

## **Agus D W Martowardojo: Enhancing financial inclusion through Islamic finance**

Keynote address by Mr Agus D W Martowardojo, Governor of Bank Indonesia, at the IFSB International Seminar “Enhancing Financial Inclusion through Islamic Finance”, Jakarta, 31 March 2015.

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### ***Bismillahirrahmanirrahim,***

- His Excellency: Mr Jaseem Ahmed, Secretary General – Islamic Financial Services Board;
- His Excellency: Dr. Muliaman D Hadad, Chairman of OJK, Board of Commissioners;
- Prominent speakers,
- Distinguished Delegates and all participants,

*Assalamualaikum Warahmatullah Wabarakatuh,*

A very good morning to all of you.

### **Greeting**

1. It is a great honor for me to deliver a keynote address in this IFSB international seminar that is emphasizing on the need to enhance financial inclusion through Islamic finance. Having observed that providing greater financial access is very crucial in delivering equitable opportunities to all segments in the society and preserving more sustained economic development, I am pleased to observe that Islamic finance has a great concern over having a better outreach in delivering financial services. The international seminar that we have today may serve as one of the efforts to deliberate ideas on how Islamic finance could formulate its roles through better financial products and regulations.

### **Recent development of Islamic financial industry**

#### ***Distinguished Guests, Ladies and Gentlemen,***

2. We have already witnessed that Islamic financial industry has been rapidly developing in terms of economic sectors, asset size, physical outreach, and financial products offered. Islamic financial products have been used in commercial retail products, corporates, and government. The products of Islamic banks, takaful, and capital market have been widely used in various economic sectors including agriculture, manufacturing, trade finance, transportation, infrastructure development, and others. Branches of Islamic financial institutions have also been established to reinforce physical presence in the market; besides technological advancement that allows the customers to enjoy sophisticated Islamic financial products such as mobile banking and e-finance. The global Islamic financial industry is expected to reach the total assets of USD 2 Trillion this year. The industry is growing at about 17.3 percent compounded average growth rate. It is almost twice as much as the conventional industry has achieved.
3. The development of Islamic financial services industry is still dominated by the 2 major industries, namely the Islamic banking sector and Islamic capital market with the share of 80 percent and 15 percent respectively. The interest of non-Muslim populated countries like the United Kingdom, South Africa and Luxembourg to issue

global Sukuk has been monumental. The total of Sukuk issuance in 2014 has reached the amount of USD 114.7 Billion. At the regulatory and infrastructure side, we could also see some significant progress taking place. The Islamic Financial Services Board has consistently produced regulatory references that are beneficial to enhance governance of the industry. Those cover prudential measures for Islamic banking, takaful (or Islamic insurance), and Islamic capital market.

4. The latest efforts coming into plates are the Guidance Note on Liquidity Risk Management and the core principles of Islamic banking supervision. Those regulatory references are expected to further streamline Islamic finance operations globally and serve as a basis for assessing the strength and effectiveness of regulation and supervision. The International Islamic Liquidity Management Corporation has also shown its presence by increasing its sukuk issuance that can be used for liquidity management of the internationally operating Islamic banks more efficiently. Despite some exogenous disturbing factors like geopolitical crises and shocks to oil prices, we could expect that the industry could sustain its development until it reaches its significant role as one of key drivers of the global economic development.
5. Cross sector activities between Islamic banking and capital market in terms of Basel III compliant sukuk, “green” sukuk issuance, and social based sukuk have also indicated progressive innovation in the industry. The central banks have also equipped themselves with some innovation allowing them to perform monetary operations using sharia compliance financial instruments and enriching the industry with more compatible products such as sharia compliance repurchase agreement (repo). At the industry level, we could also see the involvement of Islamic Development Bank as one of the Multilateral Development Banks deserves appreciation. It was through its initiatives that the establishment of supporting institutions like the Islamic Financial Services Board (IFSB), International Islamic Financial Market (IIFM), the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and the International Islamic Liquidity Management (IILM) was successfully arranged. The latest Ten-Year Framework and Strategies tries to consolidate all the efforts into a well-developed program.

## **Current global Islamic financial industry development**

### ***Distinguished Guests, Ladies and Gentlemen,***

6. The global economy is still trying to regain its momentum for the economic development in the last 5 years. The economic recovery is surrounded by uncertainty which could easily be affected by economic policies of advanced economies and other disturbances. The tapering of the US quantitative easing and the shock of international oil price caused a destabilizing force to the emerging economies that are fundamentally sustained by domestic demands well-formulated monetary policy. The growth in the capital market has also been challenged by the oil price decline and low interest policy in the advanced market.
7. Despite the uncertainty faced by the industry, I am confident that the Islamic financial industry could maintain its pace of growth in years to come. There are at least five driving forces to sustain the industrial development including the growth of emerging economies, cross-border financial transactions, innovative Islamic financial products, regulatory advancement driven by more advanced and comprehensive regulatory standards, and continuous growth of Muslim population.

## **Achieving greater sustainability in the economic development and financial outreach**

### ***Distinguished Guests, Ladies and Gentlemen,***

8. The development of Islamic finance is expected to provide benefits to wide range of customers. Those include the low income society that currently does not have access to the financial system to make their life better. According to some studies, it is found that there are quite many people in OIC member countries that still live under poverty line. Most of them is unable to upgrade their quality of life and turn themselves into productive society due to the lack of assets in hand and the absence of financial products and services with low cost of funds.
9. Moreover, due to lacks of other resources, they are also remote from supportive education program and health facilities that are potential to strengthen the basic necessities to gain quality in human capital. Without properly designed poverty alleviation program that particular group of people may be trapped in the poverty for ages. In some occasion, low income society has been perceived as involving high risk and too expensive to manage since it requires an extensive effort to manage highly dispersed customers. As a matter of fact, if proper mechanism and procedures supported by well-developed regulation, microfinance industry can also be highly lucrative.
10. Islamic finance with a wider application of equity-based financing and micro-finance products can facilitate greater outreach to medium, small and micro enterprises to promote entrepreneurship and value-creating activities. Conceptually, greater access to financial services can be provided by commercial based Islamic financial institutions such as Islamic banks providing microfinance products or micro takaful provided by takaful institutions. Other steps can be formulated such as integrating commercial sector with Islamic social sector to come up with financial services that are reachable by the micro entrepreneurs and low income society in general. The program is aimed at improving social welfare arrangement through variety of vehicles such as optimization of awqaf funds, innovative zakat disbursement program that is contributive to the job creation initiatives and poverty alleviation program.
11. Conceptually, the practice of Islamic finance signifies its favor to financial stability and quality economic development which is characterized by the use of risk-sharing concept, discouragement to excessive debt, the emphasis on ethical investment activities, and other sharia specific preferences. The emphasis on equity based investment underlines the importance of reinforcing the basic relationship between financial sector and real economy.
12. The development of Islamic financial sector could reduce over-reliance to the debt funding and excessive speculation. Having observed from the past economic crises, it has been evidence that excessive debt funding and speculation significantly contributed to the financial system fragility. In relation to the formulation of public preference, the principle to the prohibition of excessive debt taking could serve as a medium of public education that could create positive effect on the moderation of the aggregate demand; and thus more stable macroeconomic condition.
13. The application of risk-sharing principle could give more gravity to partnership in the society rather than creating lender-debtor relationship. Despite the requirement to have a favorable environment that promotes more symmetric market, the application of sharing concept could offer the potential to reinforce the link between financial sector and the real economy which base the financial contracts on value creation and viability of the enterprises. Once the transparency and governance are in place to allow better partnership, over-creation of financial engineering can be minimized since the financial activities will be focused on the intrinsic value added offered in the financial contracts.

14. From the governance perspective, the risk sharing concept strengthens the incentive to the financial institutions to exercise appropriate due diligence to the financial transactions assuring that the expected profits commensurate their risk taking. Supported by sound information and reporting system, the risk-sharing contract opens up opportunities for the entrepreneur and the financier to monitor and calculate the intrinsic values of the financial transaction that is reflected by its expected profit, cash-flow, risks involved and other influencing factors to the projects. This concept promotes greater discipline and responsibility to all contracting parties to assure its success. The combination of good governance, greater transparency and well-designed risk management would shape trust-based relationship that is essential to make the intermediation process efficient.
15. The attention of the IFSB towards enhancing the role of microfinance in the Islamic finance industry deserves appreciation. The Islamic financial institutions should be able to play significant roles in the economic development covering all segments in the society. The availability of standards on the microfinance activities is important to ensure operational prudence practiced by the Islamic financial institutions when extending their facilities to the low income society. Some regulatory incentive needs to be created in terms of relatively lower risk weighted asset to provide lower cost of capital when entertaining the micro-entrepreneurs. Although, further research need to take place to find the optimal number and prerequisites when applying the incentives.

### **Closing**

16. Finally, please allow me to wish you all a productive discussion and deliberation in this important seminar. I am confident that supported by internationally reputable academics and players, we can achieve significant outcomes that are beneficial to promote development in the area of microfinance for Islamic finance. I wish this program a great success. Thank you very much.

***Wassalamu'alaykum warahmatullah wabarakatuh.***