Zamani Abdul Ghani: Malaysia's role as an international Islamic financial centre

Keynote address by Mr Zamani Abdul Ghani, Deputy Governor of the Central Bank of Malaysia, at the International Takaful Summit 2007 "Mainstreaming Islamic Finance: Malaysia as International Islamic Financial Centre", London, 1 November 2007.

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I. Introduction

I am indeed pleased to be invited to this **International Takaful Summit 2007** hosted by the Islamic Banking and Finance Institute of Malaysia (IBFIM). The occasion of this forum is indeed an excellent opportunity for the regulators, industry practitioners and investors to discuss recent developments and key issues in Islamic finance, particularly on takaful. It would also serve as an excellent platform in providing greater awareness on the innovative products and services available in the takaful and retakaful market. IBFIM has certainly played an important role in harnessing the critical talent needs of the Islamic financial industry, not only in Malaysia, but has extended its role internationally as evidenced by this inaugural Summit in Europe. This Summit also signifies an important strategic shift in our promotional approach for the takaful and retakaful industry. This shift is towards a more active initiative to heighten competitive elements and to draw greater foreign participation in this industry where Malaysia has a strong edge, and we are positive that this industry will grow stronger with a win-win partnership with the right partners.

My remarks today will dwell on three areas. The first is to share with you selected major developments in the Malaysian Islamic finance industry that signify the vast potential for continued strong growth of Islamic banking and takaful in Malaysia. I will then endeavour to provide some highlights on how Malaysia has strengthen its position as a preferred platform for global takaful and retakaful activities, within a broader aspiration for Malaysia to be one of the key international Islamic financial centres. Finally, I will present some areas in the development of global Islamic finance, including takaful and retakaful, where Malaysia can play a major role.

II. Significant developments in Malaysian economy and Islamic financial industry

A decade after the Asian financial crisis, the Malaysian economy including its financial system is at its strongest position. With this growth, Malaysia has greater economic flexibility to shift to new areas of growth and thus sustain the development momentum. Economic growth has been achieved with relative price stability, low unemployment and strong external balances. The level of savings remains high at 37 percent as a percentage to the GDP while the level of external reserves remains strong at nearly USD100 billion. GDP per capita at current prices has increased to about USD 6,000 in 2006. Malaysia has also taken advantage of globalization to strengthen its economic and financial relationships with the major trading blocs across the globe. In 2006, the total value of the external trade exceeded for the first time the RM1 trillion mark. Malaysian investment abroad has also grown in strength. Foreign direct investment has been sustained, particularly into the new areas of growth. The private sector continues as the main driver of economic growth for the fifth consecutive year, while the public sector plays a supportive role.

While Malaysia continues to attract investment, both domestic and foreign from the traditional sectors, new sectors such as the services, manufacturing and oil and gas sectors are gaining in importance. The services sector such as information technology services, shared services and outsourcing as well as financial services, in particular Islamic finance, has increased its market share.

The Malaysian Islamic banking system saw strong performance in 2006 with higher profitability, and has remained well capitalized. Islamic banking assets amounting to about USD34 billion or 13 percent in terms of market share. The takaful sector stands at USD1.7 billion, with the assets growing at an average rate of 27% per annum since the past five years.

The performance of the Malaysian Islamic capital market has been equally encouraging. Our capital market has depth and breadth that is supported by an active secondary bond market. Islamic corporate bonds, or sukuk, now amount to USD36 billion or 48 percent of the total outstanding corporate bond issuance in Malaysia. The multinationals and multi-lateral institutions such as the International Finance Corporation and the World Bank has begun to tap funds from the Malaysian capital market by issuing ringgit sukuks, thus increasing the market's depth and diversity. The Malaysian private debt securities market, both conventional and Islamic, is now the second largest market in Asia, the largest being Japan.

More than a quarter century of experience in Islamic finance has set the foundation for the Malaysian Islamic finance industry to evolve into a competitive industry, providing efficient platform for innovation. Increased foreign-local collaboration has further accelerated the pace of innovation. It is within the last five years, in fact, that major innovative initiatives have taken place. In 2005, Malaysia became the first jurisdiction in the world to put in place a Shariah-compliant deposit insurance scheme. We do have a comprehensive range of Islamic financing instruments under both fixed and floating rate product structures to meet the demand of consumers.

III. MIFC initiatives and Malaysia as takaful & retakaful hub

Malaysia is also well-positioned to provide the linkages through Islamic finance to support the increasing flow of investment between Asia and other parts of the world, particularly the Middle East. While world trade has on average expanded by 10% over the period 2001-2005, Asia's trade with the Middle East has increased on average by 24%. More than half of the exports from the Gulf States go to Asia and more than one-fifth of its imports are from Asia. Situated centrally in the Asian time zone, Malaysia offers to serve as an investment gateway to the region, specializing in Islamic fund and wealth management, and providing a platform for the issuance of sukuks. For this, we have put in place a comprehensive Islamic financial system that includes Islamic banking, takaful and Islamic money and capital markets. These activities are adequately supported by the legal, human capital, Shariah and regulatory infrastructure, a diversity of players and a wide range of products and services.

To further promote the international dimension of Islamic finance in Malaysia, the Malaysian Government has also launched 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, the Securities Commission, the Labuan Offshore Financial Services Authority (LOFSA) and Bursa Malaysia, together with the participation of the industry representing the banking, takaful and capital markets. It is aimed towards building greater intermediation linkages between the East Asian and Middle East regions which will in turn, further expand inter-regional trade and cross border investment flows.

As part of the MIFC initiatives, local and foreign financial institutions are allowed to establish International Islamic Banks (IIBs), International Takaful Operator (ITOs), as well as International Currency Business Unit (ICBUs) to undertake international currency business in Islamic finance with non-residents through either a locally incorporated entity or a branch. This entity is granted attractive tax packages in terms of a 10-year tax holiday. The Foreign Investment Committee rules have been further relaxed to allow 100 percent foreign equity ownership in these financial institutions. In continuously creating an enabling environment for the efficient functioning of the MIFC, the Malaysian commercial banks and investment banks are allowed to establish International Currency Business Units (ICBUs) to carry out Islamic banking business under their existing entities. Foreign institutions are also allowed to take up to 49% of the equity of domestic takaful operators and Islamic banks.

To enhance the delivery system, an executive committee of key government officials, financial regulators and industry players has been set up for the effective and efficient implementation of the MIFC initiatives. Among others, an "executive green lane" has been accorded to expedite applications by expatriates for long-term employment passes with multiple entry visas. To allow greater operational flexibility within the Shariah parameters, the Islamic financial system adopt a conducive stance on Shariah interpretations and practices, consistent with its international dimensions. It mutually recognizes and accommodates the various juristic reasoning that has been approved by recognized Shariah advisers.

To accord better access to MIFC information, Bank Negara Malaysia has launched the MIFC Portal at www.mifc.com as the primary source of comprehensive on-line information on the MIFC. It provides information on the latest initiatives, incentives and developments in the MIFC, and enables convenient access to application forms, procedures and guidelines related to entrance and participation in the MIFC.

Bank Negara Malaysia has received positive response from the local and foreign financial institutions to participate in the MIFC, particularly in the establishment of International Islamic Banks (IIBs), International Takaful Operators (ITOs), as well as International Currency Business Units (ICBUs) of Islamic banks and takaful operators. To date, 14 financial institutions have been granted approval to set up ICBUs.

IV. Critical areas of contribution – Malaysia's role

In this last segment of my address this morning, allow me to share several key areas in Islamic finance where Malaysia can play major roles, particularly by capitalizing on various initiatives and incentives under MIFC banner.

The first area is retakaful. The Malaysian Government has focused efforts towards the development of the retakaful sector in complementing the encouraging growth and expansion of the takaful industry. This is a critical response to the challenge of the shortage of strong and credible retakaful capacity globally which poses an impediment to the growth momentum of the takaful sector. Besides fulfilling the need for retakaful support from the takaful operators, and reducing the industry's dependency on conventional reinsurance support, the retakaful operators will also play key roles in enhancing the technical knowledge in the market, as well as in promoting product development and innovation in the takaful industry. For this, Bank Negara Malaysia has taken a strategic move to further strengthen Malaysia's edge as a retakaful hub by inviting strong and qualified applicants, both local and foreign, to make Malaysia as their platform for retakaful activities. A strong takaful market in Malaysia, supported by the experience and expertise of several niche players in retakaful operation during the last two decades, would provide a strong base for a global retakaful operation to flourish.

Under this initiative, qualified local and foreign applicants will be allowed to conduct both Malaysian and international currencies retakaful business. Flexibility is accorded to the retakaful operators to conduct its retakaful business in Malaysia by way of an incorporated either entity or a branch. Foreign applicants are also welcomed to conduct retakaful business in Malaysia through a joint-venture with Malaysian companies. It is anticipated that this measure would serve as a catalyst in our efforts for Malaysia to become the centre for takaful and retakaful business through the establishment of a significant number of strong and reputable retakaful operators.

For the potential investors in these ventures, I wish to highlight that Malaysia maintains a liberal foreign exchange administration regime where investors are freely able to obtain ringgit and foreign currencies to fund their investments in Malaysia. Please do forget the foreign exchange administration rules introduced during the 1997/1998 Asian financial crisis.

We have even further relaxed the foreign exchange administration rules to allow resident and foreign issuers to raise foreign currency-denominated bonds, including Islamic bonds or sukuks. Foreigners investing in Malaysia are also free to hedge with onshore banks their committed flow of funds such as the repatriation of investment proceeds, dividends and profits from Malaysia as well as the purchase of ringgit assets in Malaysia. There is free mobility of inward and outward movement of funds relating to both foreign direct investment and portfolio capital investments.

The second key area that Malaysia can play a major role is sukuk issuance, origination and trading. The sukuk market serves as an important platform, complementing conventional bonds in enhancing the effectiveness and efficiency for the mobilization and allocation of funds within national financial systems and in the international financial system. Significant economic growth is taking place in Asia and the Middle East following privatization and implementation of infrastructure projects. This opens up tremendous opportunities for government entities, multinational corporations and multinational development institutions to raise funds through the issuance of sukuks to meet their financing needs. The phenomenal demand for sukuks has been spurred by the high levels of surplus savings and reserves in Asia and Gulf regions coupled with a rising demand for Islamic banking instruments from a growing Muslim population in Europe. Apart from the issuance of a sovereign Islamic sukuk by the Government of Malaysia, and the governments of Dubai (UAE), Qatar, Bahrain and Pakistan, an increase in number of multilateral agencies are also issuing sukuks to finance development projects. These developments signify the key role of the sukuk market in facilitating the economic development process.

Significant progress has in fact been achieved in the development of the Malaysian sukuk market, underpinned by strong collaboration among the Government, regulatory agencies, players and investors. By early 2007, Malaysia accounted for 67 per cent, or about two-thirds, of the global outstanding sukuk amounting to about USD47 billion. Malaysia is important for the global sukuk market, not only because it represents the largest sukuk market in terms of outstanding size, but also in terms of number of issuance which signifies a strong edge in market vibrancy.

Malaysia's strong performance in sukuk activities can be attributed to several key factors that may be similarly leveraged by other issuers and players participating in the Malaysian Islamic capital market. These are:

(i) **Firstly, Malaysia has the strong edge by having an efficient platform for sukuk issuance and trading activities** covering the infrastructure and facilitative rules that contribute towards efficient price discovery and shorter time to market. The established legal, regulatory and Shariah frameworks in the Islamic financial infrastructure are key competitive advantage for Malaysia. These initiatives have been reinforced by the supporting financial infrastructure including the settlement and bond information systems. There is no restriction on the use of proceeds, ability to use international rating services, ability to hedge positions and ability to swap issuance proceeds into foreign currencies. Submission for foreign currency sukuks from qualified issuers with at least a single “A-” credit rating would be deemed approved upon proper filing of documents with the Securities Commission.

(ii) **Secondly, Malaysia also has an edge in product innovation**. In 2006, the Malaysian market continued to embrace innovative elements with the launch of sukuk using concepts such as Mudharabah, Musyarakah and Ijarah. Landmark issuance such as exchangeable sukuk Musyarakah by Khazanah Nasional Berhad, marked the world's first issue of its kind, incorporating full convertibility features. The derivatives market has also been developed with the introduction of Islamic currency swap and Islamic profit rate swap. An important enabling factor for innovations is the availability of a pool of experienced talent and resources. In the parallel financial system existing in Malaysia, the talent and expertise for sukuk and Islamic financial activities does not derive solely from the 9,000 staff of Islamic financial institutions. It is also well supported by the workforce of domestic and foreign conventional financial institutions. Leveraging of expertise is critical in pioneering innovative products so as to ensure that the product design and structure, as well as the risk management aspects, are thoroughly addressed.

Moving forward, several initiatives were already in place to further support the international dimension of the Malaysian sukuk market, such as tax incentives and customized forex rules. For example, Malaysia has further liberalized our foreign exchange administrative rules to allow multilateral financial institutions, multinational and national corporations to issue both ringgit and non-ringgit denominated instruments in our capital market. A number of legal and regulatory requirements have been further customized to drive down the cost of sukuk issuance. These measures are key MIFC measures and incentives and these include:

(i) Profits and dividends received by non-resident investors from holding of RM and non RM Islamic instruments issued in Malaysia are exempted from withholding tax;

(ii) A special purpose vehicle (SPV) for Islamic financing purposes via the Islamic capital market is not required to comply with the administrative procedures under the Income Tax Act 1967;

(iii) A company that establishes a SPV is given a tax deduction on the issuance cost of the Islamic securities incurred by the SPV;

(iv) Tax deduction on issuance cost for all Islamic securities approved by the Securities Commission; and

(v) Stamp duty exemption for 10 years on instruments relating to Islamic securities under the MIFC.

Third area is outsourcing, insourcing and white labeling activities. Malaysia's more than two decades of experience in takaful operation and product design can be systematically structured as a complete solution to be offered to new takaful operators. Takaful operators in other jurisdictions may leverage on the services and experience of the Malaysian Islamic finance and takaful industry by outsourcing certain operational functions, such as product design and investment activities, thereby allowing them to focus their currently limited resources to important tasks of expanding the business. Strategic alliance by Malaysians can also be forged with takaful operators in other jurisdictions to provide total product solution in the form of white labeling arrangement. I hope more Islamic financial institutions will join over 700 shared services and outsourcing companies currently operating in Malaysia based on the country's proven political, social and economic stability, IT and physical infrastructure, deep pool of skilled work force, liberal foreign exchange rules, proficiency in languages and government continued commitment[1].

At this stage, I wish to inform that Malaysia has developed a credible, robust and effective anti money laundering and counter the financing of terrorism or AMLCFT regime. A group of international assessors had in early 2007 assessed Malaysia's AMLCFT regime, both at the financial and non-financial sectors as well as on the conventional and Islamic financial institutions. This assessment is based on the new and more robust FATF or Financial Action Task Force 40+9 Recommendations. So far, globally, 40 countries have been evaluated based on this new FATF Assessment Template. The assessment on Malaysia was ratified at the APG's (Asia Pacific Group on Money Laundering) July 2007 Annual Meeting in Perth.

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[1] A.T. Kearney's ranked Malaysia as the 3rd most attractive outsourcing centre, after India and China, in the Global Services Location Index for three years (2004, 2005 and 2007. There was no ranking in 2006). Frost and Sullivan ranked Malaysia as the 5th most attractive SSO location after India, China, Ireland and Singapore in 2007. Frost and Sullivan identified Malaysia's niche areas in the energy, finance and logistic sectors.

The full report on the assessment on Malaysia is published in the APG's website www.apgml.org. The report shows that Malaysia has performed very well. Malaysia received only one (1) non-compliance (NC) and is among three (3) countries that have achieved zero (0) or a single NC grading. Malaysia is also among 3 countries that had achieved a LC (largely complied) grading with no country receiving full compliance grading on customer due diligence assessment. Notwithstanding this good performance, we will continue to ensure that Malaysia collaborate with the international community to stamp out the activities of money launderers, terrorist finances or other criminal elements.

V. Conclusion

In the decade to the present, Malaysia has significantly transformed our financial sector. The restructuring, consolidation and reform of the financial sector have strengthened the capacity, flexibility and resilience of the financial system. In addition, there has been substantial deepening in several segments of the financial system, including those in takaful, the sukuk market and Islamic banking. Malaysia has also continued to progressively liberalize its already open financial system to further enable the free flow of funds into and out of the system. This transformation has opened up the potential for a range of new opportunities for participation in the Islamic financial sector in Malaysia and for facilitating greater financial flows within the region and from other regions.

In conclusion, I wish to invite the business and financial communities attending this Summit to capitalize on this event to arrange for business meetings on the sideline of this Summit. Please do explore potential strategic alliance opportunities in Islamic finance, especially in takaful and retakaful with your Malaysian counterparts.

Thank you.