

## **Mohd Razif bin Abd Kadir: Islamic banking products – theory, practice and issues**

Opening remarks by Mr Mohd Razif bin Abd Kadir, Deputy Governor of the Central Bank of Malaysia, at the 2nd Foundations of Islamic Finance Series Conference: “Islamic banking products – theory, practice and issues”, Kuala Lumpur, 8 March 2011.

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I am delighted to be here today and would like to thank the organisers for inviting me to deliver the opening address at this 2nd Foundations of Islamic Finance Series Conference. Following the success of the inaugural conference held last year in Dubai, this year's event is a commendable collaboration between the organisers; the International Centre for Education in Islamic Finance (INCEIF), the International Shariah Research Academy for Islamic Finance (ISRA) and the University Putra Malaysia, to provide an avenue for discussions on various literatures in Islamic finance by eminent practitioners and scholars, with the aim to produce quality publications for the industry. The theme of this year's conference, “*Islamic Banking Products: Theory, Practice and Issues*” is most timely as waves of innovation are pervasive in Islamic finance in the recent years, fostering the generation of a wide spectrum of Islamic financial products and services. As the next frontier of development in Islamic finance evolves through innovation, we have to be mindful that innovation within an environment of constant change and increasing uncertainties is indeed a challenge. Joint efforts between academia and industry to conduct research, to explore and deliberate on issues relating to the development of new Islamic financial products, such as the efforts that have led to this conference can therefore provide a point of reference for the industry in ensuring that new and better products are developed to match the diverse and discerning needs of customers, while meeting the requirements of the Shariah.

The ability of Islamic finance, as a form of financial intermediation that provides a range of high quality financial products and services, reflect the innovative and dynamic nature of the industry that contributes to its role as a facilitator of economic activity. Together with the fundamental requirements in Islamic finance that an underlying productive economic activity accompanies financial transactions, a close link is formed between financial transactions and productive flows. Given that Islamic financial instruments reflect the underlying economic activities and that such instruments inherently have the potential to provide tangible returns to investors, there have been significant demands on such products. This gives rise to the competitiveness of Islamic finance, which is further spurred by the proliferation of competitively priced Islamic financial products that is more evident in this recent decade.

In more recent times, there is increasing awareness and appreciation amongst the international financial community on the distinct nature and inbuilt strengths of Islamic finance. The recent global financial crisis has brought about, among others, an opportunity for Islamic finance to strategically position itself as a stable form of financial intermediation. Islamic finance has now become the fastest growing segment in the global financial industry, as the US\$1 trillion industry has shown phenomenal growth which averaged at 20 percent yearly. The Islamic financial system is no more peripheral to the conventional banking system as it has advanced from being a novelty, to become a viable and attractive alternative to the conventional banking system. Major banking and insurance groups have also shown great interest in embracing Islamic finance as part of their growth and business expansion plans in the recent years.

In Malaysia, a comprehensive Islamic financial system has been established since 1983 which operates in parallel with the conventional financial system. This dual banking model has been enshrined in the Central Banking Act 2009 following recent enhancements, thereby giving significance and due prominence to Islamic finance. A strong institutional infrastructure and effective legal, regulatory and Shariah framework form the underpinnings of our Islamic

financial industry. In terms of market share, the Islamic banking system in Malaysia currently accounts for 20 percent of our banking system while the sukuk market accounts for more than 50 percent of the bond market. The sukuk market in Malaysia is vibrant with various innovations taking place. As witnessed in the year 2010, Malaysia has evolved its sukuk market to become a multi-currency sukuk origination platform with the issuance of four foreign currency sukuk that amounted to about US\$3 trillion. This development positively contributes to the global sukuk market by promoting greater inter-linkages and integration within the international Islamic financial system. Such innovative sukuk products that are universally acceptable would be able to link Islamic financial institutions from different jurisdictions, forming a bridge to strengthen the relationship of the international Islamic financial market as well as the investment and trade links between regions.

With the internationalisation of Islamic finance, interest in Islamic finance is indeed no longer limited to Muslim nations and communities. Increased liberalisation that is initiated in this decade has facilitated the internationalisation of Islamic finance which sees Islamic financial institutions venturing beyond their domestic borders and capacity. More than 600 Islamic financial institutions now operate in more than 75 countries. In Malaysia, there is a greater foreign institutional presence and substantial foreign participation in Malaysia's Islamic financial system. Similarly, there has been an increased of foreign participants to raise and invest funds in Malaysia's financial markets. The global sukuk market, growing at an average annual rate of about 40 percent has also been a significant platform for such investors, as it effectively intermediates funds across borders, thereby fostering international financial and economic inter-linkages.

As the internationalisation of Islamic finance widens the spheres within which Islamic finance operates in, there are growing opportunities and challenges in the business environment that sets the current backdrop for Islamic finance. Continuous capacity and capability measures will be pursued to provide an enabling environment for industry players to remain competitive and innovative. Given that the recent financial turmoil has highlighted the importance of strong liquidity risk management, an important recent development to assist in the liquidity management of Islamic financial institutions is the establishment of the International Islamic Liquidity Management Corporation (IILM). The IILM has begun its operations in Kuala Lumpur from early February this year, following its official launch in October 2010. The IILM is tasked to issue short-term multi-currency liquidity instruments that would facilitate the cross-border liquidity management between financial centres, and by doing so, would enhance financial inter-linkages. The first issuance of liquidity instruments is expected to take place later during the year and is very much anticipated as it would contribute to more efficient management of financial flows across borders, thereby leading towards more efficient internationalisation of Islamic finance.

The Islamic finance industry is at a stage of growth in terms of products and services, which requires innovation to remain as the driving force behind the progress of the industry. In the pursuit of innovation, it is paramount that the Islamic banking and takaful industry achieve full Shariah compliance in the development and application of their products and services. A robust Shariah governance framework is therefore an important foundation for the Islamic financial institutions to ensure that its objectives and operations are in accordance with Shariah principles. In Malaysia, there have been recent enhancements to the Shariah governance that aim to further strengthen the existing Shariah governance process, decision making, accountability and independence of Shariah advisories. Reinforcements of the Shariah compliance functions include the requirements for internal Shariah review and audit, supported by an appropriate risk management process and research capability. It is envisaged that with a more robust and sound Shariah governance framework, with end-to-end Shariah compliant control mechanism within Islamic financial institutions would promote greater Shariah observance throughout an organisation and minimise possibilities of the products to be nullified on Shariah grounds. Effective implementation of the Shariah

governance framework will indeed further promote stakeholders confidence and enhance the integrity of the Islamic financial industry.

It is also important to note that successful attempts in innovation are very much dependent on the availability of talents who have the ability and creative inclination to develop new ideas and the capacity to turn such ideas into achievable results. A talented workforce is the engine to spur innovation and achieve breakthrough inventions. For the Islamic financial industry, it is recognised that human capital development initiatives form the vital groundwork that we need to build and strengthen to ensure that the industry remains competitive and innovative. Given that the Islamic finance industry is in its nascent development phase, more importance is thus placed on human capital development. The establishment of various institutional platforms such as the INCEIF and ISRA, as well as offerings of specialised Islamic finance courses by tertiary institutions have been instrumental in contributing to the nurturing and development of professional talent and expertise in Islamic finance. It is heartening that these institutions have had notable achievements since their inception. An example is INCEIF, where as to date, 107 students have graduated with the Chartered Islamic Finance Professional qualifications, while an estimated 1,000 more are at different stages of completing the qualification.

As the pool of talents within the Islamic finance industry widens with the entries of new players, the competition for the best talent would also intensify as demands increase for the right and most suitable talent. It is therefore opportune for the education and learning service providers to constantly review their teaching methodology and learning contents, and to be updated on the skills requirements of the industry. Greater collaboration between the industry and academia is also an important aspect to align the training and development with the business requirements of the industry.

Moving forward, more initiatives are required to expand the business horizon and product offerings in Islamic finance. Further in-depth research on Shariah issues relating to risk mitigation, liquidity management and hedging would enrich the research and development function to facilitate in the generation of ideas and creation of new ground-breaking Islamic financial products. The combined market knowledge and insights from education and training institutions such as INCEIF and ISRA can also provide meaningful contributions to the global Islamic finance industry that address both market needs and Shariah preservation. Increased global engagement in Shariah matters among scholars, practitioners and regulators through international discussion platforms, together with the massive flow of knowledge, ideas, technology and people across borders also cumulatively foster a greater global understanding on the practices in Islamic finance.

Innovation has fundamentally transformed the global financial landscape at a rapid pace and is undeniably a driver to sustain growth and to secure the competitive advantage of financial market participants. In the context of Islamic finance, the broadening of the frontier of product development can be further propelled by intensifying exploration, research and development initiatives and through intellectual discourse and engagements. It is duty-bound for us to continuously expand the dimensions of Islamic finance, hence contributing towards improving financial stability and economic prosperity in the interest of the local and global community.

I am confident that this conference and the opportunities presented for deliberation on the research papers will be a fruitful one. I wish all delegates and participants a successful conference. With the lafaz *Bismillahir Rahmanir Rahim*, it is my pleasure and honour to declare open the 2nd Foundations of Islamic Finance Series Conference.