the recent five years, there has been a rapid evolution and expansion of the industry. Today, Islamic finance has been recognised as a viable and competitive form of financial intermediation not only in Muslim countries but also outside the Muslim world and offering a wide range of financial products and services. Licences are being issued to facilitate the establishment of Islamic banks including in the industrial economies in Western jurisdictions. There are also an increasing number of international conventional banking institutions offering Islamic financial products and services through dedicated subsidiaries or branches as well as through window arrangements. In addition, countries that have pockets of Muslim population, in particular, in the Asian region are now exploring the prospect of providing access to Islamic financial services to promote greater inclusion. These trends have not only been in terms of numbers of Islamic financial institutions, but also in terms of institutions with larger size of capital and a more established operational governance framework including risk management. Islamic financial institutions that previously operated only in their own domestic jurisdictions have also begun to venture abroad to tap new growth opportunities in other regions and forge greater cross-border linkages.

In the Islamic capital markets, there has been a growing interest in the issuance of Islamic sukuks by both sovereigns and multinational corporations. At the international level, the issuance of the first sovereign global Islamic sukuk by the Government of Malaysia in 2002 has been followed by a series of other issues. Corporations and multilateral development institutions have also embarked to issue Islamic financial instruments resulting in an increase in the range of products in the international capital market. Islamic sukuks have now breached the USD15 billion mark. The Islamic sukuks have attracted a broad range of investors. In 2004, to deepen our capital market further, Malaysia liberalized our exchange administration rules to allow multinational corporations and multilateral agencies to raise ringgit denominated papers in our domestic bond market. Multilateral financial institutions including the International Finance Corporation and the World Bank have since issued Islamic based ringgit-denominated instruments. We welcome the origination and issuance of Islamic financial instruments to be issued in Malaysia.

The growth in Islamic asset and wealth management has also been phenomenal arising from the diverse and innovative structures of Islamic investment funds, including Islamic hedge funds. It is

estimated that more than 250 Shariah-compliant mutual funds are currently managing approximately USD300 billion in assets. Shariah-compliant screening techniques have been able to improve risk-adjusted returns on Islamic investment funds which in turn have led to its adoption in improving the risk-adjusted returns of conventional equity funds. Benchmark indices such as the Dow Jones Islamic Market Indexes and the Financial Times Stock Exchange Global Islamic Index Series in the international equity market and the listing of Islamic financial instruments on international exchanges have all contributed to enhance the depth of the Islamic financial markets as an attractive asset class for investment.

On the regulatory front, the standardised international rules and regulations for the Islamic financial institutions now being issued by the Islamic Financial Services Board (IFSB) will be important in effectively ensuring the stability and soundness of the system. Two important standards, the standards for capital adequacy and risk management have been approved by the Council of the IFSB in 2005. The two standards have taken into account the aspects of risks associated with the different contracts in Islamic banking business. Proper assignment of capital charge on profit-sharing arrangement and the introduction of profit equalization and investment risk reserve are risk-mitigating elements to ensure the soundness in Islamic banking business. The on-going work in the area of supervisory review process, market discipline, corporate governance and transparency will complete the range of the prudential and supervisory standards of Islamic financial institutions. The increased participation in the IFSB from across the globe reflects the growing interest of the global financial community to be involved, at the onset, in the development of regulatory standards in Islamic finance. In addition to these developments, regulatory and legal reforms are also being undertaken in a number of jurisdictions to accommodate the unique characteristics of Islamic financial transactions to support the progressive development of Islamic finance.

Following these institutional enhancements, the significant growth of Islamic financial markets and the development of the supporting financial infrastructure, the international financial architecture for Islamic finance has been strengthened considerably. Established international financial centers have now included the development of Islamic finance as part of their agenda. Also emerging on the horizon are new Islamic financial centers in which innovative and competitive Islamic financial services industry is evolving. With the supporting comprehensive Islamic financial infrastructure in place in Malaysia and the diversity of Islamic financial players following the recent increased liberalization in the Islamic finance sector, Malaysia is positioning itself as an international Islamic financial center.

Key Challenges Ahead

While Islamic finance has made significant strides, there are key challenges that needs to be addressed for Islamic finance to sustain its development in the global financial system. My remarks will focus on four of these challenges.

The development of robust Islamic financial system at the national level

Firstly, there is the challenge to develop a robust Islamic financial system at the national level. The level of development of Islamic finance across jurisdictions varies significantly. While in some, Islamic finance is at an advanced stage of development, in others, more meaningful progress is yet to be made. To foster greater international linkages and cross-border transactions, the level of development of Islamic finance needs to reach a certain threshold of development and sophistication. It requires the development of a robust Islamic financial system which encompasses both the banking and the non-bank Islamic financial intermediaries, the Islamic financial markets, offering the range of Islamic financial products that is supported by a developed Islamic financial infrastructure.

The formulation of the ten-year masterplan for the Islamic financial services industry by the Islamic Development Bank and the Islamic Financial Services Board, marks an important step in setting the blueprint for leading the development of Islamic finance in a systematic and synchronized manner across jurisdictions to achieve the common goal of a vibrant and comprehensive Islamic financial services industry. Malaysia had five years ago launched our own Financial Sector Masterplan which includes the strategic direction for the development of Islamic finance forward in Malaysia. It has now culminated in the progress that Malaysia has achieved today.

Malaysia has now evolved a comprehensive domestic Islamic financial system that is diversified in terms of its institutions, markets and players. The strategy has been to institute the entire financial system chain to ensure the smooth functioning of the system. The initiatives include building the required financial institutions including, the Islamic banking institutions, the takaful industry, the non-banking institutions and developing the Islamic money and capital markets. These respective components have recently been progressively liberalized to become internationally more integrated. The supporting financial infrastructure includes a robust regulatory and supervisory framework reinforced by the legal and Shariah framework, the payment and settlement systems, the development of the pool of talent and the mechanism for the liquidity operations of the Central Bank as part of its monetary policy.

The development of efficient and active international Islamic financial markets

The second challenge is to advance further the development of an efficient and active international Islamic financial market. Well-developed international Islamic financial markets enhance the liquidity of the instruments and risk management capacity of the players. This would promote the efficient functioning of the markets and thus facilitate capital flows and thereby strengthen global integration. Coordinated initiatives are therefore essential to foster the development of an efficient and vibrant international Islamic financial market. Sustainable supply of sukuks on a regular basis needs to be ensured. The participation of issuers including multilateral organizations, governments and multinational corporations would contribute to this process. In Malaysia, the domestic bond market now accounts for 80% of GDP. Of this, 44% of the papers are Islamic based.

A fundamental pre-requisite is to promote innovation in the development of a broader range of Islamic financial market instruments. These include instruments with equity ownership features, Islamic asset-backed securities, inclusion of permissible forms of credit enhancements as well as Shariah-compliant risk mitigating instruments. The development of an Islamic derivatives market for hedging is required for market-making activities to support the development of secondary markets. Research and development therefore need to be intensified. The Shariah fund recently established by Malaysia is to support research activities in these areas. This initiative is also to facilitate annual dialogues amongst international Shariah scholars. It is to provide a platform for deliberation on the Shariah compatibility of newly developed Islamic financial instruments and markets.

A further pre-requisite is to ensure sufficient availability of liquidity to support the intermediation of funds in the Islamic financial system. The demand for central bank discount window operations is inevitable. Central banks must therefore have sufficient Islamic financial instruments at its disposal to manage the liquidity conditions in the Islamic financial system. This is an area that has yet to be fully developed. In relation to this, Malaysia has developed Islamic monetary instruments that includes both the government and our own Bank Negara Malaysia Islamic financial instruments. We have also a dedicated clearing and settlement mechanism to ensure the smooth functioning of the Islamic financial system. To add to the existing range of Islamic financial instruments, Bank Negara Malaysia will in February this year issue an Ijarah paper to further meet the requirements of Islamic market players in the domestic Islamic money market and also for the purpose of conducting monetary policy. Of equal importance is having in place appropriate regulatory and legal framework to support the development of Islamic financial instruments and markets to ensure investor protection, uphold market integrity in addition to containing systemic risks.

The adoption of IFSB standards

The third is to ensure the adoption of the IFSB standards. The standards on capital adequacy and risk management that have now been approved by the Council of the Islamic Financial Services Board in December in 2005 is scheduled for implementation in 2007. Islamic financial institutions must therefore be equipped with the required capacity and infrastructure to capture the respective risk weights and assign appropriate amount of regulatory capital at each of the different stages of the Islamic financial transaction. The exclusion of risk-weighted assets funded by the profit-sharing investment accounts from the calculation of regulatory capital requirement places critical emphasis on a comprehensive infrastructure in the Islamic financial institutions to clearly segregate the restricted and unrestricted profit-sharing investment accounts from the non-profit-sharing accounts and shareholders funds and to track their respective flows in financing and investment transactions.

Strategic investments in the state-of-the-art IT and risk management systems are integral to this process.

Supervisory authorities need to be equipped with the specialized skills necessary to have the right assessments on the level of risks that the Islamic financial institutions are exposed to and the effectiveness of the risk management infrastructure in the Islamic financial institutions in mitigating these risks.

The development of a sufficient pool of talent in Islamic finance

Finally, the development of a sufficient pool of appropriately skilled Islamic finance practitioners needs to be accorded the highest priority. The required skill set in Islamic finance is unique. It needs to have the right blend of knowledge of finance with the understanding of the Shariah as being central. The Shariah principles must be embedded in each and every operational aspect of the Islamic financial institution, including in the design of financial products and financing structures, financial contracts and their execution, liquidity and balance sheet management, risk management as well as asset and wealth management. The upholding of Shariah principles must permeate from the highest level, including at the board and senior management levels, which provide the strategic direction for the Islamic financial institution and to the operational levels. Sound policies and practices premised on Shariah principles will evolve the Islamic financial system into a financial system that is distinctively ethical and that which promotes economic justice.

To meet this objective of providing a total talent management solution for the global Islamic financial services industry and to meet the educational needs of the different levels of Islamic finance practitioners, including professionals and specialists in Islamic finance, Malaysia is establishing an International Centre for Education in Islamic Finance (INCEIF). INCEIF will commence operations in March this year and will offer professional certification programmes in Islamic finance. INCEIF will also forge strategic alliances with domestic and foreign academic institutions to offer post-graduate programmes, namely Masters and Doctorates in Islamic Finance with specific areas of specialization. A professional association for Islamic finance professionals will also be established for the alumni of INCEIF to keep abreast with the latest developments in Islamic finance.

Conclusion

Building the foundations on which Islamic finance has been able to advance forward has been vital to its viability, competitiveness and sustainability in this challenging global financial environment. With its integration into the international financial system, it would strengthen further the global economic and financial inter-linkages and in so doing would open new frontiers towards achieving more balanced global growth and greater shared global prosperity.

Thank you.