

Toshihiko Fukui: Islamic finance – developments, diversity and challenges

Opening remarks by Mr Toshihiko Fukui, Governor of the Bank of Japan, at the Nikkei Islamic Finance Symposium 2008: "Islamic Finance: Constant Evolution and Emerging Opportunities", Tokyo, 23 February 2008.

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Introduction

It is a true honor and pleasure to be invited to the Nikkei Islamic Finance Symposium, and to have the opportunity to share my thoughts about Islamic finance along with Governor Zeti of Bank Negara Malaysia and distinguished guests.

The Bank of Japan joined the Islamic Financial Services Board (IFSB) as an observer last year. We believe that this will help us deepen our understanding of the latest developments in Islamic finance, which has rapidly evolved and come into the spotlight of global finance.

Development of Islamic finance

Islamic finance has developed phenomenally in recent years. There are no precise figures that show the market size of the Islamic finance industry, but according to an estimate by the IFSB and other Islamic institutes at the end of 2005, more than 300 financial institutions in more than 65 jurisdictions manage financial assets in a Shari'ah compatible manner, which total between US\$700 billion and 1 trillion. From this figure, Islamic finance represents a modest 1% of global financial assets, but its growth in recent years is notably impressive. Islamic finance related assets have continued to grow at a robust 10-15% per annum on average since the mid-90s, and are expected to maintain this speed of expansion over the next few years.

Among others, Asia is one of the regions characterized by the dynamic development of Islamic finance. To give a few examples, Islamic finance products are estimated to comprise more than half of the financial services provided in the Gulf Cooperation Council region by 2015. In Malaysia, more than half of private debt securities are Islamic bonds. The credit for this must go to the leadership of Governor Zeti, who has adopted a variety of policy measures to make Malaysia an Islamic financial center.

Islamic finance has a long history. As a place where the three continents of Asia, Africa and Europe meet, the Middle East has flourished as a trading center since antiquity. In those days, there were active financial transactions in funding and settlement for trade. It is said that bills and checks already circulated in the 11th century, and that the word "check" has its origin in Farsi.

Islamic finance has a long-established tradition, yet, it is only rather recently that Islamic finance has developed in a global context. The recent rise takes place against the background of an increase in financial assets supported by Middle-East petrodollars and a growing number of Muslims seeking to have their assets managed under religious tenets. An equally important factor that propelled growth in Islamic finance is recent advances in financial technologies, namely, structured finance. The Islamic finance industry has been able to introduce a scheme of profit sharing instead of prohibited interest payments. This has led the way to the development of a range of financial products, including the Islamic bond, or *sukuk*.

Islamic finance brings greater diversity

The development of Islamic finance brings diversity to financial markets and financial transactions.

When market players with different sets of values enter a market, they increase the variety of financial transactions, which in turn promotes financial market development and creates business opportunities. At the same time, it has a positive effect on the real economy through more efficient resource allocation.

Against this backdrop, I have a keen interest in what kind of new financial services Islamic finance will provide in the future. To date, Islamic finance institutions have provided many products that replicate those of conventional finance while respecting Islamic values, where interest, or *riba*, is prohibited. In other words, Islamic financial institutions have successfully provided conventional intermediary functions by utilizing the latest financial technology. I look forward to seeing further developments which will enable Islamic finance to carry out new functions that conventional financial instruments can not serve. Such innovation will improve the allocation of resources, while operating in accordance with Islamic values.

There are of course a variety of conventional transactions, but basically, all are a combination of two factors, risk and return. Islamic finance is expected to offer further possibilities to finance by adding a new dimension to risk and return, which is Islamic values. An example would be the development of microfinance under a framework that places great importance on Islamic values such as fairness and equality of social economy and business partnership.

Islamic finance that offers a broad range of products and services is also important from the perspective of financial market and financial system stability. In principle, in a time of stress, a market with diversified participants and transactions is robust compared to a market of homogeneous participants and limited types of transactions. Since the Asian currency crisis, Asian countries have been striving to create diversity in the source of funds, including bonds, instead of relying heavily on banks. I believe that the growth of Islamic finance will also contribute to resolving these problems.

Challenges ahead

Islamic finance is making impressive growth and is expected to continue to do so in the years ahead. Still, there are many unknown factors in this financial sector, as new types of Islamic finance transactions have evolved relatively recently.

For instance, how does arbitrage between Islamic finance transactions and conventional financial transactions take place? With greater presence in the global market, what kind of impact will Islamic finance have on the pricing mechanism in the global financial market?

The size of cross-border capital flows generated from Islamic finance products is growing. How will this impact the stability of the global financial system? I have expressed my view that diversity in the market will bring about stability. However, the rapidly growing modern Islamic finance industry has never been exposed to serious stress in the global financial market. Stress tolerance can only be acquired through the experience of riding out numerous crises in the financial market and financial system. In this regard, I would like to watch closely developments in Islamic finance in the coming years.

One of the potential vulnerabilities in the international financial system is the global imbalance problem. There is a huge gap between the deficit in the US current account, and the surplus in the current accounts of Asian countries and oil producing countries. The gap has been filled by the smooth flow of a significant amount of capital. In this context, understanding the flow of Islamic finance capital originating from oil money has certainly become the key when considering sustainability of the current state of the global economy.

On the regulatory front, there are ongoing discussions on how to develop risk management and a regulatory framework to match the rapid expansion of the Islamic finance industry in order to maintain stability of the financial system. The key to addressing this issue would be consistency with conventional risk management and regulatory frameworks. This is a matter of great importance for the coexistence of the Islamic financial system with conventional financial markets and systems, and for providing beneficial diversity to the global financial system.

Islamic financial standard setting organizations play an important role in bridging the gap between Islamic standards and conventional global standards. Such organizations include the IFSB, of which Governor Zeti served as Chairperson last year, and the Accounting and Auditing Organization for Islamic Financial Institutions, which sets accounting standards for Islamic finance. To give a few examples, the IFSB has issued the capital adequacy standard and guidance that complement existing global standards for Islamic banks. Exposure drafts of guiding principles for Islamic collective investment scheme and Islamic insurance, or *takaful*, will follow. I look forward to the significant role that these Islamic financial standard setting organizations play in the provision of sound and stable Islamic finance services.

Epilogue

Islamic finance has grown into an industry that is indispensable in understanding the global financial system. The Bank of Japan will closely follow developments in the Islamic finance industry through its IFSB observer membership status.

Japanese financial institutions and companies have just stepped into the world of Islamic finance. We hear that some financial institutions are already actively engaged in Islamic finance business by cultivating new markets and setting up local companies. Some companies are already introducing the framework of Islamic finance to finance their projects. I am convinced that we will be seeing more in the near future.

I would like to close my remarks by expressing my hopes that the proceedings of this symposium will deepen understanding of Islamic finance among Japanese financial institutions and companies, and that it presents an opportunity for the creation of new financial services.

Thank you for your kind attention.