

Zeti Akhtar Aziz: Recent developments in Islamic finance in Malaysia

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Malaysian Islamic Finance Issuers and Investors Forum 2006, Kuala Lumpur, 14 August 2006.

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Distinguished guests,
Ladies and gentlemen,
Assalamualaikum warahmatullahi wabarakatuh and a very good morning.

It is my great pleasure to be here today to speak at this Malaysian Islamic Finance Forum that has been the joint efforts by the key regulatory and market authorities in the financial services sector in Malaysia, that includes Bank Negara Malaysia, the Securities Commission, Labuan Offshore Financial Services Authority (LOFSA) and Bursa Malaysia. The aim of this forum is to provide a platform for industry players and regulators to interact and discuss recent developments in Islamic finance in Malaysia, the performance of the Islamic financial market, and to provide greater awareness on the innovative products and services and the opportunities for both issuers and investors.

Ladies and Gentlemen,

The rapid pace of development of Islamic finance in Malaysia has taken place in an environment of strengthening economic growth that is underpinned by strong fundamentals. The growth has been achieved with relative price stability, low unemployment and a strong external balance. The level of savings remains high and external reserves are at a comfortable level at about USD80 billion. Meanwhile, GDP per capita in current prices has increased by an average of 7.1% per annum since 1991 to about US\$5,000 in 2005. And if adjusted for the cost of living the purchasing power parity (PPP) adjusted GDP doubled over the period to US\$10,318. The sustainability of the economic growth momentum has been derived from the diversified economic structure that has evolved, as the flexibility of the economy has yielded the continuous ability to shift to new areas of comparative advantage. It is this diversification in the economy that has also reduced vulnerability to shocks and increased resilience.

Malaysia has also taken advantage of globalisation to strengthen its economic and financial relationships with the major trading blocs in the world. This year we expect our trade value to exceed **RM1 trillion** for the first time. Foreign direct investment has been sustained, in particular, into the new areas of growth. There has also been an increase in Malaysian corporates and financial institutions venturing abroad. This has strengthened our inter-linkages in the global economy and our integration in the international financial system.

Amid the environment of favourable growth and strong fundamentals, Malaysia has taken the opportunity to further deregulate and liberalise the Malaysian financial sector, with a view to enhancing its contribution to efficiency and growth. The sector has also continued to be progressively transformed through rationalisation amongst existing financial institutions and the introduction of new institutions. These developments have contributed to the strengthening of the international dimension in the financial system. This has been particularly the case for the Islamic finance sector. In the development of the Islamic financial system, the Islamic Banking Act 1983 of Malaysia accords universal banking stature to licensed Islamic banks. The banks are permitted to conduct the full spectrum of banking business, including the more sophisticated investment banking activities such as corporate finance, private equity and wealth management. It is innovations in product development in this particular sector that has paved the way for increased opportunities in the Islamic financial system.

The Malaysian Islamic banking system saw strong performance in 2005, with higher profitability and positive trends in all key indicators. Profitability surpassed the RM1 billion mark for the first time in 2005, and assets surpassed the RM100 billion mark. The Islamic banking sector has remained well capitalised with risk weighted capital ratio sustained above 12 percent. The most recent performance of the Malaysian Islamic financial market has been encouraging with Islamic banking assets amounting to RM117.4 billion, takaful assets of RM6.2 billion, and Islamic corporate bonds of RM125 billion, which constituted 46 percent of the total corporate bond market in Malaysia. A total of 26 new corporate sukuk issues with an aggregated value of about RM23 billion were announced in the first half of 2006. This is equivalent to 71 percent of the Malaysian domestic market's rated corporate bond

issues for the same period. This increase in critical mass reflects the demand for issues, providing the supply for investors.

Let me now touch on several important aspects of the Malaysian Islamic financial markets that are important to issuers and investors. These relate to the freedom to move capital into and out of Malaysia, the availability of credible and timely market information and the capacity of the Malaysian Islamic financial market to allow for greater product diversification and risk management.

On capital mobility, Malaysia maintains a highly liberal foreign exchange administration regime. The primary focus of foreign exchange administration is to support the monitoring of flows of funds to promote financial and economic stability. As part of the continuous effort to enhance efficiency and reduce the cost of doing business, the foreign exchange administration rules have been progressively liberalised and simplified. There is free mobility of inward and outward movement of funds relating to both foreign direct investment and portfolio capital investments. Foreigners investing in Malaysia are also free to hedge with onshore banks their committed flow of funds such as the repatriation of investment proceeds, dividend and profits from Malaysia as well as the purchase of ringgit assets in Malaysia. In addition, investors are freely able to obtain ringgit and foreign currency to fund their investments in Malaysia.

Strategic measures have also been taken to allow non-residents, in particular, Multinational corporations and Multilateral agencies to issue ringgit denominated bonds in Malaysia. The ringgit funds raised may be used either in Malaysia or outside Malaysia. Both the foreign issuers and investors are free to hedge their foreign exchange exposure from the issuance and interest respectively. There is no withholding tax on the profit realised from investments in these ringgit denominated bonds. The International Finance Corporation and the International Bank for Reconstruction and Development have since issued their first ever Islamic bond issuances in Malaysia. The total issuance amounted to RM1.3 billion, all of which were over subscribed. A portion of these papers was purchased by non-resident investors, indicating foreign interest in the ringgit denominated instruments.

On the availability of credible and timely information, the Malaysian regulatory framework, reinforced with the adoption of best practices, has created an environment of greater transparency and richness in financial market information. The financial regulators provide extensive information about the Malaysian economy and Malaysian financial system, including regulatory requirements. The Bank also has put in place several websites that provide market information on the issues that are available for the market participants. Finally, on the capacity for diversification and risk management in the Islamic financial system, while being relatively small compared to the conventional system, it is expected to expand as the financial system strengthens and as new products are introduced.

In the context of this financial infrastructure, the Malaysian Islamic financial system is both robust and fast growing. The market has highly diversified players, with Islamic banks, investment banks, takaful companies, development financial institutions, savings institutions, fund management companies, stock brokers and unit trusts. The Malaysian Islamic financial market has already introduced a variety of Islamic financial hedging instruments, including the Islamic profit rate swap, Islamic cross-currency swap and Islamic forward rate agreement. The wider use of commodity murabahah transactions will also add breadth and depth to the Islamic money market as it facilitates a more efficient distribution of money-market liquidity and expands the range of instruments that market participants can actively transact in.

We are pleased to announce that Bank Negara Malaysia will soon be adding murabahah-based transactions to our already diverse range of policy instruments to manage short-term liquidity in the Malaysian Islamic inter-bank money market. The Bank Negara Malaysia's murabahah based-transactions may either utilise global or Malaysian commodities as the underlying transaction, and in the future, other Shariah-approved assets similar to the Ijarah sukuk notes. The widespread usage of this globally practised financing instrument would allow market participation by a more extensive investor base, including those from the Middle-East.

Product innovation must be a continuous and deliberate part of the process of market development. We are therefore firmly committed to developing the capabilities in Islamic finance and strengthening the global pool of talent and expertise in Islamic finance to increase the potential for this to happen. As part of the initiative to meet this objective, we have established the International Centre for Education in Islamic Finance, INCEIF, in March this year to offer professional certification programs in Islamic finance, in addition to, Masters and Doctorate programs. Bank Negara Malaysia has also recently

made available a Shariah Scholarship Award and Shariah Research Grant, available to Malaysian and non-Malaysians seeking to pursue research studies in Islamic finance.

East Asian, West Asian and the Middle East regions – greater inter-linkages

Islamic finance has made significant inroads in the international financial markets that has achieved growing global awareness. Islamic finance now has a presence in over 60 countries, with total Islamic assets under management by Islamic banks and conventional banks offering Islamic banking services reportedly exceeding USD400 billion. At present, Islamic mutual funds are estimated to be at a value of over USD300 billion, while issuance of Islamic sovereign and corporate bonds, or sukuk, have reached about USD50 billion. Islamic finance has demonstrated its viability and competitiveness in the current environment of a more liberalised and globalised financial system, with changing business and technological climates. As a form of financial intermediation it is now becoming increasingly integrated with the international financial system.

Against the backdrop of this rapid development in the international Islamic financial markets, there is potential to build greater intermediation linkages between the East Asian, the West Asian and Middle East regions to expand further the inter-regional trade and cross border investments. In an increasingly globalised financial environment, sovereigns, development institutions and corporations of capital deficit countries have the option of raising Islamic financial instruments in capital surplus countries through the Islamic financial intermediaries. Significant economic benefits will arise from the strengthening of these inter-linkages.

The expansion of inter-linkages of intermediation and markets among these regions would lead to a more efficient allocation of capital and thus enhance the prospects for strengthening further the growth performance. It also offers enhanced opportunities for raising financing and would also facilitate greater risk diversification. In particular, the strong growth performance in these regions create a significant potential demand for financial instruments that conform to the Islamic injunctions. These dynamic regions can therefore be expected to contribute towards accelerating the expansion of Islamic finance in the international financial system. Indeed, these trends will also contribute towards promoting a more balanced global growth.

The participation in the Islamic finance intermediation process would require the development of a comprehensive and well established Islamic financial system, a wide range of products and services; a good legal system, adequate financial infrastructure with competitive tax structures, low cost of doing business, high standards of business ethics, and conducive living conditions and cultural offerings. It would also need to be supported by adequate human talents that would drive the business and spur innovation. In addition, a strong regulatory regime in the Islamic financial system would be another pull factor. More recently, the regulatory regime in Islamic finance has been further reinforced by rapid progress on the issuance of prudential and supervisory standards by the Islamic Financial Services Board (IFSB). Fund raising, investments and risk diversification are essentially complex transactions. These transactions are highly dependent on financial markets that are well regulated and capable of evolving to meet the emerging new challenges and the changing market needs. Finally, the potential for the markets to function efficiently would be enhanced if the financial market is developed in an environment that enjoys financial stability, monetary stability and sustained economy growth.

The MIFC initiatives

To enhance the inter-linkages in the global Islamic financial markets, Malaysia is continuing its efforts to not only develop further the Islamic financial infrastructure but to also implement measures and initiatives that will strengthen our position as an international Islamic financial hub. The Malaysian Government is therefore launching an initiative known as the Malaysia International Islamic Financial Centre or MIFC. The MIFC initiative is specifically undertaken by the collective efforts of the country's financial and market regulators, including Bank Negara Malaysia, Securities Commission, LOFSA and Bursa Malaysia, together with the participation of the industry representing the banking, takaful and capital market in Malaysia. As part of the initiatives, Islamic financial products and services that are transacted in international currencies may now be conducted **from anywhere in Malaysia**. Malaysia has the physical infrastructure, international connectivity, the communication network, cultural offerings as well as the talents which is inherently advantageous to the MIFC.

In this first phase, the MIFC initiative will introduce measures and incentives to promote the centre in the offering of Islamic financial products and services by the diversified range of financial institutions in international currencies to the international and domestic financial community. The key measures and incentives include:

- i. Firstly, the Malaysian Islamic banks and takaful operators that are offering Islamic financial services in international currencies will be granted approval under the existing licence to set up an **International Currency Business Units** within the institutions. These new divisions will have their own accounts separate from the ringgit transactions of the head offices, while at the same time sharing the same infrastructure with the head offices. This division may benefit from tax and other incentives that may be introduced.

This measure will apply to the Islamic banks and takaful operators licensed under the Islamic Banking Act and Takaful Act respectively to operate in the Islamic financial system as well as to the existing financial institutions which are eligible to participate in the Islamic financial services. This is also expected to enhance the capability of the foreign players that have identified Malaysia as their centre to serve the regional markets. International entities will also be able to participate via foreign interest of up to 49 percent in Islamic banks and takaful companies. Investment funds set up in Malaysia will be able to enjoy the Double Tax Agreements that Malaysia has entered into with over 60 treaty partner countries.

- ii. Second, Bank Negara Malaysia will issue new **conditional licences under the Islamic Banking Act** to qualified foreign and Malaysian financial institutions to conduct the full range of Islamic banking business in international currencies and enjoy the same **tax incentives** as those accorded to the International Currency Business Units. The new entity will be termed **licensed International Islamic bank**.

The business that the licensed International Islamic bank would be allowed to undertake includes the wide-ranging business of Islamic commercial banking, Islamic investment banking and Islamic leasing in international currency.

- iii. Third, Bank Negara Malaysia will also issue new **conditional registrations under the Takaful Act** to qualified foreign and Malaysian insurance companies to conduct the full range of takaful business in international currencies. Similar **tax treatment** will be accorded to these entities as that for the banks. The new entity will be termed **International Takaful Operator**.

- iv. Fourth, the Labuan offshore Islamic banks and the Islamic divisions of the offshore banks as well as offshore takaful operators will be given greater flexibility in their business operations by allowing the **opening of operational offices anywhere in Malaysia** with no limitation on staffing, to conduct non-ringgit business while maintaining their presence in Labuan. This measure would be accorded to the six existing offshore Islamic banks and Islamic investment banks operating in offshore centre Labuan to participate in the MIFC.

- v. Fifth, incentives will be given **to attract the best foreign talents and market players to the MIFC** to spur innovation and offering of attractive Islamic financial instruments. This is to further strengthen the large pool of highly trained workforce with vast experience in Islamic finance already in Malaysia. Further incentives will also be introduced to spearhead the aspiration of developing Malaysia as a **centre of education excellence in Islamic finance** to complement the MIFC.

- vi. Sixth, in the pursuit of this national agenda, an **MIFC Executive Committee** comprising heads of relevant Ministries, agencies and industry representatives has been set up as a single coordinating committee to efficiently and effectively act collectively in the implementation of the recommendations. The Committee is entrusted to provide direction as well as review existing policies for the comprehensive and coordinated promotion of MIFC, and to align the role and responsibilities of the respective parts of Government and the industry to the development of MIFC. The secretariat is Bank Negara Malaysia, which will act on behalf of this committee as a **one-stop body** to fulfil this task.

We believe that these measures and initiatives will serve as a catalyst in our efforts for Malaysia to become a centre of origination, issuance and trading of Islamic capital market and treasury instruments, Islamic fund and wealth management, international currency Islamic financial services, and takaful and retakaful business. It is also aimed at positioning Malaysia as the gateway for tapping investment opportunities in this rapidly growing region.

In this environment, financial players, particularly with investment banking and fund management expertise, would need to sharpen their strategies and intensify their efforts in structuring cutting-edge Islamic investment instruments and in attracting new funds. Investors, especially those from the Middle East have shown strong interest to invest in Malaysian assets and to become partners with our local business corporates. There are therefore significant opportunities to strengthen trade and investment ties with the Middle East region. In respect of acceptable Shariah interpretation and practices, the MIFC will adopt a policy of mutual recognition and accommodate the various juristic reasoning based on contemporary analysis and logical inference so long as it is approved by recognised Shariah advisers. Harmonisation and knowledge sharing in Shariah is expected to be further enhanced with the on-going Shariah dialogues for the regional and international Shariah communities that are held annually in Malaysia.

The gathering of so many practitioners here for these two days to discuss the wide ranging matters that concern issuers and investors will contribute to developing our collective understanding of these issues and expand the boundaries of our knowledge. In closing, I wish to say that the motivation for advancing our mission to position Malaysia to become increasingly more integrated with the international financial system is to contribute towards facilitating greater cross border flows in terms of increased intra-regional trade and investment transactions. With the strengthening of intra-regional trade and investment flows, the greater regional economic and financial inter-linkages would contribute towards raising the prospects for more balanced global growth and greater shared prosperity.

On this note, I wish you a successful forum.

Thank you.