

Zeti Akhtar Aziz: Islamic finance in a challenging economy – moving forward

Opening address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the 2nd International Shari'ah Research Academy for Islamic Finance (ISRA) Colloquium 2012 "Islamic finance in a challenging economy – moving forward", Kuala Lumpur, 27 November 2012.

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Islamic finance has experienced its most rapid pace of development and growth in this decade, signifying its dynamism and resilience as a form of financial intermediation. This has taken place in a highly challenging international financial and economic environment. It is estimated that the global Islamic finance industry will remain on this growth trajectory, with the continued expansion of Islamic financial institutions, including in new jurisdictions, and with the growing significance of financial markets in the Islamic financial system. Increased liberalisation and greater foreign participation in the Islamic financial markets are reinforcing this trend and resulting in increased cross border financial flows. This is contributing to increased international financial and economic linkages between nations, particularly among emerging economies.

During the recent global financial crisis and its aftermath, the international financial system has experienced a series of unprecedented financial meltdowns and disruptions. During this period, the Islamic financial industry has generally weathered these challenging financial and economic conditions. In relation to this, Islamic finance highlights the importance of basic banking and the need to have a clear separation from higher risk-taking activities. It therefore has limited exposure to highly leveraged activities, such as complex derivatives and structured credit instruments. Indeed, Islamic finance emphasises a close link between financial transactions and real economic activity. Islamic finance thus serves the real economy. The recent financial crisis has therefore led to a greater appreciation on the distinct nature of Islamic finance in addition to its explicit in-built strengths that supports financial stability.

These foundations have been reinforced by the global efforts taken to strengthen the international financial architecture of Islamic finance to safeguard financial stability and thus its sustainability. In the recent years, the intermediaries have also gained scale and the financial markets have gained depth and maturity. Among the institutional arrangements in the international Islamic financial system, is the establishment of the Islamic Financial Services Board in 2002 to set prudential standards while earlier in 1990, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) was established to set the accounting standards for the financial industry. Various jurisdictions have now undertaken legal and regulatory reforms to pave the way for the offering of Islamic finance in their respective countries while ensuring attention to sustaining financial stability. These developments have been particularly important to the recent intensification of the internationalisation of Islamic finance which in turn contributes towards building bridges and forging greater linkages among a wider range of economies.

Transitioning into the next stage of growth of Islamic finance

It is of no doubt that we are now facing the most challenging economic and financial environment in decades. Given that the pace of the internationalisation of Islamic finance has accelerated during this period, it has heightened the urgency to chart the next phase of development of Islamic finance to ensure that financial stability continues to be preserved and that the financial system continues to serve the economy. Its resilience during the global financial crisis should not result in complacency. As we move forward, there are three key imperatives in addition to the efforts to ensure financial stability for the industry and to the continued development of the financial system.

First is the need to highlight with greater clarity the value proposition of Islamic finance so as to ensure that it remains a form of financial intermediation that serves the real economy and that it will continue to be a benefit to society. This requires the development of financial products and services that manifests the value propositions of Islamic finance, and that such products are marketed with simplicity so as to facilitate a greater understanding of the main benefits of the products. In relation to this, Islamic finance presents significant appeal to the growing Socially Responsible Investment (SRI), sustainable investments and ethical finance. This is particularly relevant in the context of the recent global financial crisis. It has brought to the forefront the need for the financial system to be linked to the economy and for the need for greater and improved levels of transparency, fairness, ethics and social responsibility in modern finance.

Beyond financial returns, SRI also accords primary consideration to the impact on economic activity and on the broader society, thereby incorporating the important dimensions of environmental sustainability, social responsibility and governance. This is in close parallel with the inherent principles of Islamic finance, in which financial transactions must be underpinned by real economic activities, and its operations are guided by the principle that money should also be used to create social good.

The SRI market is also fast growing. It is expected to become a mainstream asset class by 2015, reaching a projected total of more than 26 trillion US dollars of asset-under-management, accounting for 15 to 20 percent of the global market. This recent growth has largely been driven by the demand from institutional investors which are increasingly prioritising the consideration of sustainability and social responsibility in their business conduct and institutional value system. Indeed, the ongoing economic challenges in the major advanced economies have resulted in the re-emphasising of the importance of growth that is sustainable and responsible. In the emerging economies, this is also important, given that rapid economic development also needs to ensure that the progress will be sustainable.

The recent growth of Islamic finance has also been fuelled by a sustained phase of innovation. This has resulted in the development of a wide range of Shariah-compliant financial solutions to meet the differentiated needs of consumers and businesses in the global economy. To sustain this trend, further in-depth applied research is needed to develop more financial products that create closer links between Islamic finance and real economic activity, in terms of its operating models, risk management and supporting infrastructure. This includes more innovative risk sharing products and to evolve from the common structures of Islamic financial products to the more unique structures with greater growth opportunities.

This trend is already apparent in the sukuk market. There has been the issuance of several new and innovative structures in this segment, with unique underlying features that has drawn significant global attention. This includes the recent issuance of the first Renminbi (RMB) 1 billion sukuk with airtime vouchers as its underlying assets and the debut issuance of a “green” sukuk by France. Another high-potential segment is the Islamic fund industry. Its recent growth momentum has spanned more than 36 countries, including markets that are relatively new to Islamic finance, such as Australia and Ireland.

The second imperative is for the outreach of Islamic finance to be inclusive and to be accessible to all, particularly the lower income groups and small businesses. An important agenda in the global economy is to achieve a more balanced growth with reduced income disparities. Financial services has a tremendous role in contributing towards a more equitable economic growth and a more sustainable development. In relation to this, Islamic financial institutions need to strive to enhance the access of their financial services to all segments of society. This imperative translates into the need and demand for more Islamic microfinancial products. In emerging as a new market niche, Islamic microfinance would meet the differentiated demands of low income communities and provide support to entrepreneurial activities. Its strong value proposition reinforced by financial inclusion would

result in significant potential to uplift the economic performance and development. Furthermore, Islamic microfinance, if supported by microtakaful, has the potential to provide a more comprehensive, sustainable and accessible financing and protection solution for the lower income groups and small businesses.

Access to financial products and services enhances the potential to thrive and to generate growth and employment. Investment in talent development and research activities for this purpose can thus contribute towards evolving a more inclusive Islamic financial system. This is also within the paradigms of development and welfare in the Islamic context, as the Islamic finance model is also designed to be relevant to social welfare and economic development of not only the under-privileged communities, but also of contributing towards intensifying the progress of low income countries in the world.

Thirdly, is for the effective dissemination of information to facilitate the standardisation and harmonisation process in Islamic finance. Several developments in this recent decade have facilitated standardisation and harmonisation in Islamic finance. The extensive engagement related to setting the prudential standards for Islamic finance by the Islamic Financial Services Board (IFSB) has facilitated consistent implementation of regulatory and supervisory standards. There has also been greater international dialogues between global Shariah scholars through several platforms and structured forums. This greater engagement facilitates convergence in interpretation and the greater leverage on technology for the active dissemination of information at real time further facilitates the harmonisation process. The next stage however is the need for more efficient information dissemination that would promote greater market transparency, price discovery and industry insights.

The development of the Islamic Financial Knowledge Repository Portal by ISRA that will be launched today will be an important effort that can contribute to meeting this objective. As a knowledge database it centralises Shariah rulings and its justifications, legal and regulatory requirements. This is enriched by the latest collection of research and development in Islamic finance. This database will become an important source of reference and guidance for Shariah and industry practitioners, policy makers, researchers and academicians. This initiative by ISRA will not only promote greater understanding but mutual respect and recognition of Islamic finance.

Concluding remarks

The global Islamic finance industry is transitioning to its next stage of development and will stand to benefit from an enhanced universal appeal with a wider consumer and business segment, greater financial inclusion and harmonisation through increased research and development and more effective dissemination of information. A strong culture of applied research and development in Islamic finance that promotes innovative financial engineering, through practical and useful applied research findings is an integral part of industry-building efforts to support the industry's growth.

Greater collaboration will be important to create greater synergy of expertise in applied research and development in Islamic finance. Initiatives by industry associations collaborating with local and international research institutes and academia to seek for new global research findings and breakthroughs will enhance the potential for increased product development activities.

This Colloquium that is organised by ISRA following the success of the inaugural Colloquium last year, to discuss the new research findings for the various segments of the Islamic financial industry with the expectation that it will contribute to opening new horizons for the future development of Islamic finance.

On this note, let me wish you a productive and successful Colloquium. I would also like to congratulate ISRA on the launching of its new Islamic Financial Knowledge Repository.