

## Halim Alamsyah: Some critical issues concerning the sustainability of Islamic finance development – Indonesia perspective

Speech by Dr Halim Alamsyah, Deputy Governor of Bank Indonesia, presented in the opening keynote session of the 2nd Annual World Islamic Banking Conference: Asia Summit, Singapore, 8–9 June 2011.

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*Bismillahir Rahmanir Rahim*

- H. E. Lim Hng Kiang, Minister for Trade and Industry, Republic of Singapore and Deputy Chairman, Monetary Authority of Singapore
- H. E. Mohd. Rosli Sabtu, Managing Director, Monetary Authority of Brunei Darussalam
- Tan Sri Zarinah Anwar, Chairman of Securities Commission Malaysia
- Distinguished Speakers, CEOs, Islamic bankers, academics and practitioners, Ladies and Gentlemen

*Assalamu'alaikum warahmatullahi wabarakaatuh and very good morning*

It is an honor for me to deliver speech in this *2nd Annual World Islamic Banking Conference in Singapore*, as a platform to discuss issues and efforts required to enhance cross-border connectivity of Islamic finance. As we have seen now, development of Islamic finance are growing very fast in the world, particularly in Asian countries such as Malaysia, Indonesia, Pakistan, and Brunei, as well as in Middle East countries such as United Arab Emirates (UAE), Saudi Arabia, Bahrain, Qatar, and in European countries such as UK and Luxemburg. Hence, collaboration between countries in those regions would potentially very important to boost the expansion of Islamic finance in the world.

*Ladies and Gentlemen,*

Islamic finance has gained a significant global exposure and experienced a phenomenal growth in the last three decades. From only US\$137 billion of the total assets in 1996, it expanded to reach US\$895 billion in 2010.<sup>1</sup> In the near future (2015), the amount will be expected to be US\$5 trillion.<sup>2</sup> With such a progressive development, certainly it needs further commitment especially among countries having Islamic finance industries to maintain and foster their sustainable growth.

Countries in Asia, which I mentioned before, are keen to tap such promising industries and want to become the center of Islamic finance in their region. Many Islamic financial institutions have been established by both foreign and local players and expanded their products and services to cover Islamic finance growing market. As such, in Malaysia, the share of Islamic finance has reached 22% of the total banking industry; Pakistan plans to capture share 12% market share of Islamic banking by 2012 and Indonesia targets 15%–20% market share of total banking industry in the next ten years.

On the other hand, in the Middle East countries, especially Gulf Cooperation Council (GCC) countries, the market share of Islamic finance has expanded to go beyond 15% headed by UAE, Bahrain, Saudi Arabia and Kuwait. Even, some of the local Islamic banks have had overseas branches such as Kuwait Financial House, Al Rajhi Banks, HSBC Amanah, etc. It

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<sup>1</sup> The Financial Express, Bangladesh (23 May 2011)

<sup>2</sup> Moody's Investors Service (2010)

reveals that the expansion of Islamic banks is underway and right now countries like Singapore, Hong Kong, China and Japan have prepared themselves to establish the Islamic finance industry. These are very interesting facts which could further enlarge the number of countries having Islamic finance industries.

With greater economic interdependency and convergency together with more open financial system and capital account regimes in many countries, the new financial system (Islamic finance) have flourished and may become an important catalyst for growth and stability in many countries. For example, Indonesia as a country with the biggest moslem population in the world has only started its Islamic banking industry since 1992. With a liberal banking system regime and regulation, Islamic banking industry has grown very fast and right now it has eleven Islamic banks and 23 Islamic windows including Islamic foreign banks such as HSBC Amanah, Maybank Islamic, and CIMB Niaga Islamic. Although its share currently is still trivial (around 3%) compared with the conventional banks, the industry has shown its resiliency. Furthermore, our research has shown that it has also positively contributed to the expansion of Islamic banking and financial services throughout the country, and enabling more multiplier for future Islamic financial development in the country.

*Excellencies, Ladies and Gentlemen,*

Besides the growing trend of Islamic banks, another promising industry is the Islamic capital market, notable Sukuk market. It emerges in various countries in the Middle East and Asian countries. The recent global Sukuk market has crossed USD134 billion in issuances and Malaysia leads this market with 65% market share followed by Middle East countries with 26% market share and the rest of the world.

However, the tenor of the world Sukuk market is dominated by short term Sukuk tenor which is 55%, while the long term tenor (for example more than 10 years tenor) is only 20%. The Sukuk market in Indonesia is also progressing, with a nominal amount of USD6.2 billion (as of May 2011) and annual growth of 9.3% (2010).

In the near future, I strongly believe that Sukuk will grow significantly as it can be developed to have various forms of contracts with attractive features offering competitive returns and liquidity. In addition, the existences of excess liquidity from surplus savings in Asia and oil revenues countries across Middle East become a potential demand for Sukuk. This opportunity can be used by the government or private companies to issue Sukuk as an alternative financing source. The current positive trend of issuing Sukuk for financing government's infrastructure projects provides a good signal of support from the government that should be maintained.

*Ladies and Gentlemen,*

Through this summit, where the meeting of regulators, practitioners, academics, potential investors and industry experts are possible, it is hoped that the potential of the Islamic banking and finance will be maximized to further improve the current swift development of the industry. In the future, it is expected that Asia will grow to be the next Islamic finance hub, in addition to Middle East. Bridging these two potential markets for developing Islamic financial industry will also contribute to the increase of economic growth in respective regions.

Despite all those success stories and potential growth of Islamic finance, we believe that the road ahead remains challenging. I would like to point out four main issues that can be further discussed in this summit. Firstly, concerning the Islamic financial products. In terms of product development, Islamic financial institutions should develop innovative products that can bring up the uniqueness of Sharia components. Instead of emulating conventional products or adopting Islamic dressing to existing products, industry should move towards creating pure or genuine Sharia products that seek to bridge the financial sector with real sector.

I believe the strength as well as the uniqueness of Islamic transactions lies within the profit-loss sharing mechanism, provision of underlying assets and commitment to promote real sector. However, in general, the record of Profit-Loss Sharing (PLS) transactions in Islamic banking industries across countries are still relatively low. I strongly believe that increasing portion of profit-loss sharing transactions, such as *mudharabah* and *musyarakah*, will be beneficial for both the financial sector and the real side of the economy and will eliminate decoupling or detachment effect between two sectors, a situation that was behind the recent global financial crisis.

Another issue related to product development is about product codification. At the moment, as you all know, there are different acceptations or agreements of *fatwas* concerning the approval of certain products. In other word, there are still some unresolved issues in *fiqh muammalah* for certain sharia products. While such differences are well understood and in Islamic tradition are well accepted, we still need to step up our efforts to make product codification as an international efforts as it will certainly have very positive benefits in promoting and facilitating sharia product developments and innovations. Product codification provided by international institutions will reduce the gap and promote products harmonization among the countries.

*Excellencies, Ladies and Gentlemen,*

Secondly, concerning the legal infrastructure and regulatory standard for Islamic finance. As mentioned above, product structured based on Islamic principles is, by nature, different from its conventional counterparts. Hence, it requires a dedicated legal framework confirming with Sharia principles. The existing law is not sufficient in solving disputes concerning the Sharia transactions. The availability of an appropriate legal infrastructure is particularly important for the development of Islamic financial institutions, especially in creating a more conducive environment for sharia transactions to grow efficiently. Perhaps, legal framework is one of the most important challenges in developing Islamic finance since so far only a limited number of countries have issued specific laws governing Islamic finance and dispute settlement, including cross border resolutions.

In addition to the availability of legal framework, development of Islamic finance also needs global regulations and standards. The existence of global regulations and standards is essential to promote cross-border transactions and foreign participations in the development of Islamic Finance in Asia and other regions. Currently, we already have several international institutions, such as IFSB and AAOIFI which have authority to issue regulations and standards. The role of those institutions should be enforced and improved. Moreover, it would be better if every country that develops Islamic finance voluntarily adopt those regulations and standards.

For instance, Islamic finance regulator in each country is encouraged to adopt voluntarily risks management standard released by IFSB. Again, due to its uniqueness, we should not apply the same approach of assessing risks in Islamic finance in a similar way with conventional institution. For example, profit-loss sharing portfolio may expose the bank from the loss incurred by the third party. Hence, Islamic financial institutions should adopt suitable global regulations and standards. It will create regulations uniformity that will spur harmonization and further integration of global Islamic finance.

My third point will be about Islamic Financial Stability. If we, who are part of Islamic finance community, work together in developing financial products which truly confirms to Sharia principles, complemented by appropriate legal framework, regulations and standards, *Insyah Allah*, this creation of "genuine" Islamic financial system would be able to reduce systemic risks and continue to become resilient to any financial shocks. As mentioned earlier that increasing portion of profit-loss sharing transaction will reduce the potential bubble in the economy and decoupling problem between financial sector and real sector.

The fourth point is about "real rate of return" references. Besides beneficial in creating and maintaining stability, we also believe that profit-loss sharing, the spirit of Islamic finance,

would give more fair return to all parties (funds owner, financial institution, and borrower). The return distributed to all parties should be a real result of business activities in the economy. However, at the moment, Islamic financial institutions seemingly tend to refer their rate of return to conventional rate of return (interest rates). Conceptually they should refer to the real rate of return in the economy. Unfortunately, currently there is no valid reference available about the real rate of return. Therefore, international Islamic institutions and countries regulator need to collaborate to study about the real rate of return that will become a reference for Islamic financial institutions in determining return, instead of referring to conventional interest rates.

*Ladies and Gentlemen,*

Beside those four main issues, I would like also raise two additional challenges regarding liquidity and human resources. Most of us aware that currently Islamic financial markets have limited instruments and restricted access to short-term funding options in raising liquidity as compared to conventional markets. We should think of methods to enhance Islamic liquidity market based on contracts consistent with Sharia principles. A caveat for such initiative will be, to carefully identify and structure the instrument for the purpose of raising liquidity only and not for the tools for speculation.

The emergence of global money market will reduce the reliant of Islamic financial institutions in mirroring the techniques regularly use by conventional banks that are still within the grey area and debatable in terms of its Sharia compliancy. Hence, Islamic finance can maintain its reputation as the sector linking financial intermediary and real sector and slowly close the door to a heavy use of leverage that once led to Global Financial Crisis.

Related to human resources issues, we understand that the fast growth of Islamic financial institutions so far isn't followed by sufficient supply of human resources. In Indonesia context, the tremendous acceleration of Islamic finance industry has created human resources supply gap of more than 30.000 people recently. I believe the same phenomenon can also be observed in many countries. In order to fill the gap of human resources supply, establishing international efforts to tackle the issues and involving more formal and informal institutions teaching Islamic finance can be one possible solution. Moreover, the well-trained and well-experienced pool of talents in more developed Islamic markets should open for learning exchange program facilitated by other countries with a strong international cooperation and engagement, more widespread supply of well-versed and skilled human resources will further foster the market growth given the rising demand for Islamic products and services.

*Excellencies, Ladies and Gentlemen,*

Let me close my speech by highlighting that Asia has bright prospects in Islamic banking and finance industry. In order to escalate the existing growth and trajectory to a next level, I sincerely hope that all parties, from the region and overseas to jointly explore new growth opportunities in Islamic banking and finance in this region.

I wish you all to have an enriching and fruitful discussion and hope that we can contribute to the development and multiply the growth of the industry. May Allah Almighty bestow us the strength and patient to persevere in fulfilling our duty for a better future.

*Thank you for your kind attention,*

*Wassalamu'alaikum warahmatullahi wabarakaatuh*

Dr. Halim Alamsyah