

Zeti Akhtar Aziz: The new Islamic finance landscape

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Islamic Financial Intelligence Summit (IFIS) 2011 “The new Islamic finance landscape”, Kuala Lumpur, 15 November 2011.

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This decade has witnessed dramatic changes in the Islamic financial landscape. As a dynamic industry, Islamic finance is responding to the forces of change emanating from the changing requirements of the real economy, the changing pattern and pace of globalisation and the wide spread financial reforms being undertaken at both the international and national levels. This transformation of the Islamic financial system is also taking place during the most challenging of times as the world enters the fifth year of the global financial crisis. A central aspect of the new Islamic financial landscape is also the increased focus on financial stability to enhance further its potential as a form of financial intermediation in an increasingly more challenging environment.

It is my great pleasure to join this Islamic Financial Intelligence Summit organised by “The Banker” held this year in Kuala Lumpur, in association with Bank Negara Malaysia to speak on the subject on the “New Islamic Financial Landscape”. This event which is being held for the first time outside London brings together practitioners from the financial community from different parts of the world. While the focus of this Summit will be on Islamic finance, it is inevitable that the discussions today will touch on the recent developments in Europe, given the potential impact it may have on the rest of the world and the need to implement strategies and policies for coping with the consequences of these developments.

While the financial solutions being implemented in managing the crisis and the measures being introduced to mitigate the impact of the crisis by the rest of the world is important, it can only provide temporary relief. It is the structural policies and reforms that are more challenging to undertake that will ensure fundamental financial stability and a long lasting self sustaining economic recovery.

My remarks today will focus on the changes in the Islamic financial landscape and its increased potential to contribute to sustainable growth, increased international connectivity following the increased pace of internationalisation of Islamic finance and new developments to achieve financial stability in the Islamic financial system. The changing financial landscape and the accelerated expansion in Islamic finance have also resulted in changes in the nature of the supporting ancillary services, including education that is being provided for the business and financial sectors.

Islamic finance and fostering sustainable growth

As the Islamic financial system evolves to become more diversified and more comprehensive to meet the changing requirements of the real economy, it is increasing its potential to fostering sustainable growth. Given that the inherent principle of Islamic finance requires that financial transactions be accompanied by underlying economic activity, it already ensures the close link between the expansion in financial assets with the real economy. As the Islamic financial system transitions from being banking centric to becoming more diversified and comprehensive, it has been able to provide the spectrum of financial products and services to the range of activities in the economy, as required by small businesses to conglomerates, and by households to the high networth individuals.

The development of intermediaries that previously was dominated by banks now comprises the range of financial institutions that also includes investment banking, specialised banking institutions, takaful, capital market intermediaries and microfinancial institutions. Financial

markets, including the Islamic money and sukuk markets have been instrumental in intermediating funds in the Islamic financial system. The Islamic money market not only facilitates liquidity management but also the implementation of monetary policy. The sukuk market has facilitated the raising of funds by businesses, while providing investors with a range of instruments for investment, thereby facilitating the mobilisation and allocation of funds to productive economic activity.

Accompanied by research and development, innovation has intensified. Islamic finance however has the governance arrangements which require the approval process by the Shariah advisories. This ensures avoidance of the creation of financial instruments that have its origins from other financial instruments. A further principle of profit sharing and hence risk sharing also ensures a high degree of transparency and disclosure, thereby a greater shared responsibility on the viability of the products.

The rapid expansion of Islamic finance is reflected in more than 600 Islamic financial institutions operating in more than 75 countries in centres that are now beyond Muslim jurisdictions. Indeed, Islamic finance is increasingly becoming part of the growth strategies of an increasing number of global financial institutions. New horizons are also fast emerging following legislative and regulatory changes in several non-traditional markets that have now emerged as the fastest growing segment in the international financial system. In fact, the Banker's latest 2011 Top 500 Islamic Financial Institutions report being released at this Summit shows that the global Islamic finance industry continues to experience double digit growth of 21%, with the Shariah compliant assets now breaching the USD1 trillion mark.

The rapid expansion of Islamic finance essentially reflects its ability to meet the changing requirements of the global financial community and its competitiveness. The elements of checks and balances in Islamic finance that promote accountability and transparency enhances its potential as a stable form of financial intermediation. There is also a growing recognition that the inherent tenets of Islamic finance are aligned with the sustainable dimensions of ethical finance and responsible financing.

As the new financial landscape emerges, it has also been accompanied by the development of ancillary support services that include legal, accounting, taxation and Shariah advisory. In addition, there is the development of Islamic indices, information repositories and consultancy services. In the areas of human capital development there is a proliferation of programmes and certifications that focus on Islamic finance. Malaysia is committed in this pursuit and has put in place a comprehensive talent infrastructure in Islamic finance with the aim of meeting the increased demand for practitioners by the global Islamic finance industry. Dedicated institutions of learning such as the International Centre for Education in Islamic Finance (INCEIF) and the Islamic Banking and Finance Institute (IBFIM) have been established to focus on education in Islamic finance.

Increased international connectivity and Islamic finance

Despite the continued strains experienced in the economy and the international financial system, it is important to recognise the fundamental long-term global transformation that is taking place. In this recent decade, the concurrent rise of the emerging economies is resulting in a fundamental realignment in the global landscape. This transformation is characterised by the shifting balance of global economic strength to the emerging economies, with its significant implications on the global economic and financial flows. The international financial landscape will also be inevitably transformed with the distribution of financial centres becoming more dispersed. Increasingly, new centres of financial activities will likely to emerge. In addition, financial system inter-linkages – particularly among the emerging economies – will deepen, supported by the increased global trade and investment that is already taking place. With considerable capacity to meet large investment requirements, opportunities therein lie in the more effective and efficient channelling of the

sizeable surplus funds towards the vast productive investment opportunities within and across the emerging economies.

These trends are being reinforced by the rapid expansion of financial institutions in emerging economies that have ventured beyond national borders. Financial institutions from the emerging economies have grown significantly in size and strength in this recent decade to now account for almost half of worldwide financial industry market value. Eight out of the twenty largest global banks, including the top two, are emerging market financial institutions. As the emerging market financial institutions continue to regionalise and internationalise, their role and importance can be expected to further expand. Another key development is the integration of financial markets amongst emerging economies, driven in part by the increased economic inter-linkages and the increased liberalisation trend in the financial sector.

The rapid internationalisation of Islamic finance is reinforcing this trend and has enhanced the economic and financial connectivity between the emerging economies. The high level of savings and wealth accumulation in several of the emerging economies, including in Asia and the Middle East, need to be effectively channelled towards productive investments including for large infrastructure development. In this environment, Islamic finance has emerged as a viable and attractive form of intermediation including financing of large scale infrastructure projects. Recent examples include the USD500 million Islamic Infrastructure Fund established in 2009 by the Asian Development Bank (ADB) and Islamic Development Bank (IDB) to meet the Shariah-compliant financing needs in the member countries.

In addition, the advancements achieved in the sukuk market also provide evidence on the ability of Islamic finance in meeting the requirements of the differentiated demands of the modern economy. The recent issuance of the world's first offshore RMB sukuk by Khazanah Nasional in Malaysia reflects the growing trend of multi currency sukuk issuances in Asia. Growing at an average annual rate of 40 percent, the global sukuk market has demonstrated its ability to effectively intermediate funds across borders, allocating funds efficiently in the international financial system and fast becoming an important financing and capital raising option.

Islamic finance and financial stability

An important aspect of the new financial landscape is the increased focus on financial stability. The more market oriented systems with market-based finance activities, the creation of new financial instruments and an increasing number of market participants with global reach, and more interconnected financial systems has expanded the potential for, and channels through which, financial shocks are transmitted to the economy and across borders. Indeed, recent experiences with crises have also shed new insights into the complex web of relationships that exist between sovereign, financial and economic risks, and underscored the critical importance of strengthening the pillars of financial stability that can serve to contain the impact of a crisis.

The increased focus on financial stability has several implications for the new financial landscape. The most significant will be the fundamental changes in the regulatory environment. These include changes to institutional arrangements for oversight of the financial system – both at the international level and within national borders in a number of countries, significantly strengthened prudential standards with a focus on building stronger capital and liquidity buffers, increased transparency in financial transactions and exposures, and enhanced options to resolve failed financial institutions.

Much progress has already been made by the Islamic Financial Services Board in promulgating an extensive set of prudential standards for the Islamic financial services industry since its establishment in 2002. The IFSB has already introduced standards for capital adequacy, risk management, corporate governance and Shariah governance. This important work has been significant in promoting international uniformity of the regulatory

framework and international best practices for the Islamic financial system in different jurisdictions. The IFSB has also established a facilitative platform to promote overall financial stability through the Islamic Financial Stability Forum (IFSF) that serves as an avenue for cross-border engagement amongst regulators.

The important goal of strengthening the foundation of the global Islamic financial system has also been reinforced further following the recent global financial crisis, through the work of the IFSB-IDB Task Force of Islamic Finance and Global Financial Stability. In its report that was released in 2010, **eight building blocks** were identified to manage potential risks and vulnerabilities to the Islamic system. These include steps that need to be taken for the implementation of the prudential standards; the development of a liquidity management infrastructure; the introduction of strong financial safety nets; the development of an effective crisis management and resolution framework; the development and implementation of accounting, auditing and disclosure standards; the formulation of an effective macro prudential framework; the development of credible credit rating institutions and processes; and finally, to strengthen efforts for capacity building and talent development for the Islamic financial services industry.

Following these recommendations, this year, the International Islamic Liquidity Management Corporation (IILM) was established to strengthen the liquidity management of Islamic financial institutions. This initiative represented a collaboration between 10 Central Banks and 2 multilateral development institutions. Its aim is to enhance the availability of liquid Shariah-based Islamic financial market instruments – a crucial step in promoting more efficient cross-border liquidity management for Islamic financial institutions to support increased cross-border flows.

Cumulatively, these efforts will build a solid foundation for the orderly growth and development of Islamic financial system that will contribute to its continued resilience and the overall stability of the global financial system in a way that better serves households and businesses.

Going forward, it is important that the international standard setting process allows and continues to promote the more effective integration and exchange of perspectives between Islamic and conventional finance to ensure a coherent global framework that is consistent across similar risks, promotes a better understanding of risk interactions between conventional and Islamic finance activities, and accelerates progress towards best practices based on the sharing of research, experiences and frameworks.

Conclusion

Let me conclude with a statement from this year's Per Jacobsson Lecture given by Sir Andrew Crockett on what should guide us in our "efforts to devise a new and stronger financial system". "It should be global, it should be robust, it should be an effective servant of the real market economy". This is what the new Islamic financial landscape has evolved to achieve. With its inherent close links to the economy and its trend towards internationalization and the robust institutional arrangements and regulatory standards being introduced and implemented, it will indeed enhance the potentials for Islamic finance to not only serve the economy but to achieve sustainability in this more challenging environment.