

Zamani Abdul Ghani: Building a progressive takaful sector in the overall Islamic financial system

Keynote Address by Mr Zamani Abdul Ghani, Deputy Governor of the Central Bank of Malaysia, at the 2nd Seminar on Regulation of Takaful, Langkawi, 23 February 2006.

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Bismillahirrahmanirrahim.

His Excellency Dr. Bassel Hindawi
Vice Chairman, Director General of the Commission
Insurance Commission of Jordan

Mr. Anwar Khalifa Ebrahim Al-Sadah
Deputy Governor, Bahrain Monetary Agency

Professor Rifaat Ahmed Abdel Karim
Secretary-General, Islamic Financial Services Board

Distinguished guests and participants,

Assalamualaikum warahmatullahi wabarakatuh and good morning.

2. It gives me great pleasure to be here this morning to welcome you to Malaysia and to this beautiful island of Langkawi. I am also pleased to be invited by the Islamic Financial Services Board (IFSB) to address this major event that brings together those among us who share deep interest in the development of global takaful and Islamic finance. Alhamdulillah, we have among us today distinguished market players, regulators, scholars, consultants as well as participants from almost twenty (20) countries around the world. I also wish to congratulate the IFSB for its efforts in organizing, for the second consecutive year, this international seminar focusing on the regulation of takaful. Let me at the outset reiterate the importance of this Seminar as a source of collaboration for ideas, sharing of knowledge and exchange of experiences for the continuous developments and improvements of the Islamic finance industry. This event is especially important as it touches on new areas such as the regulation and supervision of the takaful industry as only minimum guidance is currently available.

Ladies and Gentlemen,

3. Before I continue with this keynote address, let us all take a moment to remember Allahyarham Dr. Mohamed Aboulkhair Zaki Badawi, a great thinker and collaborator for the cause of Islam, and particularly in the area of Islamic finance. He has devoted so much of his time and energy for the benefit of the Ummah. We will always remember his numerous contributions to the development of Islamic finance. We cherish his involvement, among others, in the introduction of Shariah-compliant mortgage, the establishment of the Shariah council to reconcile conflicts between Islamic and conventional laws and the establishment of the first Islamic financial institution licensed in the United Kingdom. In Malaysia, he has made his mark a long time ago with efforts in setting up a dedicated Muslim College and the teaching of Islamic Studies at the University of Malaya, Malaysia. He was also involved in the development of Islamic finance in Malaysia by being the Shariah advisor to RHB Islamic Bank and the Labuan Offshore Financial Services Authority. In appreciation for his contribution, let us pray that God Almighty grants him a place in His paradise with the prophets, the martyrs, and the righteous, insyaAllah.

Ladies and Gentlemen,

4. Islamic finance has grown by leaps and bounds, from only one Islamic financial institution three decades ago to over 300 today in more than 75 countries, including non-Islamic countries in Europe and the United States. The total assets of Islamic finance worldwide is estimated to exceed \$250 billion, and is growing at an estimated annual rate of 15 percent. Islamic finance has been transformed from a "nice to have" into a "must-have" system, evident by the growing number of jurisdictions allowing their financial institutions to offer Islamic financial services and increasing number of global financial players now offering Islamic financial services as part of their spectrum of services. Islamic finance continues to provide tremendous potential for growth and development due to a number of

factors. These factors include the strong demand for Shariah-compliant financial services and transactions, the availability of a wider choice of products that meet consumers' discerning expectations, as well as growing acceptance of Islamic finance as a form of financial intermediation. In Malaysia, the advancement and progress that have been achieved in Islamic finance has demonstrated its potential as an effective form of financial intermediation that supports the needs of the economy. The industry has become a major contributor to the overall economic growth, with assets encompassing nearly 25% of the country's gross national product. This is a significant achievement considering the stiff competition offered by the conventional banking and insurance sectors.

5. The takaful industry in particular has shown remarkable growth. This is evidenced by the increasing number of takaful players world wide and the ability of these players in providing a comprehensive range of product and services, matching those offered by the conventional counterpart. In Malaysia, the takaful industry has experienced rapid growth and transformation since its inception more than 20 years ago. The industry continued to show positive growth, registering an average growth rate of 58% per annum in terms of asset. The growth is expected to be further strengthened with the increase in the number of takaful players. The Malaysian takaful operators are also actively venturing abroad to widen their global presence through the acquisition of equity interest in foreign takaful operators as well as exporting technical expertise to their foreign counterparts. Currently our domestic takaful operators have equity participation in Saudi Arabia, Sri Lanka, Indonesia and Pakistan.

6. On the regulatory front, Islamic finance continues to pose unprecedented challenges to regulators in their quest to be at par with conventional regulatory framework while, at the same time, upholding the true concept of Shariah. Of importance is the development of capital adequacy and solvency, risk assessment and management and corporate governance, which are very much relevant to Islamic banking and takaful. There is also a challenge to develop internationally acceptable standards for the regulation of Islamic banking and takaful sectors, specifically in areas which involve different Shariah interpretations. Currently, there are several international institutions that are working towards international Shariah-compliant standards which include the IFSB and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

7. Recognising the current state of Islamic finance and its different pace of development in different jurisdictions, it is important for us to step back a bit and carefully plan the efforts going forward. In this regard, let me share with you my thought on four areas of focus whereby greater attention should be given in order for us to achieve further progress in the development of takaful in particular, and Islamic finance in general. I will also take this opportunity to share with you on the experience and approach that Malaysia has adopted in our endeavor to develop a comprehensive and effective Islamic finance system.

Firstly, there should be greater inter linkages of components of Islamic finance supported by strong legal and regulatory framework.

8. The effective functioning of the Islamic financial system will largely depend on the development of a comprehensive package of the core components of the overall Islamic financial system. This would involve the development of the Islamic banking sector, the takaful sector, the Islamic inter-bank and capital markets as well as other non-banking financial institutions. The future development of the Islamic finance will rely on the strength of these core components and their interlinkages, due to the interdependence of the respective components within the package. The interdependence between the different components can be seen in cases where Islamic banking relies on takaful operators to provide protection and coverage for Islamic financing products offered by the Islamic banks. In the case of takaful operators, they would rely on the Islamic banks, through bancatakaful arrangement, to have automatic access to the banks' wide customer base and to leverage on the banks' reputation and prominent position to effectively distribute takaful products. The Islamic capital market will also depend on the takaful operators, and to some extent the Islamic banks, to participate in subscribing to Islamic financial instruments which fulfil the medium to long-term financing needs. In return, the adequate supply and availability of a wide range of financial instruments offered in the Islamic capital market has facilitated takaful operator to effectively manage its asset portfolio to match the liability and risk profile of the takaful fund as well as enhances the ability of takaful operator to generate attractive investment return to stakeholders.

9. Allow me now to take this opportunity to share with you Malaysia's experience in the development of the Islamic financial system that has earned Malaysia, Alhamdulillah, the recognition by the

international financial community as a leading Islamic financial hub. In developing the Islamic financial system, Malaysia has adopted a phased-in approach which can be divided into three different phases. The first phase of the development of Islamic finance in Malaysia began more than three decades ago with the establishment of an Islamic savings institution known as the Pilgrim Fund Board, or Tabung Haji. Tabung Haji is the first Islamic financial institution in Malaysia. This was followed by the establishment of the first full-fledged Islamic bank in 1983 and the first takaful operator in 1984. The establishment of the first takaful operator in Malaysia was inspired by the prevailing needs of the Muslim public for a Shariah-compliant alternative to conventional insurance, as well as to complement the operation of the Islamic bank. InshaAllah, by the end of this year we will have a complement of twelve (12) Islamic banks and nine (9) takaful operators with equity participation by Malaysians as well as renowned international market players.

10. In the second phase of the development of Islamic finance, Malaysia initiated the development of a private Islamic financial securities market. The issuance of a broad range of Islamic financial instruments contributed in creating a more conducive investment environment for investors who preferred Shariah-compliant instruments. Another significant development in the domestic Islamic financial market was the issuance of ringgit-denominated Islamic debt securities by two multilateral financial institutions, the International Finance Corporation and the World Bank. The issuance was made possible following the liberalisation of 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. At the end of 2005, Shariah-compliant private debt securities comprised 40% of the outstanding private debt securities issue of RM281 billion.

11. Other major developments that took place in the second phase include the offering of Islamic banking products and services by the conventional banking institutions on a window basis, the establishment of external credit rating agencies such as the Rating Agency Malaysia (RAM) and Malaysian Rating Corporation Berhad (MARC) and the establishment of the development financial institutions and a national mortgage corporation, that is, Cagamas Berhad, both also offering Islamic financial products.

12. The third phase of the development involves a review of the existing 'window' institutional structure of the banks to create an enabling structure that can assimilate future developments in the Islamic financial regulatory infrastructure over the longer term. Arising from this review, a new institutional structure known as 'Islamic subsidiary' was introduced in 2004. With this development, the Malaysian Islamic financial system has evolved into a strong and comprehensive Islamic financial system.

13. The comprehensive Islamic financial industry in Malaysia is also well supported by a conducive legal and Shariah framework that began more than 20 years ago. In terms of the legal infrastructure, dedicated legislations namely the Islamic Banking Act 1983 and Takaful Act 1984, were enacted to govern the conduct of the Islamic banking institutions and takaful operators respectively. A dedicated High Court judge has also been assigned to preside over cases relating to Islamic banking and finance, complementing the mediation, arbitration and other dispute resolution mechanism already in existence for the Islamic financial system.

14. Great emphasis has also been given to enhance the Shariah framework in Malaysia. The Shariah Advisory Council in Bank Negara Malaysia is recognised as a sole authority on all Shariah matters pertaining to Islamic banking and finance. At the company level, it is a legal requirement for Islamic banking and takaful operators to establish their own Shariah Committees as part of internal governance in order to ensure compliance with the Shariah.

The second focus area is that there must be efforts to have structured human talent development in the area of Islamic finance.

15. The essence of a takaful system lies in the relationship between the participants and the mudharib or wakeel, that is the person responsible for managing the takaful fund. The key success factor lies in takaful operators having high level of expertise in all relevant areas in the management of takaful business including technical, actuarial, distribution, underwriting, investment as well as strong leadership at the helm of a takaful operator. In this regard, there is a need for a structured development of human talent at all levels which include the leaders, technical personnel as well as the regulators. The takaful sector needs to develop strategic and high-performing leaders who will be able

to lead the way and are committed towards building a stronger organization that is able to contribute towards the tremendous growth potential for takaful.

16. In the area of technical expertise, the takaful sector has to intensify its efforts in the training and development of expertise in such areas as actuarial, underwriting, specialist claims and product development capabilities. In the actuarial area, for example, an issue that needs to be addressed is the scarcity of qualified actuaries to serve the takaful sector. The expertise of actuaries is needed to quantify the appropriate contribution rate to be charged to the pool of takaful participants. Additionally, the proper pricing of the contribution rate will ensure the ability of the takaful fund to fulfill the requisite obligation to participants. The actuarial methodology is also required to ensure prudent distribution of surplus to participants. The increasing roles of the actuary in the family as well as general takaful underscore the importance of developing takaful actuaries who have the understanding of the takaful business and the unique characteristic of the takaful operation.

17. Perhaps it is timely for me to share initiatives taken by Malaysia in talent development at all levels in Islamic finance. At the strategic leadership level, Malaysia has established the International Centre for Leadership in Finance or ICLIF as part of an effort to spearhead the development of a new generation of world class leaders in Islamic banking and finance who can steer the financial services sector including the Islamic finance towards high performance and excellence. An endowment fund of RM500 million has been allocated for this institution.

18. In the development of technical expertise, the Islamic Banking and Finance Institute Malaysia (IBFIM) and the Securities Industry Development Centre (SIDC), which are the industries' training arms, have played an active role in producing well-trained, high caliber individuals and management teams with the required expertise in the Islamic finance. IBFIM and the SIDC work closely with the industries to ensure that their training and education programmes are tailored to meet the evolving needs of the industry. In the case of IBFIM, the programmes on offer include the fundamental aspects of Shariah, Islamic banking and takaful and risk management in Islamic financing. Bank Negara Malaysia has provided a benevolent loan to IBFIM to complement industry contributions.

19. Recognising the need to simultaneously equip the regulators with the necessary skills in Islamic finance, we have in the pipeline for introduction shortly, a special programme for regulators called the Central Banking Course in Islamic Finance. This programme will be tailor-made to provide international regulators with knowledge on conceptual and practical aspects of Islamic finance as well as the update on the regulation and supervision of Islamic financial institutions.

20. The pressing need for sufficient pool of intellectual human capital will be more evidenced with the continuous expansion of takaful business and the growing numbers of new takaful operators being established. To be able to assist in meeting this increasing demand for intellectual capital and not cannibalising on existing ones, Malaysia has taken the initiative of establishing the International Centre for Education in Islamic Finance or INCEIF. INCEIF aims at meeting the objective of providing a talent development solution for the global Islamic financial services industry as well as the educational needs of the different levels of Islamic finance practitioners, including professionals and specialists 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 in 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. An endowment fund of RM500 million has also been allocated for INCEIF.

Third area of focus is to promote greater international collaboration and cooperation in the establishment of sound infrastructure for the development of Islamic finance.

21. This is aimed at contributing towards a progressive takaful industry by promoting greater international cooperation among the regulators, practitioners and scholars. Initiatives have and will continue to be taken to leverage on international cooperation in terms of technical assistance and sharing and exchanging of information to further accelerate the development of takaful globally. This is particularly important due to the different phase of development of the various countries in the takaful sector. The sharing and learning of the experience of the more advanced jurisdictions will not only accelerate the development of takaful but will also allow for the maximization of efficient usage of limited resources. The Islamic Development Bank (IDB) together with the IFSB should be commended for having initiated the move to chart a 10-year Masterplan for the Islamic financial services industry, one that could assist member countries in their quest to develop a well-structured Islamic financial

system. Malaysia and the IDB have also signed a memorandum of understanding to enhance cooperation among member countries of the Organisation of Islamic Conference, or OIC, in the areas of trade, investment, Islamic finance and ICT development. In the area of takaful, a working committee has been created to encourage the establishment of takaful companies in member countries and promote retakaful business amongst IDB members.

22. For the regulators in charge of Islamic finance, the setting up of the IFSB remained one of the landmark developments in this decade. Established in 2002, the IFSB's core role is to promote prudent, transparent and robust development of the Islamic financial services industry through the promulgation of international prudential standards that are consistent with the principles of Shariah. This would be the foundation for the stable and sustainable development of Islamic finance. The IFSB also provides the platform for cooperation among the regulators through meetings, conference and the setting-up of working groups that give the opportunity for regulators to discuss and exchange information on issues confronting the Islamic finance. Having a wide network comprising 84 members from all over the world, the IFSB provides members with access to broader information and guidance. In addition, the IFSB, through its linkages with other international bodies, which includes the International Monetary Fund (IMF), Bank for International Settlements (BIS), AAOIFI, the International Association of Insurance Supervisors (IAIS) and International Organisation of Securities Commissions (IOSCO), will be able to create synergies in the future development of international standard for Islamic finance.

23. In the area of takaful regulation and standard, we have seen excellent progress taken by IFSB. Of recent development is the cooperation between IAIS and IFSB in the formulation of international standards for takaful. In this regard, a joint working group comprising representatives from IAIS and IFSB has been formed to assess the applicability of the IAIS insurance core principles for takaful. The joint working group has made significant progress through the issuance of an Issue Paper on Issues in Regulation and Supervision of Takaful. The Issue Paper has identified four major areas that require immediate attention. These are the corporate governance, financial and prudential regulation, transparency, reporting and market conduct as well as supervisory process, which may lead to the issuance of a specific guidance paper or standard that corresponds with the IAIS insurance core principles.

24. Another major area requiring international collaborative efforts is the harmonization of Shariah interpretations. It is imperative for Shariah scholars globally to undertake in-depth studies and research to accelerate innovation and enhance the global integration of the Islamic financial system. Harmonisation of the differing views among the scholars from different schools of thought is necessary to enhance the global development of Islamic finance. Although variations in the Shariah principles and interpretation for takaful contract and practices are currently not a major concern, efforts should be undertaken to further minimize these variations in interpretation that may hinder the smooth progress and innovation in the development of takaful. In this regard, Malaysia has taken the initiative in promoting greater cooperation among Shariah scholars. In 2005, Bank Negara Malaysia organized an annual Shariah Scholars Dialogue that brings together renowned scholars from many parts of the world to discuss as well share and learn from each other's experience. In addition, Bank Negara Malaysia has established an endowment fund amounting to RM200 million to facilitate the activities of Shariah scholars. Other than financing the periodic dialogues among the Shariah scholars, the fund would also promote research, provide scholarships and establish better interaction among these Shariah scholars and industry practitioners. It is hoped that this effort would contribute effectively to further enhance interaction and understanding in the area of Shariah and Islamic finance.

The final area of focus in creating a progressive takaful industry is the need to build greater international linkages and strategic alliance among the Islamic financial institutions.

25. Fostering strategic alliances with the right entities will not only accelerate innovation and development but will also bring about considerable values in the formulation and implementation of new approaches, new technologies and specialisation in new product. These in turn, will pave the way for takaful operator to be competitive and in a position to be industry leaders at the national and global front. Let me share with you Malaysia's recent initiatives on this front. In January this year, Bank Negara Malaysia has agreed to award four new licences for takaful operators, bringing the total number of takaful operators to nine (9). The new takaful licences are offered to joint ventures or consortiums of sound financial institutions with experience in Islamic banking, takaful or insurance business. Such joint ventures or consortiums that include foreign partners would enable the new

takaful operators to leverage on the expertise, experience and infrastructure of their partner financial institutions. These are strong institutions from the Middle East, the United Kingdom and Japan that agreed to combine efforts and share expertise and resources with Malaysian institutions in these new ventures. In line with the liberalisation in the Islamic banking industry, foreign equity interest of up to 49% is allowed in the takaful entity to secure commitment of strong shareholders, and foster meaningful strategic alliances. For Islamic banking, the Bank has further liberalized our Islamic financial industry by allowing the establishment of three new fully foreign-owned Islamic banking institutions as part of the strategy to enhance integration with the international financial system and to strengthen inter-linkages with other economies. These foreign partners will provide strategic linkage for the expansion of the takaful and Islamic banking businesses overseas. Going forward, our aspirations are for Malaysia to be the centre for efficient, progressive and robust Islamic banking and takaful sectors which are internationally integrated. In realizing this vision, the industry has to play its role in giving unwavering commitments and collaborative efforts towards elevating the industry to new levels of dynamism.

26. Let me conclude by saying that the future success of Islamic finance will depend on the combined collaborative efforts of all stakeholders, namely the regulators, the scholars, the industry and market participants. In this regard, all parties should put in relentless efforts to continuously promote the development of Islamic finance into one which is progressive, dynamic, responsive and sustainable. I sincerely believe that for all our sincere efforts towards realizing this objective, InshaAllah, the Almighty will shower us with his blessings, guidance and assistance. This reminds me of the essence of verse 69 of Surah al Ankabut: *"And those who strive in Our (cause), - We will certainly guide them to our Paths. For verily Allah is with those who do right."* On this note, I wish you a successful and productive seminar and wabillah hitaufik walhidayah.

Thank you.