KEYNOTE ADDRESS
BY
HIS ROYAL HIGHNESS
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"WHERE NEXT FOR ISLAMIC FINANCE?"

Bismillahi Rahmani Rahim

Assalamualaikum Warahmatullahi Wabarakatuh and a very good morning.

It is a pleasure for me to be here today and to be given the opportunity to deliver the keynote address. I understand it is the second time that this important event is being held outside London and here in Kuala Lumpur. I believe this is a clear recognition of Malaysia's leadership role and success in developing the Islamic financial industry. Given the stellar rise of Islamic finance in recent years, this Summit provides an excellent opportunity for us to discuss the many ways of strengthening the industry as we move ahead on our journey.

2. In the time available, I will briefly reflect on the progress made by Islamic finance and what I observe to be the present state of the industry. I will then touch on some of the challenges facing the industry moving forward, mentioning along the way what I see are some of the inhibitors and drivers of growth. Finally I will touch on one area of emphasis I believe Islamic finance should focus on as we look into the future.

The 'coming of age' of Islamic finance – global trends

3. From humble beginnings more than thirty years ago, Islamic financial institutions today have a discernible presence in the international financial system. They have come of age. The industry registered a highly impressive annualized growth rate of almost 15% over the past 10 years to reach a size of about USD1.3 trillion globally, fuelled in large part by surging demand for Shariah-compliant financial products and services from the Middle East and other Muslim countries, but also by investors around the world.

4. Regulators and monetary authorities in Muslim and non-Muslim countries have introduced reforms and amendments to national legislations to remove regulatory and tax impediments to the development of Islamic finance within their borders. In the United Kingdom, the launch of the Islamic Finance Task Force earlier this year strongly reinforces its ambition to become the pre-eminent marketplace for Islamic finance in the West. There have also been encouraging developments in Africa, with measures initiated by countries such as Kenya and Nigeria to review and reform existing banking laws to promote the establishment of Islamic financial institutions. Emerging economies such as Turkey, India and China have also made changes to their regulations to provide greater access to Shariah-compliant banking facilities.

5. At the same time, many multinational financial institutions and professional advisory and services firms have been broadening their internal capabilities and allocating significant resources into Islamic finance as they acknowledge the tremendous commercial potential of this particular market segment. The size of Islamic financial assets is forecast to reach USD1.8 trillion by 2016, while cross-border financing and investment activities are expected to accelerate, especially in the Islamic capital market as emerging economies embark on infrastructure spending.

6. The spread of these institutions across countries has created greater connectivity between markets and financial centers, forging new relationships and enhancing the capacity and capability of the industry to deliver services, products and value beyond the reach of each country.

7. The rising numbers and growing purchasing power of Muslim consumers open up tremendous business opportunities. As Muslim consumers secure better jobs and attain higher incomes in the emerging economies, the demand for Shariah-compliant products will grow correspondingly. According to one survey, the market for such products is in excess of USD2 trillion annually and growing rapidly. At the same time the Muslim diaspora is now transferring their

needs and demands to societies that were not traditionally exposed to them. Moreover, Muslim women are playing an increasing role in businesses and are moving to the fore as an important consumer segment.

8. Sukuk has emerged as an established asset class among international investors, often providing the first inroad for countries into Shariah-compliant funding. This high growth segment in Islamic finance, with global sukuk issuance increasing by 57% in 2012 to reach USD160 billion, has become an effective tool in allowing corporations and governments to meet their capital and expenditure requirements, especially in markets with a robust Islamic financial architecture in place.

9. Many Asian countries have leveraged on the sukuk market for financing large-scale projects. It is estimated that 73% or USD212 billion of the total global sukuk outstanding in 2012 originated from the Asian region, a region that has become an important growth centre in the global economy. Future growth prospects are favourable, with approximately USD2 trillion of planned and anticipated project and infrastructure financing to be undertaken in the Gulf Cooperative Council (GCC) countries and the Asian region in the coming decade. The encouraging demographics of Asia, which accounts for 62% of the world's Muslim population and an increasing number of middle-class Muslims with savings and investment needs, form a strong pool of potential sukuk investors, as well as consumers of Shariah-compliant products and services. The ingenuity of sukuk has also been expanded to include a growing trend of multi-currency sukuk issuances that can cater to the requirements of a wider pool of investors. Here in Malaysia, sukuk has been issued in USD, Singapore dollars and Renminbi denominations that strengthen the country's appeal as the world's pre-eminent Islamic finance marketplace.

Challenges faced by the Islamic financial industry

10. One of the challenges facing the industry today is the need for intensified efforts to enhance the role of Islamic finance in growing the dimensions of financial inclusiveness. Expansion of the industry's outreach to a greater number of the global *ummah* presents a tremendous growth opportunity to tap the world's Muslim population of 1.6 billion, of whom less than 14% have access to or use financial services. The Muslim world accounts for 8% of nominal gross domestic product, yet Islamic finance represents just 1% of the global financial market. Addressing these discrepancies requires global cooperation and coordination to promote savings mobilization and develop financial intermediation in markets where they are currently lacking.

11. A second challenge is to respond to global needs and demands without losing sight of the principles upon which Islamic finance is based. As new and more sophisticated Islamic financial instruments enter global markets, it is important to ensure that innovation does not dilute the authenticity of *Shariah*. If Islamic financial instruments do no more than replicate and adapt conventional financial products, they would not reflect the uniqueness of Islamic financial intermediation. There is thus a need to extend the focus of Islamic finance beyond the legal form and towards the economic substance of financial transactions. This means moving beyond the path of adaptation and compliance and towards Shariah-based approaches that will strengthen the nexus between Islamic finance and the real economy, and that will fully embrace and reflect the link between Islamic finance and societal needs.

12. Islamic finance finds its strength from the universality of its underlying principles and values, which emphasise fairness and transparency, prohibit *riba*, *gharar* and *maysir*, and abhor excessive speculation and profiteering. If the role of finance is to promote equitable economic growth through the efficient allocation of financial resources and the management of financial risks, then Islamic finance enhances such economic functions through a set of disciplines and objectives as defined by the *Maqasid al-Shariah*. Compliance with these objectives is what gives Islam finance its unique value proposition.

13. While Islamic finance has escaped relatively unscathed from the full onslaught of the global financial crisis, the industry is by no means insulated from the risks of excesses that wreaked havoc in the conventional financial system. A third challenge that faces the industry as it becomes more integrated into the international financial system is the risk arising from an economic slowdown that can impede growth and diminish liquidity. Illiquidity has put the global banking system under severe stress, requiring central banks to support the functioning of some institutions and markets. The global financial crisis and resulting market turmoil have shown how quickly liquidity can evaporate and how market illiquidity is not only difficult to overcome, but can stretch over an extended period. The Eurozone crisis is a glaring example.

14. Among the many challenges impacting liquidity is the lack of secondary trading in the global *sukuk* market. *Sukuk* issuances have been successful, and, oftentimes, oversubscribed, but the lack of trading have led to investors holding on to the buy – and – hold attitude of the instruments until maturity.

15. Moreover, there remains a stark imbalance in *sukuk* infrastructure development between jurisdictions, thus curtailing cross-border transactions. As a result, *sukuk* trading takes place largely at the country and regional levels. This limits the ability of *sukuk* to be at par with conventional fixed income securities, which are traded extensively on a global scale.

16. To allow sukuk to grow as an important liquidity management tool, its secondary market needs to develop more depth and breath. A dynamic cross-border framework in liquidity management would enable the expansion of markets and allow *Shariah*-compliant financial products to reach communities that currently have limited access to them. To realise this, however, there needs to be greater integration among the various Islamic financial jurisdictions – a global community of investors and issuers that will make up a vibrant secondary market.

17. The recent sukuk issuance by the International Islamic Liquidity Management Corporation (IILM) is a major breakthrough that is very much welcomed by the industry. It represents a step forward towards creating an international market in Islamic financial instruments.

Where next - The role of Islamic finance in driving social welfare development

18. In reflecting on the road ahead, we have to be guided by the realisation that what has led Islamic finance to where it is now will not necessarily lead us to where we aim to be. We need to ask ourselves if enough has been done to serve the different needs of our customers, not only their business needs but also their social and welfare needs.

19. To my mind, contemporary Islamic finance has been largely disengaged from its socio-economic aspects. Just as conventional finance is said to have moved from "Main Street" to "Wall Street" in developed markets, it can be said that Islamic finance is gradually moving from the realm of retail finance into the world of high finance. I believe that Islamic finance, which has as its core pillar the promotion of social justice, can and should do more to meet the needs of the poor and the marginalized.

20. In this regard, Islamic finance has a crucial role to play in bringing the financially underserved Muslims into the economic mainstream - a path that can help alleviate poverty and create employment, thereby contributing towards more equitable economic growth and sustainable development. One way is to broaden the scope of Islamic microfinance that currently represents only 1% of the global microfinance outreach. There are also opportunities to incorporate Islamic principles like zakat, sadaqah, qardhul hasan and the like to channel long-term financing to small- and medium- sized enterprises (SMEs). Greater use of participatory- or equity-based contracts such as *mudarabah* and *musharakah* provide immense opportunities to leverage on the productive potential of SMEs, thereby encouraging entrepreneurship and the creation of real wealth.

21. It is therefore imperative that in the next stage of the journey greater emphasis should be placed on creating the environment for greater engagement between the industry and its socio-economic obligations, so as to reflect the true essence of Islam. One instrument that ties the two together is *waqf* or Islamic endowments. The traditional use of revenue from waqf was to build schools, hospitals and public facilities. Today, as an Islamic public finance instrument, *waqf* has the potential to be both a source of financing and a mechanism for wealth distribution. The principle of perpetuity embedded in the *waqf* structure sets it apart from Western- style foundations and charities. From an economic viewpoint, *waqf* can be looked upon as a savings-investment mechanism where funds are diverted from consumption and invested in productive assets. Such innovative uses have assisted in unlocking its economic potential, as well as its philanthropic objectives. With all these obvious benefits, waqf should be given a more prominent position in the industry.

22. I understand that in Bahrain, the Central Bank and financial institutions with Islamic finance operations established a waqf fund in 2006. The returns of the fund have been used to finance training, education and research at various levels in the Islamic finance industry. In Malaysia, Johor Corporation or JCorp is an example of a corporate entity that has developed extensive social responsibility programmes through its arm, the Waqaf An Nur Corporation.

Concluding remarks

Ladies and gentlemen,

23. In today's uncertain economic environment, restoration of trust and confidence is key for the sustainability and continued growth of the international financial system. Trust and confidence will return only when financial transactions are based on sound and mutually beneficial principles. Many commentators have highlighted the natural attractions of Islamic finance. The conventional financial system has many times shown a tendency to be unstable, and dramatically so in recent years. In contrast, the Islamic financial system has demonstrated itself to be less vulnerable to instability and less prone to crises.

24. The disillusionment and disenchantment with the world of finance in the aftermath of the global financial crisis offers Islamic finance a unique opportunity to present itself as a financial system that is more resilient to the very forces that brought about the crisis in the first place. We must make full use of this opportunity.

25. In Islamic economics, as in Islamic finance, the distribution of resources has a clear objective — to promote social justice. The idea is that resources ultimately belong to the Almighty and are His blessings upon us. Our responsibility for these resources is paramount and we are fully accountable for how we use them.

26. On that note, I wish all participants a productive Summit and I wish all our visitors a pleasant stay in Malaysia.

Thank you.