

Governor's Speech at the Nikkei Islamic Finance Symposium 2008: "Islamic Finance: Constant Evolution and Emerging Opportunities"

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

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

Evolution of Islamic Finance

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

Firstly, from being concentrated in Muslim populated regions, Islamic finance is now viewed as a **competitive form of financial intermediation** that has drawn significant participation by non-Muslims. For borrowers, it is seen as an alternative means of financing. For investors, it is seen as a new asset class. Islamic finance has thus witnessed exceptional growth, not only in the Muslim world, where its growth is premised on religious and business considerations, but also across the Western world where the growth is driven by commercial and business considerations. Today, the total assets of the Islamic financial system has surpassed one trillion US dollars, about fivefold of its magnitude five years ago. Islamic finance is now among the fastest growing financial segments in the world with an estimated annual growth of 20 percent.

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

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

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

The fifth dimension that has seen significant change is in the **development of human capital in Islamic finance**. It has been a vital development that has been key in ensuring an adequate supply of talent and expertise for further expansion and development of the Islamic financial services industry. High caliber professionals that have the combined knowledge and understanding of the Shariah with the necessary skills in finance² are now in great demand. Recognising this, several major institutions of higher learning are offering more focussed and structured programmes in Islamic finance. The establishment of the International Centre for Education in Islamic Finance (INCEIF) in Malaysia in 2006 represents a structured investment in human capital development to support the global development of Islamic financial services industry. It is envisioned that INCEIF will act as a professional certification body as well as an education centre for specialised post-graduate programmes in Islamic finance.

Distinctive Features of Islamic Finance

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

Based on this arrangement, interest-based transactions are prohibited. Islam encourages business and trade activities that generate a fair and legitimate profit. In Islamic finance, there is therefore always a close link between the financial and productive flows. This intrinsic

principle contributes towards insulating the Islamic financial system from potential risks of financial stress resulting from excess leverage and speculative financial activities.

A further fundamental principle of Islamic finance is the risk and profit sharing feature of Islamic financial transactions. This could involve an arrangement whereby the Islamic financial institution shares profit with the investor in a Mudarabah contract or in a Musyarakah contract, both parties share in the profit or loss. These arrangements involve an explicit sharing of the risks by the Islamic financial institution and the investor, thus requiring the Islamic financial institution to appropriately manage the risks associated with the transaction. It entails the appropriate due diligence and the integrating of the risks associated with the investment activity into the financial transaction. The real activity is thus expected to generate sufficient wealth to compensate for the risks.

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

Malaysian Experience

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

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

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

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

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

Opportunities in Sukuk

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

The Sukuk market brings with it great benefits to both issuer and investors. For issuers that include government agencies, multinational corporations and multinational development institutions, Sukuk plays a multi-faceted role in meeting different funding requirements ranging from large infrastructure and developmental projects to capital and business expansion. This is particularly important for emerging market economies. The Middle East and Asia currently represent the two fastest growing regions in the global economy. These regions are aggressive in their privatisation efforts and in the implementation of infrastructure and developmental projects. Asia alone will be spending an estimated USD1 trillion on infrastructure over the next five years, while infrastructure requirements in the Middle East are estimated to be USD700 billion over the same period³. While in Malaysia, the National Economic Regional Corridor plan requires an estimated USD192 billion (RM620 billion) of investment.⁴

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

From the investors' perspective, besides the intrinsic value of sukuk which is largely **asset-backed**, convertible to shares and

exchangeable with shares, there are **benefits of diversification** . Sukuk is fast becoming a **new asset class** . Sukuk has also generated **good investment returns** for investors arising from its higher pricing in the secondary market due to the "buy and hold" preference and its scarcity.

Opportunities in Takaful

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

Let me turn to Japan's potential participation in Islamic finance. We welcome the participation of Japanese financial institutions, authorities and corporations in Islamic finance, particularly, in the Islamic capital markets. Japan thus far has for several decades had a significant economic role in the Asian region in terms of trade and investment. Japan 's investment in the region is estimated to be USD45 billion over the period of 2004-2006⁷. Japan has also been consistently ranked among the top five investing nations in Malaysia , with investment flows amounting to 25.7% of the total flows for the period of 2000 to 2006. In 2006 alone, Japan foreign direct investment inflow into Malaysia was at USD6.1 billion⁸. Japan has also remained a significant partner in trade with Malaysia.

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

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

Conclusion

Let me conclude my remarks. The increasing awareness and appreciation of the inherent strengths of Islamic finance and its tremendous potential for advancement have ignited interests amongst the global financial community to venture into this new sphere of finance. Taking advantage of the increasing role of Islamic finance in bringing together different parts of the world with surplus funds in search of investment opportunities, with those that have financing needs, will increase these mutually reinforcing prospects. We look forward to Japan 's participation in this new financial evolution.

Thank you.

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

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

³Source: GCC Research , Kuwait Finance House.

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

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

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

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

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