44th SEACEN Governors' Conference
Kuala Lumpur, 6 February 2009

Welcoming Remarks by

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

Bank Negara Malaysia is very honoured to host the SEACEN Governor's Conference for this year. We are particularly privileged to be able to welcome Governors from the SEACEN membership to be with us, at this time, on the occasion of the 50 th Anniversary of our Central Bank. On 26 January 1959, 50 years ago, Bank Negara Malaysia opened its doors as the Central Bank for the nation. The SEACEN group is among the most inclusive grouping in the region, with highly diverse economies, in terms of size and stages of development. This has, however, not been a restraint in the progress and advancement of SEACEN as a cohesive grouping in achieving greater cooperation, particularly in the area of strengthening the capacity and effectiveness of Central Banks in the region.

This year's Governors' meeting, however, takes place at a time of great turmoil in the global financial and economic environment. Indeed, it will be a time for us to reflect on the extent to which our efforts have rendered us better able to respond and to cope with this highly challenging environment.

My dear fellow Governors, today, we are honoured with the presence of The Honourable Dato' Sri Mohd Najib Tun Abdul Razak, the Deputy Prime Minister and Minister of Finance of Malaysia, who has kindly accepted to officiate the commencement of our Conference. We are also very appreciative to Mr. Dominique Strauss-Kahn, the Managing Director of the International Monetary Fund who will be joining our meeting despite the great demands on his time during this most turbulent of times. We will most certainly benefit from the International Monetary Fund's perspective on the unfolding developments and the assessment on the respective responses and interventions that are being made.

Today, we will also have the honour of listening to Mr. Nout Wellink, President of De Nederlandsche Bank who will be sharing with us on the institutional arrangements for prudential supervision, market conduct and consumer protection, issues that are highly relevant in the current environment given the on-going search for the most effective institutional arrangements for achieving financial stability. This is also not only relevant to developed financial systems but also to Central Banks in the SEACEN membership as we continue to develop and evolve our financial systems.

Since the Asian Financial crisis more than ten years ago, the region has benefited from the reforms and restructuring of our respective financial systems and economies. While our strengthened position has not insulated us from destabilising external shocks, it has however strengthened our capacity to cope with such developments. The region has also benefited from the greater pace of regional financial and economic integration. Our increased propensity to trade and invest with one another contributes towards building the foundations for stronger regional stability and resilience. This has also been reinforced by greater regional collaboration and cooperation.

Despite the diverse financial and economic structures, we have all shared the same conviction in that financial progress has to be accompanied with the appropriate degree of regulation and supervision to preserve financial stability but without stifling the incentives for financial innovation and the adoption of prudent risk-taking. Our theme for today on preserving monetary and financial stability in the current global environment continues to resonate as the international dimensions of financial instabilities impinge on our national frontiers and on the policy options available to us. The current

experience demonstrates the fragilities in the financial systems even among the developed economies. Critical issues are emerging particularly on financial intermediation, financial innovation, and the corresponding regulatory regime and surveillance mechanisms that need to be in place to provide the necessary oversight over such activities. These experiences have underscored the critical importance of good governance, sound risk management, rigorous supervision and a strengthened crisis management framework that are sufficiently robust to withstand extreme market conditions.

Globalisation and financial integration have brought a new and salient dimension to the attainment of financial stability, namely, the consideration that needs to be given to the regional and global implications. Greater international collaboration is needed. Moreover, the re-alignment of the international financial architecture has become even more urgent, otherwise, gains achieved at the national level, will continue to be undermined. With each missed opportunity to embark on necessary reforms to the international financial architecture, the financial, economic and social costs have and will continue to become increasingly higher.

The SEACEN grouping has a long history of serving as a platform for high-level policy discussions. Although the SEACEN Centre was established in 1972, the Governors of SEACEN central banks have been meeting annually since 1967. The SEACEN Governors' Conference has always provided a valuable forum for exchanging candid views and sharing policy experiences. Regional surveillance has also been enhanced with the establishment of regional support mechanisms and the strengthening of capacities in the management of risks to our financial system and environment. SEACEN's cooperation has been able to respond to the changing regional and global environment. This has included the SEACEN Experts' Group which was established to exchange information, in particular on the financial flows in the region. In the more recent period, we have also come together to ensure that our circumstances and views be taken into account by international organisations in decisions that would affect the interests of the region.

The SEACEN Centre has also been an effective regional collaborative effort in the capacity building of Central Banks in the region. There has been continuous knowledge building and human capital development across all levels of our institutions. The SEACEN Centre has been providing support for the entire career-cycle of a central banker thus strengthening our talent development. The SEACEN Centre is the most visible outcome of our collaboration which has evolved significantly over the years.

The SEACEN Centre's steadfast efforts have trained more than 10,000 participants from our member Central Banks. With the increased demands on Central Banks, members will continue to place even greater reliance on the SEACEN Centre. I am very pleased to mention here that the SEACEN Centre will be moving to new premises in the next few weeks that will have the state-of-the-art learning facilities. It will also include a new modern residential hostel. As the host country to the SEACEN Centre, Bank Negara Malaysia is very much committed to supporting the Centre in becoming a premier learning centre that leads in the development of central bankers.

Let me conclude my remarks. I look forward to stimulating and productive deliberations at our Conference. Despite the intensive schedule that has been planned, we also hope that some time will be taken to experience Kuala Lumpur during your visit here.

Ceremony for the 50th Anniversary of Bank Negara Malaysia: "50 Years of Central Banking - Stability and Sustainability" Kuala Lumpur, 8 February 2009

Keynote Address by

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

Bank Negara Malaysia opened its doors as a Central Bank on January 26, 1959, just over a year after Malaysia gained independence in August 1957, reflecting the importance that was being accorded by our founding fathers to the institution of Central Banking. At the very outset, the Central Bank was entrusted to provide leadership in performing the traditional Central Bank mandate of promoting monetary and financial stability. Equally important was the mandate to develop the domestic financial system - a financial system that would facilitate economic growth and development.

It is my very great honour to welcome distinguished guests that have come from different parts of the world to join us on this special occasion to commemorate the fiftieth anniversary of Bank Negara Malaysia. We also wish to express our appreciation to the Prime Minister of Malaysia for his presence as the guest of honour at this occasion.

Introduction

Allow me to share our experience during these 50 years and our aspirations moving forward. These five decades have been highly challenging but rewarding with many fulfilling outcomes. And there were also lessons learned. While the country has experienced great prosperity during most of the period, our economic and financial progress has also been punctuated by episodes that have tested our resolve. Rising to manage and address these challenges, the growth and economic transformation experienced in these 50 years have been achieved in an environment of macroeconomic and financial stability.

During the five decades, Malaysia has experienced an average annual growth that has exceeded 6 per cent and an annual inflation that has been less than 3 per cent. The continued increase in incomes and the low and stable inflation have not only promoted a high rate of savings that has exceeded 30 per cent of GDP but it has also resulted in the financialisation of savings. This has allowed Malaysia to rely on domestic sources of funding to finance our growth and development, thereby minimising our levels of external indebtedness.

Monetary Stability

Being a highly open economy, the sources of monetary instability have generally emanated from external price shocks, which have occurred during periods of high commodity and energy prices, and to a lesser extent, from periods of excess demand and overheating conditions. There has essentially been only two episodes in our history in which overheating conditions have generated inflationary pressures; the major one being the period prior to the Asian financial crisis.

Since the 1990s, monetary policy has been further complicated by volatile capital flows. This was evident in several periods, the early nineties, the mid-nineties, and in the late nineties, when outflows occurred during 1997 - 1998 and in the current period following the deleveraging by financial institutions in the advanced economies.

In the early days of the Bank, policy actions were focused on the management of liquidity in the financial system through the imposition of statutory and liquidity reserve requirements, and through prescription of interest rates and portfolio restrictions that included ceilings on lending. Further progress and sophistication in the financial sector, the deepening of the financial markets and the growing influence of capital flows, resulted in the reliance on interest rates and other market-based instruments for monetary policy. Further, with the increased significance of expectations, greater clarity in policy signals became desirable.

Thus in 2004, the New Interest Rate Framework was implemented, in which the Overnight Policy Rate became the new policy rate, thereby enhancing the efficiency of the monetary transmission mechanism. The new framework has also served as a catalyst for efficient pricing of financial products and services by banking institutions.

A key issue for monetary policy in an open economy like Malaysia has been in maintaining a flexible exchange rate and monetary independence in the face of increasingly large capital flows. To better manage the surges in capital flows which have become more prevalent, the range of market-based instruments for monetary policy operations has been widened. Given the rise in intra-regional trade and investment flows, greater importance is being accorded to stability of the exchange rate against regional currencies.

The monetary policy decision-making process at the Bank has also been redefined in which the governance for monetary policy is based on the Monetary Policy Committee to achieve a more optimal process for policy making. Monetary policy communication and increased transparency have also become highly important in this framework.

Thus, while the Central Bank's responsibility towards promoting monetary stability conducive to sustainable growth has remained unchanged since the inception of the Central Bank in 1959, the strategies, framework and instruments have evolved substantially to ensure its effectiveness in delivering this desired objective.

Financial Sector Development

A key focus of the Central Bank during these five decades has been institutional building, financial market development and putting in place the appropriate financial infrastructure. The evolution of the financial system has seen its transformation, from a rudimentary financial system that was dominated by the banking sector to a highly diversified financial system, from a highly controlled financial system to a financial system that functions with greater market orientation, from a highly fragmented system to one that is more consolidated and rationalised. It has also become a financial system that is supported by an extensive legal regime and regulatory and supervisory framework, and a financial system that is more liberalised with stronger international linkages.

Part of the institutional building was the establishment of regulatory institutions that have clearly defined mandates. These institutions that include the Securities Commision, the Cooperative Commission, the Labuan Offshore Financial Services Authority (LOFSA), join us today in celebrating the long tradition of cooperation to meet the common purpose. Specialised development financial institutions were also established to promote access to financial services to sectors that are not being serviced by existing financial institutions. Financial inclusion, to ensure that all economic activities and all segments of society have access to financial services, has always been a key priority of the Central Bank. Currently, about 80% of our population have some forms of banking account as the access to the financial system becomes more extensive and widespread.

An important financial infrastructure established by the Bank to support the intermediation process includes the comprehensive centrally coordinated credit information system at the national level which allows for better-informed credit decisions by financial institutions. In addition, the Credit Guarantee Corporation was established to provide support for small businesses. Cagamas, the national mortgage corporation, was established by the Central Bank to ensure a steady flow of funds to the housing industry and to develop a secondary mortgage market.

At the centre of the financial infrastructure is the payments infrastructure which has been enhanced and modernised over the years to achieve greater efficiency and reliability of the payments system. The payments landscape has evolved from a mainly paper-based to one that includes a range of new electronic forms of payment. Internet banking which was not available in Malaysia as recent as 10 years ago is now widely used by the entire population of internet subscribers in the country. The acceleration of the nation's migration to the more efficient electronic payments continues to be an important agenda of the Central Bank.

Complementing institution building has also included the support given by the Central Bank to the development of talent in the financial services industry. The growth of the financial sector cannot

be achieved without adequate attention to the development of the professional requirements of the financial services industry.

In the recent two decades, a comprehensive Islamic financial system has also evolved in Malaysia, that includes the institutions, markets and supporting legal, regulatory and supervisory framework. The Islamic financial system now offers the full breadth and depth of Islamic financial services. Malaysia is the host to the secretariat for the Islamic Financial Services Board in Kuala Lumpur that sets the international regulatory and supervisory standards in Islamic finance.

Financial market development has also been central to building a robust financial system. The Central Bank's efforts in this direction have included establishing the institutions and the infrastructure to improve market efficiency of money, capital and foreign exchange markets. The Securities Commission, the domestic rating agencies and Cagamas, the mortgage corporation, are among the initiatives initiated by the Bank as part of the development of the domestic bond market. In addition, the Bank has also put in place a comprehensive and modern depository, delivery and settlement system that facilitates the issuance, trading and settlement of debt securities in the market, as well as mechanisms to increase liquidity in the market to enhance the overall price discovery process. This has contributed towards the proliferation of new instruments with extended maturity profiles, leading to the enhanced depth and breadth of the debt securities market.

The development of a robust and vibrant foreign exchange market still remains an outstanding area of development. As a highly open economy, this market is a vital part of our financial system. The country exit from the Currency Board system in 1967 and introduced the ringgit (known as the Malaysian dollar then). The changeover was successful. It was a time when there was an absence of speculators. It was only in 1997-98 when the ringgit and other regional currencies came under speculative attack. The volume of foreign exchange transactions had become massive, far exceeding volume of trade and the normal financial flows. This resulted in exchange rate volatility during the Asian crisis that occurred in wave after wave during this period. As a consequence, regional currencies plummeted to historical lows.

After more than a year of this turmoil and the uncertainty generated in the foreign exchange market, Malaysia implemented selective capital controls and deinternationalised the ringgit. This was instrumental in restoring stability in the market. It acted very much like a circuit breaker. Offshore trading of the ringgit, the major source for financing the speculative attacks, was effectively eliminated. Within a year, all the controls that was imposed were removed. More than 10 years later, the ringgit, however, still remains non-internationalised. An important precondition for the internationalisation of the currency is the development of a robust foreign exchange market in our financial system.

Financial Stability

The events surrounding the current financial crisis has brought into sharp focus the role of central banks in financial stability. As these events continue to unfold with great uncertainty on the financial markets and broader economy, allow me to reflect on Bank Negara Malaysia's own role in financial stability.

In addition to its functions as the lender of last resort, Bank Negara Malaysia also has the responsibility for the regulation of banking institutions. Since 1988, the Bank also assumed responsibility for the insurance industry and in 2002, the development financial institutions. The prudential regulatory and supervisory framework during these 50 years have also undergone significant evolution. The prudential framework and the supervisory approaches adopted by the Bank have provided the flexibility to respond to the new developments and challenges that have confronted the financial sector. Several factors have guided the approach adopted by the Bank. The first is to recognise the limitations of the regulatory tools and instruments. Second, is the acceptance that change is required in an environment that is constantly changing, and to carefully assess the trade-offs that arise given the different stages of development within the financial sector. And finally, to take into account the interlinkages within the financial system, and between the financial systems across borders.

Guided by these parameters, the Bank has evolved a prudential framework which at the start, comprised simple prudential rules that addressed capital, gearing, liquidity and portfolio restrictions,

to the now more differentiated and principle-based regulations that reflect the levels of risk taken by an institution. As a result, significantly greater flexibility is now accorded to institutions that demonstrate sound governance practices and robust risk management capabilities. This flexibility has been accompanied by fundamental changes in the approach to supervision that has now shifted from a predominantly compliance-based approach, to one that focuses on the assessment of the risk-taking activities of an institution and the control functions to manage the risks. The supervisory tools have also been expanded to include more forward-looking assessments of the risks to financial stability, supported by more dynamic stress testing approaches and enhanced surveillance systems.

To a large extent, the preconditions for the shift to the principle-based approach to regulation have been strengthened through capacity building measures that have been pursued in the period immediately following the Asian financial crisis. The development of the Financial Sector Masterplan which was released in 2001 is a blueprint not only for comprehensive financial sector reforms, but also it provided the framework and strategies for the modernisation of our financial system.

The financial safety net was also strengthened with the introduction of a comprehensive deposit insurance system and the establishment of institutions to assist consumers in managing their debt and resolving disputes with financial institutions. These measures have also contributed towards maintaining confidence in the financial system.

The Crisis: A Defining Moment for the Bank

In the 1990s, it became evident for emerging economies that new challenges to stability arising from the international dimensions of financial activity had emerged. In particular, highly volatile and potentially destabilising capital flows had become a dominant feature of the international financial environment. Strong economic fundamentals alone proved to be insufficient in containing instability in the domestic economy and financial system.

Many of us still vividly recall the Asian financial crisis of 1997-98 that significantly affected several of the countries in the region. What started as a currency crisis turned into a financial and economic crisis. During this period, the ringgit exchange rate depreciated by about 40% at the peak of the crisis; the stock market declined by almost 80%. While the Malaysian economy continued to expand in 1997 by 7.3%, conditions deteriorated significantly in 1998 and the economy contracted by 7.4%.

An extensive set of measures were implemented. This included a comprehensive restructuring programme for the financial and corporate sectors. While still at the early stage of the crisis, an asset management company was established to acquire and manage the non-performing loans of banking institutions. A special purpose vehicle to recapitalise the banking institutions and a Corporate Debt Restructuring Committee were also established to provide avenues for voluntary debt restructuring for businesses. Within six months of the implementation of these measures, the problems in the financial sector were addressed and lending activities resumed. This contributed to the rebound of the economy which expanded by 6.1% in 1999. Notably, the stakes taken in the financial institutions were disposed back to the private sector with the cost of the exercise being more than covered.

The Bank's efforts to sustain stability did not end when the Asian financial crisis abated and economic recovery was firmly in place. The lesson that the foundations for resilience are built during good times was earnestly embraced. Therefore, once stability was restored, the Bank embarked on a comprehensive restructuring and reform of the financial sector. This included the consolidation of domestic financial institutions; the strengthening of the corporate governance, risk management and the institutional capacity of the domestic financial institutions; as well as the deepening of the bond market. These efforts have put the Malaysian financial system in a much stronger position to weather the current global financial crisis.

Regional Cooperation

From the beginning, the Bank has always had an active engagement in the region and was from the very beginning part of the SEACEN grouping

which is the oldest and most inclusive regional grouping. Starting in 1967, SEACEN has been a valuable regional forum. While it is a group of highly diverse economies, this did not prevent it from being a cohesive grouping. The permanent secretariat of SEACEN which resides in Kuala Lumpur was established in 1979. The Bank is also part of other regional groupings including EMEAP and the Asian Consultative Council (ACC) of the BIS. Collaborative efforts among the Asian Central Banks in surveillance, regional financial market development and the sharing of information have been extensive. In Islamic finance, the Bank is a founding member of the Islamic Financial Services Board to promote and enhance the soundness and stability of the Islamic financial services industry.

Modernisation of the Central Bank

In the 50 years, the Central Bank has also been fundamentally transformed. At its inception, the Bank started with 57 people with four departments. The Bank has now grown in strength to more than 2,600 staff to accommodate our expanded roles. The modernisation of the Bank has involved change to our legal framework, our organisational and governance structure, and the nature of our human capital, so as to enable the Bank to become more effective in the changed environment.

As we advance forward into the future, the Bank will be confronted with increased challenges, and with many of the building blocks now in place, the next phase of development of the Malaysia's financial sector will involve greater market liberalisation and internationalisation. These developments will intensify the demand for greater readiness, capacity and capability from the Bank to best serve the nation moving forward.

This year, the Bank is in the process of submitting to Parliament a new Central Banking Act. As the economic and financial landscape, both domestic and international, is now significantly different from 50 years ago, the proposed Act involves a holistic review of the present legislative framework to give greater clarity to the Bank's mandate, governance, and accountability to ensure that the Bank remains effective in performing its functions. The proposed Act will provide the Bank with the necessary powers and instruments to perform the Bank's roles and functions effectively. The proposed Act will also not only institutionalise many of the practices that have been introduced in this recent decade but also to have the necessary powers which is deemed as critical in ensuring that the Central Bank is in a state of readiness to face future challenges.

In concert with these, the new Act will essentially reinforce the existing governance framework with adequate mechanisms to ensure sufficient checks and balances are in place. The governance framework will further facilitate and enhance high quality decision-making in the Bank, institutionalising both existing and new procedures and processes to enhance accountability, professionalism and transparency. The strengthening of governance and accountability will form the prerequisite for the Bank to maintain our public legitimacy and autonomy, as well as to ensure the integrity of the Bank as a public institution serving the nation's interests.

Conclusion

Bank Negara Malaysia's experience during these fifty years in preserving monetary and financial stability and in supporting the sustainability of economic development has seen many challenges. Throughout this journey, we have remained focused on what needs to be achieved and the vision of where we want to be. Key to our effectiveness is the internal capacity of the Bank. At the heart of this is the people in the Bank. While the operating environment has changed significantly and our policy focus has evolved, the values that the Bank represents, of integrity, of respect for diversity, professionalism and drive for the highest standards of excellence, have been enduring and reinforced over time.

Finally, the Central Bank could not have been successful in achieving our objectives and our policies if we did not have the support in our country - from the Government, from the financial and business communities and from the people of the country - for their confidence and trust in us during these 50 years. The Bank, going forward, through our policy actions and in discharging our responsibilities, will continue to uphold this trust that has been placed upon us.

Bank Negara Malaysia's High Level Conference
Kuala Lumpur, 10 February 2009

Opening Remarks by

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

It is my pleasure to welcome you to the Bank Negara Malaysia Conference on "Central Banking in the 21st Century: Implications of Economic and Financial Globalisation" that is being held in conjunction with the 50 th Anniversary of Bank Negara Malaysia. Indeed, the conference takes place at a time when we need to reflect on the many issues that are emerging from the current global financial and economic crisis and the new challenges and lessons that it brings to central banks.

We are most honoured by the presence of central banks from more than 50 countries who have come to be with us on the occasion of our 50 th Anniversary. This gathering has also brought together distinguished speakers not only from the central banking community but also outstanding scholars and senior practitioners from the financial services industry. It is hoped that this conference will contribute to a greater understanding of the issues confronting central banks in the 21 st century.

Indeed, we are now in a world that is fundamentally different, a world that calls for a greater appreciation of the changes that need to be made to the systems and structures, to the institutional arrangements and mechanisms, and to the manner in which we operate in this new environment. The international dimension of these changes calls for an outcome in which the international financial system is less prone to disruptions and failures and in which economic progress is a shared prosperity amongst nations.

Globalisation had a deep impact on the way modern economies function. The benefits of globalisation have accrued to diverse communities and regions but it has also brought with it significant risks. While the Asian Crisis showed the effects of globalisation, it also showed that Asia was able to rapidly rebound and continue to benefit from increased international trade and financial flows. The rapid restoration of stability and resumption of growth had confined the crisis to Asia.

As the current financial crisis is translated into an economic crisis, its repercussions are now being felt on a global scale. While the turmoil had its origins in a number of the developed economies, its continued escalation has extended the effects of the crisis to the rest of the world.

Economic and financial globalaisation thus not not only calls for policy responses at the national level but also at the international level. It also calls for the consideration that such policy responses may have implications that extend beyond domestic borders. Benefits may also be derived from cross border coordination of policy responses to increase the prospects of achieving the desired outcomes.

Our conference today focuses on the impact of economic and financial globalisation on the role of central banks, as well as to assess how central banks can effectively contribute to promote stability in this environment. In particular, this conference will be looking at the implications and challenges that globalisation brings to the mandate of the central banks in preserving monetary and financial stability. The pace and nature of globalisation has also brought significant stress to the international financial architecture. The current financial crisis has highlighted the vulnerabilities in the international financial architecture, leading to renewed thinking about the reform of the global financial system. Tonight, Professor Joseph Stiglitz will be speaking on "Strong Institutions for Growth and Crisis Management".

Tomorrow, we will address some of the specific management challenges central banks face in a globalised environment. We will also discuss some recent developments in central banks' cooperation and the areas for reform of the international financial architecture.

The crisis presents an opportunity for us to re-evaluate, promote and embrace sustainable long terms solutions. Our focus is for the discussions to contribute to the means through which central banks can contribute more effectively in promoting stability and economic growth. This conference, we hope, will provide an opportunity to reassess our traditional views on many of the issues before us. On that note, I wish you a very engaging and substantive conference.

Euromoney 8th Annual Islamic Finance Summit: "Islamic Finance and Global Financial Stability" London, 24 February 2009

Keynote Address by

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

It is my honour to be invited to speak at this 8th Annual Islamic Finance Summit organised by Euromoney. This summit, which takes place at a time of an unprecedented global financial crisis, provides us with an opportunity to reflect on the challenges confronting us and to consider the issues that have emerged in the context of the Islamic financial system.

My address will in particular focus on Islamic finance as a form of financial intermediation and financial stability. I will also touch on the steps that have been taken both at the national and international level to strengthen the resilience and robustness of Islamic finance, taking into account the lessons drawn from financial crisis that have been experienced including from the current crisis.

As we weather the current environment and prepare for the next wave of the growth cycle, it is also timely to explore the potential synergy that can be optimised between London, an international financial centre and Malaysia, an international Islamic financial hub. And in so doing, capitalise on the respective comparative advantage, thereby strengthening the linkages between Islamic financial markets, in particular, between the East and West.

It was exactly five years ago that I spoke at this forum. At that time, the world's GDP was expanding by close to 5%, with emerging economies growing by 7.5%[1]. Islamic finance during this period expanded rapidly not only in the Muslim world but across the Western world. With total global Islamic financial assets now estimated at USD700 billion in 2007, the Islamic financial industry offers a wide range of complex and sophisticated Islamic financial products and services. Of significance, is its greater integration into the international financial system.

As it becomes part of the financial globalisation process, Islamic finance has however become increasingly exposed to the systemic implications of external developments. Two issues are of interest. Firstly, as Islamic finance expands, its potential for sustaining financial stability and secondly, how robust is the industry to external shocks.

Foundations of Islamic Finance

Guided by Shariah principles in the development of the Islamic financial system, it forms the very foundation that contributes towards its overall stability and resilience. These foundations are further reinforced by the values that are extolled in Islamic finance that are similar to those found in ethical finance and socially responsible investment.

The Shariah injunctions require that Islamic financial transactions are supported by an underlying economic activity. In essence, Islamic financial transactions need to be accompanied by business and trade activities that generate legitimate profits. This ensures that the funds are channelled into productive economic activity. This results in a close link between financial and productive flows, which in turn, shields the Islamic financial system from excessive leveraging, imprudent risk taking and speculative activities.

Aligned to the primary objective of Islam (maqasid al Shariah) of promoting justice and fairness is the prohibition of interest. That is, the gaining of reward without accepting equivalent counter values ('iwad) of risk, effort and liability in the transaction is prohibited. Based on the arrangement, the real activity is therefore expected to generate sufficient wealth to compensate for the risks.

[1] IMF (28 January 2009), "Global economic slump challenges policies", World Economic Outlook Update

The risk sharing requirement thus necessitates Islamic financial institutions to institute strong risk management practices that involve the appropriate due diligence on the economic viability of the business activity or of the underlying asset. This is reinforced by the explicit requirements of transparency and disclosure. The intrinsic principle of profit and risk sharing and the upholding of the universal values of justice and fairness thus provides implicit in-built checks and balances in the system. Embedded in this arrangement is also ethics and good governance.

When embraced in its entirety, these essential features as required by the principles of Shariah, reduces the prospect of precipitating financial instability. Potential risks may nevertheless arise when the economic environment and conditions in the financial markets turn adverse or when the Shariah principles are violated. The risk of the former will be greater for those Islamic financial institutions that have pursued aggressive investment strategies during periods of strong growth.

In the current global financial crisis, the initial tightening of liquidity and the subsequent breakdown of the functioning of the financial markets precipitated stress and insolvency in the financial sector. The credit crunch that followed, has resulted in catastrophic damage to the global economy. Second round effects will be felt as the economic contraction produces further strain on the financial sector. The Islamic financial system will not be immune to these developments.

Strengthening the Resilience of the Islamic Financial System

With increased globalisation and greater integration of Islamic finance with the international financial system, the higher will be the risk of the contagion effects arising from financial and economic disruptions from other jurisdictions. Several initiatives have therefore been taken to enhance the ability of the Islamic financial system to manage such testing and challenging conditions.

Essential to this process is a well functioning liquidity management framework. An absence of a well developed money market would inhibit the capability of Islamic financial institutions to effectively manage funding of Islamic financial transactions. Facilities for adjusting portfolio balances in a Shariah compliant manner are crucial in ensuring liquidity risks are effectively managed.

Malaysia has, for more than a decade now, an efficient functioning Islamic money market that has evolved from liquidity instruments structured on profit sharing (mudharabah) basis to instruments structured on custody with guarantee (wadiah yad dhamanah), leasing (ijarah) and on a cost plus (murabahah) basis. This has accorded greater monetary flexibility in the Islamic financial system. The next step is to allow this platform to take on an international dimension and to allow for greater participation from a wider international financial community in this market. This can be achieved by expanding the number of players to include those from other jurisdictions, offering product suites that are denominated in other currencies and structured in a manner that would meet a wider range of applications and purposes.

A further strategy to strengthen the soundness and stability of the Islamic financial system is to have in place a comprehensive prudential regulatory regime. The Islamic Financial Services Board (IFSB) was established in 2002 to set prudential standards for Islamic finance. It has now issued 7 guidelines and standards that cover capital adequacy, risk management, corporate governance, Shariah governance as well as standards of transparency and disclosure. The most recent issuance was on the governance of collective investment schemes and capital adequacy for sukuk, securitisation and real estate investment activities. The adoption of the IFSB standards across jurisdictions will be key in promoting and enhancing the soundness and stability of Islamic financial services industry.

In addition to the implementation of these prudential standards, there is also a need to ensure the supervisory and legal infrastructure remain relevant to the rapidly changing Islamic financial landscape. In Malaysia these efforts are also supported by a comprehensive financial safety net that includes a deposit

insurance scheme and a resolution mechanism, so that not only are depositors protected, but it also allows for prompt, effective and least cost resolution of the financial system.

Indeed, the current crisis has highlighted the importance of having in place an integrated crisis management framework. Such measures include the mechanism and vehicle to provide short-term liquidity; arrangements to remove troubled assets from the balance sheets of financial institutions and the mechanism for recapitalization of Islamic financial institutions. Finally, initiatives to promote greater intra-regional cooperation has fostered closer linkages amongst regulators across jurisdictions and the convergence of standards in the supervisory and regulatory approaches. Sharing of information, findings and experience has also been a key area of cooperation.

One of the inherent risks facing the Islamic finance sector is operating in a more entrenched conventional financial system. The absence of an Islamic benchmark has exposed Islamic finance to "displacement risk" due to changing monetary conditions in which it co-exists with the conventional system. This fundamental issue has to be addressed to reduce the vulnerabilities of the Islamic financial sector to changing economic environment. In addition, the absence of strong corporate governance would expose the Islamic banks to similar risks as in the conventional system. In fact, it is more crucial for the board of management of Islamic financial institutions to institute higher standard of leadership and comprehensive governance culture and framework.

Internationalisation of Islamic Financial System

Let me now turn to the internationalisation of the Islamic financial system and the synergies that London and Malaysia could benefit from the collaboration.

The development of the Islamic financial system in Malaysia has progressively evolved towards becoming an increasingly more liberalised and internationalised environment. The transformation from a rudimentary Islamic financial system that was dominated by the banking sector has now transformed to a comprehensive Islamic financial system with an extensive spectrum of financial products and services, and having an extended reach that is beyond serving the domestic economy.

Since 2003, measures were introduced to create a more competitive environment in Islamic finance. Flexibilities were accorded to foreign players and dedicated Islamic licences to conduct business in international currencies were introduced. Permitting the issuance of ringgit and foreign currency denominated sukuk in Malaysia by foreign entities has also increased the diversity of players and promoted innovation in the financial system.

Our Islamic banking sector registered double-digit growth over the recent eight years with an average annual growth rate of 20% in terms of assets. As at the end of 2008, the share of Islamic banking assets in the total banking sector has expanded to reach 16.7% as compared to 6.9% in the year 2000. Our takaful industry registered a growth rate averaging 23% per annum in the recent five years with family and general takaful accounting for 11% and 7%, respectively of the overall insurance sector. Malaysia also remains the world's largest sukuk market, accounting for more than 37% of global sukuk issuances in 2008[2].

The participation of established international financial centres such as London in Islamic finance will reinforce the trend of greater internationalisation of Islamic finance, contribute towards strengthening inter-linkages in the international Islamic financial system and the optimisation of the allocation of financial resources across borders but also through the greater diversification of risk contribute towards enhancing global financial stability.

Linkages between Malaysia and London

In this regard, there are several areas of potential collaboration. In the area of liquidity management, Malaysia has an established and vibrant Islamic money market. The range of Islamic money market instruments can be

[2] Standard & Poor's (14 January 2009), RatingsDirect

a viable platform towards the development of a bilateral currency market. London has the international base for foreign currency supply and demand. With Islamic infrastructure in Malaysia and London's global reach, a mutually enriching international currency Islamic money market could potentially be developed in which other financial centres can participate and leverage on the enhanced interconnectivity. In the immediate term, it could accord advantages to Islamic financial institutions in the United Kingdom and Malaysia to manage their liquidity management requirements.

In the area of sukuk, Malaysia has the largest sukuk market whilst London has one of the most established exchanges. An area for potential cooperation could be in the area of the cross-listing of sukuks. Putting in place a mechanism for sukuks issued in one jurisdiction to be recognised by the other would have a considerable impact on market accessibility, thereby allowing for greater issuer and investor reach. In addition, mutual recognition can additionally be for all Islamic financial products already approved in the respective jurisdictions so as to facilitate greater cross border transactions.

Finally, in the area of talent development, Malaysia has a number of learning establishments that provide Islamic finance training and education. The UK in turn has long been associated with quality education. Partnerships in this area have already been entered into. The University of Reading and International Centre for Education in Islamic Finance (INCEIF) in Malaysia have already entered into a joint programme. The availability of a pool of skilled talent in Islamic finance is a core element to support the continued innovation and maintain the vibrancy of the Islamic financial system.

Concluding Remarks

The global financial crisis has highlighted several structural weaknesses and imbalances in the international financial system. Whilst Islamic finance is not insulated from the effects of the current environment, the Shariah principles and values that underlies Islamic finance provides an important underlying foundation. This has been further reinforced by the strengthening of the financial infrastructure, the regulatory regime, the supervisory and legal framework, and the crisis management capabilities. At the same time, building and strengthening linkages between nations can contribute to this process. Indeed, both Malaysia and London can pave the way towards bridging Islamic financial markets between the East and the West, while we prepare ourselves for the next phase of development of the global economic and financial system.