

Islamic Financial Intelligence Summit (IFIS) 2011
“The New Islamic Finance Landscape”
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Keynote Address by

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This decade has witnessed dramatic changes in the Islamic financial landscape. As a dynamic industry, Islamic finance is responding to the forces of change emanating from the changing requirements of the real economy, the changing pattern and pace of globalisation and the wide spread financial reforms being undertaken at both the international and national levels. This transformation of the Islamic financial system is also taking place during the most challenging of times as the world enters the fifth year of the global financial crisis. A central aspect of the new Islamic financial landscape is also the increased focus on financial stability to enhance further its potential as a form of financial intermediation in an increasingly more challenging environment.

It is my great pleasure to join this Islamic Financial Intelligence Summit organised by ‘The Banker’ held this year in Kuala Lumpur, in association with Bank Negara Malaysia to speak on the subject on the ‘New Islamic Financial Landscape’. This event which is being held for the first time outside London brings together practitioners from the financial community from different parts of the world. While the focus of this Summit will be on Islamic finance, it is inevitable that the discussions today will touch on the recent developments in Europe, given the potential impact it may have on the rest of the world and the need to implement strategies and policies for coping with the consequences of these developments.

While the financial solutions being implemented in managing the crisis and the measures being introduced to mitigate the impact of the crisis by the rest of the world is important, it can only provide temporary relief. It is the structural policies and reforms that are more challenging to undertake that will ensure fundamental financial stability and a long lasting self sustaining economic recovery.

My remarks today will focus on the changes in the Islamic financial landscape and its increased potential to contribute to sustainable growth, increased international connectivity following the increased pace of internationalisation of Islamic finance and new developments to achieve financial stability in the Islamic financial system. The changing financial landscape and the accelerated expansion in Islamic finance have also resulted in changes in the nature of the supporting ancillary services, including education that is being provided for the business and financial sectors.

Islamic Finance and Fostering Sustainable Growth

As the Islamic financial system evolves to become more diversified and more comprehensive to meet the changing requirements of the real economy, it is increasing its potential to fostering sustainable growth. Given that the inherent principle of Islamic finance requires that financial transactions be accompanied by underlying economic activity, it already ensures the close link between the expansion in financial assets with the real economy. As the Islamic financial system transitions from being banking centric to becoming more diversified and comprehensive, it has been able to provide the spectrum of financial products and services to the range of activities in the economy, as required by small businesses to conglomerates, and by households to the high networth individuals.

The development of intermediaries that previously was dominated by banks now comprises the range of financial institutions that also includes investment banking, specialised banking institutions, takaful, capital market intermediaries and microfinancial institutions. Financial markets, including the Islamic money and sukuk markets have been instrumental

in intermediating funds in the Islamic financial system. The Islamic money market not only facilitates liquidity management but also the implementation of monetary policy. The sukuk market has facilitated the raising of funds by businesses, while providing investors with a range of instruments for investment, thereby facilitating the mobilisation and allocation of funds to productive economic activity.

Accompanied by research and development, innovation has intensified. Islamic finance however has the governance arrangements which require the approval process by the Shariah advisories. This ensures avoidance of the creation of financial instruments that have its origins from other financial instruments. A further principle of profit sharing and hence risk sharing also ensures a high degree of transparency and disclosure, thereby a greater shared responsibility on the viability of the products.

The rapid expansion of Islamic finance is reflected in more than 600 Islamic financial institutions operating in more than 75 countries in centres that are now beyond Muslim jurisdictions. Indeed, Islamic finance is increasingly becoming part of the growth strategies of an increasing number of global financial institutions. New horizons are also fast emerging following legislative and regulatory changes in several non-traditional markets that have now emerged as the fastest growing segment in the international financial system. In fact, the Banker's latest 2011 Top 500 Islamic Financial Institutions report being released at this Summit shows that the global Islamic finance industry continues to experience double digit growth of 21%, with the Shariah compliant assets now breaching the USD1 trillion mark. The rapid expansion of Islamic finance essentially reflects its ability to meet the changing requirements of the global financial community and its competitiveness. The elements of checks and balances in Islamic finance that promote accountability and transparency enhances its potential as a stable form of financial intermediation. There is also a growing recognition that the inherent tenets of Islamic finance are aligned with the sustainable dimensions of ethical finance and responsible financing.

As the new financial landscape emerges, it has also been accompanied by the development of ancillary support services that include legal, accounting, taxation and Shariah advisory. In addition, there is the development of Islamic indices, information repositories and consultancy services. In the areas of human capital development there is a proliferation of programmes and certifications that focus on Islamic finance. Malaysia is committed in this pursuit and has put in place a comprehensive talent infrastructure in Islamic finance with the aim of meeting the increased demand for practitioners by the global Islamic finance industry. Dedicated institutions of learning such as the International Centre for Education in Islamic Finance (INCEIF) and the Islamic Banking and Finance Institute (IBFIM) have been established to focus on education in Islamic finance.

Increased International Connectivity and Islamic Finance

Despite the continued strains experienced in the economy and the international financial system, it is important to recognise the fundamental long-term global transformation that is taking place. In this recent decade, the concurrent rise of the emerging economies is resulting in a fundamental realignment in the global landscape. This transformation is characterised by the shifting balance of global economic strength to the emerging economies, with its significant implications on the global economic and financial flows. The international financial landscape will also be inevitably transformed with the distribution of financial centres becoming more dispersed. Increasingly, new centres of financial activities will likely to emerge. In addition, financial system inter-linkages - particularly among the emerging economies - will deepen, supported by the increased global trade and investment that is already taking place. With considerable capacity to meet large investment requirements, opportunities therein lie in the more effective and efficient channelling of the sizeable surplus funds towards the vast productive investment opportunities within and across the emerging economies.

These trends are being reinforced by the rapid expansion of financial institutions in emerging economies that have ventured beyond national borders. Financial institutions from the emerging economies have grown significantly in size and strength in this recent decade to now account for almost half of worldwide financial industry market value. Eight out of the twenty largest global banks, including the top two, are emerging market financial institutions. As the emerging market financial institutions continue to regionalise and internationalise, their role and importance can be expected to further expand. Another key development is the integration of financial markets amongst emerging economies, driven in part by the increased economic inter-linkages and the increased liberalisation trend in the financial sector.

The rapid internationalisation of Islamic finance is reinforcing this trend and has enhanced the economic and financial connectivity between the emerging economies. The high level of savings and wealth accumulation in several of the emerging economies, including in Asia and the Middle East, need to be effectively channelled towards productive investments including for large infrastructure development. In this environment, Islamic finance has emerged as a viable and attractive form of intermediation including financing of large scale infrastructure projects. Recent examples include the USD500 million Islamic Infrastructure Fund established in 2009 by the Asian Development Bank (ADB) and Islamic Development Bank (IDB) to meet the Shariah-compliant financing needs in the member countries.

In addition, the advancements achieved in the sukuk market also provide evidence on the ability of Islamic finance in meeting the requirements of the differentiated demands of the modern economy. The recent issuance of the world's first offshore RMB sukuk by Khazanah Nasional in Malaysia reflects the growing trend of multi currency sukuk issuances in Asia. Growing at an average annual rate of 40 percent, the global sukuk market has demonstrated its ability to effectively intermediate funds across borders, allocating funds efficiently in the international financial system and fast becoming an important financing and capital raising option.

Islamic Finance and Financial Stability

An important aspect of the new financial landscape is the increased focus on financial stability. The more market oriented systems with market-based finance activities, the creation of new financial instruments and an increasing number of market participants with global reach, and more interconnected financial systems has expanded the potential for, and channels through which, financial shocks are transmitted to the economy and across borders. Indeed, recent experiences with crises have also shed new insights into the complex web of relationships that exist between sovereign, financial and economic risks, and underscored the critical importance of strengthening the pillars of financial stability that can serve to contain the impact of a crisis.

The increased focus on financial stability has several implications for the new financial landscape. The most significant will be the fundamental changes in the regulatory environment. These include changes to institutional arrangements for oversight of the financial system - both at the international level and within national borders in a number of countries, significantly strengthened prudential standards with a focus on building stronger capital and liquidity buffers, increased transparency in financial transactions and exposures, and enhanced options to resolve failed financial institutions.

Much progress has already been made by the Islamic Financial Services Board in promulgating an extensive set of prudential standards for the Islamic financial services industry since its establishment in 2002. The IFSB has already introduced standards for capital adequacy, risk management, corporate governance and Shariah governance. This important work has been significant in promoting international uniformity of the regulatory framework and international best practices for the Islamic financial system in different jurisdictions. The IFSB has also established a facilitative platform to promote overall financial stability through the Islamic Financial Stability Forum (IFSF) that serves as an avenue for cross-border engagement amongst regulators.

The important goal of strengthening the foundation of the global Islamic financial system has also been reinforced further following the recent global financial crisis, through the work of the IFSB-IDB Task Force of Islamic Finance and Global Financial Stability. In its report that was released in 2010, **eight building blocks** were identified to manage potential risks and vulnerabilities to the Islamic system. These include steps that need to be taken for the implementation of the prudential standards; the development of a liquidity management infrastructure; the introduction of strong financial safety nets; the development of an effective crisis management and resolution framework; the development and implementation of accounting, auditing and disclosure standards; the formulation of an effective macro prudential framework; the development of credible credit rating institutions and processes; and finally, to strengthen efforts for capacity building and talent development for the Islamic financial services industry.

Following these recommendations, this year, the International Islamic Liquidity Management Corporation (IILM) was established to strengthen the liquidity management of Islamic financial institutions. This initiative represented a collaboration between 10 Central Banks and 2 multilateral development institutions. Its aim is to enhance the availability of liquid Shariah-based Islamic financial market instruments - a crucial step in promoting more efficient cross-border liquidity management for Islamic financial institutions to support increased cross-border flows.

Cumulatively, these efforts will build a solid foundation for the orderly growth and development of Islamic financial system that will contribute to its continued resilience and the overall stability of the global financial system in a way that better serves households and businesses.

Going forward, it is important that the international standard setting process allows and continues to promote the more effective integration and exchange of perspectives between Islamic and conventional finance to ensure a coherent global framework that is consistent across similar risks, promotes a better understanding of risk interactions between conventional and Islamic finance activities, and accelerates progress towards best practices based on the sharing of research, experiences and frameworks.

Conclusion

Let me conclude with a statement from this year's Per Jacobsson Lecture given by Sir Andrew Crockett on what should guide us in our "efforts to devise a new and stronger financial system". "It should be global, it should be robust, it should be an effective servant of the real market economy". This is what the new Islamic financial landscape has evolved to achieve. With its inherent close links to the economy and its trend towards internationalization and the robust institutional arrangements and regulatory standards being introduced and implemented, it will indeed enhance the potentials for Islamic finance to not only serve the economy but to achieve sustainability in this more challenging environment.

**Launch of the Financial Sector Blueprint at Sasana Kijang:
“Strengthening Our Future”
Kuala Lumpur, 21 December 2011**

Speech by

Tan Sri Dato’ Sri Dr. Zeti Akhtar Aziz
Governor, Bank Negara Malaysia

It is my great honour to welcome you to Sasana Kijang for the launch of Bank Negara Malaysia’s Financial Sector Blueprint. On behalf of Bank Negara Malaysia and the financial services industry, Yang Amat Berhormat Dato’ Sri, I wish to express our appreciation to you for your presence here this afternoon to launch the Financial Sector Blueprint. This Blueprint marks a new phase in the development of the financial system. It focuses on new areas that will strengthen the competitiveness and efficiency of the financial sector and its potential role in facilitating our ongoing economic transformation and greater regional economic and financial integration and thus to enhance Malaysia’s long term economic growth potential.

The Blueprint themed “Strengthening Our Future” builds on and reinforces the solid foundations that has been achieved in this decade. Malaysia has benefited from a well developed, more competitive and well regulated financial system. The financial system emerged from the global financial crisis strong and resilient, and has continued to support our domestic economy even during these most challenging of times.

The recommendations in the Blueprint has taken into account the expected changes in the international and domestic environment and its consequent demands on the financial system in this next decade. It also takes into account Malaysia’s aspirations to become a high value-added, high income economy.

Within the global economic landscape, emerging economies will assume a more significant role. While emerging economies will continue to be affected by global developments, most are able to demonstrate resilience and

are expected to remain on a growth trajectory. By 2030, emerging economies are projected to account for 60% of total world output, from the current 40%.

At the same time, the economies and financial markets in the global economy and international financial system have become more interconnected as a result of greater cross-border trade and financial flows. The continued development and deepening of our financial markets and increased financial liberalisation in emerging economies will reinforce this trend towards greater interconnectivity.

More recently, the financial sector has been the target of a renewed focus and priority by the international community. Wide ranging financial reform measures have been introduced in the aftermath of the global financial crisis to address the weaknesses that have surfaced during the crisis.

Several changes are also transforming the domestic environment. New domestic sources of growth, the greater role of the private sector in the economy, demographic changes, rising incomes and a growing middle class, and the accelerated pace of urbanisation cumulatively will significantly change the demands on the financial sector. These trends will also be affected by initiatives taken by the Government to transform the economy in this next decade into a high value-added, high-income economy, the greater leverage on the advances of technology and the acceleration of the pace of regional financial integration in Asia.

The Malaysian financial system enters this new environment from a position of strength. The successful implementation of the first Financial Sector Masterplan in this recent decade

has produced a financial system that is well positioned to respond to the new imperatives of the decade before us. Our financial institutions are well capitalised with strong buffers and improved risk management and governance practices. Significant efficiency gains have also reduced intermediation costs in an environment of greater competition. This is largely arising from the cumulative efforts to building strong institutions, the development of the financial infrastructure, and the strengthening of the regulatory and supervisory framework.

This decade has also seen the enactment of wide ranging legislation that has given greater certainty and predictability in the financial system. This includes the Central Bank of Malaysia Act 2009 and the Financial Services Act expected to be tabled in Parliament in 2012 has strengthened the legal framework for the financial sector. It will also enhance the Bank's capacity to manage risks from financial intermediation activities that occur outside the banking system and provide enhanced powers for timely intervention actions.

The enhanced intermediation during this decade has benefitted access to financing, particularly for small and medium enterprises, has also improved, both in volume and efficiency. By leveraging on the distribution networks of commercial banks, enhanced product and risk management capabilities, access to financing by this sector has increased at an annual rate of almost 20% since 2005.

The financial infrastructure in Malaysia has also been significantly strengthened. Malaysia has an effective financial safety net that includes a comprehensive deposit insurance system and institutional arrangements that provide avenues for advisory, redress and rehabilitation. Innovations in payment systems and instruments as well as infrastructure for the issuance, trading and settlement of debt securities and the access improved market information has contributed to greater efficiency and has also enhanced the overall price discovery process. To support our liberalisation measures our payment infrastructure has also been enhanced to support cross-border trade settlements in local currency and cross-border liquidity support arrangements for financial institutions.

Today, Malaysia also has a deep and vibrant bond market which is the largest in South East Asia, and a comprehensive Islamic financial system that is recognised as among the most advanced in the world. The bond market comprising of the conventional and sukuk market has trebled in size, providing businesses with alternative access to financing solutions including in multicurrency to meet a diverse range of risk and maturity preferences. The strengthened Islamic financial institutions, the establishment of key financial infrastructure for Islamic finance including the regulatory and supervisory framework have positioned Malaysia at the frontier of Islamic finance.

The recommendations in the Blueprint aim to build on this progress towards resulting in the development of a financial sector that will meet the economic and financial realities of this new decade. The financial system envisaged

- will be firmly anchored in the real economy in providing financial services that contribute positively to growth;
- that offers a diverse range of products, services and institutions that cater to the financial needs of a broader spectrum of Malaysian households and businesses;
- will be reinforced by deep, liquid and efficient foreign exchange and money markets to complement the bond market;
- that is more engaged with the region and other parts of the world;
- that can contribute meaningfully to Malaysia's economic transformation; and finally,
- a financial system that is inclusive in reaching Malaysians across all social, geographic and economic stratas.

It is envisaged that by 2020, the financial system is expected to expand from the current 4.3 times to six times of GDP. Correspondingly, the financial sector contribution to nominal GDP is projected to rise from 8.6% to between 10 to 12% in 2020. More than half of total financing in 2020 will be raised through financial markets, while Islamic finance will continue to increase in prominence, growing at a faster pace to account for 40% of total financing.

The Blueprint has adopted an integrated approach that reflects a financial sector that has increasing linkages between the various sub-sectors in the financial system. The recommendations, in the Blueprint are thus centred on achieving nine major areas: (i) effective intermediation for a high value-added, high-income economy; (ii) the development of deep and dynamic financial markets; (iii) greater shared prosperity through financial inclusion; (iv) strengthening regional and international financial integration; (v) internationalisation of Islamic finance; (vi) safeguarding the stability of the financial system; (vii) achieving greater economic efficiency through electronic payments; (viii) empowered consumers; and (ix) talent development for the financial sector.

A strong focus in the Blueprint is on developing the financial ecosystem to enhance funding for innovation which represents a key transformative agenda in our new economic model. Ten initiatives in the Blueprint are devoted directly to nurturing sources of financing for innovative enterprises in all sectors and at various stages of development. Over the next ten years, steps will be taken to achieve a wider range of funding sources for new ideas, including new conduits for financing and investments in innovative industries.

With the foundations now in place for greater liberalisation, the Blueprint extends this path by assuming a more regional and international complexion. This will entail positioning our financial sector to participate more effectively in the mobilisation of regional surplus funds to productive investments in the region. The financial sector will also advance the country's external orientation by serving Malaysian corporations in their regional and international operations, as well as facilitating greater participation of international and regional corporations in our economy. Malaysia will also continue to spearhead the internationalisation of Islamic finance to facilitate greater cross-border Islamic financial activities. The Blueprint will also pave the way for the integration of the existing national-level Shariah Councils into a single apex authority on Shariah matters to be established for all institutions offering Islamic financial services in Malaysia.

In the Blueprint, financial liberalisation will be pursued in the best interests of Malaysia. The goals for financial liberalisation are twofold. Firstly, to improve allocative efficiency to productive economic activities, to increase the operational efficiency and lower further the intermediation costs, and to encourage greater financial innovation. Secondly, to strengthen further Malaysia's economic and financial linkages with the region and other parts of the emerging world. Key recommendations in the Blueprint include more flexible limits on foreign participation in financial institutions, the issuance of new licenses to financial institutions with specialised expertise that are able to contribute to Malaysia's economic aspirations and financial sector development. In implementing these strategies an assessment will be made on the factors contributing to the best interests of Malaysia. In addition to the prudential criteria that must be met, the presence of strong and well-managed domestic banking groups that will account for a significant share of resident deposits will remain important for the orderly growth and development of the financial sector and of the Malaysian economy.

As our financial sector continues to advance over the next decade, priority will continue to be accorded to ensuring that the regulatory and supervisory regime remains current and continues to foster a sound and stable financial system within a more dynamic landscape. Given the more complex nature of risks stemming from greater convergence in the financial sector, the proposed new financial services legislation will be to promote consistent approaches to regulation and supervision across the financial sector, strengthen the Bank's capacity to manage risks associated with financial intermediation including financial activities that currently outside the regulated system.

A national consumer credit law and improved arrangements for combating financial crime are also included in the recommendations. To ensure that cross-border financial linkages do not propagate risks across borders, the Central bank will intensify its coordination with other regional and international supervisory authorities, focusing in achieving more consistent regulatory and supervisory

standards, timely information exchange and effective supervisory colleges.

An important agenda under the Blueprint will be to accelerate the migration from paper-based payments to electronic-payments to generate significant economic efficiencies from more expedient, secure and cost-effective means of moving funds. A range of measures will be introduced to accelerate the pace of migration towards e-payments, including driving the adoption of the mobile phone banking and payment transactions, increasing the number of point-of-sale terminals, and introducing a pricing structure that incentivises the use of e-payments.

Conclusion

Let me conclude by expressing the Bank's appreciation for all the valuable contributions received from the industry, Government agencies and other stakeholder groups with whom the Bank engaged over the course of this year to develop the recommendations in the Blueprint. In total, the Blueprint sets out 69 recommendations to achieve the vision for the financial sector in 2020. The Blueprint provides the vision and direction to secure a financial system that will firmly support and drive Malaysia's long-term growth potential and aspirations. It will be our shared commitment that will result in its success.