

## Zeti Akhtar Aziz: Islamic finance and global financial stability

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Seminar on Islamic Finance: During and After the Global Financial Crisis – "Islamic finance and global financial stability", Istanbul, 5 October 2009.

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*"The unfolding events during this global financial crisis have brought to the forefront the issues concerning the stability of financial systems and the robustness and resilience of the international financial architecture. At the heart of the crisis is the breakdown of the functioning of the financial intermediation process and the loss of confidence in the financial system. As the world continues to struggle with the consequent global economic recession and the continued fragile financial system, it has intensified the search for solutions. Indeed, wide ranging reforms are now currently being discussed. The future financial landscape in the aftermath of this crisis is, therefore, likely to be significantly different from the present. In the search for the appropriate reforms, there is a general consensus that we need to return banking to its basic functions – to provide financial services that adds value to the real economy. This in fact represents the very essence of Islamic finance. These are the very elements that are espoused in the Shariah principles that underpin Islamic finance and which explains its resilience during this international financial crisis. As the role and relevance of Islamic finance in the global financial system gains significance, it will not only increase its potential to contribute to global financial stability but also towards strengthening global growth."*

It is my honour to be invited to speak at this **Seminar on Islamic Finance: During and After the Global Financial Crisis**, jointly organised by the World Bank, the Islamic Financial Services Board (IFSB), the Islamic Development Bank (IDB) and the Institute of International Finance (IIF). This seminar takes place at a time in world history that is characterised by an unprecedented global financial instability, that has now precipitated a synchronised global economic recession. Although signs of an impending recovery in the world economy have appeared in the horizon, the pervasively virulent and far reaching repercussions unleashed by the crisis has shaken the foundations of the global financial system. This damage has yet to be repaired and rebuilt. This has sparked the international call for the reform of the financial architecture to one that will best serve the world economy, to one that is more resilient to shocks and to one that would reduce the prospect for future financial crises.

History has shown that there have been more than a hundred distinct banking crises in this recent three decades. There is therefore an even more urgent need to find an enduring solution to ensure the stability of financial systems. The challenge before us is to build a new financial architecture that would allow for the more efficient functioning of not only financial intermediation within national economies but also across borders. Islamic finance, with its emphasis on a strong linkage to productive economic activity, its inbuilt check and balances and its high level of disclosure and transparency offers this prospect. Indeed, inherent in Islamic finance is the explicit elements that address several of the issues that have surfaced in the conventional financial system during the current crisis.

Given the global dimension of the current crisis, the accelerated pace at which it has spread and the severity of its repercussions, it has called for a higher degree of collective determination by the international community to work together towards developing a global strategy that will evolve a financial system that is stable and sustainable over the entire business cycle. As Islamic finance continues to become an integral part of the global financial system, it will increasingly be exposed to risks of financial stress arising from global financial instability and global economic activity. This necessitates a greater global engagement between those that are driving the reform agenda given that it will result in new structures, standards and regulatory regimes for the industry. This is particularly important

when such standards become the basis on which assessments are made by multilateral agencies, rating agencies and the market at large. Such engagement also facilitates cooperation and collaboration in achieving our shared interest of preserving global financial stability.

The combination of indiscriminate lending, excessive risk-taking and overzealous financial innovation were at the root of the current financial crisis. The financial turmoil that first originated in the mortgage market in a number of the advanced economies triggered a broad-based meltdown and subsequent breakdown in the functioning of the financial markets. Despite these developments, the Islamic financial industry has been able to weather this first wave of the global financial crisis, demonstrating its robustness as a stable form of financial intermediation.

The resilience of the Islamic financial institutions during this crisis epitomises the intrinsic strengths embedded in Islamic finance that are underpinned by forces of the Shariah principles. This arises from two essential requirements of Islamic finance – firstly, that the financial transaction must be accompanied by an underlying productive economic activity that will generate legitimate income and wealth, thereby establishing a close link between the financial transactions and productive flows. Thus, in the Islamic finance business model, financing or equity participation can only be extended to activities in the real sector that have economic values. Hence, Islamic financial assets are expected to grow in tandem with the growth of underlying economic activities.

Secondly, that it is based on profit sharing in which there is a mutual risk sharing. Islamic finance, therefore, impels the Islamic financial institutions to undertake the appropriate due diligence on the viability of business proposals and by enforcing the requirement for transparency and disclosure. The role of the Shariah board in ensuring that all aspects of business operation of Islamic financial institutions are in accordance with the Shariah principles, adds another level of oversight which inherently safeguards against irresponsible practices. Embraced in its entirety, these in-built dimensions of governance and risk management contributes to safeguarding Islamic finance from the potential risks of financial stress arising from excessive leverage or speculative activities.

Despite the uncertainties and challenging environment posed by the current crisis, the expansion and development of Islamic financial services industry in global financial system have continued unabated. The dynamic nature of the Islamic financial system is reflected by its solid growth, the increased range of financial products and services and the establishment of new Islamic financial service providers from the different parts of the world including from the non-Muslim world. This increased participation is particularly pronounced in the sukuk market whereby funds have been raised by issuers from various parts of the world. Recent sukuk issuances both in domestic and in foreign currency have attracted interest from a wide investor base from Asia, Europe and the Middle East. These positive developments have been achieved despite the more challenging global financial market environment.

As Islamic finance evolves to meet the changing requirements of businesses and consumers, innovation is integral to the development of new Islamic financial products and services. It is also recognised, however, that unfettered financial innovation can become a major source of instability in the financial system. In Islamic finance, financial innovation must be tested against the “Maqasid al-Shariah” (objectives of the Shariah), where the primary objective is the realisation of benefit to the people. This demands the internalisation of Shariah principles in Islamic financial transactions, both in form and substance. Indeed, the move to embrace Shariah-based innovation brings with it a strong Shariah-compliant culture in Islamic financial institutions. This in turn serves to ensure that the product development process in Islamic finance is grounded within Shariah injunctions which also incorporates ethical value propositions.

Financial innovation also needs to be supported by robust risk management and strong governance practices. It is recognised that sophisticated and complex financial structures

very often result in the failure of consumers, investors and even regulators to understand the risks and leverages embedded in the instruments which in turn results in the lack of transparency and inadequate risk management. In Islamic finance, a prerequisite under the risk-sharing arrangements is having the necessary information to understand the risks that are to be borne by Islamic financial institutions. The explicit risk sharing element between the financier and customer in Islamic finance obligates its participants to evaluate risk profile of the product or investment proposition, the underlying trends in earnings and cash flows, and its income-producing potential. This process also allows the pricing of funds to be adjusted accordingly.

Equally important is the risk management capability of the Islamic financial institution to manage the risks that are peculiar to Islamic financial transactions. Additional capital is for example required to cushion the inventory risks of underlying assets and equity positions that are embedded in partnership contracts, therefore bringing the capital requirements closer to the true economic risks in portfolio of the financial institutions. To manage depositors' expectations and sustaining market confidence, Islamic banks are also permitted to set aside a portion of income derived from assets funded under Mudarabah contracts, in the form of profit equalisation reserves (PER), as a mechanism to address the impact of pro-cyclicality of their returns. This is reinforced by a combination of stronger governance and enhanced transparency to address the trust-based relationships which is a fundamental hallmark of Islamic finance.

With increased globalisation and greater integration of Islamic finance with the international financial system, the higher will be the risk of the contagion effects from other markets and jurisdictions. In addition, Islamic finance will also be affected by the second round effects arising from slower economic growth and the reduction in global liquidity. An essential infrastructure in this environment is a well functioning liquidity management infrastructure to enhance the capacity of Islamic financial institutions to effectively manage their liquidity positions. Of importance, is the wide availability of Shariah-based Islamic financial market instruments to facilitate liquidity management. Such facilities for adjusting portfolio balances in a Shariah compliant manner ensure that the liquidity risks can be effectively managed.

As part of the global collaborative efforts to enhance the efficiency of Islamic financial institutions in managing liquidity at both national and across borders, a Liquidity Management Task Force has been established by the IFSB and the IDB early this year. This work is being further supplemented by ongoing market initiatives by the International Islamic Financial Market (IIFM) which focus in the advancement and the standardisation for Islamic financial instruments for the Islamic capital and money markets. More recently, Malaysia established the Bursa Suq Al-Sila' under the concept of commodity murabahah. This multi-currency and multi-commodity is an electronic exchange traded platform to facilitate the trading and settlement of commodity using crude palm oil (CPO) for liquidity management between Islamic financial centres. Although Malaysia already has a well functioning Islamic inter-bank money market, this platform provides a further alternative for liquidity management, through which global interlinkages in the international Islamic financial system can also be further enhanced.

Integral to the efforts in the development of Islamic finance has been the strengthening of the regulatory and supervisory framework for Islamic finance. In the area of international prudential standards for Islamic finance, the IFSB that was established in 2002 has developed a number of standards ranging from capital adequacy requirements to governance and risk management to assist the Islamic financial institutions in adopting international best practices and standards.

While the basic legal, regulatory and supervisory framework that takes into account the distinctive features of Islamic finance are already in place, there is a need to have a more comprehensive infrastructure to meet the present challenges. Looking beyond the current crisis, there needs to be an integrated crisis management framework as part of this

infrastructure to ensure that any emerging crisis in the Islamic financial system will be promptly and efficiently managed. More facilitative and modernised legal framework is also required to make business more conducive for Islamic finance. In addition, the boundaries of the regulatory framework for Islamic finance would also have to be regularly adapted to keep pace with the evolution and transformation of the financial system. In the case of Malaysia, the comprehensive legal, regulatory and supervisory framework for Islamic finance is further supported by a financial safety net framework that encompasses the lender of last resort facility and a deposit insurance system.

Moving forward, in the aftermath of this global financial crisis there is also a need to have in place the institutional arrangements for resolution of troubled international Islamic financial institutions. In Malaysia, we have also in place a mandated resolution mechanism to provide for expedient, effective and cost efficient resolution of Islamic financial institutions. The current crisis, however, has highlighted the need to have in place a mechanism for cooperation between regulators across jurisdictions for resolution and for containing potential systemic risks beyond the national boundaries. To promote global financial stability in the Islamic financial system, the Taskforce on "Islamic Finance and Global Financial Stability" was established in 2008 by the IDB in collaboration with the IFSB, together with the participation of industry leaders and international experts to examine the development of further building blocks in Islamic financial infrastructure to strengthen its resilience and ability to meet future challenges. Substantive progress has been achieved by the Taskforce and a report including major recommendations is planned for submission to the IFSB Council in November this year. Among the areas covered by the report include the effective implementation and enforcement of the prudential standards, the supervisory framework, the strengthening of the financial safety net mechanisms and the development of an effective crisis management and resolution framework. Among the recommendations in the report will be the establishment of a Financial Stability Forum to address issues of financial stability in the Islamic financial system.

The internationalization of Islamic finance requires the industry to progress into the next stage of international acceptance, with mutual recognition of financial standards and products across jurisdictions. Indeed in the area of Shariah, there has already been progressive convergence of Shariah views and rulings, and the mutual recognition of financial standards and products across jurisdictions. As this continues to occur, it would be a major driver towards greater convergence and harmonization. This has been facilitated through greater engagement among the regulators, practitioners and scholars in Islamic finance across jurisdictions. This interface is important given the common interest of global financial stability.

The announcements following the recent G20 Summit and the associated announcements of the Financial Stability Board reflect the international economic regulatory cooperation that will set the agenda for the conventional standard setting bodies to put in place a framework to strengthen the international regulatory standards. It will also form the basis by which assessments will be made by multilateral agencies such as the IMF. It is therefore important for there to be engagement with the prudential standard setting entities for Islamic finance, not only to raise awareness of whether the new standards being introduced can be applied to Islamic finance and whether modifications need to be made but there could also be possible consequences that are unintended. Equally important is for there to be recognition of the standards that have been issued for Islamic finance specifically by the Islamic Financial Services Board. As a growing component of the international financial system, it becomes important for the interface and engagement with the international standard setting entities to take place given the common interest of global financial stability.

Let me conclude my remarks. While the inherent strengths of Islamic finance have contributed to its viability and resilience, going forward into the future, the foundations for its sustainability as a competitive form of financial intermediation will continue to be strengthened. Concerted efforts are underway focusing on the further development of the

Islamic financial markets, the financial infrastructure, the investment in research and development to support innovation, and enhancing further the legal, regulatory and supervisory framework. Tapping on the advances in technology and the development of human capital are also an important part of the development of Islamic finance. Finally, with greater liberalisation, effective infrastructure is also being put in place for enhancing interlinkages across jurisdictions. An important part of these developments will be for a more inclusive arrangement that would allow for greater interface with the current reform efforts being undertaken in the international financial system. Our vigorous pursuit and commitment to strengthening the resilience of Islamic financial industry would enhance the potential to contribute towards global financial stability and in turn enhance the prospects for global growth.

Thank you.