

Zeti Akhtar Aziz: Islamic finance and financial stability

Opening remarks by Mrs Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the BNM High Level Conference on Financial Stability, Bank Negara Malaysia, Kuala Lumpur, 24 November 2009.

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It is my great pleasure to welcome you to Bank Negara Malaysia Conference on Financial Stability that is being held in conjunction with 15th IFSB Council Meeting and the 3rd IFSB Public Lecture on Financial Policy and Stability. This conference takes place at a time when there has been intense discussion by the international community on the necessary financial reforms at both the national and international level so that we will avoid such global crisis of such a scale in the future. This conference today provide us with an opportunity to reflect on the new challenges that are emerging from this global financial and economic crisis and discuss Islamic finance and the need to ensure not only its resilience but how it might contribute to global financial stability.

Indeed, Islamic finance has a potential role in contributing not only to global financial stability but also towards a more balanced global growth. While Islamic finance by its very nature and its direct link to economic activity contributes to this process, the recognition of the new financial challenges ahead require further steps to be taken to strengthen its resilience and robustness.

In recent months, there have been increasing evidence of strong gains, a rebound in the financial markets with renewed interest in emerging market, active capitalization by banks, and the reopening of wholesale funding markets. While the Malaysian financial system has fared relatively well throughout this global crisis and remaining financially sound, well capitalised and able to withstand the current challenging global financial environment, there are however, many lessons that we can learn from the current international financial crisis to ensure the sustainability of this resilience.

The development of Islamic finance in Malaysia that operates in parallel with conventional finance for almost three decades now has demonstrated its sustainability as a form of financial intermediation. Today, the Islamic banking system has emerged as a vibrant financial system with Islamic banking assets currently accounting for 18.8% of the total banking assets of the Malaysian financial system. The product range has now expanded into an extensive range of innovative instruments while in the Islamic capital market, the sukuk market has surpassed the conventional market in terms of market share. An important aspect that has contributed to financial stability in the overall financial system is the conscious policy to develop a more diversified financial system that allows for the diversification of risks.

Potential of Islamic finance in contributing to global financial stability

This current global financial crisis has prompted a search for 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. 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. At the centre of this recent global financial crisis was the breakdown in governance that led to indiscriminate lending, excessive risk-taking and overzealous financial innovation. This is avoided in Islamic finance with the requirement that Islamic financial transactions must have an underlying economic activity

and that the process of innovation and formulation of Islamic financial products and services must be done carefully and in accordance with Shariah. The crisis has provided an important lesson that the development of new financial instruments embraces this process while being able to effectively compete in the global arena.

Strengthening the Islamic financial system

As Islamic finance becomes an integral part of the global financial system, it has become increasingly exposed to the systemic implications of external developments. There is the risk of the contagion effects arising from financial and economic disruptions that emanated from the conventional markets. The correction of asset prices and the economic contraction following this international global financial crisis has been on an unprecedented scale. Islamic finance is therefore confronted with the risks associated with these second round effects that need to be managed.

This recent financial market turmoil in the advance economies also demonstrated the consequences of liquidity constraints. This has underscored the importance of a strong and well developed liquidity management infrastructure. An important aspect that needs to be urgently addressed in the Islamic financial industry is the need to enhance the ability of Islamic financial institutions to manage liquidity. This requires the development of Shariah compliant financial instruments that facilitate this and a well internationally functioning market infrastructure to facilitate cross border management of liquidity, so that liquidity risks are effectively managed. Malaysia has, for more than a decade now, an efficient functioning Islamic money market which has accorded greater monetary flexibility in the Islamic financial system. While the market is in domestic currency, it has drawn wider participation from the international financial community. 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 was established by the Islamic Financial Services Board (IFSB) and the Islamic Development Bank (IDB) early this year to develop a liquidity management framework.

Integral to the efforts in the development of Islamic finance, is also the strengthening of the regulatory and supervisory framework. The IFSB which was established in 2002 has been instrumental in developing and issuing global prudential standards and guiding principles for the industry. The IFSB has also contributed to the harmonisation in the development of Islamic finance across different jurisdictions. Apart from the implementation of these prudential standards, there is also a need to ensure the supervisory and legal infrastructure remains relevant to the rapidly changing Islamic financial landscape. In Malaysia, these efforts are also supported by a comprehensive financial safety net that includes a deposit insurance scheme and a resolution mechanism, so that not only are depositors protected, but it also allows for prompt, effective and least cost resolution of the financial system that can facilitate recapitalization of Islamic financial institutions as well as institute programme to remove troubled assets from the books of financial institutions.

Greater collective effort by international community to strengthen global financial stability

In the reform of the international financial architecture, the G20 has launched an ambitious agenda to reform financial regulations, which include key main areas namely, (1) the strengthening of international frameworks for prudential regulation, (2) the review of the scope of regulation, (3) the revision of accounting standards; and (4) more effective oversight of the credit rating agencies as well as strengthening risk management.¹ These areas should

¹ Declaration on Strengthening the Financial System by Leaders of the G20, London 2 April 2009.

also be looked at in Islamic finance, which has also to deal with additional issues of harmonised regulation.

The G20 has agreed to establish a new global Financial Stability Board, with a wider group of developed and emerging countries as part of the new international financial architecture. It will be responsible for coordinating banking regulation, developing regulatory and supervisory standards, preparing early warning reports and exchanging information with supervisors. It is important that this forum gives due recognition to Islamic finance given its increasing importance in the international financial system and its potential role in contributing to global financial stability. In the Islamic financial industry, the IFSB is at the forefront of international efforts to increase regulatory cooperation, and encourage common rules and enhanced monitoring of international financial risks. The IFSB and the IDB has an important role in building cross-border consensus and collaboration on the strategic direction for the Islamic financial services industry for better alignment to the objectives of financial stability.

As Islamic finance continues to become an integral part of the global financial system, there is scope for the current framework of cooperation to be strengthened and broadened to address the new challenges that have emerged.

Islamic finance has been inclusive in its development, not only at the national level but also across jurisdictions. At the national level the Islamic financial system provides the full spectrum of financial services from the large multinational corporations to micro-enterprises and to households. At the international level, the development and expansion of Islamic finance become important in strengthening financial and thus economic linkages between emerging economies. It has allowed emerging economies to participate in its development thus increasing the potential to contribute to the rebalancing of global growth as financial flows not only provides support to domestic demand but also to greater trade and investment flows across borders.

Concluding remarks

In this challenging international financial environment, Islamic finance has continued to demonstrate its evolution and strong growth. Islamic finance in its advancing journey today is presented with an opportunity to increase the financial linkages with the broader financial system thereby facilitate a more efficient allocation of capital across borders. Indeed, Islamic finance as an integral part of the international financial system has the potential to contribute to global financial stability and to enhance the prospects for global growth.