

Zeti Akhtar Aziz: Enhancing interlinkages and opportunities – the role of Islamic finance

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It is my great pleasure to be here in Washington D.C. to speak at this important conference which has brought together policymakers, market practitioners, members of the academia and the business community to discuss the new opportunities in Islamic finance and its role in enhancing international financial linkages. It is exactly five years ago, when I spoke on this very subject of Islamic Finance at the First International Islamic Finance Conference that was held in Washington D.C. in 2002. The issues discussed at that time were on the challenges faced in developing an efficient and robust Islamic financial system. Five years hence, the Islamic financial system has evolved significantly to become a dynamic and competitive form of financial intermediation in the global financial system. This transformation has been achieved in an increasingly challenging environment.

My remarks today will focus on this transformation that has taken place in these five years in both the national and international Islamic financial system. Most significant has been the development of the Islamic financial markets, the increase in the range of the financial products and services, the increasing significance of the international dimension of Islamic finance, the development of the international Islamic financial architecture, and the enhanced international inter-linkages that has been brought about by these developments.

Transformation of the Islamic financial landscape

As recent as five years ago, the development of Islamic finance was regarded as an infant industry striving to prove its viability and competitiveness. At that time, the growth of Islamic finance was organic and largely concentrated in countries where the Muslim population was significant. In these five years, Islamic finance has recorded dramatic growth and has a presence in more than 75 countries both in Muslim and non-Muslim dominated communities. There are also a growing number of the international financial centres that are beginning to offer Islamic financial products and services such as in London, Singapore and Hong Kong. The number of Islamic banking institutions worldwide including conventional banks that are offering Islamic banking services have doubled to more than 300. The total Islamic financial assets under their management is now estimated to exceed one trillion US dollars, about fivefold its magnitude five years ago.

Islamic finance is now among the fastest growing financial segments in the international financial system with an estimated average annual growth of between 15 to 20 percent. More recently, there has been a growing diversity in the range of products and services being offered and in the markets that have been developed. The sukuk market, that is the Islamic bond market denominated in international currencies, has registered a remarkable growth, having doubling in size to amount to USD28 billion compared to a year ago. Including sukuks denominated in domestic currencies, the size of the market is now about USD82 billion. This market is expected to continue to expand significantly given the massive financing requirements for infrastructure investment and other private sector investment by countries that have shown interest in Islamic funding.

There has also been significant innovation in Islamic financial products. This has been especially evident in the sukuk products. Following the Malaysian Government issuance of the world's first global sovereign sukuk in 2002, there has been several other sovereign

sukuks issued by other countries. This development has also encouraged the issuance of international corporate sukuks by multinational and domestic corporations. Innovative instruments that have been developed include the landmark issuance in 2006 of the exchangeable sukuk by Khazanah Nasional, the Malaysian sovereign wealth management entity. In this arrangement, the sukuk can be exchanged for other shares held by Khazanah. In the same year, a convertible sukuk, in which the sukuk can be converted to the issuer's own shares upon initial public offering, was issued by a Middle Eastern-based corporation. The derivative market has also been developed with the introduction of Islamic currency swaps and profit rate swaps.

There has also been significant growth in Islamic asset and wealth management following the development of diverse and innovative structures of Islamic investment funds, including Islamic hedge funds. There are now more than 250 Shariah-compliant mutual funds that are managing an estimated USD300 billion in assets. Other developments include the creation of benchmark indices such as the Dow Jones Islamic Market Indexes – covering more than USD10 trillion market capitalisation in over 40 countries, the Financial Times Stock Exchange Global Islamic Index Series, and the listing of Islamic financial instruments on international exchanges. These developments have enhanced the depth of the Islamic financial markets as an attractive asset class for investment.

Another important development in Islamic finance during this period has been the strengthening of the international Islamic financial architecture. In 2002, a major structural enhancement was the establishment of the Islamic Financial Services Board (IFSB), which formulates the international regulatory and prudential standards for Islamic finance. It has since issued the standards for capital adequacy, risk management and corporate governance. Among the standards that are currently being formulated include market conduct and rules for financial disclosure, transparency, the Shariah governance framework and the supervisory review process. This is to ensure best practices and the soundness and stability of the Islamic financial system.

The IFSB now has 137 members that include 35 regulatory and supervisory authorities, five international inter-government organisations including the BIS, World Bank and the IMF, and 97 market players and professional firms from 22 jurisdictions. Of significance to note is that the membership of the IFSB comprises several authorities and international institutions from the non-Muslim countries. The IFSB complements the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) which was established earlier in 1991, to set the accounting standards to ensure that the true and fair value are reflected in the financial transactions and to ensure greater accountability and responsibility of the financial institutions.

Finally, these developments have been reinforced by greater liberalisation to increase the international dimension of Islamic finance. With increased international participation in Islamic financial markets, it has prompted increased cross-border Islamic financial flows. In addition, Islamic financial institutions that had previously operated only in their own domestic jurisdictions have begun to venture abroad to tap new growth opportunities in other regions. This new international dimension of Islamic finance has enhanced further the international inter-linkages in this more globalised environment.

Islamic finance: operating in a challenging and evolving environment

The evolution and expansion of Islamic finance has occurred in a fast changing and dynamic international environment. In the context of a more challenging and competitive environment, the issue of financial stability, viability and competitiveness are paramount. This is particularly evident in the recent developments experienced in the international financial system. An important element of Islamic finance is the strength and soundness it derives from its Shariah principles. Islamic finance has an inbuilt dimension that promotes soundness

and stability, underpinned by the Shariah injunctions. These Shariah injunctions essentially interweave the financial transactions with genuine productive activities.

The soundness and viability of Islamic finance as a form of financial intermediation is premised on the fundamental requirement that Islamic financial transactions need to be supported by an underlying productive activity. There is therefore always a close link between financial and productive flows. The financial transaction has to be accompanied by genuine trade or lease-based and business related transactions where interest is eliminated and profits or rentals are the economic rewards. Alternatively, the Islamic financial institution may enter into a joint venture as a means of financing, in which it becomes a joint partner in the economic activity based on a pre-specified profit sharing arrangement. In addition, there are also explicit restrictions on unethical and speculative financial activities.

The intrinsic nature of Islamic finance also encourages risk management and provides confidence through explicit disclosure and transparency of the roles and responsibilities defined in the contract. In Islamic finance, strategies to minimize and manage the risks involve integrating the risks in the real activities. The real activities thus 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. This could result in higher systemic risks, increasing the potential for instability and inequitable concentration of wealth.

The intrinsic principle of governance also contributes towards insulating the Islamic financial system from potential risks from excessive leverage and speculative financial activities. The explicit and transparent nature of Islamic financial contracts and the greater disclosure of information are important in contributing to the stability of the system. The focus of Islamic investment also not only involves *riba* free activities but also extends to include issues related to ethical values and fair trade. The Islamic investment guidelines thus share a number of similarities with socially responsible investment (SRI) principles.

New opportunities and linkages offered by Islamic finance

Islamic finance is now at the threshold of a new dimension in which it has an increased potential role to strengthen international financial inter-linkages between nations. Islamic finance has the potential to contribute towards the efficient mobilization and allocation of funds across regions. Regions with surplus savings may channel funds to regions with deficit savings and to bring about a more inclusive global financial integration. Financial linkages are now gaining ground as intra-regional financial flows are increasing in significance. In this context, Islamic finance has become a new vehicle contributing to increasing the financial linkages within Asia thereby facilitating cross-border allocation of capital in the region. However, it not only has a potential role in strengthening integration and linkages within Asia, but also more importantly in forging linkages with other dynamic emerging regions such as the Middle East.

Several economies within Asia are now beginning to participate in these trends thus strengthening further economic and financial linkages between these two dynamic growth regions. This enhanced inter regional linkages between Asian and the Middle East has created an environment of activity reminiscent of the Old Silk Road. This suggests that a New Silk Road has emerged in which financial services providers across continents now operate on this new route. While the New Silk Road reflects the linkages between Asia and the Middle East, the Silk Road has always been extended to the rest of the world. There is thus the potential for greater participation by global investors and the international financial community.

Islamic finance essentially presents value propositions for both investors and issuers in the respective markets, in particular, the sukuk market. For investors, Islamic financial products offer portfolio diversification and new investment opportunities in the form of new asset classes. 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. A number of international financial centres have recognised Islamic finance as an integral part of their financial markets in order to complete the suite of financial products and services available, and are therefore actively developing this segment. This trend is envisaged to stretch the New Silk Road from Asia and Middle East and extend to the West and to other parts of the world.

Further opportunities: the Sukuk market

Among the more significant developments in Islamic finance in the recent period has been the development of the Sukuk market. Although the size of the Sukuk market is modest by global standards, the Sukuk market has experienced remarkable growth, increasing at an average annual rate of growth of 40 percent. This growth is spurred in part by the growing funding requirements in emerging market economies, in particular, in Asia and the Middle East in which there has been increased investment activity. There has also been significant demand for the Sukuk spurred by the high levels of surplus savings and reserves in Asia and in the Middle East. This strong demand has also been reinforced by the strong financial flows in the international financial system that is in search of higher returns and greater diversification of risks.

It has been estimated however that about 80 percent of the sukuk issued have been subscribed by conventional international investors. Besides the intrinsic value of the sukuk which are largely asset-backed, convertible for shares or exchangeable with shares, such issuances are attractive as they have a wider investor base that comprise conventional and Islamic investors. With the rising wealth of global investors seeking Shariah compliant investments the market has become highly competitive. More recently, it has prompted corporations worldwide including global multinational companies to consider this as a financing option.

The development of the sukuk market in Malaysia has involved extensive and wide ranging initiatives that include facilitating an efficient issuance process, enhancing the price discovery process, establishing of a benchmark yield, broadening of the investor base, promoting the liquidity in the secondary market and strengthening further the legal, regulatory and the Shariah framework. These initiatives have also been supported by the development of the financial infrastructure including the settlement system and the bond information system.

To position Malaysia as a centre for origination, distribution and trading of sukuk, further steps have been taken to liberalise the market to allow foreign corporations including multinational corporations and multilateral agencies to raise funds in the Malaysian bond market. Funds raised by these entities may be used to finance investment activities in other jurisdictions. The inaugural ringgit denominated Sukuk issue was in 2004 by the International Finance Corporation, and followed by an issue by the IBRD World bank in 2005. In 2006, the market was further liberalized to allow foreign currency denominated sukuk to be issued from the Malaysian market. These sukuk issues have attracted foreign investors, thereby strengthening our inter-linkages with other international financial markets. Profits or income received by non-residents for investments in ringgit and non-ringgit Islamic securities issued in Malaysia are also exempted from withholding tax. In addition, the Government has granted tax neutrality measures to accommodate the sukuk issuance.

To further enhance Malaysia's international financial linkages with other parts of the world, the domestic Islamic banking sector was liberalised further in 2004 with the issuance of new licenses to foreign Islamic financial institutions. In addition, the allowed foreign shareholding in Islamic financial institutions was raised to 49 percent of the total equity in existing Islamic

financial institutions. New licenses are also extended to entities to conduct Islamic banking business and takaful and retakaful business in international currencies. These institutions, which may have up to 100% foreign equity ownership, are given operational flexibility to be established as a branch or subsidiary and enjoy a tax holiday for 10 years under the Income Tax Act.

Concluding remarks

The foundations for the sustainable global development of Islamic finance have now been put in place. Going forward, three key elements will be important in sustaining the current momentum. These include the investment in research and development and hence promote innovation, the development of the pool of talent, and the greater use of technology in Islamic finance.

Islamic finance as an emerging form of financial intermediation would require tremendous investment in research and development to promote innovation. Of importance is to develop a broader range of Islamic financial market instruments that 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. Malaysia has recently established a Shariah Scholar's fund to fund such research and development efforts. The fund also aims to promote greater engagement among the international Shariah scholars and thus provide a platform for deliberation on the Shariah compatibility of newly developed Islamic financial instruments and markets.

As Islamic finance continues its robust international expansion, an adequate supply of talent and expertise is vital to support the growth. While shortages in talent are now being felt, this is being addressed on several fronts. To develop the expertise to meet the increasing manpower requirements of Islamic finance, Malaysia has in 2006 established the International Centre for Education in Islamic Finance (INCEIF). It is envisioned that INCEIF acts as a professional certification body and education institute for post-graduates in Islamic Finance. Reinforcing this is the International Centre for Leadership in Finance (ICLIF) in Malaysia that provides for leadership and management programmes for the financial services sector including for Islamic finance.

As Islamic finance forges ahead, successful Islamic financial institutions will be those that have the scale and are able to exploit the full potential and opportunities that arise from the advances in information technology (IT). In embracing new leading edge technology, the potential for the Islamic financial industry to provide new products and services will be enhanced. It also represents the potential to increase access through a wider range of new delivery channels, including enhancing efficiency while reducing costs for consumers and businesses. IT needs to be leveraged on in making strategic decisions in the alignment of the business, in elevating the institutional capacity and operational efficiency and strengthening risk management capabilities.

Despite the more challenging and dynamic environment we have seen, Islamic finance has continued to emerge as a vibrant and resilient form of financial intermediation that is increasingly being embraced on a global scale to become an integral part of the international financial system. In the process of its development, it has further expanded the set of opportunities for the participation by the international financial community and thus increases the inter-linkages both within and between economic regions of the world. In enhancing these new linkages and greater integration, Islamic finance is envisaged to contribute towards unlocking new potentials that would bring mutual benefits, and in doing so, enhance our overall prospects.

Thank you.