Muhammad bin Ibrahim: Future of Islamic finance - delivering actions today for a sustainable tomorrow

Keynote address by Mr Muhammad bin Ibrahim, Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the Global Islamic Finance Forum 5.0 "Future of Islamic Finance: Delivering actions today for a sustainable tomorrow", Sasana Kijang, Kuala Lumpur, 11 May 2016.

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It is my pleasure to be here today to speak at the Global Islamic Finance Forum 2016. The forum which was conceived in 2007 has now become a hallmark event for the Islamic finance industry – where the best minds and leaders of the industry come together to address the issues, opportunities and imperatives that are shaping the current and future path of Islamic finance. The fact that this event has attracted more than a thousand participants from all over the world is a testament to the growing global significance of Islamic finance.

Today, Islamic finance is one of the fastest growing segments of the financial industry in many parts of the world. It registered double-digit growth rates in the past decade despite challenging circumstances globally. Its reach and influence has expanded beyond the traditional Islamic markets, with increasingly strong footholds in banking, takaful and the capital market. Global sukuk issuances, for instance, increased by 13% in the first quarter this year despite less favourable market conditions. This positive growth continues to be supported by the progressive development of market infrastructures, strengthened regulatory and supervisory frameworks and active industry participants. In at least 10 jurisdictions, Islamic banking now represents more than 20% of total banking assets – a feat that has been achieved in under a decade.

And in many more countries, Islamic financial services are now available alongside conventional financial services. These developments underscore a clear and sustained trend in which Shariah-compliant financial products and services have continued to gain traction among businesses and individuals from all walks of life.

In fact, the value propositions of Islamic finance has extended beyond faith and origins that appeal to the global community. It is the intrinsic qualities of Islamic finance that are multifaceted that have pulled interest from diverse backgrounds. At the core of Islamic finance lies virtues that encompass both moral and commercial aspect in deriving potential solutions for economic and financial stability. The values and principles that Islamic finance carry have opened new pathways towards achieving economic prosperity while safeguarding the interest of the public. What used to be a novel idea has become mainstream. Indeed, Islamic finance is for all.

In Malaysia, efforts led by the Central Bank to develop Islamic finance spans over three decades. The invaluable contributions by earlier Governors of the Central Bank laid the foundations for the development of an international Islamic financial centre in Malaysia, serving both global and domestic demand. Their visionary leadership in this journey not only ensured that our fundamentals were strong, they had significantly raised the global profile of Islamic finance with Malaysia setting an example that would encourage development in other countries. In the early 1980s, Governor Abdul Aziz Taha has laid down the foundations for the establishment of the first Islamic bank and the issuance of the first government sukuk. The dual financial system that we see in Malaysia today is the realisation of the vision framed by Governor Jaffar Hussein way back in 1990. From there on, we continued to advance on many fronts, including the establishment of the Shariah Advisory Council under the leadership of Governor Ahmad Don. Significant milestones were achieved with Governor Zeti at the helm of the Central Bank. During this period, Islamic finance morphed from a niche segment into the financial mainstream, and from a largely domestic-centric focus to one of global relevance. In particular, her immense contributions have enabled us to achieve much more to expand the frontiers of Islamic finance as a global community.

I wanted to take the opportunity today to acknowledge their tremendous contributions. Moving forward, the Bank will continue to build upon these foundations in making advancement that will further strengthen Islamic finance's growth trajectory.

In the same way that past efforts have delivered solid growth in the industry and significantly enhanced Islamic finance potential for future growth, our present actions will largely determine the future prospects of Islamic finance. As was the case in the past, we will continue to require innovative solutions and collaborative strategies to take Islamic finance to the next level of development. Positive transformations taking place around us will continue to pave the way for new growth opportunities for the industry. Collectively, we need to understand these developments and leverage on them to advance economic and social goals, and manage the attendant risks.

Today, I would like to touch on three key issues, the rise of fintech and its impact on Islamic finance, the growing importance of responsible, inclusive and sustainable finance and the preconditions necessary to sustain a value-based financial system.

One of the most significant transformational developments of our era is the technological revolution. More specifically, the fintech revolution was made possible by maturing social, mobile and cloud technologies. The digital revolution and widespread penetration of technology-driven applications in nearly every segment of the financial sector is already upon us. Fintech innovations are fundamentally altering the way we experience and deliver financial products and services. According to a recent McKinsey report, the number of fintech start-ups globally has now exceeded 2,000, more than twice the number less than a year ago. Such growth is expected to continue as innovators tap into the preferences of millions of technology savvy millennials who are more receptive to new ways of consuming financial services.

Fintech is challenging the status quo of the financial industry. New business models will emerge. Delivery channels will challenge existing norms. Transaction costs will be reduced. Rather than looking at the fintech revolution as unwelcoming, financial institutions ought to embrace it as an opportunity.

In the area of payment services for example, e-payment has revolutionised payment mechanisms through convenient and accessible channels. In Islamic finance, a recent initiative in Malaysia has been the Investment Account Platform (IAP) that was launched in February this year. It is an important example of a collaborative strategy by the industry to bring game-changing innovations to the market. The IAP is the first Islamic banking-intermediated internet-based platform that combines the expertise of Islamic banks and efficiency of technology to channel funds from investors to viable economic ventures. It promotes risk-sharing financial transactions by providing the platform for Musharakah and Mudharabah-based equity financing. The platform has strong prospects to support cross-border investments and increase global connectivity through the participation of banks worldwide.

The potential impact of such technological disruptions is significant. An estimated 10% to 40% of overall banking revenues could be at risk by 2025 due to fintech innovations outside banking institutions that are able to achieve a significant pricing advantage. In Islamic finance, like the Investment Account Platform in Malaysia, fintech has immense potential to be the next game changer. It offers opportunities for industry players to radically transform operational models by adopting digitisation strategies that will be able to deliver much greater scale or alternatively, a high degree of specialisation. It also opens up new possibilities for improving efficiencies, reducing wastage and enhancing the customer experience. All of this adds up to stronger market positioning and financial performance.

To further explore and leverage or these opportunities, plans are currently underway to organise an inaugural Islamic Finance Symposium on Innovation that will provide a platform for the academia and industry to come together to develop and test breakthrough ideas and innovative solutions in Islamic finance.

On its part, Bank Negara Malaysia has been actively engaging with fintech firms to better understand their activities and provide guidance on the regulations that may apply to them. The adoption of fintech is clearly not without risks, particularly in the wake of rising cybersecurity threats that could compromise safeguards that protect financial assets and customer data. The Bank has commenced a review of the changes and additional guidance needed to ensure that the regulatory framework remains appropriate to manage the risks, while encouraging productive innovation that will drive costs down and improve the quality of service to consumers.

We are looking at this from several perspectives: first, the impact of fintech strategies on the management of risks by financial institutions; second, the potential for fintech start-ups to introduce new risks to the broader financial system as a result of regulatory arbitrage; and third, the impact to consumers. We will be providing more information to the market on our approach to the regulation of fintech developments as our review progresses. In the meantime, our engagements with individual firms will continue, supported by dedicated resources within the Bank to lead the review.

Another important development in this recent decade has been the growing emphasis on responsible, inclusive and sustainable finance. The global financial crisis provided a dramatic reminder of the basic purpose of financial intermediation – as a means to create sustainable value in the real economy. Without this anchor, finance will always be inherently unstable. The central role of finance in any economy also places a critical responsibility on financial actors to promote and embrace responsible behavior, consistent with the long term preservation and development of the economy, society and environment.

In a number of developed markets, Sustainable, Responsible and Impact Investing (SRI) and Environment, Social and Governance (ESG) considerations are gaining significant momentum.

Similar trends are also starting to gain traction in emerging markets. Islamic finance is uniquely positioned to champion this cause, guided by the overarching Shariah principle which emphasises the protection and preservation of the benefits and interests of society at large. More than 750 verses in the Quran relate to the importance of achieving balance and moderation in one's life, whilst being responsible and accountable in the use of natural resources. The Islamic finance agenda must therefore embrace this cause as its core mission – a mission that has become more urgent in light of growing economic and social inequalities and environmental concerns.

The first Socially Responsible Investment Sukuk that was issued last year is an example of impact investing that generates positive social outcomes. It pioneered an innovative sukuk structure where the returns are dependent on the performance of the selected schools which are supported by proceeds from the sukuk investments. The issuance of more SRI sukuk in the future would further reinforce the value proposition of Islamic finance that combines financial returns and social welfare enhancement. Another key innovation with far reaching potential is the creation of a new financial asset class that is backed by carbon credit-based solutions structured using Islamic finance principles. This idea has enormous potential to incentivise concrete actions by businesses to reduce carbon emissions. The industry should endeavour to capitalise on the commitment of the government, as announced by the Prime Minister of Malaysia on 12 April 2016, to consider providing incentives to buyers of Malaysian rainforest carbon credits to spur the development of this new asset class.

Over the longer term, the first precondition to sustain a value-based financial ecosystem is to direct serious efforts at aligning performance measures to take into account both economic and social outcomes.

In Malaysia, Islamic financial activities are governed by a comprehensive contract based regulatory framework designed to achieve end-to-end Shariah compliance. Consistent with this framework, Islamic financial institutions are expected to evaluate and manage the impact of their activities, beyond that which is solely concerned with financial gains.

To further entrench this shift, a proposal is being developed for Islamic financial institutions to disclose their Corporate Value-Intent (CVI) as a measure of their performance and commitment towards value creation. This proposal is an important step to encourage a strong corporate and market focus on how Islamic financial institutions are generating value, not just for shareholders, but for the communities which they are a part of. On-going collaboration and active engagement with the industry are currently being undertaken under this initiative to ensure proactive behaviours and sustained momentum towards the creation of a sustainable development.

Another precondition for long term sustainable value creations is the availability of top-notch talent to drive and execute innovative business strategies that will realise the full potential of Islamic finance. Based on market assessments, a greater pool of quality professionals are required to sustain the growth of global Islamic finance that is estimated to surpass $3 trillion total assets size by 2020. The challenge in meeting this demand however goes beyond the numbers. The next phase of growth and development of Islamic finance calls for a deep talent pool that not only has a strong foundation in the application of Islamic finance principles, but also the much broader set of competencies required to use those applications effectively to provide and implement solutions to real world problems. And such talent must be developed not only within Islamic financial institutions, but also the professional ancillary service providers that are part of the Islamic finance ecosystem.

In Malaysia, there are close to 40 professional ancillary services entities under the MIFC Community which play an important role in the development of Islamic finance. These entities provide a range of key services that include Shariah advisory, accounting, tax, rating, research, accreditation and legal services, many of them serving global demand and setting benchmarks for international best practices.

To increase the impact and influence of Islamic finance, whether in a domestic or global context, all its key components must move forward together to provide complete and comprehensive solutions. This is also critically important to reduce risks inherent in any innovative venture where progress on one front without the other is more likely to invite problems.

Conclusion

There has never been a better time where a confluence of developments have called for us to propagate the value of Islamic finance in addressing the challenges confronting us today; issues relating to inequality, financial excesses and environmental damage and degradation. To elevate the Islamic finance industry to the next level, the formulation of game-changing strategies must bring in elements that leverage on technology, accelerate innovation and develop well-rounded talent to meet future needs of Islamic finance. These strategies offer an important opportunity to reinforce the foundations of a strong and resilient Islamic financial system, and advance its development and contribute towards a more inclusive and stable global financial system. It is incumbent upon us all to make the most of it to support sustainable economic growth and help to improve the lives of many. And it is on us to continuously reinvent and re-anchor our industry so that we can forge stronger links with our stakeholders. Our future will be secured if we remain relevant.

Thank you.