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"Cross-Border Challenges in Implementing Basel II in Emerging Economies"

Keynote Address by
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In most emerging markets, the banking sector forms the key component of the financial system that drives the economy. In Malaysia, despite the increased significance of the domestic capital market, the banking sector continues to be the predominant source of financing in our financial system, as it evolves to offer more innovative financial solutions to meet the more sophisticated needs of customers and investors. The increasingly complex nature of their operations have had a significant impact on their risk profile over the years. The domestic financial environment has also become more competitive, following an intensification of the liberalisation and deregulation process. Domestic banking institutions have now also ventured beyond our domestic borders. Increasingly, supervisory attention is therefore directed towards ensuring that a robust risk management framework is put in place to support such business expansion and growth strategies.

Against this background, the call for improvements in risk management through the adoption of Basel II and the discussions on the effectiveness of supervisory arrangements on cross-border banking and financial activities are most relevant. The incidence involving case of the BCCI in the early 90's as well as that of and Baring in the mid-90's have also brought to the fore weaknesses the gaps in supervisory oversight activities and highlighted the need for greater cooperation between home and host supervisors. Similarly, the arrangements for cross- border activities involving either international branch networks or the operation of subsidiaries have been discussed widelyis a subject of much discussion within supervisory circles, particularly with respect to its implications on supervisory cooperation. While there may be differences in the operational arrangements and in the nature of activities undertaken by global players in emerging markets within in Asian and Latin America regions, the significance of their presence in the financial systems in both regions makes this dialogue session most relevant and timely. In Malaysia, foreign banks' account for almost 30% of the total assets of the banking industry. In the context of cross-border banking, the local incorporation of all foreign-owned banking

institutions' branches in 1994 has contributed towards the strengthening of Bank Negara Malaysia's supervisory oversight over the activities of foreign-owned banking institutions in Malaysia. The capital and resources dedicated to support the domestic subsidiary operations reflects the commitment of the foreign-owned banking institutions in the future prospect of the country. In addition, it has also made easier facilitated the assessment of the financial soundness of local operations of foreign banks. While the merits of different operational arrangements are still a matter of much debatedebateable, particularly in terms of business flexibility, the subsidiary structure of foreign-owned banking institutions in Malaysia has allowed forfacilitated the consistent application of rules and regulations by Bank Negara Malaysia to the entire banking system.

The increasing significance of the foreign institutions, along with the different operational structures were key factors that influenced the design of the early cross-border supervisory framework. This is detailed in the Basel Concordat, that outlined the principles for supervision of foreign banks by home and host authorities, issued by the Basel Committee of Banking Supervisors (BCBS) in 1983. The concordat recognised the greater roles of host supervisors for supervising foreign banks that operate via locally-incorporated subsidiaries., Some home country supervisory in fact referred to the host supervisor as the banks' 'intermediate home supervisor'.

The framework also recommended a high level of reliance by host supervisory on the works undertaken by the home supervisors in their oversight and monitoring of the soundness of the foreign banks' branches in their jurisdictions. These important principles have become the foundations for the current cross- border supervisory framework and have been the basis for the formulation of the High- Level Principles for the Cross-Broader Implementation of the New Accord issued in 2003. The high level principles Principles have sought to further reinforce the responsibilities of home supervisors in conducting consolidated supervision of financial conglomerates and the greater expectation on host supervisors in the supervision of individual subsidiary banks in their country.

The new capital accord is yet another significant development that would challenge the robustness of the cross- border banking framework and principles. The real test would be in translating the principles into detailed policies and action plans that are both sound and practicable. The main challenge in applying the new accord uniformly across the globe is, indeed the complexity of the framework itself. While the underlying intention of the framework to promote sound risk management and best practices is not in question, noble countries, particularly the emerging markets, are at different levels of readiness to cope with the extensive changes required and potential implications of Basel II. With significantlyGiven the different level stages of development and levels of market sophistication, applying Basel II, that is designed fundamentally based on parameters and experiences drawn from developed economies, may not be appropriate without

some customisation to better reflect the situation in the emerging markets. The low liquidity in some markets and the higher level of market volatility in most emerging markets may not be adequately captured in the underlying assumptions within the Basel II framework. It is therefore important to emphasise that such constraints and the need for some customisation must be well understood and acknowledged by foreign banks operating in emerging markets. In essence, the discussions on the cross-border implementation of Basel II will contribute towards avoiding the imposition of 'one size fits all' solutions, and minimising the potential adverse implications of the differences in approaches in addition to avoiding the unnecessary duplication of efforts and investments.

In many emerging economies, Basel II is seen as an important catalyst to accelerate the introduction of best risk management practices within the banking sector in the medium and longer term. While best practices that have been adopted by global banks have even surpassed the expectations of Basel II, this is not the case for most domestic institutions. In many emerging markets where the banking system is still highly fragmented, promoting the adoption of these practices throughout the entire industry will indeed be a challenge. Such efforts would therefore need to be implemented within the agenda of the overall financial sector development programme in the individual countries. It is within this context that Malaysia has chosen to adopt a flexible timeframe, underpinned by four key implementation principles:

First, for capacity building measures to be implemented;

Second, within these capacity building efforts, the emphasis on the enhancement of the risk management framework for all banking institutions;

Third, to emphasise on strong business justification instead of regulatory mandate in the adoption of the more advanced approaches; and

Finally, to enhance the supervisory methodology to assess the internal models and the advancedd risk management systems.

The rigorousness of the analytical process under Basel II will certainly be demanding for banking institutions. It is equally demanding from the supervisory perspective to develop an appropriate response and assessment framework on these processes. Instead of over focus on validating the detailed quantitative and statistical procedures, supervisory attention should would need to ensure that the analytical processes are undertaken to support decision making, and not merely to meet regulatory expectations. Supervisors also should need to undergo early training to identify the relevant issues when undertaking the supervisory assessment. This underscores, the importance of efforts to accelerate supervisory capacity building efforts, particularly in the development of specialised supervisory skills to conduct model validation. underestimatedWhile emerging market economies may have different timelines and prioritypriorities, rigorous training programmes need to be

simultaneously pursued to ensure that the supervisors are able to fully understand well and interpret the qualitative materials, yet and at the same time, are able to comprehend the broader supervisory issues and concerns.

The benefits of Basel II cannot be fully realised if emerging countries do not have the necessary foundation for effective implementation. In reality, many some developing and emerging countries still need to develop a more efficient and comprehensive legal, accounting, regulatory and market infrastructure. The challenge for the emerging economies is therefore to place high priorities towards establishing and strengthening these fundamental infrastructures. Without the proper foundations in place, the countries are not only creating athis could pose impediments to the implementation of Basel II, in addition tobut also inhibiting inhibiting the proper implementation of cross- border regulations and the effective conduct of consolidated supervision.

In emerging countries where the necessary infrastructures are is already in place, supervisors need to look beyond the state of the current financial landscape, in the context of the globalisation of financial services, and integration into with the international landscape. Against such this backdrop, the appropriate regulatory framework for the banking industry, in particular, the future of cross-border supervisory arrangements, needs to be articulated. In this regard, let us not forgetit is also important to recognise that the challenge of cross-border banking in the context of the increased significance of international banks is has far wider implications.

The effectiveness of cross border arrangements would be easier to achieve when there is a greater consistency in the regulatory rules and standards as well as supervisory practices among the home and host supervisors. The new capital accord was therefore intended to accelerate the convergence process with respect to the adoption of international standards for capital adequacy in the global environment. In reality, however, total convergence cannot be expected given the varying levels of sophistication between developed and emerging countries. At any point in time, differences in rules and standards can be expected to exist. Our main task will be to find areas where convergence can be accelerated. There may also be room for greater mutual recognition of supervisory assessments among fellow supervisors that could avoid duplicating duplication of efforts and resources and efforts that could contribute towards reducing compliance costs to the banking institutions.

While we deliberate on the complex issues relating to cross- border implementation of Basel II, supervisors and banking institutions operating in emerging markets also need to take into account the broader implications of Basel II on the economy as well as the access to financing for specific economic sub-sectors, such as the small and medium size enterprises (SMEs) during economic downturn. The highly risk sensitive framework could indeed have a potential adverse impact on bank

lending behaviour. There has to be continuing discussion between supervisors and the banking institutions on the broader supervisory issues and the effectiveness of regulatory and supervisory framework that could mitigate such potential adverse implications. Basel II is only one component of prudential regulation, and hence must not be viewed in isolation. In this context, the suitability of other rules such as the provisioning framework and the stress testing practices must also be discussed with a view for future enhancements.

While we engage ourselves in the intricacies of implementing Basel II we should not loose sight of the ultimate objective of maintaining financial stability. This dialogue is most important in providing a forum for the exchange of views and the sharing of experiences. Indeed, the outcome of the discussions should be escalated to a higher level of policy deliberation so as to further accelerate the progress in detailing the issues relating to the cross-border implementation of Basel II.

2005 Dialogue Session with Insurers and Takaful Operators
9 August 2005, Kuala Lumpur

Keynote Address by
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The Malaysian economic and financial landscape continues to be dramatically transformed. As this transition process gains momentum, the key issues confronting the insurance and takaful industries today are: defining effective growth strategies in an increasingly borderless world; sustaining confidence in the face of increased demands for greater transparency; responding to the challenges of regulatory and accounting changes; and managing risk in an increasingly complex and volatile environment. These challenges have spawned multi-faceted reforms, involving changes in business models, risk orientations, operating practices and in the interface with customers. It is this modernisation process of the insurance and takaful industries that will take it to new heights, bringing with it widespread and far reaching implications on the overall financial system and the economy.

It is my pleasure to welcome you to this year's dialogue session between Bank Negara Malaysia and the insurance and takaful industries to discuss these issues in greater depth within our domestic context, and to consider the necessary actions that need to be taken under increasingly more challenging conditions. The theme for this year's dialogue: "Moving Towards a More Competitive Market", will focus on the challenges of pricing deregulation, product transparency, operating cost efficiencies and commission disclosures. The issues revolving around operating practices and the interface with customers also needs to be viewed in terms of the broader dimensions of public confidence, transparency and risk management.

The dialogue this year is also based on a new format focused on issues with long-term strategic implications that need to be addressed in the current environment. It is designed to encourage deliberations from the different perspectives between industry participants and Bank Negara Malaysia. The dialogue will also serve as a platform to reflect on recent economic and financial developments and the major policy initiatives by Bank Negara Malaysia. Allow me to take this opportunity to share some thoughts with you in these areas.

The outlook for the Malaysian economy continues to remain favourable, despite some signs of moderating growth in the global economy arising from the higher oil prices. Malaysia has had a track record of solid and steady growth for a number of years now. The diversified economic structure and sound macroeconomic fundamentals have been important in supporting this trend. Of importance is that this growth is private sector

driven. While price pressures have been contained by improvements in labour productivity and capacity expansion, domestic inflation has begun to edge upwards, largely due to cost-related factors. In balancing these trends, monetary policy has continued to remain supportive of growth. Growth in Asia has also remained strong with mutually reinforcing effects for regional economies, including Malaysia, as regional integration continues to intensify.

The global environment, however, is clouded by uncertainties amid the persistence of global imbalances. The United States continues to record large deficits in its external accounts. There is significant discussion in the global community on how these imbalances may be unwound. The consensus, however, is clear that the adjustment should be orderly. There has however, been an over focus on realignment of exchange rates to facilitate this adjustment. But this may risk destabilizing adjustments. Ultimately, the structural imbalances have to be addressed by some combination of adjustments in demand, prices and exchange rates. In particular, the rebalancing of global growth can be expected to be a major factor contributing to an orderly adjustment to these imbalances. Indeed, it would require more than just adjustments in exchange rates. The nature and breadth of the adjustments will be important to achieve a long-term solution.

With its young workforce, growing productivity, competitive and dynamic economies, there is great potential for the Asian economies to contribute towards the re-balancing of global growth. With rising income levels in regional economies, particularly among the growing middle-income group in China, India and the ASEAN economies, there is potential for an expansion of demand within the region. The rebalancing of global growth across the world will eventually contribute towards reducing the prevailing imbalances. Malaysia's own agility to absorb and respond to the external and domestic challenges has allowed us to efficiently shift resources to new areas of growth, to new areas of comparative advantage and thus, sustain our long-term prospects. Going forward, Malaysia's economic policy will therefore continue to focus on ensuring that the economy's flexibility and resilience is sustained.

With the strengthening of the economy, the financial system and our fundamentals, the opportunity has been taken to deregulate and liberalise the environment further. The most recent policy initiative in this direction has been the shift in the exchange rate regime to a managed float. Under this regime, exchange rate stability will continue to be a primary objective of exchange rate policy. Malaysia is a trading economy that is highly integrated with the world economy, and in this context, a stable exchange rate environment continues to be important. With changes in the international economic and financial environment, the move towards a managed float was important to enable Malaysia to maintain a stable exchange rate against its major trading partners. Under this arrangement, Bank Negara Malaysia will now monitor the exchange rate against a currency basket to ensure it remains close to fair value. The transition to the new system has been

orderly, with transactions mainly reflecting trade and foreign direct investment as well as portfolio investment activities.

As providers of long-term capital and efficient risk transfer solutions for productive economic activity, the insurance and takaful sectors play an important role in supporting the economic transformation process. Over the years, that role has increased in prominence with the impressive growth achieved by the industry. In 2005, the insurance and takaful industries have continued to demonstrate resilience and strong performance despite challenging investment and underwriting conditions. Premiums and contributions have continued to expand at double-digit growth rates in the first half of 2005, with the general sector rebounding strongly after two consecutive years of slow growth. The underlying fundamentals for sustainable growth has also strengthened with stronger solvency positions reported by the majority of players, continued profitability and improved underwriting discipline.

The growth has also been accompanied by enhancements to the competitive structure, improvements in innovation and a greater degree of differentiation in the market, offering consumers a wider range of products and services. In particular, the advent of bancassurance and bancatakaful has seen more players packaging life insurance and family takaful with innovative investment options that incorporate banking product features. Today, bancassurance and bancatakaful constitutes a significant feature of Malaysia's financial landscape, and continues to develop rapidly in terms of market reach and operational sophistication.

The recent passage of the Insurance (Amendment) Bill on Financial Advisers marks yet another important milestone in ongoing efforts to achieve a more diversified market structure. With the legislative framework now in place, I am pleased to announce that Bank Negara Malaysia will soon be issuing licences for financial advisers. The introduction of financial advisers in the Malaysian insurance industry will further diversify the distribution system for life insurance. Corporate bodies with a minimum paid-up capital of RM100,000 will be eligible to apply for a financial adviser's licence. Similar amendments to the Takaful Act 1984 will be undertaken in the near future within the context of more substantive and wide-ranging changes to the current legislation.

Our foundations for financial stability will also continue to be strengthened with the ongoing evolution of a more diversified and balanced financial structure. Today, Malaysia stands at the forefront in the provision of comprehensive Islamic financial services covering banking, takaful, and the capital and money markets. In the area of takaful, Bank Negara Malaysia continues to undertake initiatives aimed at developing significant market players that are able to compete effectively and efficiently.

Although the organic growth of the existing takaful operators may meet the current demand for takaful products and services, it is envisaged that players with strong capabilities in operational and risk

management, and product development would hasten the further expansion of the takaful industry. In May this year, the Bank announced the issuance of up to four new licences for takaful operators. The additional takaful licences are offered to sound financial institutions, with priority accorded to those with experience in Islamic banking, takaful or insurance business. It could also include joint ventures or consortiums of financial institutions, which includes at least a banking group. Such joint ventures or consortiums would enable the new takaful operators to leverage on the expertise, experience and infrastructure of their partner financial institutions. In line with the liberalisation in the Islamic banking industry, foreign equity interest of up to 49% will be allowed in the takaful entity to secure strong shareholders, and foster meaningful strategic alliances.

For insurers, the potential to participate with strong local and foreign partners in the new takaful operators will open up significant opportunities to expand their product offerings to include a comprehensive range of insurance and takaful products. Existing takaful operators will therefore need to review their business and management strategies in response to the increased competitive elements that are set to shape the takaful industry.

Malaysia has also moved strategically to establish closer economic linkages and integration with our neighbours to enable Malaysian businesses to tap the vast commercial opportunities present in Asia. The Government has already started negotiations on a number of free trade agreements that will open doors to greater market access in the growth economies within the region. These negotiations are currently now at various stages. We remain confident of achieving a positive outcome that will be balanced and mutually beneficial. Specific opportunities for expansion abroad by Islamic financial institutions, in particular, are also being further enhanced through various bilateral and multilateral arrangements. This includes the signing of a memorandum of understanding between Malaysia and the Islamic Development Bank in 2004 to enhance cooperation among member countries of the Organisation of Islamic Conference, or OIC, in the areas of trade, investment, islamic finance and ICT development. These initiatives will pave the way for Malaysian takaful operators to promote and expand takaful and retakaful business to key target markets abroad, in particular, within the OIC.

The net benefits that will ultimately accrue to Malaysia will depend on the ability of Malaysian institutions to develop targeted globalisation strategies that will position them to gain from the first-mover advantages where they arise. This needs to be reinforced with research into the new growth markets, and exploring opportunities for strategic alliances or joint ventures in these markets. At the same time, the growth strategies must also accord an equal inward focus on reinforcing financial strength and resilience, human capital development, a strong business reputation and high standards of service and professionalism all of which are the critical success factors for effective strategies abroad.

Maintaining financial stability remains a primary mandate of the Central Bank. In response to the constantly changing financial landscape, Bank Negara Malaysia's approach to the regulation and supervision of the insurance and takaful sectors has evolved to achieve a more robust regime that emphasises three key dimensions: first, creating a strong risk management culture that overlays the operations of insurers and takaful operators; second, facilitating market-led adjustments that will allow the industry to evolve in response to market, technological and demographic developments, while maintaining sufficient regulatory oversight to maintain financial stability and public confidence; and third, ensuring mutually consistent policies for the banking and insurance sectors.

Two fundamental changes underpinning the Bank's current approach to regulation and supervision are the shift towards "principle-based" regulations and the implementation of a risk-based regulatory and supervisory regime. Increasingly, regulations have focused less on prescriptive rules, and more on establishing the broad parameters for sound financial and business practices that provide substantial flexibility for insurers and takaful operators to apply the principles in the manner most appropriate to their specific circumstances. Under this approach, greater attention is also being given to the creation of appropriate incentives within the system to achieve the desired outcomes.

The adoption of "principle-based" regulations is complemented by an increased focus on risk management in the capital and supervisory framework. On this front, I am encouraged by the industry's positive response to the new risk-based supervisory framework implemented for the insurance and takaful industries since August 2004. The new approach amplifies the focus on institution-specific risks in the supervisory assessment and rating process. Importantly, the framework serves to mutually enhance understanding by the institutions and the Central Bank of the inherent risks faced by the respective institutions, and thereby establish the common expectations regarding the management and control of those risks, taking into account the nature, scope, complexity and risk profile of the institution. This process, in turn, facilitates appropriate supervisory and institutional responses that are proportionate to the risk assessments of individual institutions and their systemic impact.

Similarly, the implementation of the risk-based capital framework for insurers will further reinforce the regulatory focus on risk. The adjustments to this framework will take into account the feedback received from the industry on the concept paper released by Bank Negara Malaysia in December last year, as well as the results of the impact study that was concurrently carried out to assess the potential capital adjustments required by insurers. Specifically, the adjustments to the framework are being made to achieve greater consistency between the valuation bases for assets and liabilities, and to fine-tune the asset risk charges. A second consultation paper, incorporating these changes, will be released for further industry comments later this year.

Insurers will no doubt welcome the greater degree of investment flexibility that will be allowed under the risk-based capital framework. It is an important improvement over the current "admitted assets" framework, and one that is also expected to significantly raise the profile of the investment management function within the industry. As the scope for differentiation between institutions increases under the risk-based regime, it will become more critical for insurers to attract, develop and retain the right human capital resources. With the liberalisation of financial markets and the rapid pace of financial convergence, the investment management function within insurers needs to be flexible, risk-focused, and equipped with professionals who are able to respond to the exigencies of the marketplace.

An important component of the new risk-based capital and supervisory framework is the notion of supervisory target capital levels which insurers will be required to maintain under the risk-based framework. This is new to our environment, and has been a matter of some concern to insurers which may view it as an additional capital burden. Although the risk-based capital regime will more closely align economic capital with regulatory capital, it is important to recognize that it necessarily derives its application from industry-wide tests which cannot fully address risks that are specific to an individual institution. The supervisory capital target therefore serves to provide an early signal of emerging difficulties so that appropriate intervention measures can be taken to prevent a further deterioration of conditions which would warrant more drastic and costly actions. For insurers that already adopt robust internal approaches to capital management, the introduction of the supervisory target level in itself should not significantly alter existing capital management strategies. Insurers that do not yet have such systems in place, will be encouraged to develop them, and thereby enhance their own resilience to adverse changes in business conditions.

The Bank is mindful that developments internationally on this front remain extremely fluid. Work is still in progress on the International Financial Reporting Standard for Insurance Contracts, the Solvency II initiative in the European Union, and the development of cornerstones for solvency assessments by the International Association of Insurance Supervisors. The Bank will therefore continue to maintain an open consultative approach in proceeding with this initiative to preserve our ability to respond appropriately and to ensure its smooth implementation.

Going forward, greater attention will be given to market conduct issues, which recent experience in other markets has shown to be an increasingly important factor in promoting confidence in the insurance and takaful industries. Financial markets cannot operate efficiently and effectively unless market participants act with integrity. This needs to be reinforced with adequate information to consumers and investors to make informed decisions. In today's information era, the business environment has changed dramatically, and with it, the expectations of consumers and investors have also increased. The industry needs to adapt accordingly.

Policy initiatives by Bank Negara Malaysia in the area of market conduct will continue to focus on achieving complete, true and plain disclosures to consumers, thereby equipping consumers to make informed decisions essentially through consumer education initiatives, and ultimately, promoting the fair treatment of policyholders. In this connection, I am pleased to announce that after more than two years of extensive discussions with the industry, the revised Guidelines on Medical and Health Insurance Business have now been finalized. The Guidelines will be released to the industry this month for implementation early next year. This is an important strategic development, both from the public policy and consumer perspectives. Today, medical insurance business accounts for the largest share[1] of non-tariff general insurance premiums in the market, with premiums exceeding RM1.3 billion in 2004. The revised Guidelines have retained a significant degree of product flexibility, and enhanced disclosure requirements to promote increased competition while more clearly defined rules governing minimum policy terms and conditions will be put in place to deliver a reasonable level of protection to policyholders. These requirements will also promote more consistent treatment of consumers in the provision of core benefits under medical insurance policies.

Where regulatory intervention remains necessary, the Bank will continue to balance the business interests of industry participants with that of consumers, to ensure that the costs of regulation are commensurate with its perceived benefits to consumers. In the long term, however, reliance on regulation and supervisory oversight alone is not a sustainable solution to the market conduct and broader confidence issues that confront the industry. The desired outcome should be one where freedom of action is accompanied by an appropriate degree of moral restraint on the part of the market. This requires compatible incentives in the system and a strong ethical foundation built within institutions which will ensure that insurers and takaful operators act responsibly within an environment that allows greater business flexibility.

The strategic issues before us today concern the industry's responsibility to deliver a fair proposition to consumers, its relevance in the changing environment and its readiness in terms of capacity and infrastructure to support and sustain a successful strategy for growth.

It is hoped that discussions at this dialogue will contribute towards the thinking on future corporate strategies as well as on the regulatory responses to ensure sound development. This will be an opportunity to engage actively in the discussions on these keys issues confronting the industry in moving forward. I wish you a successful and productive dialogue.

[1] 10.5% of total general gross direct premiums, third (in terms of market share) only to motor and fire business.

ASLI's World Islamic Economic Forum
1 October 2005, Kuala Lumpur

"Metamorphosis into an International Islamic Banking and Financial Hub"

Special Luncheon Address by
Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz
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In evolving the Islamic financial system, important considerations include the development of a system that is able to meet the changing requirements of the consumer and business community, that is efficient and competitive, that is safe and sound and that is robust and resilient and able to withstand a more challenging and uncertain world environment. These considerations are vital to ensure the sustainability of the system not only as a form of financial intermediation in the domestic economy but also as an integral component of the international financial system.

Evolving a Robust Islamic Financial System

Malaysia has adopted a holistic approach in developing its Islamic financial system. Our initial focus was to develop a comprehensive domestic Islamic financial system. The strategy has been to institute the entire financial system chain to ensure its smooth functioning thereby contributing to a balanced allocation of financial and economic resources within the economy, and a greater diversification of risks within the system, and thus achieving overall stability of the Islamic financial system. The initiatives taken include building the required financial institutions, robust regulatory and supervisory framework, effective legal and Shariah framework, the financial markets, effective payment and settlement system, reinforced by the development of the skill talents, and putting in place the mechanism for the operation of the Central Bank. The development of this chain has promoted greater linkages and integration within the domestic Islamic financial system.

Attention has therefore been given to the development of the key structural components of the system, comprising the Islamic banking industry, the takaful industry, the non-banking institutions and the Islamic interbank and capital markets. These respective components of the Islamic financial system have now become highly integrated and interdependent. This more diversified financial infrastructure has also enhanced the efficiency in the functioning of the overall financial system.

The development of the Islamic financial system in Malaysia started with the establishment of *Tabung Haji* in 1969 as the

first Islamic savings institution. This was followed by the establishment of full-fledged Islamic banking and non-banking institutions. A year after the establishment of the first Islamic Bank in 1983, a takaful or Islamic insurance company was established under the Takaful Act. These developments were subsequently expanded with the introduction of Islamic windows by conventional banking institutions where Islamic products and services could be offered by these banking institutions. At the same time, adequate firewalls have been instituted to ensure absolute separation of banking operations to avoid co-mingling between the Islamic and conventional funds so as to ensure the integrity of the Islamic banking operations.

More recently, this structure has been strengthened. Conventional banking institutions that have achieved a critical mass in their Islamic finance operations have the option to transform their operations into a dedicated Islamic subsidiary. Within this framework, Islamic finance in Malaysia has proven to be resilient and able to function effectively and efficiently alongside the conventional financial system. The ability of the Islamic banking institutions to arrange and offer products with attractive and innovative features at competitive prices has appealed to both Muslim and non-Muslim customers, reflecting the competitiveness of Islamic finance as a form of financial intermediation. Since 2000, the domestic Islamic banking industry has been growing at an average of 18% per annum in terms of assets, while growth in the takaful industry was at an average of 28% per annum, with an increasingly more important role in supporting the growth and development process of the country.

Attention has also been given to develop both the Malaysian Islamic money market and capital market. A wide range of instruments has been developed to facilitate the effective management of liquidity and funding by the Islamic financial institutions. This has facilitated the smooth flow of funds in the Islamic financial system. With the development of the bond market in Malaysia which now accounts for 81% of GDP, the Islamic private debt securities account for about 44% of the total outstanding amount of private debt securities in the market, while the monthly traded volume of the Islamic money market is now about RM30 to RM40 billion. The money market also effectively serves as a channel for the conduct of liquidity operations by Bank Negara Malaysia as part of its monetary policy.

The rapid expansion of the Islamic financial services industry in Malaysia is also supported by a conducive legal and Shariah framework. In terms of the legal infrastructure, the Islamic Banking Act 1983 and Takaful Act 1984 governs the conduct of the Islamic banking institutions and takaful operators respectively. There is also the Government Funding Act which governs the issuance of government Islamic instruments. A dedicated High Court judge has also been assigned to preside over cases relating to Islamic banking and finance. An arbitration centre is also available to deal with disputes. 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. The treatment of tax neutrality has also been accorded to Islamic financial transactions.

To ensure the soundness and stability of the Islamic financial system the regulatory and supervisory framework has also been improved for the Islamic financial institutions, with the incorporation of stronger standards for corporate governance, transparency, disclosure, accountability, market discipline, risk management and customer protection. In addition, the payment system has also been continually upgraded to ensure efficient and effective clearing and settlement of payments. It is now highly automated with the ability to handle scriptless debt securities trading, processing and settlement. By providing a real time settlement system for inter-bank fund transfers, the credit and settlement risk in the Islamic financial system has been minimised.

Attention has also been given to human talent management to create a sufficient pool of competent bankers essential to spearhead innovation in Islamic financial products and services. To meet the increasing manpower requirements, institutions of higher learning and the Islamic banking and finance institutes have also initiated new programmes on Islamic finance.

Leading initiatives in the global integration

Islamic finance in Malaysia has now taken on a new dimension to become more internationally integrated. This is part of the strategy to evolve Malaysia as an integrated international Islamic financial hub that will have a greater role in facilitating international economic and financial flows.

The liberalisation of the Islamic financial system in Malaysia commenced in 2004 with the issuance of three new Islamic bank licences to foreign Islamic financial institutions. These new entrants with distinct capabilities and strengths will not only participate in the growing domestic Islamic banking industry, but will also be able to tap new markets in the region. This initiative will also promote healthy competition, thereby contributing to elevate the domestic industry to new levels of dynamism. In addition to this initiative, up to 49% foreign interest is permitted in the Islamic subsidiaries of the conventional banking institutions and in the takaful companies. The increased international integration is also reinforced by our own institutions venturing beyond our domestic borders, in particular to the Asian region and to the Middle East. This international integration would contribute towards facilitating greater cross-border flows in terms of increased trade and investment transactions, thereby strengthening the global economic and financial inter-linkages.

Apart from banking, Malaysia is also initiating efforts to promote takaful internationally. This is being done in close coordination with the Islamic Development Bank where a taskforce has been established to spearhead, among others, the development and promotion of trade, investment, Islamic banking as well as takaful and retakaful industries among OIC member countries.

Among the main initiatives to be undertaken under a Memorandum of Understanding signed between Malaysia and the Islamic Development Bank is to specifically promote and expand takaful and retakaful businesses in the member countries.

A further initiative by Malaysia was to access the international capital market with the issuance of global Islamic financial instruments. The Government of Malaysia made this inaugural primary issuance of a globally-accepted sovereign Islamic *sukuk* in 2002. Since then, there have been several other issues by other countries. To-date, the total issuance of the four global sovereign *sukuk* has exceeded USD3.5 billion. The *sukuk* has broadened the investor base by creating a new asset class for both Islamic and conventional investors. This has also been followed by the issuance of global corporate *sukuk,* which now amounts to USD12 billion. Several of these products are listed on the Labuan international financial exchange.

In 2004, Malaysia liberalised the foreign exchange administrative rules to allow Multilateral Development Banks and multinational corporations to raise ringgit-denominated instruments in the Malaysian capital market. Towards this end, two institutions, the International Finance Corporation and the World Bank, have issued ringgit-denominated instruments based on Islamic principles in our market. This has contributed to enhancing the depth of the market.

At the international level, Malaysia has also participated actively in initiatives to develop the supporting international Islamic financial architecture. The formation of the Islamic Financial Services Board (IFSB) in 2002 is one of the most important achievements in this development to set the international prudential standards for Islamic finance. To-date, the IFSB has made commendable progress, and this includes the issuance of two exposure drafts on capital adequacy and on risk management. Work is in progress for three other standards that relate to corporate governance, transparency and market discipline, and the supervisory review process. The IFSB has also played a catalytic role in expanding its membership and outreach, thereby contributing further to the global recognition of the Islamic financial system. Today, the IFSB has 78 members from all over the world. This will contribute towards the standardisation of the prudential rules and more importantly contribute to the soundness and stability of the Islamic financial system.

The International Islamic Financial Market, or the IIFM, which is another leading international initiative, will also contribute towards promoting the development of both the primary and secondary international Islamic financial market. IIFM provides the environment to link all the financial centres around the world that participate in Islamic finance, thereby encouraging active participation by both Islamic and non-Islamic financial institutions in the secondary market for Islamic financial instruments. As the volume increases, it would strengthen the inter-linkages and integration amongst the Islamic financial centres.

In the area of Shariah, Bank Negara Malaysia is currently promoting intellectual discourse on Shariah issues. Our own Shariah scholars have contributed towards the rapid growth of the Islamic financial products. Earlier this year in conjunction with the IDB Annual General Meeting that was held in Putrajaya, the opportunity was taken to bring the international Shariah scholars together to deliberate the issues and to foster greater understanding and convergence of the practices of Shariah. Bank Negara Malaysia has established a RM200 million dedicated endowment fund to facilitate regular dialogues among the Shariah scholars, to finance research and scholarships, and to facilitate enhanced interaction between the Shariah scholars and the industry practitioners.

Malaysia will continue to initiate international endeavours and collaborate closely with the Islamic financial community on developing the global Islamic financial system by dedicating our resources and commitment.

Key challenges moving forward

One of the key challenges in promoting greater linkages within the domestic Islamic financial system and integration with the international financial system is having the pool of talent and professional skills. Talents are an important pre-requisite for the national and global development of the Islamic financial system. They are important assets that will drive innovation in the Islamic financial business and sustain its competitive strength.

As the industry moves forward, the need to develop the range of products and services including risk-mitigating products intensifies. These products are a necessity for the Islamic financial industry not only to meet the new and changing requirements of the domestic and international economy but also to allow for hedging against potential adverse events and uncertainties. This is important to strengthen the resilience and risk management framework of the Islamic financial industry amidst the increasingly more challenging and competitive global financial environment.

To fast track the creation of a pool of talents and skill set to meet the increasing manpower requirements, Malaysia is currently undertaking an initiative to establish an international centre for education in Islamic finance. It will be designed to act as a professional certification body and a training institute for post-graduates. In addition, Malaysia established the International Centre for Leadership in Finance (ICLIF) in 2003 to also provide leadership development and management training for the Islamic financial institutions.

Closely linked to having the talent is the need to have strong and well established Islamic financial institutions. This presents another challenge for the Islamic financial industry as there are currently not many large Islamic financial institutions. Many of the players are not large enough globally to finance large development projects, particularly in Muslim countries and are not strong enough to underwrite the needs of the Islamic financial community on a large scale. Currently, some of the project financing in

Muslim nations are undertaken by large conventional banks because of the under capitalisation of the Islamic financial institutions. We therefore need to have strong and highly capitalised Islamic financial institutions that are able to offer the comprehensive and complete range of Islamic financial products and services.

Besides having large Islamic financial players with the required pool of expertise, the integration of the Islamic financial system with the international financial system needs to be supported by the development of a full Islamic financial system at the national level, thereby increasing the potential to effectively participate in a more liberalised and globalised environment.

Towards this end, Malaysia together with other OIC countries, are collaborating with the IDB and IFSB to formulate a ten-year master plan for the future global development of the Islamic financial services industry. The Master Plan will provide a road map to achieve a convergence towards the common vision among countries in the development of an Islamic financial system.

Conclusion

In developing and strengthening our Islamic banking and financial system to become more integrated with the international financial system, Malaysia is positioning itself as an Islamic financial gateway to the East Asian region. In emerging on the radar screen of international investors, Malaysia thus not only offering financial communities that want to deal in Islamic financial transactions, but also the international investment community at large, the potential for further opportunities for financing and investment in productive activities.

In closing, I wish to say that our mission is for the development of an increasingly international integrated Islamic financial system. I am confident that in taking this approach, it would contribute towards facilitating increased trade and investment transactions, strengthening the global economic and financial inter-linkages, and thereby raising the prospects for more balanced global growth and shared prosperity among the *Ummah*, InsyaAllah.