

## Zeti Akhtar Aziz: Potential role of Islamic finance in strengthening the New Silk Road

Special address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at GIFF Investors & Issuers Forum: "Islamic Finance: The New Silk Road", Kuala Lumpur, 28 March 2007.

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Up until the 14th century, the Silk Road served as a major global conduit between ancient civilizations in the East and West. It created mutual prosperity, encouraged knowledge transfer and enhanced understanding between civilisations through trade, cultural and technological exchange. Now in the 21st century, globalisation and liberalisation, and the emergence of new financial centres and their increased integration have created an environment of flourishing activity reminiscent of the Old Silk Road.

Indeed, it suggests that a New Silk Road has emerged. This new route not only carries flows of oil, manufactured goods, and technological innovation, but also flows of direct investment, portfolio capital, private equity and human capital. Previously, silk was one of the main commodities traded on this route. Now, the emergence of Islamic financial products and services has brought together financial services providers across continents to trade on this new route. The emergence of the New Silk Road reflects the increasing and evolving economic and financial relationships and inter-linkages, with Islamic finance well positioned to further facilitate these linkages to offer mutually-reinforcing benefits to those who participate in it. Indeed, the New Silk Road opens up the prospect of exciting opportunities for economic progress and prosperity for us all.

I first made reference to the New Silk Road at the 2nd World Islamic Economic Forum (WIEF) on "Unleashing the Potential of Emerging Markets" in Islamabad, Pakistan in November 2006.

It is my pleasure today to share some thoughts on the potential role of Islamic finance in strengthening the New Silk Road. My remarks will focus on four areas that is the emergence of the New Silk Road; how the linkages on the New Silk Road have built on the comparative advantages of Asia and the Middle East; how Islamic finance is able to foster the linkages along the New Silk Road; and finally, how we can extend the New Silk Road to the rest of the world to advance global economic stability and prosperity.

### The emergence of a New Silk Road

Today, signs that a New Silk Road is flourishing are abundant. The economic and financial linkages between Asia and the Middle East are growing. While the world trade has on the average expanded by 10% over the period 2001-2005, Asia's trade with the Middle East has increased on the average by 24%. More than half of the exports from the Gulf states<sup>1</sup> goes to Asia and more than one-fifth of its imports are from Asia. The Gulf is the major supplier of fuel to Asia, while Asia in turn supplies manufactured goods and food to the Gulf.

Recent trends in investment activities have been equally significant. Investment projects amounting to more than USD160 billion to be financed by the Gulf states in Asia have been announced since 2005<sup>2</sup>. In 2006 alone, mega-deals<sup>3</sup> involving corporate acquisitions and real estate purchases from the Gulf to Asia, are estimated to total more than USD18 billion, including multi-billion dollar IPO purchases in financial institutions in China, large oil refineries and telecom companies. The value of such investments are expected to increase to between USD20-30 billion in 2007.

For economic regions with high savings and surpluses such as Asia and the Middle East, the challenge is to recycle part of these surplus funds to productive investments in the region. The supply of savings in Asia and the Middle East is by far higher than in any other part of the world. Savings rates here in Asia are expected to remain in the region of 30-40% of GDP for some years to come.

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<sup>1</sup> The Gulf Cooperation Council represents Saudi Arabia, UAE, Bahrain, Qatar, Oman and Kuwait

<sup>2</sup> "A route to riches on the new Silk Road", Financial Times, 21 Dec 2006

<sup>3</sup> Worth more than USD1 billion

Similarly, savings in the Middle East economies have been rising in the recent decade and is expected to average about 30-35% of GDP in the coming years. In 2006, the current account surpluses as percentage of GDP for Asia and the Middle East were about 5% and 23% respectively<sup>4</sup>. With Asian official foreign currency reserves exceeding USD2 trillion, and Middle East oil revenues exceeding USD1 trillion since 2000, the management of surplus savings and reserves in both regions will offer significant investment opportunities.

Besides the institutional pool of wealth, the rapidly expanding middle class in both regions is a further trend sustaining the high savings rate and the increased demand for more sophisticated including consumer finance and wealth management. In Asia alone, we now have more than 2.4 million high net worth individuals<sup>5</sup>, not far behind the US with 2.9 million and Europe with 2.8 million, and these Asian individuals control an estimated amount of USD7.2 trillion financial assets. The size of this group in Asia is estimated to be increasing at 7% per year, second only to those in the Middle East, numbering 300,000 and growing at 9% per year. Traditionally, investors in Asia and the Middle East have looked to the developed Western markets to meet their investment needs, in view of the more developed financial markets and the range of asset classes. Increasingly however, there is growing interest and search for improved returns on investment in other parts of the world. This has been a global phenomenon for some years now, characterised by excess liquidity and low yields in the traditional markets.

### **The New Silk Road creates linkages that build on the comparative advantages between Asia and the Middle East**

Ladies and Gentlemen,

Historically, trade and investment in Asia and the Middle East has been linked to the developed economies. However, it is now increasingly recognised that there are significant complementarities between our two dynamic regions. These complementarities provide a platform for two-way flows that enhances income and wealth creation. The different demand patterns of each respective region reinforces the significance of the complementarities.

The Middle East investors have a greater need for diversification, both in terms of geographical allocation and asset classes, beyond the traditional investments in the US and Europe. Asia in turn, the home to some of the fastest growing economies in the world, offers highly diverse investment opportunities, ranging from in Vietnam to Japan, and in a broad scope of industries, ranging from natural resource producers to established high-tech brands. Such investment opportunities continue to support the growth momentum in the region. At the same time, Middle East domestic infrastructure requirements are estimated to total USD500 billion for the next five years, and Asian companies have demonstrated the capacity to provide the technology, expertise and human capital to meet these infrastructure demands.

Asia's relentless march towards development offers new opportunities for the Middle East. Asia's continued need for productive capital and uninterrupted energy supply to sustain its high growth matches the Middle East's resource endowments. It is estimated that Asia needs USD 1 trillion worth of infrastructure investment over the next five years, and is in search of new partnerships and strategic investors to co-invest in these undertakings.

In focussing on the respective comparative advantages and connecting via the New Silk Road, it contributes to expanding the opportunities in both the regions. Essentially, this extends the production possibility frontiers to create new areas of growth. The participation of a wider pool of investors also enables better risk sharing and consequently, increases the viability of projects as well as the returns to the investment. New value is also created in mutually beneficial collaborations, such as in downstream energy activities. Products resulting from hybrid ideas are also evident in innovations in several areas, including in Islamic finance, with the early global sukuk being issued from Asia and the Middle East economies.

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<sup>4</sup> Refers to IMF data

<sup>5</sup> Refers to individuals with at least USD1 million in financial assets. Sourced from Merrill Lynch - Capgemini World Wealth Report 2006

## **Islamic Finance: strengthening the financial linkages between Asia and the Middle East**

Ladies and Gentlemen,

Islamic finance has demonstrated its viability and competitiveness in a more liberalised and globalised financial environment and has become important in strengthening the linkages between the two regions. While the sizeable Muslim populations in both regions have been attracted to the unique features of Islamic finance, it has also attracted interest and participation from non-Muslims within these regions. At present, there are more than 100<sup>6</sup> Islamic banks in both regions, while Islamic financial transactions involving sovereigns and corporations have amounted to USD 35 billion during the period 2004 and 2006<sup>7</sup>.

Several factors have supported this trend. The orientation of Islamic finance towards real underlying assets is aligned to the nature of the investment opportunities in both regions. Infrastructure and project finance in both regions are particularly suited for Islamic finance.

The emphasis in Islamic finance on risk-sharing and the equity-oriented nature of such financing also suits the requirements. The Islamic financial structures clearly distinguish the roles and responsibilities as well as risk and profit-sharing profiles of the parties involved. This clear delineation of the roles also promotes greater transparency and the appropriate governance. The nature of the structures also enables the risks to be transferred to those more able to contribute towards value creation.

In addition, the use of Islamic finance promotes stability in the financial markets and the financing flows, which is important for emerging market economies such as those in Asia and the Middle East. In Islamic finance, strategies to minimize and manage the risks involve integrating with the risk in the real activities. The real activities therefore need to generate sufficient wealth to compensate for such risks. In contrast, conventional instruments generally separate the risks from the underlying assets. As a result, risk management and wealth creation may at times move in different or even opposite directions. Conventional financial instruments also allow for the commoditisation of risks, leading to its proliferation through multiple layers of leveraging and disproportionate distribution. These could result in higher systemic risks, increasing the potential for instability and inequitable concentration of wealth. The adoption of Islamic financial principles encourages financing to be primarily adopted as a means to facilitate real underlying economic transactions and not for speculative purposes.

There are also clear value propositions in Islamic finance for both investors and issuers from both regions. For investors, Islamic financial products offer portfolio diversification and new investment opportunities as they avail themselves to a new asset class. They also encourage risk management and provides confidence through explicit disclosure and transparency of the roles and responsibilities defined in the contract. For issuers, Islamic finance allows access to a new source of funds and liquidity besides providing, new risk management options and new mechanisms for price discovery.

Islamic finance is well positioned to be a vehicle on the New Silk Road, as the enabling supporting infrastructure is already in place. The required regulatory and legal frameworks for Islamic finance have been established, not only in a growing number of countries in both regions but also at the international level through standard-setting bodies such as the International Financial Services Board and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). Efforts towards the harmonisation of Shariah interpretations and issues concerning mutual recognition are at an advanced stage. The platforms for extending regional linkages and cross-border initiatives, including to the Middle East, are already in place within Asia, where there has been a significant degree of regional financial and economic integration.

### **Malaysia as an intermediary destination along the New Silk Road**

Malaysia is committed to and extensively engaged in strengthening linkages through Islamic finance. In collaboration with the participation of the industry representing the banking, takaful and capital markets in Malaysia, the regulators have worked towards enhancing the inter-linkages with the global

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<sup>6</sup> Estimates based on the listing of Islamic financial institutions provided by the Institute of Islamic Banking and Insurance, London.

<sup>7</sup> Data sourced from Islamic Finance Information Service website. The Islamic financial deals mostly based on Murabahah, Ijarah, Mudharabah, Istisna principles.

Islamic financial markets, not only by the further development of the Islamic financial infrastructure but also through increased liberalisation and through the implementation of measures to increase competitiveness of the financial services sector. This has included further liberalisation of the capital account of the balance of payments and the implementation of tax neutrality measures. Just as historical Malacca was a key port along the ancient trade routes between Asia and the Middle East, it is envisaged that Malaysia would serve as a key destination along the New Silk Road.

Today, as part of Malaysia's efforts to further spur the infrastructure development of the Islamic financial system, it is my pleasure to announce that Bank Negara Malaysia, the Securities Commission, Bursa Malaysia and industry players have worked collaboratively towards establishing a mechanism referred to as the Commodity Murabahah House. This mechanism which uses crude palm oil as the underlying commodity will facilitate Islamic financing applying the concept of murabahah or tawarruq.

### ***BNM commodity murabahah acceptance***

As part of these efforts to promote development of products to meet the diversified requirements of investors, Bank Negara Malaysia is pleased to announce the introduction of a new Islamic monetary instrument, Commodity Murabahah Programme (CMP) as part of its diverse range of policy instruments in managing the short-term liquidity in the Malaysian Islamic inter-bank money market. Unique to Malaysia is that the CMP is designed to be the first ever commodity-based transaction that utilises the Crude Palm Oil based contracts as its underlying asset. The Bank has executed CMP master agreements with the eight Islamic banking institutions including the three foreign owned banking institutions to promote the use of the instrument for liquidity management. Several CMP transactions have now been conducted between the Central Bank and the respective Islamic Banks.

As commodity murabahah is widely used in other Islamic centres, it is envisaged that this CMP will promote increased linkages between Malaysia and these centres.

### ***BNM Sukuk Murabahah/tawaruq short-term securities***

The Central Bank also intends to diversify the issuance concept of the existing Islamic monetary notes from being based on Bai Inah and Ijarah into murabahah. Currently, the outstanding amount of the respective notes is RM 8 billion. This initiative is the continuation from the commodity murabahah acceptance initiative as the issuance involves the securitisation of the acceptance facility. There are several key benefits of issuing the Islamic Monetary Notes under this structure. It provides Islamic financial institutions an additional instrument to manage liquidity risk on a short-term basis. It is also a financial instrument whose structure has been widely used for retail banking and syndication products in the Middle East. Finally, it provides an opportunity for new investors to invest in Islamic financial papers in the Malaysian market, thus diversifying the investor base.

As part of the initiative to be linked to the global Islamic financial markets, this instrument will be promoted to the international financial market.

### ***Islamic Derivative Master Agreement (IDMA)***

Recognising the importance to develop Islamic hedging products for Islamic financial market to mitigate investment risks, Malaysia has introduced the first global Islamic Derivative master agreement to document Islamic derivative transactions. The effort is initiated by Bank Negara Malaysia and driven by the financial industry via the Persatuan Pasaran Kewangan Malaysia. The implementation of the agreement is expected to improve the risk management practices, balance sheet management, increase fund mobilisation efficiency and enhance their investment banking capability of the Islamic banking institutions. With the introduction of IDMA, the rights and obligations of contracting parties are clearly stated, thus creating an environment that is more transparent. As IDMA also incorporates best practices in market conduct, this document serves as an important catalyst for the future linkages between financial markets that offer Islamic financial market instruments.

## **Extending the New Silk Road to the world**

Ladies and Gentlemen,

While the New Silk Road is enhancing linkages between Asia and the Middle East, both regions have always extended the Silk Road to the rest of the world to participate in the these exciting developments on this route. Indeed, global investors and the international financial community are already drawing the benefits from the increased diversification of asset classes while riding on the dynamism of the two regions. As Islamic finance expands further, reinforced by the activities on the New Silk Road, there will be greater convergence towards ethical or socially responsible-type of investments (SRI) in the global financial community. Islamic investment guidelines share significant similarities with the SRI principles. The focus of Islamic investment not only involves the avoidance of riba-free activities but also extends to include issues related to ethical values, such as fair trade and environmental protection. Furthermore, the prospects of increased stability for financing flows and the focus on the role of real sector economic activities have ignited interest in utilising Islamic finance for sustainable development.

This overwhelming gathering of so many issuers and investors here today provides some indication of the growing interest in Islamic finance, reinforcing the potential increased activity on the New Silk Road. We all have a part in the making of the New Silk Road into a vibrant source of wealth and prosperity in the global economy.

In closing, Malaysia is committed to be part of the New Silk Road to facilitate greater cross border economic and financial flows for increased inter-regional trade and investment transactions. Insha-Allah, the greater inter-regional economic and financial linkages would bring greater benefits which will be mutually reinforcing and contribute towards raising the prospects for greater global shared prosperity.