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Session 1 : Changes After the Crisis:
ASEAN's Economic Dynamism and Prospects
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by

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Ten years after the crisis, ASEAN stands out as a dynamic region with diverse strengths. With a growing population of over 550 million, ASEAN remains one of the fastest growing regions in the world (2005: 5.6%; world: 4.9%). The combined GDP of the ASEAN economies is expected to exceed USD 1 trillion in 2007. This growth has been extensive and includes all the developing economies in the group.

The ASEAN economies have always been highly open economies, with total trade accounting for more than 130 percent of GDP and the value of trade flows now exceeding USD 1 trillion. In view of this high degree of openness, ASEAN has also always been vulnerable to external developments. The ASEAN economies have however demonstrated, time and again, their capacity to rebound from adverse shocks, and to do so within a short period of time. While the 1997 – 1998 crisis was devastating, most ASEAN economies were able to restore stability and resume growth just after a year. ASEAN has also continued to weather other both regional and international shocks that have since occurred.

While the current global and regional environment has since the last ten years changed dramatically, bringing with it new risks and challenges, the region has emerged strengthened with greater economic and financial resilience. Strong macroeconomic fundamentals have been sustained, and reinforced by enhanced economic flexibility. The financial and corporate sector restructuring and reform that were undertaken during the ten years have also supported

these developments. Equally important is the aggressive development of the domestic financial infrastructure and financial markets. The ASEAN economies have also developed complementarities with the major regional economies in the Asian region including China, Japan, South Korea and India that has contributed to deepening of regional economic integration, reinforcing further the strong trade and investment linkages that was already present in the region.

The issue before us now, is whether the South East Asian nations can rise to the challenge of sustaining its dynamism and prospects in this more challenging global environment. Allow me to elaborate on the elements that have facilitated the ability of the ASEAN economies previously to successfully adjust to shocks and to take account of the recent developments that have further strengthened their capacity and capability to deal with future shocks and thus sustain their dynamism.

Improved macroeconomic fundamentals

While the macroeconomic fundamentals were favourable just before the crisis, in the current environment, the external position of the regional economies have strengthened further. The current account balances are in surplus, the foreign currency reserves are at record highs and the external debt levels are at significantly lower levels, with improved maturity profiles. Government budget positions are broadly stronger with ongoing measures towards consolidation. Inflation has generally been contained, despite the recent

adjustments due to the high oil prices. More flexible exchange rate regimes are also now in place allowing for the potential for smooth adjustments to external shocks.

In this environment, Foreign direct investment (FDI) has also continued to increase reflecting confidence in the ASEAN economies. In 2005, Foreign direct investment to the ASEAN economies reached USD 37 billion, exceeding the pre-crisis peak of USD 34 billion in 1997.

Economic flexibility in ASEAN has been enhanced

Economic flexibility has always been one of ASEAN's strengths. It has been a major element that has facilitated adjustment to the changing global environment and to external shocks. This economic flexibility of the ASEAN economies has ten years later been further augmented. This has been achieved by the increased labour and capital mobility, financial market development, a strengthened financial system, and the extensive institutional developments that have taken place.

Economic flexibility has been important in enabling the ASEAN economies to shift to new areas of comparative advantage. Significant changes in economic structures have taken place and shifts to new sectors have occurred in response to the changing global competitive dynamics. Diverse new sources of growth have now emerged across ASEAN, with the economies now moving beyond their traditional reliance on manufactured exports to expanding the production of resource-based products, and increasingly to the services sector and thus providing greater flexibility to respond to shifts in external demand.

There has also been a rebalancing of the sources of growth between domestic and external demand. The role of private consumption has strengthened in the ASEAN economies. ASEAN now possesses a burgeoning consumer market that is valued at

more than USD 330 billion. With high savings rate continuing to prevail, there is potential for this trend to be sustained. Consumption demand has also been supported by rising incomes, with GDP per capita having increased to over USD 1,500 compared to USD 1,157 in 2000. In the long-term, these trends are expected to be reinforced by the positive demographic structure in the ASEAN region. ASEAN's population is not only large but also young with 55% at less than 30 years old and becoming increasingly urbanized.

There is also greater involvement of the private sector in the economy following the period of adjustment post-crisis. Private investment which was initially slow to adjust has now shown prospects for a stronger recovery. The potential for greater investment is driven by the rising infrastructure requirements throughout the region that is estimated at USD 160 billion for the period 2006-2010. There has also been growing interest in resource-based industries. The investment climate has also improved amidst the better economic conditions and more efficient functioning systems that have been put in place.

Financial and corporate reforms and restructuring have supported these developments

An area in which the payoff has been significant is the financial sector. The banking sectors in the ASEAN region as a whole have increased their resilience and ability to manage risks as reflected by their profitability, asset quality and capitalization, all which have generally strengthened since the Asian crisis. The renewed strength in the banking sectors have been underpinned by recapitalisation programmes, rationalization and consolidation and improvements in banking supervision and regulation. The implementation of financial reforms has not only increased the capacity but the resilience of the financial system.

Similarly, corporate balance sheets across the region have strengthened considerably with significantly improved

standards of corporate governance. With the more positive investment climate, it has resulted in a resumption of investment activities. A major development since the crisis has been the development of the capital markets, in particular, the bond market. This has led to greater diversification of sources of financing for the corporate sector. In Malaysia, the bond market now accounts for almost 90% of GDP with the size of the corporate debt securities market now exceeding the public debt securities market. There has also been increased attention to greater financial inclusion, to reduce income disparities and achieve more balance growth.

The stronger domestic financial sectors in the ASEAN economies have also allowed for greater liberalization and deregulation to occur. This has not only enhanced the range of business opportunities for the financial institutions but also their potential to expand beyond domestic borders and building further on regional linkages.

Increased Asian regional complementarities

Post-crisis, ASEAN has further increased intra-regional trade and investment linkages within ASEAN and with the other major economies in the region. Intra-Asian trade now accounts for more than half of the total trade of the region. The emergence of China and India have created new export markets for ASEAN, thus diversifying the ASEAN export market from over-concentration in the traditional markets. ASEAN is among the few regions to have a significant and growing trade surplus with China, reaching about USD 20 billion in 2005. Meanwhile, the total trade between the ASEAN-5 and India has expanded by more than tenfold from only USD 2 billion in 1990 to USD 21 billion in 2005.

In investment activities, Japanese investors have had an early presence in most of the ASEAN economies. This has generally reflected the diverse comparative advantage of ASEAN economies that range from labour

cost advantages to natural resources and the increasingly more deregulated and liberalised regimes. Foreign investors have also leveraged their supply chain networks on the ASEAN platform to take advantage of this diverse comparative advantage. Even within ASEAN, there has been an increasing trend of outward direct investment especially by Malaysia and Singapore, being undertaken to leverage on regional growth opportunities.

Greater regional financial integration

While there has been a high level of economic integration, a more recent development has been the acceleration of regional financial integration. As high savings economies, this would facilitate a more efficient allocation of part of the surplus funds of the region into productive investments in the region. This would contribute towards lower financing costs in the region and reducing the risks while at the same time promoting the economic potential of the region.

To facilitate financial integration, the liberalization of foreign exchange rules, the harmonization of standards and the removal of impediments to cross-border investment have been undertaken. The ASEAN Roadmap on Capital Market Development has been formulated to foster alliances and linkages in the equity and bond markets among ASEAN exchanges, including the harmonisation of regulations. In the equity markets, multiple listings are being promoted as regional bourses attract domestic companies in the region to list on their exchanges. The FTSE/ASEAN Index and the FTSE/ASEAN – 40 Index, launched in 2005, also serves to increase the integration of the regional bourses and to promote ASEAN as an asset class. In the bond markets, the Asian Bond Funds (ABF 1 and ABF 2) initiated by the central banks aim to broaden and deepen the regional bond markets. Meanwhile, the Asian Bond Markets Initiatives (ABMI) aims to enhance the infrastructure, which includes plans to develop a regional credit guarantee mechanism, a regional credit rating agency and a regional settlement link to facilitate

cross-border transactions. Specifically, the ASEAN Roadmap on Capital Account Liberalization, launched in 2003, aims to gradually achieve a freer flow of capital over the medium-term. Malaysia has since progressively further liberalised its rules for foreign exchange transactions culminating in the removal of most of the rules in April 2005.

Strengthened Regional Financial Cooperation

During the 1997/1998 crisis, Asia did not come together to collaboratively and cumulatively act to contain the crisis and subsequently to facilitate its resolution. Perhaps, it was due to the nature of the crisis, its severity on the financial markets and the economies. Domestic stability had to be first restored before time could be taken to formulate a holistic crisis management solution. The instability in the currency markets lasted for about one and a half years. There was also no entity in the region during that period that provided any authoritative assessment on whether the programmes that were subsequently being implemented would in fact produce the desired outcomes.

While efforts to strengthen the domestic economies and the financial systems will continue, this has now being reinforced by the improved regional surveillance including on cross border financial flows, and by institutional arrangements that would contribute towards crisis containment and management. The regional cooperative efforts going forward will continue to gain momentum. These efforts should not be seen as attempting to substitute but rather as efforts to complement the existing international arrangements. The objective to be achieved is the same, that is, to build the regional capacity to be better positioned to prevent, contain and resolve any potential crisis at minimum costs to our financial systems and to our economies.

In conclusion, the cumulative effect of the changes since the Asian crisis has transformed ASEAN – opening up new opportunities and making the region resilient and a dynamic centre of growth. The ASEAN “tigers” are back, and poised to leap on to the next wave of economic advancement and prosperity.

INCEIF Inaugural Intellectual Discourse 23 February 2007

“Islamic Finance: Issues and Challenges of Co-existence in an Entrenched Conventional System”

Welcoming Remarks by

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

It is my great pleasure to welcome you to INCEIF Inaugural Intellectual Discourse Series. INCEIF has made remarkable progress within a period of less than a year. In 2006, INCEIF has gained the university status, it has currently enrolled 756 students from 39 countries, and it has entered into strategic alliances with a number of industry training and education providers from the Middle East, South East Asia and the West. Indeed, INCEIF has received an overwhelming response. As an institution of higher learning dedicated to the development of human capital for the growing global Islamic finance industry, INCEIF will have an important role in meeting the increased demand for talent and expertise for the industry.

The topic for today’s deliberation, “Issues and Challenges of the Co-existence of Islamic Finance in an Entrenched Conventional System”, is most relevant in the currently highly competitive financial services industry where new challenges and opportunities are continuously emerging in this era of globalisation and of rapid change that is also driven by advances in technology.

Today’s initiative brings together Islamic finance experts and scholars to deliberate the issues confronting Islamic finance in an environment where the conventional finance is dominant and highly entrenched. The primary objective of today’s Inaugural

Intellectual Discourse is to explore the prospects for Islamic finance which has now reached a stage of development in which it is now no longer regarded as a niche product serving a specialised market. Today, it is a robust industry that operates in more than 60 countries, and it is a viable form of financial intermediation that is competitive and resilient. Islamic finance, nevertheless faces many challenges with respect to its product offering, its distinctive ethical and moral dimension, and its relevance to all customers.

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 will continue 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. The global experience has however shown that institutional and development financial infrastructure, the broadening and deepening of the financial markets, and a rigorous legal and regulatory framework is vital for the soundness, stability and resilience of the financial system. Developments in both domestic and international economic and financial conditions have from time to time tested the resilience of financial systems. Thus, Islamic financial institutions will not only be assessed by their Shariah aspects, but also by other factors including their

effectiveness and efficiency, their resilience and their ability to evolve and reinvent to meet the challenges of the continuously changing demands as we advance forward.

After more than two decades of experience in the development of Islamic finance, we are now seeing the international dimension of our Islamic financial system gain significance. This has followed the increased foreign presence and participation in our domestic Islamic financial system. Malaysia has also ventured to participate in international financial markets and in term of presence beyond our domestic borders. More specifically, three new foreign Islamic banks are now participating in our domestic financial system. Following further liberalisation measures, there is also increased foreign participation in our domestic Islamic financial institutions. Our takaful industry has also become one of the success stories in Islamic finance. In the four new licences issued recently, it has comprised of joint ventures with foreign participation. The Malaysian bond market has also been liberalised to enable foreign entities to raise funds in our domestic market. Our experience in launching the first Sukuk has drawn significant interest by corporates and sovereigns for raising long-term financing based on Islamic structure instruments.

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. This is therefore the beginning of a new phase of development for Islamic finance in Malaysia as it becomes more integrated with the international financial system.

We have set high standards in market coverage and broadening of Islamic financial products being offered to the market. The

challenge is for the financial institutions to have a more extensive outreach. Islamic finance must promote greater financial inclusion involving all levels of the community. Opportunities also need to be created for Islamic financial products to have an outreach to the small and medium-sized enterprises. Moreover, financial instruments structured under the Salam, Istisna' and Musyarakah contracts need to be designed to stimulate activities in those sectors such as agriculture and manufacturing where there is limited participation by conventional finance. We need to reach those segments of society and economic activities that have not fully benefited from the success of Islamic finance.

As part of the global development of Islamic finance, of equal importance is the supporting international architecture that is evolving. Both AAOIFI and IFSB have contributed significantly to the development and the harmonisation of accounting and prudential standards. This will allow for the potential of strengthening the inter-linkages across borders to take place.

The conventional banking as a more matured market has also continued to grow and prosper in Malaysia. Since the beginning, it has attracted dominant global players. There are fourteen 100% owned banks in our financial system that accounts for almost one third of the market share. In the insurance sector the foreign participation is even greater. In conventional finance, Malaysia is therefore already highly integrated with the international financial system. This has been reinforced by the progressive liberalisation of our capital account which now allows for the free inflow and outflow of funds. Our financial system has therefore facilitated Malaysia's strong international economic and financial linkages which have for several decades contributed to our economic growth and development.

In this competitive global environment, new challenges and risks can be expected to continuously emerge. The growing world

wide participation in Islamic finance as a form of financial intermediation in this highly challenging environment has demonstrated its viability and competitiveness. This dynamic environment in which we operate will thus require continued developments to be pursued on all fronts.

The discourse among the expertise in the field will not only provide us with further insights into the issues and challenges of coexistence not only in our domestic systems but also in the international financial system. This will contribute to the awareness and understanding of the journey for the sustainable development of Islamic finance.

GIFF Investors & Issuers Forum: “Islamic Finance: The New Silk Road” 28 March 2007

Special Address by

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

Up until the 14th century, the Silk Road served as a major global conduit between ancient civilizations in the East and West. It created mutual prosperity, encouraged knowledge transfer and enhanced understanding between civilisations through trade, cultural and technological exchange. Now in the 21st century, globalisation and liberalisation, and the emergence of new financial centres and their increased integration have created an environment of flourishing activity reminiscent of the Old Silk Road.

Indeed, it suggests that a New Silk Road has emerged. This new route not only carries flows of oil, manufactured goods, and technological innovation, but also flows of direct investment, portfolio capital, private equity and human capital. Previously, silk was one of the main commodities traded on this route. Now, the emergence of Islamic financial products and services has brought together financial services providers across continents to trade on this new route. The emergence of the New Silk Road reflects the increasing and evolving economic and financial relationships and inter-linkages, with Islamic finance well positioned to further facilitate these linkages to offer mutually-reinforcing benefits to those who participate in it. Indeed, the New Silk Road opens up the prospect of exciting opportunities for economic progress and prosperity for us all.

I first made reference to the New Silk Road at the 2nd World Islamic Economic Forum (WIEF) on “Unleashing the Potential of Emerging Markets” in Islamabad, Pakistan in November 2006.

It is my pleasure today to share some thoughts on the potential role of Islamic finance in strengthening the New Silk Road. My remarks will focus on four areas that is the emergence of the New Silk Road; how the linkages on the New Silk Road have built on the comparative advantages of Asia and the Middle East; how Islamic finance is able to foster the linkages along the New Silk Road; and finally, how we can extend the New Silk Road to the rest of the world to advance global economic stability and prosperity.

The Emergence of a New Silk Road

Today, signs that a New Silk Road is flourishing are abundant. The economic and financial linkages between Asia and the Middle East are growing. While the world trade has on the average expanded by 10% over the period 2001-2005, Asia’s trade with the Middle East has increased on the average by 24%. More than half of the exports from the Gulf states¹ goes to Asia and more than one-fifth of its imports are from Asia. The Gulf is the major supplier of fuel to Asia, while Asia in turn supplies manufactured goods and food to the Gulf.

¹ The Gulf Cooperation Council represents Saudi Arabia, UAE, Bahrain, Qatar, Oman and Kuwait

Recent trends in investment activities have been equally significant. Investment projects amounting to more than USD160 billion to be financed by the Gulf states in Asia have been announced since 2005². In 2006 alone, mega-deals³ involving corporate acquisitions and real estate purchases from the Gulf to Asia, are estimated to total more than USD18 billion, including multi-billion dollar IPO purchases in financial institutions in China, large oil refineries and telecom companies. The value of such investments are expected to increase to between USD20-30 billion in 2007.

For economic regions with high savings and surpluses such as Asia and the Middle East, the challenge is to recycle part of these surplus funds to productive investments in the region. The supply of savings in Asia and the Middle East is by far higher than in any other part of the world. Savings rates here in Asia are expected to remain in the region of 30-40% of GDP for some years to come. Similarly, savings in the Middle East economies have been rising in the recent decade and is expected to average about 30-35% of GDP in the coming years. In 2006, the current account surpluses as percentage of GDP for Asia and the Middle East were about 5% and 23% respectively⁴. With Asian official foreign currency reserves exceeding USD2 trillion, and Middle East oil revenues exceeding USD1 trillion since 2000, the management of surplus savings and reserves in both regions will offer significant investment opportunities.

Besides the institutional pool of wealth, the rapidly expanding middle class in both regions is a further trend sustaining the high savings rate and the increased demand for more sophisticated financial products and services including consumer finance and

wealth management. In Asia alone, we now have more than 2.4 million high net worth individuals⁵, not far behind the US with 2.9 million and Europe with 2.8 million, and these Asian individuals control an estimated amount of USD7.2 trillion financial assets. The size of this group in Asia is estimated to be increasing at 7% per year, second only to those in the Middle East, numbering 300,000 and growing at 9% per year. Traditionally, investors in Asia and the Middle East have looked to the developed Western markets to meet their investment needs, in view of the more developed financial markets and the range of asset classes. Increasingly however, there is growing interest and search for improved returns on investment in other parts of the world. This has been a global phenomenon for some years now, characterised by excess liquidity and low yields in the traditional markets.

The New Silk Road creates linkages that build on the comparative advantages between Asia and the Middle East

Historically, trade and investment in Asia and the Middle East has been linked to the developed economies. However, it is now increasingly recognised that there are significant complementarities between our two dynamic regions. These complementarities provide a platform for two-way flows that enhances income and wealth creation. The different demand patterns of each respective region reinforces the significance of the complementarities.

The Middle East investors have a greater need for diversification, both in terms of geographical allocation and asset classes, beyond the traditional investments in the US and Europe. Asia in turn, the home to some

² "A route to riches on the new Silk Road", Financial Times, 21 Dec 2006

³ Worth more than USD1 billion

⁴ Refers to IMF data

⁵ Refers to individuals with at least USD1 million in financial assets. Sourced from Merrill Lynch - Capgemini World Wealth Report 2006

of the fastest growing economies in the world, offers highly diverse investment opportunities, ranging from in Vietnam to Japan, and in a broad scope of industries, ranging from natural resource producers to established high-tech brands. Such investment opportunities continue to support the growth momentum in the region. At the same time, Middle East domestic infrastructure requirements are estimated to total USD500 billion for the next five years, and Asian companies have demonstrated the capacity to provide the technology, expertise and human capital to meet these infrastructure demands.

Asia's relentless march towards development offers new opportunities for the Middle East. Asia's continued need for productive capital and uninterrupted energy supply to sustain its high growth matches the Middle East's resource endowments. It is estimated that Asia needs USD 1 trillion worth of infrastructure investment over the next five years, and is in search of new partnerships and strategic investors to co-invest in these undertakings.

In focussing on the respective comparative advantages and connecting via the New Silk Road, it contributes to expanding the opportunities in both the regions. Essentially, this extends the production possibility frontiers to create new areas of growth. The participation of a wider pool of investors also enables better risk sharing and consequently, increases the viability of projects as well as the returns to the investment. New value is also created in mutually beneficial collaborations, such as in downstream energy activities. Products resulting from hybrid ideas are also evident in innovations in several areas, including in Islamic finance, with the early global sukuk being issued from Asia and the Middle East economies.

Islamic Finance: Strengthening the financial linkages between Asia and the Middle East

Islamic finance has demonstrated its viability and competitiveness in a more liberalised and globalised financial environment and has become important in strengthening the linkages between the two regions. While the sizeable Muslim populations in both regions have been attracted to the unique features of Islamic finance, it has also attracted interest and participation from non-Muslims within these regions. At present, there are more than 100⁶ Islamic banks in both regions, while Islamic financial transactions involving sovereigns and corporations have amounted to USD 35 billion during the period 2004 and 2006⁷.

Several factors have supported this trend. The orientation of Islamic finance towards real underlying assets is aligned to the nature of the investment opportunities in both regions. Infrastructure and project finance in both regions are particularly suited for Islamic finance.

The emphasis in Islamic finance on risk-sharing and the equity-oriented nature of such financing also suits the requirements. The Islamic financial structures clearly distinguish the roles and responsibilities as well as risk and profit-sharing profiles of the parties involved. This clear delineation of the roles also promotes greater transparency and the appropriate governance. The nature of the structures also enables the risks to be transferred to those more able to contribute towards value creation.

In addition, the use of Islamic finance promotes stability in the financial markets and the financing flows, which is important for emerging market economies such as those in

⁶ Estimates based on the listing of Islamic financial institutions provided by the Institute of Islamic Banking and Insurance, London.

⁷ Data sourced from Islamic Finance Information Service website. The Islamic financial deals mostly based on Murabahah, Ijarah, Mudharabah, Istisna principles.

Asia and the Middle East. In Islamic finance, strategies to minimize and manage the risks involve integrating with the risk in the real activities. The real activities therefore need to generate sufficient wealth to compensate for such risks. In contrast, conventional instruments generally separate the risks from the underlying assets. As a result, risk management and wealth creation may at times move in different or even opposite directions. Conventional financial instruments also allow for the commoditisation of risks, leading to its proliferation through multiple layers of leveraging and disproportionate distribution. These could result in higher systemic risks, increasing the potential for instability and inequitable concentration of wealth. The adoption of Islamic financial principles encourages financing to be primarily adopted as a means to facilitate real underlying economic transactions and not for speculative purposes.

There are also clear value propositions in Islamic finance for both investors and issuers from both regions. For investors, Islamic financial products offer portfolio diversification and new investment opportunities as they avail themselves to a new asset class. They also encourage risk management and provide confidence through explicit disclosure and transparency of the roles and responsibilities defined in the contract. For issuers, Islamic finance allows access to a new source of funds and liquidity besides providing new risk management options and new mechanisms for price discovery.

Islamic finance is well positioned to be a vehicle on the New Silk Road, as the enabling supporting infrastructure is already in place. The required regulatory and legal frameworks for Islamic finance have been established, not only in a growing number of countries in both regions but also at the international level through standard-setting bodies such as the International Financial Services Board and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). Efforts towards the harmonisation of Shariah interpretations and issues concerning mutual recognition are at an advanced stage. The

platforms for extending regional linkages and cross-border initiatives, including to the Middle East, are already in place within Asia, where there has been a significant degree of regional financial and economic integration.

Malaysia as an intermediary destination along the New Silk Road

Malaysia is committed to and extensively engaged in strengthening linkages through Islamic finance. In collaboration with the participation of the industry representing the banking, takaful and capital markets in Malaysia, the regulators have worked towards enhancing the inter-linkages with the global Islamic financial markets, not only by the further development of the Islamic financial infrastructure but also through increased liberalisation and through the implementation of measures to increase competitiveness of the financial services sector. This has included further liberalisation of the capital account of the balance of payments and the implementation of tax neutrality measures. Just as historical Malacca was a key port along the ancient trade routes between Asia and the Middle East, it is envisaged that Malaysia would serve as a key destination along the New Silk Road.

Today, as part of Malaysia's efforts to further spur the infrastructure development of the Islamic financial system, it is my pleasure to announce that Bank Negara Malaysia, the Securities Commission, Bursa Malaysia and industry players have worked collaboratively towards establishing a mechanism referred to as the Commodity Murabahah House. This mechanism which uses crude palm oil as the underlying commodity will facilitate Islamic financing applying the concept of murabahah or tawarruq.

BNM commodity murabahah acceptance

As part of these efforts to promote development of products to meet the diversified requirements of investors, Bank Negara Malaysia is pleased to announce

the introduction of a new Islamic monetary instrument, Commodity Murabahah Programme (CMP) as part of its diverse range of policy instruments in managing the short-term liquidity in the Malaysian Islamic inter-bank money market. Unique to Malaysia is that the CMP is designed to be the first ever commodity-based transaction that utilises the Crude Palm Oil based contracts as its underlying asset. The Bank has executed CMP master agreements with the eight Islamic banking institutions including the three foreign owned banking institutions to promote the use of the instrument for liquidity management. Several CMP transactions have now been conducted between the Central Bank and the respective Islamic Banks.

As commodity murabahah is widely used in other Islamic centres, it is envisaged that this CMP will promote increased linkages between Malaysia and these centres.

BNM Sukuk Murabahah/tawaruq short-term securities

The Central Bank also intends to diversify the issuance concept of the existing Islamic monetary notes from being based on Bai Inah and Ijarah into murabahah. Currently, the outstanding amount of the respective notes is RM 8 billion. This initiative is the continuation from the commodity murabahah acceptance initiative as the issuance involves the securitisation of the acceptance facility. There are several key benefits of issuing the Islamic Monetary Notes under this structure. It provides Islamic financial institutions an additional instrument to manage liquidity risk on a short-term basis. It is also a financial instrument whose structure has been widely used for retail banking and syndication products in the Middle East. Finally, it provides an opportunity for new investors to invest in Islamic financial papers in the Malaysian market, thus diversifying the investor base.

As part of the initiative to be linked to the global Islamic financial markets, this instrument will be promoted to the international financial market.

Islamic Derivative Master Agreement (IDMA)

Recognising the importance to develop Islamic hedging products for Islamic financial market to mitigate investment risks, Malaysia has introduced the first global Islamic Derivative master agreement to document Islamic derivative transactions. The effort is initiated by Bank Negara Malaysia and driven by the financial industry via the Persatuan Pasaran Kewangan Malaysia. The implementation of the agreement is expected to improve the risk management practices, balance sheet management, increase fund mobilisation efficiency and enhance their investment banking capability of the Islamic banking institutions. With the introduction of IDMA, the rights and obligations of contracting parties are clearly stated, thus creating an environment that is more transparent. As IDMA also incorporates best practices in market conduct, this document serves as an important catalyst for the future linkages between financial markets that offer Islamic financial market instruments.

Extending the New Silk Road to the world

While the New Silk Road is enhancing linkages between Asia and the Middle East, both regions have always extended the Silk Road to the rest of the world to participate in these exciting developments on this route. Indeed, global investors and the international financial community are already drawing the benefits from the increased diversification of asset classes while riding on the dynamism of the two regions. As Islamic finance expands further, reinforced by the activities on the New Silk Road, there will be greater convergence towards ethical or socially responsible-type of investments (SRI) in the global financial community. Islamic investment guidelines share significant similarities with the SRI principles. The focus of Islamic investment not only involves the avoidance of riba-free activities but also extends to include issues related to ethical values, such as fair trade and environmental protection. Furthermore,

the prospects of increased stability for financing flows and the focus on the role of real sector economic activities have ignited interest in utilising Islamic finance for sustainable development.

This overwhelming gathering of so many issuers and investors here today provides some indication of the growing interest in Islamic finance, reinforcing the potential increased activity on the New Silk Road. We all have a part in the making of the New Silk

Road into a vibrant source of wealth and prosperity in the global economy.

In closing, Malaysia is committed to be part of the New Silk Road to facilitate greater cross border economic and financial flows for increased inter-regional trade and investment transactions. Insyah-Allah, the greater inter-regional economic and financial linkages would bring greater benefits which will be mutually reinforcing and contribute towards raising the prospects for greater global shared prosperity.

Third IFSB Seminar on Legal Issues: Surveys on Legal & Shariah Issues in the Islamic Financial Services Industry 28 March 2007

Opening Remarks by

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

A strong legal and Shariah framework as a pillar to Islamic finance

The need to continually strengthen the legal framework for the financial services industry is imperative given the powerful forces of change continually transforming the functioning of the global economy and the international financial system. A legal framework which is aligned with market developments lends certainty and predictability to financial transactions and innovative products and instils public confidence in the financial system.

The legal and Shariah framework is a vital pillar in the sustainable development of Islamic finance. It provides the legislative framework that unambiguously defines the conduct of Islamic financial institutions. It also gives due protection to the consumers of Islamic finance, ensures the enforceability of Islamic financial contracts and provides an effective mechanism for legal redress.

The legal framework for Islamic finance also needs to address any specific elements that could result in a comparative disadvantage to the industry. More specifically, in a world in which finance has long been defined by conventional practices and laws, the features that are unique to the requirements of Islamic finance need to be taken into account to ensure neutrality of treatment.

In Malaysia, the rapid evolution of Islamic finance has been supported by the development of a comprehensive legal infrastructure. A series of legislation since 1983 has provided the foundation

for a regulatory regime for Islamic banks, takaful operators, the Shariah Council for Islamic finance, Islamic finance windows in conventional banks and the various forms of bond and money market instruments. In addition, the corporate, securities and insolvency laws and guidelines are compatible with the Shariah. These legislation have been reinforced by the establishment of a dedicated High Court bench to provide a comprehensive adjudicative system to deal with disputes involving Islamic finance. In addition, the new Islamic Finance Arbitration Rules of the Kuala Lumpur Regional Centre for Arbitration provides a customised mechanism for the resolution of disputes in the Islamic financial services sector.

The development of an efficient and vibrant Islamic financial market

Equally important to the development of Islamic finance is not only the financial intermediaries but also the Islamic financial markets. The demand for Islamic financial products and instruments is expanding at increasingly significant rates in predominantly Muslim countries in the Middle East and Asia as well as in the non-Muslim economies in the West. The rapid growth of the Islamic financial markets has seen the development of a wide range of products including money, debt and capital market instruments. Such markets are important for the effective management of investment portfolios and for the diversification of risks.

Today, the global demand for Islamic capital market products is served by the existence of the Dow Jones Islamic Index whose market capitalisation now exceeds

USD 10 trillion. About 350 Shariah-compliant funds have already been established across the globe.

In Malaysia, the sukuk market has been a leading segment of growth in the domestic bond market accounting for half of our domestic bond market and two thirds of the total global outstanding sukuk. A wide range of new Islamic financial instruments has been developed including the Bank Negara Malaysia Sukuk Ijarah, Bank Negara Malaysia Monetary Notes, the Islamic residential mortgage-backed securities and most recently the Commodity Murabahah Programme for managing short-term liquidity in the inter-bank money market.

While Islamic finance practitioners and scholars continue to draw from the source of fiqh muamalat to create new and innovative instruments, the legal framework however, needs to be further strengthened to ensure continued acceptance and utility of the financial instruments. In Malaysia, the progress in this area has been facilitated by the common law which forms the foundation of the legal system. More specifically, the concept of "trust" under the common law has facilitated the issuance of Islamic securities such as sukuk and Islamic Real Estate Investment Trust (REIT). Since "trust" as an inherent notion embedded in the common law system is not generally found in the jurisprudence of civil law, some civil law countries have enacted specific legislation to provide for the introduction of trust so as to align their legal systems with the requirements of Islamic finance.

The challenges brought by the integration of Islamic finance with the international financial system

While legal issues within a domestic financial system can be resolved by the home regulators and Shariah authorities, the integration of Islamic finance with the international financial system brings with it many challenges. There is a need for mutual recognition of financial standards and

products across jurisdictions. The progressive harmonisation of Shariah, in this respect, needs to be viewed as a driver towards greater international financial integration.

Such a convergence and harmonisation can only happen with greater engagement among the regulators, practitioners and scholars in Islamic finance in the international community. The Annual International Shariah Scholars' Dialogue that has been taking place since 2005 is aimed at achieving this objective. This Dialogue has served to promote interactions between Shariah scholars from around the world contributing towards greater understanding and international convergence.

In Malaysia, the efforts to enhance the international dimension of our Islamic financial system have been intensified in the more recent period to facilitate greater international trade and cross-border investment flows. The new initiatives that have been announced allow the establishment of new International Islamic financial institutions that will be permitted to offer the full range of Islamic financial services to residents and non-residents in international currencies. These initiatives also aim to serve as a catalyst for the development of the domestic financial markets as well as the development of talent and knowledge in Islamic finance. Collaboration with other emerging regional centres in Islamic finance will be an important part of this process that will contribute towards greater international financial integration.

The establishment of the Islamic Financial Services Board in 2002 represents a major structural enhancement in building the international financial architecture for Islamic finance. The achievements thus far by the Islamic Financial Services Board in developing the prudential standards that can be universally applied have been very encouraging. The efforts represent a testimony of the collective capacity for greater international collaboration which has contributed towards strengthening the fabric of Islamic finance.

While the legal framework and rules are constantly being reviewed to ensure that they remain relevant for the new areas of financial activity, it should not only be undertaken for the domestic Islamic financial system but also in the context of the international financial system.

Conclusion

In closing, I would like to take this opportunity to congratulate the Islamic Financial Services Board for commissioning the “Surveys on Legal and Shariah Issues in the Islamic Financial Services Industry”. The survey

findings represent an important contribution towards augmenting the literature on the existing legal and Shariah framework across different jurisdictions. It serves as a useful source of reference for countries that are interested in establishing a legal and Shariah framework for their Islamic financial system. Deliberation on the survey results and the exchange of views and experiences among lawyers, Shariah scholars and Islamic finance practitioners will be important in contributing to increasing the efficiency in Islamic finance and facilitating its robustness as an integral component in the global financial system.