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"Towards World-Class Banking - Efficient, Effective and Resilient Banking System"

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I. Introduction

The turn of the century has seen a significant transformation of our banking sector. The changes have been driven by the new emerging economic opportunities, changing customer requirements, new technology, the more competitive environment and changes in the regulatory and supervisory framework. This period has also seen significant progress achieved in the strengthening of the domestic banking system. The strengthening of the banking sector has been driven by the restructuring, re-engineering, rationalisation and consolidation that has been undertaken during this period. Indeed, this progress has been achieved against a background of a challenging global financial and economic environment. As we strive for high performance benchmarked against international standards, we must not lose sight of the context of the financial and economic environment in which we operate. Central to this is a common vision of developing a world class banking system that is best able to serve the nation and thus contribute to economic growth in an environment of financial stability. The expectations are thus for the banking system to be able to provide the intermediation function that is effective, efficient, resilient, and that supports sustainable economic growth.

To ensure that the financial system is best placed to serve the economy, important attention has been directed to enhance the financial infrastructure to increase access to financing to meet the new, more complex and differentiated demands of the various sectors of the economy, to enhance efficiency in the banking institutions and the functioning of the financial markets, and to put in place other supporting infrastructure that reinforce the achievement of these objectives. These efforts have been complemented by measures to ensure the soundness and stability of the system.

High performance of the industry would require the banking institutions to increasingly offer greater product differentiation and value added services. This requires resources to be directed to research and development to introduce a wider range of structured and customised products and to become a one-stop financial services solution provider. The

ability of the banking institutions to address the needs and preferences of specific segments and focus on customer relationships in a timely and cost effective manner is key to achieving competitive advantage and long-term sustainability.

II. The Journey towards Realising the Vision

The banking system policy has evolved from financial sector restructuring during the late 1990s to institutional development and capacity building, and the development of supporting infrastructure to enhance efficiency and the strengthening of prudential regulation to enhance resilience and preserve stability. In terms of the development of the financial infrastructure, efforts were intensified towards evolving a more diversified financial infrastructure to facilitate the economic transformation into a more diversified economic structure. This has involved the development of a more diversified financial structure anchored by a more efficient and resilient banking system, to support economic transformation and growth. The strategies to achieve this vision are outlined in the Financial Sector Masterplan launched in March 2001.

Three years into the Financial Sector Masterplan, positive results have been achieved on several fronts.

- The capacity of the banking sector now has strengthened with the level of capitalisation at its strongest, reflected by the risk-weighted capital ratio of the banking system that has been consistently maintained at above 13%. This has enhanced the resilience of the banking sector and is reflected in the ability of the banking system to weather a number of adverse external developments in the recent period, without any destabilising and disruptive consequences.

- Following the consolidation exercise in 2002, the banking system today is characterised by larger and better-capitalised domestic banking institutions operating within larger banking groups, benefiting from economies of scale to provide a wider range of products and services to cross sell, and therefore widen the reach nationwide.

- Domestic banking institutions have also embraced a higher level of technology and improved business processes.

- There have been marked improvements in the level of efficiency. Operating cost of domestic banking institutions has declined from 41.2% in 2001 to 40.3% of total income in 2003. There have also been improvements in turnaround time in processing loans and in response time in resolving customer problems.

- There has also been a higher level of innovation and introduction of new products and services to meet the customer needs that are becoming increasingly complex and sophisticated. These services include wealth management, structured investment products, bancassurance and Islamic financial products.

- New delivery channels through innovative technology-based mechanisms such as internet and mobile banking have enhanced the delivery of products and services as well as widened access to banking services.

- Despite a more competitive environment, domestic banking institutions have been able to sustain their market share at 80%. The domestic banks commanded a 83% share of the outstanding loans to the small and medium enterprises, while their market share in the credit card business has increased from 46% in 2000 to 54% of total credit cards issued in 2003.

- With the increased investment in risk management systems, the risk management capability in the banking sector has been further strengthened on all fronts through increased availability of risk management tools. This has been reinforced by enhanced prudential policies. Banking institutions are now better positioned to withstand challenges arising from unfavourable developments.

- The resumption of credit growth has now gathered momentum to meet the growing financial demands of the economy, while keeping risks at acceptable levels. There has also been significant shifts in the asset portfolio composition. Following the initiatives to promote SME access to financing, banking sector loans to this sector have increased significantly to account for 38% of total business loans. Retail lending for consumption has also increased. The strong banking system has been well positioned to meet customer demand for financial services. Indeed, the banking industry has continued to benefit from strong demand for household credit.

- The enhancement to the legal infrastructure including enactment of the Payment Systems Act 2003 will serve to strengthen Bank Negara Malaysia's payment system oversight, and to provide the legal framework to ensure that payment systems are protected from disruptions and its consequent effects on financial stability.

- The Islamic financial system has evolved to form a vital component of the Malaysian financial system. The Islamic banking system now accounts for almost 10% of the total assets of the banking system, from 6.9% in 2000. Significant milestones have been achieved in developing the Islamic financial infrastructure as well as in the development of the prudential regulatory and supervisory framework in meeting the changing requirements of the new economy.

- Following the intensified consumer awareness and literacy programme that has been implemented, there is evidence of growing consumer involvement in product development and delivery. Customers are demanding greater service quality and product offerings to fulfil their preferences and requirements.

III. Philosophy of Financial Regulation

The ability of regulators, banking institutions and market participants to respond to the changing financial landscape is key to the development of an efficient, effective and resilient banking system. Given the unique role of the banking system in the economy, and the importance of maintaining public confidence and trust in the banking system, regulation and supervision is a vital component of a well-developed financial system.

In designing and implementing financial regulation, a careful balance is made between achieving the objective of promoting efficiency in the banking system and the objective of maintaining financial stability. Consideration also needs to be given to the socio-economic agenda. In addition, a fine balance needs also to be made between the objective of promoting competition and innovation and that of maintaining prudence and stability in the financial system.

In line with this, the regulatory approach has become increasingly more "principle-based" rather than "rule-based". To ensure that regulation remains relevant in preserving financial stability, while allowing sufficient flexibility for banking institutions to design their own strategies and market niches, the regulatory approach is increasingly focussed on developing broad prudential guidelines and principles, rather than prescribing common requirements across institutions and activities. The Central Bank is therefore moving away from prescribing detailed rules and regulations to govern the activities of banking institutions. Regulation will instead focus on identifying risks at the system level, and on ensuring that individual banking institutions have the necessary capacity in terms of internal controls and systems to undertake and manage risks. This, therefore, does not mean less regulation.

As the strength of individual institutions is often the first line of defence against any crisis, the responsibility is therefore increasingly on the board and management of individual institutions to strengthen the resilience of the institutions. The Central Bank's focus is increasingly on the need for banking institutions to adopt and promote good governance, integrity, strong internal controls and risk management practices. Greater regulatory scrutiny is undertaken to ensure that the shareholders, board of directors and management of banking institutions are "fit and proper" and have the capacity to discharge their responsibilities and accountabilities. This is reinforced by greater transparency and disclosure requirements. Integrity and transparency is critical for financial institutions to gain public trust and investor confidence.

IV. Strategic ICT Investment as Driver for Performance

In an era where advancements in technology have significant impact on our daily activities, we are constantly presented with the challenge to make decisions on the best ICT products that will meet our preferences and requirements. Similarly, in the financial industry, advancements in ICT have certainly had a significant impact on how businesses operate and on the landscape that they operate in. The financial services industry is

one of the single largest users of technology. The rapid advancement of technology will indeed continue to drive improvements in the banking system, particularly new technology with respect to information management systems, product development, risk management and delivery of products and services. A recent industry survey has estimated that the global ICT spending on enhancement of branch network alone was more than USD15 billion in 2001 and expected to increase to USD20 billion by 2005.

Not all of such investments however, will produce the desired improvements. IT investments need to be backed by strong business justification and implementation consideration. New technologies need to be adopted with adequate review as to how it will operate within the broader organisational context. This also applies to initiatives to implement organisation-wide IT enhancements, so that it will bring about the intended results. Indeed such investments as in the CRM application need to be well tailored to individual business models.

Wasteful investment needs to be avoided. The key is to align and integrate ICT into the business models. As technology end-users, the industry is faced with a multitude of product offerings with solutions to improve processes and business activities. This has required sound decision-making. The assessment on the return on IT investment needs to be based on a longer time horizon, incorporating both qualitative and quantitative benchmarks to ensure that it will translate into improved performance. A key part towards achieving such return targets would be to ensure smart deployment of IT applications within the organisation. Underlying this process is the need for close interaction between technology and business operators in the customisation stage. Such new applications need to be reviewed as to how they will contribute towards improving product and services delivery, aid in risk management activities, and enhance management capability.

V. Opportunities from Regional Integration

Another important development that is taking place is the growing regional integration, driven by increasing intra-regional trade and investment flows. Asia has seen a rising pattern of intra-regional trade and investment where trade between countries in the region now accounts for almost half of Asia's trade from just a fifth over a decade ago. Malaysia's share of trade with ASEAN member countries now accounts for 24% of our total trade reflecting higher intra-regional trade (notably, increased imports from lower-cost suppliers such as Thailand, Indonesia and the Philippines) and better economic performance of ASEAN countries. In 2003, Malaysia recorded strong growth in exports of 29.6% to China and 26.7% to Hong Kong. Large businesses and corporations have begun to review their business architecture more aggressively and have moved to relocate their business operations. Such structural shifts driven by new demand patterns and new ways of organising production have led to increased specialisation and complementarity within the region.

ASEAN alone offers a huge growing market of 500 million people. Therein lies the opportunities for the domestic banking institutions, opportunities to support Malaysian businesses and investors who are venturing abroad and opportunities to diversify across geographical sectors and across product range. The role of banking institutions needs to extend beyond the traditional role of being a financier, to manager of financial relationships. Each time a borrower ventures abroad, new opportunities are created. As managers of such financial relationships, banking institutions can be part of this process by fostering the banking relationship into a long-term strategic partnership, and by providing the right range of financial products.

These opportunities may also be realised by setting up presence in new markets. It can also be in the form of partnerships or strategic acquisition of an existing banking institution in a foreign market. Mergers or alliances in services and products can be pursued through co-branding or complementary products, delivery channels and marketing or product development. Alliances can also be formed to capitalise on intangible assets such as human capital. Such alliances can also translate into increased innovation in processes, structures, business models and ultimately innovation in products and services. Indeed, strategic alliances have been growing, cutting across many industries and business segments. As banking institutions are able to fulfil the differentiated demands and expectations, this would enhance their capacity to compete in both the domestic and external markets and thus be able to capture the opportunities accorded from liberalisation and globalisation.

VI. Customer-centric Banking System

As the financial landscape evolves and competition intensifies, banking institutions need to respond to the changing market needs, and continually reassess strategies and alternatives in this rapidly changing and dynamic market and shift from just the traditional offerings. Consumers are becoming increasingly discerning and demanding. Strategic decisions about the future needs to be made to sustain the ability to offer and deliver unique value propositions to customers whilst at the same time effectively managing customers' expectations.

An area that banking institutions may venture into is micro-financing. Micro-enterprises perform an important economic activity for a large segment of the country's population. While institutional arrangements are being put in place to increase access to financing for such micro-enterprises, the banking sector with its large network of branches can become an important channel for such financing. These could be provided via a micro-financing window. Global experience has shown that such micro-financing operations can be successful and profitable with good loan portfolio quality.

As part of the efforts to raise the quality performance in the financial services sector, Bank Negara Malaysia initiated a nation-wide survey in 2003 to assess the requirements, expectations and the satisfaction level of consumers on the quality of products and

services offered by banking institutions. While the primary objective of the study is to develop an index on the levels of quality of customer service, the findings indicate that the real issues in enhancing the industry's level of performance goes beyond this, towards developing a stronger customer-centric orientation. The findings provide a discernable indication of the differences in customer needs and requirements, and identify specific areas where customer-orientation issues tend to arise.

Let me briefly share some of the key findings of the survey. The findings reveal that while the general level of customers' satisfaction is favourable, the relationship between customers and the banking institutions needs to be improved. While one in three customers is satisfied with the banking relationship, it did not imply loyalty.

The survey also identified factors that customers are looking for in their banking relationship. Among the primary needs are the quality of interface with bank staff; and the effectiveness and efficiency of delivery channels, in particular branch banking and ability to deliver effective service in transacting and the efficiency in application processing.

Secondary requirements represent potential leverage factors which can be used to substantially improve overall customer relationship. These include product innovativeness with value-added features and electronic banking including internet banking. These secondary core needs would become primary drivers and important elements in banking relationship.

Additionally, the survey indicated that younger and middle-income individuals, a growing customer segment, prefer to use ATMs and electronic channels. Another growing segment is the "Older Affluent", in the middle and higher income levels. Given the growing size of this customer segment and their higher income level, they require a wider range of innovative investment products that offer safe and steady returns as well as personalised financial advisory services.

The challenge therefore is for the industry to pro-actively respond to these customer priorities now rather than waiting for increased customer churning. Fundamental to achieving greater customer-centricity is to ensure that the staff, processes and orientations are aligned towards fulfilling customers' expectations and delivering superior customer's experience. Of importance is to have clarity of purpose that is communicated, shared and understood by all levels of staff, especially the front-office staff. Having a culture that is built around such commonality of purpose will ensure consistent service performance. Another further aspect is the design of the operational processes with customers' perspective in mind to ensure easy access, speedy and accurate execution of transactions that are responsive to many facets of customers' demands. To facilitate this, it is essential that banking institutions embrace the relevant technology to support business processes, enhance risk management capabilities while at the same time provide seamless access to customers through a wider range of delivery channels. All these need to be supported with an effective human resource management framework that

ensures the availability of best talent and the right skills.

As competition intensifies, banking institutions increasingly must be able to deliver personalised and customised financial solutions. Therefore, it is important for institutions to understand the dynamics of customer segmentation, build customer relationship and address requirements and preferences of specific segments. Understanding specific segments requires banking institutions to understand complex intangibles such as customer behaviour, motivation and life events. Sustainable growth will be very much dependent on the ability to develop lasting and profitable relationships with customers.

Investing in new products in meeting the complex customer needs and demands is important. Equally important is the need to develop an effective communication plan or strategy as a package to product delivery. Even the best of products would not have a good chance of success without a well-conceived communication strategy. This goes beyond marketing and advertisement. It would include educating customers to adapt to the new ways of doing banking transactions or changes being introduced and to use the innovative products being offered. It is also interesting to note that the survey findings clearly indicated the importance of quality interface between customers and banks. As such, numerous interface points need to be reengineered to ensure the right mix of the virtual and physical environment. New branch models have emerged, incorporating features from both virtual and physical environment, to fulfil the varying needs of different localities and market segments.

VII. Conclusion

While the new emerging trends in both the domestic and global economy will have significant implications on the domestic financial landscape, each banking institution will need to be able to formulate differentiated strategies to effectively respond to these forces in a strategic manner. Thus, the ability to precisely assess the institutions individual capabilities and strengths as well as opportunities in this changing environment is key to facilitate effective strategic management at the organisational level. Through this process, I envisage that the domestic financial landscape will evolve into a banking environment characterised by three types of banking institutions that will emerge to meet the future demands of the economy.

a. First, large Malaysian banks with nationwide and regional and international presence that are able to compete with global financial players;

b. Second, banking institutions with nationwide presence that are able to offer a broad range of financial products and services; and

c. Third, specialist niche players delivering specialised value added products and services for specific segments of the market.

The financial services industry has evolved considerably over the recent period.

New emerging trends have provided us with new opportunities in our quest to create a dynamic financial system that will best serve our economy. In striving towards high performance and world-class standards in the industry, we look forward to working with you in this dynamic and challenging environment to achieve this common goal.

Islamic Financial Services Board Summit
Islamic Financial Services Industry and The Global Regulatory Environment
18 May 2004, London

"Approaches to Regulation of Islamic Financial Services Industry"

Address by
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I. Introduction

Preserving financial stability in the Islamic financial system extends beyond the regulatory framework to the building of an intermediation system that is robust and resilient, that is efficient and competitive and that is able to contribute to the growth process. Islamic finance has evolved to become a dynamic industry that has extended beyond domestic borders to become an integral component of the international financial system. Indeed, amidst the changing global financial landscape, the Islamic financial industry has demonstrated its ability to operate in an increasingly more challenging and competitive environment. The challenge before us is to maximise the potential and the seamless opportunities Islamic finance accords. Each component - the financial infrastructure, the institutions, the legal, regulatory and supervisory framework and the Shariah infrastructure all have an important role in the progressive development of the Islamic financial system. The strengthening of these respective components will provide the foundations on which future sustainable progress and expansion can be realised.

While the rapid expansion of Islamic finance has been achieved in an environment of financial stability, the regulatory and supervisory agenda continue to be an important priority. Today's increasingly challenging environment of heightened risks have prompted reassessments of existing prudential rules and supervisory approaches amongst regulators to develop a dynamic regulatory and supervisory framework to achieve financial stability in all areas of the financial services sector. No less attention has been given to these issues in Islamic finance. Indeed, the work that is being undertaken by the IFSB to develop prudential, regulatory and supervisory standards and core principles that are in compliance with Shariah rules and principles represents a breakthrough in the regulation and supervision of the Islamic financial services industry.

The focus will be on regulatory approaches adopted for Islamic banking institutions that take into consideration the

context of the varying customer-banking institution relationship based on the contracts entered into that is inherent in the Islamic financial transactions. These considerations are essentially required to take into account the Shariah governance which reinforces the efforts to achieving the stability and soundness of the Islamic financial system. The presentation will also touch on areas of challenges in the formulation of the regulatory approach that arise from the multi-facet role performed by the Islamic banking institutions, and for systems in which Islamic finance operates side-by-side with the conventional financial system.

II. Objective and Regulatory Philosophy

In designing and implementing financial regulation for Islamic banking institutions, the challenge is to formulate a framework that not only takes into account the unique characteristics peculiar to Islamic banking business, but that does not put Islamic financial institutions at a comparative disadvantage and affect their competitiveness and growth potential in the overall financial system. Imperative is that the regulatory requirements need to be consistent with the injunctions of Shariah. Secondly, it needs to take into account the multi-faceted role performed by the Islamic banking institutions. Thirdly, in a dual financial system where Islamic financial institutions operate in a system side-by-side with conventional banks, including that where conventional banks may offer Islamic banking products and services through Islamic banking windows, the regulatory approach adopted needs to provide a level playing field.

Islamic banking institutions in most jurisdictions have to a large extent been governed by the same regulatory framework that is applied to conventional banking operations reinforced by the compliance to the Shariah framework. However, as the conventional banking framework is premised on an interest-based debtor-creditor relationship, the regulatory framework for conventional banking is built to assess and mitigate risks arising from loan-based financial transactions. Islamic banking is different in term of its underlying philosophy on the prohibition of interest. This in turn shapes the nature of the financial transactions that has its own risk characteristics. The specific risks associated in Islamic banking activities therefore needs to be identified to ensure its prudential regulation is adequately addressed.

It is within this context of diversity of systems and players that the regulatory approach adopted needs to ensure harmonisation and a level playing field for a competitive and robust financial system. Efforts towards achieving this objective will include the elements of greater transparencies and disclosure, a strong legal and judiciary system, reinforced by strong Shariah governance. It is in this aspect that the IFSB assumes a key role in developing prudential standards aimed at addressing issues peculiar to Islamic banking and identifying the gaps on existing regulatory and prudential standards. The IFSB represents an important catalyst that will contribute to enhancing the resilience of Islamic financial institutions in the global financial system and that will strengthen the

foundation for the progress in the development of the global Islamic financial landscape.

III. The multiple contractual relationship of Islamic banking institutions

A strong regulatory framework must have the important elements of adequate capital standards, effective risk management practices and strong governance. In building a sound prudential framework for Islamic banking, aligning regulatory capital requirements to the underlying risks requires a dichotomisation of the risk intricacies in the Islamic banking asset portfolio.

On the asset side, the Islamic banking institutions enter into different financing modes that have varying risk characteristics, ranging from the low risk sales and lease-based modes to the higher risk equity-based modes of finance. Each of these modes of finance have a distinct intrinsic characteristic dictated by its underlying Shariah principle, and thus entail different risk profiles. An equity-based finance, may for example involve higher risks and therefore attract higher capital requirement. In this regard, the challenge in formulating the risk management infrastructure in Islamic banking institutions lies in having an accurate assessment of the various risk variants underlying the alternative modes of finance to provide for their effective quantification and management.

Similarly, the liability structure of Islamic banks is characterized by two distinct categories of deposits: demand deposits which is not subject to risks associated with banking business and for which the principal is guaranteed, and investment deposits which involves risks and hence, is eligible to share the profits earned from the banking business. Given this liability structure of Islamic banking institutions, the design of the regulatory framework for Islamic banking needs to give emphasis to full financial disclosure, prudent risk management and adherence to Shariah principles. This will serve as a firewall to prevent the transmission of risks from investment deposits to demand deposits thus enhancing transparency, depositors' protection and systemic stability.

Rate of return framework

A further regulatory challenge arises from the liability structure of Islamic banking institution and the determination of a standard rate of return for account holders. Unlike conventional banking where returns are pre-determined, profit-sharing depositors of Islamic banking institutions know their returns at the maturity of the deposits. These returns are subject to the earnings of the assets that is shared between the Islamic banking institutions and the profit-sharing depositors. In the event of loss, the depositor as the capital provider will bear the losses. As the deposits in Islamic banking are for the most part are in the form of profit-sharing deposits, it places a higher degree of fiduciary risk on the management to ensure the funds are utilised in the most efficient manner.

Hence, regulators need to establish an effective rate of return framework to provide standard methodology for deriving the rate of return for depositors. Of equal importance is the need to address the information

asymmetry between the Islamic banking institutions and the depositors by enhancing the level of transparency and ensuring that depositors would receive fair returns on their investment. Within the regulatory context, the framework would provide a means of assessing the efficiency of Islamic banking institutions as well as their profitability, prudent management and fairness.

In this regard, Malaysia has introduced the Profit Equalisation Reserve in the rate of return framework. To generate rates of return that are competitive and stable, the Profit Equalisation Reserve acts as a mechanism to mitigate the fluctuation of rates of return arising from the flow in income, provisioning and total deposits. This reserve is appropriated out of the total gross income and is shared by both the depositors and the banking institution. In a dual banking environment, the ability to maximise risk adjusted return on investment and sustain stable and competitive returns is an important element for the development of a competitive Islamic banking system.

IV. Regulatory approach in a dual banking system

In a dual banking environment where Islamic banking institutions are operating side-by-side with conventional banking institutions, it is important to maintain harmonisation of the regulatory infrastructure, thus providing a level playing field for both the Islamic and conventional financial industry. The challenge lies in the development of a rigorous regulatory framework, legal and tax structure that will not position any of the financial players at a disadvantage. Of equal importance is the need to ensure that there is no opportunity for regulatory arbitrage in banking practices that makes one system more superior to the other in terms of product pricing. The Malaysian experience has a further variant of the dual banking model where conventional banking institutions are able to offer Islamic banking products and services.

In Malaysia, the Islamic financial system operates in parallel with the conventional system. The system has remained competitive and resilient as demonstrated by its growing market share and its ability to withstand adverse development. Their resilience to market vulnerabilities was demonstrated during the 1997-1998 Asian currency crisis. While the Islamic banking institutions observe similar international standards prescribed in the banking regulatory and supervisory framework and are subject to the same supervision by the Central Bank, the Islamic banking institutions are required to observe additional requirements, including observing minimum Islamic banking fund for its Islamic banking operations and maintaining an internal separation of accounting books. Further steps have been taken to require the banking institutions to disclose the fair and true value of the Islamic banking operations in the form of Balance Sheet and Profit and Loss Statements as part of the Notes to the Accounts in the principal financial statements of the banking institutions. This is to duly reflect the different risks and unique characteristics inherent in Islamic banking as compared to conventional banking. Where Islamic banking operates on a window basis,

the existence of a firewall is to ensure the strict compliance to Shariah.

Whilst the appropriate regulations and standards are vital to mitigate the risks involved, of equal importance is the oversight and monitoring of the Islamic banking institutions through effective supervision by the regulatory authority to ensure that the prudential requirements are observed. Lack of oversight, inadequate check and balances, and over exposure to risks are amongst the factors that may result in vulnerabilities to the system. The best of regulations and financial safety nets would not be able to avoid such vulnerabilities if early warning systems are not in place. To effectively perform the supervisory functions, there has to be an understanding and appreciation of Islamic banking business and operations. Supervisors therefore need to be fully equipped with the required knowledge and skills to be able to identify the risks involved in various Islamic banking transactions to effectively conduct supervisory oversight of Islamic financial industry.

V. Enhancing Shariah framework and governance

A distinct feature of Islamic banking vis-à-vis conventional banking is the requirement to set up a Shariah advisory committee within the Islamic banking institutions. The establishment of Shariah advisory committee is important to serve as a check and balance to ensure that the management and operations of the Islamic banking institutions does not deviate from the Islamic principles in the formulation of their policies. Integral to this process is to achieve "unity in diversity" of the interpretations of Shariah injunctions in the realm of finance. In this regard, the IFSB has an important role to strengthen the current initiative to achieve a greater degree of convergence and harmonisation.

Strong adherence to the Shariah is also enforced through guidelines and procedures to ensure its compliance amongst the Islamic banking institutions. Procedures for decision-making by the Shariah advisory committee of the Islamic banking institutions therefore need to be clear and transparent. The role and responsibility of the committee therefore needs to reflect their responsibility and accountability to the management and the public. Their position is comparable to the auditors of the Islamic banking institutions. Hence, the financial reporting by an Islamic banking institution is required to provide the necessary disclosure to report on the conformity of its operations with the Shariah principles. These will promote the foundations for building public confidence and assurance that the Islamic financial products are Shariah compliant.

To enhance the Shariah framework in Malaysia, the Shariah advisory council at the central bank acts as a sole authority on all Shariah matters pertaining to Islamic banking and finance. Being an apex body, the council standardises Shariah ruling on similar issues to provide greater certainty and confidence to the financial institutions and to the investors and consumers. To strengthen the Shariah and legal framework, the Malaysian Judiciary has set up a dedicated High Court to adjudicate cases involving Islamic banking and takaful in accordance with the existing

Malaysian civil laws. Any dispute, within or outside the court system that calls into question issues concerning Shariah is referred to the Shariah advisory council for guidance and clarification. Alternatively, disputes may also be referred to the arbitration centre for resolution. In this connection, Malaysia will enhance the Regional Centre for Arbitration in Kuala Lumpur to serve as a platform to deal with dispute cases on Islamic banking and finance, and to extend these services beyond our borders.

VI. Conclusion

The challenge to develop regulatory standards that remain true to Islamic core principles is an important element in the development and growth of the Islamic financial services industry. The development of an Islamic financial system that is able to contribute towards stability and balanced global growth needs for its development to be achieved in the context of a rigorous and robust legal, regulatory and supervisory regime. This is reinforced by effective supervision, strong Shariah framework and an efficient judiciary system that promotes confidence and soundness in the Islamic financial system. It is with the combined commitment and concerted efforts by regulators, the industry and market participants that these goals can be achieved.

Euromoney Conference
3 August 2004, Kuala Lumpur

"Remaking Malaysia: Investing in the New Malaysia"

Opening Address by
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This conference takes place at a time of strengthening economic conditions in the global and domestic economy. At the forefront of investors' minds is the sustainability of these trends. There is also much interest on the policy strategies being adopted and how Malaysia will reposition itself in this more competitive environment. This Conference has brought together key policy makers, investors, fund managers as well as leading corporate and government officials to discuss these issues.

Building on the economic success that has been achieved for more than three decades, Malaysia is now taking the opportunity to reposition its strategies to ensure the sustainability of this strong growth performance. In Remaking Malaysia, the strategy is essentially to focus on our distinct capabilities and to leverage on the areas of our strengths to secure our competitive advantage.

Let me touch briefly on the current economic developments:

- Malaysia has seen a steady and strengthening economic recovery since 2001, with the growth performance strengthening substantially in the first half of this year increasing the potential for growth for the year as a whole to surpass our earlier estimates.

- This favourable performance has been accompanied by a rebalancing of focus between external and domestic sources of growth. In the external sector, there has been a greater balance between the traditional and new markets and between the goods and services sectors.

- In the domestic sector, there has been a greater balance between the economic sectors. The strategy to have a more diversified economic structure and more extensive markets has aimed to reduce vulnerability of the economy to global shifts in demand in any specific sector or to any particular region.

- The positive fundamentals of low inflation, strong external balance, low debt and stable employment conditions have accorded policy flexibility to support the growth during this period.

Going forward, the process of rebalancing the economy to enhance the competitiveness of the economy can be expected to intensify and widen.

- There will be a greater rebalancing between the role of the public and private sectors in the economy, with the public sector activity focussed on providing the enabling environment to strengthen the role of the private sector in the economy.

- While large domestic corporations and multinational corporations will continue to be important in the economy, the role of the small and medium-scale enterprises will gain significance.

- Greater focus will be given to secure competitiveness on a more comprehensive basis in terms of other dimensions such as productivity and efficiency, labour quality, logistics, research and development, the delivery system and the supply chain.

Malaysia will also continue to leverage on our low country risks in terms of the political stability, industrial maturity and the supply of a skilled workforce.

To promote endogenous sources of growth, greater focus has been directed at promoting greater private investment, including by the small and medium enterprises (SMEs). The financial infrastructure and incentive structure will continue to be enhanced to promote investment in new sub-sectors, in particular the services, agriculture and manufacturing sectors.

On the external front, while there has been a synchronisation of growth among the major economies, there has also been some rebalancing of the relative strength of the growth among the economies. The increase in the expansion of world trade and the strengthening of labour market conditions in most of these economies suggest continued and self-sustaining growth. Meanwhile, the Asian region has shown strong growth performance amidst robust intra-regional trade. This will be mutually reinforcing for the region in expanding the cumulative domestic market of the region and thus contributing to the overall growth prospects of the region.

While growth remains strong, there are risks on the horizon. The recent moves to raise interest rates have however aimed to adjust the economic expansion to converge to more sustainable levels. Policies in a number of the major economies have now shifted from addressing a deflationary environment to a more neutral position that is aimed at removing the inflationary bias. This is in contrast to an anti-inflationary stance which would require aggressive tightening.

On the domestic front, Malaysia continues to be highly integrated with the world economy in which economic and financial developments in our major trading partners will have implications on our economy. The strengthening of our economic structure, our financial system and our macroeconomic fundamentals, particularly since the Asian crisis in 1997-1998, has raised our tolerance level for absorbing volatility, enhanced our resilience to shocks, improved the agility to adjust to change and increased our policy

flexibility to mitigate any adverse external developments on our domestic economy.

Going forward, the strong growth in manufacturing and services sectors will continue to sustain growth. The prospects for higher consumption spending is also positive. With the savings rate still high at about 35% of GNP and the rising incomes, Malaysia has the potential to promote a higher level of consumption without undermining the potential for financing of private investment from domestic sources. The higher consumption has also not created risks of increased household indebtedness which has remained within prudential levels at less than 60% of GDP.

Capital spending continues to gain momentum both in domestic and export oriented activities. Domestic companies are also forging strategic alliances as part of the strategy to expand to new export markets and leverage on new technologies. The on-going capacity expansion and more competitive business environment will keep inflation low thereby allowing domestic interest rates to continue to remain low for sometime to come. Malaysia's trade and investment links with Asia, particularly with the large economies in the region, is also expected to strengthen further.

There also continues to be steady inflows of foreign direct investment. In addition to sustained inflows into the manufacturing and oil and gas sectors, these flows have become more broad based with higher shares of new flows shifting towards higher value-added activity in the services sector. This structural change in FDI flows reflect the changing opportunities Malaysia accords with the services sector now gaining significance as an engine of growth. The new inflows have also tended to be low import content and higher value added. The FDI in services sector has also been increasingly broad based. A number of regional and global business processing centres and other regional facilities have been set up including the OHQs, regional offices, international procurement centres and regional distribution centres.

As part of the Government policy commitment to improve the delivery system and reduce the cost of doing business, the Central Bank has undertaken a progressive liberalisation of domestic rules and regulations to reduce the cost of doing business. An area of focus has been the rules governing the foreign exchange transactions. Reducing cost of managing risks associated with such transactions include the recent liberalisation of rules on foreign currency accounts, interest rates swaps and hedging. To broaden and deepen our capital markets, the multilateral agencies and multinational corporations are now allowed to issue bonds in Malaysia. Going forward, Malaysia will continue to undertake further liberalisation while balancing the need to accord flexibility and choices to businesses with the macroeconomic objectives of ensuring stability in financial markets. Ensuring such long-term stability that facilitates planning and investment decisions has been an important part of maintaining our competitive position.

In the development of our financial sector, the banking sector continues to be the

pillar of the financial system and is now at its strongest position with high level of capitalisation, improving asset quality and stronger profitability. Policy initiatives to strengthen the banking system, including in the areas of regulatory and supervisory frameworks, risk management, corporate governance and best practices in transparency and disclosure have contributed to strengthen the system further. These have been complemented with initiatives to deepen the bond and equity markets, resulting in a more diversified financial infrastructure.

Another priority area has been the development of the Islamic financial system as a viable component of the financial system. With more than two decades experience in developing Islamic finance, Malaysia today has a comprehensive Islamic financial system with all the core components of banking, takaful and the money and capital markets, and supported by a strong legal and supervisory framework. The assets mobilised by the Islamic banking sector have increased significantly to account for about 10% of the total assets of the banking system. In the Islamic capital market, outstanding Islamic bonds amounted to about 45% of the total outstanding bonds.

As our domestic financial system develops and strengthens, Malaysia has gradually moved towards a more deregulated and liberalised environment. In the regulation of the banking institutions, a balance will be made between promoting competition and innovation, and maintaining prudence and stability. Regulations will continuously be reviewed to provide greater operational flexibility for banking institutions without compromising prudential objectives. The introduction of the new interest rate framework reflects the move to promote more efficient pricing in the banking system. As progress is achieved in enhancing the capacity and capability of domestic institutions, the financial sector will continue to be gradually liberalised. Moving forward, further deregulation will be undertaken to simplify and liberalise regulations and administrative rules for businesses. To ensure stability as regulations are lifted, leveraging on technology to improve data monitoring systems have enhanced the ability to monitor developments to assess any emerging risks to the system.

During this period of strong fundamentals and rising potential for economic expansion, Malaysia has the flexibility to introduce measures not only to support growth but also to improve the quality of the growth and its long term sustainability. This includes significant investment in education and according priority towards achieving socio-economic stability. Overall, a balanced and holistic approach to economic management is aimed to ensure the foundation for a strong economy and its competitive position in the global economy.