

**The Fifth IFSB Summit:
“Globalisation of Islamic Finance Services - Opportunities and Challenges”
Amman, Jordan, 13 May 2008**

by

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This decade has seen the financial globalisation of Islamic finance gain significant momentum. While the early development of Islamic finance was domestic centric, its internationalisation is now manifested by increased cross border flows, greater participation in international Islamic financial markets, the increased presence of Islamic financial institutions in new jurisdictions and more recently, the increased number of Islamic financial institutions which have shareholders from multiple jurisdictions. This trend has strengthened the international economic and financial interlinkages between nations bringing with it mutually reinforcing gains.

Financial globalisation has essentially been facilitated by the more rapid pace of liberalisation, the advancement in the information and communications technology, and the significant progress achieved in the development of the international financial infrastructure. This trend has also been reinforced by the search for higher returns and the need to diversify risks. In the current international financial environment of increased uncertainties, this trend has become even more pronounced prompting investors to venture into new asset classes and markets that provide stability.

The Globalisation of Islamic Financial Services

With the increased significance of the international dimension of Islamic finance, the financial landscape has been dramatically transformed with more diverse players and a more competitive environment. This in turn has been a catalyst for increased financial innovation and resulted in a wider range of

Islamic financial products and services. This has ignited interest from conventional global players from Non-Muslim countries largely in the form of increased participation in Islamic financial markets and in acquisition of strategic stakes in domestic Islamic financial institutions. With the opening of borders for banking institutions and other players, the Islamic financial system has become more diversified and the Islamic financial markets deepened. These developments have contributed to its rapid expansion across the globe, and Islamic finance has now emerged as among the fastest segments in the financial services industry.

The scope of Islamic finance business has thus expanded beyond retail and trade financing, to more sophisticated financial products in response to the changing global customer base. Such Shariah-compliant products include private equity, project finance, the origination and issuance of sukuk, as well as fund, asset and wealth management products. The sukuk market in particular, has become an important avenue for international fund raising and investment activities, has expanded by an annual growth rate of 40%. The vast potential in sukuk market in the international financial system indeed represents the crest of a new wave of innovation in Islamic finance and is very much part of the globalisation process in Islamic finance. Sukuk Musyarakah and Ijarah, which command the broader global acceptance, represents the majority of global sukuk issuances.

As part of the on going internationalisation of Islamic finance has been the development of the supporting international financial architecture. Of significance, is the establishment of the Islamic Financial

Services Board (IFSB) in 2002 to set the prudential standards for Islamic finance, and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) that was established in 1990. The importance of these international standard setting institutions has been their role in the harmonisation of prudential and accounting standards across the different jurisdictions. More importantly is their role in instituting international best practices in the global development of Islamic finance. It is these concerted efforts to develop robust international best practices in the prudential and supervisory framework that will ensure the resilience and long term sustainability of the Islamic financial industry.

With globalisation also comes enhanced interdependence. While the strengthened interlinkages can be expected to bring about a more efficient allocation of capital across borders which in turn would result in lower cost of capital, it has also resulted in the potential for the transfer of risks across different jurisdictions. This underscores the need to ensure the quality of financial globalisation. While the intrinsic nature of Islamic finance encourages risk management and provides confidence through explicit disclosure and transparency, the new risks resulting from globalisation needs to be taken into account. This is to ensure that the Islamic financial institutions have the capacity to manage the risks and that the regulatory authorities have the necessary instruments at its disposal to respond to any destabilising implications.

Emergence of new set of challenges

The enhanced international dimension of Islamic finance has thus brought about a new set of challenges. The emergence of more diverse Islamic financial institutions and the expanded development of Islamic financial markets have intensified the development of sophisticated Islamic banking, takaful and

capital market intermediaries. This has also resulted in the creation of sophisticated and complex structured financial instruments including hybrids of debt-equity structures. The increased competition has not only intensified the pace of innovation in products and services, but also of the operational processes and delivery channels. These developments have contributed to the **increasing complexity of the risks** profiles of Islamic financial transactions.

Global strategic initiatives

Recognizing the importance of ensuring financial resilience of the Islamic financial services industry in this more challenging environment, collaborative international efforts have been undertaken.

Spearheading the strategic development of the industry is the **ten-year Master Plan** for the development of the global Islamic financial industry, a joint initiative by the Islamic Development Bank (IDB) and the IFSB. This strategic initiative provides a blueprint for the orderly development of Islamic financial system across jurisdictions to achieve the common goal of a vibrant, efficient and progressive Islamic financial services industry. This blueprint also outlines the broad strategies for the development of the key components of the various parts of the Islamic financial sector, including the guide for determining the best options for the different stages of development of the Islamic financial system so as to ensure that it would contribute to the growth and development of the economy and also become an integral component of the international financial system.

Of importance is that the master plan not only represents a blueprint for the development of a cohesive and a comprehensive Islamic financial system but also it promotes increased

understanding and appreciation for those that wish to participate in the Islamic financial system, including providing information on the expected level of achievements that are required.

Another important global initiative in Islamic finance already mentioned is the promulgation of the **international prudential and supervisory standards** by the IFSB. The IFSB has fast-tracked the development of these standards to address the unique and peculiar characteristic of risks of Islamic financial contracts. Fundamental to the implementation of the standards is the strengthening of the risk management capabilities of the financial institutions. In addition, the implementation of these standards needs to be complemented by the continuous surveillance so as to ensure the early identification of the new emerging risks and to ensure that the institutions undertake to manage the risks.

Resilience reinforced by the intrinsic features of Islamic finance

The intrinsic features of Islamic finance also contribute to its overall resilience. This is derived from the Shariah principles, the key pillar of Islamic finance. The Shariah injunctions require that Islamic financial transactions be accompanied by an underlying productive activity resulting in a close link between financial and productive flows. Under the risk sharing concept, there is an explicit risk sharing by the financier and the customer. In this arrangement, the real activity is expected to generate sufficient wealth to compensate for the risks. Parties to the transactions would thus be insulated from excessive risks exposure given that the Shariah prohibits the excess leverage and involvement in speculative financial activities. The intrinsic principle of profit and risk sharing thus provides an in-built check and balance to the Islamic financial transactions. A combination of these distinct features together with the implementation of prudential risk management standards and

practices would contribute to the robustness and resilience of Islamic financial system.

Mutual respect on Shariah matters

This decade has thus been a phase of innovation in the global Islamic financial system with a number of breakthroughs and major milestones in innovative deals and structures. The advancement of sukuk, Islamic securitization, Islamic private equity, Islamic real estate investment fund and other financial instruments in terms of sophistication and product range has widened the international market reach of Islamic finance, particularly in the cross border transactions.

At the same time, this phase is also seeing a number of key issues being raised, particularly in respect of divergence of Shariah views underlying a number of the Islamic financial transactions. While such a divergence of opinions in Islamic financial transactions is not a new phenomenon, it has presented a new set of challenges in today's increasingly more globalized market. To forge closer linkages between the global Islamic financial markets would require a common understanding and acceptance on the applicable rules and standards. Indeed, cross border transactions would require the jurisdictions involved to **mutually recognise the validity of respective rules, practices and underlying Shariah interpretations**. This is key for the orderly development and for advancing the pace of progress of the international Islamic financial industry.

For this, it is important to have a concerted effort in providing greater clarity on the mutually acceptable strategy for the development of global Islamic finance. In the current globalised environment, the role of scholars needs to transcend beyond pure advisory or Shariah rule-making, to a more strategic role in charting industry development. This could be in part be achieved by having **global Shariah standards** for the Islamic

financial industry. A mutually agreeable position could be achieved with the application of **mutually recognized principles and processes to deduce the Shariah rulings and views**¹.

In relation to this, Malaysia has taken a **three-prong strategic initiative** to promote greater mutual respect of the Shariah views. The first is to recognise the principle of mutual respect in Shariah opinions issued in other jurisdictions by a recognized Shariah committee for transactions undertaken in Malaysia. In addition to the key role of a centralized Shariah Advisory Council as the reference point for all Shariah matters in Islamic finance, Malaysia welcomes Shariah rulings by other Shariah committees that are deemed to be **deduced through generally accepted rigorous principles, processes and rules**.

The second initiative is to have **strong resource foundation** supported by a pool of qualified and competent Shariah talent, as well as to accord more emphasis on extensive Shariah research in Islamic finance. Given the rapid global growth of Islamic finance, there is an urgent need to meet the talent demand for Shariah scholars with strong interest in the strategic development of the Islamic finance industry. From the supply side, the International Centre for Education in Islamic Finance (INCEIF) established in 2006 has made significant progress with more than 1000 registered students in its professional Islamic finance certification. It also has 28 PhD students and has recently launched a Masters Programme in Islamic finance. The Islamic Banking and Finance Institute Malaysia

(IBFIM) also offers a structured, modular training solutions for Shariah advisers focusing on practical and operational aspects of Islamic banking and takaful².

Given the importance of the in depth of Shariah research in Islamic finance, the International Shariah Research Academy (ISRA) was recently established as part of INCEIF to conduct applied Shariah research on the contemporary Islamic finance issues. The third strategy is to provide a platform that promotes active engagement and dialogue among the relevant stakeholders. The annual Shariah dialogue at international and regional levels have contributed to increased understanding of different views on Islamic finance matters and enhanced mutual respect of Shariah opinions.

Closing

In conclusion, against a backdrop of an increasingly uncertain global environment, Islamic financial system is indeed well positioned, as a form of financial intermediation in this more challenging environment. In the coming years, it is important for adequate focus to be given on the implementation of international prudential standards and sound risk management practices in Islamic financial institutions to ensure the financial stability and integrity of the financial system. According greater mutual respect to global Shariah views for Islamic finance would also contribute to the orderly global development of Islamic finance, thus sustaining the overall viability and soundness of the Islamic financial system as it becomes an integral part of the international financial system.

¹ There are lessons to be drawn from the previous success stories in the history of Islamic jurisprudence whereby the strong sense of mutual respect prevailed among Muslim jurists with multiplicity of Shariah opinions. The jurists from different mazhab had high regard for differing views expressed by other jurists, even in ibadah matters.

² IBFIM's "Shariah Scholars Induction Programme".

**The Mobile Digital Signature Symposium 2008:
“Towards a More Efficient Payment System - Electronic Payments”
Kuala Lumpur, 3 June 2008**

Keynote Address by

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

It is my honour and pleasure to be here today at this Mobile Digital Signature Symposium 2008 to deliver an address at this important forum. This forum takes place at a time when developments taking place in the global economy are resulting in fundamental changes to our lives. While the global economy has benefited from an extended period of high performance and strong growth, it now requires greater agility to adapt to the rapid changes that has occurred. A major emerging international phenomenon is the rising inflationary pressures.

We are now living in an environment characterised by rising prices, with energy and commodity prices prevailing at record highs. Energy and commodity prices which have risen steeply have been driven by demand and supply factors and reinforced by market conditions. Clearly, the global factors that have influenced these international prices are beyond our control. Individually and collectively, we therefore need to adjust and adapt to these new conditions. Increasing efficiency and adopting new business processes needs to be explored to reduce costs.

An area in which the quantum leap forward can be made, particularly by emerging economies, that will substantially increase the level of efficiency and thus reduce costs, is through the adoption of a more expedient and efficient means of payment. This will be the subject of my remarks today. While the Central Bank supplies currency notes and coins, we are also concerned with payments in its broader context. An important function and responsibility of the Central Bank is to promote the development of safe and efficient payment systems. Any inability to make payments in an economy would have a far reaching and widespread impact on

society. Our task is therefore to ensure that the public and businesses can make payments in a safe and efficient manner.

The task also involves taking advantage of the technology and innovation wave and to move towards more efficient payment modes. The economic benefits from this can be immense. Studies have shown that shifting from paper based to a more electronic based payment systems can generate an annual savings up to 1% of GDP. Further research has also shown that it becomes a catalyst that promotes increased consumption spending. Moreover, it can also enhance financial inclusion by extending financial services to the unbanked communities. In so doing, such communities would be brought into the formal financial system and into the economic mainstream. This would not only promote the opening of banking accounts amongst this target group but would also enable them to enjoy lower cost of financial services and better means of savings, thus benefiting the economy as a whole. As the electronic payment channels become more easily accessible, user-friendly and offered at a low cost, it would thus provide the opportunity to shift the remittance flows from the informal to formal channels.

Indeed, electronic payments can be one of the strategic tools to meet these objectives and achieve higher economic growth. Electronic payment increases operational efficiency and improves productivity levels through expedient payments and receipts of funds. Electronic payments would also provide the speed and convenience of making payments from any place or time. It also reduces costs through the reduction or redeployment of resources used for handling cash and cheques. Accelerating the

country's migration to electronic payments has therefore become a part of Malaysia's larger national agenda to increase the efficiency of the nation's payment systems which would ultimately improve the competitiveness of our economy.

Cash payments in Malaysia still account for a large portion of the number of transactions in the economy. Going forward it is expected that its use will level off and stabilise with the increased use of electronic means of payments. Credit cards, ATM cards, debit cards including the e-purse application embedded in the MyKad are among the card payments possibilities in Malaysia. The increased use of cards is an international trend and is expected to gain significance in Malaysia. Giro transfers, other credit transfers and direct debit are also gaining significance by both individuals and businesses. Finally, Internet banking has also begun to experience stronger growth.

While we have made considerable progress in promoting the adoption of electronic payment with notable growth registered across all electronic payment methods, paper-based payments still remains the more popular form of payment. Cheques continue to account for a high percentage of the total non-cash retail payments while currency-in-circulation (CIC) as a percentage of GDP remains relatively high at 5.7%. In 2006, Malaysian consumers on average, made only 0.7 transaction via direct debit and credit transfer and 0.2 transaction via debit card transaction as compared to 84.7 and 109.5 transactions, respectively, in Sweden. Hence, more needs to be done to raise the level of adoption of electronic payments.

In this regard, the Bank has formulated an Electronic Payments Roadmap aimed at bringing together relevant stakeholders to address the barriers that have impeded the increased adoption of electronic payment in a comprehensive and strategic manner. The Roadmap identifies the priority areas that require attention and collaboration to promote an environment that is conducive for greater use of electronic payment in financial transactions.

Firstly, is the need to put in place the payment infrastructure. The infrastructure for making payments would need to be widened and enhanced to provide the convenient access to electronic payments. In addition, solutions need to be developed to enable users to integrate easily with the payment offerings. Secondly, the product range, the range of services would need to be expanded to cater for the different payment needs of consumers and business sectors. Thirdly, the pricing framework, the formulation of a transparent and cost-effective pricing framework is important to provide the incentive structure that would spur the adoption of electronic means of payments. Fourth, is the consumer awareness. Programmes need to be implemented to inculcate the behavioral change among consumers. There needs to be trust and confidence in the electronic payment systems. The fifth area relates to the standards, the setting of common standards to address the interoperability of systems including standardising the payment messaging format is vital to the wider acceptance of electronic payment. Finally, is the need to ensure the security and integrity of the payment system which thus requires the supporting regulatory and legal framework to be in place.

Among the series of initiatives that have been implemented to promote the greater use of electronic payment relates to the leadership role of the Government in the migration to electronic means of payment. As most individuals and businesses have payment transactions with the Government, the role of the Government in accepting electronic payments has provided an important catalyst for the adoption of electronic payment on a national scale. In this regard, Bank Negara Malaysia has been in active partnership with the Government to drive the electronic payment agenda. This has also served to reinforce the Government's objective to enhance the efficiency of the public delivery system. This collaboration has resulted in the acceptance of the use of cards including the ATM card, which also functions as a debit card, for over the counter services and the offering of payment services via Internet banking and the Internet-based Financial Process Exchange (FPX) payment system.

Another initiative undertaken has been the review of the remittance and e-money regulatory framework to encourage the introduction of payment products that would cater for the unbanked and underserved communities such as migrant workers and consumers with low income and low financial literacy and who may have no alternative but to rely on informal payment service providers. There are now more than 20 new remittance and mobile payment products that have been launched.

The Bank has already engaged the relevant stakeholders on the priority areas identified and welcomes any further industry efforts to address these issues. Given the significant pay-offs from the use of low cost technologies in accelerating the adoption of electronic payment, the mobile phone is identified as one of the delivery channels that should be leveraged on.

Potential of mobile phones to make the transformation

Bank Negara Malaysia sees tremendous promise in mobile telecommunication networks as an electronic payment channel since mobile phones are already in the hands of most Malaysians, with 88% of the Malaysian population subscribing to mobile phone services.

The high penetration rate affirms mobile phone networks as an increasingly popular channel for Malaysians to perform a plethora of activities beyond voice communication, encompassing all forms of digital communication, commerce, banking and payments. Indeed, payments via text messaging has the potential to grow in importance.

With 25 million mobile phone subscribers in Malaysia, there are immense opportunities to leverage on mobile phones to accelerate the migration to electronic payments, to widen the reach and appeal of electronic payment services, to deliver innovative mobile payment products that offer speed, simplicity and convenience at minimal cost for the public, as well as to provide an efficient and cost-effective method of delivering financial services even

in the remote areas. Also of significance is the high level of financial inclusion in Malaysia. With a population of 27 million, the banking system in Malaysia has 55 million deposit accounts indicating that a high percentage of the population have deposit accounts with the banking system. This is confirmed by a survey of a sample of 5,000 in 2003 that indicated 97% of those surveyed have a bank account. The financialisation of savings is also confirmed by the high percentage of deposits to GDP at 152%.

The high percentage of mobile phone subscriber and the high rate of participation of the population in the banking system are important pre-conditions for the significant use of the mobile phone as an ideal platform for personal payments. Indeed, the large mobile subscriber base and the positive transformational effects of mobile banking and payments offer a unique opportunity to open up the financial system to more customers and communities, in order to achieve financial inclusion for all segments of our society.

With the favourable market conditions, various mobile banking and payment initiatives have been launched in recent years. This however, has yet to achieve widespread acceptance. To date, there are only 460,000 subscribers for mobile banking and payment services. This represents only 1.8% of the 25 million mobile phone subscribers in the country. There is, therefore, a significant untapped, and potentially lucrative market for mobile payment and banking services.

Pushing mobile channel beyond the tipping point of development

There are fundamental issues that need to be addressed if we are to realise the opportunities and allow Malaysia to take full advantage of new mobile technologies. To achieve their full potential, it is important to identify the gaps in the service offerings, and plan the way ahead for Malaysia to make the quantum leap in e-payment adoption. Market participants need to address the mismatch between what consumers expect and what is being offered. Openness and inter-connectivity are also critical

in the mobile banking and payment initiatives. Exclusive and proprietary services where the target market is limited to the customer base of individual mobile operators or individual banks will not allow for the potential to be realised. Any lack of interoperability across mobile operators and across banks will not achieve the required critical mass and will also result in high transaction cost for consumers.

It is hoped that market participants will be able to offer new and innovative mobile payment products and services that opens up new markets for mobile service providers and payment operators, offer the convenience at reasonable costs and thus deliver the cost savings and efficiency gains that consumers and businesses seek, and thus allow for the economic benefits to be realised.

Industry players also need to work together. An area that needs critical attention is for the industry players to focus on the bigger picture and regard the mobile phone as a mechanism towards achieving a common goal. To promote the significant use of the mobile phone for financial services, the industry has to respond rapidly to address the need for interoperability and collaborate in areas such as developing a common infrastructure, common payment messaging format, as well as common security and authentication standards. Common standards and infrastructure will create an accessible, open and vibrant payment eco-system that will attract a wider consumer base allowing all market participants to reap the benefits of a larger customer base. A shared integrated network with common security standards and common messaging standards will make it easier, more cost-effective, and more convenient for consumers, merchants and service providers to execute and receive payments, thereby increasing the attractiveness of the mobile network as a payment channel. Such collaboration will also lead to greater innovation and increased productivity that will contribute to the overall effectiveness and performance of the mobile payment system.

In delivering products that the market demands, substantial investments would be required of participants in the mobile eco-system: the mobile operators, banking institutions, mobile device manufacturers, and payment service providers. Equally important therefore, is the need for all the stakeholders to ensure that investments are channeled judiciously into the areas of greatest impact. Strengthened collaboration in the key areas will minimise duplication and achieve greater resource efficiency. In this regard, there is a need to fully understand customer payment preferences. Product offerings need to meet the expectations of increasingly discerning and sophisticated consumers of payment services. Collaboration is also required in the area of education and outreach programmes to increase consumer awareness and public confidence in mobile payments.

Thirdly, regulators and market players must also share a common vision on the future mobile payment landscape in order to align strategies and interests to achieve holistic mobile payment solutions that will widen access to the retail payment system and thus achieve a critical mass of consumers. The network externalities and the social benefits of the wide adoption of the mobile banking and payment system provides justification for Governmental intervention. The Bank together with Malaysian Communications and Multimedia Commission will work towards providing the appropriate environment for economic development and to catalyse the transformation of the mobile initiatives. This will also include engagement with the market participants, payment service providers and industry players to collaborate in these important areas.

Finally, for mobile payment products to succeed and achieve widespread acceptance, we need to strengthen consumer confidence in the safety, security and reliability of mobile networks as a means for consumers to access financial services. Indeed, mobile digital signature, which ensures the confidentiality, authenticity

and integrity of payments initiated from mobile phones, is one of the ways forward towards building a secure mobile infrastructure that is conducive for the delivery of financial services.

Conclusion

We are now operating in an environment where we have to do more with less. The point I would like to stress this morning is that in the pursuit of this cause, we have to learn to work together. We need to come together to

decide how this cooperation can be shaped. I believe this symposium will contribute towards achieving this objective. In this regard, I hope that the results of your deliberations in this symposium will provide valuable input for the formulation of strategies and modalities for both the industry and authorities. On that note, I would like to thank Malaysian Communications and Multimedia Commission for this opportunity to share my thoughts on electronic payments. I wish you a stimulating and productive discussion in this symposium.

**The 12th Malaysian Banking Summit organised by ASLI:
“Taking the Leap in Paradigm Shift of Banking - New Wave, New Ventures”
Kuala Lumpur, 5 June 2008**

Keynote Address by

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In this recent decade we have seen a period of profound modernisation of the Malaysian banking sector. Today, the banking sector has evolved from facilitating and supporting the economic growth process to becoming a significant source of growth. Innovation and product pioneering has proliferated the diversity of products and services offered. The adoption of best business practices, the use of new technologies, systematic cross selling and the new means of interface with consumers have become more pervasive. The banking system is also significantly stronger, reinforced by strengthened institutional structures, enhanced financial safety nets and developed financial markets, that includes one of the most developed bond markets in this region. Progressive deregulation and liberalisation have increased the flexibilities for banking institutions to capitalise on new business opportunities, both onshore and overseas. The strengthened incentives and more competitive environment have also prompted continuous performance improvements. Indeed, these developments have well positioned the banking sector to take the next leap forward.

It is my pleasure to be here this morning to speak at this year’s Malaysian Banking Summit which has focussed on the theme, the next wave for the banking system in Malaysia. My remarks today will focus on three areas - firstly, the outlook for the Malaysian economy as developments continue to unfold in the domestic and international economic environment. Secondly, I will discuss some of the key lessons that may be drawn from the recent credit turmoil and their implications for the Malaysian banking system. And finally, I will take the opportunity to share with you some thoughts on our vision for the financial

sector beyond our current Financial Sector Master Plan and the thrust of our strategies going forward.

The Malaysian economy enters this more challenging period following several consecutive years of solid growth that averaged 6%. The economy grew by 6.3% in 2007, the fastest pace in three years with the growth momentum being sustained in the first half of 2008. In the first quarter of this year, the economy expanded by 7.1%.

This stronger growth was achieved despite the more difficult environment with slower global growth and increased uncertainties in the international financial markets. The successful transformation of the Malaysian economy in this recent decade has been one of the important contributing factors. It has led to more diversified sources of growth resulting in a more balanced economy. While the external sector remains important, domestic demand now has a more significant role in driving the growth process. In addition, the services sector has become a more important source of growth. Moreover, the agriculture sector continues to expand as Malaysia benefits from the high commodities prices. These developments have continued to sustain our external balance with the current account of the balance of payments likely to continue to record large surpluses.

Going forward, in the next 12 to 18 months, several external and domestic developments need to be taken into account in the assessment of our economic outlook. First, the slowdown experienced in a number of the major economies is likely to extend into 2009. This more prolonged period of slowdown

is likely to have spill over effects on other economies including emerging economies. Global financial markets are also expected to remain volatile as the financial stress experienced by financial institutions in these economies continue to have an impact on credit conditions, the housing market and their overall economy. These developments have resulted in a number of institutions scaling back their global operations. The disruptions in the credit markets have already exerted some restraint in economic activity. While the adjustments are still taking place, there remains uncertainty about the full magnitude of the losses and its consequent impact on financial stability and thus on their overall economy.

Despite these developments, indications are that growth remains resilient here in the Asian region, benefiting from the strengthened domestic demand and the increased trade activity within the region and with the non-traditional markets. The region however, still remains highly integrated to the global economy and international financial system and therefore will have to manage the risk of moderation in global growth in the event that a more pronounced slowdown occurs in the major developed economies.

This risk is compounded by the high and rising energy and commodity prices, which are impacting inflation in most countries today. Stronger demand for grains, the diversion of land used for food crops to biofuel crops, the higher transportation costs and adverse weather conditions are some of the factors driving the rise in food prices. As a consequence, rising cost pressures on inflation in the global economy can be expected to persist. Should global growth however, continue to moderate in the second-half of 2008, this can be expected to slow the pace of increase in energy and food prices, which in turn, will moderate the inflationary pressures that are currently being felt.

Several domestic factors have sustained the growth of the Malaysian economy indicating

that external demand has thus far resulted in only a modest moderation in our overall growth as the underlying strength of the economy has been able to sustain the resilience of the growth process. This has been underpinned by the strong domestic demand which has become a key driver of growth. The strong growth that has been achieved so far is on account of the robust expansion in private consumption and investment expenditure.

Malaysia's economic structure has also become increasingly more diversified with increased contribution to growth from the services, agriculture and commodities sectors and the resource-based and knowledge-driven industries. Malaysia is also very much part of the regional integration that is taking place. Today, about 63% of our exports are to the countries in the Asian region. Efforts are also being put into forging stronger trade linkages with other non-traditional markets in West Asia and the Middle East and these efforts are now showing positive results. The trade links are also reinforced by increased investment flows within and between these regions. The inflow of foreign direct investment into Malaysia has remained steady while Malaysia's investments abroad, in particular, to this region are increasing.

Finally, an important factor supporting the resilience of the economy in this more challenging time is the sound macroeconomic fundamentals, the high international reserves and the capacity for policy stimulus to be undertaken to manage the risks to growth. The economy is also supported by the favourable financing conditions and strengthened banking system. Ample liquidity amidst a relatively low interest rate environment and declining non-performing loans have sustained private sector access to financing.

The urgent issue that may be raised today is to what extent will the price adjustments announced yesterday have an impact on the economy. Related to this is the extent to which inflation will increase and whether this would in turn affect the country's competitiveness.

Key to dealing with these risks is the flexibility of the Malaysian economy. Malaysia has a proven track record over several decades in successfully dealing with difficult periods in our economic history. Each time, the flexibility of the economy, the agility of the private sector to adjust and reinforcement by the policy response, has allowed the economy to emerge stronger. This was demonstrated during the Asian crisis. Within a period of one year, our economy was able to resume growth, expanding by 6.1% in 1999 and by 8.9% in 2000.

The current conditions are by no means of such threatening proportions. If managed well by all parts of the economy, the economy will in fact emerge more competitive and stronger. This will require concerted efforts by the private and public sectors to become more efficient and thus reduce costs. This will also require shifting resources to new areas of activities where Malaysia has the competitive advantage. With the aptitude for hard work and prudent practices, and the ability for reinvention, this can be realised. To a great extent this has been achieved in the financial sector which has now emerged as an economic sector that generates income and employment and accounts for 11% of the economy, from only 4.5% in 1990.

The current increasing inflationary pressures is a global phenomenon, the result of rising international prices of energy and commodities prices. In Malaysia, domestic inflation has increased from less than 1% in April 2004 to 3% in April 2008, primarily reflecting higher food and energy prices. The Bank's preliminary assessment of the impact of the rationalisation of the domestic fuel and energy prices on inflation in 2008, is that it will rise to an average of 4.2% for the year. The initial price impact would be felt in June during which inflation is expected to be in the region of 5%. The increases in prices are expected to peak in the first quarter of 2009 before moderating to less than 3% in the fourth quarter.

As international prices of commodities are expected to continue to remain high and as direct influence over these prices is limited,

efforts will have to be focussed on increasing efficiency and productivity to reduce cost and to shift resources to areas of comparative advantage. From the perspective of monetary policy, the concern would be on the potential second-round impact of these price increases, the extent to which they lead to more generalised price increases and whether they pose a serious risk to inflationary expectations.

It must be remembered that the current inflationary pressures is a global phenomenon, and that many of our trading partners and neighbours are having similar or higher inflation rates. Given this fact, the increase in inflation is unlikely to erode Malaysia's comparative advantages in global trade.

The experience during current international financial turmoil have demonstrated fragilities in financial systems even among the developed economies. These events have brought to the forefront key issues regarding financial intermediation, financial innovation and the corresponding regulatory and surveillance mechanisms that need to be put in place to provide the necessary oversight over such activities. Although our domestic financial system was not impacted by the sub-prime crisis, its underlying causes bear important lessons for Malaysia, and indeed, for other emerging economies, as the forces of globalisation continue to drive the modernisation of our financial systems.

Firstly, the combination of a misaligned incentive system, a favourable macroeconomic environment and heightened competition generated excessive risk-taking by financial institutions. Under these circumstances which prevailed prior to the current crisis, financial innovation occurred at a pace that outstripped the capacity of the financial system to manage the risks associated with such innovations. Indeed, one of the fundamental underlying weaknesses was the erosion of sound practices in the mortgage market segment, with banks compromising on sound underwriting standards and risk management practices in pursuit of short term gains and market share. While the banking institutions

had increasingly employed sophisticated financial engineering techniques to repackage mortgages into complex structured securities, such financial innovation was not supported by commensurate enhancements to governance processes and the risk management infrastructure and practices. This resulted in a significant underestimation of the risks being borne by the financial institutions and to an overestimation of the capital buffers in the financial system.

Secondly, the events of the financial and credit market crisis have re-focused attention and debate on the susceptibility of the financial system to market failures. Indeed, the crisis unraveled significant gaps in the extent and manner of public disclosures that were made by financial institutions regarding their on- and off-balance sheet risk exposures. Investors on the other hand, were over-reliant on credit ratings which were based on methodologies which were not sufficiently robust, or lacked transparency about the rating parameters. As a result, the effects of market discipline did not occur as expected, while regulators which relied on market discipline to take effect, did not act pre-emptively to add discipline where it was needed.

Thirdly, developments in the regulatory, accounting and macro-surveillance frameworks had not anticipated, nor provided for, the complex inter-linkages of the modern financial system. The most significant evidence of this was when large scale downward valuations of assets due to accounting rules which heightened risk aversion, which in turn further constricted market liquidity, thereby perpetuating a vicious cycle. Globally, episodes of financial crisis have again demonstrated that market, credit and operational risks are closely inter-linked.

These experiences have underscored the critical importance of good governance, sound risk management, rigorous supervision and a strengthened crisis management framework which is sufficiently robust to withstand extreme market conditions.

The Malaysian banking sector on the whole is sound. Domestic banking institutions, in particular, have benefited from the broad-based reforms and capacity building measures that had been undertaken following the Asian financial crisis. Notably, the consolidation of the banking sector, the strengthened board and senior management oversight functions within banks, and the more risk-sensitive capital and the stress-testing requirements have contributed towards reinforcing the core foundations for a more resilient banking system. Banking institutions have also made significant advances in the adoption of improved risk management infrastructure and practices.

Today, the payoffs from these efforts are evident. The banking sector has maintained a steady growth momentum since the Asian financial crisis, with profitability of the Malaysian banking system growing by 36.7% to record RM17.7 billion in 2007. The exposure of the Malaysian banking sector to the sub-prime market has been minimal amounting to only 0.3% of the capital base of the banking sector.

The Malaysian banking institutions are thus now on a stronger foundation to venture into new businesses, undertake more complex risks and withstand shocks. Their enhanced capabilities are backed by stronger balance sheets, with the risk-weighted capital ratio of the banking sector at 13.2% and net non-performing loans ratio of 3.0%.

On the regulatory front, Bank Negara Malaysia continues to direct significant effort and resources towards strengthening our surveillance capabilities to detect, monitor and to deal pre-emptively with emerging risks and vulnerabilities in the financial system. These efforts have also been reinforced by improvements in the surveillance tools and processes to enable pre-emptive action to be taken to avoid disruptions to the financial system. The supervisory processes have also been enhanced with more granular and holistic risk assessments of the financial institutions.

In terms of the regulatory framework, the Bank will be outlining the approach for the implementation of Pillar 2 of the Basel II Framework. The Bank is providing further guidance in the areas of liquidity and operational risk management, the maintenance of internal capital targets, market disclosures, and the valuation processes and controls - particularly for illiquid instruments. The guidance will also be issued to address the implementation of the internal capital adequacy assessment process within the institutions to complement the minimum regulatory standards under Pillar 1 and will also stipulate the minimum requirements for banks that are adopting the Internal Ratings-Based Approach. Details of the proposed capital framework for securitization will also be released during the year. In addition, the liquidity guidelines will be revised to strengthen the requirements in the management of foreign currency cash flow mismatches over different time horizons.

Corporate governance will remain an important priority of the regulatory framework in preserving a sound financial system. The progressive adoption of more principle-based regulations has placed greater reliance on the effective oversight by boards and the senior management to ensure that the regulatory flexibilities accorded to financial institutions are exercised in a judicious manner. A revised fit and proper standard for directors, senior management and controllers of financial institutions will be issued, complemented by an improved and coordinated strategy for the education of directors of financial institutions to strengthen their oversight responsibilities in a more complex financial landscape.

The recent crisis also brought to light the critical importance of coordinated and prompt response by regulators in dealing with crises, whether through market interventions or in the resolution of banking institutions that are experiencing difficulty. Coordinated actions by the Central Banks in Europe and the United States have relieved the liquidity tensions in the financial markets. However, national arrangements for dealing with problem banking institutions are being severely tested.

Decisive action is vital to ensure the continued intermediation process to stem the spread of the financial crisis within the financial system and to the real sector. Such early action will also reduce the cost of the crisis. For Malaysia the cost of the crisis ten years ago was less than 5% of GDP. Danamodal in fact recorded a pre-tax profit of RM200 million upon full repayment from the recapitalised institutions.

More recently, additional initiatives have been taken to strengthen the safety net, inter-agency coordination arrangements and the legal framework for interventions. Today, we have a holistic financial safety net framework in Malaysia which includes a lender of last resort framework and a comprehensive deposit insurance system. The regulatory and supervisory framework is also supported by enhanced intervention framework for dealing with banks under financial stress. The enhanced supervisory intervention powers is to be embodied in the amendments to the various legislations administered by the Central Bank.

The provision of liquidity support by Bank Negara Malaysia for financial institutions in distress is a key component of the safety net. In light of recent international experiences of bank failures, the traditional intervention criterion of lending to 'solvent but illiquid' banks has been put to the test as it becomes increasingly difficult to determine the necessity for intervention as well as the method and timing of such measures. The extension of such support will therefore be based on a careful balance of various considerations, which include amongst others, its potential systemic implications, the cost of the intervention, the cost of failures, avoiding disruptions in the functioning of markets and finally its potential social implications. In order to avoid long term moral hazard, the lender of last resort is based on the rigorous application of viability tests and the 'first loss principle', where losses are borne by the shareholders of the financial institutions. The operational framework also needs sufficient flexibility, in terms of policy instruments, acceptable collateral and range of counterparties, to deal with exceptional market conditions.

Going forward, cooperation arrangements for dealing with crises will continue to be further enhanced. This includes further strengthening current cooperation arrangements among the various regulatory agencies in Malaysia, as well further advancing cross-border cooperation in the region. Indeed, significant strides have already been taken to strengthen the cooperative framework between central banks and supervisory agencies in the region to promote financial stability at the regional level. These have included the establishment of various regional mechanisms for cooperation and coordination in surveillance, information sharing and crisis management. These mechanisms will become increasingly important as regional integration continues to deepen and as more Malaysian financial institutions venture overseas.

The progress that has been achieved in the financial sector has surpassed the initial expectations outlined in the Financial Sector Master Plan. The foundation of a vibrant, sound, stable and resilient financial sector accords the opportunity of advancing the sector to a new level where new opportunities with new formulas and strategies for success can be achieved. The financial sector has been key in supporting the transformation of the Malaysian economy, to increase its significance and to promote a more diversified economic structure. This has been achieved by the increased financing extended via the banking system and capital market. In particular, outstanding loans and private debt securities expanded by an average of 7.8% for the period 2001-2007. Malaysia is also ranked third in terms of access to credit amongst 175 countries surveyed by the World Bank in the Doing Business Report 2007. In an environment of rising incomes and expanding domestic demand, the further modernization of retail banking will be important going forward. With increasing financial literacy and growing consumer sophistication, product pioneering and cross-selling, the trend towards electronic financial transactions will gain significance.

Increasingly, loans to the corporate sector will become less dominant with an expanding and efficient functioning capital market.

In particular, the bond market presents opportunities for increased corporate advisory and debt and equity underwriting business. Private debt securities now represent 45.5% of GDP. An increasing trend that will become even more important in the future are the SMEs. By 2010, it is expected that SMEs contribution to the economy will be 37%, and account for 22% of exports. Loans approved by the banking institutions and development financial institutions to SMEs have increased by 34.3% to RM63.2 billion in 2007. This trend is expected to accelerate in the future. Microfinancing is also important for micro-enterprises to accord to greater financial services and hence contribute towards balanced growth.

In the recent three years, the finance and insurance sector expanded by 8.3% per annum, outpacing the growth in real GDP of about 6%. The financial sector now accounts for 11.0% of GDP, with about 140,000 people employed in the industry. Reflecting the higher skilled positions in the industry, the average salary in the industry is 2.4 times the country's per capita income and is amongst the highest in the economy. The financial sector's high demand for skilled talent thus require significant investment.

As part of the strategic positioning of Malaysia to attain a developed economy status in 2020, the financial sector moving forward also has an important role as a catalyst of economic growth. Studies have shown that banks play an important role in promoting the creation of new industries as well as in generating spillover effects on other sectors of the economy. In developing the financial sector, it contributes substantially to the growth of the professional services sector, that includes the network of supporting services encompassing software development, telecommunications, shared services, and legal and accounting services. Often, the ability of the financial sector to play this catalyst role depends on the sector having sufficient critical mass. Such a financial sector is able to play an important role in mobilising talent and business linkages to strengthen research and development efforts and spur innovation in other economic sectors. Through

the channeling of productivity, the financial sector can drive endogenous growth in other economic sectors.

Let me turn to two areas where Malaysia has strong competitive advantage. The first is in Islamic finance and the second is shared services and outsourcing (SSO). Malaysia is at the forefront in the development of Islamic finance, housing the world's largest sukuk market with 65.8% of the global outstanding sukuk as at end-March 2008. Building on our established foundation in Islamic finance in terms of experience, infrastructure and knowledge, the promotion of Malaysia as an international Islamic financial hub is expected to catalyse growth in other economic sectors. Positive effects are expected to spill over to the markets and related industries such as the property market and health, education and business services sectors, spreading the sector's growth momentum to the economy.

Similarly, there exists potential for a greater mutually reinforcing relationship between the financial sector and the SSO industry in Malaysia. The financial sector's participation in the SSO sector is expected to provide the impetus for growth in the information communication technology industry as more technology-driven hubs are established in Malaysia. Indeed, Malaysia is ranked as the third most attractive outsourcing centre globally, already housing 123 SSO centres which include leaders in the finance, technology and energy industries.

The liberalisation plan moving forward aims to reinforce the role of the Malaysian financial sector in the next phase of development, capitalising on core comparative advantages whilst reaping benefits from alliances and partnerships. The strategy will focus on the strategic positioning of the Malaysian financial sector, with differentiated strategies tailored towards different sub-sectors and markets. Malaysia will pursue more aggressive liberalisation strategies to maximise our potential in areas where there will be mutual benefits from such greater liberalisation. An

area that will be pursued is increased strategic alliances with foreign partners and greater foreign participation in our financial markets. This will be key to enhancing our economic and financial interlinkages with other parts of the world.

In particular, initial advancements to support the ongoing efforts on integration with the other South East Asian nations through the ASEAN Economic Community (AEC) will facilitate broader and deeper economic cooperation in the region. It is evident from the recent ventures abroad by Malaysian banking institutions, that the prospects in the region are recognised. There is tremendous potential for Malaysian banks to reap greater benefits from increased regional integration through diversification of income streams and the fast-growing prosperity of the region. Such expansion however, needs to commensurate with the institutional capacity. On reciprocal grounds, consideration will be granted towards enhancing the presence of ASEAN-origin financial institutions in Malaysia. Indeed, liberalisation including greater market access may be granted to countries where there are also reciprocal potential for Malaysian financial institutions to promote greater economic and financial integration in the region.

The operating landscape moving forward is going to be increasingly challenging. Competitive pressures and global developments will continue to shape the transformation process of the financial sector. While the growth prospects of the financial sector remain positive, with the financial sector having emerged stronger and more effective, it also has the prospects of staying ahead of the curve, break new grounds in the development and quality of banking services and delivery channels. The ability to compete will drive performance and innovation within the financial sector, raising the potential to contribute to the economy to make the leap towards realizing Vision 2020. There is a high degree of confidence that the Malaysian financial sector will rise to the challenge.