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"Ensuring Stability in the Islamic Financial System"

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I. Introduction

"In its nascent history spanning three decades, Islamic banking and finance has undergone rapid growth and transformation. From an industry striving to fulfil the religious obligations of the Muslim community, it is now a multi-billion dollar industry driven by well-defined business considerations and profit optimisation, whilst steadfastly upholding the Islamic principles. Indeed, this progress has been achieved against a challenging global financial and economic environment. The further development of Islamic finance requires for it to be endowed with the right pre-requisites that will ensure the evolution of an intermediation system that is viable, resilient and sustainable. Of essence, is the timeliness to develop an Islamic financial industry that is comprehensive and sound, that promotes financial stability and growth through the robustness of its regulatory framework, the dynamism of its inter-connected markets, the strength of its financial infrastructure and the responsiveness and sophistication of its products and services."

In the development of the Islamic financial system, significant attention has been given to ensuring financial stability. Several initiatives have been taken to promote financial stability in the Islamic financial system and thereby strengthen its foundations. My address this morning will focus on these initiatives. Allow me to also take this opportunity to share with you Malaysia's experience in this endeavor.

II. Current trends in the international financial landscape

The international financial landscape is constantly being reshaped and transformed by the rapid pace of globalisation, financial liberalisation and the advances in technology. Globalisation has manifested itself with the geographic expansion and consolidation of financial establishments beyond national boundaries and the massive flow of financial resources across borders. This has unleashed a greater volume of resources through the financial system, increasing the importance of the financial sector. These trends have been reinforced by the advances in technology, which has radically changed the way we do business and the structure of markets and their dynamics in the national and global economy. This has resulted in an environment in which businesses, markets and economies are becoming internationally more integrated and inter-dependent.

Financial liberalisation and deregulation of the financial services industry has also resulted in increased competition and the proliferation of new financial products and services. Also, the business operations of global financial conglomerates now span over multiple jurisdictions. Against these developments, regulators have reassessed existing prudential rules and have adopted a consolidated supervision framework to prevent regulatory gaps that could become a source of systemic concern.

While deregulation of the financial sector has expanded the range of opportunities, it has also increased the incidence of instability in the financial markets. Heightened uncertainties and greater volatility in financial markets have required greater attention on building more robust risk management capabilities. Greater investments have gone towards refining risk quantification techniques to enhance the overall risk management framework. There is also greater emphasis on risk management in the new international regulations such as in the Basel II capital framework. Maintaining relevant financial data and information has also become more important, and has resulted in large investments to enhance data mining and IT capability.

While the global financial markets have become increasingly sophisticated, unstable market conditions and the failure of large financial institutions have prompted more stringent regulatory requirements and increased transparency. The message is that integrity and transparency is critical for financial institutions to gain public and investor confidence. In response to a number of high-profile corporate failures, there has also been a review of international accounting standards and practices to address inadequacies in the existing standards. In some countries, independent oversight committees/public boards have been formed to establish auditing standards and to impose new rules on auditing quality control and auditor independence. The trend is, therefore, towards improving the value of financial reporting and increasing the overall level of transparency.

The 1997 Asian financial crisis also resulted in a reexamination of policies and practices. This has prompted extensive financial restructuring and reform to strengthen domestic financial systems. Five years after the crisis, the financial systems in East Asia have emerged significantly strengthened and demonstrated greater resilience.

III. Pre-requisites to a stable Islamic financial system

Despite a more challenging environment, the development of Islamic finance as a viable form of financial intermediation has moved forward. It is while Islamic finance is still at its early stage of development that the opportunity has been taken to strengthen its foundations and put in place the pre-requisites that will pave the way for its development and safeguard the stability of the system.

Not only has closer attention been given to the supervisory, regulatory and legal dimension but also to the development of the financial infrastructure and the markets as well to

institutional development. In essence, the prudential regulatory design has been complemented by concurrent efforts to develop Islamic financial markets, the Islamic institutions and the financial instruments. Allow me to highlight the key areas that are important to this objective.

First, effective regulatory and supervisory framework

The hallmark of a well-developed financial infrastructure is an effective legal, regulatory and supervisory framework which would underpin the stability of the financial system. The regulatory and supervisory function is an indispensable and vital component of the financial infrastructure. For the Islamic financial system, this framework also needs to be consistent with the requirements of the Shariah principles, including the establishment of a Shariah council, which provide assurance that the strategic direction, the formulation of policies and the conduct of financial transactions are in compliance with the Shariah principles. This would need to be supported by an efficient court system that can effectively deal with all Islamic banking and finance cases, whose decisions are enforceable over the range of financial issues such as contracts, bankruptcy, collateral and loan recovery all of which are essential for businesses to operate. The legal framework should also deal with supervisory issues, including the relevant regulatory agencies involved in the supervision of Islamic financial institutions and encompass the licensing and conduct of Islamic banking business. The relevant agencies should have clear responsibilities and objectives to ensure effective financial supervision.

While the conventional banking system is guided by the Basel core principles which outlines the minimum requirements for the supervisory regime, these principles need to be reviewed from the perspective of Islamic banking, taking into account the unique characteristics and risks involved in Islamic banking and its products and services.

A fundamental issue is the setting of prudent and appropriate minimum capital adequacy requirements for Islamic banks. Such requirements need to reflect the risks that the banks undertake. The framework devised would need to incorporate fundamental Islamic concepts. The principle of Mudharabah, for example, creates a class of depositors that can also be construed as quasi-shareholders. Similarly, risk weights assigned to individual asset components need to reflect the nature of inherent risks involved. It is not as straightforward as a debtor-creditor relationship in conventional banking but also needs to include other inherent risks arising from the investor-entrepreneur relationship that is inherent in Islamic banking.

Islamic banking operations therefore need to be governed by its own standards and best practices in parallel with the international best practice. The establishment of the Islamic Financial Services Board (IFSB) in 2002 as an international prudential standard-setting body to promulgate the international regulatory and supervisory standards for Islamic financial institutions is aimed towards achieving this objective. In this regard, the IFSB has already made progress in developing the prudential standards on the capital adequacy and risk management framework. These standards are

expected to be completed in 2005. In addition, the IFSB will commence work on developing standards on corporate governance.

At present, some countries have adopted the Basel Accord standards in their regulatory and supervisory framework for their Islamic banking industry. However, these standards do not adequately address the requirements of Islamic banking operations and transactions, resulting in gaps in the standards. Therefore, these gaps will be taken into account with respect to the capital treatment and risk associated for the different types of Islamic financial contracts to truly reflect their features and characteristics.

While certain products in Islamic finance by their nature may not attract capital, the Islamic financial institutions need to have a more rigorous risk management systems in managing the funds placed under this arrangement. In this regard, the risk management standard needs to specifically address this concern. The Islamic financial institutions can expect to be better regulated and supervised following the adoption of the standards to be issued by the IFSB. The IFSB will also have a prominent role in facilitating the streamlining of the standards covering the cross-border supervision issues including the home-host supervisor issue.

Since its establishment just over a year ago, the IFSB has attracted a wide participation. To-date, there are 13 full members, 3 associate members and 20 observers in the IFSB. This encouraging development demonstrates the keen interest towards the orderly and sound development of Islamic banking and finance. The wider participation which also includes several international and regional multi-lateral agencies will facilitate the consultation process and the adoption of these standards. Another important role to be played by IFSB is in the harmonization of the different Shariah interpretations towards a more universally accepted practice. These positive developments are expected to bring about a more robust regulatory and supervisory framework for the Islamic financial institutions to promote financial stability in the system.

Second, existence of strong corporate governance

It is also recognised that good corporate governance reinforces sound regulation and supervision. It contributes towards maintaining market confidence, and strengthening transparency and accountability. Its emphasis is to be value-oriented and promote fairness and justice with respect to all stakeholders of the banking institution. For corporate governance to work, good corporate practices need to be instilled and embedded in all aspects of the operations and at all levels within the organisation.

Indeed, Islam strongly advocates all forms of positive governance. These values and ethical conduct have already been in built and are inherent in the community. Islamic corporate governance serves through its underlying principles of economic well-being of the Ummah, universal brotherhood, justice, accountabilities and equitable distribution of income. Therefore, while the virtues of Islam have always advocated good corporate governance, the challenge to us lies in its

application. For Islamic banking institutions, good corporate governance should have already been embedded in all aspects of their operations.governance, the challenge to us lies in its application. For Islamic banking institutions, good corporate governance should have already been embedded in all aspects of their operations.

Closely linked to the corporate governance issue is the role of market discipline. Central to the effectiveness of the corporate governance arrangements is the empowerment of shareholders. This would mean providing the conditions under which shareholders have both the incentive and the means to act to discipline Management. The market for corporate control is an important way in which shareholders exercise, in effect, an ultimate discipline over bank Management on the premise of allocating capital where sound management is practised.

Third, greater transparency and disclosure of information

Transparency and disclosure is essential particularly in a rapidly changing environment. While the comprehensive and timely availability of financial information will increase market discipline, the disclosure of information needs to be complemented with the ability of the market players to analyse, and appropriately interpret the information.

Closely related to this issue is the need to strengthen the framework for consumer protection to provide an avenue for redress due to lack of transparency. This is even more relevant in the multi-facet role played by the Islamic financial institutions in dealing with Islamic banking customers as the Islamic financial transaction is not merely based on the lender and borrower relationship as is the case in conventional banking. The move towards the adoption of the supervised market approach requires continuous efforts to enhance product disclosures and to elevate the level of financial literacy of consumers.

To further enhance transparency in the conduct of banking institutions, proper accounting standards need to be in place to reflect the true and fair value of banking operations that would lead to greater accountability and responsibility on the part of the banking institution. Accurate financial reporting requires a body of financial accountants that are well-versed in Shariah principles to ensure that the accounts are not only drawn in accordance with the international accounting standards but are also in line with Islamic principles. This is to enable the investors and supervisors to obtain the true and fair assessment of the Islamic institution's financial condition and the profitability of the business. Transparency and disclosure is even more crucial in Islamic banking where the concept of mudharabah (profit-sharing) entails an investor-entrepreneur relationship and is a significant element in sourcing of funds.

The establishment of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has made a significant contribution in formulating and issuing accounting and auditing standards for Islamic financial institutions. The standards issued by AAOIFI have contributed towards improved quality of financial statements and reporting

methodology of Islamic financial institutions. AAOIFI has also issued standards on the role of the Shariah committee as well as the code of ethics that should govern the accountants and auditors of Islamic financial institutions. Efforts by AAOIFI have also accelerated the pace of transparency and corporate governance of Islamic financial institutions.

Fourth, risk management framework

Emphasis on improved corporate governance goes hand in hand with the need for improvements in risk management standards. Sound risk management practices will minimise adverse consequences faced by financial institutions during periods of uncertainty. Robust internal controls to provide qualitative standards are also necessary to complement the quantitative analysis of risk to provide a check and balance in the overall risk management practices.

Effective risk management systems is central to supervisory efforts. The risk management system in Islamic institutions need to be able to address the unique characteristics and attributes associated with Islamic financing operations involving financial contracts and instruments which may give rise to other risks besides credit risk. The risk management infrastructure needs to be in place to facilitate the identification, measurement, monitoring and control of all inherent risks present in all the various types of financing so that the specific risks involved may be 'unbundled'. The complexities of the respective risks in the Islamic financial instruments therefore need to be fully explored and quantified to provide for their effective assessment and management.

In the area of Islamic banking, the requirement to manage the risks becomes more important because of the unique peculiarities in the contracts. Basel II has, to a certain extent, incorporated some aspects in the identification of risks, in particular the credit, market and operational risks that can be assimilated by the Islamic banks in terms of its product offering. However, further refinement will have to be done by the Islamic financial specialists to assess the appropriateness of the capital definition in particular as outlined by the Basel committee. One of the considerations that need to be addressed in assessing the risks associated with the Islamic bank is with regard to the capital charge on its investment accounts. Basel II does not address this unique feature in its framework. Assets that are funded by monies in the investment account may not require the capital charge for the purpose of capital adequacy measurement except in the case of misconduct and negligence. Similarly, if the Islamic banking institutions were to be more engaged in the profit-sharing arrangement in its balance-sheets, it will require the Islamic bank to have a more rigorous risk management assessment and monitoring mechanism. This is an area that is being addressed by the Islamic Financial Services Board in the drafting of the standard on the overall risk management framework for the Islamic financial community that takes into account this unique requirement of Islamic banking.

While risk mitigation is desirable in Islamic finance, further improvements need to be made to the existing risk management framework. New hedging products which are

scarce in the market need to be developed in the quest to seek for compatible risk mitigating products. In accordance with the principles Islamic the Shariah has allowed the Ummah to undertake juristic reasoning based on contemporary analysis and logical inference. Indeed, the development of new hedging products is something that the Islamic financial community can look forward to. In conventional banking, these instruments are used to mitigate risk. Indeed the Islamic financial community will soon develop such products for this purpose.

Fifth, effective and dynamic Shariah framework

One of the central issues towards developing a dynamic Islamic financial industry is the Shariah. The Shariah should always be viewed as an enabler to innovation and creativity, rather than a constraint. Efforts, therefore, need to be enhanced to fully appreciate and maximise the true potential and wisdom of the Shariah. The collaboration among the Shariah scholars, practitioners, researchers and regulators to undertake in-depth studies and research to create new products will provide the fundamental foundation towards the development of a dynamic Islamic financial system.

Sixth, development of comprehensive legal infrastructure

Another important pre-condition to sustain the continued growth of Islamic banking and finance is a comprehensive legal infrastructure for legal redress arising from Islamic financial transactions. The legal infrastructure needs to comprise both effective regulatory and substantive laws as well as appropriate adjudicative fora for parties to resolve disputes relating to Islamic financial transactions. To address this, efforts are needed to develop a sufficient number of competent lawyers and judges that are equipped with sound knowledge and expertise in both Shariah and civil laws to deal with such matters.

Seventh, development of vibrant Islamic financial markets

In the more developed financial centers, the development of inter-related financial markets has contributed towards the stability in the financial system. This is an area of priority for the Islamic financial industry. In this regard, the development of a comprehensive Islamic financial system including the various components of the financial markets would meet the requirements of the various differentiated groups. The challenge in the Islamic banking industry is, therefore, to steer the development of an Islamic financial system towards one which is more dynamic and responsive. The development of an Islamic financial system should include the key components comprising the Islamic money market and the Islamic equity and debt capital market, given the strong linkages, inter-dependence and synergies among these components in the system. Of importance is the Islamic money market to act as a platform to provide a ready source of short-term funding and investment. Financial instruments and interbank investment will allow surplus banks to channel funds to the deficit banks, thereby maintaining the funding mechanism necessary to promote stability in the system. The Islamic money market will also facilitate the conduct of monetary policy.

The Islamic financial system also needs to include the capital market to provide an alternative source of financing, as well as to create broader and more diverse Islamic financial instruments for investors. The equity and bond markets will provide a more balanced allocation of financial and economic resources. This would result in a more efficient distribution of risks within the system, thus creating stability in the system. The equity and bond markets would also provide an avenue for raising long-term capital. With a wider spectrum of instruments in the market, fund managers would be able to manage their portfolios better and spread their risk according to their desired risk tolerance, thereby contributing toward greater stability.

Complementing these financial markets is the development of non-bank Islamic financial institutions. Takaful, or Islamic insurance, provides the risk protection to its policyholders and serves as an important mobiliser of long-term funds. In addition, development financial institutions, savings institutions and housing credit institutions need to be developed to meet the diversified customer demands. These specialised institutions will meet the different requirements of the economy.

IV. Malaysia's experience in the development and management of the Islamic finance

The strategy adopted by Malaysia has been to develop a comprehensive Islamic financial system. Malaysia started with the establishment of one Islamic bank to spearhead the introduction of Islamic banking products and services, and at the same time, identified the relevant financial segments that were required to support the expansion of Islamic banking activities. The Islamic financial system in Malaysia operates in parallel with the conventional system.

Following the establishment of Islamic banking was the establishment of takaful or Islamic insurance to provide the coverage for Islamic housing mortgages. As these two segments progressed, Malaysia expanded its implementation approach by allowing the conventional banking institutions to offer Islamic banking products and services on a window basis. To preserve the integrity of the system, firewalls between the conventional and Islamic funds were put in place. It was made mandatory for the Islamic banking operations in these institutions to be separated from the conventional banking operations, either electronically or through other designated means. This move created more players in the Islamic financial system and provided the platform for the establishment of a vibrant Islamic money market. The Islamic money market served as a platform for the Islamic financial institutions to manage their short-term portfolio adjustments. Recognising the importance of the capital market, Malaysia initiated the development of a private Islamic financial securities market in the early nineties.

The Islamic financial system today has emerged as an important component of the overall Malaysian financial system that contributes to the growth and development of the Malaysian economy.

Malaysia has also adopted legal reform, self-regulation and measures to encourage market-based regulation. New measures have been introduced to further improve the level of governance among banking institutions. This includes reviewing the responsibility and accountability of the Board and Management as well as requiring for the setting up of various Board committees. In the case of Malaysia, the High Court of Malaysia has dedicated high court judges to preside on litigated cases over matters relating to Islamic banking and finance. To undertake a holistic legal review, the Central Bank of Malaysia has set up a Law Review Committee to review the common law-based domestic legislations to assimilate the Shariah principles with the aim of removing any impediments to ensure the unhindered and efficient functioning of the Islamic banking and financial system. The Central Bank Act has also been amended to provide for the establishment of a Shariah Advisory Council at the Central Bank as the sole authority and reference on all Shariah matters pertaining to Islamic banking and finance

The successful integration of these core components to become a comprehensive Islamic financial system has contributed towards a more active domestic Islamic financial intermediation process. To-date, Islamic banking has mobilised assets amounting to RM76 billion or 10 percent of the market size, of which approximately 70 percent of the Islamic banking assets were generated by the conventional banks with Islamic windows. In the takaful sector, the four takaful operators registered a total of RM4 billion in terms of assets. Significant progress was achieved in the area of Islamic money and capital market where the volume traded in the Islamic money market reached RM340 billion, while the outstanding amount of Islamic private securities was amounted to RM75 billion or 44 percent of the total outstanding private securities. In the stock market, more than 80 percent of the counters in the Kuala Lumpur Stock Exchange are Shariah-permissible counters. This year the Islamic banking sector will be liberalised to include up to three foreign Islamic banking institutions as the system becomes more integrated with the global financial system.

V. Positioning the Central Bank to meet the challenges ahead

My remarks on pre-requisites to a stable and comprehensive financial system would not be complete without a few words on the role of the central bank. To stay at the forefront in dealing with the new challenges and to effectively perform our responsibilities, the Central Bank's efforts have also been focused on strengthening its capacities and capabilities.

Central Banks in emerging market economies have a much broader mandate than our counterparts in the more advanced and mature economies. Of importance, is our developmental role in charting the development of the financial system, institutional development and the overall economic management. This is over and above the objectives of achieving monetary and financial stability and ensuring the sound and efficient functioning of the payments system. The Central Bank also has the

important role of developing the financial infrastructure, developing the financial markets, the legal framework and driving the institutional development. In Malaysia, our vision of the development of the financial sector over the next ten years is outlined in our Financial Sector Masterplan. The plan includes the strategic direction and strategies for the development of the Islamic financial sector.

Finally, greater cooperation among the regulators is necessary in order to ensure that the Islamic financial system is not subject to vulnerabilities and abuses. In this respect, 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 continuously exchange views and share information on key issues and developments faced in their own financial jurisdictions.

Another important aspect is in regard to the development of the international Islamic financial market. Although this market is to be driven by the market players, a greater role is expected from the regulators and central banks to support its expansion. In this respect, the encouraging support shown by various regulators and central banks in making the launching and issuance of the sovereign Sukuk papers a success represents an important progress that has been achieved. These initiatives will bring about a more coordinated effort in achieving market development and stability.

VI. Conclusion

Our quest to develop a dynamic Islamic financial system is to achieve the ultimate objective for Islamic finance that contributes significantly toward the overall development of our economies. This is achieved through the intermediation process to facilitate trade, business and investment. This will facilitate the integration of the Islamic financial system as a viable component of the global financial system.

It is the ability of the Islamic financial industry to build institutional capacity, intensify the collaborative efforts to strengthen the effectiveness of the Islamic financial infrastructure, and the acceleration of its global integration that will provide the synergies and opportunities for the Islamic financial industry to evolve into an important component of the international financial system that can contribute to greater global financial stability and enhance the prospects for a more balanced global growth.

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"The Use and Documentation of OTC Derivatives"

Keynote Address by
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We are in a period of great change. As the pace of globalisation intensifies the global environment has been marked by greater volatility and uncertainty. As a consequence we are often dealing with probabilities. The process of globalisation has resulted in international capital movements and developments in the global financial, and regulatory arena that have had significant implications on domestic financial institutions. There is therefore a need for a global perspective in effectively managing these risks. The universal application of ISDA Master Agreements is a demonstration of the need for globally oriented solutions. This morning my remarks will focus on the need to appreciate the nature of risks involved in dealing with OTC financial derivatives, both by the market and the regulators. I will also touch briefly on the opportunities emerging in terms of developing derivatives within Islamic banking and finance.

Financial institutions, as the linchpin for the process of financial intermediation, have a crucial role in facilitating the flow of capital to areas where it can be most productively used. The process of financial intermediation responds to changes in the environment with product and service innovations, and in this manner have continually re-shaped the international financial landscape. Derivatives are among the most innovative sub-sectors of the financial industry. Specifically, the 'over-the-counter' (OTC) products are not derivatives on organized markets, but rather individually customized, often highly complex with combinations of standard financial instruments packaged together to meet the specific needs of clients. Such contracts involve very little direct lending by banks to clients, and generate little net interest income to the banks. Derivatives generate substantial fee and commission income without the need to commit any of the institution's capital. This therefore involves a different risk management approach as there is a shift away from continuous risk assessment and risk monitoring of funded investment projects that usually produce recurring flows of interest payments over time to the identification of riskless 'trades' that produce large, single payments, with much of the residual risks carried by purchasers of such packages. This process has possibly been accelerated by the introduction of risk-weighted capital requirements. Market players and regulators both have a role to play in balancing potential

risk with potential returns in order to promote a vibrant financial system, without compromising the stability and integrity or agility of the system.

One of the Central Bank's primary responsibilities is to maintain financial stability and confidence in the financial system and to ensure that the process of financial intermediation continues to function without disruptions. The financial and banking system provides vital financial services to the public. It is also a channel through which the central bank's monetary policies are implemented. In the efforts to preserve financial stability, a careful balance is made in achieving the objectives of a sound and stable financial system with that which is efficient and effective in meeting the requirements of the economy. This is so that the system is innovative and competitive, while at the same time, the risks do not undermine the stability of the system.

In Malaysia, derivatives are generally used as hedging instruments and to a limited extent to enhance yield. Derivatives have allowed banking institutions to increase product innovation without losing their ability to manage the increased risks. With the advent of credit derivatives and Basel II proposals, derivatives have been more widely recognized as a risk mitigation technique which could also economise on capital adequacy requirements. In 2003, it is estimated that the notional value of total outstanding OTC derivatives, comprising interest rate and foreign exchange forwards, swaps and options, grew by more than two fold in Malaysia, to RM171 billion over the last four years. It is important to note that statistics on OTC derivatives are difficult to capture, and that notional amounts are not an accurate reflection of the actual risk exposure to financial institutions. Between 1999 and 2003, it is estimated that the average annual growth in interest rate and foreign exchange OTC contracts collectively and in aggregate is about 40 percent. However, interest rate derivatives have experienced stronger growth given the sensitivity to interest rate changes and the need to manage exposure to fixed and floating rate financial assets.

In the international financial markets, the growth in OTC derivatives has been phenomenal in recent years. The statistics compiled by the Bank for International Settlements indicate that as of the end of June 2003 the total outstanding OTC derivatives in notional amounts was 169 Trillion US dollars. This total figure includes 22 Trillion US dollars of foreign exchange contracts, 121 Trillion US dollars of interest rate contracts, principally swaps, 2.7 Trillion US dollars of equity-linked contracts, almost 1 Trillion US dollars of commodity contracts and 18 Trillion US dollars classified as Others.

The fact that growth in financial derivatives has far surpassed the growth in the underlying real economies that generated the original transactions and risks for diversification is a matter of concern to regulators. It seems that speculators appear to have embraced derivatives as another form of investment for short-term capital gains. If financial derivatives take on a life of their own due to excessive speculative activity, the utility for risk diversification may prove illusory from a systemic point of view because the new

risks introduced by derivatives may well overshadow the risks posed to the financial system by the underlying more risky financial assets.

On a preemptive note, in response to a series of derivative debacles that was sparked off by the Barings crisis in 1994, Bank Negara Malaysia has taken steps to enhance prudential regulations on the derivatives business of banking institutions. In 1996, the Guideline on Minimum Standards on Risk Management Practices for Derivatives was issued to provide a framework that outlines the minimum risk management standards for the derivatives business of banking institutions. It requires banks to ensure that risk management controls and procedures are in place before engaging in derivatives business. The guidelines also ensure that derivatives can be offered to customers for hedging purposes only. In May 2003, as a step towards a more liberalized financial market, banking institutions are allowed to embed derivatives into investment instruments to enhance yields. The investment has to be principal protected, and may be offered to high net worth or corporate clients and for a minimum transaction amount of one million Ringgit. As part of the prudential requirements, no leveraging is allowed on the structure. Gradual liberalization allows the banking industry and the regulator to work in a collaborative manner in developing an innovative yet stable financial system.

In the context of the significant growth in OTC derivatives, both in the domestic market as well as the global market, there is therefore an important need for prudential management in derivatives since speculation would itself introduce risks into OTC derivatives market and could deter the principal objectives of risk diversification and risk management.

Allow me now to share 3 points concerning risk management opportunities in the wake of developments emerging in the international financial landscape. The first point is that regional integration offers increased opportunities for OTC financial derivatives in managing financial risks. The second point is that the new Basel II Capital Accord must be studied carefully to ensure that the portfolio of derivative products is profitable and innovative while remaining in compliance with the risk-weighted capital requirements, and thus preserving the financial stability of the institution. The third point is that the growth of Islamic banking and finance offers substantial new opportunities with respect to designing OTC derivatives compliant with the Syariah principles and appropriate for commercial use. As bankers and legal practitioners involved in the OTC derivatives industry, I believe these points will be of relevance to you in providing quality services to your clients and in developing your organisation's OTC business portfolio.

There are significant opportunities emerging in the Asian region. Regional integration has become more pronounced in recent years with the more rapid expansion of intra-regional trade in Asia. Intra-regional exports account for about one third of total exports of the region. Intra-regional trade with the ASEAN nations accounts for about 24% of the region's total trade, exceeding ASEAN's

trade with the United States. Trade with China, India and Korea has increased significantly. Notably, since 1993, China's role in the region has reversed from that of a net exporter to a net importer. East Asian exports to China have doubled during the past decade. There has also been a trend towards greater intra-Asian investment flows in the region. This includes higher investment of surplus funds into the region, in the form of foreign direct investments as well as portfolio capital flows.

These regional developments will lead to greater demand for OTC financial derivatives, which can be met by any of the major national, regional or global financial institutions operating in these markets. Malaysian banking institutions must be prepared to compete in this highly innovative and agile global industry by staying ahead on the learning curve for writing OTC derivatives that precisely match the risk management characteristics needed for effective hedging. At the same time, banking institutions must take into account the need for robust internal controls specifically in the area of credit, market, operational and legal risks to prevent the failure of any derivative contract.

My second point concerns the New Basel II Capital Accord. The International Swap Dealers Association, as the global trade association representing the leading participants of the OTC derivatives industry, has provided its views to ensure that the capital requirements of the New Capital Accord's will reflect the actual amount of risk that a bank is exposed to in a particular derivatives transaction. According to the recommendations put forth by the Basel Committee, capital requirements to support off-balance sheet derivatives are calculated by reference to the credit risk of the item adjusted for credit quality of the counter party. The approach essentially "marks to market" to determine the current replacement cost including the potential future exposures.

One particular development that should be observed is the growth of the use of credit derivatives. The 2001 Triennial Survey of Foreign Exchange and Derivatives Market Activity conducted by the BIS indicates a rapid expansion of the market for credit derivatives, with outstanding positions increasing from 108 Billion US dollars in 1998 to 695 Billion US dollars in 2001. The Centre for the Study of Financial Innovation has identified credit derivatives as a major risk area due to their rapid growth coupled with a lower understanding of the product. The implementation of Basel II's risk weighted approach to capital adequacy will have implications for banking institutions whose risk management systems have not assessed correctly the exposure due to off-balance sheet derivative items. As I have mentioned earlier, globalization and regional integration are introducing changes that will alter the nature of risks relevant to international trade, capital and the use of derivatives for risk management. Banks should be transparent and upfront in disclosing the risk and valuation approach of their derivative products such that the inherent risk of the product is adequately addressed. Let me also stress that the effectiveness of the risk adjusted capital requirements hinges not only on the capacity to perform sound risk assessments, but also on the legality of such derivatives transactions.

How banking practices and products reflect clearly and fairly the requirements of current and proposed prudential standards in their dealings with clients is a challenge, both for bankers and lawyers. The availability of a sufficient pool of legal experts in the Malaysian legal fraternity who are well versed with the detailed content and strategic intent of the prudential requirements will contribute immensely to the future development of the Malaysian derivatives industry, and as a consequence provide more opportunities for greater innovation in risk management within the Malaysian financial system.

Let me now turn to the final point I wish to make, which is about the opportunities within the rapidly growing Islamic banking and finance sector to develop derivatives that facilitate hedging of risks. The Islamic financial system, comprising the Islamic banking industry, the Islamic money and capital markets, and the Takaful market, is becoming an increasingly important component in the Malaysian financial system and in the global arena. Indeed, the Islamic capital market has registered very strong growth. In the debt market, the outstanding Islamic private debt securities as at the end of June 2003 was RM 68.2 billion, or 37% of total outstanding private debt securities. Malaysia has also made progress in developing offshore Islamic banking and financial products. The latest listing of the inaugural Sukuk by the Government of Qatar on the Labuan International Financial Exchange (LFX) on the 28th of January 2004 increased the market capitalisation of the exchange to USD2.95 billion (RM11.2 billion). The Bahrain-based International Islamic Financial Market (IIFM) has also endorsed the Sukuk in September 2003. The Labuan Financial Exchange has signed an MOU with IIFM to establish a framework for greater co-operation and to pave the way for both organizations to jointly develop an Islamic Capital Market with greater global reach. The importance to innovate and develop appropriate risk management tools is clear.

There are unique challenges to manage in developing derivative products for Islamic banking and finance because the end product must not only be Syariah compliant, in form and substance but also be globally attractive to all customers. While Islam encourages risk management in financial transactions, the tools or instruments used in such management must not have the prohibited elements of *riba* (interest or usury), *gharar* (uncertainty) and *maysir* (gambling). Certain basic Islamic financial products already exist that offer the benefits of hedging. The Bai' as-Salam contract, for instance, is essentially a forward contract where two parties agree to carry out a sale/purchase of an underlying asset at a pre-determined future date, but at a price negotiated and fully paid today. The *Istisna* contract is an example of a futures contract where a buyer contracts with a manufacturer to manufacture a product at a future date. A more interesting example is the *Istijrar* contract, introduced in Pakistan, which includes the characteristics of a put and call option, allowing the buyer to cap the purchase price, and the seller to set a floor for the selling price.

There is still considerable debate amongst Islamic scholars about the acceptability of the various forms of derivative products from the perspective of Islamic

jurisprudence. Hence, there is a need for more investment in intellectual capital in the field of Islamic finance to promote innovation that integrates the appropriate Syariah principles within the Islamic financial instruments. Our efforts to keep abreast with such developments will facilitate more rapid development of Islamic financial instruments for the purpose of risk management, using derivatives.

It is evident that the derivatives business has global opportunities since risk in today's financial environment is a product of uncertainties prevailing in the global markets, whether financial or non-financial. The ISDA Master Agreements have been the universal means of bringing order and certainty to the complex and rapidly developing world of OTC derivatives. The culmination of the new 2002 ISDA Agreement, 10 years after its predecessor, comes in the wake of many financial crises. Legal documentation of derivative transactions has a role in mitigating risks for banks and businesses. The world has changed considerably in this recent 10 years - financial liberalization driven by rapid advances in information technology is altering the financial landscape at an unprecedented pace. The legal and regulatory infrastructure must keep pace. We must continuously learn, un-learn and re-learn. The acquisition and application of knowledge must be a deliberate strategy and activity in pursuing the path of excellence.

Apart from the developments in the nature of financial risk due to globalization and regional integration, the ramifications of the Basel II capital accord, and the potential for developments in Islamic derivative instruments, I am aware that there are many other highly technical matters that need to be appreciated and understood. I will leave this to the experts who have given their valuable time to share their knowledge with us today at this banking and law school event.

Islamic Financial Services Board Interactive Session
31 March 2004, Bali, Indonesia

"The Future Prospects of the Islamic Financial Services Industry"

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

Our endeavour is to develop an Islamic financial system as an intermediation process that will contribute to overall wealth creation, growth and development and a greater shared prosperity. As the pace of globalization and liberalization accelerates, securing financial stability and confidence have increased demands for more robust and resilient financial systems. The challenge is therefore to evolve strategies that will promote a competitive, dynamic and sustainable Islamic financial services industry. Central to this common vision, to create a comprehensive Islamic financial system that will be able to respond to meet the requirements of the domestic economies and also to become an integral component of the international financial system.

Malaysia's experience in the development of our financial system is outlined in our ten year Financial Sector Masterplan. The Masterplan represents the blueprint that provides the strategic direction for the development of the sector that looks beyond the near term and takes a long-term perspective into the needs of the future. The aim of the plan is to provide clarity of the vision and objectives that are to be achieved in the context of a more challenging environment that is driven by rapid change in a world that is becoming increasingly more integrated and more technology and knowledge-based.

In the development of our Islamic financial system, a comprehensive approach has been adopted. Malaysia has given emphasis to the development of a comprehensive financial infrastructure that includes the Islamic financial markets, Islamic financial instruments, contract law and law enforcement procedures, Shariah governance framework, Islamic accounting practices and valuation standards, appropriate disclosure requirements as well as an efficient and secure payment and settlement system. Attention has also been directed to develop the prudential regulatory and supervisory framework that underpins the stability of the Islamic financial industry. Today, my remarks will focus on three key areas in which greater attention is needed in order to secure a promising future for the Islamic financial services industry. These areas include accelerating the pace of financial innovation, strengthening risk management capabilities and leveraging on information technology.

Accelerating the pace of financial innovation

As we advance forward in the development of Islamic finance, innovation will be key in securing the competitive advantage. It will be vital to the future of Islamic finance. While the initial focus has been on institutional building and financial infrastructure development, greater attention needs to be given to increasing the range of products and services to meet the greater sophistication of consumers and the more complex requirements of today's businesses in addition to enhancing the overall efficiency at which such products and services are provided.

Several factors are important to provide an enabling environment that would encourage and promote innovation. Firstly, a highly qualified and skilled workforce in the industry is indispensable for innovation. Training is a major means for promoting innovation. Personnel development in the industry is therefore important. In addition, industry involvement and participation in university education through course development, teaching and internship will contribute to this process. In Malaysia, an industry-owned research and training institute in Islamic banking and finance known as the Islamic Banking and Finance Institute Malaysia or IBFIM has been established to spearhead greater collaborative efforts with universities to undertake research in areas that are vital for the progressive development of the Islamic financial industry.

Increasing the capacity to innovate and securing long term competitiveness also underscores the importance of developing strategic leaders for Islamic financial institutions, leaders who are able to reinvent themselves in this new environment. Recognising this, Malaysia has established the International Centre for Leadership in Finance (or ICLIF) as part of our commitment to spearhead the development of a new generation of world class leaders who can steer the financial services sector to high performance and excellence in the industry.

Secondly, significant investment in the infrastructure that supports research and development will enhance the capacity for innovation. Financial support for advanced research at universities and research institutes will increase research opportunities. In addition, increasing the workforce involved in research and development will also increase the potential for innovation.

Thirdly, extensive education of the consumer and business community would increase the outreach resulting in increasing demands for new and innovative products and approaches. Malaysia has implemented a ten year structured consumer education programme to increase the level of consumer awareness on the unique characteristics of Islamic financial products and the product choices offered by Islamic financial providers. Increased awareness will drive the demand for a broader range of Islamic products and services customized to their requirements at more competitive prices and through more convenient channels. The outreach has also been for small businesses on the Islamic products and services. This process prompts the financial industry to increase innovation to

strengthen their competitive position. This can be reinforced by market research to enhance the understanding of customers' distinct financial needs and their risk tolerance and therefore enable the design of Islamic financial instruments that offer tangible benefits and value to customers.

In addition, as there is greater disclosure and transparency in the manner in which Islamic financial transactions are being conducted and Islamic financial contracts are being executed as well as on the risk and return profiles of Islamic financial products, this will strengthen the role of market discipline in driving Islamic financial institutions towards ensuring Shariah compliance in the operations, improving operational efficiency, strengthening risk management infrastructures and instituting sound and dynamic risk management practices.

These developments will create spin-off effects to increase innovation in developing hedging instruments that are Shariah compliant. While innovation in conventional banking has led to the development of a number of derivative instruments to hedge risks, there is still considerable debate amongst Islamic scholars about the acceptability of the various forms of derivative products from the perspective of Islamic jurisprudence. Towards this end, there is a need for more investment in intellectual capital and greater collaborative efforts among Shariah scholars, Islamic financial engineers and researchers to accelerate innovation that can integrate Shariah principles in the process of designing risk mitigation techniques and products. The Shariah should therefore be viewed as an enabler to innovation rather than a constraint. Leveraging on the true potential and wisdom of the Shariah would evolve Islamic financial instruments into distinct innovative and cutting-edge products.

Fourth, the environment and the incentive structure are also important in providing an enabling environment that promotes innovation. In particular, the regulatory framework and the tax structure are important to the innovation process. The regulatory framework should not be so onerous that it forms a high cost and a burden to businesses. Intrusive regulatory approaches on new products can become a disincentive. Tax structures can also be structured to support the innovation process. Within financial institutions, organisational structures can also create an environment for innovation by avoiding product-oriented structures and aligning instead to the organization's processes as well as implementing appropriate performance incentives.

Fifth, entering into strategic alliances with entities may bring new approaches, new technologies or specialisation in a new product. In addition, 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 jurisdiction 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. To facilitate the achievement of this objective, the sharing of information can be made on the product

features and the Shariah methodology adopted in ascertaining the permissibility of the products in the various jurisdictions.

Strengthening risk management capabilities

While financial liberalization and innovation have expanded the range of opportunities, it has also led to heightened uncertainties, greater volatility and increased potential of financial vulnerabilities. These developments require financial institutions to move to a higher standard of risk awareness and management. Regulatory emphasis has shifted towards a more risk sensitive regulatory capital framework and the assessment of risk management systems and processes in financial institutions. Extensive investment has been made by the industry to adopt a comprehensive and robust internal risk management infrastructure.

In Islamic banking, the requirement to manage risks becomes more important due to the special nature of the financial intermediation process that is guided by the Shariah. Islamic financial institutions have a multi-facet role. On the asset side, Islamic financial institutions enter into diverse modes of Islamic financial contracts, each with its own peculiar risk characteristics. Basel II, has to a certain extent, incorporated the identification of credit, market and operational risks that can be assimilated by Islamic financial institutions. However, Islamic financial institutions need to be ahead in exploring other dimensions of risks in these Islamic financial contracts. The risk management infrastructure in Islamic financial institutions must therefore be in place to identify, unbundle, measure, monitor and control all the specific risks in Islamic financial transactions and instruments to provide for their effective quantification and management.

Strong risk management capabilities become more pertinent in view of the different contractual arrangements entered into by the Islamic financial institutions with the different classes of depositors. Demand deposits, under the guaranteed custody contract and investment deposits, under the Mudharabah contract, each has its own unique risk and return attributes. Islamic financial institutions must ensure that demand depositors are protected from the risks of Islamic banking business. In respect of the Mudharabah depositors, any adverse shock to the financial performance of the asset portfolio in the balance sheet will be directly transmitted to the liability side, resulting in an adverse impact on the returns to the investment depositors. Islamic financial institutions have a fiduciary accountability in ensuring that depositors' funds are prudently managed and that the risk-adjusted returns on investments are maximized. The ability to maximize risk-adjusted returns on investments and sustain stable and competitive returns to depositors will contribute to promoting confidence in the Islamic financial industry.

Leveraging on information technology

As we forge ahead, successful financial institutions will be those that are able to exploit the full potential and opportunities that arise from the IT revolution. 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 to financial products through a wider range of new delivery channels. Greater application of IT in the industry can also enhance efficiency by driving down costs for consumers and businesses. Other areas include leveraging on IT in making strategic decisions in the alignment of business, in elevating institutional capacity and operational efficiency and strengthening risk management capabilities.

The advent of Basel II for conventional banking has compelled institutions to make strategic investments in technology and risk management systems to be equipped in making the required quantification of credit, market and operational risk. Enhancing the IT infrastructure has therefore become indispensable in view of the need to capture and maintain sufficient financial data and information for risk analysis.

In Islamic banking, IT applications in strengthening risk management capabilities are even more demanding in view of the risk intricacies in the different Islamic modes of finance. A financing facility for example that is extended to a client based on Murabahah, Ijarah, Istisna' and Musyarakah will all have its own unique risk exposures. The risk exposure is not only different across the different modes of finance but also across clients. In addition, different maturities of the Islamic financial contracts will have different implications for risk across modes and across clients. Islamic financial institutions need to have a robust internal rating system that can map all assets in the balance sheet in accordance with the risk characteristics of each asset. Comprehensive IT systems will be needed to capture and store long-term historical data so that expected probability of the return can be estimated and a risk weight can be quantified and assigned. Indeed, the heterogeneous modes of Islamic finance require an even more rigorous system for expected return calculation as compared to interest-based credit transactions.

The complex and volatile financial environment requires enhanced capacity of Islamic financial institutions in dealing with uncertainties and probabilities. This will enable Islamic financial institutions to strengthen tolerance levels to deal with financial vulnerabilities. Towards this end, well-developed internal risk management systems are required to identify any potential deterioration in the asset quality of the Islamic banking portfolio. This will allow Islamic financial institutions to be in a position to maintain adequate provisioning in a dynamic manner, forecast future earnings and apply Shariah-compliant risk mitigation techniques at an early stage so as to manage the volatility in returns to ensure stable and competitive income to depositors.

Similarly, applications of risk-based models allow Islamic financial institutions to conduct stress testing, sensitivity analysis and simulations based on multiple scenarios to take into account all possible potential outcomes that may occur. This will enhance the capacity of Islamic financial institutions to better anticipate the possible impact of financial shocks on future earnings and hence formulate contingency plans leading to a more

effective and efficient asset and liability management.

In addition, IT-based risk management systems would strengthen the capacity of Islamic financial institutions to effectively manage the segregation of demand deposits, restricted and unrestricted investment accounts and shareholders funds in accordance with their distinct investment objectives and risk tolerance. The mapping of financial performance of assets with risk-adjusted returns to these specific classes of investors will lead to enhanced accuracy and transparency in the determination of returns. In addition, as returns in Islamic banking are uncertain and can only be ascertained on an ex-post basis, well-developed IT systems can equip Islamic financial institutions with the ability to make projections on future returns to reduce the degree of uncertainty in the returns to be paid to the depositors. This would enhance credibility and strengthen the competitiveness of the Islamic financial industry.

Conclusion

The future prospects of the Islamic financial services industry will be the result of the combined efforts of all the relevant entities in the financial sector - the industry, the regulators, the market participants and the international community. These collective efforts need to be galvanized as a coordinated and concerted effort to maximize the potential for the industry. Evolving the shared vision and common goal to be achieved will be an important first step. Of greater importance will be the actions that need to be taken to make this happen. It will be our actions and initiatives taken today that will contribute towards determining the future that we aspire.

Risk Management Seminar on the New Capital Accord (Basel II)
15 April 2004, Kuala Lumpur

"Enhancing the Soundness of the Banking Sector - The New Capital Accord"

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

The objective of this seminar is to promote greater understanding of the impending changes to the international capital adequacy regulation. Given the importance of the subject and its implications on the banking industry, it is important for the industry to understand the intentions and the challenges arising from these changes so that the necessary action may be taken in a manner in which the benefits to be derived from it can be maximised. While there has been global acceptance of the broad principles of the new accord, differing implementation approaches are being adopted by different countries. I will take the opportunity to discuss the new Accord from our perspective and the approach that will be adopted for Malaysia. This seminar will provide you with the opportunity to engage in discussions on the issues concerning the new Accord.

Philosophy and objective of capital regulation

A well functioning and efficient banking sector is vital to the economic growth process. The banking institutions perform the important intermediation function of mobilizing funds to finance productive activities. This intermediation process needs to be performed in an environment of financial stability. Therein lies the importance of confidence and soundness of the financial system. Banking business inherently involves risks and these risks need to be rigorously managed. In an environment of heightened uncertainty and increased volatility, this needs to be reinforced with the development of a more robust and resilient banking system. Hence the importance of prudential regulations to ensure the soundness and stability of the financial system.

An important component of prudential regulation is having a sound capital framework that measures risks accurately and allocates adequate capital to the risks. The current capital accord issued in 1988 has served as the international benchmark for capital adequacy assessment for banking institutions. While it has achieved the desired results in terms of developing more well-capitalized banking institutions globally, the rapid developments in the financial markets over the years, including the growth of off-balance sheet financing such as asset securitisation

have rendered the broad-brush measurement of the existing accord to be less effective.

Risk and Risk Management - the need for new accord

New institutional structures and evolving market practices have reduced the effectiveness of the existing accord. While the basic categorization of risks have not changed significantly, the ways in which risks present themselves have changed quite substantially. With the introduction of new products and more complex financial transactions enabled by technological innovations, risks can be disaggregated and rebundled in new ways. Similarly, the advances in financial engineering and improved expertise have allowed the introduction of new hedging instruments to facilitate risk management. Significant enhancements have been achieved in the measurement of market risk where the use of internal value-at-risk models is fast becoming the industry standard.

The advances in the quantitative approach to the management of market risks have also expanded to the areas of credit as well as operational risks. Despite the significant data constraints, new research has strengthened the theoretical foundation for internal credit and operational risk modeling. The development of new hedging instruments such as credit derivatives has also increased the use of credit risk transfer mechanisms within the financial system, thus promoting more active credit portfolio risk management. Key developments have also taken place in the area of operational risk. The experience of large corporate failures due to fraud and lapses in internal controls has focused greater attention on improving operational risk management in banking institutions. This has prompted the need for banking institutions to provide capital for operational risk and to put in place a more integrated risk management framework on an enterprise-wide basis.

The essence of the new accord

The efforts of the BIS to introduce an enhanced framework for capital adequacy regulation through Basel II is in the context of these developments. The accord seeks to bring into greater alignment the more advanced concept of capital management into the regulatory equation. The assessment of capital adequacy needs to look beyond the computed capital ratio. The new Basel Accord therefore comprises **three pillars**. The first pillar provides a minimum capital measurement framework for credit and operational risks. In essence, the regulatory capital requirement is aligned more closely with the actual degree of underlying risk that the banking institution faces. It provides the capital measurement that has three options with different levels of complexities for both credit and operational risks to better reflect actual risk. The second pillar focuses on strengthening the supervisory process, particularly in assessing the quality of risk management in the banking institutions. The supervisory process aims to provide the mechanism to ensure that other risks such as concentration risks and market risks in the banking books being managed. Under such an environment, prudent lending such as that characterized by a high degree of portfolio diversification, could justify lower capital

requirements. The third pillar specifies minimum disclosure requirements on capital adequacy to enhance market discipline.

Despite its relatively more complex architecture, the implementation of the new framework provides a number of options and flexibility to banking institutions. This is to ensure that the approach adopted reflects and is commensurate with the nature of risk-taking activities and the level of sophistication of individual institutions. In adopting the **standardized approach** for credit risks, the credit exposures are weighted based on recognized external credit ratings. However, for large banking institutions with businesses which are highly complex, the more advanced approaches, that is, the **foundation or advanced internal rating based (IRB)** approach may be more appropriate to reflect their actual risk profile. Similarly, there are three alternative approaches that may be adopted in allocating capital for operational risks, that is the basic indicator approach, the standardised approach and the advanced measurement approach.

The objective of the new framework is to emphasise on the need for refined measurement of risks, more efficient capital management and the adoption of sound risk management practices that will ultimately contribute to greater financial stability. This will be complemented with efforts to enhance the corporate governance framework, the robustness of the internal control systems, and to introduce greater transparency and market discipline. Within the context of these developments is the importance of the ability of the board members and top management of banking institutions to assess risk from a broader perspective and its strategic impact on the institution.

In view of the significant implications of this new capital framework, Bank Negara Malaysia has been directly involved in the consultative process through regional forums to ensure that issues and concerns of the emerging markets are considered by the BIS in designing the new accord. We are pleased to note that many of these issues have been taken into consideration.

Motivation for migration to the new accord

The adoption of the new accord is consistent with building strong risk management capability. The enhanced risk management practices required by the new accord not only can result in greater capital savings but becomes vital as the domestic banking system becomes increasingly competitive and integrated with the global marketplace. Effective and efficient decision making is enhanced with relevant and timely information supported by more quantitative analysis. This can be achieved through having a more robust data architecture and information system, integrated processes and enhanced information flow and reporting. Having a robust risk management framework would also allow banking institutions to better assess the marginal contribution of existing as well as new business lines to the institution's overall financial performance. This would allow for more-informed decision-making, thus contributing towards greater competitive advantage.

Moving forward, there will be increased expectation for more efficient use of internal resources. A more enhanced and integrated risk management framework, and the adoption of a risk adjusted performance management model would serve to further facilitate shareholders' activism and drive greater efficiency among banks.

Risk management however does not operate in a vacuum or in isolation and it should not be viewed merely for the purpose of regulatory compliance. Priority should be given to ensure that the risk management framework is well-aligned and well-integrated with the strategic business directions of the banking institution. The benefits of refined risk quantification and more robust risk management should be translated into improvements in business operations and more effective functioning of the institutions. This will in turn ultimately bring benefits to the consumers and the economy at large.

Implementation challenges and considerations

Given the complexity of Basel II, the ability to comply appears to be the main concern within the banking community. This is truly a major undertaking with respect to the IRB approaches or the internal rating based systems. The resources involved and data constraints are often cited as the two main challenges in implementing the IRB approach, particularly for banks in the emerging markets. At this stage, data on default and credit migration for certain market segments is too limited to facilitate any meaningful analysis. It is therefore recognized that some lead time would be needed for banking institutions to produce a robust and meaningful validation of internal estimates of probabilities of default and loss given default. However, this does not mean that banks should wait until all the requisite data is in place. Banks can initiate work to establish the framework for analytical functions.

While the industry survey conducted by Bank Negara Malaysia revealed a strong preference among Malaysian banking institutions to adopt the IRB approach, many had indicated the need to further strengthen their business case and undertake more comprehensive gap and impact analysis. This is indeed a critical process. Of importance is to be able to extract the benefits out of the new accord. This would however, take time even for large and internationally active banking institutions that have made substantial enhancements over the years.

Standardised approach offers benefits with much less complexity

While capital savings from the adoption of the standardized approach may be relatively lower than the IRB approach, the benefits to be gained under the standardized approach are still considerable compared to the current accord. It includes the lower risk weights to be assigned to the mortgage portfolio, which would be reduced from 50% currently to 35% under the standardized approach. Similarly, substantial capital savings could be generated from lending to small and medium enterprises (SME) that would qualify as retail exposures where the risk weights would be lowered from 100% to 75%. The potential impact of lower risk weight for this sector under the standardized approach could

result in greater participation by banking institutions in this market segment.

Bank Negara Malaysia's initial estimates on the impact of the standardized approach indicated that benefits would be derived by individual institutions in terms of capital savings. However, improvements in a number of areas such as loan identification systems as well as collateral management systems would result in higher capital savings for credit risks under the standardized approach. Continuous calibration would be required to ensure that banks under the standardized approach would continue to maximize capital savings for credit risks in view of the requirement for an explicit capital charge for operational risk under the new accord.

While the IRB approaches promise greater capital savings in the longer term, the adoption of the standardized approach in the transition is considered a more pragmatic option even for some internationally active banking groups. Under the IRB approaches, banks would need to reach an agreement with the regulator in the countries they operate on the robustness of group internal estimates and validation. The standardized approach is therefore seen to provide the breathing space for a smooth transition to IRB approaches while at the same time allowing banking institutions to avail themselves of the benefits of capital savings.

Different approaches are adopted by regulators

While there has been global acceptance of the broad principles of the new accord, differing implementation approaches are being adopted by different countries. In some countries, regulators have opted for the accord to be applied to all institutions while in others selected banks are being mandated specific approaches. Some other regulators have given greater flexibility for banks or have extended the timeline for the implementation of the new accord. These reflect the different considerations and priorities accorded by the various regulators in their policy agenda. In essence, the decision by national regulators are based on a number of common factors, namely, the stage of industry development and market infrastructure, the size and types of institutions involved, the regulatory philosophy and priorities, as well as the economic environment. Of importance is to ensure that the implementation of the new accord is consistent with the overall agenda and objectives for the financial sector to facilitate growth and economic expansion.

Implementation principles for Malaysia

In Malaysia the appropriateness of the new accord is being assessed in the context of our own objective to develop a more effective and resilient banking system that is best able to serve the nation. In view of the significant and special role of the banking sector in the economy, a well-capitalised banking system has always been a priority in the regulatory framework. In this context, the principles advocated by the new accord are consistent with our regulatory philosophy that encourages capacity building and enhancing risk management.

Effective Basel II implementation strategies would be premised on the industry

having the correct understanding of the new framework. To implement the required changes, it is therefore vital that the management of banking institutions understands the principles of the new accord. One common misperception is that the recognition of financial collateral under the new framework will encourage more collateral-based lending within the banking sector. This is a simplistic conclusion given the stringent minimum standards for the recognition of such financial collaterals before banks can qualify for the capital savings. Moreover, the potential capital savings under the new framework is not from the recognition of financial collateral, but rather from the much lower risk weights attached to higher rated loans.

Indeed, the real benefit to be gained under Basel II environment comes from improved standards of loan underwriting and more accurate quantification of risks that can subsequently translate into enhanced performance. Acceptance of collateral is only to mitigate loss severity should a default take place. In an increasingly more competitive marketplace, the emphasis is on maximizing risk-adjusted returns on capital and maintaining an optimal asset portfolio that reflects the risk tolerance level of the institution. In such an environment, overemphasis on collateral is certainly not viable.

Bank Negara Malaysia will adopt four key principles in the implementation of Basel II in Malaysia:

Firstly, the need to accommodate capacity building efforts, with strong emphasis on gradual enhancement to risk management framework for all banking institutions;

Secondly, a more flexible timeframe that allows capacity building measures to be implemented;

Thirdly, an emphasis on strong business justification instead of regulatory mandate for the adoption of IRB approaches; and

Finally, an enhanced supervisory methodology to assess internal models and advanced risk management systems.

Malaysia will adopt a two-phased approach for Basel II

These principles would be implemented in a two-phased approach. The first phase will begin in January 2008 where all banks will adopt the standardized approach for credit risks and basic indicator approach for operational risks. Banking institutions would be required to submit to Bank Negara Malaysia parallel calculation of capital adequacy on a monthly basis for one year prior to the implementation of the standardized approach.

In Phase I, Bank Negara Malaysia may also allow banking institutions to remain on the current accord if they intend to adopt the Foundation Internal Rating Based (FIRB) approach, instead of the standardized approach. However, Bank Negara Malaysia would require a submission of business case justification as well as a blueprint for implementation that has been approved by the Board of Directors of the banking institutions concerned. These banking institutions would be expected to have undertaken a comprehensive gap and business impact studies to justify their roll-out plans. In this

regard, a broad guideline on the required processes and expectations will be issued to facilitate the process.

Banking institutions intending to adopt the FIRB approach are expected to do so by January 2010. This is when the second phase of implementation will commence. These institutions will be required to submit to Bank Negara Malaysia parallel calculation of capital adequacy on a monthly basis for one year prior to implementation. However, during the second phase, banks on the standardized approach will not be mandated to migrate to the FIRB approach. For purposes of regulatory validation and approval, Bank Negara Malaysia would expect that all parameters and assumptions used for the FIRB approach would be based on local data inputs.

Conclusion - capital is key, but not the sole factor to ensure soundness

Despite the increased sophistication of the regulatory capital framework and internal economic capital model in banks, capital remains the last line of defence. Capital regulations will have to be complemented with prudent banking that includes enhanced underwriting standards, effective internal controls and risk management, as well as strong corporate governance. In achieving your future goals and aspirations, significant benefits can be derived from Basel II provided that your institutions undertake the necessary efforts to align your strategy and business orientation with the new standards. Your interest, participation and decisive actions on the new accord are therefore important in positioning your institution in this increasingly competitive and more dynamic environment.