Zeti Akhtar Aziz: Finance and the real economy – fostering sustainability

Speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Islamic Development Bank (IDB) Regional Lecture Series on Islamic economics, finance and banking: "Finance and the real economy – fostering sustainability", Jakarta, 19 December 2012.

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I am most honoured to be invited to deliver this inaugural lecture of the Islamic Development Bank Regional Lecture Series. I am also most delighted to be back here in Jakarta. I would like to thank the Islamic Development Bank for the invitation, and Bank Indonesia for kindly hosting this event.

For more than three decades now, the Islamic Development Bank has had an important role in promoting economic growth and development in so many parts of the world, and associated with this, has been its role in fostering the development of Islamic finance. It has supported the building of key international financial infrastructure that has been important for the orderly global development of Islamic finance and for safeguarding financial stability. The Islamic Development Bank has also supported research and education efforts in this area, while its strategic interests in financial institutions in different jurisdictions have been an important catalyst for their establishment and expansion. In the current more uncertain environment, in the aftermath of the recent global financial crisis, the role of the Islamic Development Bank will continue to be important, given that the goal of sustainable growth and development in the world economy has now become even more challenging.

As the conventional financial system currently confronts what is perhaps its most defining period, several important lessons can be drawn for our collective efforts to build more resilient financial systems. Important considerations need to be accorded to the issues that have emerged, and on the policy directions affecting growth and stability. My address today will discuss several of these issues, and discuss how Islamic finance, given its nature and inherent features, can contribute to the process of enhancing the discipline that contributes to ensuring growth and financial stability.

At the core, the financial system needs to serve the real economy. The purpose of the financial system is intermediation – that is, to match savings and investments for the purpose of generating economic growth. Yet, in recent decades, a number of factors have contributed to the weakening of the link between financial intermediation and productive economic activity. Deregulation opened up new opportunities for financial institutions to enhance performance and expand the scope of their activities. Greater competition, reinforced by significant advances in technology, intensified the pace of innovation. And, the extended period of low inflation and low interest rates incentivised greater risk-taking. Cumulatively, these developments contributed to a dangerous build-up of financial imbalances.

This has prompted a rethinking of the issues related to the financial business and its models, and wide-ranging regulatory reforms by the international community. Related to these issues is the question on the "appropriate" size of the financial sector. As economies develop, the size of financial sector assets and, correspondingly, the value-added contribution of the financial sector, is expected to increase. However, while there is a fundamental relationship between the growth of the financial sector and the real economy, the relationship is not well-understood or captured in current macroeconomic models. This creates a potential challenge for policymakers to determine the point at which growth of the financial sector may be outstripping the demands and the potential of the real economy. This issue has become even more pronounced with greater regional and global financial integration, and in countries that are also international financial centres. To the extent that corporate and personal income growth is driven by financial transactions rather than by an increase in production or employment growth, economies become potentially more vulnerable to the consequences of financial system stress.

The recent global financial crisis provides a distinct example of how excessive leverage and exponential growth in financial activities that are detached from the growth trajectory of the real economy can become a source of instability. Leverage increased sharply in the years leading to the crisis, buoyed by years of strong economic growth. In the advanced economies, bank balance sheets exploded, growing to multiples of annual GDP. For example, in the case of Iceland, the three largest banks that were nationalised in early October 2008 had seen their total assets expand from 100 percent of GDP in 2004, to more than 900 percent of GDP as at end-2007. Similarly in Ireland, assets in their financial institutions with substantial domestic businesses were more than 400 percent of GDP by 2008, while in the United Kingdom, bank assets were more than 500 percent of GDP prior to the global financial crisis. The sheer size, complexity and leverage in the banking system increased the fragility of financial institutions and limited their ability to absorb even small losses, thereby resulting in widespread and deep economic dislocations.

This expansion of financial activities was also in part due to the activities in the shadow banking system, which in the United States, grew to be even larger than the traditional banking sector in gross terms. At the height of the crisis, the size of gross amounts outstanding of over-the-counter (OTC) derivatives globally was estimated at over 614 trillion US dollars[1], more than ten times global GDP. Despite its size, the over-the-counter market was opaque and inadequately regulated, making it more difficult to quantify the risk that had been assumed by the financial institutions.

A further issue relates to financial innovation and for policy interventions not to stifle those innovations that are beneficial to society, while reining in those that are harmful. The current debate on the international financial reforms continues to reveal that this is a challenging task. While there is wide support for a return to basic banking, it is also acknowledged that financial innovations have been instrumental in improving financial access levels, by enabling financial institutions to manage risks in ways that have allowed for higher-risk economic activities to be undertaken. Contrary evidence, however, also exists. In the run-up to the crisis, derivatives were extensively used to arbitrage regulatory requirements and to extract excessive profits through opaque and complex transactions that resulted in the fundamental mispricing of risk. Current reform efforts are therefore confronted with the need to strike a balance between constraining harmful practices, without restricting innovation that is key to a progressive financial system.

Another issue relates to the prospect for aligning the expectations of capital providers with the imperatives of sustainable banking. In the years preceding the crisis, the growth of the financial system substantially exceeded that of the overall economy. Published data[2] indicates that the balance sheet of the world's largest 1000 banks increased by about 150 percent between 2001 and 2009. At its peak, the scale of the assets of the financial sector far exceeded those in other sectors, with record profits reported from year to year. In the current environment, banks continue to remain under considerable pressure to support activities that generate the kind of rates of return that capital providers have come to expect from the industry. This runs counter to expectations for banking to be returned to its fundamental role of supporting real economic activity. The extent to which these conflicting imperatives can be reconciled in a sustainable manner remains unclear.

A focal point of the reforms has been to protect retail banking from the vagaries of investment banking that often has involved higher risk-taking activities. In the United States,

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[1] As at December 2009. BIS Quarterly Review Statistical Annex, June 2010, Table 19.

[2] The Banker publication.

the Volcker Rule prohibits banks from carrying out certain types of investment banking activities if they wished to continue to rely on deposit funding. In a similar vein, in the United Kingdom, the adoption of the recommendations by the Independent Commission on Banking mandates banking groups to establish a separate subsidiary for their retail activities, and it prohibits the subsidiary from undertaking other businesses and risks. Solutions to these challenges are far from straightforward. While these and other reforms by the Basel Committee and the Financial Stability Board are expected to have far reaching implications for the landscape of the financial system as we know it today, they have yet to provide answers to many of the key questions that policymakers and the financial industry need to address in the pursuit of effective functioning and sound financial systems as we progress forward into the future.

Since the global financial crisis, significant attention has been directed at evolving an effective macro-prudential policy framework, which can serve to rein in excesses and strengthen the nexus between finance and the real economy. The concept of macro-prudential policies is hardly new and can be traced back to as early as the late 1970s, in reference to the macroeconomic and financial stability implications from the rapid pace of lending to developing economies[3]. Some emerging markets, including Asia, have, since the 1990s, deployed macro-prudential policy instruments to manage imbalances in the financial system and capital flows.

Following the recent global financial crisis, greater attention is now being focused on the role, scope, instruments and governance arrangements for macro-prudential policy to preserve financial stability. New or strengthened mandates for macro-prudential policies are being established in a growing number of jurisdictions, supported by wide-ranging changes to the legislative framework and institutional structures. Used effectively in combination with other policy tools, including micro-prudential measures and monetary and fiscal policy tools, macro-prudential policies have been demonstrated to significantly improve financial stability outcomes.

Effectively operationalising macro-prudential policy frameworks, however, remains a key challenge. By design, macro-prudential policies are intended to reduce the probability and severity of a *future* crisis. While further research will deepen our understanding of leading indicators and transmission channels, judgments will continue to have a key role. History has shown that political economic considerations have, at times, had an effect on the willingness of policymakers to act. Despite the high costs of crisis on the financial system on the economy and on the society, there is still an inherent bias towards inaction. This underscores the need for a stronger focus on creating an environment in which policymakers will have the confidence to act. This requires a strong mandate, sufficient policy instruments, and clear accountability structures.

While macro-prudential policy has a clear and important role in contributing towards financial stability moving forward, it does not however diminish the important role of micro-prudential supervision. Indeed, the notion that more developed macro-prudential policy frameworks can, over time, provide a credible alternative to the close supervision of systemic financial institutions – for example, through the development of better predictive macro indicators, or through reliance on recovery and resolution plans alone – is misplaced. There can be no substitute for the effective ongoing supervision of financial institutions, which relies on supervisory assessments and judgments, and enhances the understanding of firm behaviours in a manner that models and plans, no matter how sophisticated, will never be able to fully achieve. Efforts should therefore also be accorded towards further strengthening

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[3] Based on the article entitled "The term 'macro-prudential': origins and evolution" published in the BIS Quarterly Review March 2010, which contains excerpt of the unpublished minutes of a meeting of the Cooke Committee (the precursor of the present Basel Committee on Banking Supervision)

the conduct of micro-prudential supervision and promoting the complementarities between micro- and macro-prudential policies.

Let me now turn my remarks to the growing role and relevance of Islamic finance in contributing to the global agenda of fostering sustainable growth that is firmly anchored to the real economy.

The core proposition of Islamic finance draws from its inherent features and the values that it brings to the economy, and the tremendous potential that it offers in supporting sustainable economic growth and in safeguarding financial stability. These core propositions are derived from the Shariah, which dictates that Islamic financial transactions must be supported by underlying productive activities. This Shariah ruling ensures a close link between financial transactions and the real economy. Innovation and intermediation in Islamic finance are thus aligned to generating productive economic activities. There is also strong discouragement against excessive risk undertakings and a prohibition against speculative elements. These rulings also serve to insulate the Islamic financial system from excessive leverage, which in turn contributes towards promoting financial stability and its long-term sustainability. These fundamental elements resonate with the call for banking to focus on its core function of providing financial services that add value to the real economy.

This recent decade has also witnessed a dramatic transformation of the Islamic financial landscape. It has been marked by sustained rapid growth and the widening of its geographical reach, resulting in more diverse Islamic financial institutions and the generation of a wide spectrum of innovative products, particularly in the high-growth segment of the sukuk market. In this decade, Islamic finance has also evolved from being domestic-centric to become increasingly internationalised. In this dynamic environment, the scope of the Islamic finance business has expanded from simple retail and trade financing to include private equity, project finance, sukuk origination and issuance, as well as fund and wealth management products. Today, the total global size of the Islamic financial assets has surpassed more than 1 trillion US dollars. There are now more than 600 Islamic financial institutions operating in 75 countries.

The vision for the Islamic financial system in Malaysia was articulated in our first Financial Sector Masterplan that was launched in the year 2001, in which the plans for building the foundations for the Islamic financial system were outlined. This included strengthening and diversifying the financial intermediaries in the financial system, building and developing the financial markets, and enhancing the regulatory supervisory, Shariah and legal framework. Ten years later, in 2011, a new Financial Sector Blueprint was launched, charting the path for Islamic finance to transition to become increasingly internationalised, and thus to become more integrated into the mainstream of the global financial system.

Whilst Islamic finance has all the ingredients and the potential to meet the needs of the global economy, the channelling of funds to productive activities in Islamic finance today is still largely being carried out through non-participatory contracts, that includes the mark-up sale (Murabahah) and the lease-based (ijarah) structures, which continue to remain essential to cater for financing trade and the purchase of assets. Such contracts are similar to lending instruments which expose the Islamic financial institutions mostly to credit risk elements. Whilst non-risk-sharing contracts will continue to contribute to the future growth of Islamic finance, the wider use of risk-sharing transactions and undertakings under participatory finance models have significant scope in evolving a broader representation of Islamic financial products that will spur the next phase of industry growth and development. This includes participatory or equity-based contracts such as Mudarabah and Musharakah that support ventures involving entrepreneurship endeavours. Greater use of equity-based models in Islamic financial solutions has been observed in the more recent period. This has been most evident in the sukuk segment, with Shariah structures evolving from predominantly ijarah and murabahah structures to musharakah partnerships as well as convertible and exchangeable trusts.

The further development of participatory Islamic finance contracts on a broader scale offers particular potential in efforts to reinforce links between finance and the real economy. Several elements of risk- and profit-sharing participatory contracts support this. As profit-sharing and loss-bearing are clearly identified and agreed based on the contractual agreements between the financier and the entrepreneur, strong emphasis is placed on the value creation and economic viability of productive efforts that create new wealth. In equity-based contracts, the financial intermediation is thus also directed towards promoting entrepreneurship, in that the clearly defined risk- and profit-sharing characteristics of the Islamic financial transaction provides strong incentives for both parties to contribute to the success of the investment. This also provides the foundation for a long-term trust-based relationship, and a clear interest for the financial institutions to undertake the appropriate due diligence to ensure that the returns are commensurate with the risks being assumed. Aspects of governance and risk management thus strongly underpin these contracts. In particular, such contracts demand higher standards of disclosure and transparency to be observed, which in turn act to strengthen market discipline.

The legal, regulatory and supervisory framework will need to be adjusted to accord greater clarity to the appropriate legal and regulatory treatment in order to foster the sound and orderly growth of risk-sharing structures and activities, both in terms of the funding and the assets-side of Islamic banks. In Malaysia, steps are currently being taken to provide a conducive enabling environment for this next phase of development that will spur more risk-sharing transactions though the formulation of new legislation for Islamic banking and takaful. This legislation is now at the final stages of the process of its enactment. This new law for the industry is aimed at promoting certainty to the legal and regulatory treatment of Islamic financial transactions by providing legal recognition to the contractual requirements in accordance with the Shariah. This provides a comprehensive legal environment under which effective risk and profit sharing activities can take place, encompassing all aspects of Islamic financial transactions, from its prudential and business conduct requirements to the legal treatment of Islamic banking assets upon its resolution, to be fully consistent with the distinctive elements of the respective Shariah contracts employed in these transactions.

This legal framework will also further enhance the capacity of the regulatory and supervisory framework for the Malaysian Islamic finance industry to evolve in greater alignment with the international regulatory and the supervisory standards and best practices issued by the Islamic Financial Services Board (IFSB) to govern the specificities of Islamic financial transactions. To complement the efforts to strengthen the regulatory law for Islamic finance, Malaysia has also established the Law Harmonisation Committee in 2010 to undertake objective reviews on other relevant laws and recommend legislative changes to ensure that the laws in the country would allow for Islamic financial transactions to take place effectively and efficiently.

Another important dimension in fostering the further development of risk and profit sharing instruments is the need to ensure the institutional soundness of the Islamic financial institutions and their enhanced ability to assess risks in the real sector. This underscores the imperative of robust risk management capabilities to manage new risks peculiar to risk and profit sharing contracts and the adoption of strong governance, transparency and disclosure practices within the Islamic financial institutions to meet the due diligence requirements for determining the viability of business and investment proposals.

Business risks of equity positions and ownership risks of underlying assets are, for example, embedded in these arrangements arising from the contractual relationships between the investors and entrepreneurs as well as the Islamic banking institutions as the intermediary of funds. Further in-depth applied research is also needed to develop more innovative financial products using risk and profit sharing structures with the corresponding development of risk management techniques. This also needs to be reinforced by enhanced consumer protection and education initiatives to deepen the understanding and awareness of consumers on the associated risks and rewards in the Islamic financial contracts, in particular for equity-based instruments.

Equally important in ensuring the institutional soundness of Islamic financial institutions is the need for robust liquidity management. Today, Islamic financial institutions operating in the different jurisdictions are still confronted with the challenge of managing their liquidity positions effectively, given the limited supply of high quality Shariah-compliant liquid instruments being the reason most commonly cited. The lack of high quality liquidity instruments for Islamic finance is not only constraining effective liquidity management, but it is also affecting the efficient cross-border diversification of financial flows. It is therefore our hope that through the mandate of the International Islamic Liquidity Management Corporation (IILM) in issuing high-quality liquid sukuks, it will contribute to promoting more efficient cross-border liquidity management by Islamic financial institutions whilst facilitating Islamic financial institutions in meeting the international requirements on liquidity.

Let me conclude my remarks. Whilst the evolution of the global financial landscape is currently being shaped by the need to return finance to its basic functions of serving the real economy, several critical questions remain, the answers to which will continue to have an important bearing on the global agenda to build sound and resilient financial systems that promote sustainable growth. In particular, determining the appropriate size of a financial sector relative to its economy before it becomes a risk to overall financial system and economic stability; promoting conditions that ensure that financial innovation is beneficial to the economy; and enhancing prospects for aligning expectations of capital providers with more sustainable banking strategies present significant policy challenges that will continue to occupy the attention of policymakers going forward.

The global community has made some important strides, but more work remains to achieve an appropriate balance between preserving safety and soundness of the financial system and allowing financial institutions and markets to perform their intended functions. We are not without policy options. The role of macro-prudential policy and the developments in Islamic finance have gained greater prominence in terms of their potential to improve financial stability outcomes, and most notably by the vital contribution that they make towards restoring the foundations for finance that supports sustainable economic growth, and bringing with it immense benefits to the real economy and to the well-being of society.