

Heng Swee Keat: The future of Islamic financial services

Welcome address by Mr Heng Swee Keat, Managing Director of the Monetary Authority of Singapore, at the 6th Islamic Financial Services Board Summit, Singapore, 7 May 2009.

* * *

President of the Islamic Development Bank, H.E. Dr. Ahmad Mohamed Ali Al-Madani
IFSB Council Chairman and Governor of the Saudi Arabian Monetary Agency,
H.E. Dr. Muhammad Al-Jasser,
IFSB Governors,
Secretary-General Prof Rifaat Ahmed Abdel Karim,
Ambassadors,
Honoured guests

Welcome

I extend a very warm welcome to all our guests, especially those from overseas. As an Islamic Financial Services Board (IFSB) member, MAS is honoured to host this 6th IFSB Summit. This is IFSB's first Summit in East Asia, and the strong interest shown by participants here is a testament to the growing opportunities for Islamic Finance and economic cooperation in our region. I very much appreciate the support of fellow Governors and IFSB Board members. A special thanks to all our panel chairmen and speakers, and to Professor Rifaat and the IFSB secretariat for organising this so well.

We meet at a most challenging time. The IMF and the World Bank have forecast the global economy to contract for the first time since World War Two. The economies of Asia, like the rest of the world, have slowed significantly. So have all forms of financial services, including Islamic Finance. While actions taken by governments and financial authorities have helped to stem the sharp deterioration, the road to full economic recovery is likely to be bumpy.

While the crisis is painful, there are several silver linings. This Summit, with its theme of "The Future of Islamic Financial Services" provides a timely opportunity for us to reflect on the shortcomings in economic and financial models, and in our supervisory approaches. By drawing the right lessons, we can build the foundation for a better future. Allow me to share some reflections on the future shape of economic linkages and financial services, as well as the supervisory approach.

Economic linkages

First, the crisis shows that while the idea of the "de-coupling" of Asian economies from the rest of the world was premature, the structural trend of a dynamic Asia remains. I should clarify that in this speech, my reference to Asia includes the Middle East. Even for 2009, while the World Bank has trimmed its growth forecasts for Asia,¹ this remains the faster growing region in the world.²

When global growth resumes, developed economies will remain important markets. But the significant deleveraging and the repair of balance sheets are likely to dampen growth prospects for some time. Asia has entered this crisis with less baggage. But this crisis will

¹ World Bank East Asia and Pacific Update, "Battling the Forces of Global Recession", April 2009.

² The World Bank projected Developing East Asia (including China) to grow by 5.3% in 2009; South Asia by 3.7% and Middle East and North Africa by 3.0%.

force an acceleration of structural economic change in Asia. The drive towards greater domestic consumption, as well as greater Asia intra-regional trade, investment and consumption, will take on greater urgency.

The growth of intra-Asia trade and investments will be driven by both bottom-up initiatives as businesses expand their ties, as well as top-down policy measures as governments enter into agreements on free trade and economic cooperation. A recent survey by the ADB Institute found that a higher than expected 22% of responding firms use preferences accorded by free trade agreement (FTA) and more are planning to do so.³ China, Japan and Korea have implemented their FTAs with ASEAN. The ASEAN-Australia-New Zealand FTA was signed in February 2009. Singapore has signed FTAs with the GCC and Jordan, and we can expect more of such pacts within Asia in the future. Cross-border capital flows between the GCC and East Asia will grow significantly in the coming years.

With this forced pace of global re-balancing, the relative economic weight of Asia will rise. This would be a positive development for the global economy, as more engines of growth provide greater resilience.

Financial services and Islamic finance

However, it is crucial that our optimism does not turn into hubris. Economies in our region face many important challenges. In particular, getting the financial system to play its proper role is critical. So let me turn to my second reflection on the role of financial services.

Many causes have been cited for the current financial crisis – excessive leverage, complexity and risk-taking incentivised by inappropriate compensation systems; pro-cyclical regulatory requirements and inappropriate cost of capital; the flawed originate-to-distribute model in credit origination that worsened the principal-agent problem; the role of rating agencies; and the use of instruments such as CDS and CDOs that were supposed to distribute risks more broadly but ended up concealing and concentrating risks instead. The list goes on. Each of these plays a role but if we are to identify a common factor across these various causes it is this: that finance has become detached from economic realities.

As we look to develop our financial system, we have to bear in mind that the basic role of finance is to allocate scarce capital to its most productive use. We earn a return only if the capital is deployed to eventually produce goods and services that are valued by the market. When the nexus between the mobilization of capital and the productive use of capital is broken, the returns cannot be sustained – the bubble must eventually burst, with painful consequences.

In this crisis, both conventional and Islamic financial markets have been affected, but the restrictions on the use of leverage and speculation has put Islamic Finance in a better stead. In the coming years, as the Shariah principles of using capital to build productive capacity gain wider recognition, Islamic Finance will assume a more prominent role. Estimates of global Islamic Finance assets today range from US\$700 billion to US\$ 1 trillion and one consultancy firm estimates this could potentially grow to US\$1.6 trillion by 2012.⁴

Countries in Asia are using Islamic Finance to fund urban development and public infrastructure projects to meet the growing demands of their populations. The ADB estimates that Asian countries would need more than US\$8 trillion of infrastructure investment between

³ Kawai and Wignaraja, "The Asian "Noodle Bowl": Is It Serious for Business?" Asian Development Bank Institute Working Paper Series No. 136, April 2009.

⁴ Oliver Wyman, "The Next Chapter in Islamic Finance - Higher Rewards but Higher Risks", April 2009.

2010 and 2020.⁵ International financial institutions such as the Islamic Development Bank are active in funding worthwhile investment projects.

The global sukuk market remains a relatively new asset class with much room to grow out. In 2007, Asian currency-denominated sukuk outstanding grew by almost 50% but the market contracted by only 1.5% to US\$64.3 billion at end-2008.⁶ Around US\$1.3 billion in sovereign sukuk issuance will come from Malaysia, Indonesia and Singapore in the first half of 2009, and more private sector issuers are expected to tap the sukuk market and to attract new investors and clients.

In asset management, an industry report⁷ estimates the number of high net worth individuals and their financial wealth in Asia combined to be about the same as those of Europe and America, but growing faster. The number of Asian middle class has also surged with economic growth. While growth momentum may moderate in the next few years as the global economy recovers, the underlying trend remains. The growing interest in Islamic funds will provide opportunities for asset managers who can provide the right products.

In short, my second reflection is that nature of financial services in the coming years will change, with a focus on deepening the symbiotic relationship between financial services and economic growth. This will be favourable for various segments of Islamic finance.

Nature of financial regulation

Let me move on to my third reflection, on the nature of financial regulation. This crisis shows that proper regulation of financial activities is difficult – it's unpopular to take away the punch bowl when the party is going. But it is necessary. Equally important is the need to focus on the economic substance and underlying risks of the activities, regardless of its form.

Prof. Rifaat provided a very timely reminder when he said recently, "Every financial institution requires close supervision, regardless of whether it is conventional or Islamic." While Islamic Finance has features that make it robust, there are also risks such as liquidity and concentration risks that demand special attention.

MAS applies a single regulatory framework to both conventional and Islamic banking because our regulations address prudential issues of liquidity, credit, market, operational and concentration risks. These are relevant to both conventional and Islamic banks. While Islamic funding and financing structures are different, we consider the economic substance the underlying risk of these structures, and apply the regulatory treatment that is consistent with the risk. Our regulatory framework therefore provides a level playing field for Islamic and conventional banking. MAS has for some time now issued regulations to clarify the regulatory treatment of various Islamic finance structures under our rules.

Today, we have issued another two regulations,⁸ as well as a consolidated set of Guidelines which provide clarity on how our banking regulations apply to Islamic banking, and offers specific information of the regulatory treatment of various Islamic banking structures. This set of Guidelines will provide greater clarity and certainty for financial institutions offering Islamic banking products in Singapore. Taken together, these various changes will allow banks to

⁵ ADB, "Infrastructure for a Seamless Asia", April 2009.

⁶ Moody's Global Corporate Finance, "Islamic Finance: Asian Sukuk Market Faces New but also Familiar Challenges", April 2009.

⁷ Capgemini & Merrill Lynch, "World Wealth Report" 2008.

⁸ MAS Regulations 23C and 23D on Diminishing Musharaka financing and Spot Murabaha transactions respectively.

conduct a wide range of Islamic financing activities, and to have greater flexibility to structure instruments to meet their risk management needs.

The facility for a reverse-enquiry Singapore dollar sukuk was completed in January. We have issued the first tranche to the Islamic Bank of Asia, and are reviewing applications from other banks. We have also ensured equal tax, regulatory and liquidity treatment of the sukuk with Singapore Government Securities, effective immediately.

Members of the IFSB Board and the industry have been very active in developing talent. Several credible Islamic finance training providers are offering courses here. The Singapore Management University offers an undergraduate module on Islamic Law, Banking and Commerce and the Wealth Management Institute has incorporated an Islamic Finance module in its Masters of Science in Wealth Management programme. The National University of Singapore recently organized an Islamic Finance conference. These initiatives help to raise understanding of Islamic Finance among students and industry practitioners. To support professionals who wish to deepen their expertise, I am pleased to announce that beginning from this year we will sponsor students for the eligible Islamic Finance Masters programmes.

MAS will continue to work towards a regulatory approach that is clear, relevant and consistent, across the range of Islamic financial activities. We are committed to working with fellow regulators, and to developing the infrastructure and talent to support the growth of Islamic Finance in Singapore.

Conclusion

In conclusion, we face challenging times. But the dynamism of Asia, including the Middle East, will return and the structural economic changes are likely to accelerate. The focus on the role of finance to develop productive sectors will raise the profile of Islamic Finance, and create new opportunities.

On that note, I wish you a fruitful discussion during this Summit and a very pleasant stay in Singapore. Thank you.