



BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

SIARAN AKHBAR

Ref. No.: 11/10/05

EMBARGO: For immediate release

Keynote Address at the World Congress of Accountants (WCOA)

**Kuala Lumpur Convention Centre
Wednesday, 10 November 2010**

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“Islamic Finance: Strengthening the Global Financial Market”

Restoring stability in financial markets, resuming the efficient functioning of financial systems and reigniting a sustainable economic recovery are the pressing priorities in the current global environment. As financial markets across jurisdictions become more connected, and as economies become more inter-linked, the resulting increased interdependence has however rendered the search for solutions to be even more challenging.

While the extensive international response involving massive stimulus measures have contained the extent of the global crisis, it has however, not been sufficient to produce a self-sustaining long lasting economic growth. Over and above the regulatory reforms are the required restructuring, resolution and the other financial and economic reforms to address the crisis related and structural issues that are still confronting the world economy. These prevailing conditions can therefore be expected to result in an extended period of increased uncertainty.

In such a period of extraordinary challenges and uncertainties, Islamic finance has continued its global expansion and development. In addition, this recent decade has seen the increased internationalisation of Islamic finance. It is my great pleasure to join you today at this World Congress of Accountants to speak at this session on Islamic Finance and its introduction in the global financial markets. My remarks this morning will discuss the potential role of Islamic finance in the international financial system as it becomes increasingly internationalised and its role in strengthening international financial and economic linkages in the global economy. Of importance to this trend are both the inherent features of Islamic finance and the financial infrastructure

development that have contributed to its resilience and sustainability and thus its positive role in the international financial system.

The Islamic finance model

As a form of financial intermediation, Islamic finance incorporates several elements that guide the process of the mobilisation and allocation of funds. The Shariah injunctions fundamentally require that the financial transactions in Islamic finance be accompanied by an underlying productive economic activity that will generate legitimate income and wealth. This gives rise to a close link between financial transactions and productive flows. Therefore, the growth in Islamic financial assets is generally accompanied with growth of underlying activities that have economic value.

Islamic finance also has its own inherent inbuilt checks and balances that address the issues in financial stability. Its value proposition of profit and risk sharing requires the appropriate due diligence, disclosure and transparency. The features inherent in Islamic finance, thus, emphasise the importance of governance and risk management. The contracts entered into therefore demands high standards of disclosure and transparency, which in turn, reinforces market discipline and minimises informational asymmetries. A further layer of oversight that acts as a safeguard against irresponsible practices is the Shariah board in the respective individual financial institutions that has an important role in ensuring that the business operations of Islamic financial institutions are in accordance with the Shariah principles. Thus, Islamic finance, embraced in its entirety, supports responsible and sustainable innovation that contributes towards the real economy and to society.

These important elements in Islamic finance provide the foundations on which it contributes to growth and development and towards preserving financial stability. Despite the turmoil and uncertainties in the global financial system, Islamic finance has demonstrated its resilience and its continued global expansion during this period. Expanding at an average annual rate of 20%, Islamic finance represents one of the fastest growing segments in the financial industry. The Islamic financial services industry is now approximated to be worth more than US\$1 trillion.

Of importance is that Islamic finance has also been able to respond to the changing demands of consumers and businesses by providing the range of differentiated products and services. Today, Islamic finance offers an extensive spectrum of innovative and high quality financial products and services that include consumer financing, asset and wealth management and products from the Islamic insurance industry and capital markets. Islamic finance has also demonstrated its capacity to undertake project financing with the sukuk market becoming a highly competitive fundraising option for large scale projects and infrastructure development.

Today, in Malaysia, we have developed a comprehensive Islamic financial system that operates in parallel with the conventional financial system. The

Islamic banking system in Malaysia currently accounts for 20 percent of our banking system while the sukuk market accounts for more than 50 percent of the bond market that is now 98% of GDP. Following the liberalisation initiatives in this decade, there is greater foreign institutional presence and substantial foreign participation in Malaysia's Islamic financial system. Of significance is that the participation from multinational corporations and international financial institutions from both the Muslim and non-Muslim countries. The Islamic financial system in Malaysia is also well supported by a robust regulatory and supervisory regime, legal and Shariah framework, and payment and settlement systems that are also important in supporting its sustainability.

Islamic finance: Strengthening international economic and financial linkages

The internationalisation of Islamic finance has in a large part been facilitated by increased liberalisation initiated in this decade and by the further development of the international Islamic financial infrastructure. This trend has prompted Islamic financial institutions to venture beyond their domestic borders. Today, there are more than 600 Islamic financial institutions that operate in more than 75 countries. Similarly, the liberalisation of the Islamic financial markets has resulted in increased foreign participation to raise funds in these markets. This participation also includes institutional investors that have surplus funds for investment. This wave of internationalisation of Islamic finance has continued unabated despite the challenging global economic environment. In financing trade and investment activities, it has influenced new global patterns of trade and financial flows. In particular, it has strengthened financial and economic ties between Asia and the Middle East. In strengthening international financial linkages between nations, it reflects its potential for the diversification of risks and for the efficient allocation of resources across borders.

The fastest growing segment of the Islamic financial system is the sukuk market which has become a significant platform upon which international financial and economic inter-linkages are being fostered. Sukuk instruments are fast emerging as an attractive new asset class for investors while becoming a preferred financing and capital raising option for issuers. Growing at an average annual rate of about 40 percent, the global sukuk market has demonstrated its ability to effectively intermediate funds across borders, allocating surplus funds from one part of the world to productive investment opportunities in other parts of the world. Today, the sukuk market has become a truly global product, generating significant cross-border financial flows.

In tandem with the rapid internationalisation of Islamic finance, this decade has also seen the increased emphasis that has been given to the development of the international Islamic financial infrastructure relating to financial stability. The Islamic Financial Services Board (IFSB) was established in 2002 as the international prudential standard setting body for

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the Islamic finance industry. With only nine regulators as members when it was established, the IFSB now has membership of more than fifty regulators from both Muslim and non-Muslim countries. In considering risks that are specific to Islamic finance, the IFSB has introduced standards for capital adequacy, risk management and corporate governance as part of the regulatory regime to strengthen the resilience of Islamic financial institutions. The work of the IFSB has not only contributed to the orderly global expansion of Islamic finance, but has also contributed towards achieving a cohesive cross-border regulatory framework and international best practices for the Islamic financial system.

During this year, two new initiatives have been introduced to further strengthen the international financial infrastructure in Islamic finance and to promote the sound and efficient functioning of its financial markets. The first is the establishment of the Islamic Financial Stability Forum (IFSF) that serves as a platform for cross-border engagement among regulators to discuss efforts to achieve financial stability in the Islamic financial system. The forum aims to promote better understanding of the developments in the Islamic financial system and their implications for national and global financial stability.

The second major breakthrough for Islamic finance is the establishment of the International Islamic Liquidity Management Corporation (IILM) in October this year - a liquidity management infrastructure for Islamic financial institutions. It represents a concrete collaboration and commitment by twelve regulatory authorities to establish a mechanism for more efficient management of liquidity across borders, and to address the issue of liquidity management in achieving financial stability. Cumulatively, these efforts serve to contribute towards the continued resilience of the global Islamic financial system.

Addressing the financial reporting issues in Islamic finance

As the Islamic finance industry continues to grow and expand beyond domestic boundaries, the role and support of the accounting profession and standards setters will become more important. Applying the existing accounting frameworks and conventions to Islamic financial institutions may prove to be more challenging given the unique features of Islamic financial transactions such as the equity based and profit sharing contracts. In addition, given the risk sharing features of these contracts, it may raise the case for a higher level of transparency for users to better understand and be better positioned to assess the underlying risks and their likely financial impact.

More broadly, there are the questions on whether the current international accounting framework adequately addresses the different Islamic financial transactions, structures and business models which are continuing to evolve as the industry develops and matures. There are differences in views on how conventional accounting concepts, such as reporting based on substance over form, and cash flow discounting principles, can be applied to Islamic financial transactions. There is therefore a need for greater understanding on

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these issues to further evolve solutions that would improve the value of the financial reporting.

Harmonisation of financial reporting standards in Islamic finance

An important development that has accompanied the internationalisation of Islamic finance is the effort to enhance the cross-border comparability of Islamic financial transactions. In this area, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has made contributions towards improving the measurement approaches for Islamic transactions and the overall quality of financial statements. There has also been greater cooperation at the regional level through the recently formed Asian-Oceanian Standard-setters Group (OSG) to examine the technical issues in financial reporting of Islamic finance. The efforts by AAOIFI and OSG represent important contributions to current efforts to evolve an accounting framework that is appropriate and that will support further the global development of Islamic finance. It is important that the standards setting bodies such as the IASB is engaged in this process to complement, and to leverage on the current global efforts to converge international accounting frameworks.

Conclusion

Allow me to now conclude. The internationalisation of Islamic finance pushes forward the new frontier that brings with it tremendous potential to become a further means by which cross border financial flows are intermediated between economies from different parts of the world. Islamic finance, as an increasingly important component of the international financial system can be leveraged upon to facilitate surplus funds to be intermediated to economies that present new opportunities. As Islamic finance continues to gain global acceptance, strengthening the accounting reporting, auditing and disclosure standards are very much a vital part of this process.

As we enter this new phase of globalisation in which Islamic finance is very much a part of, the cumulative efforts of the standard setters, the regulators and the industry will raise the potential to address the many challenges before us. We need to leverage on the respective areas of strengths and address the weaknesses with unrelenting perseverance. While a more connected world may bring with it new vulnerabilities, I do believe it also brings with it new prospects for new opportunities, new relationships and new hope for a greater shared prosperity.

Thank you.

10 November 2010