Muhammad bin Ibrahim: Financial services industry – opportunities and challenges for Asia and Europe

Speech by Mr Muhammad bin Ibrahim, Deputy Governor of the Central Bank of Malaysia, at the 12th Asia-Europe Business Forum: "The Potential Role of Islamic Finance in Contributing to Global Financial Stability", Brussels, 4 October 2010.

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I am honoured to be invited to speak at this Asia-Europe Business Forum themed "Financial Services Industry: Opportunities and Challenges for Asia and Europe". During a time of global economic challenge and uncertainty, following the recent unprecedented global financial and economic crisis, it is timely for this forum to take place as a platform for business leaders and policymakers across Asia and Europe to reflect on the challenges and to discuss on solutions that can contribute to restoration of global financial stability.

My address has a specific focus on Islamic finance since over the last ten years it has grown phenomenally and it will play an important role in promoting greater global financial stability. In the current search for an enduring solution to ensure stability of financial systems, Islamic finance offers tremendous potential in shaping more resilient financial systems that enables financial intermediaries to function efficiently within national economies and across borders. The much talk about discussions that banking should return to its fundamental functions of providing financial services which add value to the real economy, represents the very principle of Islamic finance that explains its relative resilience during the crisis.

Effects of the 2008/09 global financial crisis and Asia's response

The recent crisis had the global financial system badly shaken with widespread effects of an unprecedented scale across the world. The Asian region has however demonstrated remarkable resilience during the crisis as most countries in Asia entered the crisis period with a sound set of economic and financial fundamentals, mainly attributed to the lessons learned from the Asian financial crisis of the late 1990s. It was painful. It was a bitter lesson. We embarked on a bold reform that fundamentally alters the landscape of our financial system. But the payouts have been tremendous. The governments of the Asian economies have now the flexibility to implement large stimulus, given the strong economy and low public debt levels in the region. Credit flows to the private sector remain undisrupted as financial institutions in the Asian countries were strong and well capitalised. The household and corporate sectors in Asia were also not over leveraged. Furthermore, Asia was not confronted by widespread unemployment. The various reform measures had enabled the Asian economies to build more shock absorbers and reduced the number of shock amplifiers in their economies following the 1997/98 financial crisis. What we have learnt is that there are no short cuts in reforming a broken system. We also learnt that we should always have an open mind in looking at probable solutions. Just like what a good doctor would prescribe, some time, administering bitter medicines are the only way to go.

The international community is now intensifying its efforts to strengthen the international financial system, with the aim to build the foundations for a stronger and more inclusive global economy. In this post-crisis era, the role and relevance of Islamic finance have gained increasing attention. Islamic finance emphasises on achieving socio-economic goals in congruence with the Shariah objectives, thus reinforcing the fundamental disciplines that are essential to preserve financial stability.

Overview of Islamic finance and linkages between Islamic finance and conventional financial system

In this last decade, Islamic finance has evolved to become a complete and competitive form of financial intermediation that serves both Muslim and non-Muslims consumers and businesses. The Islamic finance industry is currently worth more than US$1 trillion and growing at a rate of 15–20 percent annually, with anticipation of further growth to reach US$2 trillion in the next 3 to 5 years, as more countries around the world seek to further develop Islamic finance within their jurisdictions. Its appeal as a competitive and innovative form of intermediation has led a number of established conventional players to enter the Islamic finance industry, thus widening the diversity of Islamic financial institutions and its product range.

Exceptional growth in Islamic finance is registered not solely in the Muslim world, but now spans across the western world and the Asia Pacific region where the growth is driven by commercial and business considerations. The emerging interest in Islamic finance includes countries such as Australia, Germany, United Kingdom, France, Italy, Luxembourg, Hong Kong, Japan, Korea and China, with initiatives in introducing Islamic finance in their financial systems. Such developments would create a dynamic and competitive environment for the global Islamic finance industry.

The development of the Islamic financial system is guided by Shariah principles that form the very foundation which contributes to its overall stability and resilience. Shariah embodies Islamic law with rules and regulations derived from the Quran and Sunnah, or practices of Prophet Muhammad. The intrinsic value propositions embedded in Islamic finance are universal and subscribe to the values of ethical finance and socially responsible investment. In essence, it is a requirement for Islamic financial transactions to be supported by an underlying economic activity, with business and trade activities that generate legitimate profits. This precondition ensures that the funds are channelled into productive economic activity, thus strengthening the link between financial and productive flows. This serves to protect the Islamic financial system against the excesses, in terms of leveraging, imprudent risk taking and speculative activities that were root causes of the recent global financial crisis.

Profit and risk sharing are also fundamental elements in Islamic finance which strengthens incentives for appropriate due diligence to be undertaken to ensure the economic viability of business activity and profits that are commensurate with the risks involved. This in turn increases for greater transparency and disclosure in Islamic financial transactions. Embedded in this arrangement are also good governance and ethics, together with the upholding of the universal values of justice and fairness provide implicit checks and balances in the system.

These very elements of Islamic finance, which are essential features as required by the principles of Shariah, provide an in-built mechanism that enhances the prospects for its soundness and stability. These explicit elements address several of the issues that have surfaced in the conventional financial system during the current crisis, including in particular the breakdown in governance that led to indiscriminate lending, excessive risk taking and irresponsible financial innovations that were motivated by greed and short-term gains.

In Islamic finance, the process of innovation and formulation of Islamic financial products and services must also be done carefully and in accordance with Shariah. As it is recognised that unfettered financial innovation can become a major source of instability in the financial system, financial innovation in Islamic finance must have the primary objective of realising benefits to its users, thus incorporating ethical value propositions. The explicit risk sharing element between the financier and customer further ensures that these mutual benefits are well-supported through requirements for necessary information to be provided to the market on the risks borne by Islamic financial institutions. There is also the governance structure in place, for example, the need for the establishment of Shariah committees at Islamic financial institutions and Shariah audit.

Innovation of competitive Shariah compliant products is exemplified by the sukuk or Islamic bonds which is a significant and vibrant component of the international Islamic financial system. The sukuk are structured based on the specific contract of exchange of Shariah-compliant assets with a risk sharing mechanism between issuers and investors. The sukuk instrument is seen by issuers as an attractive alternative method to raise capital and investors are enthusiastically embracing it as a new asset class in their investment universe.

Dynamism of the sukuk in the Islamic capital market is evident with the large variety of sukuk being structured and issued, including exchangeable, convertible and hybrid sukuk. The sukuk market stands at almost US$130 billion today and is growing at a rate of 40 percent annually. New issuance of sukuk in the global sukuk market has remained robust despite the challenging economic environment, with an increase of 43 percent to US$20 billion in 2009 while linkages with Europe have resulted in a more cautious market in the first half of 2010 which saw decline by about 20 percent in the global sukuk issuance, the trend is expected to reverse with initiatives by the Governments in Asia and the Middle East to raise funds for the implementation of infrastructure development and investment projects.

In Malaysia, the Islamic financial system operates in parallel with the conventional financial system. With a humble beginning of establishing the first Islamic bank in 1983, Islamic finance in Malaysia has evolved to become a comprehensive domestic Islamic financial system, comprising the Islamic banking institutions, the takaful industry, the Islamic money and capital markets. Malaysia's Islamic banking sector grew 20% annually since 2001 in terms of assets and as at the end of June 2010, the share of Islamic banking assets in the total banking sector has expanded to reach 20.9 percent as compared to 6.9 percent a decade ago. Malaysia also remains the world's largest sukuk market, accounting for more than 60 percent of global sukuk issuances. Islamic finance prospers in Malaysia because it is competitive, innovative and in sync with what the market want.

Recent developments of Islamic finance that strengthen its resilience

Significant milestones achieved in the recent decade in the area of international financial infrastructure provides further support for sustainable and orderly development and continued growth of Islamic finance. In 2002, the Islamic financial Services Board or IFSB was established with the role as an international prudential standard setting body for Islamic finance. The IFSB has been instrumental in developing and issuing global prudential standards and guiding principles for the industry.

Further efforts to ensure sustainability of Islamic finance in this new and more challenging environment include the formation of a Task Force on Islamic Finance and Global Financial Stability by the Islamic Development Bank and IFSB. The report by the Task Force was completed in April this year and highlights eight building blocks to strengthen the financial infrastructure of Islamic finance, drawing also on important lessons learnt from the global financial crisis. The building blocks include first, ensuring the effective implementation of prudential standards; second, the development of robust liquidity management infrastructure; third, the establishment of strong financial safety net; fourth, having in place an effective crisis management and resolution frameworks; fifth, further strengthening of the accounting, auditing and disclosure standards; sixth, putting in place an effective macro prudential surveillance; seventh, having credible credit rating institutions and processes; and eighth; enhancing close international cooperation and coordination among countries, which includes capacity building and talent development.

The report further recommends the establishment of an Islamic Financial Stability Forum (IFSF) based at the IFSB as a strategic platform for productive dialogues to promote financial stability in the Islamic financial system. The IFSF would be an important institutional arrangement for the Islamic financial system to interface with the conventional system via the Financial Stability Board. With the growing significance of Islamic finance in the international financial system, this is critical to constructive dialogue and promotes a comprehensive approach in efforts to strengthen global financial stability.

Concluding remarks

Let me conclude. The recent international financial crisis has been a defining event in economic history and its effects will likely cast a long shadow over policymaking in the coming years.

As we enter into a gradual stabilisation and recovery period, policymakers are now faced with the challenge to find an enduring solution to ensure the stability of financial systems. Islamic finance has a role in shaping the future of the global financial system and reinforcing ethical and moral values that are inherent in Islamic finance principles and fundamental towards promoting the stability of the global financial system. Ongoing efforts to further strengthen the resilience of Islamic financial industry would enhance the prospects for global growth and the potential of Islamic finance to contribute towards global financial stability.