BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Enhancing the Resilience and Stability of the Islamic Financial System

Regulators Forum
Global Islamic Finance Forum 2010

Special Session on Islamic Finance and Financial Stability Report

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Gabenor
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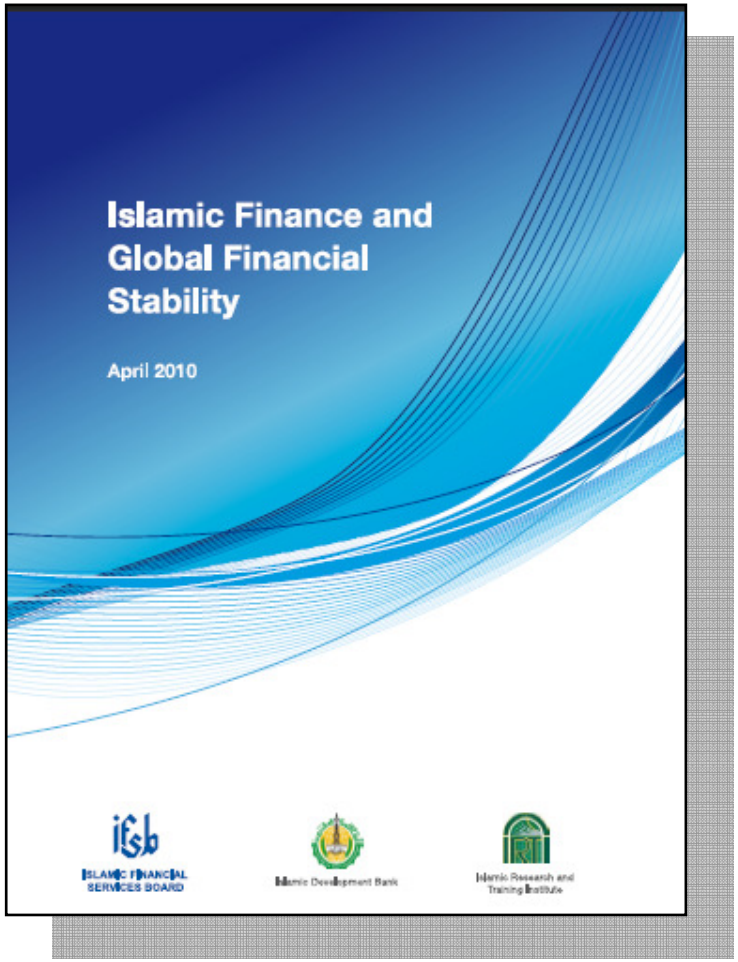
Strengthening the Islamic financial system by the Task Force on Islamic Finance & Global Financial Stability

- The Task Force was jointly formed by the Islamic Development Bank & the Islamic Financial Services Board (IFSB) in October 2008

- Mandates of the Task Force
  - To analyse the Islamic finance model in the context of ensuring financial stability
  - Take stock of the progress, the development and performance of the Islamic financial services industry in the face of the challenges of the current global financial environment
  - Examine important key building blocks to further strengthen the international system and the Islamic financial architecture

- "The Islamic Finance and Global Financial Stability Report" was completed in early 2010 and contains 8 recommendations to strengthen the resilience and ensure sustainability of Islamic finance in a more challenging global environment
  - The Report was endorsed by the Council of the IFSB in April 2010

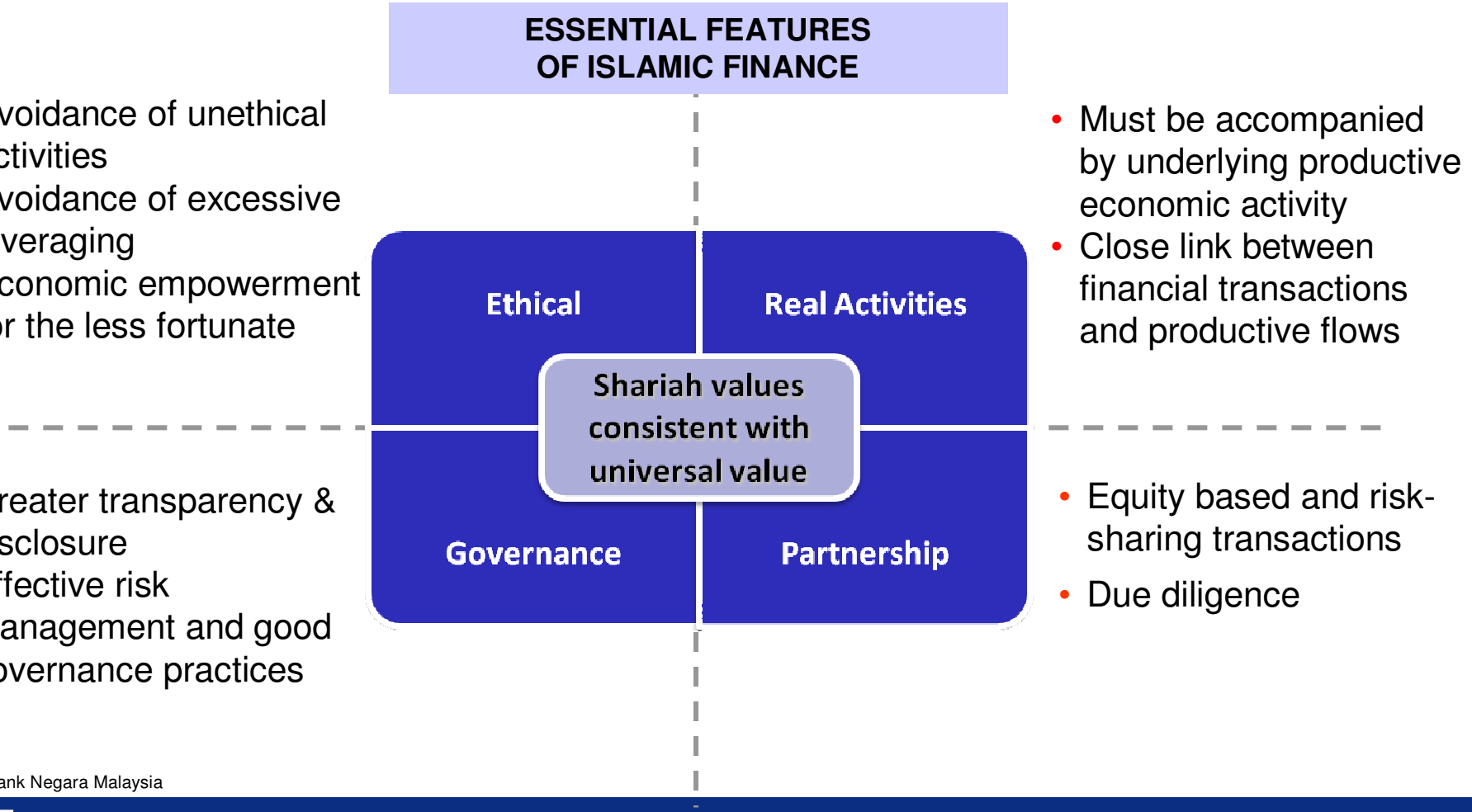
Islamic Finance and Global Financial Stability Report



- Appreciating the Islamic finance model
- The state of Islamic financial services industry
- Challenges and strategies for strengthening financial stability in the Islamic financial system

Appreciating the Islamic finance model

- The intrinsic strength of Islamic finance is derived from the Shariah principles



- Avoidance of unethical activities
- Avoidance of excessive leveraging
- Economic empowerment for the less fortunate

- Must be accompanied by underlying productive economic activity
- Close link between financial transactions and productive flows

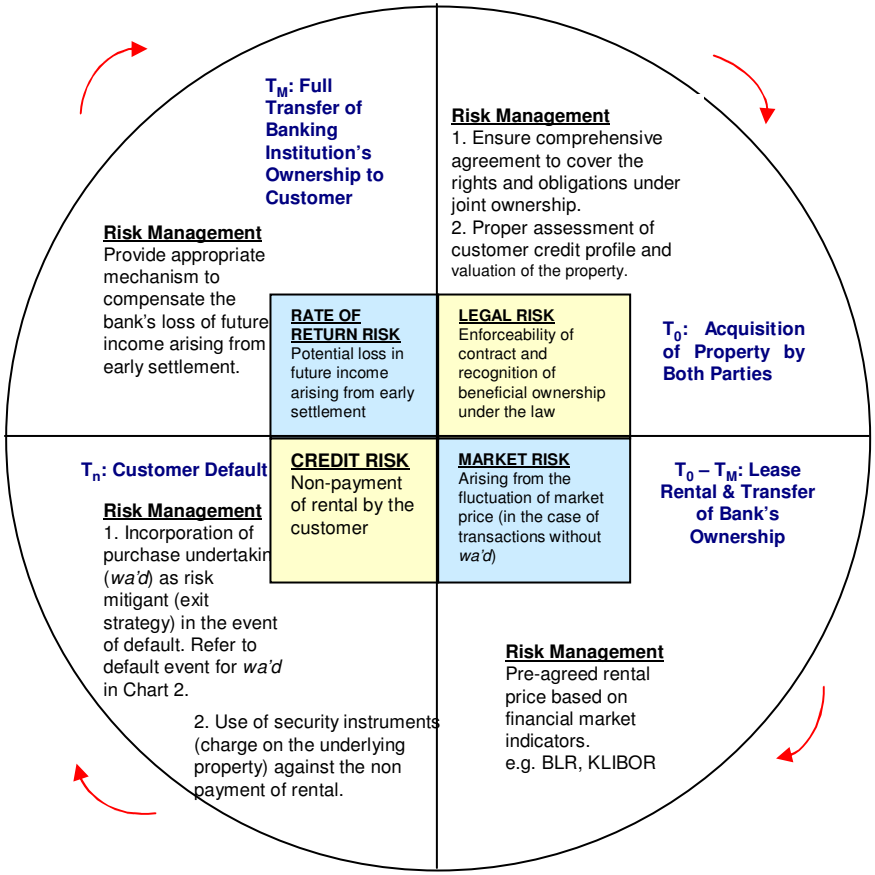
- Greater transparency & disclosure
- Effective risk management and good governance practices

- Equity based and risk-sharing transactions
- Due diligence

Source: Bank Negara Malaysia

The very nature of Islamic finance requires robust risk management

Example: Management of Key Risks in *Musharakah Mutanaqisah* Contracts



- Participative element of Islamic finance brings additional risk taking to institutions providing Islamic financial services
- More transparent arrangement and disclosure requirement
- More risk considerations, ie risk of Shariah non-compliance
- Require stronger consumer protection framework

Leads to

More resilient financial system

More inclusive financial system

Source: Bank Negara Malaysia, Islamic Finance & Global Financial Stability report

The features and value propositions inherent in Islamic finance have the potential to contribute towards financial and economic stability

Preserves genuine liquidity

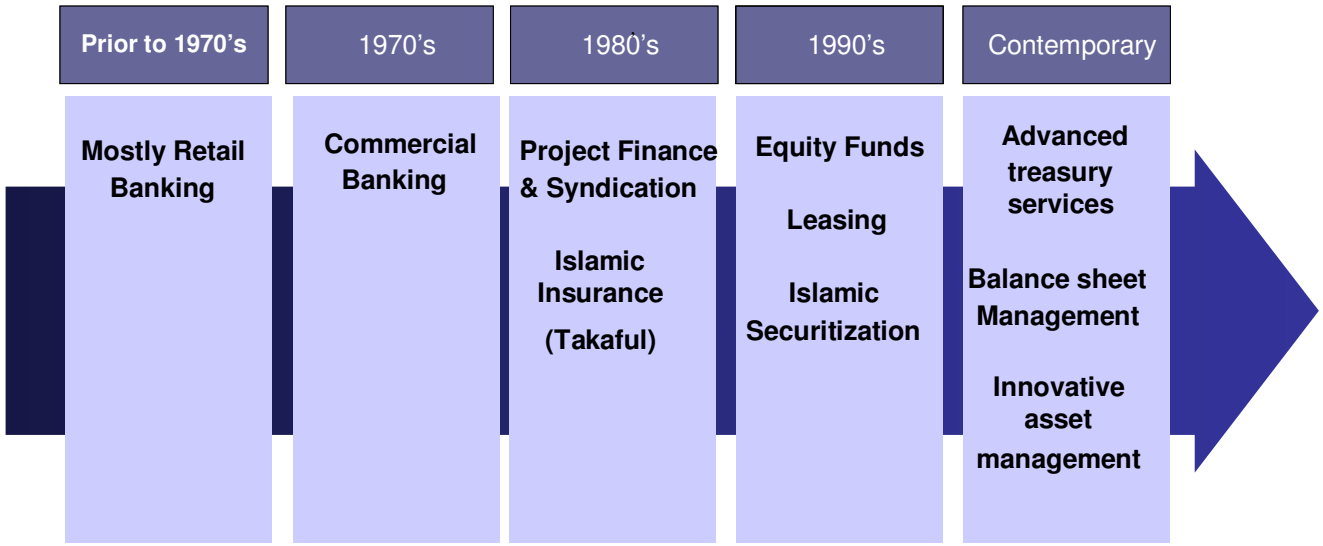
As opposed to synthetic liquidity, genuine liquidity further adds to the stability of institutions offering Islamic financial services

Manages procyclicality

Measures such as dynamic provisioning is strongly encouraged where the concept has been narrated in the Holy Qur'an

Consistent with the current regulatory reform measures

Evolution in the development of Islamic finance

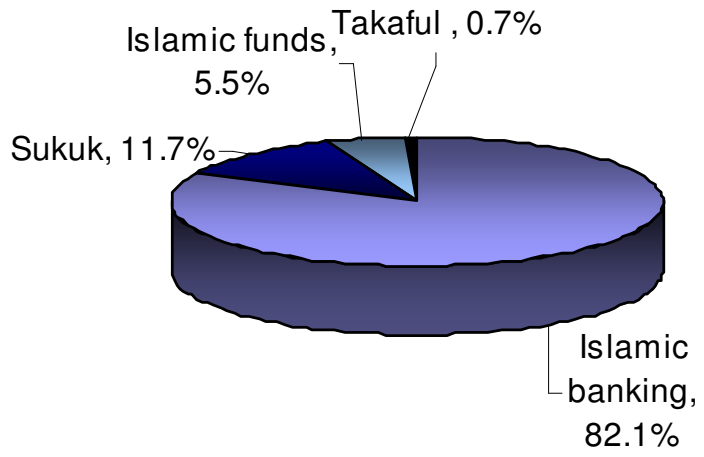


- Since the 1960s, the Islamic financial services industry has evolved from a 'fringe industry' to a global industry encompassing banking, insurance and capital market

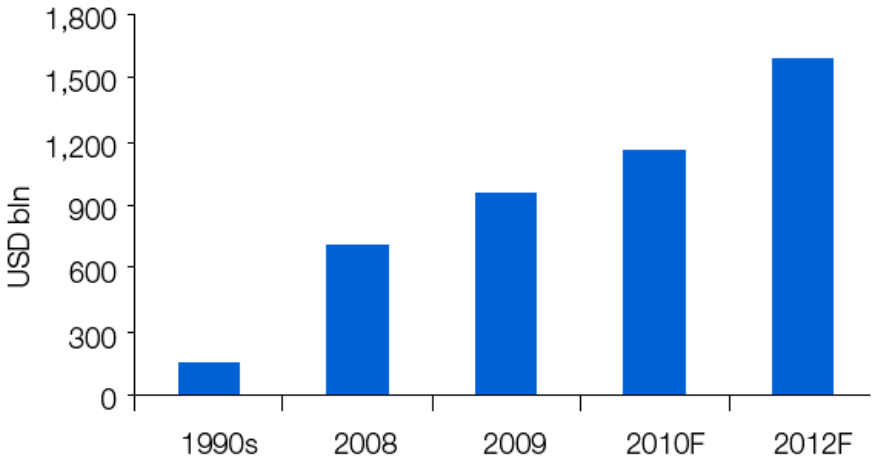
- The Islamic financial landscape has been transformed with more diverse players and extensive range of financial products and services

Expansion of Islamic finance assets

Breakdown of global shariah compliant assets



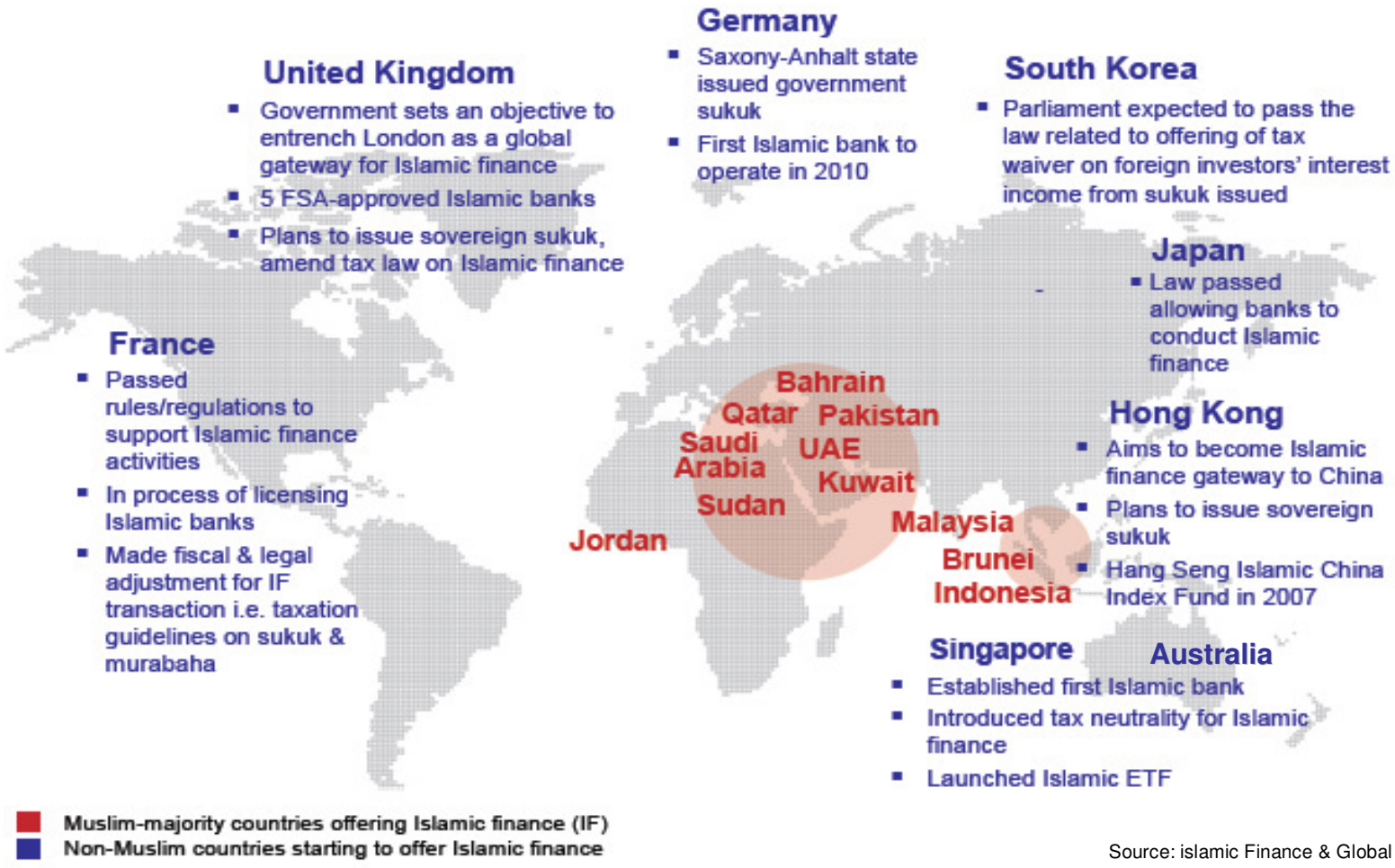
Global Islamic finance assets growth trend



Source: S&P, KFHR

- **Global Islamic finance assets are estimated to be approximately USD1.0 trillion in 2009, of which about 82% consists of Islamic banking assets**
- **Islamic finance assets have grown at an impressive CAGR of 14.1% from USD150 billion in the mid-1990s to about USD1.0 trillion in 2009**
- **Maintained the 28% annual compound growth achieved in the recent 3 years**
  - **In comparison, asset growth of world's top 1,000 conventional banks slumped to 6.8% during this period**

Growing interest in Islamic finance…

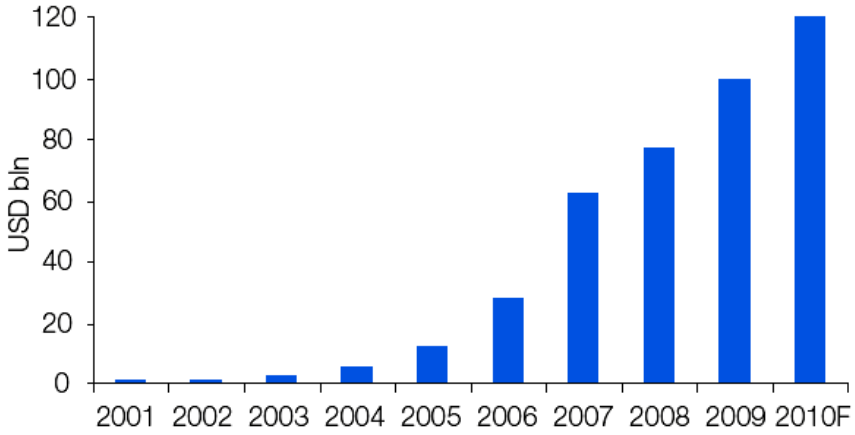


Source: islamic Finance & Global Financial Stability

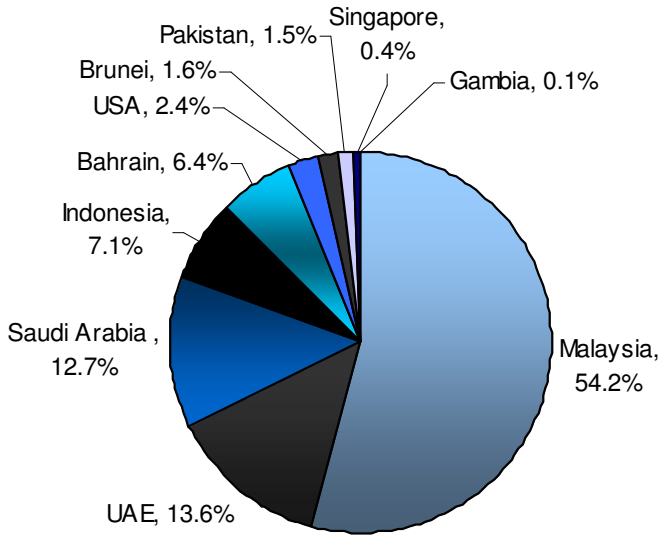
- **Strong interest from beyond Islamic incumbents**
- **Greater cross-border flows in financial transactions, thus strengthening economic linkages**

Rapid expansion of the sukuk market

Global sukuk outstanding



Issuances by country (2009)

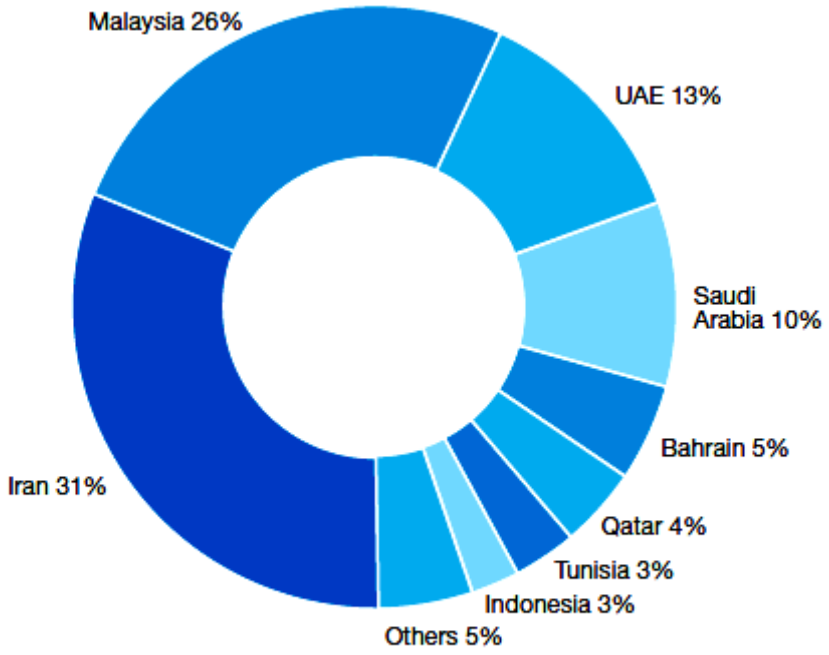


- Global sukuk outstanding reached the USD100 billion mark in 2009 with USD23.3 billion worth of issuances

Source: S&P, KFHR

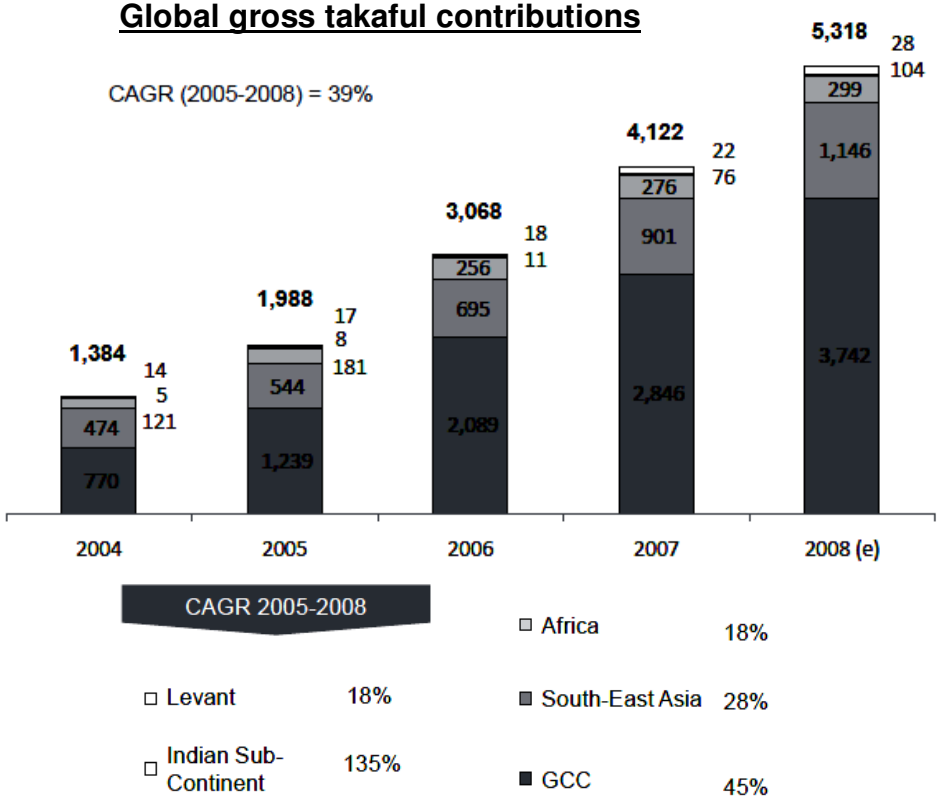
Increasing potential of Takaful market

Share of global takaful assets in 2009



Source: The Banker Top 500 Islamic Institutions, November 2009

Global gross takaful contributions

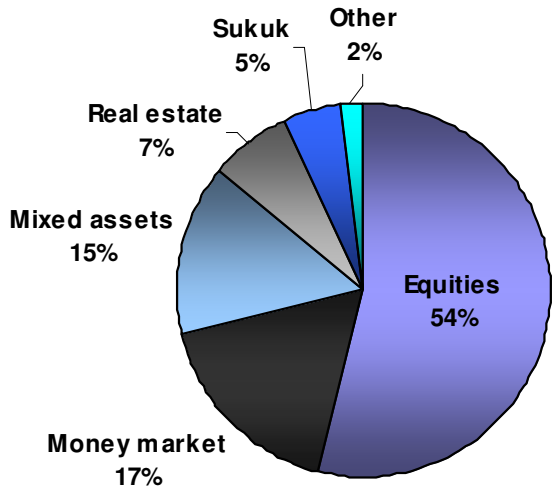


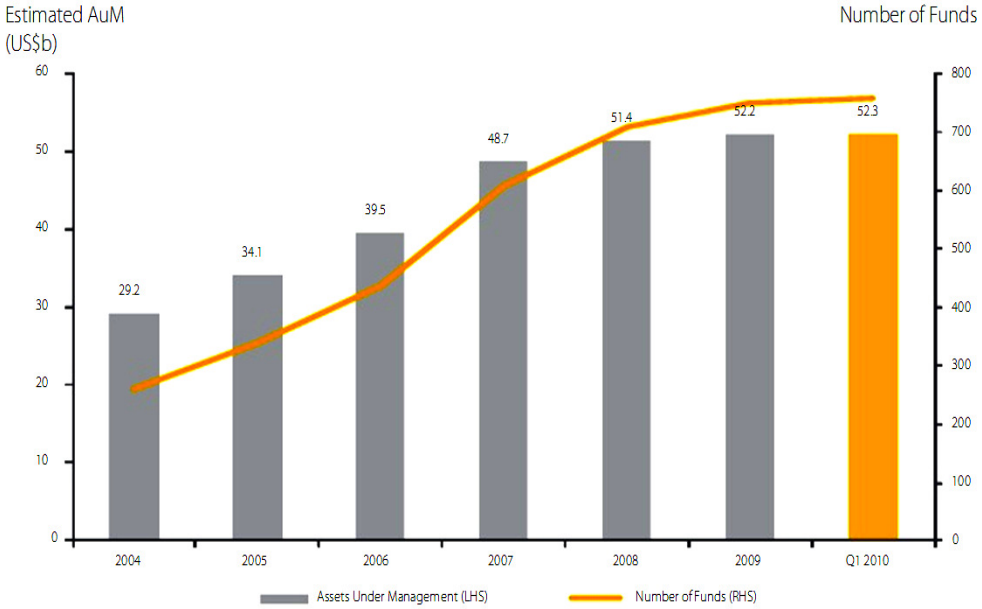
Source: Ernst&Young

- Takaful industry expected to grow by 15% to 20% annually & estimated to reach US$14.4 billion by 2010
- Malaysia is the 2nd largest takaful market after Iran
- Malaysia has the largest takaful market in South East Asia with total takaful assets expanded at a CAGR of 20.6% between 2005 – 2009

Increasing Shariah-compliant funds

Composition of global Islamic funds by type 2009





SourcSee: PWC, Ernst & Young , IFIS

- Strong growth in global Shariah-compliant funds
  - Expanding at 15% - 20% per annum
- At end 2009, total global Islamic funds amounted to US$52.3 billion
- Total number of Islamic funds increased from 200 in 2003 to 671 as at end 2009
- The Islamic fund management industry has vast potential to contribute to growth of Islamic finance
- Equities form the largest composition of Islamic fund (54%)

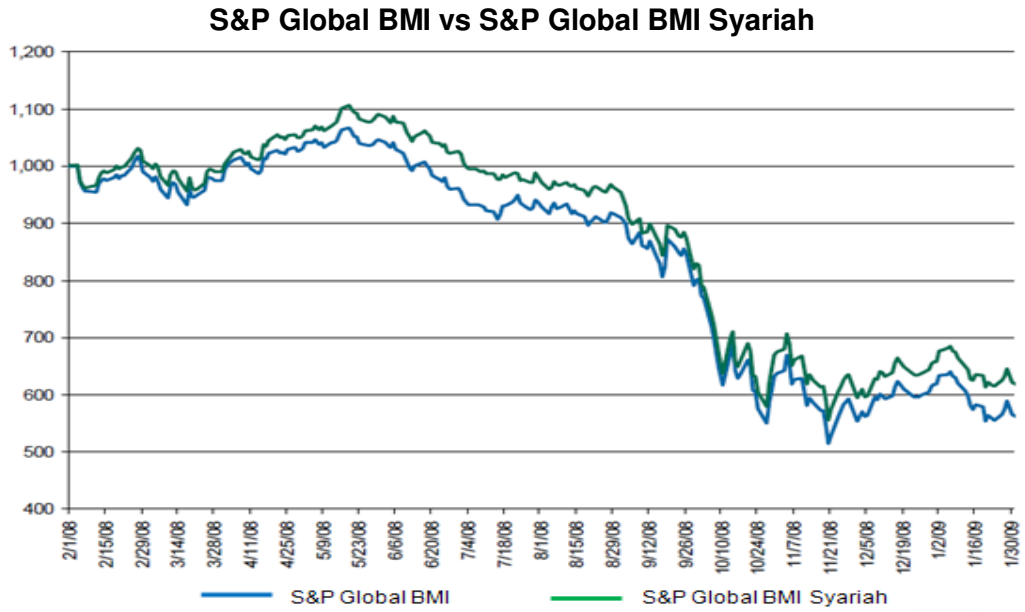
Development of international financial infrastructure



- Establishment of key institutions
  - The AAOIFI to develop accounting & auditing standards
  - IFSB as an international prudential standard setting body to develop & disseminate prudential standards
- Specialised institutions providing Islamic financial services, eg. rating agencies & deposit insurance entities
- Formation of IILM as supranational to enhance Islamic liquidity management infrastructure & activities internationally & domestically

Islamic financial institutions remained resilient during the recent crisis

- Positive performance of Islamic banks in terms of combined market capitalisation, aggregate net profits, growth of total assets, bank's leverage ratio and requirement of government financial assistance



- Better performance of Islamic indices
  - Global adverse impact on Islamic indices and conventional stock indices due to crash in stock market. However, impact was to a lesser extent for Islamic indices

Source: O'Brien (2009),, Islamic Finance & Global Financial Stability report

Challenges and strategies to strengthen financial stability in the Islamic financial system

Challenges

Key issues relating to financial intermediation, financial innovation and the regulatory and surveillance framework

- The underlying causes of the recent global crisis bear important lessons for the Islamic financial industry going forward
- As Islamic finance operates within the global financial system in which large and volatile cross-border capital flows creates greater interdependence

Strategies

Three key areas of priority to further strengthen and enhance the Islamic finance ecosystem

- Strengthening the **foundations** of the Islamic financial system
- Accelerating the **effective implementation** of Shariah & prudential standards
- Creating a **common platform** for regulators of the Islamic financial services industry to enhance constructive dialogue

Eight building blocks to strengthen the foundations of the Islamic financial system

1. Implementation of cross-sectoral prudential standards

- Effective implementation and enforcement of prudential and supervisory standards issued by IFSB
- Adoption of a coordinated cross-sectoral approach for regulation and supervision

2. Development of a robust liquidity management infrastructure

- Development of robust national and international liquidity infrastructure, which encompasses the monetary policy and exchange operations, payment and settlement systems

Eight building blocks to strengthen foundations of the Islamic financial system (cont'd)

3. Strengthening financial safety nets

- Financial regulators to strengthen the financial safety net mechanisms for the Islamic financial services industry:
  - Lender of last resort (LOLR) facilities and emergency financing mechanisms
  - Deposit insurance

4. Effective crisis management and resolution framework

- Development of a crisis management and resolution framework, which includes:
  - Bank insolvency laws
  - Arrangements for dealing with non-performing assets
  - Asset recovery
  - Bank restructuring
  - Bank recapitalisation

Eight building blocks to strengthen foundations of the Islamic financial system (cont'd)

5. Strengthening accounting, auditing and disclosure standards

- Enhancement of financial reporting to facilitate the effective monitoring and assessment of Islamic financial institutions

6. Macro-prudential surveillance

- Development of macro-prudential surveillance framework and financial stability analysis, integral to strengthening the resilience of the Islamic financial system

Eight building blocks to strengthen foundations of the Islamic financial system (cont'd)

7. Strengthening the rating processes

- Credible rating institutions to be appreciative of the unique features and risk profiles of Islamic institutions and instruments

8. Capacity building and talent development

- More collaborative efforts in capacity building and talent development

Establishment of IILM signifying close international collaboration to further strengthen the resilience and competitiveness of Islamic finance

Primary objectives

- Issue highly rated Shariah compliant financial instruments in foreign currencies to facilitate more efficient & effective liquidity management solutions for institutions offering Islamic financial services
- Foster regional & international cooperation to build robust liquidity management infrastructure

11 central banks & 2 multilateral institutions are IILM's current shareholders

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BANK NEGARA MALAYSIA
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CBOS
CENTRAL BANK OF SUDAN

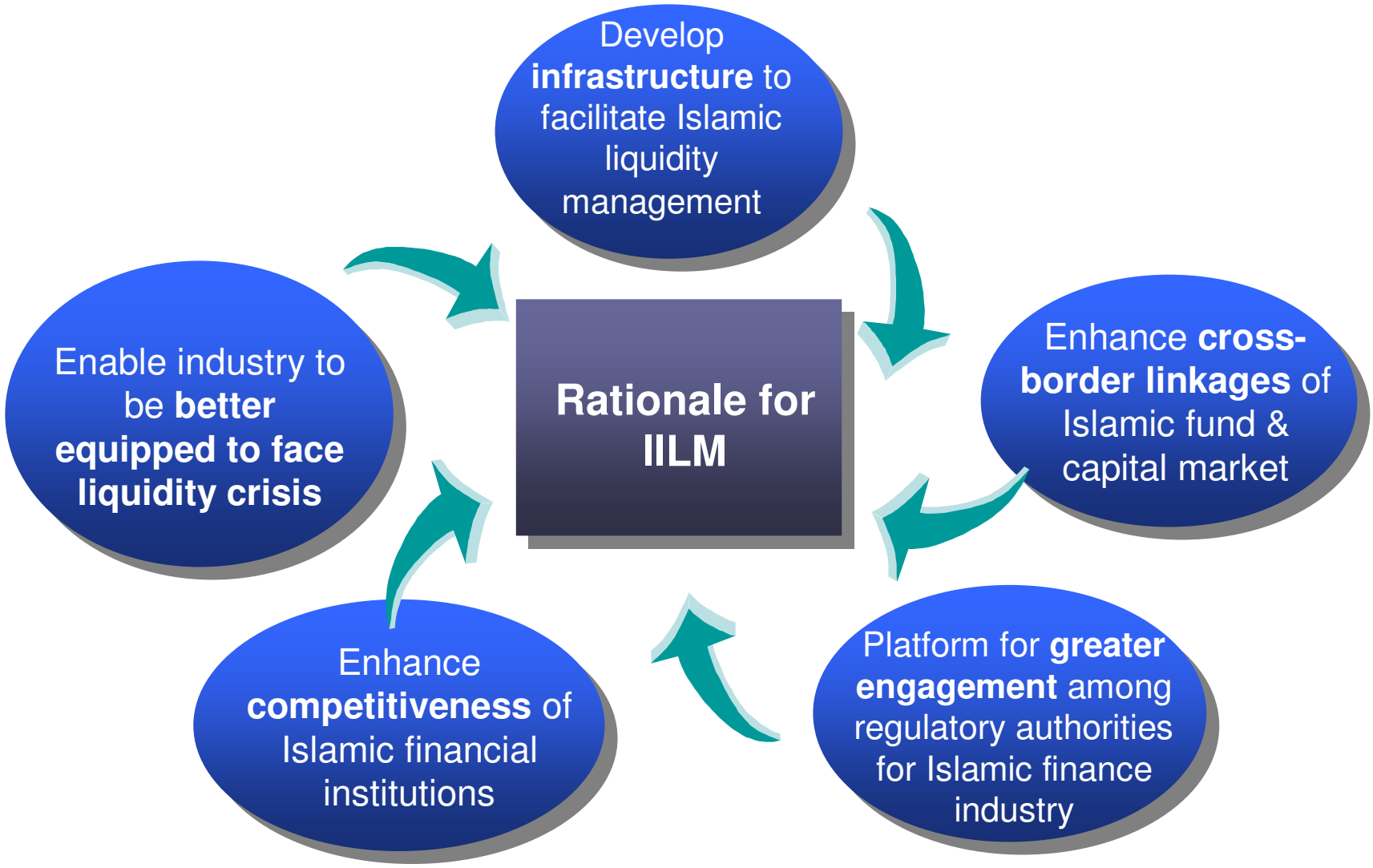
TCMB
TÜRKİYE CUMHURİYET MERKEZ BANKASI

Qatar Central Bank

CENTRAL BANK OF THE U.A.E.

More central banks & multilateral institutions are expected to join in future

IILM establishment is key for the resilience & competitiveness of Islamic financial institutions



Fostering global cooperation through the Islamic Financial Stability Forum

A platform for constructive dialogue:
The Islamic Financial Stability Forum

MISSION

To provide a strategic platform for enhanced collaboration in Islamic finance to promote global financial stability

PURPOSE

Greater cooperation & collaboration among IFSB members in areas of surveillance, risk in the Islamic financial system, crisis management and crisis resolution

KEY OBJECTIVES

- Facilitate better understanding of emerging issues in the Islamic financial system & their implications for financial stability
- Build capacity to manage risks to financial stability in Islamic finance
- Maintain an interface with the Financial Stability Board to ensure constructive exchanges between conventional and Islamic finance

Conclusion

- A concerted initiative by the Task Force to appraise the conceptual elements of Islamic finance & reinforcing this with foundations recommended in the Report so that Islamic finance contribute to the process of promoting global financial stability

- The strategies & recommendations outlined in the Report aim to provide focus on strengthening the resilience of Islamic finance

- Moving forward: In this more connected and interdependent world, it is critical for the industry participants to collaborate not only to create greater financial and economic linkages but to ensure greater resilience & secure an inclusive and balanced global growth

Thank you