Nor Shamsiah Mohd Yunus: Value based intermediation - beyond profit

Keynote address by Ms Nor Shamsiah Mohd Yunus, Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the Global Islamic Finance Forum 2018 (GIFF) "Value Based Intermediation - Beyond Profit", Kuala Lumpur, 3 October 2018.

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Henry Ford, credited with revolutionising the American transportation industry in the 20th century, once remarked that "*Business must be run at a profit, else it will die. But when anyone attempts to run a business solely for profit and thinks not at all of the service to the community, then also the business must die, for it no longer has a reason for existence*".

Nearly a hundred years since, these words of wisdom remain true. Perhaps, even more so now than ever. Indeed, we have witnessed time and again, episodes of excessiveness, and the sole and unchecked pursuit of profits, that have led to global financial crises. The theme of this conference, "Value Based Intermediation – Beyond Profit", is therefore a fitting reminder of the role of finance, and Islamic finance in particular, in helping build a more resilient and sustainable future.

In the past half century, the world economy expanded sixfold, despite experiencing the worst and most expensive financial crisis. Average per capita income more than doubled to about USD11,000, compared to only about USD5,000 in 1967. People are living longer, with better quality of life, greater access to basic necessities, improved health and medical care, and better education.

Despite such progress, we are faced with daunting challenges. These include harmful effects of environmental degradation and climate change that threaten global prosperity, stability and sustainable living. Socioeconomic challenges such as rising inequality and lack of affordable housing are affecting the well-being of many communities. At around 225% of global GDP, global debt is at a record high level and may leave a heavy burden for future generations to bear.

It is increasingly clear that economic prosperity in the long run cannot exist without social equity and environmental responsibility. While the governments of 150 countries are committed to realising the United Nation's 17 Sustainable Development Goals (SDGs) by 2030, this must be a shared responsibility. The private sector has a key role to play – a role, with finance at its centre, that has yet to live up to its full potential.

With much at stake, the call to action for sustainable finance is one that the financial sector, perhaps more particularly Islamic finance, cannot afford to ignore. Encouragingly, more, though not nearly enough, Islamic financial institutions are moving beyond Shariah compliance to performance and risk management practices that reflect social and environmental impacts. A key question for us present today, and for those beyond this forum, is how the value propositions of Islamic finance can be further developed, to bring us closer to the reality of "finance beyond profit".

To my mind, the answers will invariably call attention to three imperatives – a rethinking of value; a rethinking of risk; and a rethinking of human capital. Allow me to briefly address these in turn.

Key Message 1 – Rethinking value through a renewed focus on the fundamentals of Shariah

First, rethinking value. The industry must elevate the fundamentals of Shariah to realise its full promise. The business models of Islamic financial institutions should be guided by the overarching objectives of Shariah (Maqasid Shariah) – which are to preserve and advance the common interest of society at large, by preventing harm and maximising benefits. This is now more important than ever to steer growth and development on a more sustainable path.

In Malaysia, the industry with the support of the Central Bank, is taking concrete steps to drive strategies aimed at increasing the positive impact of finance on society. This is outlined in a Strategy Paper on Value-based Intermediation (VBI), which was released in July last year. The commitment to adopt VBI is a significant step by the industry to clearly identify Islamic finance with sustainable practices, as it should. It has also set in motion initiatives that will raise the bar for processes, practices, offerings and conduct that promote sustainable businesses and communities.

We expect that over time, the adoption of VBI will have a significant impact on business models of Islamic financial institutions, including the drivers of profitability and risks. Post-financing expert advisory services which help borrowers mitigate the environmental impact of projects financed by the bank will feature more prominently in the product and service offerings of VBI banks. VBI-oriented Islamic financial institutions can, and indeed *should,* also play an important role in mobilising resources to finance climate change mitigation and adaptation initiatives. Funding for climate adaptation in particular, remains critically low, despite millions already at risk from the effects of climate change and in need of assistance to cope with the effects. For example, in the agriculture sector, resources can be channelled towards building flood defences, and developing local structures and facilities that are more resilient to harsh weather conditions. Takaful solutions also have an important role in strengthening resilience against climate events.

These developments are likely to see important changes to the way financial institutions make decisions, and to the characteristics of banking and takaful portfolios.

In supporting these changes, two new tools will be published by Bank Negara Malaysia today for public consultation – a VBI Impact Assessment Framework (VBIAF) and the VBI Scorecard. The Assessment Framework provides guidance on the assessment of financing and investment applications taking into consideration economic, social and environmental impacts, while the Scorecard supports the implementation of performance measurement frameworks for Islamic financial institutions that drive positive value and impact on society and the environment. I look forward to receiving constructive feedback from the industry and interested parties, and to further strengthen these frameworks to drive a renewed focus on sustainable financial solutions.

Key Message 2 - Rethinking risk

The second imperative calls for a re-thinking of risk by Islamic financial institutions. Non-traditional forms of risks such as social, political and environmental risks are business threats that simply cannot be ignored. Research indicates that there are material benefits to managing these risks more proactively. An IFC survey of global banks showed that around 86% of respondents which integrated social and environmental risks in their business have yielded positive business results. There are also growing calls by shareholders for financial institutions to play a more proactive role in the sustainability agenda.

I am among those who believe that the true mark of a sustainable financial system ultimately lies in the extent to which, the market's and management's view of risks reflect sustainability factors. In June 2017, the Financial Stability Board published recommendations, for helping businesses disclose climate-related financial information. In the context of "finance beyond profit", this was a significant development by a global standard setting body, and the broader G20 community, to encourage the provision of better information on climate-related risks and their financial impact. For many, this is both a reflection of, and catalyst for, the closer examination of risk- and impact-adjusted returns, by capital and funding providers.

As natural stewards of sustainable finance models, Islamic financial institutions are well placed to develop richer perspectives of social and environmental risks. This calls for a review of internal risk decision-making processes and inputs within financial institutions, alongside enhanced disclosures to market participants. Yet little, if anything, is done today to consider how such risks need to be managed – both for existing portfolios and future growth strategies. Actions taken by financial institutions to mitigate, transfer or control the risks have the potential to generate corresponding, broader responses by policymakers, businesses and other financial institutions. This in turn can create new markets for sustainability services, and a virtuous cycle of mutually reinforcing market forces, that promote sustainable business practices across the economy.

As we further develop the VBI systems for Islamic finance in Malaysia, this will be an area of important focus. This work will also address the role of domestic regulations, in creating a level playing field, for value-based banking practices, where appropriate. To date, policy documents developed on 14 Shariah contracts, serve to provide a clear and consistent framework for lending, underwriting and investment activities of Islamic financial institutions. I am encouraged by efforts among some Islamic financial institutions to introduce value-adding innovations, building upon these Shariah contracts, and further differentiating their solutions from conventional offerings. I would of course like to see much more traction in this direction going forward.

Key Message 3 – Rethinking human capital

My third point relates to rethinking human capital. Despite growing awareness on the importance of sustainable business practices, in creating long term value and reducing risks, the challenges of building internal human capacity to support sustainable practices continues to be left largely unattended to. For Islamic financial institutions, this goes beyond strategy alignment and culture, which has been the primary focus to date, to building or acquiring the *fundamental skillsets,* required to implement sustainable financing and risk management practices. Without these, VBI cannot hope to progress very far.

To illustrate, a study by the National Bureau of Economic Research found that jobs requiring a higher intensity, and concentration of “green skills” to support the transition to greener economies, lies among *high-skilled professional* profiles. In other words, if Islamic financial institutions are serious about adopting VBI, the complement of skillsets at the management levels of the organisation will need to be fundamentally re-assessed. Relevant skills that need to be brought into the organisation include engineering and technical skills in the design, construction and assessment of technology; science skills; and monitoring skills focusing on observing compliance with environmental laws and standards. Even boards too have to learn and adapt to the demands of the new operating environment.

Relevant skillsets are also critical to support innovation within the financial sector to capture opportunities and improve the delivery of Islamic financial solutions. Indeed, technology can be better optimised to revolutionise the way Islamic finance operates and offer innovative solutions to customers. For example, blockchain or artificial intelligence applications hold enormous potential for simplifying documentation requirements associated with Shariah contracts, thus improving the overall efficiency of business operations.

It should be abundantly clear by now to any financial institution that is serious about VBI, that, the task of building the human and intellectual capital to achieve and sustain value-based business models cannot be left solely to the human resource departments. It requires nothing less than strategic direction and resourcing decisions at the highest levels of the organisation.

Changing mindsets

Einstein once said “*The world as we have created is a process of our thinking. It cannot be changed without changing our thinking*”. The world today continues to push the limits of social and environmental thresholds, that are posing increasingly serious threats to humanity. VBI is therefore, much more than a current and passing fad, but a deeper conviction of the critical need to begin the process of changing mindsets in a lasting way. Financial institutions are a key, but not the only catalysts in this process.

Customers and investors need to be supported with relevant information, along with the means and ability to compare such information, in order to better understand the value propositions of Islamic finance. The encouragement of pension and institutional funds with a sustainable investment orientation, particularly in markets where such funds remain largely underdeveloped, would be important to provide a stronger impetus for VBI. Credit rating agencies could also be important contributors to a new landscape, with stronger emphasis on economic, social and environmental sustainability in assessment frameworks and methods. And regulators and policymakers need to be appropriately responsive to the adoption of sustainable practices.

Conclusion

In conclusion, the Islamic finance industry today faces an important, strategic choice – to either continue on a path that largely ignores the stark social and environmental realities that confront humanity, or to thoughtfully chart a new path that fully embraces the idea and philosophy of finance beyond profits. The latter will be an unfamiliar path in many respects, but one that is far closer to the fundamental premise of Shariah on which Islamic finance is based upon. Embarking on this path will require deep conviction and visionary leadership across financial institutions, governments and policymakers. But the pay-offs will be immeasurable. For many in society, it will also make the difference between economic freedom and opportunities, and a lifetime of hardship.

Thank you.

See also:

1. Implementation Guide for Value-based Intermediation
2. Value-based Intermediation Financing and Investment Impact Assessment Framework (Consultative Document)
3. Value-based Intermediation Scorecard (Consultative Document)