Ravi Menon: The next phase in Islamic finance

Opening address by Mr Ravi Menon, Managing Director of the Monetary Authority of Singapore, at the 3rd Annual World Islamic Banking Conference: Asia Summit (WIBC Asia 2011), Singapore, 5 June 2012.

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Dr Ahmad Mohamed Ali Al-Madani, President, Islamic Development Bank,

Your Excellencies, distinguished guests, ladies and gentlemen, good morning.

And to all our foreign guests, a warm welcome to Singapore.

An increasingly difficult conjuncture

We are meeting here for the 3rd Annual World Islamic Banking Conference Asia Summit, at a time of increasing stress in the global economy and financial system.

- The effects of monetary stimulus, which had helped to support the economy and prevent a full-blown financial crisis, are now levelling off in both the Eurozone and the US.
- The labour market remains a significant drag on growth in the advanced economies. Unemployment has hit new highs in the Eurozone while employment and production numbers in the US are showing signs of weakness.
- The story of a two-speed global economy is coming under strain, with demand weakening across emerging Asia. The moderation in China's economic growth appears to be somewhat sharper than expected. India is undergoing an even more pronounced and broad-based slowdown.

But the key risk that has increased in recent months and poses the biggest threat to global economic prospects is the situation in Europe.

- Greece is preparing for a historic election that may well decide its future in the Eurozone.
- Spain is experiencing severe strains in its banking system against a backdrop of a sharp reduction in GDP, high unemployment, and a deteriorating real estate sector.
- Italy and Spain are facing higher sovereign borrowing costs that threaten fiscal sustainability.

To be fair, Eurozone governments have been taking extraordinary measures to help stabilise the situation, reduce fiscal deficits, and restore growth. But they have reached a turning point where bolder, decisive actions will be needed to reverse the tide. The next few weeks and months will be critical.

Islamic finance: challenges to overcome

Let me turn now to the subject of our conference. Islamic finance has shown remarkable resilience during the last five years – perhaps the most challenging economic environment in the post-war era. The industry has grown by an estimated 20% annually in the last five years to reach US$1.3 trillion in total assets in 2011. Islamic banks have grown both in number and in scope.

But the sustained growth of Islamic finance is in no way guaranteed. For Islamic finance to continue thriving, the industry has to overcome a few key challenges. But in every challenge, there is also opportunity. Let me highlight three of them this morning.

Islamic finance in the era of deleveraging

The clear and present danger to all financial activity, including Islamic finance, is the risk of contagion from an escalation of the Eurozone crisis. Islamic finance is closely intertwined with underlying economic activity and will be affected by the impact of slower global growth. Contagion from the Eurozone has already curtailed economic growth and capital inflows to many emerging economies where Islamic finance has taken root. Potential spillovers from an escalation of the Eurozone crisis could lower output in the Middle East and North Africa region by about 3¼ percent relative to baseline, the largest spillover effect for any region outside Europe.

But Islamic finance has a window of opportunity in the current climate of deleveraging in the global financial system. With its strict prohibition on excessive leverage, Islamic finance has been spared the worst of the financial crisis. Islamic banks are well positioned to reach out to new customers who are in need of financing as many global institutions pull back on their lending due to the need to repair their balance sheets.

Islamic finance should diversify into growth areas such as trade and infrastructure financing, where demand is still strong, especially in emerging economies. With a focus on supporting real productive activities, Islamic finance is naturally compatible with trade and infrastructure development. Tapping these sectors also brings about greater diversification benefits, especially for Islamic institutions which have been hurt by their significant lending exposure to the real estate sector.

Islamic finance and global regulatory reforms

A second factor that Islamic finance will have to contend with is the ongoing global regulatory reforms. The scale and scope of these reforms are probably unmatched in recent history. Islamic financial institutions will have to devote considerable resources to meet the new international standards.

But there are certain inherent characteristics of Islamic finance that will stand it in good stead in the emerging regulatory environment. Take for example, banking, where the emphasis of regulatory reform is on more capital and more liquidity. Islamic banks have consistently held higher levels of capitalisation vis-à-vis conventional banks, by some 2.5 percentage points on aggregate, according to research from the World Bank. Islamic banks also start off with a higher level of liquid assets compared to their conventional counterparts.

Islamic finance is also well placed to meet the increased “return-to-basics” investor demand. Following the global financial crisis, investors have become more averse to the unknown risks embedded in complex financial instruments. Islamic finance, with its stronger emphasis on transparency, price certainty and risk-sharing, can benefit from this renewed demand for more basic investments, from Muslim and non-Muslim investors alike.

Integrating Islamic finance with global finance

The third, and perhaps most important, challenge that Islamic finance must overcome is its present fragmented state. Islamic finance currently suffers from low economies of scale. The overall size of Islamic assets is still less than 1% of the global financial system. Being smaller and relatively young, Islamic finance currently offers fewer product choices for consumers and less comprehensive risk management options for institutions. Cross-border investment flows are also constrained by differing interpretations of permissible transactions under

Shariah principles. The isolated pools of Islamic liquidity in each market restrict opportunities for more efficient allocation of capital across consumers, industries, and jurisdictions.

Islamic finance must become more integrated with the global financial system. The industry must expand beyond its traditional markets to include a wider range of financial institutions, investors and consumers. This means Islamic finance must strike roots in the key international financial centres of the world. These centres can contribute to Islamic finance in several ways.

First, market liquidity. The broad and deep investor pools in international financial centres offer an opportunity to channel non-traditional sources of funds into Islamic finance. In Singapore, for instance, several local and foreign issuers have successfully tapped the capital markets using Islamic instruments. The demand comes from not just Singapore but a diverse group of international investors across Asia and Europe. Many of them are conventional investors, attracted by the credit quality and yields.

Second, capabilities in global financial markets. Islamic finance should leverage on the capabilities and strengths offered by conventional financial markets in international centres, to augment the range of Shariah-compliant products. Take for example the market for Real Estate Investment Trusts, or REITs. Singapore has grown over the past decade to become the largest REIT market in Asia outside of Japan. Building on this strength, players in Singapore have established the world's largest Shariah-compliant REIT, which draws in conventional and Islamic investors around the world.

Third, opportunities for interaction and collaboration. As Islamic finance gains prominence, conventional financial institutions increasingly want to be involved to tap these opportunities. Financial centres like Singapore serve as intersecting nodes where Islamic financial institutions collaborate with their conventional partners to jointly grow the industry. By applying the same regulatory framework to both conventional and Islamic financial institutions, Singapore aims to encourage financial institutions here to grow their suite of products and services for the Islamic finance industry.

Conclusion

Let me conclude.

Islamic finance has come a long way. As it embarks on its next phase of growth, the industry must overcome the challenges posed by slower growth and global deleveraging, and build scale and reach critical mass. This requires financial institutions, regulators, and international standard setting agencies to work closely together. Forums like these are ideal platforms.

I wish you fruitful discussions. Thank you.