Fifth Annual Islamic Finance Summit
24 January 2006, London

"Towards Evolving Islamic Finance as an Integral Component of the International Financial System"

Opening Speech by

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

It is my great pleasure to be here in London to speak at this fifth Annual Islamic Finance Summit organised by Euromoney. Islamic finance has made significant breakthroughs to now gain a place in today's challenging global environment with its international dimension now becoming increasingly more significant. It has now evolved to become an integral part of the international financial system. As this international financial integration process intensifies, it will not only increase the potential for Islamic finance to contribute towards enhancing the prospects for more balanced global growth through fostering greater trade and wealth creation, but also through facilitating greater diversification of risks, it will contribute towards increased global financial stability.

Rapid Evolution of the Global Islamic Financial Services Industry

As recent as five years ago, the development of Islamic finance was still regarded as an infant industry striving to prove its viability and competitiveness in the global financial environment. At that time, the growth of Islamic finance was mainly organic and largely concentrated in countries where the Muslim population was significant. Islamic finance was also for the most part governed by conventional regulatory and accounting standards. In addition, the divergence of views on some of the outstanding issues called for greater harmonization. Indeed, there was also some apprehension amongst the regulatory authorities, consumers, business communities and investors on the future potential of Islamic finance.

Notwithstanding this, over the recent five years, there has been a rapid evolution and expansion of the industry. Today, Islamic finance has been recognised as a viable and competitive form of financial intermediation not only in Muslim countries but also outside the Muslim world and offering a wide range of financial products and services. Licences are being issued to facilitate the establishment of Islamic banks including in the industrial economies in Western jurisdictions. There are also an increasing number of international conventional banking institutions offering Islamic financial products and services through dedicated subsidiaries or branches as well as through window arrangements. In addition, countries that have pockets of Muslim population, in particular, in the Asian region are now exploring the prospect of providing access to Islamic financial services to promote greater inclusion. These trends have not only been in terms of numbers of Islamic financial institutions, but also in terms of institutions with larger size of capital and a more established operational governance framework including risk management. Islamic financial institutions that previously operated only in their own domestic jurisdictions have also begun to venture abroad to tap new growth opportunities in other regions and forge greater cross-border linkages.

In the Islamic capital markets, there has been a growing interest in the issuance of Islamic *sukuks* by both sovereigns and multinational corporations. At the international level, the issuance of the first sovereign global Islamic *sukuk* by the Government of Malaysia in

2002 has been followed by a series of other issues. Corporations and multilateral development institutions have also embarked to issue Islamic financial instruments resulting in an increase in the range of products in the international capital market. Islamic *sukuks* have now breached the USD15 billion mark. The Islamic *sukuks* have attracted a broad range of investors. In 2004, to deepen our capital market further, Malaysia liberalized our exchange administration rules to allow multinational corporations and multilateral agencies to raise ringgit denominated papers in our domestic bond market. Multilateral financial institutions including the International Finance Corporation and the World Bank have since issued Islamic based ringgit-denominated instruments. We welcome the origination and issuance of Islamic financial instruments to be issued in Malaysia.

The growth in Islamic asset and wealth management has also been phenomenal arising from the diverse and innovative structures of Islamic investment funds, including Islamic hedge funds. It is estimated that more than 250 *Shariah*-compliant mutual funds are currently managing approximately USD300 billion in assets. *Shariah*-compliant screening techniques have been able to improve risk-adjusted returns on Islamic investment funds which in turn have led to its adoption in improving the risk-adjusted returns of conventional equity funds. Benchmark indices such as the Dow Jones Islamic Market Indexes and the Financial Times Stock Exchange Global Islamic Index Series in the international equity market and the listing of Islamic financial instruments on international exchanges have all contributed to enhance the depth of the Islamic financial markets as an attractive asset class for investment.

On the regulatory front, the standardised international rules and regulations for the Islamic financial institutions now being issued by the Islamic Financial Services Board (IFSB) will be important in effectively ensuring the stability and soundness of the system. Two important standards, the standards for capital adequacy and risk management have been approved by the Council of the IFSB in 2005. The two standards have taken into account the aspects of risks associated with the different contracts in Islamic banking business. Proper assignment of capital charge on profit-sharing arrangement and the introduction of profit equalization and investment risk reserve are risk-mitigating elements to ensure the soundness in Islamic banking business. The on-going work in the area of supervisory review process, market discipline, corporate governance and transparency will complete the range of the prudential and supervisory standards of Islamic financial institutions. The increased participation in the IFSB from across the globe reflects the growing interest of the global financial community to be involved, at the onset, in the development of regulatory standards in Islamic finance. In addition to these developments, regulatory and legal reforms are also being undertaken in a number of jurisdictions to accommodate the unique characteristics of Islamic financial transactions to support the progressive development of Islamic finance.

Following these institutional enhancements, the significant growth of Islamic financial markets and the development of the supporting financial infrastructure, the international financial architecture for Islamic finance has been strengthened considerably. Established international financial centres have now included the development of Islamic finance as part of their agenda. Also emerging on the horizon are new Islamic financial centres in which innovative and competitive Islamic financial services industry is evolving. With the supporting comprehensive Islamic financial infrastructure in place in Malaysia and the diversity of Islamic financial players following the recent increased liberalization in the Islamic finance sector, Malaysia is positioning itself as an international Islamic financial centre.

Key Challenges Ahead

While Islamic finance has made significant strides, there are key challenges that need to be addressed for Islamic finance to sustain its development in the global financial system. My remarks will focus on four of these challenges.

The development of robust Islamic financial system at the national level

Firstly, there is the challenge to develop a robust Islamic financial system at the national level. The level of development of Islamic finance across jurisdictions varies significantly. While in some, Islamic finance is at an advanced stage of development, in others, more meaningful progress is yet to be made. To foster greater international linkages and cross-border transactions, the level of development of Islamic finance needs to reach a certain threshold of development and sophistication. It requires the development of a robust Islamic financial system which encompasses both the banking and the non-bank Islamic financial intermediaries, the Islamic financial markets, offering the range of Islamic financial products that is supported by a developed Islamic financial infrastructure.

The formulation of the ten-year masterplan for the Islamic financial services industry by the Islamic Development Bank (IDB) and the Islamic Financial Services Board (IFSB), marks an important step in setting the blueprint for leading the development of Islamic finance in a systematic and synchronized manner across jurisdictions to achieve the common goal of a vibrant and comprehensive Islamic financial services industry. Malaysia had five years ago launched our own Financial Sector Masterplan which includes the strategic direction for the development of Islamic finance forward in Malaysia. It has now culminated in the progress that Malaysia has achieved today.

Malaysia has now evolved a comprehensive domestic Islamic financial system that is diversified in terms of its institutions, markets and players. The strategy has been to institute the entire financial system chain to ensure the smooth functioning of the system. The initiatives include building the required financial institutions including, the Islamic banking institutions, the *takaful* industry, the non-banking institutions and developing the Islamic money and capital markets. These respective components have recently been progressively liberalized to become internationally more integrated. The supporting financial infrastructure includes a robust regulatory and supervisory framework reinforced by the legal and *Shariah* framework, the payment and settlement systems, the development of the pool of talent and the mechanism for the liquidity operations of the Central Bank as part of its monetary policy conduct.

The development of efficient and active international Islamic financial markets

The second challenge is to advance further the development of an efficient and active international Islamic financial market. Well-developed international Islamic financial markets enhance the liquidity of the instruments and risk management capacity of the players. This would promote the efficient functioning of the markets and thus facilitate capital flows and thereby strengthen global integration. Co-ordinated initiatives are therefore essential to foster the development of an efficient and vibrant international Islamic financial market. Sustainable supply of *sukuks* on a regular basis needs to be ensured. The participation of issuers including multilateral organizations, governments and multinational corporations would contribute to this process. In Malaysia, the domestic bond market now accounts for 80% of GDP. Of this, 44% of the papers are Islamic based.

A fundamental pre-requisite is to promote innovation in the development of a broader range of Islamic financial market instruments. These include instruments with equity ownership features, Islamic asset-backed

securities, inclusion of permissible forms of credit enhancements as well as *Shariah*-compliant risk mitigating instruments. The development of an Islamic derivatives market for hedging is required for market-making activities to support the development of secondary markets. Research and development therefore need to be intensified. The *Shariah* fund recently established by Malaysia is to support research activities in these areas. This initiative is also to facilitate annual dialogues amongst international *Shariah* scholars. It is to provide a platform for deliberation on the *Shariah* compatibility of newly developed Islamic financial instruments and markets.

A further pre-requisite is to ensure sufficient availability of liquidity to support the intermediation of funds in the Islamic financial system. The demand for Central Bank discount window operations is inevitable. Central banks must therefore have sufficient Islamic financial instruments at its disposal to manage the liquidity conditions in the Islamic financial system. This is an area that has yet to be fully developed. In relation to this, Malaysia has developed Islamic monetary instruments that includes both the government and our own Bank Negara Malaysia Islamic financial instruments. We have also a dedicated clearing and settlement mechanism to ensure the smooth functioning of the Islamic financial system. To add to the existing range of Islamic financial instruments, Bank Negara Malaysia will in February this year issue an *Ijarah* paper to further meet the requirements of Islamic market players in the domestic Islamic money market and also for the purpose of conducting monetary policy. Of equal importance is having in place appropriate regulatory and legal framework to support the development of Islamic financial instruments and markets to ensure investor protection, uphold market integrity in addition to containing systemic risks.

The adoption of IFSB standards

The third is to ensure the adoption of the IFSB standards. The standards on capital adequacy and risk management that have now been approved by the Council of the Islamic Financial Services Board in December 2005 is scheduled for implementation in 2007. Islamic financial institutions must therefore be equipped with the required capacity and infrastructure to capture the respective risk weights and assign appropriate amount of regulatory capital at each of the different stages of the Islamic financial transaction. The exclusion of risk-weighted assets funded by the profit-sharing investment accounts from the calculation of regulatory capital requirement places critical emphasis on a comprehensive infrastructure in the Islamic financial institutions to clearly segregate the restricted and unrestricted profit-sharing investment accounts from the non-profit-sharing accounts and shareholders funds and to track their respective flows in financing and investment transactions. Strategic investments in the state-of-the-art IT and risk management systems are integral to this process.

Supervisory authorities need to be equipped with the specialized skills necessary to have the right assessments on the level of risks that the Islamic financial institutions are exposed to and the effectiveness of the risk management infrastructure in the Islamic financial institutions in mitigating these risks.

The development of a sufficient pool of talent in Islamic finance

Finally, the development of a sufficient pool of appropriately skilled Islamic finance practitioners needs to be accorded the highest priority. The required skill set in Islamic finance is unique. It needs to have the right blend of knowledge of finance with the understanding of the *Shariah* as being central. The *Shariah* principles must be embedded in each and every operational aspect of the Islamic financial institution, including in the design of financial products and financing structures, financial contracts and their execution, liquidity and balance sheet management, risk management as well as asset and wealth management. The upholding of *Shariah*

principles must permeate from the highest level, including at the board and senior management levels, which provide the strategic direction for the Islamic financial institution and to the operational levels. Sound policies and practices premised on *Shariah* principles will evolve the Islamic financial system into a financial system that is distinctively ethical and that which promotes economic justice.

To meet this objective of providing a total talent management solution for the global Islamic financial services industry and to meet the educational needs of the different levels of Islamic finance practitioners, including professionals and specialists in Islamic finance, Malaysia is establishing an International Centre for Education in Islamic Finance (INCEIF). INCEIF will commence operations in March this year and will offer professional certification programmes in Islamic finance. INCEIF will also forge strategic alliances with domestic and foreign academic institutions to offer post-graduate programmes, namely Masters and Doctorates in Islamic Finance with specific areas of specialization. A professional association for Islamic finance professionals will also be established for the alumni of INCEIF to keep abreast with the latest developments in Islamic finance.

Conclusion

Building the foundations on which Islamic finance has been able to advance forward has been vital to its viability, competitiveness and sustainability in this challenging global financial environment. With its integration into the international financial system, it would strengthen further the global economic and financial inter-linkages and in so doing would open new frontiers towards achieving more balanced global growth and greater shared global prosperity.

Second International Conference on Islamic Banking: Risk Management, Regulation And Supervision 7 February 2006, Kuala Lumpur

"Building a Robust Islamic Financial System"

Keynote Address by

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

Let me first of all extend a warm welcome to the participants of this Second International Conference on Islamic Banking: Risk Management, Regulation and Supervision, jointly organized by the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank (IDB) and the Islamic Financial Services Board (IFSB). This forum has an important role of not only fostering the dissemination of knowledge and exchange of experiences on the subject of risk management, regulation and supervision, but also in facilitating a better understanding on the issues confronting us, and thus contribute towards advancing forward the development of the industry. Effective risk management capabilities is particularly important in this more challenging global financial environment of heightened uncertainties and increased potential for financial vulnerabilities. And an effective regulation and supervision will ensure the soundness and stability of the system. In the recent decade, the Islamic financial system has experienced remarkable growth and transformation, demonstrating its potential as a competitive form of financial intermediation. Today, Islamic finance represents a multi-billion dollar industry with a comprehensive range of products and services, serving a broad spectrum of consumers and businesses that extends beyond the Muslim world.

In developing the Islamic financial system, it is important to focus on the appropriate pre-requisites that will facilitate its efficient evolution. Fundamental to this is the development of the institutions, the markets, the range of financial products and services and having in place the legal, regulatory, supervisory, accounting and *Shariah* frameworks, as well as, for the monetary authority to have the capacity to manage its financial policies within this context.

With the development of these respective components having made significant progress, we are now seeing the Islamic financial services industry enter a new phase of development. Following increased liberalisation, the progress in the development of the international financial architecture for Islamic finance and the increased innovation resulting in the development of new products and services, the international dimension of Islamic finance is becoming increasingly more significant.

Islamic financial institutions are now also venturing their operations beyond their domestic borders. Islamic-based papers are also being issued in international financial markets, generating significant interest from global investors. The international financial architecture for the development of Islamic finance has also been strengthened with the establishment of the international standard setting bodies to draw-up the accounting and prudential standards. These developments have cumulatively evolved the Islamic financial system to increasingly become an integral component of the international financial system.

The Malaysian experience has been to develop a comprehensive domestic Islamic financial system that is diversified in terms of its institutions, markets and players. The strategy has been to institute the entire financial system chain to ensure the efficient functioning of the system. The initiatives include establishing the required financial institutions, including the Islamic banking institutions, *takaful* companies, the non-banking institutions and developing the Islamic money and capital markets. These respective components have recently been progressively liberalized in terms of allowing for the entry of new foreign players and in terms of increasing the potential for foreign participation in the domestic financial markets. In addition, both these domestic and foreign operations have been encouraged to tap on regional and international business opportunities. This move has strengthened the cross-border financial inter-linkages, prompting greater international integration. To ensure the robust functioning of the system, these developments are supported by a strong regulatory and supervisory framework reinforced by the legal and *Shariah* framework and the payment and settlement systems.

While the positive growth and developments in the Islamic financial system have brought about expanded opportunities, the financial liberalization and technological advancement have brought about increased competition and greater innovation in the development of products and services, operational processes and delivery channels. These developments have contributed to increasing the risk profile of the institutions. These new risks are generally more complex and have more profound systemic implications to the financial system. This has increased the need for strengthened risk management capabilities by the industry and for greater attention to this aspect by regulators and supervisors in ensuring the stability and integrity of the financial system. Of importance is to ensure an understanding and awareness of the risks inherent in Islamic banking activities. The challenge is to ensure that each component that supports the risk mitigation requirements, comprising the framework and institutional infrastructures, legal, regulatory, supervisory as well as the *Shariah* infrastructures are in place.

My remarks this morning will focus on the challenges of risk management in Islamic financial institutions, and the roles of effective regulation and supervision in this context as part of the efforts to promote the development of a robust and sound Islamic financial system.

In Islamic banking, the management of risks becomes more challenging due to its peculiar risk characteristics and the requirement for compliance to *Shariah* principles. While the Basel II initiatives on the identification of credit, market and operational risks can be assimilated into Islamic banking, the initiatives have to be complemented with consideration of the other dimensions of risks that are inherent in the Islamic financial transactions. The risk management infrastructure in Islamic financial institutions needs to identify, unbundle, measure, control and monitor all the specific risks in the Islamic financial transactions and instruments. This is to ensure that the systems and controls will be effective in the quantification and management of the risks arising from the operations.

New innovations in technology would be particularly important to enhance the potential to manage risks. In addition, as the returns in Islamic banking are uncertain and can only be ascertained on an ex-post basis, well-developed IT systems would be necessary to enable Islamic banking institutions to make projections on future returns so as to reduce the degree of uncertainty in the returns to be paid to the depositors. This would also strengthen the potential competitiveness of the Islamic financial services industry.

Another facet to risk management is the need for the Islamic banking industry to develop a

derivatives market. In the current increasingly uncertain global financial environment, investors need to be in a position to mitigate and manage these emerging new risks. Islamic banking institutions, in particular, have to a large extent long-term assets which include long-term Islamic housing mortgages and Islamic financial instruments, that are funded by short-term deposits, thus giving rise to a maturity mismatch between the assets and liabilities. There is therefore a need for the development of a broader range of Islamic financial market instruments to provide the industry with effective risk mitigating instruments.

In addition to the derivatives market, the Islamic financial system also needs deeper and more efficient money and capital markets to facilitate sound asset and liability, and liquidity management by Islamic financial institutions. In addition to the existing Islamic instruments, Bank Negara Malaysia will issue *sukuk Ijarah,* to meet the requirements of participants in the Islamic money market.

At the core of a strong Islamic financial system in any jurisdiction, there needs to be a strong regulatory framework that enforces the standards for capital adequacy, ensures effective risk management practices, financial disclosure and governance, reinforced by a strong *Shariah* and legal framework. *Shariah* principles serve as a self-regulating mechanism that protects Islamic financial institutions from unproductive, speculative and unethical activities, given the prohibition of interest in banking business, and the requirement that all financial transactions are to be accompanied by genuine trade and business-related transactions and the prohibition from the involvement in illegal and unethical activities. Thus, the regulatory framework in which Islamic banking operates is able to draw on the strength of the *Shariah* injunctions, to reinforce financial soundness and stability of the Islamic banking system.

In Malaysia, Islamic banking institutions are required to establish a *Shariah* committee within their respective institutions to ensure that the products and services to be introduced are *Shariah*-compliant. In addition, emphasis is also placed on the internal audit function to ensure that all transactions undertaken by the Islamic banking institutions are in compliance with the *Shariah* principles.

In designing and implementing financial regulation and supervision for Islamic banking institutions, the challenge is to enforce a framework that takes into account the unique characteristics of Islamic banking business, without being a regulatory burden and restricting its growth potential or providing arbitrage opportunities between the conventional and Islamic financial systems. In building a sound prudential framework for Islamic banking, aligning the regulatory capital requirements to the underlying risks, requires dichotomization of the risk intricacies in the Islamic banking asset portfolio, given the asset structure of Islamic banking institutions, such as the diverse spectrum of Islamic financing structures, which range from low-risk sales and lease-based modes to the higher risk equity-based modes of finance. The intricacy in profiling the risk in Islamic banking is further increased as the risks may transform from one type of risk to another at the various stages of the contract. For example, in the diminishing *Musharakah* contract, the Islamic financial institution initially acts as a joint-owner of the asset, but the asset ownership will be transferred fully to the customer at the conclusion of the contract. In this regard, the Islamic financial institution is exposed to higher market and impairment risks at the initial part of the transactions as compared to the exposure during the later stage of the contract. At the same time, the amount of repayment by customers represents the credit risk to the Islamic financial institution. As each of these respective parts of the transaction has a distinct intrinsic characteristic, it would entail different degrees of credit, market and operational risks. In this regard, in formulating prudential standards for Islamic banking institutions, there is a need to have an accurate assessment of the various risk variants underlying the alternative parts of the transaction to determine the capital

adequacy requirement. This is important to ensure the stability of the overall financial system.

Similarly, the liability structure of the Islamic banks is characterized by two distinct categories of deposits: the non-*Mudarabah* deposits which are not subject to the risk associated with the banking business and for which the principal is guaranteed, and the *Mudarabah* or investment deposits which involve risks and sharing of profits earned from the banking business. Given that the returns are not pre-determined, profit-sharing depositors of Islamic banking institutions, as the capital provider will also be exposed to the losses. This places a higher degree of fiduciary risk on the Islamic financial institutions in ensuring that the investment deposits funds are managed in the most effective and efficient manner. This is further compounded by competition in managing the liquidity in the system. The share of profits distributed needs to be competitive relative to that earned and paid by the conventional banks. This is important to avoid a shift of deposits and to retain the funds in the system.

A central feature of the regulatory framework for Islamic financial institutions is financial transparency and disclosure. Market conduct disclosure and customer relationship management form the core of these principles. Addressing the information asymmetry between Islamic banking institutions and the depositors is of vital importance. Under the *Mudarabah* principles, there is a need for disclosure by Islamic financial institutions to investors on how the funds are being managed so as to provide the assurance that the underlying business operations, the risk profile and the risk control mechanisms are in place. In Malaysia, this has been addressed through the rate of return framework, which provides a standard methodology for deriving the rate of return on deposits. The profit equalisation reserve, as provided in the rate of return framework for Islamic financial institutions, serves as a mechanism to mitigate the impact of the fluctuations in the rates of return. The reserve is appropriated from the gross income and is shared by both the depositors and the banking institution. Given the dual banking environment, as the one in Malaysia, the ability to maximize risk-adjusted returns on investment and sustain stable and competitive returns is an important element in ensuring the competitiveness of the Islamic banking system. From the regulatory perspective, the rate of return framework provides a means of assessing the efficiency of Islamic banking institutions, its profitability, management competency and fairness. To further protect Islamic depositors, the Malaysia Deposit Insurance Corporation has established a separate deposit insurance scheme based on Islamic principles.

Disclosure of the true and fair value of the Islamic banking operations in the financial statements is also essential for depositors to undertake a true and fair assessment of the bank's performance. The enhanced financial disclosures need to be complemented with customer education and awareness programs to elevate the level of financial literacy among the consumers and businesses. Towards achieving this objective, consumer education programs have been conducted, providing information among others, on the unique characteristics of Islamic banking and finance, Islamic financial products and services and the underlying *Shariah* principles and concepts. Enhanced consumer awareness is expected to strengthen the role of market discipline in driving the Islamic financial institutions towards strict *Shariah* compliance, enhanced operational efficiency, and strengthened risk management infrastructures and practices.

In Malaysia, Islamic banks and conventional banks with Islamic banking windows observe similar prudential standards as imposed on conventional banks such as the minimum risk weighted capital ratio (RWCR), standards for corporate governance and risk management, financial disclosures and know your customer policy. The principles of prudent management and enhanced operational efficiency are inculcated through the minimum risk weighted capital adequacy requirement.

Corporate governance standards have been enforced through specific guidelines on the code of conduct for directors, officers and employees of the banking institutions and guidelines on the directorship and prohibition of loans to directors, staff and their selected corporations. In addition, strict compliance with the tenets of *Shariah* would also ensure that the Islamic financial institutions are managed on the basis of a high degree of prudence, ethics and integrity.

The Basel Committee on Banking Supervision has enhanced its capital regulation to include operational risk in the computation of capital adequacy, in addition to credit and market risks. The task of formulating a framework that addresses the peculiar risks associated with Islamic banking is being undertaken by the Islamic Financial Services Board (IFSB), which serves as an international standard-setting body for regulatory and supervisory agencies. Its mandate is to develop prudential, regulatory and disclosure standards for Islamic finance, and promote uniformity in the best practices on the governance of Islamic financial institutions worldwide. In this respect, the IFSB has recently issued two prudential standards on risk management and capital adequacy for institutions offering Islamic financial services, which are recommended for implementation in 2007. The IFSB has also made progress in developing three other standards on corporate governance, transparency and market discipline, and the supervisory review process to be released in due course.

A key challenge in managing operational risk in Islamic banking is ensuring *Shariah* compliance. Bank supervisors in their assessment would need to give due attention to the adequacy of the financial institutions' board and management oversight, policies, procedures and limits, risk measurement, monitoring and management information systems, and internal controls. The risk management standards issued by the IFSB would serve as a guide to bank supervisors in this regard.

Notwithstanding the significant progress made so far, there are still outstanding issues confronting the Islamic financial system today, particularly the different interpretations of the *Shariah* injunctions. Internationally, there continue to be debates among *Shariah* scholars on the compliance to the *Shariah* principles. In Malaysia, we have invited prominent international *Shariah* scholars to participate in an intellectual discourse on *Shariah* matters with respect to Islamic banking and finance. The move is expected to foster greater harmonization and interaction among the *Shariah* Scholars from different parts of the world. In addition, a RM200 million endowment fund has been established by Malaysia to facilitate *Shariah* research activities and the development of competent *Shariah* scholars through scholarships and training.

The development of a vibrant Islamic banking sector cannot be achieved without the support of appropriate human capital development. Underpinning the success of Islamic banking system is the strengthening of research and intellectual capacity in the sphere of finance and *Shariah*. The Islamic banking industry needs to be equipped with a new breed of innovators, risk managers, regulators and supervisors who have the right blend of knowledge of finance and the understanding of the *Shariah*. For this purpose, Malaysia has established the International Centre for Education in Islamic Finance (INCEIF), which will commence operations in March 2006, aimed at developing talents in Islamic finance. INCEIF will offer professional certification programs in Islamic finance and will forge strategic alliances with domestic and foreign institutions of higher education to offer Masters and PhD. programs in Islamic finance in specific areas of specialisation.

As we advance forward, changes in the financial landscape will continue to accelerate and the level of complexity and sophistication in the financial markets will further intensify. Islamic banking institutions will need to reinvent themselves to meet the

emerging issues, challenges and opportunities. The regulatory and supervisory approach and the methodologies to be applied must continue to evolve in order to remain effective and relevant. In addition, given the global dimension of the Islamic financial products and services, and the increasing interdependence of financial markets, efforts by individual countries to strengthen risk management practices needs to be matched by efforts to enhance the safeguards at the international level.

The future prospect of the Islamic banking industry thus depends on the combined cumulative efforts by the industry, regulators, the market participants and the international community. The collective efforts needs to be co-ordinated to maximise the potential of the industry. Setting shared vision and common goals to be achieved would be an important first step. Of greater importance are the actions that needs to be taken to realise these goals. It will be the actions and initiatives which we take today that will contribute towards achieving the future that we aspire.

ICLIF Alumni Association Dinner
17 February 2006, Kuala Lumpur

Dinner Address by

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

It is my pleasure to be here this evening at this Inaugural Annual Dinner of the ICLIF Alumni Association. This occasion provides an excellent opportunity to promote greater engagement and networking among the industry leadership. This is particularly important for our region where the financial sector has experienced a pronounced transformation in the financial landscape. There will be new dimensions and new requirements for leaders and leadership capability in this new and highly challenging environment. It calls for being able to meet the new demands of the new economy, being able to perform in a more competitive environment, being able to reap the benefits of the new technologies and finally being able to operate in an environment of heightened uncertainty.

Despite these increased challenges, the world economy has entered 2006 on a stronger note. The latest indicators suggest that the global economic outlook remains favourable, with sustained growth across the major economies. While the US and China are expected to continue to experience strong growth, it is expected that the recoveries in Japan and Europe would provide additional support to global demand. This provides a positive external environment for Asia. In the Asian region, domestic demand has proved resilient with most countries experiencing a strengthening of domestic demand. Cumulatively, this rapidly expanding domestic demand has represented an important market for the region. It has also increased the pace of regional integration.

While energy prices have remained high, this is not expected to undermine the global growth momentum. Oil price increases thus far have mainly been demand-driven, and therefore, well absorbed compared to historical episodes of oil shocks. However, the tight global supply conditions that prevail have not removed the risks of higher oil prices. The inflationary trends that have emerged, has prompted the monetary authorities in a number of countries to raise interest rates. While the degree has varied across countries, these moves have primarily reflected the need to anchor expectations and limit the second-round effects of rising oil prices. This has therefore continued to allow monetary conditions to remain supportive of growth.

In view of the broadly favourable outlook for the global and regional economies, renewed attention has been focused on the prevailing imbalances in the global economy. This is a pertinent issue especially as these imbalances are expected to widen in 2006. It is recognised that reducing the global imbalances is a shared responsibility, across the major regions of the world. Several reasons have been cited as constraints to the process of adjustment. This include the relative lack of strength in domestic demand outside the US; the large gap between saving and investment in major regions of the world; and the fragmented structure of global capital intermediation that hinders surplus regions from financing productive investments within their region.

It is important to recognise the important role that Asia can have in contributing to rebalancing global growth and in so doing contribute towards global adjustment of the imbalances. In terms of economic growth, the region has consistently recorded performance that is, one-and-a-half times higher than the global average. On demographics, Asia is home to more than

half of the world's population, with a young and growing workforce, and expanding middle-class in a number of countries. Robust domestic consumption and rising investment have therefore become important sources of growth. This has been supported by the rising income and increased productivity and the expansion of intra-regional trade. The increasing importance of intra-regional trade, which accounts for more than 50% of Asia's total trade, makes the region the next most integrated region after the European Union in trade. This has positioned Asia as the largest and fast-growing market in the world. In addition, the Asian region has also embarked on measures to spur its economic openness by forging free trade agreements, which would contribute to increasing the capacity of the region and the potential of the region, in addition to improving prospects for contributing towards the rebalancing of global growth and the global adjustment process.

Combined with the region's traditionally high degree of economic openness with a total trade averaging 95% of GDP in the region, it reflects Asia's potential to be a self-sustaining and mutually reinforcing the region's growth. The greater degree of economic flexibility in the region in responding to shocks and the dynamic global conditions is a further feature that contributes towards strengthening the region's potential.

While private consumption's contribution to domestic demand is becoming increasingly more significant in the region a renewed expansion in investment is also needed to create a more sustainable growth path. Significant initiatives are already underway to increase the contribution of private investment and secure new areas of growth. These include improving the investment climate and reducing the cost of doing business. Efforts would also continue to be on-going on the priorities in the region as countries have the potential to further expand the role of domestic demand. For several of the countries in the region, a significant boost to investment is expected to stem from an expansion in physical and social infrastructure as well as from research and development activities being relocated to Asia.

On the financial front, the region's high savings rate and the pool of capital in the region for productive investments would be able to provide a boost to development of the region's financial markets. Strengthening the structure of the regional markets would facilitate the surplus savings to financing investment within the region. Significant progress has already been made in the Asian region in strengthening the financial sectors, in the banking system or the capital markets. This has increased the region's capacity to intermediate funds, especially within the region. The regional banking systems as a whole have increased their strength and ability to manage risks. This renewed resilience is being underpinned by more market-driven initiatives, improved standards of corporate governance as well as the development of the necessary infrastructure to promote the financial markets.

In this respect, regional financial ties underpin the reforms in the intermediation of capital and for re-channelling for productive investment within the region. The implementation of the Asian Bond Funds (ABF1 and ABF2) marks an important milestone in the path towards regional financial integration as part of the foreign reserves are invested in Asian sovereign bonds. Meanwhile, the introduction of ABF2 Funds as a new asset class in Asia, together with improvements to the financial infrastructure, tax and regulatory reforms, would contribute towards the broadening and deepening of regional bond markets over time. Building region-wide financial markets is relevant given that each regional market is typically small in size. Thus, inter-linked regional markets would raise the attractiveness of Asian investments to both global and regional investors.

Following these external developments, Malaysia's growth prospects are expected to

strengthen in 2006. The favourable external demand would reinforce the sustained expansion in domestic demand, which is expected to be positive for both real income and employment generation. Real private consumption is therefore set to grow further, while real private investment is forecast to expand, supported by the need to undertake capacity expansion, particularly in the manufacturing and oil and gas sectors, in addition to the services sector. As a result of both supportive external and domestic demand, the economy is expected to register improved performance in 2006.

For Malaysia, the focus of policy thrusts in 2006 would be to build on the gains of 2005, ensuring fundamentals are strengthened and the flexibility of the economy is further enhanced. In this respect, the Central Bank will determine the interest rate policy to provide a sound environment for sustainable performance of the economy. Macroeconomic policy would thus continue to stress growth in an environment of price stability. Of importance, is to strengthen private sector-led growth. Further efforts will therefore be undertaken to ensure that the economic and financial structures and systems are conducive for the building of a dynamic, resilient and flexible economy.

The dynamics of growth and development in the region are reshaping our environment. Effective chief executives and corporate leaders in this new environment need to develop accordingly taking into account the new requirements. In its programs, ICLIF has focused on these new dimensions of leadership development, particularly for the financial services sector.

As a leadership development institution, ICLIF has also evolved over time by continuously reviewing the contents of its programs to match the needs of the rapidly changing environment. A review of the Global Leadership Development Program (GLDP) has now been undertaken, based on the valuable suggestions and feedback from participants, faculty, facilitators and expert panel. Refinements in the structure and content of the GLDP are expected to be introduced in the subsequent sessions and will include, among other things, new areas such as geopolitical and economic trends, corporate entrepreneurship and innovation, diversity and inclusiveness, culture and corporate social responsibility. The US part of the Summer program will also be changed. The change will bring participants closer to distinguished faculty from such renowned institutions as Stanford, UC Berkeley and UCLA.

Let me now conclude my remarks. Leadership is all about a vision for the future, setting the strategic direction for the organization and having the ability to translate the vision into results. This involves having the ability to promote the shared vision and energizing the organization to produce the results.

Let me conclude with what I have mentioned to one of the groups of the GLDP program "The quest for leadership excellence is a journey and not a destination." When we talk about enhancing leadership capability, we are talking about leaders who are continuous learners, who strive for cutting edge excellence, leaders who have strong convictions and beliefs and yet having humility and recognizing the need to reinvent themselves and in doing so become dynamic leaders pushing the frontiers of excellence and having the courage to take on the new challenges.

Launching of The International Centre For Education In Islamic Finance (INCEIF), 23 March 2006, Kuala Lumpur

Luncheon Address by

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

It is my great pleasure and honour to welcome you to this luncheon in conjunction with the Meeting of the 1440 Hijrah Vision Commission of the Islamic Development Bank (IDB) and the Launch of the Vision Document that has taken place this morning for the transformation of the Islamic Development Bank to become the premier catalyst for greater shared prosperity and development among the ummah. We are most honoured today by the presence of Yang Amat Berhormat Dato Seri Abdullah Ahmad Badawi. I would like to take this opportunity to congratulate the IDB for the successful launch of the IDB 1440 Hijrah Vision. The Vision Document would serve as an important blue print for the transformation of the IDB into a dynamic Development Bank that will contribute to the "comprehensive human development", and thereby achieving prosperity for the ummah. We are also honoured today by the presence of His Excellency Tun Dr. Mahathir bin Mohamed, Chairman of the Commission, and His Excellency Dr. Ahmad Mohamed Ali, President of the Islamic Development Bank Group.

Today, we are also taking the opportunity of this very auspicious occasion, with the grace of Allah, to lay the foundations for another initiative, the launch of the International Centre for Education in Islamic Finance, INCEIF.

The Islamic banking and financial services industry has experienced profound growth in this recent decade. This growth is expected to accelerate further global expansion as demand for Shariah-compliant financial products and services intensify. To sustain and support the future growth of the industry, an important prerequisite is the development of the talent and expertise that is needed to drive innovation and to raise the performance of the industry to greater heights.

The establishment of the International Centre for Education in Islamic Finance (INCEIF) represents an investment in human capital to support the global development of the Islamic financial services industry. Human intellectual capital plays a pivotal role in driving the performance and market competitiveness of the industry. Going forward, it will be the defining factor. The fast pace of innovation in global financial services in general and in the Islamic financial services sector in particular, will demand new expertise and skills. Indeed, there will be an increase in demand for adequately qualified professionals. In this environment, the creation of a substantial pool of talent and expertise is thus indispensable for the future growth of Islamic finance. Strengthening research and development capabilities is also important for enhancing the capacity for innovation to meet the diverse requirements of the rapidly changing global economy.

The establishment of the International Centre for Education in Islamic Finance thus comes from the recognition of this need to invest in human capital to advance the industry forward to greater heights. Bank Negara Malaysia has allocated an endowment fund of RM500 million for this purpose. The income from the endowment fund will be utilised to finance the operations of INCEIF. The objective of INCEIF is to produce high-calibre practitioners and professionals in Islamic finance as well as specialists and researchers in the disciplines of Islamic finance. INCEIF will leverage on the wealth of

experience of the Islamic finance industry, both in Malaysia and abroad, to provide its graduates with value added insights and perspectives, in particular for their research programmes. Malaysia's experience in Islamic finance for over more than two decades will also provide a training environment, including for internships for developing Islamic finance professionals.

The required skill set in Islamic finance is unique. It needs to have the right blend of knowledge of finance with the understanding of the Shariah as being central. The Shariah principles must be embedded in every operational aspect of the Islamic financial institution, including in the design of financial products and financing structures, financial contracts and their execution, liquidity and balance sheet management, risk management as well as asset and wealth management. The upholding of the Shariah principles must permeate from the highest level, including at the board and senior management levels. Sound policies and practices premised on Shariah principles will evolve the Islamic financial system into a financial system that is distinctively ethical and that which promotes economic justice.

In meeting this objective of providing a total talent management solution for the Islamic financial services industry, INCEIF will offer the world's first certification on Islamic finance, the Certified Islamic Finance Professional (CIFP) programme. The CIFP modules to be offered has been designed by renowned experts of their respective fields and have been developed in full consultation with local and international industry players in order to ensure their relevance to the requirements of the industry. Following the launch of the INCEIF today, the programme will be open for registration. Classes for the first enrolment will commence in June 2006. INCEIF also offers post-graduate programmes in Islamic finance that will include specialised Masters and Ph.D. programmes in the various Islamic finance disciplines.

INCEIF will be governed by the INCEIF Governing Council and the Professional Development Panel. The INCEIF Governing Council, comprising eminent local and international professors from the academia and industry practitioners, will set the strategic direction and provide visionary global insights on the learning needs of the Islamic financial services industry. The Professional Development Panel, with vast experience in the Islamic finance industry and academia will represent the authority in academic matters and will have the responsibility for establishing the academic policies of INCEIF as will as the quality assurance of the CIFP and post-graduate programme modules. The academic faculty will include permanent as well as regular visiting professors and scholars-in-residence.

INCEIF will also form strategic alliances with leading local and international learning institutions to complement our pursuit to provide world-class knowledge for the benefit of the industry in particular, and the ummah in general. It is our vision that INCEIF will one day be an international nucleus for tertiary education in Islamic finance, training and research and provide a strong support in the development of Islamic financial infrastructure.

With the grace of Allah, and with the support of the international Islamic financial community, it is our hope that INCEIF will make a meaningful contribution to the future development of Islamic finance for the benefit of the ummah.

In closing, once again, I would like to express our deepest appreciation to the Yang Amat Berhormat, Dato' Seri Abdullah Haji Ahmad Badawi, Prime Minister of Malaysia for gracing this occasion and for accepting to officiate the launch of INCEIF.