

## **Zeti Akhtar Aziz: Banking on Islamic finance – from legality to economic value**

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the 8th World Islamic Economic Forum (WIEF) “Banking on Islamic finance – from legality to economic value”, Johor Bahru, 6 December 2012.

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Powerful forces of change are transforming the functioning of the international financial system and the global economy. In the aftermath of the global financial crisis, the quest has been to build financial systems that will best serve the real economy, that provides financial intermediation that promotes sustainable growth through productive and responsible innovation, and that will be resilient to shocks and less prone to crisis. There is tremendous potential to draw on the economic value that Islamic finance has to offer. In realising this potential, in a now more challenging environment, will depend on our capacity to build new capabilities that will unleash the inherent intrinsic value propositions of Islamic finance that supports and energises the real economy.

It is my honour to participate in this 8th World Islamic Economic Forum in my hometown, Johor Bahru to speak on the topic “Banking on Islamic Finance: From Legality to Economic Value”. The first part of my remarks will elaborate on the economic value of Islamic finance, in terms of its emphasis on the close linkage to the real economy, in terms of its merit as a potent tool for enhancing financial inclusion, and in terms of its emergence as a vehicle in bridging economies and strengthening economic and financial linkages, in particular between emerging economies.

The second part of my remarks will touch on three key imperatives that will be important to the ability of Islamic finance to enhance its value proposition to the global economy. These include the legal framework, in particular that which supports its internationalisation, the pool of talent that has the international exposure and orientation and finally the convergence and harmonisation of Shariah interpretations across jurisdictions. These imperatives will be key to reinforcing the gains from the increased economic inter-linkages.

There are three core propositions of Islamic finance that can be harnessed as the industry continues with its rapid growth momentum. The first is to ensure that Islamic finance remains a form of financial intermediation that serves the real economy and that it will continue to benefit the society. In staying true to the inherent principles of Islamic finance, financial transactions will be underpinned by real economic activities. This ensures its close linkage to the economy as it directs the overall intermediation function towards economic production and wealth creation. This therefore requires the continuous development of financial products and services that manifests the value propositions of Islamic finance.

In providing the comprehensive range of the whole spectrum of financial products and services that are in accordance with these principles, Islamic finance has been able to provide the total financial solution to consumers and businesses. The recent growth of Islamic finance has been fuelled by a sustained phase of innovation. The scope of financial business has also increased in sophistication, particularly in the areas of private equity, project finance, sukuk origination as well as fund and wealth management. To sustain this trend, further in-depth applied research is needed to develop more financial products that create such links with the real economy in terms of the operating models, risk management and supporting infrastructure.

The second value proposition of Islamic finance lies in its merit as a potent tool for enhancing financial inclusion and for being beneficial to all members of society. Its immense potential in advancing social-economic development is mirrored by the continuing efforts to introduce Islamic finance offerings in emerging economies, particularly in Asia, the Middle East and

African nations in recent years. In bringing unserved communities into the economic mainstream through the financial intermediation process, it can contribute towards poverty alleviation, job creation and more equitable economic growth.

A recent study has however revealed that, despite being a promising financial segment, the availability of microfinance in Muslim-majority economies is either non-existent or still at very early stages. Islamic financing instruments currently comprise only a small fraction of microfinance business in the Organisation of Islamic Cooperation (OIC) countries. While there are success stories on the application of Islamic finance principles in microfinance programs, there is potential to have better models for Islamic microfinance. In addition, it should also integrate with other financial products such as microtakaful and other social welfare tools such as waqf to create a viable and impactful microfinance initiative. There are also immense opportunities for Islamic finance to leverage on the productive potential of small medium enterprises (SMEs) through greater application of equity-based structures in such financing structures. There is seemingly a natural fit between Islamic finance and SMEs financing in that both strongly promote entrepreneurship and value-creating activities.

The third value proposition of Islamic finance refers to its emergence as new vehicle in bridging economies and contributing to increasing the financial linkages, in particular, the emerging markets. Previously Islamic finance was domestic centric. It is now increasingly providing financial solutions for cross border trade and investment. Progressive liberalisation has facilitated the internationalisation of Islamic finance. This has been reinforced by the dynamic pace of innovation in Islamic finance that has widened the range of financial products and services. This internalization process has thus contributed to the more efficient allocation of funds across borders from centres with surplus funds to regions with investment opportunities and to the diversification of risks.

The now more developed Islamic financial markets have been particularly instrumental in intermediating such funds. Sukuk has been a major driving force behind this development since its emergence as an important platform for international fund raising and investment activities that are generating increased cross border flows. The international dimension of the sukuk market has now evolved on many fronts – It has seen the participation of issuers and investors across continents with sukuk origination centres transcending the issuers' own home countries. The total global sukuk outstanding now domiciles in 20 countries and more recently, there has also been a growing trend for multi-currency sukuk issuances. The sukuk market continues to solidify its position as a leading segment of growth for Islamic finance. Its strong performance is driven by its unique value proposition to both issuers and investors. For investors, it has now become a new asset class with orientation towards real underlying assets in which the issuer cannot leverage in excess of the asset value and in which, the financing must be channeled towards productive purposes. For the issuers, sukuk financing provides a competitive avenue for fund raising and access to a wider investor base of both Islamic and conventional, including the growing investor base looking for a socially-responsible or ethical investment.

Moving forward, there are three key imperatives that will determine the ability of Islamic finance to further enhance its value proposition for the global economy. First, is the evolution of the legal framework that is facilitative to the continuing market evolution and the internationalization of Islamic finance. Whilst the global financial crisis has provided Islamic finance with a unique opportunity in the international financial system, the future success of the industry moving forward, will also depend on its continuing ability to innovate more indigenous shariah-based instruments and evolve business models that strengthen the nexus of Islamic finance with the real economy. An essential part of the overall infrastructure therefore is an effective legal framework to provide an enabling environment that will enforce the legality of contracts according to the Shariah and the regulatory treatment of the new and innovative Islamic financial solutions.

While Islamic finance practitioners and scholars continue to draw from the source of fiqh muamalat to create new and innovative instruments, the legal framework needs to be further strengthened to ensure alignment with new market developments. This is to ensure that it continues to lend certainty and predictability to the innovative products and financial transactions. Furthermore, as Islamic financial activities venture beyond national boundaries, the development of legal frameworks that is facilitative of cross-border transactions is pivotal. There has to be court recognition and acceptance of the Islamic contracts within the common and civil law systems, with a common approach of interpreting the rights of the contracting parties based on Shariah principles, in particular for cross-border transactions.

Malaysia has taken the approach to address this imperative via the Law Harmonisation Committee which was established in 2010. As part of its mandate, the Committee undertakes an objective review on the legislation and proposes the necessary amendments on existing Malaysian laws which are applicable to execute the whole chain of Islamic financial practices. Since its inception, the Law Harmonisation Committee has reviewed seventeen (17) laws in Malaysia and identified the areas that require legislative amendments so that Islamic financial transactions can be conducted in the most legally efficient manner. The work of the Committee will continue to remain relevant as the Islamic financial markets continue to expand and develop new products and business models. This mandate of the Committee will not only ensure that non-Shariah compliant elements in the legal provisions are harmonised, it will also ensure that our laws are facilitative to Islamic financial transactions.

Another major milestone in Malaysia, is the new legal framework for Islamic banking and takaful, which is currently undergoing the legislative process towards its enactment. This new legal framework, will not only streamline the legal requirements across sectors, but will also ensure that the law is reflective of the nature and features of Shariah contracts and that the degree of regulation is commensurate with the level of risks that Islamic financial institutions, markets and products pose to the overall financial system. The greater clarity on the legal and prudential requirements underpinned by Shariah principles will enable participants of the Islamic financial system to align to their practices and expectations accordingly when undertaking Islamic financial business and transactions.

The second imperative relates to the continuous effort to develop the key resources of the industry, by expanding and building new capabilities needed to support its growth and development. There is a critical need to upskill the leadership and technical competency of talents given the increasing complexity of the industry. With broader scope, scale and internationalization, the demands on the capability of talents in Islamic finance industry can only increase. It will require more internationally oriented management teams that have the necessary international exposure and orientation. In addition to education and research to build the expertise in Islamic finance, a more structured framework for capacity-building that includes other key resources including the investment in technology for industry development is also needed.

Such a coordinated effort in capacity-building has been initiated by the Islamic Development Bank (IDB) in support of its member countries in the development of Islamic finance. This is being undertaken through the IDB's Member Country Partnership Strategy (MCPS) programme. Indeed, in a world of increasing interconnectedness, there is a need for such a strategic approach to capacity-building through cross-border cooperation for the mutual benefit of the members so that growth and development of the industry can be collectively strengthened.

Finally, the third imperative is to accord importance to mutual recognition of Shariah interpretations across jurisdictions and thus contribute towards greater international financial integration. A critical factor that will support this process pertains to the need to enhance awareness in respect of the justifications underlying the Shariah resolutions in the industry. To achieve this greater awareness will require both openness on the grounds for the rulings

and in-depth research on the basis of such grounds. A recent study conducted by the International Shariah Research Academy for Islamic Finance (ISRA) on fatwas of Shariah boards in the Asian region and the GCC countries reveals that, contrary to the popular perception, there are more similarities than differences in Shariah resolutions between the two regions. The study by ISRA however further indicates that there is a lack of awareness on the Shariah justifications to most of the resolutions being reviewed. This awareness is essential to pave the way towards greater understanding and nurturing of mutual respect. Whilst there are some initiatives to enhance the greater awareness on the juristic reasoning in Islamic finance, to facilitate greater mutual recognition, it will require greater transparency in the Shariah rulings in addition to constructive dialogue on the grounds of such rulings.

With the efforts of the Islamic Development Bank (IDB), the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAIOFI), it has facilitated greater cross-border engagement among practitioners and Shariah scholars. In turn this has contributed to a greater understanding on issues and challenges faced by the industry and the progressive convergence of Shariah views and rulings. More such international collaborative work and engagement would further facilitate this harmonization process.

To navigate amidst turbulent seas to arrive at the new frontier of opportunities in Islamic finance, there is a need for the industry to build on its strengths and achievements thus far, in the pursuit to realize the distinctive value that Islamic finance brings to the global economy. Indeed, Islamic finance needs to leverage on its inherent strengths and demonstrate leadership in the real economic agenda and contribute towards global economic prosperity and stability.