Encik Adnan Zaylani Mohamad Zahid: Islamic finance - future trend

Keynote address by Mr Encik Adnan Zaylani Mohamad Zahid, Assistant Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the 13th Kuala Lumpur Islamic Finance Forum 2016 (KLIFF) "Islamic Finance - Future Trend", Kuala Lumpur, 21 November 2016.

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It is my pleasure; and an honour to be given the opportunity to speak at this forum today. Since the first introduction of KLIFF, more than a decade ago the event has gained recognition as a prestigious annual gathering for industry experts and key players in Islamic finance. I therefore wish to congratulate the organisers for its success in organising this event and maintaining its momentum. This year, in line with the chosen theme deliberations in the forum will revolve around strategies to elevate Islamic finance to the next level. As we are now at an important crossroads in Islamic finance, its continued dynamism in the journey ahead, requires the industry to strategically respond to the changing requirements of the global economy.

My remarks today centres on the future trend of Islamic finance. In charting our growth for the industry, I will reflect on our achievements; and offer some thoughts on key areas that can accelerate the industry forward. I would then deliberate on the key underpinnings for the industry to successfully meet the intended objectives, in my conclusion.

Islamic finance with a growth rate of between 10 to 12% annually in the past decade is gaining prominence at many fronts, including its ability to meet the unique demands of the modern economy. The sukuk market in particular, has produced a dynamic stream of cutting edge products with an appeal that transcends beyond borders and beliefs. It has a wide geographical spread, with global sukuk outstanding domiciled in over 20 countries, and an investor base that spans from Europe to the Middle East and Asia, thus allowing greater diversification of exposures and risks. Malaysia, with a consistent global sukuk market share of more than 50%, over the last 10 years, has sustained its position as the market leader.

In the last few years, we have witnessed increasing sovereign sukuk issuances by non-Muslim jurisdictions to meet the varying motivations of its issuers. In 2015, at least 13 jurisdictions have tapped the global sovereign sukuk market. Issuances by the United Kingdom and Hong Kong, are testimonies that the sukuk has come of age. As for Malaysia, its market share of sovereign sukuk stands at 40% and the recent issuance of a Sukuk Wakalah by the Government, with 30-year tenure is currently the longest tenured sovereign sukuk globally. The horizons and usability of sukuk have also expanded into the sphere of Socially Responsible Investment (SRI); following the issuance of the first SRI Sukuk in 2015 by a Malaysian GLC. This is an example of innovative impact investing that generates positive social outcomes.

Progress is also evident in our agenda towards becoming the centre for Islamic fund and wealth management. We emerged as the largest hub, with 35% market share and the most number of Islamic funds. The Malaysian Islamic capital market has also gained its pace as a reputable destination for investment, given its wide range of world class financial products. Backed by a robust Shariah screening methodology, more than 70% of total listed securities in the country are Shariah-compliant, thus providing a wide array of selection for investors.

Islamic finance has also become part of the growth strategies of global financial players, indicating greater appreciation of its value propositions. A host of global banking players offering Islamic banking services from diversified regions including from Japan; Europe; and the Middle East have also established their presence in Malaysia.

A number of our industry players that offer Islamic finance have also ventured abroad to various jurisdictions. Our MIFC Community, with nearly 40 professional ancillary service entities not only provide key services locally, but many serve global demand and have set benchmarks for international best practices.

These industry developments which I have highlighted have indeed enhanced the depth and breadth of the Islamic financial services industry. Nevertheless, against the onslaught of global challenges that have intensified uncertainties and complexities, there is heightened urgency for the industry to strategically chart its next phase and reinforce its core strengths. In the Malaysian context, the various initiatives and developments taken place during the period of the Financial Sector Masterplan; between 2001 to 2010 have indeed sparked the growth and vibrancy of the industry. While achievements in various market segments have placed us at the forefront, more ground breaking initiatives are needed to seize the opportunities in new growth areas; and to re-energise the industry. An honest assessment on the existing business models and product offerings must be undertaken to recognise gaps and issues, which is a crucial step towards realising the true value propositions of Islamic finance.

The future growth of Islamic finance, in my view, is underpinned by three key areas. This could also lead us to defining the future of Islamic finance as the 'New Normal' that can bring greater sustainable and equitable economic development.

First, is to have a more cohesive efforts by industry players across all sectors in Islamic finance to realise its virtues that uphold social justice; equality; economic prosperity; and inclusivity. Indeed, these are challenging and daunting expectations. However, it is only through collaboration, that the Islamic finance industry could push its growth trajectory, into the next level of maturity. Working in silos should be replaced by promoting a culture of collaboration. Industry players should not only play a proactive role to enhance collaboration within the industry, it should also be extended beyond sectoral boundaries. In the area of product development for example, collaboration within the banking group can be explored to offer a more comprehensive range of products and gain greater scale such as the offering of microfinancing and microtakaful as a composite product.

Moving forward, collaboration beyond traditional sectors; and into competitive industries, such as retail, communication and oil and gas should be advanced as it opens up and extends our outreach to form new alliances. Joining forces with other industries will allow us to embark on a faster learning curve, while equipping ourselves with new skill sets. This will enable the intended business objectives and outcomes to be met within a short period of time.

A recent example of such collaboration between a few domestic Islamic banks is the establishment of the Investment Account Platform. The test of the collaboration however, lies in its strength and sustainability in pursuing the intended outcomes. At the regional level, there is also potential for industry players to collaborate through the Islamic Infrastructure Investment Platform or (I3P) that is now still at the proposal stage. Through this regional dialogue platform, collaboration may be fostered between financial institutions, regulators and ministries from APEC economies with multilateral institutions and academic experts to explore measures that can expand cross-border investments by Islamic financial institutions. In particular, the potential for Islamic pension funds and takaful to finance infrastructure projects in APEC economies can be explored.

In realising the virtues of Islamic finance, it also warrants Islamic banks to progressively strengthen its intermediary functions. I would like to encourage Islamic banks to take on a more prominent and proactive role as investment intermediaries in addition to credit intermediation. In Malaysia, the Islamic Financial Services Act 2013 (IFSA) provides the enabling grounds for Islamic banks to extend its role to include investment intermediation.

The virtues of Islamic finance are also characterised by its range of financial offerings with diverse products that meet the needs of customers across all levels. However, statistics have shown that retail financing by Islamic banks in the country dominates at nearly 60% and indeed, Islamic banks are predominantly strong in household financing. In addition to that, there is a large concentration of financing by domestic Islamic banks using the Tawarruq contract, estimated at 20% of outstanding financing. There is a wide array of Shariah contracts that is readily available for the Shariah and product development units in Islamic banks to explore to reduce over reliance on Tawarruq, including risk sharing contracts such as Musharakah and Mudarabah to better serve the diverse needs of customers.

The contract-based regulatory framework under IFSA 2013 provides the regulatory support for Islamic banks to expand their product offerings beyond the traditional debt-based products. The 14 Shariah Standards comprising debt-based contracts; equity contracts; leasing; and ancillary contracts and arrangements are expected to facilitate the Islamic financial institutions in diversifying their spectrum of products and services.

The second key area to drive industry growth is the acceleration of innovation by Islamic financial institutions. By embracing and embarking on digital innovations, it opens up new and ample opportunities for our industry players to re-ignite productivity growth and increase efficiency of processes. Technology will certainly redefine the future financial landscape; and fintech is progressing by leaps and bounds in the conventional sphere; and rapidly changing consumer behaviour and needs. Islamic finance, being a relatively young industry, has vast opportunities to leverage on technology as a catalyst to scale up businesses and enhance operational efficiency. This includes understanding the potential of blockchain technology and its associated risks to enable its effective adoption that is both cost and time-saving.

The integration of digitisation strategies in the business model of our domestic players is already taking place with the recent launch of the Investment Account Platform. Another important area of growth for industry players to optimally use technology to increase process efficiency is Islamic trade finance that currently has a domestic market share of only 4% of total Islamic financing. A more advanced trade execution leveraging on technology is expected to further stimulate cross-border trade and growth of the real economy.

From the regulators' perspective, disruptive innovations in the industry are very much welcomed. Financial regulators in Australia, China, Singapore, United Kingdom and the United States are amongst those that have positively embraced the infusion of technology in their financial industries. For Malaysia, the issuance of the Regulatory Sandbox policy document in October provides regulatory clarity; lowers barriers to entry; and accelerates the time-to-market for productive innovations. Our Sandbox is unique as it is the first to include Islamic finance. Thus, industry players can be assured of the regulatory support by the Bank in expanding their frontiers of innovation. We would therefore expect to see more technological platforms to be introduced and infusion of technology to take place not only to disrupt the way we do things, but at the end of the day, to be able to significantly enhance values and experience for the consumers.

The third and final key area relates to the measurement of the industry's contribution to society and the wider economy. Islamic finance has more to offer beyond the confines of the conventional parameters of Sustainable, Responsible and Impact Investing (SRI); as well as the Environmental, Social and Governance (ESG) considerations. A natural alignment between Islamic finance and SRI already exist, given that the principles of fairness; equality; and ethics are embedded in Islamic finance which are associated with social well-being of the people.

Given these common core values, there are certainly vast opportunities for Islamic finance to broaden its investor portfolio to access the global SRI funds that stands at more than USD3 trillion. In broadening the horizon of Islamic finance by tapping into socially-conscious investments, the industry can actively spearhead efforts to promote and reach out to investors whom are value driven. We envision that investments through Islamic finance products would meet the aspiration and needs of this group of investors. It is therefore important for Islamic finance practitioners to have greater understanding on the scope of SRI to effectively match the segments of opportunities available in the SRI space.

An imperative to the successful outcomes of the key growth areas is the availability of multi-skilled and top-notch talent in the industry. In Malaysia, we have over 26,000 talents in the Islamic banking industry and a holistic infrastructural ecosystem that supports their developmental needs. As we move forward, we need a deep talent pool with wider set of competencies beyond the scope of Islamic finance knowledge to provide the additional competitive edge to the industry. Continuous nurturing of Islamic finance talent, with intellectual diversity in other related disciplines such as economics, finance, law and financial technology can give rise to new visions and wisdoms that go beyond traditional boundaries.

Under the current scenario, talent development is crucial at every level of the organisation from the Board to Shariah committee members as well as front-liners. Currently, an initiative is underway to develop a dedicated programme for Board of Islamic financial institutions with a scope that includes wide-ranging and unique issues within the Islamic finance industry. The Shariah Leaders Education Programme that has commenced since last year has enriched more than 100 local Shariah scholars with the necessary governance and business insights for them to effectively perform their roles as Shariah Committee members. Given the success of this programme, an international flagship programme will soon be introduced to enhance business professionalism of Shariah scholars worldwide, thus complementing their existing Shariah expertise.

Conclusion

In conclusion, the environment that we operate in will continue to be unpredictable with economic, social and political changes taking place in the global economy. For Islamic finance, we have witnessed its increasing recognition and widespread appreciation. The future however requires greater impact by Islamic finance to truly realise its potential in providing solutions to the problems faced by society.

Domestically, we are beyond half way of our Financial Sector Blueprint. While certain targets have been met, more tangible outcomes are required from the industry to meet the targeted 40% market share by 2020. Of importance is the need for the industry to be driven by clear objectives and targets that leverage on the key growth areas that have been deliberated. “Reflect on existing strengths; and build new capabilities to create new engines of growth within the industry. Seize various growth opportunities. Continuously reinvent, re-energise and re-anchor the industry”. We can therefore successfully reap the immense dividends of the future.

Thank you.