

**Seminar on Islamic Finance
Jointly Organized by
Islamic Financial Services Board & Hong Kong Monetary Authority
“Towards Gaining Global Growth Potential of Islamic Finance”
Hong Kong, 15 January 2008**

by

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

It is my honour and great pleasure to be in Hong Kong today to speak at this seminar on Islamic Finance jointly organised by the Hong Kong Monetary Authority and the Islamic Financial Services Board. Islamic finance is now at the threshold of a new dimension in which, it has now an increased potential to strengthen international financial linkages between nations. And in so doing, it would contribute towards a more optimum allocation of financial resources across borders. Hong Kong, with its sophisticated financial infrastructure and high level of expertise in the financial sector, has strong potential to be an important linkage and an engaging partner in the international Islamic financial activity.

It is exactly six years ago that we were here in Hong Kong as our first destination, to promote the world's first sovereign sukuk issuance. The overwhelming response we received in Hong Kong provided the momentum effect that resulted in the successful issuance of the pioneering USD600 million Malaysian sovereign sukuk. It was more than two times over subscribed with one-third of the investors from this region. Six years hence, the Islamic financial landscape has been dramatically transformed into a vibrant, dynamic and competitive global intermediation mechanism that is supported by more than 300 Islamic financial institutions in more than 75 countries. It also has become among the fastest growing segments in the financial services industry.

In the early phase of its development, Islamic finance was essentially domestic centric, focussing on retail financing, trade financing and the financing of other commercial business activities. Two recent developments have

however, influenced the subsequent direction of the development of Islamic finance.

Firstly, the drive to diversify the domestic financial infrastructure so as to avoid the over dependence on the banking sector and secondly, the trend towards greater liberalisation of the financial system. These two trends have spurred the development of the Islamic financial markets and its greater integration into the international financial system, thereby raising the international dimension of Islamic finance.

This more dynamic environment, has fostered the generation of a wide spectrum of Islamic financial instruments that has ranged from instruments to manage liquidity to structures for the financing of that for financing mega investments. These developments have led to the emergence of a new asset class. It has also drawn a higher level of foreign participation in the Islamic financial markets which has resulted in increased cross-border flows. This has not only contributed to enhancing international financial inter-linkages between economies but it has also contributed towards the more efficient allocation of financial resources across borders.

Islamic finance in 2008 and beyond remains positive despite the current challenging global financial environment. The viability and competitiveness of Islamic finance is derived from several factors. It is from its ability to meet the changing demands of the economy, from its cost competitiveness and from being supported by a well developed legal, regulatory and supervisory framework. But more importantly, are the fundamental Shariah requirements of Islamic finance that support its viability and stability.

Shariah is the key pillar of Islamic finance from which Islamic finance derives its unique characteristics. The Shariah injunctions require that Islamic financial transactions be accompanied by an underlying productive activity. In Islamic finance, there is always a close link between financial and productive flows. Moreover, under the risk sharing principle required, Islamic financial institutions will share the profit or the loss incurred by the entrepreneur. There is an explicit sharing of risk by the financier and the borrower. This arrangement will thus entail the appropriate due diligence and the integrating of the risks associated with the real investment activity into the financial transaction. In this arrangement, the real activity is expected to generate sufficient wealth to compensate for the risks.

In contrast, conventional instruments generally separate such 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. This has led to its proliferation through multiple layers of leveraging and disproportionate distribution, in turn, which could result in higher systemic risks, thus, increasing the potential for instability in the financial system.

In addition, transparency represents a basic tenet underlying all Islamic financial transactions. There is an inherent obligation on Islamic financial services providers to meet the appropriate standards of transparency. It is from the profit-sharing feature of Islamic financial transactions that imposes a high level of disclosure in the financial contract. The accountabilities of the respective parties involved in the transaction are clearly defined in the contract. This transparency also provides a strong incentive for Islamic financial institutions to appropriately manage risks. This disclosure allows the market to assign the appropriate risk premiums to the respective companies and thus the potential for the enhanced role of market discipline to take effect. These inherent features as required by the Shariah injunctions provides

inbuilt checks and balances which serves to ensure financial stability in the Islamic financial system.

These features are also reinforced by the development of a comprehensive regulatory and supervisory regime which has been strengthened considerably with the establishment of the Islamic Financial Services Board in 2002. It's establishment has also contributed to the harmonisation in the development of Islamic finance across different jurisdictions. Finally, education institutions have been established to develop the supply of professional talent and expertise in Islamic finance to support the growth and development of Islamic finance going forward.

The evolution of sophisticated Islamic financial products that have been structured based on multiple Islamic concepts have resulted in a new wave of innovation. These products have become competitive and efficient both in terms of product structure and pricing. The more recent innovations include the introduction of Islamic hedge funds and the creation of Islamic benchmark indices. There has also been increased listing of Islamic financial instruments in international exchanges. This has enhanced the depth of the Islamic financial markets has increased its attractiveness of an asset class for investment. This has contributed to increased sophistication of Islamic banking and takaful products evidenced by the recent surge of structured products and investment-linked products.

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. Significantly, 90 percent of the sukuk issuance are corporate issuances. 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. Strong demand for sukuks have

also been spurred by the high levels of surplus savings and reserves in Asia and the Middle East.

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 competitive rates to finance long term funding needs. At this juncture, the demand for sukuk is tremendous. The high demand for the sukuk instrument is evidenced by the over subscription which 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 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, has resulted in a higher pricing in the sukuk secondary market thereby generating good investment returns for investors. The sukuk thus offers a positive value proposition for both issuers and investors.

Let me turn to Malaysia's experience in Islamic finance. Malaysia has had three decades of experience in which we have developed a comprehensive Islamic financial system that operates in parallel to the conventional system. The supporting legal framework includes a dedicated legislation that takes into account the unique principles of Islamic contracts. The legal infrastructure also includes the court system and arbitration mechanism to resolve disputes to ensure that contracts relating to Islamic financial transactions are effectively enforced. The Islamic financial system is also well supported by a significant number of diverse players in the banking, takaful and capital market. Finally, for a dual financial system, the tax reforms have been undertaken to accord neutrality in treatment between conventional and Islamic financial products. The establishment of a national central Shariah Council has been important to ensure harmonisation of Shariah decisions in the Islamic financial services industry.

The Islamic financial industry in Malaysia has experienced rapid transformation in recent five years. The product range has now expanded into broad array of innovative instruments. Several new Islamic financial products were introduced which included residential mortgage backed securities, commodity based financing, as well as investment and equity linked product based on musyarakah, mudarabah and ijarah.

The Islamic financial system in Malaysia has evolved as a competitive component of the overall financial system, complementing the conventional financial system as a driver of economic growth and development. Malaysia continues to foster the expansion of the dual banking system where both, the Islamic and conventional systems operate in parallel to deliver innovative and competitive financial products and services. More recently, the increased pace of liberalisation in the Islamic financial services industry has increased foreign presence and participation in our domestic Islamic financial system. This has increase the diversity of players in our system. The Malaysian bond market has also been liberalised to enable foreign entities to raise ringgit and foreign denominated funds in our domestic market. Following these developments we are now entering a new phase in the development of Islamic financial system in Malaysia with the new initiatives to promote Malaysia as an International Islamic Financial Centre. This aims at strengthening our economic and financial inter-linkages and thus promoting greater trade and investment across borders. We are therefore entering a new phase of development for Islamic finance in Malaysia as it becomes more integrated with the international financial system.

Given the surge in demand for Islamic financial products and services, several countries and financial centres are increasingly participating in the industry. The global front-runners will be those with combined strengths of having the capabilities and resources, as well as the ability to secure the confidence of the international Islamic financial community. It is against this backdrop of rising competitive environment

that the potential of cumulative bilateral and multilateral strengths will become important in managing the complexities and constraints found in the Islamic financial services industry.

This increasing interest by several financial centres together with their international linkages will contribute towards creating a more integrated international Islamic financial system. Such centres, such as Hong Kong, have the potential infrastructure and the ability to facilitate product offerings that will bridge the regional and international financial linkages. Strategic alliances among Islamic finance players would be a catalyst unleashing the regional and global potential of Islamic finance.

In South East Asia alone there is an immense potential market to be tapped. This market not only comprises the 217 million Muslim population but extends to the non-Muslim community and the foreign national community that operates in the region. The region is increasingly becoming an investment destination, including from the Middle Eastern investors. In 2006, Asia Pacific region has surpassed Europe as second largest region for investment from Gulf Cooperation Council (GCC) with USD460 billion investment.

The recent specific initiative to enhance the securitisation market by Cagamas Berhad, the Malaysian Mortgage Corporation and Hong Kong Mortgage Corporation by establishing a joint venture company to provide a mortgage guarantee programme for both Islamic and conventional mortgages in Malaysia is an example of a collaboration. This could be a catalyst for more similar initiatives in the future.

Conventional financial institutions may also enter into alliances with Islamic financial institutions to be co-arrangers, to structure sukuk or other Islamic products based on Shariah compliant assets in this region. The wide ranging availability of such assets and the massive financing needs of the new growth areas in the region such as in China, Indonesia and Vietnam will be attracting funds from surplus economies such as from the Gulf economies. Efforts can also focus on facilitating

cross listing of sukuk in multiple jurisdictions. Additionally, the viability of setting up of Asian Sukuk Fund as an extension of Asian Bond Fund can also be explored.

Potential issuers may leverage on Malaysia's sukuk platform and the strengths as the world's largest sukuk issuance centre with over **US\$56b** or **62%** of world's sukuk issues. Malaysia has one of the most active primary sukuk market with an average annual growth of 17% during the period 2001-2006. It also has one of the most active secondary market with the turnover of the sukuk trading registered more than USD40 billion annually. International issuers with good rating will benefit from the simplified issuance procedures. This is in addition to the ability to issue multi-currency sukuk and the flexibility to swap RM funding into other currencies to enable foreign issuers to capitalize on the price premium of issuing RM denominated sukuks.

A further area of collaboration is outsourcing, in-sourcing or white labelling. These mechanisms will not only serve as a means to drive down cost of doing business, achieving economies of scale and the avoidance of duplication of resources, but also gives optimum focus by players to develop the newly ventured Islamic finance business. Malaysia's experience in Islamic financial operations and product design can be leveraged upon to systematically structure a complete solution to be offered to other players.

Going forward, Islamic finance as a new industry requires more initiatives to expand the horizon of business parameters and innovative products offerings. There is a need to conduct further in-depth research on Shariah issues relating to risk mitigation, liquidity management and hedging. The combined market knowledge and insights from education and training institutions such as INCEIF, the International Centre for Education in Islamic Finance in Malaysia can make meaningful contributions to the global Islamic finance industry that addressed both market needs and Shariah compliance. In addition, INCEIF's flagship

programme, the Chartered Islamic Finance Professional (CIFP) offers the world's first professional certification programme in Islamic finance aims to nurture skilled talent pool for Islamic finance.

Let me conclude my remarks. The global Islamic finance industry has evolved from a faith-based to a business driven industry for all communities. With total global Islamic financial assets amounting to only 40% of the largest conventional bank and with only 300 players compared to 23,000 conventional players

globally, competitive pressure moving forward are likely to be intense. But with the underlying strength inherent in Islamic finance and its potential role in bringing together different parts of the world with surplus funds in search of investment opportunities to those with financing requirements accords tremendous opportunities to be drawn from Islamic finance. The combined efforts and collaborative alliances will pave the way for mutually reinforcing developments that will contribute to the overall international finance system and global economic prosperity.

The Launch of Labuan International Business and Financial Centre Kuala Lumpur, 28 January 2008

Launch Address by

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

It is with great pleasure that I welcome you to the launch of Labuan International Business and Financial Centre. This decade has seen the Labuan Offshore Financial Centre demonstrate its ability to adjust and reinvent itself in a rapidly changing international and regional environment. This decade has also witnessed the robustness and resilience of the Labuan Offshore Financial Centre as evidenced by its ability to continue to expand and mature even during the most challenging of periods.

The global and regional market place however, continues to transform, bringing with it new opportunities and challenges. To have the flexibility to benefit from the new opportunities and to have the capacity to rise to the new emerging demands and challenges, continued reassessments need to take place to rediscover new directions, build new strengths, new comparative advantages and to define our new role in this ever changing and more competitive market place. Today we are defining a new beginning for the Labuan Offshore Financial Centre as it positions itself for a much larger role. Your presence here today to share in this auspicious occasion is indeed appreciated.

In providing the full range of financial services, Labuan offers a total financial solution both in both conventional and Islamic finance. Labuan also has the top-ranked financial institutions that originate from more than 80 countries, including Islamic financial institutions that also originate from different parts of the world. The Labuan Offshore Financial Centre has seen steady expansion both in terms of the number of players, the diverse financial product offering and the volume of activity.

Labuan today has also become a thriving regional business centre. It is making its mark as a regional base for the oil and gas industry and as an entreport for the regional triangle of Brunei-Sabah-Philippines. Its convenient location and excellent deep harbour are natural advantages. Its modern airport which has been enhanced has also promoted increased tourism. Being a duty free zone and a free port status has supported these activities. Growth in these peripheral commercial and economic activity in Labuan has provided the potential for Labuan to succeed as an international business and financial centre.

Labuan benefits from being centrally located in the Asia Pacific region, a region that has been one of the fastest growing regions in the world. The Asian region is also among the most open in the world in terms of international trade and investment. A more recent phenomenon is the increased intra-regional trade and investment resulting in greater regional economic integration. This has been reinforced further by increased investment flows from the Middle East to Asia. In 2006, the Asia Pacific surpassed Europe as the second largest region for investment from the Gulf Cooperation Council (GCC) with USD460 billion investment.

Despite the current financial upheavals that are occurring in the international financial system, the underlying trends in the region including the cumulative regional demand, greater regional integration and the increased appeal of the region as an investment destination have continued to present immense opportunities for Labuan as a business and financial centre.

Labuan is well positioned to tap these business opportunities. Key to the success of a business and financial centre is its competitiveness, the convenience and cost effectiveness of doing its business, its connectivity and the confidence in the centre. The Government of Malaysia has been highly committed to ensuring that Labuan has all these elements. Massive investment has been made to provide for the physical infrastructure and amenities in Labuan. This includes the modern communication links, and the business and education amenities to support Labuan's designated role as an international business and financial centre. Recently, the Labuan International airport was enhanced further and open sky policy has been adopted to facilitate enhanced access to the island. Also, improvements have been made to the deep harbour facilities.

Increased access is however, not only limited to the physical access but also the easy access to other financial markets. This requires the infrastructure that allows for the efficient conduct of international financial transactions. Intermediaries need to be able to have easy access to participate in other jurisdictions. To facilitate this and to promote the cost competitiveness in Labuan, it is supported by a balanced regulatory regime that effectively regulates the market while facilitating market development. LOFSA, the Labuan Offshore Financial Services Authority was established ten years ago not only to put in place an effective regulatory regime and to provide the supervisory oversight, but also to focus on market development and facilitation. To further ensure a conducive business environment, it is also supported by a robust legal framework including trust laws. While Labuan has in place a business friendly tax regime it also has never been positioned as a low tax finance repository. On the contrary it has leveraged on its strengths and unique advantages to meet the market's need.

In going forward, a number of programs will be initiated. The Labuan International Business and Financial Centre (IBFC) aspires to achieve the status of being the "gold standard for

holding company jurisdiction". This market has been identified as a further business driver for Labuan IBFC. Malaysia's extensive tax treaty network with over 63 countries in addition to the introduction of a more flexible tax framework supports this initiative. It was announced in the 2008 Budget that Registered Labuan offshore companies now have the option to be taxed under the Malaysian Income Tax Act 1967 or the Labuan Offshore Business Activity Tax Act (LOBATA) 1990, thus enabling businesses to structure their transactions more efficiently. The Labuan IBFC's competitiveness will be further enhanced through a revision of the pricing structure pertaining to incorporation and maintenance fee charges. There will be an annual reviews and prices will be revised in response to competitive market developments.

The Labuan IBFC will also leverage on the national strategy of the Malaysian Islamic Financial Centre by promoting Syariah-compliant trusts and foundation. These products will complement Islamic financial products and services already available in Kuala Lumpur. Efforts will also be taken to further develop Labuan's captive insurance business which has enjoyed commendable growth over the years.

Conclusion

The establishment of Labuan as an international offshore financial centre in 1990 was indeed a bold step in its time. We are now seeing the payoffs from this initiative. With the transformation of Labuan as an International Business and Financial Centre, our ambition will be taken further. The new name signals that Labuan is ready to take on the much broader and larger role. The new name also represents a commitment. A commitment for the future. To demonstrate this commitment, the Government and the regulators have put in place the supportive and enabling environment to promote a more connected and more cost effective environment. Continued initiatives will also be taken to remove any impediments and obstacles to a more efficient delivery system and to advance forward the Labuan IBFC.

The responsibility for ensuring the ambitions of the Labuan IBFC to be realised, is however, a shared responsibility. The future will be for the competitive. The future will be for the cost efficient. The future will be for the creative and innovative. The future will be for those that

are able to give good value propositions to their customers. Achieving this will therefore involve the industry, the market professionals and participants. With these cumulative efforts, we are confident Labuan IBFC will be another chapter of success, Insya Allah.

Nikkei Islamic Finance Symposium 2008
“Islamic Finance: Constant Evolution and Emerging Opportunities”
Tokyo, 23 February 2008

by

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

It is my great honour and pleasure to be here in Tokyo to speak at this Islamic Finance Symposium organised by the NIKKEI. This is an important forum that provides the opportunity to foster a greater understanding and appreciation of Islamic finance and its increasing role in the international financial system. We are also very honoured by the presence and participation of Governor Fukui from the Bank of Japan at this Symposium.

My remarks today will focus on the evolution and new emerging opportunities in Islamic finance as its growth and development in the global financial system gains further momentum. My presentation will also touch on our experience in the development of an Islamic financial system in Malaysia which operates side by side with the conventional financial system and in which the international dimension has now become increasingly significant.

Evolution of Islamic Finance

Modern Islamic finance was initially developed as an intermediation channel for Muslims to conduct their savings and investment activities in accordance with the Islamic principles. As recent as five years ago, however, Islamic finance has experienced major transformations. Its rapid evolution is particularly evident in five dimensions of its development.

Firstly, from being concentrated in Muslim populated regions, Islamic finance is now viewed as a **competitive form of financial intermediation** that has drawn significant participation by non-Muslims. For borrowers, it is seen as an alternative means of financing. For investors, it is seen as a new asset class. Islamic finance has thus witnessed exceptional

growth, not only in the Muslim world, where its growth is premised on religious and business considerations, but also across the Western world where the growth is driven by commercial and business considerations. Today, the total assets of the Islamic financial system has surpassed one trillion US dollars, about fivefold of its magnitude five years ago. Islamic finance is now among the fastest growing financial segments in the world with an estimated annual growth of 20 percent.

Secondly, the nature of the business of Islamic finance has also evolved, from being mainly focused on retail and trade financing to the financing of other commercial business activities. With the emergence of more diverse Islamic financial institutions and the development of the Islamic financial markets, the **scope of Islamic finance business has been expanded** to include private equity, project finance, the origination and issuance of sukuk, and fund, asset and wealth management activities. The pace of product innovation has also intensified with more sophisticated Islamic banking and takaful products as evidenced by the surge of structured products and investment-linked products. These products have become competitive both in terms of product structure and pricing. The enhanced depth of the Islamic financial markets has also increased its attractiveness as an asset class for investment. These developments have resulted in an extensive range of Islamic financial products and services that is being offered to consumers and businesses.

The third dimension in which there has been significant evolution is in the **regulatory and legal framework** for Islamic finance which has taken into account the distinct features of

Islamic financial transactions. This has ensured that the growth and developments of Islamic finance is accompanied by the corresponding development of the supporting legal, regulatory and supervisory framework to ensure its soundness and stability. The establishment of the Islamic Financial Services Board in 2002 also marked an important milestone in the development of the prudential regulatory standards and best practices for Islamic financial institutions. Its establishment has also contributed to the harmonisation in the development of Islamic finance across different jurisdictions.

Fourthly, the international dimension of Islamic finance has rapidly gained significance as it evolves to become an **increasingly important part of the international financial system**, and as it becomes poised to contribute towards greater global financial integration. Islamic financial institutions have now ventured beyond their domestic borders and funds raised in Islamic financial markets in different jurisdictions have drawn investors from financial centres across the globe. As market players across continents participate in the expansion of inter-regional investment flows, it has enhanced financial linkages among the major regions. To date, the number of Islamic financial institutions worldwide has increased to more than 300, spanning more than 75 countries both in the Muslim and non-Muslim countries¹. The expansion of the inter-linkages among intermediaries and markets across regions would contribute towards a more efficient allocation of financial resources across borders and thus contribute to enhancing global growth prospects.

The fifth dimension that has seen significant change is in the **development of human capital in Islamic finance**. It has been a vital development that has been key in ensuring an adequate supply of talent and expertise for further expansion and development of the Islamic financial services industry. High caliber professionals that have the combined knowledge and understanding of the Shariah

with the necessary skills in finance² are now in great demand. Recognising this, several major institutions of higher learning are offering more focussed and structured programmes in Islamic finance. The establishment of the International Centre for Education in Islamic Finance (INCEIF) in Malaysia in 2006 represents a structured investment in human capital development to support the global development of Islamic financial services industry. It is envisioned that INCEIF will act as a professional certification body as well as an education centre for specialised post-graduate programmes in Islamic finance.

Distinctive Features of Islamic Finance

While Islamic finance has continued to evolve, the distinct features remain fundamental. Islamic finance is required to operate in accordance with the rules of Shariah from which it derives its unique characteristics. The Shariah injunctions require that the Islamic financial transaction be supported by an underlying economic activity. This requires that the financial transaction must be accompanied by a genuine trade and business related activity.

Based on this arrangement, interest-based transactions are prohibited. Islam encourages business and trade activities that generate a fair and legitimate profit. In Islamic finance, there is therefore always a close link between the financial and productive flows. This intrinsic principle contributes towards insulating the Islamic financial system from potential risks of financial stress resulting from excess leverage and speculative financial activities.

A further fundamental principle of Islamic finance is the risk and profit sharing feature of Islamic financial transactions. This could involve an arrangement whereby the Islamic financial institution shares profit with the investor in a Mudarabah contract or in a Musyarakah contract, both parties share in the profit or loss. These arrangements involve an explicit sharing of the risks by the Islamic financial institution and the investor, thus requiring the Islamic

¹ Sources: Islamic Finance News, Islamic Financial Services Board & National Authorities.

² The trend is now to have both "Shariah savvy financial practitioner" and "financial savvy Shariah Scholars".

financial institution to appropriately manage the risks associated with the transaction. It entails the appropriate due diligence and the integrating of the risks associated with the investment activity into the financial transaction. The real activity is thus expected to generate sufficient wealth to compensate for the risks.

It is from this profit and risk sharing feature of Islamic financial transactions that a high level of disclosure and transparency is required. This represents a basic tenet underlying all Islamic financial transactions. There is an inherent obligation to meet the appropriate standards of transparency. The accountabilities of the respective parties involved in the transaction are also clearly defined in the contract. These disclosures also allow the market to assign the appropriate risk premiums to the respective companies thereby enhancing the potential for market discipline to take effect. These intrinsic features as required by the Shariah injunctions provide an in-built checks and balances which serve to ensure financial stability in the Islamic financial system.

Malaysian Experience

Allow me to take this opportunity to share with you Malaysia's experience in developing the Islamic financial system, and in particular, the Islamic capital market. Malaysia has developed over more than two decades, a comprehensive Islamic financial system that operates in parallel with the conventional financial system. The Islamic financial system in Malaysia has evolved as a competitive component of the domestic financial system with a significant number of diverse players in the Islamic banking, the takaful industry and the Islamic money and capital markets. Our approach has been to focus on institutional development, reinforced by a robust Shariah, legal and regulatory framework as well as the investment in human capital development. In this more recent decade, attention has been focussed on developing the financial markets, in particular the sukuk market, and on the liberalisation of the Islamic financial system.

We are now entering a new phase in the development of Islamic financial system in Malaysia with initiatives to position Malaysia as International Islamic financial hub. The initiative is aimed at strengthening our international economic and financial inter-linkages and thus promoting greater regional and international trade and investment activities. As part of the wide ranging liberalisation measures, we have seen the entrance of new foreign Islamic financial groups into our financial system. New licences have been issued and greater foreign interest in the domestic Islamic financial institutions have also been permitted. In addition, the listing rules were liberalised to facilitate foreign and cross-border listings. New licences are also being issued for International Islamic Bank and International Takaful Operator to conduct Islamic banking and takaful and retakaful business in international currencies.

The most significant progress that has been achieved is in the development of the Malaysian sukuk or Islamic bond market. The Malaysian sukuk market is now the largest Islamic bond market in the world with more than 62% (or USD60 billion) of the global outstanding sukuk having been originated from Malaysia. Supported by a comprehensive infrastructure including the settlement and bond information system, Malaysia has an active primary sukuk market with an average annual growth of 17% over the period 2001-2006. It also has one of the most active secondary markets with a turnover of sukuk trading registering of more than USD40 billion annually.

The Malaysian bond market has also been liberalised to enable foreign entities to raise ringgit and foreign currency denominated funds from our market. International issuers may thus issue multi-currency Sukuks or alternatively have the flexibility to swap domestic currency funding into other currencies. At this juncture, I'm also pleased to inform you that a Malaysian corporation recently issued the largest-ever sukuk issue in the world amounting to equivalent USD4.7 billion which was two times oversubscribed. This hybrid sukuk which has

both equity and debt natures is one of the several innovative instruments that has been issued in the sukuk market.

Malaysia's development of Islamic finance has contributed positively to our overall financial system in several respects. This has resulted to a more diversified financial system that has increased its overall resilience. Secondly, it has increased our international linkages. Thirdly, it has also contributed to greater financial inclusion particularly in the area of financing for small and medium scale enterprises and micro financing. Then, enhanced with the in-built checks and balances, it contributes towards financial stability. Finally, Islamic finance has become a new area of growth that has become very vibrant in generating income, wealth and employment.

Opportunities in Sukuk

In the current liberalised and globalised environment, Islamic finance is now at the threshold of a new dimension in strengthening financial **inter-linkages** between nations in the global economy. With the expanded scope of activities in Islamic finance, the Islamic bond market or Sukuk market has fast become an important avenue for **fund raising and investment activities**. The Sukuk market has registered a remarkable growth, increasing at an average annual rate of 40 percent with a current size of more than USD82 billion. The **vast potential** in Sukuk market in the international financial system indeed represents the crest of a new wave of innovation in Islamic finance. This is evidenced by the active participation of a great number of global players such as investment banks, Islamic banks and securities firms in the issuance of Sukuk.

The Sukuk market brings with it great benefits to both issuer and investors. For issuers that include government agencies, multinational

corporations and multinational development institutions, Sukuk plays a multi-faceted role in meeting different funding requirements ranging from large infrastructure and developmental projects to capital and business expansion. This is particularly important for emerging market economies. The Middle East and Asia currently represent the two fastest growing regions in the global economy. These regions are aggressive in their privatisation efforts and in the implementation of infrastructure and developmental projects. Asia alone will be spending an estimated USD1 trillion on infrastructure over the next five years, while infrastructure requirements in the Middle East are estimated to be USD700 billion over the same period³. While in Malaysia, the National Economic Regional Corridor plan requires an estimated USD192 billion (RM620 billion) of investment⁴.

On the demand side, the issuer also benefits from **the competitively attractive pricing** of Sukuk ranging from 10 to 20 basis points lower than mainstream bonds. This has resulted from the continuous over subscription of the sukuk which has ranged from two to thirteen times. The phenomenal demand for sukuk is further reinforced by excess liquidity in the global financial system. This demand comes from a **relatively wider investor base** that comprises both the conventional and Islamic investors. The strong demand for sukuk has also been spurred by the higher level of surplus savings and reserves in Asia. In the case of Japan, apart from the high savings rate, Japan has the largest percentage of high net worth individuals wealth distribution in the Asia Pacific.

From the investors' perspective, besides the intrinsic value of sukuk which is largely **asset-backed**, convertible to shares and exchangeable with shares, there are **benefits of diversification**. Sukuk is fast becoming a **new asset class**. Sukuk has also generated

³ Source: GCC Research, Kuwait Finance House.

⁴ An estimate amount of investments for Eastern Corridor Economic Region (RM112 billion), Northern Corridor Economic Region (RM100 billion), Iskandar Regional Development (RM382 billion) and Sabah Development Corridor (RM25.8 billion).

good investment returns for investors arising from its higher pricing in the secondary market due to the “buy and hold” preference and its scarcity.

Opportunities in Takaful

The other opportunities in Islamic finance are in the takaful or Islamic insurance and re-takaful. The global takaful market, in particular, has also undergone positive developments at the international level. From only a single takaful company being in existence more than twenty years ago in Sudan, the takaful industry has now expanded with the establishment of more than 50 takaful companies worldwide with a total contribution estimated at about USD3 billion for the year 2005. The takaful industry is expected to grow at about 20% per annum to reach USD7.4 billion in global annual contributions over the next ten years⁵. It is also encouraging to note that the number of retakaful companies have also grown in tandem with the increased number of takaful companies⁶. The need for **strong and credible retakaful operators** globally is important to complement the growth and expansion of the takaful industry.

Let me turn to Japan’s potential participation in Islamic finance. We welcome the participation of Japanese financial institutions, authorities and corporations in Islamic finance, particularly, in the Islamic capital markets. Japan thus far has for several decades had a significant economic role in the Asian region in terms of trade and investment. Japan’s investment in the region is estimated to be USD45 billion over the period of 2004-2006⁷. Japan has also been consistently ranked among the top five investing nations in Malaysia, with investment flows amounting to 25.7% of the total flows for the period of 2000

to 2006. In 2006 alone, Japan foreign direct investment inflow into Malaysia was at USD6.1 billion⁸. Japan has also remained a significant partner in trade with Malaysia.

While Japan’s economic relationship in investment and trade in the region is well established, there is a significant potential for strengthening further the financial linkages in future. There is potential to evolve the direct investment and trade in goods to grow the financial ties. Islamic finance represents a vehicle that could further deepen our financial relationship and the regional financial integration process. By enhancing new linkages in this relationship and the prospect for greater integration, it would contribute towards unlocking potential opportunities for mutual prosperity of the region.

To advance relations in the area of Islamic finance, a memorandum of understanding between the Central Bank of Malaysia and Japan Bank for International Corporation (JBIC) was signed in 2007. There is also a strategic alliance between one of the world largest Japanese insurance groups with a domestic insurance company in Malaysia which resulted in the establishment of a takaful company. Efforts can also be focussed on facilitating cross listing of sukuk in multiple jurisdictions. Japan may also use Malaysia as a platform for innovation and research in Islamic finance. There are various institutions, including the industry-owned research and training institute in Islamic finance, the Islamic Banking and Finance Institute Malaysia (IBFIM), INCEIF and universities which have undertaken research on Islamic finance. Thus, it is hoped that the Japanese participation in the Islamic financial markets would contribute towards further international financial integration and thus achieve a more efficient allocation of resources across borders.

⁵ Based on projection by Institute of Islamic Finance and Insurance & Investor Offshore Review, February 2006.

⁶ To-date there is more than 10 retakaful companies providing retakaful capacity for both family and general takaful business.

⁷ United Nations Conference on Trade & Development’s (UNCTAD) World Investment Report 2007.

⁸ Sources: JETRO from Ministry of Finance Balance of Payments Statistics and Bank of Japan foreign exchange rates.

Conclusion

Let me conclude my remarks. The increasing awareness and appreciation of the inherent strengths of Islamic finance and its tremendous potential for advancement have ignited interests amongst the global financial community to venture into this new sphere of

finance. Taking advantage of the increasing role of Islamic finance in bringing together different parts of the world with surplus funds in search of investment opportunities, with those that have financing needs, will increase these mutually reinforcing prospects. We look forward to Japan's participation in this new financial evolution.

9th Bank Human Resources Conference 2008
Organised by the Indian Institute of Banking and Finance
“Building Human Capital for Emerging Challenges”
Kuala Lumpur, 29 February 2008

by

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

Let me first of all extend a warm welcome to the participants of this 9th Bank Human Resource Conference organised by the Indian Institute of Banking and Finance (IIBF). It is our honour to host this conference that is being held outside India for the first time. This is one of the concrete outcomes of the alliance that has been entered into between the Indian Institute of Banking and Finance and the International Centre for Leadership in Finance following the MoU that was signed about three months ago between the two organisations.

The development of human capital has to be a constant undertaking in an environment of constant change. As recent as ten years ago, we have seen the economic and financial environment dramatically transformed. There has therefore required a corresponding change in the knowledge, skills, competencies and capabilities that are now required, in particular, by the banking industry, which is a highly knowledge-intensive and skills based industry.

New challenges have also emerged in this environment arising from the rapid globalisation and internationalisation of the financial system and the significant advancement in technology. These developments have led to a rapid pace of innovation and enhanced international interdependence and inter-linkages. This has generated an environment that is increasingly more complex, competitive, uncertain and ambiguous. The recent episodes of financial turmoil, have shown that even financial systems in developed and advanced economies continue to be vulnerable to financial stress.

This more difficult operating environment demands new skills and the ability to manage

these new challenges. Indeed, the role of leadership has changed. It is essential to have the talent that are not only able to see the new emerging opportunities, but also to be able to deal with the high level of unpredictability and navigate through turbulent conditions. The industry leaders need to be visionary and comprehend future trends, chart strategic directions and adapt to changes to stay competitive and relevant. Effective leaders in this era, will be those who are continuous learners, who are on the cutting edge of excellence, who have strong convictions, and yet, having humility to recognise the need to reinvent themselves and inspire their organization to adapt to the new environment. Such attributes are vital if the financial services sector is to forge ahead and remain at the forefront of new innovations and thus secure long-term competitiveness. In this process, there needs to be avenues for continuous learning. The establishment of ICLIF is part of our commitment towards providing such an avenue to enhance leadership capability and develop world-class leaders in the financial services sector.

The changing configuration of the global economy and financial markets, increasing regional economic and financial integration, increasing internationalisation of financial services, the continued enhancement to the regulatory structures and approaches will have a significant bearing on the future of the financial services industry. The road in front of us is therefore likely to be significantly different to the one from which we have travelled on. The investment in human capital development is thus important for the future development and growth in the financial services sector.

Building human capital has become much emphasised in today's world. Successful banking institutions in the future will be increasingly dependent on intangible assets such as talent. As competition intensifies, the need for banking institutions to attract and retain the best skills and talents will become more urgent. Going forward, the availability of talents will become the pivotal factor determining the capacity for the industry to reinvent and transform. Banking institutions would need professionals with the requisite skills and expertise not only at the strategic and management level, but also at the technical and operational level. Successful institutions will be the ones which accord high priority to the continuous enhancement of human capital. Human capital development has thus become of strategic importance and is integral to the success of an organisation. The involvement by senior executives in the management of human capital development has also become essential. Senior executives need to take the lead and devote a considerable amount of their time to this initiative. Human resource development functions is integral to the talent management process and in supporting the human capital management strategy. Of equal importance is that this should occur at all levels in the organisation. In essence, the accountability for talent development requires concerted efforts throughout the organisation and needs to be embedded as part of the working culture that is communicated, shared and understood at all levels.

While the need for human capital development is apparent, what is less apparent are the appropriate methods and policies that should be adopted to advance human capital development. The financial services industry needs to identify the appropriate strategic direction for human capital development. Attention need to be given to the entry level, to the specialists and to the senior management levels. This would benefit from greater industry-university linkages which is a major channel through which the talent requirement and talent gap can be narrowed. The industry involvement in the curriculum design and delivery will ensure graduates are equipped with the relevant knowledge and skills that meet the requirements of the industry. Participation

by the industry players may be in the reform of the academic curriculum and methodologies and in providing other forms of practical support to the institutions of higher learning. This will contribute directly towards meeting the human capital needs for the future.

The quality of human capital is the cutting edge of competitiveness. Having competent staff to deliver high quality products and services is critical to building customer confidence and goodwill, driving customer satisfaction, enhancing reputation and ultimately realising individual institutions' corporate vision and strategic goals. It is therefore, in the best interest of banking institutions to strengthen further the competence and professionalism of staff in the industry. In this regard, financial institutions can of course adopt the measure of "buying talent" from the market. This may however, risk in high compensations that are not commensurate with the value added. The more desirable option is the building, developing and maintaining a pipeline of talent from within the company.

Let me turn to Malaysia's experience in human capital development for the financial services industry. In Malaysia, structured and comprehensive approach to human capital development has been a key part of our efforts for the development and advancement of the industry. The programmes by ICLIF, which is now in its 6th year of operations, provide programmes in leadership development for the senior management level in the financial services industry. The programmes carried out by the Institute of Bankers Malaysia, the training arm of the banking industry, have also been recently reviewed to meet the new demands of the financial sector. In addition, dialogue between the industry and other education providers including institutions of higher learning have taken place to promote well equipped supply of talent. In September 2007, Bank Negara Malaysia initiated the Financial Sector Talent Enrichment Programme (FSTEP) to train and prepare 1000 highly qualified graduates for immediate placements in banking and insurance institutions. This effort is undertaken in collaboration with the industry and training institutes and is aimed at boosting the supply

of well-trained and competent personnel for the financial services industry.

In the area of Islamic finance the continued international expansion has increased the demand for talent and expertise in the industry. The establishment of the International Centre for Education in Islamic Finance (INCEIF) in Malaysia in 2006 represents a structured investment in the development of human capital to support this global development of the Islamic financial services industry. The programmes are for practitioners and graduate students. In addition, it is envisioned that INCEIF will act both as a professional certification body as well as an education centre for post-graduate programmes in Islamic finance.

With the firm commitment to build human capital, the challenge is to formulate the

appropriate strategies and mobilise the resources necessary to produce results that will enhance the intellectual capital of the industry. This will require the combined efforts of internal strategies within banking institutions, that involves a holistic approach that coordinates the strategies for human resource management and development reinforced by strategies for organisational development. This will also involve putting in place the appropriate processes and structures. A total solution will be required. These efforts will also need to be supported by education providers. Finally, this initiative of bilateral engagement on the issues in developing talent in the industry will also gain from the synergy and will contribute to strengthening the ability to further the agenda of building human capital in the financial services industry.