Zeti Akhtar Aziz: Islamic finance – financial stability, economic growth and development

Speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the Islamic Development Bank (IDB) Prize Lecture on "Islamic finance – financial stability, economic growth and development", Jeddah, 27 November 2013.

* * *

It is my honour to be invited to deliver this lecture on Islamic Finance: Financial Stability, Economic Growth and Development, here in Jeddah. I wish to thank the Islamic Development Bank for the invitation. The Islamic Development Bank has been pioneering and instrumental in the development of Islamic finance and has been an inspiration in driving its progress and evolution. It is indeed a privilege for me to be part of this journey, and to have witnessed the increasing dynamism of the Islamic financial industry amidst a highly challenging economic and financial international environment.

Global financial and economic adjustments

My remarks today will focus on the relevance of Islamic finance in modern market economies, taking into account the knowledge that we have today about the vulnerabilities of finance, its causes and its wider economic ramifications. Five years on after the global financial crisis erupted, the most pressing challenge confronting the world economy continues to be securing financial stability and generating growth and employment. While regulatory reforms both at the global and national levels have been extensive to strengthen financial systems, there has been less progress on the recovery in growth. While conditions in the world economy have improved, the growth prospects going forward is expected to remain modest for an extended period of time.

Several important lessons have emerged from this recent global financial crisis. The first relates to the exponential expansion of the financial system which did not commensurate with the expansion in economic activity. This resulted in a significant disconnect between the financial sector and its role in serving the economy. A number of factors contributed to the weakening of the link between financial intermediation and productive economic activity. Deregulation had opened up new opportunities for financial institutions to expand the scope of their activities. Increased competition, reinforced by advances in technology intensified the pace of innovation. And, the extended period of low interest rates in an environment of low inflation also prompted greater risk taking which in turn contributed to the significant build up of financial imbalances.

The role of leverage in the global financial crisis, both in the public and private sectors, was also a particularly important contributing factor. It has also become a factor that is now holding back growth. At the height of the global financial crisis, the total leverage in the major industrial economies increased significantly. In the US, private sector leverage alone had reached over 200 percent of GDP in 2008. Other reports place the average debt level to GDP of major advanced economies at over 300 percent in 2010. The current process of deleveraging in the private sector remains incomplete, while pressures on fiscal sustainability in these economies also continue to weigh on confidence and growth. Significant challenges continue to be faced in the implementation of the structural adjustments which in turn is affecting the process of fiscal consolidation. This has further restrained the policy flexibility to support growth. The extraordinary and exceptional monetary measures taken by central banks in these economies have provided support to their economies, but they have also come at a cost to savers with growing risks of market distortions and financial imbalances the longer these measures are held in place.

In efforts to build stronger defences against a repeat of the events that precipitated the 2008 global financial crisis, the global regulatory reform agenda has placed significant focus on addressing elements of the regulatory and supervisory systems that allowed the build-up of excessive leverage. These elements include the unfettered innovation by financial institutions and the prevailing incentive system. Financial engineering had led bankers and investors to lose focus on their risk exposures when they failed to understand the increasingly complex products that purported to reduce the risks. The weak regulatory regime and supervision also failed to rein in such unbridled innovation. Misaligned incentives then fuelled excessive risk taking both at the institutional and individual levels. The inadequate financial buffers held by banking institutions against risk, a growing disconnect between the creation of credit and its use for productive economic activity and a highly interconnected system of financial intermediation ultimately combined to give rise to risks that disrupted credit flows to the economy. Over time, these trends were substantially amplified.

The global reform agenda has made important progress in efforts to reduce the fragility of the financial system and to strengthen its resilience. Substantial work has already been advanced and largely completed on the development of global liquidity standards, the adoption of leverage ratios, and the significantly strengthened capital regulations which are important components of the reform effort. Greater focus has also been placed on strong supervision, effective resolution regimes and arrangements for the oversight of systemically important financial institutions. While the effective implementation of these reforms is crucial, the world continues to seek more enduring solutions that will place financial institutions firmly back in the service of society. In some countries, fundamental structural changes are being pursued to reduce the complexity of banking and to protect banking services from such higher risk-taking activities. The challenge however, is how this might be achieved in a sustainable manner without undermining growth and development, and erasing the important efficiencies in financial management.

A model to reanchor finance to the real economy

While the global financial stability efforts have made progress in generating an enabling environment for a new equilibrium of financial stability, a key consideration as we move forward is the need to redefine the fundamental character of modern finance and how it would interface and interact with the economy and the broader society. New considerations that prioritise justice and fairness, sustainability and inclusion have also become essential underpinnings of such a financial ecosystem. The recalibration of finance should aim to serve the needs of the real economy and more importantly the broader society. This would generate positive externalities that would in the medium term lead to more sustainable financial systems, and in turn contribute positively to growth and development.

A core underpinning of Islamic finance is the tenet that requires Islamic financial transactions to be supported by genuine productive economic activity. Islamic finance is also a financial regime that places emphasis on risk-sharing, thereby strengthening further the link of finance to the real economy. Thus, it provides a greater understanding on the fundamental relationship between the financial sector and the real economy. The concept of risk-sharing in finance is not new. While risk-transfer activities currently dominate the conventional financial systems, risk-sharing in the form of equity has long been a cornerstone of capital markets with vibrant stock exchanges. Techniques used by venture capital financiers also have similarities to risk-sharing contracts in Islamic finance. The development towards a more equity-based financial system where risk-sharing takes place reduces the over-reliance on debt funding, thus avoiding excessive debt and speculation and thus financial system fragility. In Islamic finance, this is further reinforced by Shariah principles that strongly discourage excessive debt given its detrimental effects on society.

The use of risk-sharing transactions and undertakings under participatory finance models in Islamic finance thus offers the potential to reinforce the links between finance and the real economy. The contractual arrangements between the financier and the entrepreneur place strong emphasis on the value creation and economic viability of the enterprise. This results in a close link between the growth of the financial sector and real sector activities in which the expansion or contraction of credit is dependent on developments in the real sector. This would provide a restraint on financial engineering and innovation as financial transactions need to be supported by real assets, thus aligning innovation to productive economic activities. As a result, the dangers of unbridled innovation are also substantially reduced.

The move to embrace the risk-sharing dimension of Islamic finance also presents new opportunities for financial management. The profit sharing and risk-sharing characteristics of Islamic financial transactions strengthen the incentives for Islamic financial institutions to undertake the appropriate due diligence on the transactions to ensure that the profits are commensurate with the risks assumed. The explicit risk-sharing element between the financier and customer instils greater discipline and responsibility, given the obligation and economic incentives created for participants to the contract to evaluate the risk profile of the product or investment proposition, the underlying trends in earnings and cash flows, and its income-producing potential. Such a process strengthens safeguards against the widespread mispricing of risks. The strong incentives for financial institutions to understand the nature and level of risk and leverage that is embedded in the Islamic financial instruments would in turn lead to more responsible innovation. This ensures that the products offered are aligned in delivering real benefits for the investors. Reinforced by a combination of stronger governance, enhanced transparency and more robust risk management, the trust-based relationship that underpins Islamic finance is therefore strengthened, thereby promoting overall confidence in the intermediation process.

More recently, in this decade, the greater use of equity-based models has been most evident in the sukuk market, with Shariah structures evolving from predominantly lease-based (Ijarah) and mark-up sale (Murabahah) structures to profit and loss sharing partnerships (Musharakah), as well as convertible and exchangeable trusts. The evolution of asset-backed and asset-based sukuk provides further options for investors to diversify their portfolio. Asset-backed sukuk, has profit and loss sharing elements that thus offers investment sustainability. The possibility of a default is minimised, as investors of asset-backed sukuk are not guaranteed to receive income or capital gains, and profits are paid by the issuers only when the underlying assets earn profits.

Risk-sharing transactions and undertakings under the participatory finance models in Islamic finance also enhances prospects for increasing financial inclusion and in bringing the financially unserved into the economic mainstream. In many IDB member countries, studies have shown that economic development is constrained by the lack of access to finance, given that only about 30 percent of the adult population use formal financial intermediaries. Greater outreach to small and medium enterprises (SMEs) and microenterprises can be achieved through the wider application of equity-based structures in financing for SMEs and Islamic microfinance given their strong emphasis on promoting entrepreneurship and value-creating activities. This contributes towards the overall objective of generating inclusive growth that enhances the prospects for job creation. Integration with other financial products such as microtakaful and social welfare arrangements such as endowment (waqf) can also provide a total financial solution for the lower income groups and small businesses.

Risk-sharing in Islamic finance also extends to the creation of a more equitable and just distribution of wealth. Redistributive instruments such as obligatory alms giving (zakat), endowment (waqf) and charity (sadaqah) complement risk-sharing financing tools to form part of a comprehensive approach to address poverty and promote social justice within the community, aspects that are important in increasing the potential for a more balanced economic growth.

Another important dimension of risk-sharing that enhances financial inclusion lies in the potential for Islamic finance to become a powerful tool that can enhance financial access for emerging economies, in particular the less developed countries that have been marginalised by modern finance. Debt financing or risk-transfer activities are heavily dependent on conventional measures of financial and economic performance. In contrast, equity financing, with its risk-sharing elements, can provide the required financial solution that is not dependent on such conventional assessments. This will allow those countries which are less developed but have assets and resources to access finance. The strong emphasis on governance and risk management in risk-sharing contracts will also have an important role in catalysing broad-based improvements in standards of oversight and financial discipline in these countries as safeguards against irresponsible practices. Taken together, these elements of Islamic finance offer enormous potential for less developed countries, more so those that are rich in resources, to mobilise and channel economic resources to finance growth and development, and significantly raise standards of living for their communities.

In the sukuk market, sukuk structured in profit and loss sharing partnerships (Musharakah) represents one of the majority in global sukuk issuances and outstanding. The emergence of sukuk as an alternative fund raising and investment instrument has opened up an important new source of funding for long term development projects. Many Asian countries have leveraged on the sukuk market to raise funds for infrastructure development in the healthcare, transportation, telecommunications and education sectors that contribute towards generating broad-based growth. There is a seemingly good fit between sukuk and infrastructure project financing that requires large capital outlays with long gestation periods. This can significantly benefit IDB member countries which can tap into the sukuk market to meet the strong current and future demand for infrastructure financing, particularly for countries that face large funding gaps for infrastructure development. Indeed, it is encouraging that developing economies in Africa have already begun to leverage on the sukuk market for infrastructure financing particularly those that have progressed further in laying the legal groundwork to enable sukuk issuances.

Globally, the performance of the sukuk market has exceeded expectations. From an outstanding amount of US$33 billion in 2006, the sukuk market has expanded more than eightfold to US$292 billion by December of 2012. Future growth prospects for the sukuk market is supported by the positive growth prospects in both the GCC and Asian regions and the increasing funding needs for infrastructure projects in these regions. In the Asian region, it is estimated that US$8.3 trillion is required for infrastructure development until the year 2020. Infrastructure spending has also been one of the key drivers of economic growth in the GCC in the recent decade. In the MENA region, the changing energy landscape towards more renewable energy and clean, efficient technologies presents significant potential for the use of sukuk to meet such financing requirements.

With its growing international dimension, Islamic finance has assumed an increasingly important role in facilitating regional and international trade and investment flows thereby intermediating significant cross border financial flows. More recently, international financial centres such as London and Hong Kong have been increasing their connectivity with the Middle East and Asian regions, two important growth centres in the global economy. The increased international dimension of the sukuk market, in particular has facilitated the movement of funds across borders from jurisdictions with surplus funds to regions with investment opportunities thereby enhancing its potential as a vehicle to foster greater trade flows and investment and thus facilitating growth and development.

The development of Islamic finance and its risk-sharing and equity financing aspects could be significantly rewarding for countries that venture into this alternative form of financial intermediation. However, to fully realise its potential, different elements of the financial system must evolve in tandem to provide the enabling conditions for this to occur. In such a system, it is essential for both investors and entrepreneurs to embrace different approaches in managing risk and return relationships that are embedded in the many variations of Shariah contracts. It is important that these relationships are well understood by the parties involved, and aligned with the clear contractual and operational requirements.

Islamic finance: financial stability issues and challenges

It is imperative that the lessons of the global financial crisis are not lost as the growth of Islamic finance gains further traction. Having already achieved remarkable growth and development over the recent decade, the continued success and viability of Islamic finance will also depend critically on ensuring focus on preserving financial stability. While contractual relationships and obligations may be different under Islamic finance, thus requiring different risk governance arrangements and skill sets, both conventional and Islamic financial institutions are exposed to similar risks including credit, market, liquidity and operational risks. For these reasons, the relevance of reforms to strengthen capital and liquidity buffers such as that under Basel III also extends to Islamic financial institutions and their universal implementation is important to avoid competitive distortions and regulatory arbitrage.

Beyond prudential standards however, ensuring strong adherence to Shariah principles is central to delivering the financial stability benefits that were found wanting in conventional financial systems prior to the global financial crisis. In addition, the agenda to promote fair, responsible and professional conduct by Islamic financial institutions and more empowered consumers must be equally advanced. In Malaysia, the new legal framework for Islamic banking and takaful that recently came into force is set to pave the way for the development of an end-to-end Shariah compliant regulatory framework, reinforcing the effective application of Shariah principles in the conduct of Islamic financial institutions.

It is encouraging to see that substantive progress has been made in respect of the development of prudential standards for Islamic financial institutions and the cooperation arrangements that are taking place to facilitate the implementation of these standards at national levels. Since its establishment in 2002, the Islamic Financial Services Board (IFSB) has introduced prudential standards for the Islamic financial services industry in the areas of capital adequacy, risk management, corporate governance and Shariah governance. Nine countries have implemented these standards and 19 more are expected to implement them within the next few years. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has also contributed to the issuance of more than 80 standards in the areas of accounting, auditing, governance, ethics and Shariah for the international Islamic financial industry.

Further progress on two fronts remains important. The first is to continue to evolve a more refined distinction within prudential and financial reporting frameworks to reflect the different nature and profile of risks under risk-sharing contract arrangements. The second is the need to accelerate efforts to further strengthen the infrastructural underpinnings for the development of the overall Islamic financial system. While the broad regulatory principles and standards developed in the aftermath of the global financial crisis can be applied to most Islamic finance transactions, a broad-brush application of these rules would limit the ability of Islamic financial institutions to implement the more unique risk-sharing contract arrangements. The stage of development of the overall financial system in which Islamic finance operates must also be considered to ensure that the effective application of global standards can be achieved without unintended consequences, given the prevailing associated constraints. Islamic banks today continue to be confronted with limitations in the availability of a sufficiently deep and diverse pool of Shariah compliant instruments – in both domestic and international currencies – in which they can invest. Under the strengthened international capital and liquidity standards, this can result in higher costs of compliance, inefficiencies in funding structures and increased risks of funding mismatches.

Strengthening prudential standards alone would therefore be an incomplete response to building a strong foundation for the future of Islamic finance. Beyond the more stringent capital and liquidity standards, a further response to strengthen the global Islamic financial system should therefore also include measures to strengthen the infrastructural underpinnings and building blocks of the industry. It is equally important that initiatives such as the establishment of the International Islamic Liquidity Management Corporation (IILM) to support cross-border liquidity management by Islamic financial institutions, continue to be pursued. The recent sukuk issuance by IILM represents a major breakthrough in global cooperation on Islamic finance which has made available short-term USD Shariah compliant instruments in the global market to Islamic financial institutions to facilitate more efficient management of their cross-border liquidity requirements.

As Islamic finance further evolves and advances, more fundamental questions on the framework for financial stability in the context of Islamic finance will need to be addressed. At a national level, such questions will include the relevance and design of financial safety nets such as deposit insurance and lender of last resort facilities in an Islamic financial system. To a large extent, these safety nets have in mind the traditional roles played by conventional banks – the acceptance of deposits which are payable on demand and which enjoy principal protection for the depositors. In a risk and profit sharing model with participatory or equity-based contracts that support ventures involving entrepreneurship endeavours, savers and fund providers stand to bear the losses in such ventures, similarly to gaining profits from such ventures. A main challenge would be in structuring financial safety nets which honour the true nature of Islamic contracts, while preserving confidence in the financial system given the entrenched expectations of consumers. Consumer protection and education initiatives are also essential to further deepen the understanding and awareness of consumers on the associated risks and rewards in the Islamic financial contracts. In addressing these questions, there is much to be gained from sharing experiences and strengthening cooperation in research initiatives.

At the global level, the framework for financial stability in the context of Islamic finance needs to interface with the arrangements that exist for the conventional financial systems. As conventional frameworks for financial stability are being strengthened and in some areas being fundamentally revisited, it is timely to take the opportunity to elevate the level of engagement and coordination between global standard setting bodies in international standard setting and implementation activities. Closer coordination will be increasingly important to avoid fragmentation in regulatory frameworks and improve the surveillance of risks to global financial stability. As lessons from previous crises should teach us, we would be well served to ensure that the growth of Islamic finance – on a global scale – is well supported by the strengthening of our collective capacity to understand, monitor and manage the attendant risks.

Conclusion

In concluding, Islamic finance, through its emphasis on risk-sharing for the attainment of socio-economic goals based on the objectives of Shariah, provides the discipline that enhances the prospect of strengthening the link between finance and the real economy, thus contributing towards overall financial stability. With the global economy now on the recovery path, Islamic finance offers enormous potential in supporting a more inclusive and sustainable economic growth. Developing and emerging economies in particular stand to reap the largest benefits from this potential. To fully realise this potential, regulatory priorities in strengthening financial stability taking into consideration the specificities of Islamic finance will ensure its continued resilience and its potential to effectively service the functioning of economies and the economic wellbeing of societies.