

## The 11th Malaysian Banking Summit - “The Malaysian Banking Industry Reinvention and Transformation” 19 July 2007, Kuala Lumpur

Keynote Address by

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In this recent decade, the Malaysian banking sector has been significantly transformed and reinvented. The restructuring, consolidation and rationalisation efforts that were undertaken in the banking sector have placed the financial sector on a stronger foundation. This decade has also been a period of favourable performance and increased resilience. This has been achieved with the successful integration of business processes and the redeployment of resources to support new areas of growth. Financial reforms have also changed the environment. Progressive deregulation and liberalisation have increased the flexibility to financial institutions, while also resulting in new business opportunities and increased competition. These developments have also further strengthened the incentives for improved performance. Significant structural changes during this period have also reshaped the landscape. The introduction of capital market intermediaries, investment banks, an increasing presence of new international players in Islamic finance, and a significantly more developed bond market, has resulted in a significantly more diversified financial system.

The resulting payoffs for the financial system, and the economy generally, have clearly been positive. Today, the financial sector has evolved from being an enabler of growth to become an important source of growth in its own right. The sector, in the banking and insurance industries, now provides employment to more than 123,000 Malaysians. Despite conditions that have remained challenging for a large part of the decade, the banking system remained consistently on solid financial ground with a risk-weighted capital ratio of over 13%, low NPL ratios, and continued profitability for

eight consecutive years. Substantial progress has been made towards consumer retail finance and access to banking services. Such consumer lending has increased from RM134 billion in 2000 to RM343 billion in 2007 while loans disbursed to small and medium enterprises have increased from RM71 billion to RM108 billion over the same period. Domestic banking institutions are also building on their strong domestic performance to expand beyond Malaysian borders. Today, six domestic banks have presence in 10 countries around the region.

The current encouraging state of the banking system, however, should not make us complacent on the need to continually transform and reinvent. The road in front of us is likely to be significantly different from the one we have traveled on. As our previous experience has shown, we need to constantly recognize that strategies that serve well in today’s environment would not necessarily be a formula for success in tomorrow’s environment.

In looking at the future terrain of the financial sector in Malaysia, six trends are particularly important - **first**, the changing configuration of the global economy and global financial markets; **second**, regional economic and financial integration; **third**, financial sector development amidst increased liberalisation in the Asian region; **fourth**, increased role of domestic demand in the Asian economies; **fifth**, growing significance of Islamic finance in the international financial system; and **finally**, developments in the regulatory structures and approaches. It can be expected that all these trends will have a significant bearing on the future of the banking industry.

**First**, the global economic configuration has been altered by the emergence of several large emerging economies into the global economy. This is especially evident in Asia, where the rise of China, India and the South East Asian economies have increased Asia's global role. As a result, Asia today features four of the world's twelve largest economies and several of the fastest-growing economies. Collectively as a region, Asia contributes about 40% of global output and one-fourth of world trade. The region is also a significant net exporter of capital, holding two-thirds of the world's foreign exchange reserves and is the largest holder of the developed economies' sovereign bonds. One-quarter of Fortune's top 500 global companies are Asian corporations. This opens up tremendous business opportunities for Malaysia as a part of this dynamic growth region.

Accompanying these changes has been the prevalence of abundant liquidity in the global financial markets, resulting in an intensified search for higher yields. These trends are encouraging flows into the capital markets of emerging economies, presenting new opportunities for wholesale banking and capital market related financial services. These flows, however, also pose potential risks of reversals in financial market conditions. This increases the need to ensure that we have the capacity to absorb or adjust to changing financial flows.

A **second** significant trend shaping the future financial landscape is the intensification of regional economic and financial integration. Economic integration through trade is already well-advanced in Asia, with the share of intra-regional trade already more than half of the total trade in Asia. More recently, however, greater financial integration at the regional level has been an important development, bringing complementary and mutually-reinforcing benefits to the economies in the region. Intra-regional investments among the Asian economies have increased with an accompanying rise in cross-border financing activities. There has already been an increase in cross-border mergers and acquisition activity among Asian financial institutions in

order to reap emerging opportunities. The transformation in the financial landscape in the current environment has not been confined to the Asian region but has also involved growing ties with other emerging regions. Of significance is the rising trend of trade and financial linkages between Asia and the Middle East and other parts of the world. Malaysian banks now have the capacity to take advantage of these trends.

The trends towards regional financial integration also present significant opportunities to tap into the enlarged pool of savings in Asia. Besides institutional pools of wealth, the rapidly expanding middle class has been a key factor sustaining the high savings rate. In Asia alone, we now have more than 2.6 million high net worth individuals who collectively control an estimated USD8.4 trillion in financial assets. These trends underpin the increasing demand for more sophisticated consumer finance and wealth management products. There is also potential to tap the appetite for growing international diversification among the more developed economies in Asia, to meet the rising demand for regional financial assets. Furthermore, the continued growth momentum in the region has created demand for infrastructure. It is estimated that Asia needs USD 1 trillion worth of infrastructure investment over the next 5 years, offering huge potential for financing opportunities.

**Third**, reinforcing the move towards regional financial integration, authorities across the region have encouraged greater financial sector development and progressively liberalised their capital accounts. Many regional countries are moving beyond financial restructuring to promote more diversified and vibrant financial systems that embrace a broad range of service providers and asset classes, including private equity, hedge funds, structured products and Islamic finance.

In Malaysia, the gradual but progressive liberalization of foreign exchange administration rules undertaken since 2003 has led to significant benefits in terms of

providing enhanced flexibility of the financial sector, contributing to reducing the cost of doing business as well as expanding the scope of activities of the financial sector. In April this year, several liberalization measures were implemented to further increase international investors' participation in the Malaysian capital market, provide greater flexibility for resident investors to diversify into non-ringgit investments in Malaysia and overseas, and to facilitate the expansion of the domestic banks' foreign currency business.

**Fourth**, the trend for the growing significance of domestic demand has also become more pronounced and is expected to continue going forward. Supported by rising incomes, firm labour market conditions and a young demographic profile, private consumption activity has moved towards income-sensitive goods and lifestyle services for which the retail banking sector should be well-positioned to offer a wider range of innovative products and services to meet the requirements of increasingly more sophisticated consumers.

The change in demographic structure of the population will also have an indirect impact on the domestic financial landscape. While Malaysia's population is still relatively young, an increasing segment of the population is in the group aged 64 and above. This development will have implications for human capital, business and product strategies of banking institutions in terms of savings behaviour and demand for different types of products.

**Fifth**, a new area of growing significance in the international financial system is Islamic Finance as a viable and competitive form of financial intermediation. The Malaysia International Islamic Financial Centre, or MIFC, initiative, launched in August 2006, has taken Malaysia's liberalisation strategies to a new level with the aim of positioning Malaysia strategically in this new growth area. Islamic banking institutions are allowed to undertake a broader array of Islamic financial activities that include commercial banking,

consumer banking, investment banking as well as international currency business under the MIFC initiative. Financial institutions need to consider their own competitive positioning in this area and to have the appropriate strategies to participate in this dynamic growth sector.

**Finally**, the regulatory and supervisory paradigm will also continue to evolve. Indeed, we have over the recent decade witnessed significant global shifts in the approaches to regulation and supervision across many countries. These have ranged from radical policy responses in some countries that led to the introduction of costly regulatory systems to address the problems that have emerged, to bold deregulatory measures pursued in other countries, especially during times of exuberance and strong market conditions. A convergence towards the middle ground between these two extremes now seems to be emerging.

Two dimensions of regulatory change will be relevant to the context of the new environment. First, the emphasis on creating a strong risk management culture that is fundamental to sound banking operations will become significantly more pronounced. The transition to Basel II and the implementation of the risk-based supervisory regime are important elements of this change.

Second, regulations will continue to focus more on facilitating market-led adjustments that will allow the industry to evolve in response to market developments, while maintaining a sufficient degree of regulatory oversight to maintain financial stability and public confidence. This includes the adoption of principles-based regulations and an increased focus on harnessing market forces and discipline, as well as internal oversight functions, to reinforce prudential regulation and supervision. The aim is to promote a more efficient and responsive financial system.

In this connection, Bank Negara will soon introduce a more facilitative process for product innovations with revisions to the new

product approval framework. The changes are aimed at improving time to market for the introduction of new products by financial institutions, while ensuring that institutions put in place a sound product management programme within their respective institutions. The new framework will provide for more simplified regulatory processes and allow greater flexibility for well-managed banks and insurers to introduce new products more quickly in the market. Qualifying banks and insurers are expected to exercise this flexibility responsibly and in particular, with due regard to the interests of consumers.

The realignment of the regulatory and supervisory structures within the Central Bank in November 2006 has marked a significant turning point in consolidating these regulatory changes. As a result of the realignment, the Bank is better positioned to conduct effective surveillance of the financial system; to address regulatory overlaps and duplication within the system; to deal more strategically with the weight of multiple objectives and range of issues confronting the financial system, and more importantly, to preserve regulatory neutrality in the management of similar risks between different financial service providers.

These emerging trends in the international and regional environment will have an important bearing on the changing climate shaping the banking sector. While it brings new opportunities, it will also bring challenges. Let me return to the theme of this summit - the continued reinvention and transformation that needs to be considered for the industry going forward. I would like to focus on three main areas.

The **first** concerns human capital development. This is vitally important for the future development and growth of the financial sector. Going forward into the future this will become the pivotal factor determining the capacity to reinvent and transform. Financial institutions have two broad options. One would be to 'buy talent'. This remains a viable option as long as productivity growth

remains aligned with wage increases. Banks, however, need to be wary of bidding up wages without commensurate efficiency improvements or increases in value-add. This would not be sustainable and given the prevailing competitive market conditions, such a strategy will eventually erode the banks' competitiveness resulting from the additional costs.

The other option is to 'build talent'. This can be achieved through strategic partnerships with training providers, actively contributing towards industry-wide efforts to support the training agenda and continuous improvements to internal learning programmes.

This is also the option that is by far more challenging, but ultimately the one that provides the optimal payoff for individual institutions, for our financial sector, and the economy. The magnitude of the task, however, demands our collective efforts to secure a sustainable pool of talent that will serve both the present as well as future needs of the industry. The industry also needs to participate in the formal learning programmes by the institutions of higher learning. It is encouraging to note that several have volunteered following the recent dialogue earlier this year organised by Bank Negara Malaysia and the Ministry of Higher Education. By contributing towards positive reforms in the academic curriculum and providing other forms of practical support, the industry is making an important investment in its own future.

To take this effort further forward, Bank Negara Malaysia is initiating an extensive programme to train and prepare at least 1,000 deserving graduates for immediate placements in banking and insurance institutions. This effort will be undertaken in collaboration with the industry and training institutes and is aimed at boosting the supply of well-trained and competent personnel for the financial services industry. The selection process will be rigorous, and the training programme will be designed to produce first

grade candidates for employment at the management trainee level. It is also hoped that foreign financial institutions will draw on their extensive global network to support the programme. I urge the industry to lend its full support to this effort which will ultimately benefit the industry.

Collectively, these efforts will go a long way towards preparing students well for productive careers in the financial services industry and to provide a strong foundation for the development of the future generation of leaders and captains of industry.

The **second** area relates to financial inclusion. Strategies that are aimed towards consumer outreach and promoting financial inclusion will serve to increase access to financial services for all segments of society, promote more balanced growth, while at the same time, providing new sources of revenue for the financial industry. Significant efforts have been taken to strengthen the elements that support financial inclusion. This includes various outreach initiatives, including the consumer education programme, development of small and medium enterprises, increased public accessibility to financial information and greater access to advice and assistance.

Part of this effort is the development of a sustainable and commercially-driven microfinance industry in Malaysia. In Malaysia, there are at least 435,000 micro enterprises, but only 13% rely on financial institutions for funding. Of importance is promoting commercially viable microfinance ventures. In this connection, greater flexibility has been provided for foreign banks to enhance their presence in non-urban areas. Given the objectives of financial inclusion, it is hoped that foreign banks support this initiative given the flexibility that is being accorded to widen the outreach to segments of the economy which are currently underserved. Also embedded within the financial inclusion agenda is the responsibility that banking institutions have towards their customers, and to ensure that adequate information is

provided to consumers and investors to make informed judgments.

In the area of product development, both the interest of consumers and businesses will be taken into account. Financial institutions that demonstrate their ability to act responsibly can look forward to greater business flexibility to innovate. Financial institutions that uphold the necessary principles in their business strategies stand to reap long-term gains from enhanced franchise value, a strong reputation and positive association with socially responsible values that will engender public trust and confidence.

The **third** area relates to the need for banking institutions to enlarge their sphere of influence going forward given the changing environment. Banks will increasingly be exposed to external developments and the forces of market discipline. There are several particular areas in which banking institutions can take strategic positions to influence such developments. First is to leverage on the 'network economy' through strategic alliances. With global integration deepening further at the same time that competitive forces are exerting pressures on margins, the way forward would be to build on strategic alliances to increase capacity and expand reach, while containing costs. Strategic alliances with third parties, including those within and outside Malaysia, provides efficient opportunities to capitalize on the strengths of each partner and in the process promote development, the transfer of skills and improvement of best practices and pave the way for successful cross-border ventures.

The second relates to the area of international standard setting. With the gaining momentum of international standards in such important and pervasive areas such as capital adequacy standards, financial reporting and cross-border activities, it is important for financial institutions to participate more constructively in the standard setting process together with the regulatory community in order for such developments to take into account domestic circumstances and risks.

The third is in the area of ongoing negotiations on trade agreements. Banking institutions need to follow these developments and negotiations closely to consider implications it would have to their organisations and future business strategies.

The last area of influence relates to communication strategies. With increasing market discipline, effective communications has become more critical. Institutions will need to be more active in responding to consumer and business expectations and the building of long term customer relationships in order to be able to implement longer term business strategies. This is a significant challenge which demands deliberate, planned and well-designed communication strategies and resources dedicated for this effort.

### **Conclusion**

This decade has demonstrated the capacity of the banking sector to reinvent and transform. Going forward, the changes

in the global economy and international financial landscape will continue to accelerate beyond expectations. The ability of financial institutions to remain relevant in the future will depend on the actions that are taken now in the current environment. The leadership of the industry will be instrumental in charting the future growth path and cultivating a performance culture that will steer financial institutions towards continued success.

There therefore needs to be an awareness of the emerging cyclical and structural forces that will impact the economy as well as their linkages with the banking industry, to anticipate new developments and opportunities, and most importantly, to be equipped to respond to the new opportunities and to remain competitive and relevant. The challenge for banking institutions is in being able to balance between demands of the immediate term with a longer term outlook and how this would feed into the organisation's continuous renewal and transformation process.

**The 2nd Malaysian Islamic Finance - Issuers and Investors Forum 2007**  
**“Malaysia as Global Sukuk Centre: Towards Greater Vibrancy of**  
**Malaysian Sukuk Market”**  
**13 August 2007, Kuala Lumpur**

Keynote Address by

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It gives me great pleasure to speak at the 2nd Malaysian Islamic Finance - Issuers and Investors Forum 2007 that brings together industry practitioners and investors to discuss recent developments and key issues in Islamic finance. Islamic financial markets in particular, have experienced significant evolution and rapid expansion. We are now seeing the emergence of highly innovative products and services in sukuk market. My remarks today will focus on the vast growth potential of the global sukuk market and Malaysia’s experience in strengthening our market for Global Sukuk activities.

***Vast Growth Potential for sukuk***

The growing role of Islamic finance in mobilising and channelling funds to productive investment activities across borders contributes to more efficient allocation of funds across borders and facilitates international trade and investment. Greater diversification of risks also contributes towards promoting international financial stability. The more recent developments in Islamic finance is the growing significance of the sukuk market to become an increasingly important component of the Islamic financial system. Five major trends are having a significant bearing on the future development of the global sukuk market.

Firstly, the bond market is now becoming key to meeting the funding requirements for both the public and private sectors in emerging market economies. This is particularly the case for the Middle East and Asia, which are among the fastest growing regions in the global economy. This includes

financial needs of the private sector following the privatisation and implementation of infrastructure projects. The development of the Islamic Bond Market, the Sukuk Market will provide opportunities for the corporate sector, the government agencies, multinational corporations and multinational development institutions to raise funds through the issuance of sukuk to meet their financing requirements. The sukuk market also serves as an important platform, complementing the conventional bond market, in enhancing the effectiveness and efficiency for the mobilisation and allocation of funds within the domestic financial system, as well as in the international financial system.

Secondly, while there has been growing interest in the issuance of sukuks by corporations, sovereigns and multinational corporations, the demand for sukuks significantly exceeds the supply. Today, the global sukuk market, denominated in international currencies, is estimated to exceed USD50 billion. Although the size of the market is modest by global standards, the sukuk market is experiencing remarkable growth, increasing at an average rate of growth of forty per cent per annum.

The significant demand for sukuks have been spurred by the high levels of surplus savings and reserves in Asia and in the Middle East. This has been reinforced by increased liquidity in the international financial system in search of higher returns and greater diversification of risk. Since the issuance of the first sovereign global Islamic sukuk by the Government of Malaysia in 2002, there has been a series of other issues by the

governments of United Arab Emirates, Qatar, Bahrain and Pakistan. An increased number of multilateral agencies have also issued sukuk to finance development projects. In addition, both government agencies and the corporate sector have considered the sukuk market as an attractive instrument of financing.

Thirdly, there is a great number of global players such as investment banks, Islamic banks and securities firms that are involved in the issuance of sukuk in the international financial markets. A large number of Western banks are also providing Islamic financial services taking advantage of the opportunities and to provide customised products and services to their customers.

Fourthly, the established international financial centres have also shown interests to have an active role in promoting the development of the sukuk market including enacting the appropriate legislative provisions. These developments would augur well for the development of the sukuk market.

Finally, the regulatory and supervisory paradigm continues to evolve. Indeed, the recent decade had witnessed significant global shifts in the approach to regulation and supervision across many countries. In addition, the harmonisation of standards and practices is also important. The establishment of the international standard setting organizations such as the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), to formulate appropriate prudential and accounting standards that would not only facilitate the process of harmonisation but also contribute to the strengthening of the Islamic financial system. The IFSB has already formulated the prudential treatment for sukuk investment by the Islamic financial institutions as stipulated in the Capital Adequacy Standards.

### **Malaysia's Strength in the Sukuk Market**

Let me now turn to Malaysia's sukuk market. Significant progress has been achieved in the development of the Malaysian sukuk market. In 2007, Malaysia accounted for about two-thirds of the global sukuk outstanding, amounting to about USD47 billion. Malaysia not only represents the largest sukuk market in terms of outstanding size, but also in terms of number of issuance.

In developing the sukuk market, Malaysia provides a total solution for sukuk activities by providing a complete sukuk issuance and trading platform, that is supported by four elements: a wide range of Islamic instruments, strong legal and regulatory infrastructure, sound Shariah governance framework and the talent supply. These elements are also further strengthened by Malaysia's comprehensive Islamic financial system with all the key components of the financial system comprising the Islamic banking, takaful, Islamic money and capital markets that are now at an advanced stage of development. These different parts of the Islamic financial system not only facilitates the issuance and the distribution of the papers but also creates a strong demand for sukuk by providing a broad investor base.

There is also a variety of Islamic instruments in the sukuk market in Malaysia that includes currency swaps and Islamic forward contracts available to facilitate hedging and other risk management activities. The Malaysian Sukuk market, is also supported by appropriate rules and regulations, and by the pool of experienced global and domestic players as well as the legal and accounting professionals including legal and tax consultancy, as well as documentation in the issuance and trading exercise.

In promoting Malaysia as an International Islamic Financial Centre (MIFC) we aim to develop Malaysia into a centre for the origination, distribution and trading of sukuk to provide further impetus to the development of an increasingly vibrant and progressive bond market in Malaysia as well as in the Asian region. This would reinforce the international dimension of the sukuk market in Malaysia by providing linkages with international issuers and investors. To deepen and widen the bond and sukuk markets, Malaysia has further liberalised the foreign exchange administration rules to allow multilateral financial institutions, multinational and other national corporations to issue both ringgit and non-ringgit denominated instruments in our capital market.

Malaysia also has in place the financial infrastructure and facilitative rules that contribute towards efficient price discovery and shorter time to market, thus providing an efficient platform for sukuk issuance and trading activities.

The established legal, regulatory and Shariah framework in the Islamic financial infrastructure in Malaysia is reinforced by the supporting financial infrastructure, including the settlement and bond information system.

To facilitate an efficient sukuk issuance process in Malaysia, an **MIFC One-stop centre** is being established as a single contact point for efficient delivery process to facilitate the issuance of sukuk. To further facilitate this process, there is no restriction on the ability to use international rating services, on the ability to hedge positions and on the ability to swap issuance proceeds into foreign currency.

As part of our ongoing efforts to position Malaysia as an attractive gateway for the issuance of sukuk, a number of legal and regulatory requirements are further customised to reduce the cost of sukuk issuance. Profits and dividends received by non-resident investors from holding of ringgit and non-ringgit Islamic instruments

issued in Malaysia are exempted from withholding tax. Special Purpose Vehicles (SPV) for Islamic financing purposes via the Islamic capital market are not subject to the administrative procedures under the Income Tax Act 1967. In addition, companies that establish these SPVs are given a tax deduction on the issuance cost of the Islamic securities incurred by the SPV. The issuance cost for all Islamic securities approved by the Securities Commission are also eligible for tax deduction. Finally, there is a stamp duty exemption for 10 years on instruments relating to Islamic securities under the MIFC.

Malaysia has also put in place an efficient platform for trading of bonds including the Real-time Electronic Transfer of Funds and Securities System (RENTAS), Fully Automated System for Issuance/Tendering (FAST), and Bond Information and Dissemination System (BIDS) to provide post-trade transparency and market liquidity on par with developed markets. Malaysia has a payment system link with Hong Kong Monetary Authority on US dollar settlements, while the Malaysian Government Securities are clearable with Clearstream.

Finally, of importance is a conducive environment for innovation and this has been put in place. In 2006, the Malaysian market continued to generate innovative products with the launch of sukuk using Mudharabah, Musyarakah and Ijarah. Landmark issuance such as exchangeable sukuk Musyarakah by Khazanah Nasional Berhad, marked the world's first issue of its kind, incorporating full convertibility features common to conventional equity-linked transactions.

An important enabling factor driving innovation is the availability of the pool of experienced talent. There are currently 9,000 staff with the Islamic financial institutions. They are also reinforced by the workforce of domestic and foreign conventional financial institutions. This expertise that resides in Malaysia allows for the development of innovative products so as to ensure that the product design and structure, as well as the

risk management aspects that are being rigorously addressed.

There is also positive response from the local and foreign financial institutions to establish International Islamic Bank, International Takaful Operator, as well as International Currency Business Unit to undertake international currency business in Islamic finance in Malaysia. To date, eight financial institutions have been granted approval to set up such International Currency Business Units in Malaysia.

Commercial banks and investment banks licensed under the Banking and Financial Institutions Act 1989 (BAFIA) are allowed to establish International Currency Business Units to carry out Islamic banking business under their existing entities.

To enhance the delivery system to facilitate their establishment, an “executive green lane” has been accorded to expedite applications by expatriates for long-term employment passes with multiple entry visas. In addition, the Foreign Investment Committee rules are also relaxed further to allow for 100 percent foreign equity ownership in these financial institutions.

The MIFC portal has also been launched as the primary source of comprehensive online information on the latest initiatives and developments, and enables convenient access to application forms, procedures and guidelines related to entrance and participation in the MIFC. This Portal, is now accessible online at [www.mifc.com](http://www.mifc.com).

The large gathering of practitioners here for these two days to discuss the wide ranging matters that relate to issuers and investors will contribute to enhancing the collective understanding and expanding the boundaries of our knowledge on the opportunities in the sukuk market and the potential that the Malaysian sukuk market provides and its linkages with other international Islamic financial systems. This would facilitate greater cross border flows and not only contributing to enhancing greater international economic and financial integration, and thus to the global growth, but also towards financial stability of the international financial system.

### ***Supplementary Information:***

The MIFC Secretariat is pleased to announce that the MIFC Portal has been launched as a key communication platform to strengthen the global identity and branding of Malaysia as an International Islamic Financial Centre, or MIFC. The development of the MIFC Portal is an important initiative to promote awareness and global outreach of the MIFC.

The MIFC Portal provides comprehensive information on the latest initiatives, incentives and developments in the MIFC. In addition, the MIFC Portal enables convenient access to application forms, procedures and guidelines related to entrance and participation in the MIFC. The Governor of Bank Negara Malaysia announced the launch of the MIFC Portal during her keynote address at the 2nd Malaysian Islamic Finance - Investors and Issuers Forum 2007. The MIFC Portal is now accessible online at [www.mifc.com](http://www.mifc.com).

**The Malaysia - Japan Business Forum “Enhancing New Linkages And Opportunities”  
24 August 2007, Kuala Lumpur**

by

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It is my honour and great pleasure to be here to speak at this important forum which brings together government leaders and the business community from our two countries. I would like to take the opportunity to thank the Japan External Trade Organisation (JETRO) for inviting me to speak at this Forum. JETRO has played an important role in fostering the economic relations between Malaysia and Japan. While Japan and Malaysia has established strong economic ties, the environment in which we are operating has experienced pronounced changes. These changes present the potential for new linkages and opportunities between Japan and Malaysia.

***Enhancing Interlinkages and Integration in Asia***

Asia today is increasingly recognised as a dynamic growth region in the global economy. Asia’s previous success was accomplished in part by strengthening its global interlinkages by exports to the rest of the world. Today, new regional interlinkages are emerging as Asia expands further its trade and investment within the region, a trend that has generated mutually reinforcing regional growth.

The Asian economic integration is now already well advanced through the intensification of intra-regional trade and investment. Trade within Asia now accounts for more than half of the total trade of the region. This change is partly the result of the rapidly growing economies in Asia, which has created a large and expanding cumulative export market. This economic integration is also the result of Asia’s participation in the globalization of production. These trends

have led to greater diversification of economic activity in the region and a reduction in the over-concentration in the traditional export markets. In the area of investment, Japan has for several decades been a major foreign direct investor in the Asian region. A more recent phenomenon is the more widespread cross-border investment undertaken in the region to capitalise on the growing opportunities arising from the diversity of economic strengths in the region.

These developments have increased the potential for Asia to be an important engine of growth in the global economy. The advancement that has been achieved in the increased economic integration needs to be reinforced by greater financial integration. Accelerating the regional financial integration process would serve as a powerful impetus, not only for reinforcing the trade and investment inter linkages, but more importantly to facilitate a more efficient international allocation of capital. In so doing it would contribute towards unlocking Asia’s full potential in the global economy. Indeed, such greater financial integration would also play an important role in facilitating the allocation of some part of Asia’s surplus funds into productive investments within the region. The more effective and efficient recycling of funds within the region will help reduce financing costs, stabilize financial prices, and increase the potential for the diversification of risks. All this would cumulatively promote stability and resilience of the financial systems in our region. The current turmoil in the global financial markets and the uncertainties it has generated underscores the need for greater financial stability and resilience of our financial systems.

There are several ways to enhance financial interlinkages, some of which are already in progress. In the financial sector, we have already seen Asian financial institutions expand beyond domestic borders, thus strengthening the regional economic linkages. The regional authorities and regulators have also come together to develop the regional financial markets, including the capital markets, the supporting regional financial infrastructure and mechanisms for crisis management and resolution. These developments have paved the way for new forms of economic partnerships and strategic alliances and advance further the regional integration process and its inter linkages with the rest of the world.

### **Malaysia and Japan : Interlinkages and Opportunities**

Malaysia is one of the most open economies in the world, with significant global trade and investment linkages, and has become a significant profit centre for foreign direct investment for several decades. Similarly, the volume of trade activity in Malaysia is two times the size of our economy, among the highest in the world. Our outreach for trade has been with both large and small economies. For several decades Malaysia has had an extensive economic relationship with Japan, with Japanese foreign direct investment being particularly significant since the mid 1980s. Japanese investments have also been important in making Malaysia part of the regional production network. To this day, Japan remains a significant partner in trade and investment for Malaysia.

While Japan's economic relationship with Malaysia through trade and investment is well-established, going forward there is significant potential for strengthening the financial linkages. In this recent decade, Malaysia has significantly transformed our financial sector. The restructuring, consolidation and reform of the financial sector has strengthened the capacity, flexibility and resilience of the financial system. In addition, there has been the development of several new segments

of the market, including the bond market and Islamic finance. The Malaysian bond market is the largest in South East Asia with a vibrant private debt securities market. Malaysia has also continued to progressively liberalise its already open financial system to further enable free flow of funds into and out of the system. This transformation has opened up the potential for a range of new opportunities for participation in the financial sector in Malaysia and for facilitating greater financial flows within the region.

### **New Linkages and Opportunities Offered by Islamic Finance**

This decade has also witnessed a rapid evolution and global expansion of the Islamic financial services industry. Malaysia has developed a comprehensive Islamic financial system that operates in parallel with the conventional financial system. More recently, its international dimension has gained significance as Islamic finance is becoming an increasingly important part of the international financial system. In doing so it is contributing to strengthening international interlinkages between financial markets and systems that is more widespread and inclusive. The number of Islamic financial institutions worldwide has increased to more than 300 spanning over 75 countries. Total assets of the Islamic financial system are estimated to exceed one trillion US dollars. It is among the fastest growing financial segments in the world with an estimated annual growth in the region of 15 to 20 percent. There is now a growing strong demand for Islamic financial product in the global market, far exceeding the current availability of financial products and services being provided by the Islamic financial institutions.

The global development of the Islamic financial system has become particularly important in this more challenging financial and economic environment. As the international financial system becomes more diversified and as this new form of financial intermediation develops, it has presented businesses with alternative means of

raising funds while investors are presented with new asset classes. It has contributed towards greater diversification of risks. More importantly, the very fundamental requirement of Islamic finance is that it requires an underlying economic transaction thereby avoiding emphasis on speculative purposes. It also prohibits the commoditisation of risks, which leads to its proliferation through multiple layers of leveraging and disproportionate distribution. Islamic finance as a form of financial intermediation will also contribute towards enhancing the efficient mobilisation and allocation of funds across regions. This will bring about strengthening of a more wide spread and inclusive global financial integration. The greater diversification of risks also contributes towards promoting international financial stability. The transparent nature of Islamic financial contracts and the need for underlying economic transaction reinforces the stability of the Islamic financial system.

Going forward, in the current liberalised and globalised environment, Islamic finance is at the threshold of a new dimension in strengthening financial inter-linkages between nations across the globe. Just as the Old Silk Road in the 14<sup>th</sup> century offered a route that facilitated the trade in goods from the East to the West, we can now envisage the New Silk Road that facilitates financial flows across borders between the East and West. As regional financial integration intensifies, it will be a route that will facilitate this process. The previous trade linkages between the Middle East and Asian regions also has potential to strengthen, being the two of the fastest growing regions in the global economy. While the world trade has on the average expanded by 9 percent over the period 2002-2006, Asia's trade with the Middle East has increased on the average by 30 percent. In 2006 alone, mega transactions involving corporate acquisitions and real estate purchases from the Gulf to Asia, are estimated to total more than USD18 billion. Going forward, the value of such investments are expected to increase. Over the next five years, it is estimated that Asia will need USD1

trillion in terms of infrastructure investment and is in search of new partnerships and strategic investors to co-invest in these undertakings. This trend would benefit the economic regions with high savings and surpluses such as Asia and the Middle East because it would promote intermediation of a part of the surplus funds in the region to be channelled to productive investments in the region.

Several financial centres in the West, Middle East and Asia are now introducing Islamic finance as an integral part of their financial markets to offer the wide range of financial products and services. This trend is envisaged to stretch the New Silk Road from East Asia and Middle East and extend to Europe and the rest of the world. Indeed, we are already seeing the participation of global investors and the international financial community.

### *The Malaysian Experience*

Let me share with you Malaysia's experience in developing on Islamic financial system in a highly liberalised environment. Malaysia has developed a comprehensive Islamic financial system that includes the banking and takaful industries, and the Islamic money and capital markets - a matrix which mutually reinforces the integrity and stability of the Islamic financial system. Significant progress has in particular, been achieved, in the development of the Malaysian sukuk, or Islamic bond market. The Malaysian sukuk market has now evolved into the world's largest Islamic bond market. In 2007, Malaysia accounted for about two third of the global sukuk outstanding amounting to about USD47 billion. In 2002, the Government of Malaysia issued the first global sovereign sukuk. With this issuance, it became an international benchmark for the issuance of global sukuk. There have since been several further sovereign issues in the global capital market. The sukuk market has been an important source of financing for productive investment activities, while for investors, it provides greater potential for diversification into new asset classes.

The development of the Malaysian sukuk market has involved wide ranging initiatives to facilitate an efficient issuance process, the price discovery process, the broadening of the investor base, the establishment of a benchmark yield promoting the liquidity in the secondary market and strengthening of the regulatory framework. These initiatives have been reinforced by the legal and Shariah framework and the supporting financial infrastructure including the settlement system and the bond information system.

The international prudential standards for Islamic finance is set by the Islamic Financial Services Board (IFSB), is located in Malaysia . The IFSB thus formulates the international regulatory and supervisory standards for Islamic financial institutions aimed at achieving best practices in order to secure soundness and stability of the Islamic financial system. With the setting up of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), appropriate accounting standards have also been put in place to reflect the true and fair value of banking operations to ensure greater accountability and responsibility of the financial institutions.

With the increased maturity of our domestic bond market, further steps have been taken by Malaysia to allow foreign corporation, multinational corporations and multilateral agencies to raise funds in the Malaysian bond market with no restrictions for the utilisation of these funds. These funds maybe used to finance foreign investment activities outside the country. Following this liberalisation, the inaugural ringgit denominated sukuk issue was in 2004 by the International Finance Corporation (the investment arm of the IBRD World Bank),

followed by the issue by the IBRD World Bank in 2005. In November of 2006, our market was further liberalised to allow for the raising of foreign currency sukuks from our domestic market. More recently, a landmark issuance the 750 million dollars exchangeable sukuk Musyarakah by Khazanah Nasional, the Government's investment arm, marked the world's first issue of its kind, incorporating full convertibility features common to conventional equity-linked transactions. These issues have attracted investors from outside of Malaysia , thereby strengthening our inter-linkages with other international financial markets.

I am pleased to mention that a memorandum of understanding between the Central Bank of Malaysia and the Japan Bank for International Corporation (JBIC) has been signed this year for us to advance relations in this area between JBIC and the central Bank of Malaysia . In addition, a Japanese consumer credit company based in Malaysia marked another significant milestone by issuing an Islamic commercial papers early this year.

The changes that have occurred in the economic and financial environment in our region and the global environment have presented us with wide ranging new opportunities. The partnership between Malaysia and Japan thus not only needs to evolve not only in the trade in goods and direct investment but also needs to encompass growing financial ties. Islamic finance represents a vehicle that could further deepen our financial relationship and the regional integration process. In enhancing these new linkages and greater integration, it would contribute towards unlocking the new potential opportunities for our mutual prosperity.

**The 2007 INCEIF Global Forum “Leadership in Global Finance -  
The Emerging Islamic Horizon”  
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Keynote Address by

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

It is my honour and great pleasure to be here to speak at this first INCEIF Global Forum, which has drawn together a distinguished gathering of scholars, researchers and practitioners from the financial services industry. Let me focus on the international dimension of Islamic finance which has continued to gain significance. Islamic finance now extends beyond the traditional predominantly Muslim economies to become an increasingly important part of the international financial system. Total assets of the Islamic financial system are estimated to exceed one trillion US dollars. It is among the fastest growing financial segments in the international financial system with an estimated annual growth of 15 to 20 percent. There is now a growing demand for Islamic financial products in the global market, far exceeding the supply of financial products and services that is being offered by the Islamic financial institutions.

As we advance forward, the international environment in which we are operating is also rapidly evolving to become **more complex, competitive and challenging**. In the current environment it has become more volatile and uncertain. The challenge for Islamic finance is to evolve strategies that will ensure its competitiveness, dynamism and sustainability. An aspect in the contemporary global Islamic finance that is fundamental is the ‘principled centred’ nature of Leadership in Islam, that involves “trust” (*amanah*), and with that comes “responsibility” (*taklif*) and “accountability” (*mas’-u-li-yah*<sup>1</sup>). My remarks today will discuss the positive elements that Islamic

finance brings to the global financial system, its prospects for enhancing international integration and the potential to strengthen the socio economic aspects of Islamic finance.

**Optimizing Benefits of Islamic Finance**

In evolving the international dimension of Islamic finance an important aspect is the optimization of the oasis of benefits and opportunities Islamic finance has the potential to provide. Islamic finance implicitly embraces strong core values and universally beneficial characters. The fundamental requirement of Islamic finance is that it confines its activities to that which is supported by an underlying economic transaction thereby avoiding emphasis on speculative purposes. The Islamic principles require that the financial transaction be accompanied by genuine trade and business related transactions. This provides for a high level of disclosure and transparency. This thus prohibits the commoditisation of risks, which effectively leads to its proliferation through multiple layers of leveraging and disproportionate distribution. It reduces the potential for information gaps and for mispricing of risks and thus avoids the elements that could contribute to uncertainty and disruptive market conditions.

The Islamic financial system derives its strength and stability from its faculty to uphold Shariah principles. The Islamic financial system thus has an in-built dimension that promotes financial soundness and stability,

<sup>1</sup> ICLIF Leadership Competency Model - Syed Naquib al-Attas & Wan Mohd Nor Wan Daud

as it resides within a financial trajectory underpinned by the forces of Shariah injunctions. These Shariah injunctions interweave Islamic financial transactions with genuine productive activities and prohibit involvement in illegal and unethical activities. This intrinsic principle of governance contributes towards insulating the Islamic financial system from the potential risks of financial stress triggered by excessive leverage and speculative financial activities. Equally important is that the key components of the Islamic financial system, comprising the financial institutions, the markets and the financial infrastructure, has demonstrated its viability and robustness as a form of financial intermediation, with a mutually reinforcing role in enhancing the overall stability of the financial system. Its growing role in mobilising and channeling the funds to productive investment activities across borders brings significant benefits to the global economy. Firstly, it has the potential to contribute global growth and contributing towards some rebalancing of the global growth given that it brings about a more inclusive financial integration. Secondly, the strengthened international financial linkages allows for the potential for greater diversification of risks. The increase in the Islamic financial products, the growing number of assets classes being offered, the increased cross ownership of assets have all expanded the possibilities for greater diversification of risks and the potential for return.

The intrinsic nature of Islamic finance encourages risk management and provides confidence through explicit disclosure and transparency of the roles and responsibilities defined in the contract. The transparent nature of the Islamic financial contracts and the need for underlying economic transaction reinforces the stability of the Islamic financial system.

A vital challenge going forward is however to build a stronger, competitive and dynamic Islamic financial system that

better reflects the internalization of Shariah principles in financial transactions, in its form, spirit and substance. This epitomizes the objectives of the Shariah in promoting economic and social justice. While developing Islamic financial system with products and services mirroring the conventional counterpart is acceptable as a pragmatic approach, it needs to develop further on its own paths and merits so as to maximize the potential benefits of Islamic financial system. Key to this is having an appropriate pricing benchmark to be an indicator for Islamic securities to be efficiently priced and credible. In addition, the role of Shariah scholars who have the full understanding of the mechanics of Islamic financial products and services, are key to ensuring its continued development. At the same time, Shariah decisions, when made, needs to be disclosed. This will allow others to appreciate the juristic reasoning, which in turn would lead to a wider acceptance of Shariah decisions, particularly if they have implications on cross-border transactions.

As the Islamic financial system becomes increasingly more internationally-integrated, it is important to recognize the different regional and institutional strengths and complementarities and the need to maximize synergies. Collaboration among regional centres and key players in Islamic finance will be an important part of the process that will contribute towards greater international financial integration. Constructive engagement in the form of strategic partnerships and collaboration, as well as in market access needs to be enhanced. Allowing greater market access among players in Islamic financial centres can be a catalyst for enhanced integration and innovative elements in the Islamic financial industry.

Malaysia's experience in strengthening the international dimension of the Islamic financial system has shown positive results. This has commenced in 2002 with the inaugural issuance of a global Sukuk to the

liberalizing to allow for greater market access in Islamic banking and takaful initiatives by permitting entry of foreign players.

The third area of international integration is the liberalization of our financial markets to allow for greater foreign participation. In particular, in the sukuk market, foreign corporations, multinationals and multilateral agencies may raise ringgit and foreign currency denominated instruments in our market. Our private debt securities market is the largest in South East Asia. Malaysia also has highly liberalized exchange administration system that allows for the free inflow and outflow of funds. There is also no restriction on the utilization of the funds raised in our market. The funds may be utilized for investments outside the country.

Finally, our own financial institutions have ventured beyond our domestic borders. These cumulative developments have strengthened our linkages with other Islamic financial centres.

Another area important for Islamic finance is the investment in research and development (R&D). The promotion of international strategic alliances through smart partnerships can create greater synergy that will bring about new approaches, new technologies and new areas of specialization. Such collaborative efforts amongst Islamic financial institutions would strengthen the ability to leverage on the industry's expertise. The introduction of innovative Islamic financial products in a specific jurisdictions can be expanded to other jurisdictions, which in turn, will contribute to broaden and deepen Islamic financial markets and thus strengthen the overall development of the Islamic financial industry. In addition, collaboration between academic researchers and the practitioners will enable the practical application of such research findings. In the area of education and training in Islamic finance, there is now a critical shortage of talent in the Islamic financial industry. Collaboration between training institutions is

vital to developing the pool of expertise in Islamic finance that subscribes to common standards. Establishing a network of mutual co-operation and collaboration would strengthen the efforts among the institutions of higher learning across regions in the areas of curriculum development, research, training, exchange of ideas and information, and resources in Islamic finance. Such partnerships in connecting the knowledge communities between regions would facilitate this process.

In the area of Shariah, the progressive convergence of Shariah views and rulings, the mutual recognition of financial standards and products across jurisdictions would be major 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.

Finally this integration process also requires greater cooperation among the regulators to ensure that the Islamic financial system is not subject to vulnerabilities and abuses and thus ensuring its soundness and stability. In this respect, the sharing of information among the regulators including across borders is important especially in a more globalised and liberalised environment where financial transactions and activities have become more complex and globalised. In this regard, there is a greater need for regulators to be continuously connected to share information on key issues and developments faced in their own financial jurisdictions. In this respect, the Islamic Financial Services Board has an important role to facilitate this process.

Closer financial linkages among Islamic financial institutions from different jurisdictions is essential to contribute towards accelerating the process and towards serving as a bridge to strengthen the relationship of the international Islamic financial markets as well

as the investment and trade ties between regions. Such linkages within the industry could also lead to new product offerings and to co-arranging financing. There could also be mutual development of IT systems and other technologies including other research and development endeavours.

Finally, let me touch on the development of the socio-economic aspects of Islamic finance. While “profit motivated” Islamic financial institutions will continue to evolve and gain greater significance, this trend also needs to be complemented with similar evolution in the socio economic aspects of Islamic finance such as waqf and zakat. A stronger zakat and waqf system would not only complete the equation for a comprehensive Islamic financial system that supports a more equitable distribution of wealth to ensure fairness and equity, it will also become the user of the Islamic financial services particularly in the management and investment of the zakat and waqf funds. In

addition, access to Islamic financial services to micro enterprises would bring such activities into the economic mainstream and improve their level of performance.

### **Conclusion**

As Islamic finance advances forward to become an integral component of the international financial system, continuous efforts are needed to further develop the domestic financial system to meet the changing requirements of a highly dynamic and rapidly evolving environment. In our quest to build a viable and sustainable Islamic financial system, the aim is to contribute to the channeling of capital flows to productive investments, create wealth and promote economic activities, that conforms to the principles and values of Shariah. With this, the Islamic financial system will ultimately bring benefit not just among Muslims but with the rest of humanity, Inshaallah.