

**Speech at the Islamic Finance Conference
“Islamic Finance in Southeast Asia: Local Practices, Global Impact”
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“Enhancing Interlinkages and Opportunities - The Role of Islamic Finance”

by

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

It is my great pleasure to be here in Washington D.C. to speak at this important conference which has brought together policymakers, market practitioners, members of the academia and the business community to discuss the new opportunities in Islamic finance and its role in enhancing international financial linkages. It is exactly five years ago, when I spoke on this very subject of Islamic Finance at the First International Islamic Finance Conference that was held in Washington D.C. in 2002. The issues discussed at that time were on the challenges faced in developing an efficient and robust Islamic financial system. Five years hence, the Islamic financial system has evolved significantly to become a dynamic and competitive form of financial intermediation in the global financial system. This transformation has been achieved in an increasingly challenging environment.

My remarks today will focus on this transformation that has taken place in these five years in both the national and international Islamic financial system. Most significant has been the development of the Islamic financial markets, the increase in the range of the financial products and services, the increasing significance of the international dimension of Islamic finance, the development of the international Islamic financial architecture, and the enhanced international inter-linkages that has been brought about by these developments.

Transformation of the Islamic financial landscape

As recent as five years ago, the development of Islamic finance was regarded as an infant industry striving to prove its viability and competitiveness. At that time, the growth of Islamic finance was organic and largely concentrated in countries where the Muslim population was significant. In these five years, Islamic finance has recorded dramatic growth and has a presence in more than 75 countries both in Muslim and non-Muslim dominated communities. There are also a growing number of the international financial centres that are beginning to offer Islamic financial products and services such as in London, Singapore and Hong Kong. The number of Islamic banking institutions worldwide including conventional banks that are offering Islamic banking services have doubled to more than 300. The total Islamic financial assets under their management is now estimated to exceed one trillion US dollars, about fivefold its magnitude five years ago.

Islamic finance is now among the fastest growing financial segments in the international financial system with an estimated average annual growth of between 15 to 20 percent. More recently, there has been a growing diversity in the range of products and services being offered and in the markets that have been developed. The sukuk market, that is the Islamic bond market denominated in

international currencies, has registered a remarkable growth, having doubling in size to amount to USD28 billion compared to a year ago. Including sukuks denominated in domestic currencies, the size of the market is now about USD82 billion. This market is expected to continue to expand significantly given the massive financing requirements for infrastructure investment and other private sector investment by countries that have shown interest in Islamic funding.

There has also been significant innovation in Islamic financial products. This has been especially evident in the sukuk products. Following the Malaysian Government issuance of the world's first global sovereign sukuk in 2002, there has been several other sovereign sukuks issued by other countries. This development has also encouraged the issuance of international corporate sukuks by multinational and domestic corporations. Innovative instruments that have been developed include the landmark issuance in 2006 of the exchangeable sukuk by Khazanah Nasional, the Malaysian sovereign wealth management entity. In this arrangement, the sukuk can be exchanged for other shares held by Khazanah. In the same year, a convertible sukuk, in which the sukuk can be converted to the issuer's own shares upon initial public offering, was issued by a Middle Eastern-based corporation. The derivative market has also been developed with the introduction of Islamic currency swaps and profit rate swaps.

There has also been significant growth in Islamic asset and wealth management following the development of diverse and innovative structures of Islamic investment funds, including Islamic hedge funds. There are now more than 250 Shariah-compliant mutual funds that are managing an estimated USD300 billion in assets. Other developments include the creation of benchmark indices such as the Dow Jones Islamic Market Indexes - covering more than USD10 trillion market capitalisation in over 40 countries, the Financial Times Stock Exchange Global Islamic Index Series, and the listing of Islamic financial instruments on international

exchanges. These developments have enhanced the depth of the Islamic financial markets as an attractive asset class for investment.

Another important development in Islamic finance during this period has been the strengthening of the international Islamic financial architecture. In 2002, a major structural enhancement was the establishment of the Islamic Financial Services Board (IFSB), which formulates the international regulatory and prudential standards for Islamic finance. It has since issued the standards for capital adequacy, risk management and corporate governance. Among the standards that are currently being formulated include market conduct and rules for financial disclosure, transparency, the Shariah governance framework and the supervisory review process. This is to ensure best practices and the soundness and stability of the Islamic financial system.

The IFSB now has 137 members that include 35 regulatory and supervisory authorities, five international inter-government organisations including the BIS, World Bank and the IMF, and 97 market players and professional firms from 22 jurisdictions. Of significance to note is that the membership of the IFSB comprises several authorities and international institutions from the non-Muslim countries. The IFSB complements the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) which was established earlier in 1991, to set the accounting standards to ensure that the true and fair value are reflected in the financial transactions and to ensure greater accountability and responsibility of the financial institutions.

Finally, these developments have been reinforced by greater liberalisation to increase the international dimension of Islamic finance. With increased international participation in Islamic financial markets, it has prompted increased cross-border Islamic financial flows. In addition, Islamic financial institutions that had previously operated only in their own domestic jurisdictions have begun to venture

abroad to tap new growth opportunities in other regions. This new international dimension of Islamic finance has enhanced further the international inter-linkages in this more globalised environment.

Islamic finance: Operating in a challenging and evolving environment

The evolution and expansion of Islamic finance has occurred in a fast changing and dynamic international environment. In the context of a more challenging and competitive environment, the issue of financial stability, viability and competitiveness are paramount. This is particularly evident in the recent developments experienced in the international financial system. An important element of Islamic finance is the strength and soundness it derives from its Shariah principles. Islamic finance has an inbuilt dimension that promotes soundness and stability, underpinned by the Shariah injunctions. These Shariah injunctions essentially interweave the financial transactions with genuine productive activities.

The soundness and viability of Islamic finance as a form of financial intermediation is premised on the fundamental requirement that Islamic financial transactions need to be supported by an underlying productive activity. There is therefore always a close link between financial and productive flows. The financial transaction has to be accompanied by genuine trade or lease-based and business related transactions where interest is eliminated and profits or rentals are the economic rewards. Alternatively, the Islamic financial institution may enter into a joint venture as a means of financing, in which it becomes a joint partner in the economic activity based on a pre-specified profit sharing arrangement. In addition, there are also explicit restrictions on unethical and speculative financial activities.

The intrinsic nature of Islamic finance also encourages risk management and provides confidence through explicit disclosure and transparency of the roles

and responsibilities defined in the contract. In Islamic finance, strategies to minimize and manage the risks involve integrating the risks in the real activities. The real activities thus 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. This could result in higher systemic risks, increasing the potential for instability and inequitable concentration of wealth.

The intrinsic principle of governance also contributes towards insulating the Islamic financial system from potential risks from excessive leverage and speculative financial activities. The explicit and transparent nature of Islamic financial contracts and the greater disclosure of information are important in contributing to the stability of the system. The focus of Islamic investment also not only involves riba free activities but also extends to include issues related to ethical values and fair trade. The Islamic investment guidelines thus share a number of similarities with socially responsible investment (SRI) principles.

New opportunities and linkages offered by Islamic finance

Islamic finance is now at the threshold of a new dimension in which it has an increased potential role to strengthen international financial inter-linkages between nations. Islamic finance has the potential to contribute towards the efficient mobilization and allocation of funds across regions. Regions with surplus savings may channel funds to regions with deficit savings and to bring about a more inclusive global financial integration. Financial linkages are now gaining ground as intra-regional financial flows are increasing in significance. In this context, Islamic finance has become a new vehicle contributing to

increasing the financial linkages within Asia thereby facilitating cross-border allocation of capital in the region. However, it not only has a potential role in strengthening integration and linkages within Asia, but also more importantly in forging linkages with other dynamic emerging regions such as the Middle East.

Several economies within Asia are now beginning to participate in these trends thus strengthening further economic and financial linkages between these two dynamic growth regions. This enhanced inter regional linkages between Asian and the Middle East has created an environment of activity reminiscent of the Old Silk Road. This suggests that a New Silk Road has emerged in which financial services providers across continents now operate on this new route. While the New Silk Road reflects the linkages between Asia and the Middle East, the Silk Road has always been extended to the rest of the world. There is thus the potential for greater participation by global investors and the international financial community.

Islamic finance essentially presents value propositions for both investors and issuers in the respective markets, in particular, the sukuk market. For investors, Islamic financial products offer portfolio diversification and new investment opportunities in the form of new asset classes. 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. A number of international financial centres have recognised Islamic finance as an integral part of their financial markets in order to complete the suite of financial products and services available, and are therefore actively developing this segment. This trend is envisaged to stretch the New Silk Road from Asia and Middle East and extend to the West and to other parts of the world.

Further opportunities: The Sukuk Market

Among the more significant developments in Islamic finance in the recent period has been the development of the Sukuk market.

Although the size of the Sukuk market is modest by global standards, the Sukuk market has experienced remarkable growth, increasing at an average annual rate of growth of 40 percent. This growth is spurred in part by the growing funding requirements in emerging market economies, in particular, in Asia and the Middle East in which there has been increased investment activity. There has also been significant demand for the Sukuk spurred by the high levels of surplus savings and reserves in Asia and in the Middle East. This strong demand has also has been reinforced by the strong financial flows in the international financial system that is in search of higher returns and greater diversification of risks.

It has been estimated however that about 80 percent of the sukuk issued have been subscribed by conventional international investors. Besides the intrinsic value of the sukuk which are largely asset-backed, convertible for shares or exchangeable with shares, such issuances are attractive as they have a wider investor base that comprise conventional and Islamic investors. With the rising wealth of global investors seeking Shariah compliant investments the market has become highly competitive. More recently, it has prompted corporations worldwide including global multinational companies to consider this as a financing option.

The development of the sukuk market in Malaysia has involved extensive and wide ranging initiatives that include facilitating an efficient issuance process, enhancing the price discovery process, establishing of a benchmark yield, broadening of the investor base, promoting the liquidity in the secondary market and strengthening further the legal, regulatory and the Shariah framework. These initiatives have also been supported by the development of the financial infrastructure including the settlement system and the bond information system.

To position Malaysia as a centre for origination, distribution and trading of sukuk, further steps have been taken to liberalise the market to allow foreign corporations

including multinational corporations and multilateral agencies to raise funds in the Malaysian bond market. Funds raised by these entities may be used to finance investment activities in other jurisdictions. The inaugural ringgit denominated Sukuk issue was in 2004 by the International Finance Corporation, and followed by an issue by the IBRD World bank in 2005. In 2006, the market was further liberalized to allow foreign currency denominated sukuk to be issued from the Malaysian market. These sukuk issues have attracted foreign investors, thereby strengthening our inter-linkages with other international financial markets. Profits or income received by non-residents for investments in ringgit and non-ringgit Islamic securities issued in Malaysia are also exempted from withholding tax. In addition, the Government has granted tax neutrality measures to accommodate the sukuk issuance.

To further enhance Malaysia's international financial linkages with other parts of the world, the domestic Islamic banking sector was liberalised further in 2004 with the issuance of new licenses to foreign Islamic financial institutions. In addition, the allowed foreign shareholding in Islamic financial institutions was raised to 49 percent of the total equity in existing Islamic financial institutions. New licenses are also extended to entities to conduct Islamic banking business and takaful and retakaful business in international currencies. These institutions, which may have up to 100% foreign equity ownership, are given operational flexibility to be established as a branch or subsidiary and enjoy a tax holiday for 10 years under the Income Tax Act.

Concluding Remarks

The foundations for the sustainable global development of Islamic finance have now been put in place. Going forward, three key elements will be important in sustaining the current momentum. These include the investment in research and development and hence promote innovation, the development

of the pool of talent, and the greater use of technology in Islamic finance.

Islamic finance as an emerging form of financial intermediation would require tremendous investment in research and development to promote innovation. Of importance is to develop a broader range of Islamic financial market instruments that include instruments with equity ownership features, Islamic asset-backed securities, inclusion of permissible forms of credit enhancements as well as Shariah-compliant risk mitigating instruments. The development of an Islamic derivatives market for hedging is required for market-making activities to support the development of secondary markets. Malaysia has recently established a Shariah Scholar's fund to fund such research and development efforts. The fund also aims to promote greater engagement among the international Shariah scholars and thus provide a platform for deliberation on the Shariah compatibility of newly developed Islamic financial instruments and markets.

As Islamic finance continues its robust international expansion, an adequate supply of talent and expertise is vital to support the growth. While shortages in talent are now being felt, this is being addressed on several fronts. To develop the expertise to meet the increasing manpower requirements of Islamic finance, Malaysia has in 2006 established the International Centre for Education in Islamic Finance (INCEIF). It is envisioned that INCEIF acts as a professional certification body and education institute for post-graduates in Islamic Finance. Reinforcing this is the International Centre for Leadership in Finance (ICLIF) in Malaysia that provides for leadership and management programmes for the financial services sector including for Islamic finance.

As Islamic finance forges ahead, successful Islamic financial institutions will be those that have the scale and are able to exploit the full potential and opportunities that arise from the advances in information technology (IT). In embracing new leading

edge technology, the potential for the Islamic financial industry to provide new products and services will be enhanced. It also represents the potential to increase access through a wider range of new delivery channels, including enhancing efficiency while reducing costs for consumers and businesses. IT needs to be leveraged on in making strategic decisions in the alignment of the business, in elevating the institutional capacity and operational efficiency and strengthening risk management capabilities.

Despite the more challenging and dynamic environment we have seen, Islamic

finance has continued to emerge as a vibrant and resilient form of financial intermediation that is increasingly being embraced on a global scale to become an integral part of the international financial system. In the process of its development, it has further expanded the set of opportunities for the participation by the international financial community and thus increases the inter-linkages both within and between economic regions of the world. In enhancing these new linkages and greater integration, Islamic finance is envisaged to contribute towards unlocking new potentials that would bring mutual benefits, and in doing so, enhance our overall prospects.

**Malaysia Financial Exhibition 2007 at the Mid Valley Exhibition Centre
30 October 2007**

Opening Speech by

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

It is my pleasure to be here this afternoon at the Opening Ceremony for the Malaysia Financial Exhibition 2007 or MYFex2007, organised by PIDM, Perbadanan Insurans Deposit Malaysia. PIDM was established two years ago to reinforce the role of Bank Negara Malaysia in ensuring the soundness and stability of the financial system. PIDM forms part of the financial safety net and plays a crucial role in administering an effective deposit insurance system that promotes public confidence in the soundness of the banking system. Public Confidence is key to financial stability and to the efficient functioning of the financial system. In this context, PIDM is actively raising awareness about deposit insurance and this exhibition is an effort to frame deposit insurance within the larger scope of the financial landscape.

A financial system that is not firmly rooted in the public belief that it is safe and sound cannot hope to expand and evolve successfully. This confidence is enhanced with having an effective deposit insurance whose role is to act in the best interest of depositors. With an explicit deposit insurance system, depositors can have further certainty of the safety of their money at the banking institution as well as knowing that banking system has a strong element of protection that can be count upon.

The Malaysian financial sector has undergone significant transformation and progress since we launched the Financial Sector Masterplan in 2001. This is particularly most evident in the banking sector which has undergone restructuring, consolidation, and rationalisation. Gradual deregulation and liberalization has also altered the

financial landscape bringing with it improved performance and enhanced resilience. This has further matured the banking sector and paved the way for new areas of growth. Besides these tangible results, structural changes have also taken place in the form of the emergence of new entities, the increased presence of new international players and more diversified and developed financial markets. The advancement of deregulation and liberalization have also increased competition which has in turn resulted in further new business opportunities. Within the context of these developments, the banking sector has become an important pillar of strength of our economy.

One dimension that is growing rapidly in the context of these developments is the rise of consumerism. The improvement in the quality of life, the rising affluence and better education has resulted in a new generation of consumers whose financial requirements are becoming increasingly more sophisticated. This has resulted in a major reorientation of the banking industry to become consumer driven and to become more focussed on consumer needs. This has brought new financial products and services for consumers. The rise of consumerism demands that products and services can no longer be just generic but must now be tailored to meet consumers' evolving needs.

With the rise of consumerism, the need to create informed consumers is even more important. As the financial sector continues to rapidly evolve, offering sophisticated products and services to cater for greater and more diverse needs, consumers need to become even more financially savvy. While

the consumer has an important responsibility to become more informed, financial service providers, the regulators and the authorities have an important role to provide the enabling and conducive environment that nurtures consumer empowerment. Indeed, consumer empowerment begins with financial awareness and consumer education. This in part can be achieved through greater disclosure and by increasing the education outreach to consumers thereby enhancing their ability to make informed financial decisions.

This exhibition aims to provide an enabling platform for consumer empowerment. MYFex2007 is a conscious effort to raise financial awareness by bringing together the various entities in the financial system that includes the industry, regulators and other agencies that provide information, the avenues for redress and financial advice with the aim of creating financially informed consumers. In essence, this one stop centre creates a comprehensive opportunity for consumers to improve their financial literacy and for the financial players to engage the consumers.

An important thrust of our policies at the Central Bank is financial inclusion. This is to ensure that every economic activity, geographical region and segments of society have access to financial services thereby promoting a more balanced growth. Financial inclusion is supported through a number of strategies amongst which includes increased access to financial services, access to financial information and advisory services and consumer education. Currently, 98% of the adult population in Malaysia have a savings account. Given this greater financial inclusion, banks need to recognise their role and their special relationship with their customers. Customers expect banks to provide relevant financial information to them to ensure that they will be able make informed judgments.

Avenues for the public to seek redress is also an important part of the financial safety net. The Financial Mediation Bureau provides an alternative redress mechanism

between the service providers and consumers on financial disputes. In addition, with the objective of promoting prudent financial management, the Credit Counselling and Debt Management Agency offers free advisory services. This is to ensure the sustainability and resilience of the household sector. In addition, there is also the BNMLINK and BNMTELELINK at the Central Bank to provide a further interface with the public.

The objectives of financial inclusion can also be met with the support of banking institutions as the benefits would justify the effort. Banks and other financial institutions that approach their business strategies responsibly and with the consumer interest in mind will 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.

Public confidence is an important pre-condition for financial stability. Public confidence is however, not one that is created and expected to remain constant without making conscious efforts to enhance it. Public confidence must be created, nurtured and continuously enhanced by all the players in the financial sector working together through a range of approaches and strategies. This mandate requires a holistic and a collaborative effort of the authorities, financial service providers, private sector, educators and related associations that are here today.

I am delighted to note that MYFex2007 is one such effort. In the short 26 months it has been in existence, PIDM has gone beyond its statutory duty to create public awareness about deposit insurance and promoting public confidence in the resilience of the Malaysian financial system. They have embarked on a noteworthy initiative to contribute to financial system stability by organising a comprehensive financial awareness exhibition that seeks to create informed consumers with a view to contribute to financial system stability. I am pleased to see various Government agencies, the market players and related associations

and professional bodies participating in this important financial awareness initiative.

The vision for an effective, efficient and resilient financial sector requires the unified

efforts of all the stakeholders in the financial system. The financial players, the regulators, the Government and the consumers all have a meaningful role in achieving this vision. With this let me conclude my remarks.

**6th International Association of Deposit Insurers (IADI) Annual Conference
“Deposit Insurance and Consumer Protection”
31 October 2007, Kuala Lumpur**

Keynote Address by

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

As the international and domestic financial landscape continues to transform, the quest to secure financial stability has become increasingly challenging. Regardless of the stage of development, financial systems have continued to be vulnerable to crisis that have resulted in financial disruptions that have had severe economic repercussions. In these circumstances regulators and financial safety net frameworks have been tested to the limit.

While the rapid pace of globalisation, the rising internationalisation of the financial system and the advances in technology have brought benefits in terms of increased access to new markets, encouraging financial innovation and increasing consumer choice, it has also brought new risks to the financial system. The intensification of cross-border financing, and the growing complexity of financial structures has resulted in new international inter-linkages which has increased the international interdependence. The transmission of negative shocks in one country to others via the international financial system has demonstrated the potential for financial crises and economic disruptions to spread on a global scale. These concerns have been brought into the forefront recently with the developments in the sub-prime mortgage market in the United States and its contagion effect on financial systems in other parts of the world. Indeed, it has shown that in today’s globalised and increasingly internationally integrated financial markets, seemingly isolated events in a small segment in one market can have far reaching and vastly magnified implications in other financial markets across the world.

This recent episode of financial turmoil has shown that even the more sophisticated

and informed investors are pre-disposed to over-react to uncertainties in financial institutions. It also needs to be recognised that the changes in the international environment has also increased the challenges to understanding and managing risks, even for financial institutions and the authorities. These developments have also brought issues of the effectiveness of financial safety nets as well as institutional arrangements for the regulation and supervision of banks, to the forefront.

Elements of financial safety net

It is in this context that the components of the financial safety net, the prudential regulation and supervision, deposit insurance, liquidity support arrangements, crisis management approaches and the consumer protection framework - have continued to evolve over the recent decade. My remarks this morning will consider some of the developments and challenges that are shaping the calibration of the financial safety net in the current environment.

Prudential regulation and supervision

Sound risk management by banking institutions, which is reinforced by prudential regulation and supervision, remains the first line of defence against financial crisis. This recent decade has seen important strides being achieved at both the international and national levels towards strengthening the prudential regulatory and supervisory frameworks in response to the changing nature and scope of banking activities.

While lending and deposit-taking remain the mainstay of commercial banking,

the profile of credit markets has changed significantly. Today, conventional credit products are being offered alongside the growing significance of asset securitisation and credit derivative activities. This has had a profound impact on the nature of banking. The rapid development of these synthetic credit markets, coupled with an extended period of ample liquidity in the global financial system, has expanded the avenues for banks to engage in more aggressive lending practices that are funded by borrowing from the wholesale money markets, and by repackaging and selling loans to other investors in the form of asset-backed securities. This represents a significant shift from the more traditional banking models where loans are predominantly funded by deposits.

The increasing complexity in the way that debt is created and distributed in the financial system raises important implications for financial stability. The “originate and distribute” strategy that has been adopted by some institutions warrants addressing more comprehensively the full range of risks to which the banks are exposed. This includes the liquidity, foreign exchange and moral hazard risks in banking institutions. Credit risk exposures have also taken on more complicated forms, including counterparty risks on derivatives and foreign exchange transactions. The valuation of such financial transactions and instruments are also often difficult to measure particularly under distressed market conditions. In addition, the correlations between credit and market risk, both within and across national borders, have become more complex. Of concern has also been lack of adequate information on debt concentrations in the system partly due to the increasingly elaborate ways in which debt is passed on from originating institutions to different investors. The propensity to under-price credit risk, especially under conditions of excess liquidity, has also increased concerns over underwriting standards. The consequent sharp pricing corrections would in turn have the potential to result in broader economic disruptions.

Recent developments in the prudential regulatory and supervisory framework have, and will continue to play an important role in promoting sound risk management practices in the light of these changes. These of course, include the modification of capital standards that are more granular in addressing different types of risk. Supervisory approaches globally have also evolved to place a greater emphasis on sound risk management and early interventions to address emerging risks before they become major problems. There is also more emphasis being placed on the expectations of financial institutions to play a greater role in ensuring that financial products offered to customers and investors are suitable given their needs and financial circumstances, and that they have a good understanding of risks assumed with the products.

Bank Negara Malaysia’s approach to the financial regulation and supervision has similarly evolved to achieve a more robust regime that emphasises three key dimensions: first, creating a strong risk management culture that overlays the operations of banking institutions; second, facilitating market-led adjustments that will allow the industry to evolve in response to market and technological developments; and third, ensuring mutually consistent prudential policies across the financial sector.

Underpinning this approach has been a more pronounced shift towards principle-based regulations. Increasingly, regulations have focused less on prescriptive rules, and more on establishing broad parameters for sound financial and business practices that leave substantial flexibility for banks to apply the principles in the manner most appropriate to their specific circumstances. Of importance, has been the creation of appropriate incentives within the system to counteract potential market distortions that could undermine financial stability. The differentiated regulatory framework under which stronger banking institutions would have substantially greater operating flexibility and a lower level of supervisory intervention,

for example, provides a powerful competitive incentive for the adoption of sound risk management practices.

While enhanced bank regulatory and supervisory functions have had a direct and significant impact on improved risk management by banking institutions, the primary responsibility for sound institutional risk management will continue to rest with the boards and senior management of banks. It is the boards, and not supervisors, that are principally responsible for the performance of banks and for their financial strength. Boards set the tone for their institutions' risk taking activities, and provide effective oversight to ensure that their decisions are followed. Of paramount importance is the need for boards to ensure that risks are estimated in a consistent and timely manner, and escalated to the board with attention being focussed on the management of the emerging risks. Today, boards face additional challenges of discharging these responsibilities in an environment that is rapidly changing and highly competitive. Achieving effective boards and strengthening the foundations of sound corporate governance have therefore become a priority in the reform agenda for many countries in the recent period. The implementation of Basel II, new financial reporting standards and principles-based regulatory approaches have also significantly increased the importance of, and reliance on sound judgement, integrity and competence by the board and senior management. This, in turn has been a key driver in galvanising efforts to strengthen market discipline as a countervailing influence that will rein in high risk behaviour by banking institutions.

Achieving a framework with the right mix of regulatory and market-based incentives, however, continues to remain a significant challenge. Transitioning to market-based discipline can be particularly challenging in emerging markets where regulation has tended to be more prescriptive. In these markets, safety nets are also more prevalent and the tolerance for institutional failures is lower given its far reaching implications on consumer confidence. For the most part,

the liabilities of banks are not traded in the market, so debtholders generally lack the opportunity to exercise market discipline. Moreover, the market preoccupation with short-term stock price, rather than long-term creditworthiness also presents potential risks to financial stability.

Notwithstanding these challenges, several recent positive developments in emerging economies have augured well for market discipline to have a more effective role in reinforcing sound governance. In particular, the development of financial markets have resulted in more efficient markets with wide options for investors to exert discipline. The adoption of international financial reporting standards, efforts to strengthen auditor independence as well as financial capability initiatives will also reinforce market-based discipline going forward.

All of these initiatives will improve the prospects for financial stability by preventing problems from occurring at the level of individual institutions. However, the recent events in the international financial environment have demonstrated the increasing complexity of banking activities which has raised the broader challenges for financial regulation and the design of safety nets in the context of managing systemic risk. Regulators have begun to carefully consider the need to re-calibrate current regulatory approaches to appropriately address risks to the financial system stemming from large and complex institutions that are increasingly engaged in non-traditional activities. This has, in turn, placed new demands on financial regulators as well as for institutions to develop a deeper understanding of the inter-linkages between the financial system and the economy, and in particular, the macro-economic transmission of financial risk. Going forward, a more optimal balance of micro (that is, at the institution level) and macro (that is, affecting broader economy) responses will become increasingly important in the management of such systemic risks.

An important dimension to effectively manage the increasing inter-linkages between

the financial system and the economy involves the strengthening of cooperative arrangements between Central Banks and other regulatory authorities, within and across borders. Indeed, cooperation, coordination and goodwill have become essential in the increasingly integrated system. Such arrangements could include the more formal institutional arrangements for cooperation in surveillance efforts and crisis management, as well as the home-host arrangements for the supervision of international financial institutions, in supporting the early identification of risks and the pre-emptive interventions that need to be made. Cross border surveillance in the Asian region in particular has now been enhanced to ensure that information gaps are identified and that the mechanisms to facilitate information sharing are put in place.

Achieving effective inter-agency coordination between financial safety net participants also needs to be considered carefully in the context of crisis management. Inevitably, the task of managing a financial crisis particularly in the areas of timely decision making, coordination and communication become much more complex when the functions of lender of last resort, bank supervision and deposit insurance are allocated to separate agencies, as each respective agency is accountable for discharging its own mandate having regard to its own inherent priorities. Consequently, issues relating to information sharing, allocation of powers, responsibilities, accountability and coordination among the various agencies must be clearly and explicitly addressed at the outset. The legislative mandates would need to provide clear roles and responsibilities for each relevant authority. This will form the foundation for the adoption of an integrated and coordinated approach. The need for such coordinated action becomes particularly important in conditions of an imminent financial crisis. Having in place a crisis management framework would allow for its prompt and effective implementation. The issues relating to the effective management of the inter-relationships between the safety net

participants were brought to the forefront recently in the United Kingdom, testing the framework in which the functions of lender of the last resort and the supervisory function are placed in separate entities.

In comparison, when a single agent such as the central bank is entrusted with these respective functions, the interrelationship issue, as well as potential conflicts and trade-offs become internal and would be resolved across the organisation. It would nevertheless still need to rely on an adequate accountability regime among the respective departments or divisions that are responsible for each mandate.

Malaysia's own experience during the Asian financial crisis exactly ten years ago allowed the Central Bank as a single regulator, to promptly respond to the liquidity and solvency issues that were confronting the financial system. The preemptive action that was supported by a comprehensive resolution programme significantly reduced the cost of the crisis on the financial system and the overall economy.

More recently, the Central banks in the East Asian region have come together to put in place a comprehensive regional surveillance system that is supported by a comprehensive integrated crisis management framework that would deal with any imminent financial crisis in the region. These initiatives are aimed at effectively preventing or containing developments that could trigger destabilising consequences, thereby promoting regional financial stability.

Deposit insurance system

Following the restructuring and reform of our financial system, Malaysia has two years ago implemented the deposit insurance system as part of our efforts to build a cohesive and mutually reinforcing financial safety net system. The deposit insurance system has an important role not just in promoting confidence with explicit coverage of deposits, but also in reinforcing sound risk management practices. It therefore has embedded features

that complements the supervisory process in promoting sound risk management practices in the financial institutions. In addition, the deposit insurance corporation in Malaysia is also mandated with the responsibility for the 'least-cost' resolution of problem financial institutions.

A comprehensive approach was thus adopted in establishing the Malaysia Deposit Insurance Corporation (MDIC). To promote depositors confidence, the deposit insurance scheme was designed to ensure that there was optimum coverage with sufficient reach to retail depositors. In designing the deposit insurance scheme, about 95% of all depositors are covered in full while in value terms about 35% of total deposits is covered. An important element in the framework is the strong collaboration between the supervisor and deposit insurer in promoting discipline in the banking system. As the supervisor, recognition is given to sound risk management practices demonstrated by banking institutions to have greater business flexibility, while the deposit insurer, through a differential premium system, provides incentives for financial institutions to adopt sound financial and business practices.

In adopting this framework, clear accountabilities have been critical in ensuring that there is no duplication in efforts so that the banks would not be over burdened by overlapping regulation and submission requirements. There was also a need to ensure close co-operation and collaboration between the supervisor and the deposit insurer to ensure the intervention and resolution actions instituted by the deposit insurer, would not be to the detriment of the system as a whole. These resolution powers would be invoked by the deposit insurer following notification by the Central Bank that a member institution was likely to cease to be viable.

It is in this context, the strategic alliance between the Central Bank and the deposit insurer was formed as a basis for cooperation to ensure the safety and soundness of the financial system. In Malaysia, Bank Negara

Malaysia is mandated with the responsibility of safeguarding and ensuring the stability of the financial system. The overall supervision of the financial institutions remains within the functions of Bank Negara Malaysia. The Strategic Alliance Agreement with the Deposit Insurer provides for a structured collaboration between the Bank and MDIC to share information on key issues and developments to facilitate the operations of MDIC.

Both formal and informal information exchange mechanisms have been put in place to facilitate timely data and information exchange that can be leveraged upon to support and enable MDIC to fulfil its mandated role. This has proven to be effective in minimising duplication of efforts. These information exchanges include cooperation and consultations on supervisory and prudential regulations where both agencies are involved from the early planning stage, particularly in circumstances in which the initiatives impact the functions of the respective institutions.

Consumer protection framework

To complement the deposit insurance system, Bank Negara Malaysia has also put in place a comprehensive consumer protection framework that covers financial education, fair treatment of consumers, avenues for redress, distress management and rehabilitation as well as advisory services. These include having in place the Financial Mediation Bureau to ensure that consumers of financial services that are under the purview of the Central Bank have recourse to a fair and impartial dispute resolution mechanism. The establishment of the Credit Counselling and Debt Management Agency provides individuals with credit counselling and assistance in restructuring of debts; and the establishment of the Bank Negara Malaysia LINK and BNMTELELINK forms an integrated customer service centre for members of the public and small and medium sized enterprise on matters relating to services provided in the financial sector. This has evolved a high rate of participation in the financial system with deposits now accounting for 160% of GDP.

This has allowed for the efficient functioning of the intermediation process to effectively mobilise and channel savings to productive activity thereby supporting the overall growth and development process.

Conclusion

Ladies and gentlemen

Essential to a progressive financial system is prudential safety and soundness, competition and consumer protection which needs to co-exist to effectively serve the interests of various stakeholders. As regulators we

need to adopt the right balance between providing adequate protection for consumers while promoting competition and financial innovation in the financial system. But it is the combined efforts of regulators, the industry, and consumers that ultimately maintain market confidence and ensures the effective and efficient functioning of the financial system. The recognition of, and commitment to this shared responsibility will not only contribute to the evolution of the financial landscape and preserving financial stability, but will enhance its overall contribution to the overall functioning of the economy and securing its full potential.

**2nd Islamic Financial Services Forum : The European Challenge
“Islamic Finance: Approaching New Horizons”
5 December 2007, Radisson SAS Frankfurt, Frankfurt, Germany.**

by

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

This decade has witnessed the dramatic transformation of the financial services industry driven by the forces of globalisation, advances in technology and the increased pace of innovation. The financial sector has also been confronted with increased vulnerability to turmoil, distress and periodic crisis. Financial intermediation that is vital to the economic growth process has become intensively more complex and challenging. In the context of this environment, Islamic finance has continued to evolve as a viable and competitive form of financial intermediation. More recently, this trend has gained momentum. Islamic finance is now among the fastest growing segments in the financial services industry.

The viability of Islamic finance has been derived from its ability to meet the changing demands of the economy and from its cost competitiveness. Its development has also been supported by a well developed legal, regulatory and supervisory framework that has been important in ensuring its soundness and stability. Also important has been the efforts to bring about harmonization in the development of Islamic finance across the different jurisdictions. Finally, and most importantly, the principles of governance, risk management and transparency which are explicitly embedded in Islamic finance have provided the foundations that have contributed towards ensuring its viability and sustainability.

More recently the development and expansion of the Islamic financial services industry has entered into a new phase of development following increased liberalisation. This trend has fostered the shift from a domestic centric approach to

entering into transborder ventures in terms of greater financial presence in other jurisdictions as well as the higher level of participation in the Islamic financial markets, resulting in increased cross border flows. This has contributed to enhancing international financial inter-linkages between the different respective economies.

It is my honour to be here in Frankfurt to speak at the '2nd Islamic Financial Services Forum: The European Challenge' jointly organized by Islamic Financial Services Board (IFSB) and the Financial Stability Institute (FSI), supported by the Deutsche Bundesbank. My remarks today will elaborate on the factors that have fostered the development and remarkable expansion of the Islamic financial services industry. My presentation will also touch on Malaysia's experience in the development of a comprehensive Islamic financial system that is now being increasingly integrated into the international financial system.

Islamic Finance in a Challenging Environment

The very fundamental requirement of Islamic finance is that financial transactions must be accompanied by genuine trade and productive activities. In addition, the involvement in illegal, unethical and speculative activities is prohibited. It is in this respect that Islamic finance has the element of stability. At the same time, Islamic finance also promotes more equitable distribution of wealth arising from the various modes of Islamic financing contracts that ranges from a simple mark-up contract to the more equity-based contracts of mu-da-ra-bah (profit sharing) and mu-sha-ra-kah (profit and

loss sharing). Today, most of these Islamic financial contracts have been used in many business engagements in various respective financial sectors such as banking, insurance, capital and money markets.

Fundamental to Islamic finance is that the risk is shared by the financier (lender) and the customer (borrower). In such an arrangement, due diligence becomes essential. Under this risk sharing principle, Islamic financial institutions share the profits or the losses incurred by the entrepreneur. Hence, both are accountable for the performance of the enterprise. Thus, strategies to minimize and manage the risks in Islamic finance involve integrating the risks associated with the real activities. The real activities will need to generate sufficient wealth to compensate for the 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. This could in turn result in higher systemic risks, increasing the potential for instability and inequitable concentration of wealth.

In Islamic finance, transparency represents a basic tenet underlying all Islamic financial transactions. There is an inherent obligation on Islamic financial services providers to meet certain standards of transparency. It is from the unique profit-sharing feature of Islamic financial transactions that it imposes a high level of disclosure, which is explicit in the financial contract. In addition, the role and responsibilities of the financier and customer are clearly defined in the contract. This transparency provides a strong incentive for Islamic financial institutions to appropriately manage risks. The disclosure also allows the market to assign appropriate risk premiums to the respective companies and thus enforce the potential to market discipline. This provides the foundations for the enhanced

role of market discipline to take effect, thereby promoting financial stability.

The adoption of governance best practices is also inherent in Islamic finance, given the wider range of contracts entered into between the Islamic financial institutions and their customers. As a partner, the Islamic banks must oversee the quality of the corporate governance, not only for achieving the business performance but also ensuring the accountability. The principle of governance embedded in Islamic finance also contributes towards insulating the Islamic financial system from potential risks associated with excessive leverage and speculative financial activities. This governance framework is also reinforced by the Shariah board or committee which represents another stratum in the governance structure which serves to ensure that the management of the Islamic institution is in compliance with the Islamic principles. These elements provides inbuilt checks and balances which serves to ensure financial stability in the Islamic financial system.

Islamic Finance and Financial Stability

The development and expansion of Islamic finance has also been accompanied by the development of the robust and comprehensive regulatory and supervisory framework. With the establishment of the Islamic Financial Services Board (IFSB) five years ago, Islamic finance has made remarkable progress in the advancement of having its own prudential and regulatory standards to govern its operations. The standards that have been issued by the Islamic Financial Services Board have taken all aspects of capital adequacy, risk management, corporate governance, transparency and market discipline and the supervisory review process as to ensure that Islamic banking institutions are well positioned to address all the risks associated to various types of Islamic financial contracts.

While these standards are consistent with the conventional standards, efforts have

also been taken to minimise any potential for regulatory arbitrage between conventional and Islamic financial system so as to avoid undermining the stability of the overall financial system. The IFSB also engages and also interfaces with other international standard setting bodies specifically BIS, BCBS, IOSCO, IAIS and FATF to ensure within the context of financial supervision and surveillance, similar risks are monitored and dealt with in a consistent manner so that there are no gaps in the overall supervisory processes. At the same time, tax and legal reforms are also being undertaken in a number of jurisdictions to accommodate the unique characteristics of Islamic financial transactions.

Against this backdrop, the Islamic financial industry has become one of the fastest growing financial segments in the international financial system with an estimated annual growth in the region of 15 to 20 percent. There is also a growing number of the Islamic financial institutions that now operate in several parts of the world both in Islamic and non-Islamic countries. The total Islamic assets under management are estimated to exceed one trillion US dollars. Islamic mutual funds are estimated to be at a value of over USD300 billion while the issuance of sovereign and corporate sukuk has now exceeded USD80 billion.

The rapid evolution and expansion of Islamic finance is also evident from the growing range of Islamic products and services with the Islamic financial solutions being developed to meet the demands of different consumer and business segments. This has been accompanied by the development of a diverse number of Islamic financial intermediaries including banking, takaful (Islamic insurance), capital market intermediaries and other specialized institutions that offer Islamic financial products and services. Such specialized institutions include mortgage corporations, credit guarantee corporations, deposit insurance, Islamic hedge funds, and other shariah compliant collective schemes such as Unit Trusts, Real Estate Investment Trusts (REITs)

and Exchange Traded Funds. We have also seen the rapid evolution of the Islamic financial markets including the Islamic money and capital markets with the development of a wide range of structured products and significant growth in activity.

Backed by its strong foundation and the growth that has been experienced, the Islamic financial services industry is now at a new threshold to make further advancement while at the same time to address some of the gaps that still exist. Of particular importance, is that the robust development of the Islamic financial markets needs to be reinforced by the development of risk mitigating instruments, increased product innovation and the continuous awareness of these developments by society at large, businesses, the financial services industry and regulators.

The evolution of sophisticated Islamic financial products which have been structured based on multiple Islamic concepts will allow us to start venturing into a new wave of innovation that will evolve Islamic financial instruments into distinct products and services that will maximize its potential. These products have already become competitive, flexible and efficient both from the perspective of pricing as well as product structure so as to cater to the demands of the business communities. The recent innovations that include the introduction of Islamic hedge funds, the creation of Islamic benchmark indices and the listing of Islamic financial instruments on the international exchanges have enhanced the depth of the Islamic financial markets as an attractive asset class for investment.

Sukuk: A Fast Emerging New Asset Class

The sukuk market is fast emerging as the most significant form of Islamic financing and continues to receive strong interest as an avenue for fund raising and investment. The sukuk market has been gaining growth momentum, increasing at an average annual rate of 40 percent with the current outstanding issuance estimated at USD 80 billion.

Significantly, 90 percent of the sukuk issuance are corporate issuances. Strong demand for sukuk have also been spurred by the high levels of surplus savings and reserves in Asia and the Middle East. In Malaysia, the issuance of sukuk has surpassed the issuance of conventional bonds for three consecutive years, with the annual turnover in sukuk trading in the secondary market at about RM135 billion.

The sukuk is also an attractive instrument to assist Islamic financial institutions in managing their liquidity requirements. At the same time, it is also an effective instrument used by corporations, institutions and sovereigns in tapping funds at a very competitive rates to finance their long term funding needs. At this juncture, the demand for sukuk is tremendous. This is evidenced by the significant gap between the demand for and the supply of Islamic financial instruments. The high demand for the sukuk instrument is shown by the experience of many issuers whereby the over subscription has ranged from two to thirteen times. This has pushed down the cost of issuance by at least 10 to 20 basis points. This demand has also originated from several different parts of the world, both from conventional as well as Islamic financial investors. Due to the scarcity of sukuk issuance, the investors have tended to hold the sukuk for investment thereby reducing the secondary activity in the market thus resulting in a higher pricing in the sukuk secondary market thereby generating good investment returns for investors.

Malaysia's Experience in the Development of Islamic Finance

Let me take this opportunity to share with you Malaysia's experience in developing our Islamic financial system. Over two decades, Malaysia has developed a comprehensive Islamic financial system that operates in parallel with the conventional financial system. The domestic Islamic financial system is now well-supported by a significant numbers of diverse players in the banking, takaful and the capital market. A robust regulatory and supervisory framework, as well as a legal and

Shariah governance framework have also been put in place. There is now also a high degree of consumer awareness on Islamic finance. In addition, there is also an efficient settlement and bond information system. The Islamic financial industry has been expanding at a double digit growth rate and has registered a market share of more than 12 per cent in the banking sector while the Islamic capital market in Malaysia has evolved as one of the largest in the world. More than 60 per cent of global sukuk market originates out of Malaysia. In the equity market, 86% of the listed stocks are Shariah compliant with market capitalization of USD193 billion. Malaysia has also structured the first Islamic real estate investment trust (Islamic REIT) listed on the stock exchange.

Following the development of a robust domestic Islamic financial system, initiatives have now been taken to raise the significance of the international dimension of the Islamic financial system. Malaysia has therefore implemented wide ranging liberalization measures, including the issuance of three new Islamic banking licences to foreign Islamic players that have come from the Middle East and through increasing the strategic stakes possible by foreign interest in our Islamic financial institutions, to up to 49 per cent. In the area of Islamic fund management, licences will be issued to entities with foreign equity of up to 100 per cent.

Our foreign exchange administration rules have also been progressively liberalized. In this regard, liberalization of capital account through the removal of restrictions to foreign exchange transactions have increased foreign participation in our financial markets. In addition, foreign corporations may raise funds either in ringgit or foreign currency out of Malaysia. The participation of foreign investors in the Malaysian bond market has also been increasing and now represents about 13% of the total outstanding debt securities. The increased foreign participation has also widened the investor base to extend beyond the Muslim countries. Participation in the equity market now represents about 20 per cent of the market. The increased

foreign participation has strengthened our interlinkages with other international financial markets.

Conclusion

In conclusion, Islamic finance is emerging as a viable and sound financial intermediation. The new wave of innovation and the increased awareness and interest in Islamic financial solutions are contributing to its dynamic advancement. The acceleration of the integration of Islamic finance into the international financial system would also

contribute towards strengthening further the global economic and financial inter-linkages and we believe increases the prospect for securing more balanced global growth. In addition, the increased diversification of cross border flows into new asset classes would not only result in the more efficient allocation of resources across borders but also enhance the potential to contribute towards global financial stability.

On this note, I wish you a productive and successful forum.