Zeti Akhtar Aziz: Building financial systems for sustainable development

Speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the Global Ethical Finance Forum "Building Financial Systems for Sustainable Development", Edinburgh, 1 September 2015.

* * *

It is my distinct pleasure to speak at the Global Ethical Finance Forum here in Edinburgh. I would like to warmly thank the Scottish Government and the Middle East Global Advisors for the kind invitation for me to speak at this forum. It is a privilege to be here in the company of this distinguished and diverse gathering of professionals from the various fields that are prioritising ethical finance for sustainable development.

The discussion on ethical finance that supports sustainable development is timely. In this recent decade, we have had to deal with a financial crisis of unprecedented global proportions that has stemmed in part from the prevalent ethics and culture in the financial services industry. In this period, we have also witnessed significant occurrences of misbehaviour and ethical lapses surface in the financial services profession, including the manipulation of reference rates and deliberate compliance failures. Since the global financial crisis, we have now had several years to reflect on these weaknesses and to institute the much-needed reforms that have prioritised resilience and stability. Having made important progress on this front, it is timely to direct our attention to developing more enduring solutions that will place the financial sector firmly back in the service of society. This calls for a closer examination of the fundamental character of modern finance – where ethical and responsible finance that is strongly anchored to the real economy has a more significant role.

My remarks today will begin with some observations on the evolution of financial systems and the trends that have increased the vulnerability to financial crises, highlighting some of the key issues that have contributed to the breakdown of financial systems. Finally, I would like to take this opportunity to discuss some possibilities for the future of finance.

Financial systems, then and now

The development of finance has historically been a positive and inseparable part of world economic growth and prosperity. There is a large body of research that points to the significant benefits of financial development, recognising the economic value in financial intermediation that mobilises savings, catalyses investment, enables an efficient allocation of resources, reduces information asymmetries, and facilitates the management of risks. The transformative role of finance in economic progress is evident throughout history. The intrinsic power of finance essentially lies in its linkage to the real economy – that finance exists to serve the real economy. As has been described, "where enterprise leads, finance follows". This can be seen in the early financial innovation and growth of financial systems around the world. In the 17th century in the Netherlands, the establishment of the Amsterdam Exchange Bank and the availability of instruments such as bills of exchange contributed towards financing their extensive domestic and international trade. This became the bedrock upon which the Netherlands evolved to become the foremost maritime and economic power in the world during the Dutch golden age. It was also the financial revolution of pre-modern Britain that provided the foundation for the industrial revolution to take effect in the 18th to 19th centuries.

A more recent observation unfolding is the experience of China, where the process of financial intermediation has been key for the infrastructure development that has propelled China's economic growth story that began in the 1980s. In the process, it has lifted millions from extreme poverty. Though these are distinct experiences separated by chasms of geography and history, finance was a common and powerful component of the overall rise of these economies. More recently, this transformative role of finance can also be observed in the many emerging economies in different parts of the world in the 20th century as they transitioned to becoming a significant and important component of the global economy. Further, as the regional and international dimension of finance increased, this globalisation of finance facilitated greater cross border trade and investment activities.

In this recent two decades however, finance has progressively evolved from being a means to an end, to being an end itself. The role of finance shifted from being an enabler of growth to an engine of growth in its own right. In the more globalised world economy, financial centres also flourished to become an important source of national income and wealth. These trends however saw the start of the erosion of the linkage between finance and the real economy, sowing the seeds of financial activity that would become inherently unsustainable. In several parts of the world, finance progressively deviated from long-term value creation towards the pursuit of short-term returns. Banks' trading and fee-generating activities became much more lucrative than traditional lending activities. This in turn spurred innovation in financial services that became more and more removed from the service to society and the economy. During the period just prior to the global financial crisis, domestic credit provided by the financial sectors such as in Iceland and the US, which had previously averaged 48% and 149% of GDP respectively, had become decisively decoupled from, and had far outstripped real economic activity. Domestic credit by the financial sectors in Iceland and the US had by 2007, risen sharply to 299% and 236% of GDP respectively.

The experience of the global financial crisis highlights the potential for the benefits of finance to be dramatically reversed, resulting in destructive rather than constructive effects of finance. Several studies have shown that the marginal returns to growth from finance diminish at high levels of financial development. In other words, there can be "too much finance" where the costs to growth and stability outweigh the benefits of financial development. Similar to other booming industries, the financial sector at the height of its exuberance showed an overinvestment of resources in terms of capital including human capital which only became apparent after the bust. With the benefit of hindsight, it has become clear that in the lead up to the global financial crisis, many financial systems were close to, or had long surpassed, the point where bigger was better.

The breakdown of financial systems

The gradual severance of the link between finance and the real economy, in my view, represents the foremost factor that has weakened the positive role of finance and increased the potential for financial instability. As witnessed during the recent crisis, the degradation of finance eventually rendered its noble economic function of intermediation as ineffective, causing greater harm than good to the economic growth process. The various factors contributing to the recent crisis have already been extensively researched and discussed, highlighting that in most cases finance had become highly disconnected from real, productive economic activity. Additionally, is the role that it had in altering the relationship between the growth and distribution of risks created distortions in which the gains from excessive risk-taking were privatised among the few while the losses were socialised among the many.

The abuse of securitisation and the "originate and distribute" model was a particularly telling display of this malaise, severing the link between risk-taking agents and those who ultimately bore the risk. While intended to facilitate better risk management by transferring risk from the banks to a diversified set of investors, this distancing gave rise to problems in the incentive structure and in the availability of information. There was a clear breakdown in the relationship between creditor and borrower. Banks were essentially incentivised to focus on aggressively originating loans which were of compromised quality due to lowered underwriting standards. Investors of such bundled risks had then become far removed from their origins. Information was no longer transparent and risks could no longer be fully understood. Economic agents seeking larger returns were in turn encouraged to achieve them through greater leverage, thereby amplifying the vulnerabilities of the financial system and wider economy.

Much attention has also focused on the misaligned incentives of financial services professionals as reflected by the compensation structures that rewarded short-term performance and inadequate reprimand for overzealous risk-taking. This, I believe, was also symptomatic of the growing disembodiment of finance from its consumers and the wider economy. When social bonds are reduced to just profit measures, it provides a weak foundation for sustainable finance. Outcomes for finance need to be measured based on end services to the real economy, reflected for example, by an entrepreneur's successes or the financial well-being of retail clients. The detachment of finance from its function in serving the economy, results in clients being viewed as opportunities for extracting value and transactions as bets on financial outcomes. The prevalence of mis-selling of complex financial products exemplifies this shift in trend.

Future finance: re-anchoring finance to the real economy

Allow me now turn to some of the imperatives for re-anchoring finance to the real economy.

Firstly and most critically, future finance needs to have stronger links to the real economy by effectively having an intermediation role that is in the service to society. Financial systems have to be both ***value-adding*** and ***value-based*** – value-adding, in that they contribute meaningfully by intermediating and facilitating real economic activity, and value-based in that they aim to benefit society. Such finance that is value-adding and value-based is deeply needed in the global economy. Many parts of the world, notably the developing world, require large amounts of funding to address infrastructure development. Financial inclusion also remains an important agenda to uplift the living standards of the marginalised segments of society in our global community.

Secondly, a functioning regime practising value-adding and value-based finance needs to be built on a set of universal principles that will create a sustainable model for mainstreaming such positive finance in the global financial system. A regime that is deep-rooted in genuine productive activity that discourages excessive leverage that emphasises transparency, and that strengthens financier-client relationships would cumulatively be a positive force for the global financial system. Indeed, these are some of the core underpinnings of Islamic finance which has already garnered significance in many parts of the world. The central tenet in Islamic finance requires that financial transactions be supported by genuine economic activity, reinforcing the link between finance and value creation and aligning financial innovation to productive economic activity. Additionally, the emphasis on risk-sharing in Islamic finance strengthens the incentives for participants to screen and monitor transactions for economic viability and risks, and to institute the governance process. In Malaysia, our efforts to widen the reach of such value-adding and value-based finance include the development of a multi-bank platform to match funds from potential investors with entrepreneurial ventures in the real sector.

Thirdly, the efforts to strengthen the supply and demand of value-adding and value-based finance would contribute significantly towards re-anchoring the global financial system to the real economy. On the supply side, the focus on professionalism, ethics and the quality of talent would contribute to drive for positive changes in the financial services industry. In Malaysia, we have initiated the Financial Services Professional Board, launched in 2014, comprising of an independent group of eminent experts from around the world is currently refining a voluntary code of ethics that may be internationally applicable across the financial services industry.

A meaningful change in the culture of financial institutions requires a true commitment from the industry. A display of such commitment through the measurement and disclosure of a financial institution's non-financial performance, such as its impact in social, environmental and governance metrics, can be a powerful tool for change. In Malaysia, such a proposal is being developed for Islamic financial institutions to disclose their Corporate Value-Intent, a performance measure their commitment to value creation. Greater consumer activism and demands for more consumer-focused corporate information reflects the increased demand by consumers for institutions to account for their behaviour and values.

In terms of the demand for ethical and responsible finance, greater awareness among consumers and investors on the availability and viability of such positive finance is also needed, including among governments, corporates and the retail market. Education, engagement, incentives and the alignment of legal and regulatory frameworks on the utilisation of such finance will be important to achieve this.

Finally, is the need to foster strong leadership at the global level that can have an advocacy and facilitative role in resolving barriers and bringing together different stakeholders to work together in a coordinated and cohesive manner. The Responsible Finance Institute, initiated as a think tank based in the United Kingdom, that brings together responsible finance experts from around the world and has a unique role for this endeavour. The focus on collaboration and convergence between the diverse fields of ethical and responsible finance has great potential to harness the best practices of positive finance in its various forms to collectively wield a powerful force in shaping future finance.

Moving forward, stable and sustainable development can be best served by re-connecting the current gulf between finance and value creation that is reinforced by bringing benefit to society. With the financial reforms by the international community now much in place, the imperative for future finance is not only by becoming stable and resilient but also becoming a deep anchor to its bedrock, the real economy and generating a positive benefit to the greater society.

With that, allow me to wish you an engaging and productive forum. Thank you.