Zeti Akhtar Aziz: Regulatory and governance for Islamic finance

Speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Brunei Darussalam Islamic Investment Summit 2013 "Regulatory and governance for Islamic finance", Bandar Seri Begawan, Brunei, 19 June 2013.

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It is my great pleasure to be here in Brunei Darussalam to speak at this Islamic Investment Summit 2013. My remarks today will discuss the current landscape of Islamic finance in Asia in the context of the growing role of Asia in the global economy, and the important priorities for Islamic finance to strengthen its prospects for future growth and stability.

Asia and the global economy

The global economic landscape is now significantly evolving as it progresses towards a new more multi-polar world. This is being shaped by the increasing contribution of emerging economies to global economic growth, with some of the most vibrant and dynamic emerging economies being in the Asian region. In 2012, the Asian region contributed 56% to global growth. This advancement takes place at a time when the world economy continues to be significantly challenged by the lingering effects of the 2008 global financial crisis, with a sustainable economic recovery yet to be secured.

Asia's growth trajectory has been underpinned by several favorable fundamentals, which will continue to support its prospects for growth going forward. Asia is a highly diverse region in terms of its economic and demographic structure, market size, stage of development, and political systems. This provides immense opportunities for the region to leverage on its complementarities to boost economic growth.

Being the most populous region in the world, Asia's favourable demographic structure, comprising a significant young population and a rising middle income segment, constitutes a huge and growing consumer market. The unlocking of this potential growth has also been advanced through wide ranging policy initiatives to promote higher consumption demand. The measures have essentially aimed at strengthening the social welfare system through increased arrangements for healthcare and retirement, and improving the macroeconomic environment and reducing the income gap. These measures collectively seek to support domestic drivers of growth thus making the development process more inclusive and sustainable.

In parallel with these measures is the drive towards urbanization and the infrastructure development in the region. The Asian Development Bank has estimated that Asia needs to invest a total of USD8 trillion to fund infrastructure development such as rail networks, airports, power networks and water treatment plants in the current decade to 2020. These investments, reinforced by the growing consumer market, have become an important driver of private investment activity. This trend is also well supported by the growing and resilient financial systems in the region.

Intra-regional trade activity is also rapidly increasing, signifying the deepening of economic ties within the region. Intra-regional trade in East Asia has expanded from an average of 44% of total trade in 1995, to 50% in 2010. Similarly, intra-regional investment activities have been on a rising trend. More recent efforts have focused on strengthening regional financial integration which is aimed at promoting the more efficient intermediation of funds in Asia. The strengthening of domestic demand and the greater regional financial and economic connectivity within Asia has also enhanced the resilience of the region.

Islamic finance in the evolving new frontier in Asia

Given that Islamic finance is a form of financial intermediation that is closely linked to the real economy arising from its requirement that financial transactions needs to have an underlying economic transaction, its accelerated growth and dynamic expansion across the financial landscape in Asia brings with it the tremendous potential to reinforce the transformative trend that is characterizing the region. With greater liberalization, Islamic finance is increasingly supporting regional and international trade and investment flows, intermediating significant cross border financial flows. With its internationalisation, Islamic finance has become an increasingly more important channel for the efficient allocation of Asia's surplus funds towards productive investments in the region. This trend is also contributing towards the strengthening of global financial and economic linkages, particularly between Asia and the Middle East.

The vast population in Asia and the growing middle-income group, combined with high savings rates in the region have substantially heightened the demand for a wider spectrum of financial products and services. These trends have increased the opportunities in retail and investment banking, takaful, and fund and wealth management businesses in the region. An area that Islamic finance has a major potential role is in the reorientation towards achieving a more inclusive and sustainable growth – an important post-crisis development agenda. Serving the small and medium-size enterprises (SMEs) presents huge potential for Islamic financial institutions, particularly those with the capability to deploy innovative equity-based structures and alternative forms of financing, such as private equity and venture capital.

Asia is also now becoming a primary force for the global Sukuk market, with 68% or USD120 billion of the total sukuk outstanding in 2011 originating from the region, thereby providing an important investor base for sukuk issuance from different parts of the world. Whilst Malaysia has evolved a vibrant sukuk market, more Asian countries have turned to the sukuk market for financing large-scale projects including for infrastructure development. Several countries in the region are currently reviewing their legislation and taxation to enable debut sukuk issuance. The Asian sukuk market has also been progressive in the innovation frontiers. There has also been a growing trend for multi-currency sukuk issuances. This provides greater prospects for tapping a wider pool of investors, including from the Middle East and Europe.

In Malaysia and more recently, in Indonesia, Sukuk issuances have also aimed at retail investors. This is to take advantage of the high levels of surplus savings in Asia, whilst providing wider investment options to retail investors that have traditionally invested in bond funds and unit trusts. The trend for greater regional economic and financial integration will also provide substantial opportunities for Islamic financial institutions to facilitate the integration process in the region and with other parts of the world, and thus have a greater role in financing Asia's future growth.

Priorities for strengthening financial stability and growth

Let me turn to the priorities for strengthening financial stability and growth. Whilst there needs to be continued efforts at the national level to develop the institutional foundations for Islamic finance that will foster effective and efficient financial flows, and ensure that financial stability is preserved, the new wave of internationalization for Islamic finance requires increased collaboration across jurisdictions to strengthen the international financial infrastructure of Islamic finance. Going forward into the future, this will be particularly important given that the international environment has become more challenging. This is to ensure that the greater internationalization of Islamic finance takes place in an environment of financial stability.

At the national level, the first priority relates to trend for the domestic Islamic financial system to become more integrated allowing for risks to be rapidly transmittal across the financial system. This requires the development of enhanced regulatory, supervisory and legal frameworks that are also adaptive and effective to the innovative dynamics and unique mix of risks in Islamic finance. Fundamental to this is the implementation of the international regulatory and supervisory standards and best practices for Islamic finance. The Islamic Financial Services Board (IFSB) has introduced prudential standards for the Islamic financial services industry – in all key areas of capital adequacy, risk management, corporate governance and Shariah governance. Their implementation would in turn promote more consistent regulatory and supervisory frameworks across borders.

Importantly, the adoption of these international prudential standards which are aligned to the core principles and standards adopted by the Basel Committee, the International Association of ***Insurance*** Supervisors (IAIS) and the International Organization of Securities Commissions (IOSCO), would serve to minimise the opportunity for regulatory arbitrage arising from cross-sectoral and cross-border differences, whilst ensuring that the regulatory requirements that are distinct for Islamic finance are effectively addressed. A survey conducted by the IFSB in 2011 indicated that 9 countries have implemented the standards issued by the IFSB and that 18 countries are expected to implement them within the next five years. Their consistent implementation will be vital. This harmonization will also facilitate consistent participation in Islamic finance across borders and contribute towards global financial stability.

Whilst micro-supervision is an integral part of the toolkit for ensuring financial system stability, the recent global crisis highlighted the need for it to be complemented by macroprudential surveillance and measures. This dimension of prudential regulation involves the incorporation of horizontal assessments of risks across institutions, sectors and national borders, including the risks in asset markets. This is to address systemic risks and to take into account the interconnectedness within the financial system. This is particularly relevant for the Islamic financial services industry given the ***close link of Islamic finance with the real economic sector*** through the various modes of Islamic financing contracts. In particular, heightened surveillance is needed over developments in the real estate and commodity markets. Equally important is a greater understanding of the inter-relationships between the financial and the real sector, including the potential for second round effects that are transmitted across sectors of the financial system and the economy.

The increased cross-border reach of Islamic finance has also underscored the importance of enhanced cross-border collaboration among the supervisory authorities. Information-sharing and effective coordination among supervisors will enable a complete understanding of the entire risk spectrum of the risk taking activities undertaken across jurisdictions by the Islamic financial institutions. This is especially important in crisis situations, given the serious ramifications of a delayed or ineffective response to cross-border contagion. Robust institutional arrangements are therefore vital to improve the efficiency of the supervisory processes and to allow for the early detection and management of cross-border transmission of risks arising from group-wide activities.

Another key area is the evolution of the legal framework for Islamic finance. This is to provide greater certainty and to build public confidence in the system as a whole. This necessitates a legal framework that enforces end-to-end Shariah compliance in the Islamic financial services industry – through provisions and mechanisms that unambiguously define the conduct and governance of Islamic financial institutions. It needs to recognize the distinct elements in Islamic finance and identify risks and challenges associated with the different Islamic contractual arrangements and the instruments for the appropriate regulatory treatment of the Islamic financial transactions. There is also a need for court recognition and acceptance of the Islamic contracts within the common and civil law systems, with a consistent approach of interpreting the rights of the contracting parties based on Shariah principles. This will lend certainty and predictability to the financial transactions and is particularly important in evolving legal frameworks that are facilitative of cross-border transactions as Islamic financial activities continue to venture beyond domestic borders.

In Malaysia, the new legal framework for Islamic banking and takaful that will come into force this year, will pave the way for the development of an end-to-end Shariah compliant regulatory framework for the conduct of Islamic financial operations. This new framework provides clarity on the fundamental requirements of Shariah that must be adhered to for the contractual arrangements between the financial institution and the customer to remain enforceable. The framework also outlines the operational requirements for the effective application of Shariah principles in the conduct of Islamic financial institutions. This aims to strengthen the risk management practices beyond the traditional credit, market and liquidity risks, to also include inventory risk, ownership risk and Shariah compliance risk. The legislation also provides for the resolution of Islamic financial institutions to be in line with distinctive elements of the relevant Islamic contracts, thus improving the legal and procedural aspects for the orderly resolution of Islamic financial institutions.

Another important area of priority is to achieve the further harmonization and mutual recognition of Shariah interpretations across jurisdictions. The progressive harmonization will be a major driving force for the internationalization of the Islamic financial system. The reduced uncertainty from differences in Shariah interpretations will also contribute to safeguarding financial stability. The continuous and constructive engagement amongst scholars, regulators and practitioners within and across the regions will pave the way for greater understanding and mutual respect for the Shariah views. This also needs to be supported by in-depth research and greater transparency on Shariah rulings and resolutions. The International Shari'ah Research Academy for Islamic Finance (ISRA), through its Shariah research undertakings and activities in promoting constant engagement among international scholars, has been at the forefront in driving progressive harmonization of Shariah at the regional and international levels. Its annually organized Muzakarah Cendekiawan Shari'ah Nusantara has emerged as an important platform for greater consensus to be forged among the Shariah scholars in the Nusantara.

Finally, is the imperative for a robust liquidity management infrastructure for Islamic finance, both at the national and international levels. This is vital not only to ensure the resilience and stability of the Islamic financial system but also to reduce the cost of intermediation. Cross-border liquidity risk management in the Islamic financial system still remains a significant challenge, with the lack of short-term Shariah compliant instruments in international currencies. The global efforts to strengthen the liquidity arrangements for the international Islamic financial system will be an important breakthrough in facilitating more efficient cross-border liquidity management by Islamic financial institutions, thereby meeting the challenges of the trend of greater internationalisation.

Conclusion

Let me now conclude. The growing role of the emerging economies as an anchor to global growth in particular, in Asia, represents a major shift in the global economic landscape. In this environment, Islamic finance is well-positioned to assume a much larger role as a competitive form of financial intermediation for supporting economic activity, and as a channel for enhancing greater global connectivity. Efforts to strengthen the foundations for Islamic finance to ensure its continued resilience amid the more challenging environment must remain a priority going forward into the future. Indeed, our commitment to act guided by this foresight will strengthen the prospect for Islamic finance to realize its potential in the region and beyond.