

Zeti Akhtar Aziz: The challenge for a global Islamic capital market – strategic developments in Malaysia

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Sukuk Summit 2007, "The Challenge for a Global Islamic Capital Market – Strategic Developments in Malaysia", London, 20 June 2007.

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Ladies and gentlemen, distinguished guests.

It gives me great pleasure to be here in London to speak at this landmark sukuk summit. The Islamic bond market – the sukuk market – represents a key component of the Islamic financial system. This recent decade has seen the accelerated development of this market and its significant role in strengthening the evolution of Islamic finance. The global development of this market is particularly important in this more challenging financial and economic environment. It has contributed to enhancing the effectiveness and efficiency of the mobilisation and allocation of funds within national financial systems and in the international financial system. This development is also evidenced by the level of innovation and sophistication of the products and services being offered by the Islamic financial institutions. The encouraging development of the Islamic bonds market has also had an important role in enhancing the linkages between financial markets as it facilitates cross-border flows in the international financial system.

The sukuk market as an important source of financing for large scale investment projects, has a key role in facilitating the economic development process. For investors, it provides greater potential for diversification into new asset classes. My remarks today will focus on the vast potential of the Islamic bond market in the economic development process, in its role in ensuring financial stability and its role in promoting greater financial integration in the global financial system. I would also like to take this opportunity to share with you Malaysia's experience in the development of this market. The Malaysian sukuk market has now evolved into one of the world's largest Islamic bond market.

Immense role of sukuk market in the economic development

The financing requirements for economic development are immense. The bond market is key to meeting these funding needs for both the public and private sectors. This is particularly important for emerging market economies. In the Middle East and in Asia, two of the fastest growing regions in the global economy are taking place following privatisation and implementation of infrastructure projects. Asia alone will be spending an estimated USD1 trillion on infrastructure over the next five years, while infrastructure requirements in the Middle East are estimated to be USD500 billion over the same period. The challenge is to put in place an intermediation system that will channel the surplus savings in both these regions into productive investments. It is in this context that the Islamic capital market, in particular the sukuk market will serve as an important avenue to efficiently mobilise longer term funds to meet these funding requirements.

The global experience has shown that the lack of well developed bond markets brings with it vulnerabilities arising from over-reliance on financing from the banking sector. This has often resulted in funding mismatches with adverse implications on financial stability. The development of the bond market allows for access to funding with the appropriate maturities, thus avoiding the funding mismatches. It also allows for the diversification of risks by issuers and investors.

The central merit of the sukuk structure is that it is based on real underlying assets. The ijarah sukuk for example – an Islamic bond which applies a sales and leaseback arrangement – is an asset-backed instrument providing continuous security to the investor. This approach discourages over-exposure of the financing facility beyond the value of the underlying asset, given that the issuer cannot leverage in excess of the asset value.

In addition, Islamic finance requires that the financing must be channelled for productive purposes, such as for project financing, rather than for speculative activities. The risk exposure is therefore to the project and not to the uncertainties or activities that have no real economic benefits. Islamic financial intermediation therefore has the potential role of contributing towards financial stability.

In the current environment, the demand for sukuk significantly exceeds the supply. Today, the global sukuk market, denominated in international currencies, is estimated to be USD18 billion. If domestic sukuk issuance is included, it has now exceeded USD50 billion. Although the size of the market may seem modest by global standards, the sukuk market has been registering an impressive average growth of 40 per cent per annum. The phenomenal demand has been spurred by the high levels of surplus savings and reserves in Asia and Gulf regions. Asia has a savings rate which is higher than any other region in the world and is expected to remain between 30 and 40 per cent of GDP for many years to come.

The sukuk market brings with it many benefits to both issuers and investors. Issuers can benefit from the huge increase in liquidity in the Islamic world, and can tap on these new sources of funds. Raising funding from the Islamic bond market in the current environment has been 10 to 20 basis points lower than mainstream bonds. An increased number of multilateral agencies are issuing sukuk to finance development projects. In addition, both government agencies and the corporate sector have considered the sukuk market as an attractive source of financing.

From the investor perspective, there are the benefits of diversification. In a sukuk issue in 2005, 48 per cent of the issuance were subscribed by conventional-based investors. This increased appetite for sukuk reinforced by excess liquidity in the global financial system is part of the reasons sukuk are attractively priced for issuers.

Extending the linkages to other parts of the world

The emergence of Islamic financial products, in particular, in the capital market has also promoted greater global financial integration. The bringing together of financial institutions and market players across continents to participate in this expansion of inter-regional investment flows has fostered financial linkages among the major regions. This will not only provide great synergies and opportunities but will contribute towards facilitating international financial stability.

Just as the old Silk Road in the 14th century offered a route that facilitated the spice trade from the East to the West, we can now envisage the new Silk Road which financial flows across borders between the East and West, thereby promoting international financial integration. In this context, the Islamic capital market, in particular, the sukuk market has a major role in strengthening this interlinkage. The essence of the New Silk Road is to provide a route for such flows and promote greater financial integration for the benefit of a wider community. The New Silk Road should not be envisaged as just a link between Asia and the Middle East but that which extend to Europe and the rest of the world. Indeed, we are already seeing the participation of global investors and the international financial community. The participation of a financial centre like London will foster the global growth and international integration of this market. The involvement of regulators and government agencies is also contributing to accelerating this process.

Malaysia is one of the key intermediary destinations along this New Silk Road that offers a platform for the origination, distribution and trading of Islamic capital market and treasury instruments, including sukuk. Malaysia is positioning itself as an Islamic investment gateway to Asia, with a niche in Islamic fund and wealth management. Malaysia has developed a comprehensive Islamic financial system that operates in parallel with the conventional financial system. Of significance, is the inter-connectivity within the system that includes the banking and takaful industries, and the Islamic money and capital markets – a matrix which mutually reinforces the integrity and stability of the Islamic financial system. This is supported by the financial infrastructure, the legal and regulatory framework and the expertise to contribute to the growth of Islamic finance.

Malaysia's achievements in developing the sukuk market

Allow me to share the Malaysian experience in developing the sukuk market. The Malaysian Islamic bond market has made significant progress since the first sukuk issue in 1990 by a multinational corporation operating in Malaysia. The development of the market involved initiatives to facilitate an efficient issuance process, the price discovery process, the broadening of the investor base, the establishment of a benchmark yield, the liquidity in the secondary market and the strengthening of the regulatory framework. These initiatives have been reinforced by the legal and Shariah framework and the supporting financial infrastructure including the settlement and bond information system.

Following the development of a robust and vibrant domestic market, initiatives have now been taken to raise the significance of the international dimension of our Islamic financial system. This has included wide ranging liberalization measures including bringing in new Islamic finance foreign players into our system through the issue of new licences and allowing for greater levels of foreign interest in our domestic financial institutions. The liberalisation has also involved the potential for greater foreign participation in our domestic financial markets.

In 2002, Malaysia achieved a further significant milestone when the Malaysian government issued the first global sovereign sukuk, raising USD600 million. With this issuance, it became an international benchmark for the issuance of global sukuk. The sukuk issue was listed on the Luxembourg Stock Exchange, Labuan International Financial Stock Exchange and Bahrain Stock Exchange. There has since been further sovereign issues in the global capital market.

In 2006, the Malaysian market saw the launch of a sukuk using concepts such as Mudha-rabah, Mu-sya-rakah and Ijarah. The issuers included Malaysia's government-linked companies. A landmark example was the USD750 million exchangeable sukuk Musyarakah by Khazanah, the government's investment corporation for the purpose of selling a stake in Telekom Malaysia. It marked the world's first issue of its kind, incorporating full convertibility features common to conventional equity-linked transactions.

Following these developments, the Malaysian sukuk market has attracted a wide range of lead arrangers. In addition, the rising demand and the growing number of issuers and the broadening investor base has led to the growing sophistication of the market. By January 2007, Malaysia accounted for 67 per cent, about two-thirds of the global sukuk outstanding, amounting to about USD47 billion.

The growth in the sukuk market also reflects the commitment and combined efforts of the Malaysian government and regulators. There is a clear articulation of the vision and policies to drive the local Islamic capital market. This is reinforced by the implementation of a strong legal, regulatory and tax framework.

Bank Negara Malaysia and the Securities Commission have worked closely on a sequence of vital blueprints: the 10-year Financial Sector Master Plan, the 10-year Capital Market Master Plan and the Islamic securities guidelines. The government has reaffirmed all these plans and initiatives with the announcement of a range of tax measures in the 2006 budget.

Another important aspect of the development of the sukuk market is the development of the other key components of the Islamic financial system, the money market, banking, and takaful sectors. The various components are able to meet the different requirements of the economy including the differentiated tenor for which the funds are required. This includes providing stable long-term funds for large investments and development projects. These would allow for a balanced allocation of financial and economic resources within the economy, diversifying the risks through the Islamic financial system, and enhancing its flexibilities to adjust, thus strengthening its resilience.

As Malaysia moves to a more liberalised and globalised Islamic capital market, the role of the industry in advancing the Islamic financial system becomes increasingly important. The role of the industry has been important in spearheading product innovation, branding, profiling, promotion and marketing of the Islamic capital market products and services. This has contributed to the development of a deeper and more liquid, efficient, transparent and effective sukuk market.

Challenges in the development of the global Islamic capital market

While much has been achieved, much remain to be done. Let me turn to some of the challenges and initiatives taken to address them. A vital ingredient for the development of capital markets, including the Islamic capital market, is the creation of a secondary trading platform for the capital market instruments. This will provide investors with the flexibility in managing their liquidity requirements. In this respect, more needs to be done in terms of the creation of a continuous supply of Islamic papers and instruments that would promote the secondary trading of instruments and add greater depth to the market.

There also needs to be greater diversity in the type and maturity of the sukuks in the market for Islamic financial institutions and portfolio managers to manage their funds effectively. As part of the efforts to address these issues, the Malaysian government regularly issues sukuk with different maturities in order to create a benchmark yield curve. Since the year 2000, the government has developed an

auction calendar for both the conventional and sukuk government issues. In 2005, the government commenced issuing shorter term Islamic treasury bills and longer-dated sukuk, with a maturity of 10 years, to further diversify the instruments available to investors. In the Malaysian sukuk market, Islamic private debt securities now account for 50 per cent of the total private debt securities market.

Another challenge to the growth of the market concerns pricing issues. For the Islamic security to be efficiently priced and credible, further initiatives need to be undertaken to develop its own indicator. For example, if a sukuk is issued based on the Ijarah principle, and uses the property as its underlying asset, the actual rate of rental may be explored to be used to determine the rate of return on the instrument. It would then fluctuate depending on the demand and supply for that property. It will then give a true reflection of the price of the underlying asset.

Shariah experts, who have a full understanding of the mechanics of sukuk, are key to ensuring its proper governance. And shariah decisions, when made, should be transparent and disclosed. This will allow others to appreciate the juristic reasoning, which in turn should lead to wider acceptance of shariah decisions, particularly if they have implications on cross-border transactions. In relation to this, a guide for issuers and investors to refer with regards to shariah decisions would facilitate the development of the market.

Of further importance is the attainment of the convergence of Shariah principles and interpretation to ensure market confidence among investors from different parts of the world. To achieve this, there needs to be continuous investments in intellectual capital and greater engagement among Shariah scholars. The regular engagement that is now taking place among the scholars is already producing this convergence.

Similarly for the global acceptance of Islamic finance, the harmonisation of standards and practices is important. Full support has to be accorded to the international standard setting organizations such as Islamic Financial Services Board (IFSB) and to the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) to formulate appropriate standards that would strengthen the Islamic financial system. The IFSB has already formulated the prudential treatment for sukuk investment by the Islamic financial institutions as stipulated in the Capital Adequacy Standards. The IFSB has also undertaken initiatives to strengthen the framework and practices in the Islamic money market. Further work is being undertaken to formulate strategies for strengthening the liquidity management framework and to identify measures to develop benchmark Islamic securities that can help to determine benchmark rate for system-wide application.

Global co-operation to develop the Islamic financial markets

Indeed, while there remains many challenges that need to be overcome, the overall direction and potential of the global Islamic financial markets are certainly well recognised. Greater engagement and interface between the industry, the scholars, and the authorities will create greater awareness, understanding and appreciation of the issues and the direction for its resolution. This will provide an environment in which the full potential of Islamic finance can be realised. This is indeed a global challenge and it will be the cumulative efforts of the scholars, industry and authorities that will produce the best outcome.

In conclusion, I would like to congratulate the organisers in successfully providing a platform at this conference for all the sukuk stakeholders ranging from the issuers to investors. I wish all of you a highly productive and successful conference. Thank you.