Zeti Akhtar Aziz: Enhancing the resilience and stability of the Islamic financial system

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It is my honour and great pleasure to speak before this distinguished audience, at this conference, jointly organised by the Islamic Financial Services Board and the Institute of International Finance . At a time when the international financial system is currently in turmoil, this forum provides an important opportunity to enhance our understanding of the developments, the issues that have come to the forefront and the implications it has for achieving stability in the global financial system.

Our specific interest today is to consider these issues in the context of the Islamic financial system, in particular, whether Islamic finance as a form of financial intermediation could be vulnerable to such risks of instability. In addition, what are the possible steps that might be taken to strengthen the resilience and stability of the Islamic financial system. The collaboration between the IFSB and the IIF in creating this platform is most timely. The global challenges posed by current international financial crisis necessitates global engagement. Given its far reaching repercussions, the strategic solutions need to be global in nature involving both reforms and measures to restore soundness and stability of the international financial system.

My remarks today will focus on the implications for the strategic direction of the Islamic financial industry taking into consideration the lessons learned from such financial turbulence including the current crisis. As Islamic finance becomes an integral part of the international financial system, it will be increasingly tested by such developments. History has shown that the world will continue to be plagued by such crises. The key for the Islamic financial industry is therefore to ensure that it would not be a source of such financial instability and is able to achieve a level of resilience that would ensure its sustainability.

Lessons learned from systemic banking crisis

The world has experienced more than 124 distinct banking crises in the recent 27 years.[1] While the triggering factors that precipitated financial crisis have been different, for most, it resulted in a general loss of confidence and a downward spiral in asset prices.

Such a crisis was experienced in the Asian region just over ten years ago. Following the lessons that were learnt from this experience, Asia has emerged in a better position to manage the spill over effects of the current financial turmoil. The key elements in the efforts have been the strengthening of the foundations that accord the resilience to withstand shocks to the system and that will ensure sustainability through episodes of such turmoil.

There are several similarities in the current financial crisis and the Asian financial crisis. In both cases, the crises followed a period of strong growth, rapid credit expansion and sharply rising asset prices. Prior to the Asian crisis, there was indiscriminate lending to the corporate sector. Investment activity was excessive, with the ratio of investment to GDP exceeding

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[1] L. Laevan and F. Valencia, "Systemic Banking Crises: A New Database", (Sept 2008) International Working Paper of the International Monetary Fund, WP/08/224.

35% for many economies in the region. The sub-prime crisis similarly originated from imprudent lending practices. The low interest rate environment also accentuated the build up of the excesses and rising asset values. In Asia , domestic credit increased to unsustainable levels, reaching 180% of GDP during this period. In the United States , it had increased close to 240% in 2007. The excessive leveraging and increased risk taking reinforced the formation of asset bubbles.

In both cases, there was also abundant liquidity. Both Asia and the United States experienced surges of capital inflows. This was reinforced by favourable sovereign ratings in Asia and the strong ratings for the securitized instruments in the US . The eruption of the crisis set off the reversal of these trends. There was also a failure to recognise that in a highly integrated international financial system, it meant that a crisis that originate in one part of the financial system not only would have an impact on other parts of the system but it could have far reaching implications on other jurisdictions.

A further similarity relates to the lack of capacity to manage the increased risks associated with the transformation of the financial sector. For Asia , the increased liberalisation was not accompanied by the development of the necessary domestic financial infrastructure and the capacity to manage the increased risks and vulnerabilities associated with the liberalisation. In the current crisis, financial innovation occurred at a pace that outstripped the ability to manage the associated risks with such innovations. There was excessive risk taking and a lack of transparency and disclosure in the financial transactions. The complex structured instruments and securitisation process resulted in multi-layered structuring of financial products which were not supported by enhancements to governance processes and the risk management infrastructures and practices. This resulted in an underestimation of the risks involved and the capital buffers that were necessary.

The ensuing turmoil in the financial markets that followed was increasing illiquidity in the financial markets and the subsequent breakdown in the functioning of the markets. As this continued, it has translated into stress and insolvencies in the financial sector. In both crises, this precipitated a sudden pull back in bank lending. The ensuing credit crunch magnified further the damaging impact on the economy.

In Asia, the economic contraction was severe in the range of minus 7% to 13%. In the current financial crisis, however, the spillover impact of the effects on the economy has yet to be fully felt. In the Asian financial crisis, it ran its full course with the rapid price adjustments in most asset markets taking place within a period of just over a year. In Asia , there was limited potential to reduce interest rates in an environment that was vulnerable to capital outflows. The focus of policy in Asia was therefore on the resolution of the banking sector and to restore the functioning of the intermediation process. In most of the crisis affected economies in Asia , this strategy produced positive results and growth resumed within twelve to eighteen months.

Financial crisis and Islamic finance

In the midst of the unfolding of the global financial crisis, it is useful to review the foundation and structures of the Islamic financial system to assess its resilience in withstanding the impact of the current and future crises. In taking into account the dynamics of the crisis and the potential implications for Islamic finance, two important dimensions are key in undertaking the assessment.

The ***first key dimension*** highlights the inherent ability of Islamic financial system to deal with the test of such crisis. Islamic finance is well-supported by two essential features which serve as pillars to Islamic financial transactions. Firstly, Islamic finance encourages business and trade activities that generate legitimate profits, subject to an explicit requirement of materiality and validity of the transaction. This requirement ensures that the funds are channelled into real financial business activities, reinforcing a close link between financial and productive flows. This reduces the Islamic financial system from over exposure to risks associated with excessive leveraging and imprudent risk taking. In Islamic financial transactions, money is not a commodity, but a medium of exchange, a store of value and a unit of measurement. Money represents purchasing power and cannot be utilised to increase the purchasing power without any productive activity.

Secondly, Islamic finance encourages business transactions on a mutual risk sharing basis. The practice of risk sharing provides the impetus for the Islamic financial institutions to conduct the appropriate due diligence and maintain the explicit requirements for disclosure and transparency. These requirements thus serve to promote the adoption of sound risk management practices by the Islamic financial institutions.

By embracing these essential features and the objectives of Shariah in its entirety and by exemplifying the true practice of Islamic finance as required by the principles of Shariah, the resilience of the Islamic financial system is strengthened. It is therefore paramount that Islamic financial professionals, practitioners, scholars and regulators fully understand the inherent requirements of Islamic finance, which are in fact consistent with the international best practices and standards in the conventional financial services industry. It is these very elements of Islamic finance that provides an additional in built mechanism that enhances its prospects for soundness and stability.

The second key dimension relates to potential risks for Islamic finance in a crisis environment. This could arise when the economic environment and the conditions in the financial markets turn adverse. The increased globalisation of Islamic finance and its greater integration with the international financial system increases the exposure of the system to contagion effect from such developments. In the dynamics of a financial crisis in the conventional financial system, this would be referred to as the second round effects. The first round effects is when developments within the financial system triggers the financial crisis which in turn impacts the real economy. The second round effects is when the resulting slower growth causes further strain to the financial sector.

The experience has shown that when such crisis is not contained, the consequent deterioration in economic conditions results in a worsening of the financial crisis. For this reason, resolution has to take place quickly. For Malaysia, in the 1997-98 crisis, every effort was taken to give attention to financial sector resolution so as to prevent the spiral that could have set in as economic activity became affected by the financial crisis.

In this indirect manner, Islamic finance would be affected by such financial turmoil. Slower economic growth and the reduction in the global liquidity would affect those institutions that are heavily reliant on a business model that focuses on real estate and asset finance. Islamic financial institutions would also be exposed to increased inventory risk due to the increased volatility and the reduction in asset prices. Islamic financial institutions with a high proportion of their businesses in profit sharing business (Mudharabah and Musyarakah) may be exposed to losses due to equity investment risk, possibly by the inability of the enterprises in generating the expected returns. The absence of an Islamic money market infrastructure would also expose the Islamic financial system to higher liquidity risks.

Strategies to strengthen the resilience of Islamic financial system

As innovation of Islamic financial products and services intensifies and as Islamic finance becomes more integrated with the international financial system, it becomes imperative that the foundations upon which Islamic finance has been built remains intact. This will be the key to sustaining the resilience of the Islamic financial system in this more challenging international financial environment.

Key to this is to embrace Shariah-based innovation in the development of Islamic financial products. In a highly globalised financial market, innovation has been a key differentiating factor to remain competitive. The current turmoil has however, highlighted that highly complex, unbridled innovation can become highly destabilising resulting in major disruptions in a financial system. It is therefore important for financial innovation to have clear Shariah objectives and adhere to the requisite principles of Shariah. In this manner, Shariah-based innovation would contribute towards Islamic financial products that have distinct value propositions with in-built strengths arising from the essential features of Shariah.

To achieve this objective, it is important to have strong initiatives that promote Shariah-based innovation in Islamic finance. In Malaysia , several steps have been taken. The establishment of the International Shariah Research Academy for Islamic Finance (ISRA) aims to engage in applied research on dynamic Shariah-centric innovation. ISRA can provide a global platform for greater global engagement and research with the focus on innovation.

In addition, the Central Bank has also embarked on the initiative to develop the Shariah Parameters to promote more consistent application of Islamic financial contracts. This initiative aims to determine the essential features of Islamic financial products derived from underlying key Shariah contracts. These features will serve as a guide for the application of the Shariah contracts for the Islamic financial products.

The second strategy is to raise the bar in the status of the Islamic financial infrastructure that supports the risk management and governance of Islamic financial institutions. To ensure sustainability of the resilience of Islamic finance, it is important to have the comprehensive enabling infrastructure that allows for the management of the risks that are peculiar to Islamic finance. There is a need for Islamic financial system to have the capital requirements, effective risk management and strong governance that are fully equipped to manage the risks that are specific to Islamic financial transactions. It is also important for the institutions to spread the risks by having prudent asset allocation based on different Islamic contracts so as to ensure a sustainable revenue stream and to ensure the institutions are in a position to absorb the extreme circumstances that occur during a crisis.

In the case of Malaysia, an additional capital requirement is required to cushion inventory risks of underlying assets and to cover the potential equity position risks that are embedded within the partnership contracts. This is also reinforced by the requirement on the appointment of board representatives in the invested entities under the partnership contracts so as to serve as a safeguard for the interest of the Islamic financial institution thereby allowing for continuous monitoring and surveillance. Islamic financial institutions are also allowed to transfer the risk to investment account holders under Mudharabah, i.e. profit sharing and loss bearing contract, if the institution can demonstrate the appropriate disclosure and governance practices that would ensure an effective risk transfer. Islamic banks are also permitted to set aside a portion of income derived from assets funded by Mudharabah contracts, in the form of profit equalization reserves (PER) to sustain stable and competitive returns. Several of these requirements are based on the international standards that have been issued by IFSB. The implementation of IFSB standards across jurisdictions will be key in the continued robust expansion of Islamic finance.

While the above measures facilitate the managing of risks peculiar to Islamic finance, the legal, regulatory and supervisory infrastructure also needs to keep abreast with the evolution and rapid transformation taking place in the industry. As part of this infrastructure, there needs to be an integrated crisis management framework to ensure that any emerging crisis in the Islamic financial system will be promptly managed. Such efforts, among others need to involve three basic aspects. This includes having the mechanism and vehicle to preserve short-term liquidity, to remove troubled assets from the balance sheets of financial institutions and to recapitalise Islamic financial institutions.

In the case of Malaysia , this infrastructure has been put in place. The Central Bank has a range of Islamic financial instruments to manage liquidity in the financial system. This is supported by a well developed Islamic money market. In addition, the financial safety net framework in Malaysia encompasses the lender of last resort facility and a comprehensive deposit insurance system that provides coverage for both conventional and Islamic deposits.

The Deposit Insurance Corporation has also been given sufficient statutory powers to ensure a prompt, effective and least cost resolution to safeguard the stability of the Islamic financial system. This entails among others, the regulatory powers and mandate to ensure expedient resolution of financial institutions in distress. Our supervisory oversight also subjects the Islamic financial institutions to periodical stress testing to assess whether the institutions would be able to cope in extreme conditions.

Global ramifications of the crisis also calls for more concerted efforts at the international level to avert an escalation of the scale of a crisis. Central to this is to have coordinated initiatives, by having in place on-going assessments of any vulnerabilities in the Islamic financial system so as to avoid crisis. As part of this, the close cooperation of the central banks would enable a swift response if it is required.

Thirdly is to assimilate the Shariah values in the realisation of benefit (*Masalih*) to the relevant stakeholders. Islamic finance industry may, by according attention to the preservation of good relationship with the customers and relevant stakeholders, avoid extreme solutions when severe deterioration has taken place. Consistent with this is the principle in Islamic finance to promote justice, fairness and shared responsibility. The focus of Islamic finance thus transcends beyond just the pursuit of growth and monetary performance by emphasising ethical market conduct practices. Central to this is the adoption of a comprehensive consumer protection framework.

Conclusion

In shaping the robust growth of Islamic finance, the strategic direction of the industry moving forward needs to be accompanied by the efficient implementation of the legal, regulatory and supervisory regime, including having in place a crisis prevention and management framework. While recognising the strengths of Islamic finance and the opportunities it presents, key to this is ensuring the essential features of Islamic finance are preserved so as to retain its inherent resilience and stability.

The robust growth of Islamic finance has been from the significant interest from both the Muslim and non-Muslim communities. This would not occur if Islamic finance was not able to meet the growing and differentiated financial requirements, if it were not an efficient form of financial intermediation and if it were not competitive. As a growing part of the international financial system that has become increasingly challenging, our task will be to build on the inherent strengths of Islamic finance and to continue to strengthen the supporting structures so as to ensure that Islamic finance will contribute to the overall stability of the global financial system.