

2nd Islamic Financial Services Forum : The European Challenge
“Islamic Finance: Approaching New Horizons”

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Radisson SAS Frankfurt, Frankfurt, Germany
5 December 2007

Introduction

1. This decade has witnessed the dramatic transformation of the financial services industry driven by the forces of globalisation, advances in technology and the increased pace of innovation. The financial sector has also been confronted with increased vulnerability to turmoil, distress and periodic crisis. Financial intermediation that is vital to the economic growth process has become intensively more complex and challenging. In the context of this environment, Islamic finance has continued to evolve as a viable and competitive form of financial intermediation. More recently, this trend has gained momentum. Islamic finance is now among the fastest growing segments in the financial services industry.

2. The viability of Islamic finance has been derived from its ability to meet the changing demands of the economy and from its cost competitiveness. Its development has also been supported by a well developed legal, regulatory and supervisory framework that has been important in ensuring its soundness and stability. Also important has been the efforts to bring about harmonization in the development of Islamic finance across the different jurisdictions. Finally, and most importantly, the principles of governance, risk management and transparency which are explicitly embedded in Islamic finance have provided the foundations that have contributed towards ensuring its viability and sustainability.

3. More recently the development and expansion of the Islamic financial services industry has entered into a new phase of development following increased liberalisation. This trend has fostered the shift from a domestic centric approach to entering into transborder ventures in terms of greater financial presence in other jurisdictions as well as the higher level of participation in the Islamic financial markets, resulting in increased cross border flows. This has contributed to enhancing international financial inter-linkages between the different respective economies.

4. It is my honour to be here in Frankfurt to speak at the '2nd Islamic Financial Services Forum: The European Challenge' jointly organized by Islamic Financial Services Board (IFSB) and the Financial Stability Institute (FSI), supported by the Deutsche Bundesbank. My remarks today will elaborate on the factors that have fostered the development and remarkable expansion of the Islamic financial services industry. My presentation will also touch on Malaysia's experience in the development of a comprehensive Islamic financial system that is now being increasingly integrated into the international financial system.

Islamic Finance in a Challenging Environment

5. The very fundamental requirement of Islamic finance is that financial transactions must be accompanied by genuine trade and productive activities. In addition, the involvement in illegal, unethical and speculative activities is prohibited. It is in this respect that Islamic finance has the element of stability. At the same time, Islamic finance also promotes more equitable distribution of wealth arising from the various modes of Islamic financing contracts that ranges from a simple mark-up contract to the more equity-based contracts of mu-da-ra-bah (profit sharing) and mu-sha-ra-kah (profit and loss sharing). Today, most of these Islamic financial contracts have been used in many business engagements in various respective financial sectors such as banking, insurance, capital and money markets.

6. Fundamental to Islamic finance is that the risk is shared by the financier (lender) and the customer (borrower). In such an arrangement, due diligence becomes essential. Under this risk sharing principle, Islamic financial institutions share the profits or the losses incurred by the entrepreneur. Hence, both are accountable for the performance of the enterprise. Thus, strategies to minimize and manage the risks in Islamic finance involve integrating the risks associated with the real activities. The real activities will need to generate sufficient wealth to compensate for the 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 in turn result in higher systemic risks, increasing the potential for instability and inequitable concentration of wealth.

7. In Islamic finance, transparency represents a basic tenet underlying all Islamic financial transactions. There is an inherent obligation on Islamic financial services providers to meet certain standards of transparency. It is from the unique profit-sharing feature of Islamic financial transactions that it imposes a

high level of disclosure, which is explicit in the financial contract. In addition, the role and responsibilities of the financier and customer are clearly defined in the contract. This transparency provides a strong incentive for Islamic financial institutions to appropriately manage risks. The disclosure also allows the market to assign appropriate risk premiums to the respective companies and thus enforce the potential to market discipline. This provides the foundations for the enhanced role of market discipline to take effect, thereby promoting financial stability.

8. The adoption of governance best practices is also inherent in Islamic finance, given the wider range of contracts entered into between the Islamic financial institutions and their customers. As a partner, the Islamic banks must oversee the quality of the corporate governance, not only for achieving the business performance but also ensuring the accountability. The principle of governance embedded in Islamic finance also contributes towards insulating the Islamic financial system from potential risks associated with excessive leverage and speculative financial activities. This governance framework is also reinforced by the Shariah board or committee which represents another stratum in the governance structure which serves to ensure that the management of the Islamic institution is in compliance with the Islamic principles. These elements provides inbuilt checks and balances which serves to ensure financial stability in the Islamic financial system.

Islamic Finance and Financial Stability

9. The development and expansion of Islamic finance has also been accompanied by the development of the robust and comprehensive regulatory and supervisory framework. With the establishment of the Islamic Financial Services Board (IFSB) five years ago, Islamic finance has made remarkable progress in the advancement of having its own prudential and regulatory standards to govern its operations. The standards that have been issued by the Islamic Financial Services Board have taken all aspects of capital adequacy, risk management, corporate governance, transparency and market discipline and the supervisory review process as to ensure that Islamic banking institutions are well positioned to address all the risks associated to various types of Islamic financial contracts.

10. While these standards are consistent with the conventional standards, efforts have also been taken to minimise any potential for regulatory arbitrage between conventional and Islamic financial system so as to avoid undermining the stability of the overall financial system. The IFSB also engages and also interfaces with other international standard setting bodies specifically BIS, BCBS, IOSCO, IAIS and FATF to ensure within the context of financial supervision and

surveillance, similar risks are monitored and dealt with in a consistent manner so that there are no gaps in the overall supervisory processes. At the same time, tax and legal reforms are also being undertaken in a number of jurisdictions to accommodate the unique characteristics of Islamic financial transactions.

11. Against this backdrop, the Islamic financial industry has become one of the fastest growing financial segments in the international financial system with an estimated annual growth in the region of 15 to 20 percent. There is also a growing number of the Islamic financial institutions that now operate in several parts of the world both in Islamic and non-Islamic countries. The total Islamic assets under management are estimated to exceed one trillion US dollars. Islamic mutual funds are estimated to be at a value of over USD300 billion while the issuance of sovereign and corporate sukuk has now exceeded USD80 billion.

12. The rapid evolution and expansion of Islamic finance is also evident from the growing range of Islamic products and services with the Islamic financial solutions being developed to meet the demands of different consumer and business segments. This has been accompanied by the development of a diverse number of Islamic financial intermediaries including banking, takaful (Islamic insurance), capital market intermediaries and other specialized institutions that offer Islamic financial products and services. Such specialized institutions include mortgage corporations, credit guarantee corporations, deposit insurance, Islamic hedge funds, and other shariah compliant collective schemes such as Unit Trusts, Real Estate Investment Trusts (REITs) and Exchange Traded Funds. We have also seen the rapid evolution of the Islamic financial markets including the Islamic money and capital markets with the development of a wide range of structured products and significant growth in activity.

13. Backed by its strong foundation and the growth that has been experienced, the Islamic financial services industry is now at a new threshold to make further advancement while at the same time to address some of the gaps that still exist. Of particular importance, is that the robust development of the Islamic financial markets needs to be reinforced by the development of risk mitigating instruments, increased product innovation and the continuous awareness of these developments by society at large, businesses, the financial services industry and regulators.

14. The evolution of sophisticated Islamic financial products which have been structured based on multiple Islamic concepts will allow us to start venturing into a new wave of innovation that will evolve Islamic financial instruments into distinct products and services that will maximize its potential. These products have already become competitive, flexible and efficient both from the perspective

of pricing as well as product structure so as to cater to the demands of the business communities. The recent innovations that include the introduction of Islamic hedge funds, the creation of Islamic benchmark indices and the listing of Islamic financial instruments on the international exchanges have enhanced the depth of the Islamic financial markets as an attractive asset class for investment.

Sukuk: A fast emerging new asset class

15. The sukuk market is fast emerging as the most significant form of Islamic financing and continues to receive strong interest as an avenue for fund raising and investment. The sukuk market has been gaining growth momentum, increasing at an average annual rate of 40 percent with the current outstanding issuance estimated at USD 80 billion. Significantly, 90 percent of the sukuk issuance are corporate issuances. Strong demand for sukuks have also been spurred by the high levels of surplus savings and reserves in Asia and the Middle East. In Malaysia, the issuance of sukuk has surpassed the issuance of conventional bonds for three consecutive years, with the annual turnover in sukuk trading in the secondary market at about RM135 billion.

16. The sukuk is also an attractive instrument to assist Islamic financial institutions in managing their liquidity requirements. At the same time, it is also an effective instrument used by corporations, institutions and sovereigns in tapping funds at a very competitive rates to finance their long term funding needs. At this juncture, the demand for sukuk is tremendous. This is evidenced by the significant gap between the demand for and the supply of Islamic financial instruments. The high demand for the sukuk instrument is shown by the experience of many issuers whereby the over subscription has ranged from two to thirteen times. This has pushed down the cost of issuance by at least 10 to 20 basis points. This demand has also originated from several different parts of the world, both from conventional as well as Islamic financial investors. Due to the scarcity of sukuk issuance, the investors have tended to hold the sukuk for investment thereby reducing the secondary activity in the market thus resulting in a higher pricing in the sukuk secondary market thereby generating good investment returns for investors.

Malaysia's Experience in the Development of Islamic Finance

17. Let me take this opportunity to share with you Malaysia's experience in developing our Islamic financial system. Over two decades, Malaysia has developed a comprehensive Islamic financial system that operates in parallel with the conventional financial system. The domestic Islamic financial system is now well-supported by a significant numbers of diverse players in the banking, takaful and the capital market. A robust regulatory and supervisory framework,

as well as a legal and Shariah governance framework have also been put in place. There is now also a high degree of consumer awareness on Islamic finance. In addition, there is also an efficient settlement and bond information system. The Islamic financial industry has been expanding at a double digit growth rate and has registered a market share of more than 12 per cent in the banking sector while the Islamic capital market in Malaysia has evolved as one of the largest in the world. More than 60 per cent of global sukuk market originates out of Malaysia. In the equity market, 86% of the listed stocks are Shariah compliant with market capitalization of USD193 billion. Malaysia has also structured the first real estate Islamic trust (Islamic REIT) listed on the stock exchange.

18. Following the development of a robust domestic Islamic financial system, initiatives have now been taken to raise the significance of the international dimension of the Islamic financial system. Malaysia has therefore implemented wide ranging liberalization measures, including the issuance of three new Islamic banking licences to foreign Islamic players that have come from the Middle East and through increasing the strategic stakes possible by foreign interest in our Islamic financial institutions, to up to 49 per cent. In the area of Islamic fund management, licences will be issued to entities with foreign equity of up to 100 per cent.

19. Our foreign exchange administration rules have also been progressively liberalized. In this regard, liberalization of capital account through the removal of restrictions to foreign exchange transactions have increased foreign participation in our financial markets. In addition, foreign corporations may raise funds either in ringgit or foreign currency out of Malaysia. The participation of foreign investors in the Malaysian bond market has also been increasing and now represents about 13% of the total outstanding debt securities. The increased foreign participation has also widened the investor base to extend beyond the Muslim countries. Participation in the equity market now represents about 20 per cent of the market. The increased foreign participation has strengthened our interlinkages with other international financial markets.

Conclusion

20. In conclusion, Islamic finance is emerging as a viable and sound financial intermediation. The new wave of innovation and the increased awareness and interest in Islamic financial solutions are contributing to its dynamic advancement. The acceleration of the integration of Islamic finance into the international financial system would also contribute towards strengthening further the global economic and financial inter-linkages and we believe increases the prospect for securing more balanced global growth. In addition, the increased

diversification of cross border flows into new asset classes would not only result in the more efficient allocation of resources across borders but also enhance the potential to contribute towards global financial stability.

21. On this note, I wish you a productive and successful forum.

Thank you.

5 December 2007