Abdul Rasheed Ghaffour: Unlocking full potential of Islamic finance through sustainability

Welcoming remarks by Mr Abdul Rasheed Ghaffour, Deputy Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the RFI Roundtable on Responsible Finance "Unlocking Full Potential of Islamic Finance through Sustainability", Kuala Lumpur, 23 September 2019.

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It is my great pleasure to welcome all of you to the RFI Roundtable on Responsible Finance. I would like to thank the RFI foundation and Dubai Islamic Economy Development Centre (DIEDC) for organising such gathering of policymakers and captains of the financial services industry. The chosen theme "Unlocking full potential of Islamic finance through sustainability" is indeed very apt and timely. We are now in an environment where global aspirations are at risk – indebtedness is high[1], inequality has widened[2], effects of climate change continue to accelerate[3]. **Doing nothing is not a responsible option**! Despite the growing focus in sustainable finance, I am certain many within this room would agree that this transition in the financial system, more so the Islamic financial system, is happening not at the desired pace, scale and intensity. For the next five to ten minutes, allow me to highlight the catalytic role that Islamic finance can play in advancing sustainability agenda.

Shariah embeds inherent features that make it **natural** for Islamic financial institutions to play such role. The three main features:

i. First, **impact-driven**. Intended outcome of Shariah emphasises on minimisation if not prevention of negative impact and maximising positive value creation to wider stakeholders namely people and planet. The dos and don'ts of Shariah aim to enhance people's well-being by preserving five stipulated key outcomes of Shariah *(maqasid)* namely the wealth, faith, lives, posterity (lineage) and intellect[4]. In the context of financial intermediation, preserving wealth entails beyond its literal meaning – to include encouragement to generate, accumulate and distribute the wealth in a just and fair manner.
ii. Secondly, **real economy**. Islamic financial intermediation activities must be backed by real economic activities, thus aligning innovation with the needs of productive activities. Requirement to support the real economy thereby avoids element of speculation.
iii. Thirdly, **partnership**. Another distinct aspect of Islamic finance is the application of risk-sharing in financial transactions. This strengthens the incentives for both financial institutions and business clients or investors to screen and monitor transactions for commercial viability and risks.

The growing momentum in global trend towards sustainability agenda does not only sharpen the focus on formulating necessary solutions to key global challenges such as poverty, food security and inequalities. Most importantly, it creates a sense of urgency for financial institutions to embrace long-term value creation mindset. Increasingly, stakeholders are setting higher expectations on financial institutions to manage the threats of climate and environmental-related risks that are real, with irreversible consequences. Failure to respond appropriately and in a timely manner may have adverse implications on the economy and direct financial consequences on financial institutions. A case in point is the reputational risk a financial institution that provides financing to companies involved in environmental destruction activities could face, which may eventually affect the institution's financial sustainability.

Malaysia's experience and approach

A question in mind is therefore whether Islamic finance has fully optimised on these value propositions. Allow me to share this in the context of the Malaysian Islamic financial industry.

After three decades of development, the Islamic finance industry has progressed to become an integral component of the Malaysian financial system[5]. Most notably, Islamic finance has played a catalytic role in financial inclusion – enabling access to formal financial services for the different segments of the society. In charting its strategic direction, in 2017, a few Islamic financial institutions began to explore value-based intermediation or VBI as a new operational model. The VBI encapsulates the vision to focus on being more impact-driven, reinforcing the overarching intent of Shariah to promote good and prevent harm. Islamic finance, moving forward, strives to be relevant to all as a financial intermediation that creates positive and sustainable values for broader stakeholders – consistent with the long-term value creation for shareholders and aligned with the national targets of sustainable development goals (SDGs).

To date, 12 Islamic banking institutions have committed to integrate environmental and social considerations in their offerings, practices and cultures. In facilitating the industry in this journey, Bank Negara Malaysia collaborates with the industry to create an enabling environment for smooth and orderly transition. These include the issuance of several guidance documents such as VBI implementation guide, VBI Scorecard and Value-based Impact Assessment Framework (VBIAF). More recently, the Bank and the VBI community of practitioners (COP) have embarked on efforts to develop sector-specific guide on value-based impact assessment alongside sectoral experts. As a start, the focus is on renewable energy, efficient energy and primary commodity (palm oil).

As the industry began to operationalise the VBI, the market has observed efforts to infuse key elements of VBI in the offerings and practices. These include the launch of the first working capital financing for women entrepreneurs this year. This collateral-free facility embeds financial literacy sessions and focus group discussions to help entrepreneurs in managing and growing their businesses more efficiently. Other examples include the launch of an Islamic Index-based investment scheme embedding with environmental, social and governance (ESG) principles, as well as a financing programme via matching fund platform between financial institution and public contributions, which aims to empower communities through entrepreneurship.

The takaful industry is also taking steps to implement VBI. The industry has formed a VBI Takaful Task Force to formulate the strategic roadmap for the takaful industry. Several takaful operators, on their own, have also undertaken a comprehensive review of business strategies. This review has begun to shape changes in the corporate value intent and strategic direction of these takaful operators to be more aligned with VBI. Additionally, some of these takaful operators are beginning to formulate more value-based protection solutions.

Role of technology in optimising potential of Islamic finance

One final point before I conclude – **technology makes the impossible possible**. Recent financial technology advancements enable Islamic finance industry players to deliver practical yet value-adding solutions. For instance, application of blockchain[6] to address challenges[7] in managing endowment fund (*waqf*). Fintech is rapidly changing the facets of the global financial industry, reshaping expectations of consumers and businesses on financial services. There are untapped opportunities of fintech to develop financial solutions that can help drive Islamic finance to deliver even greater, wider and deeper positive impact – particularly in realising its promise in risk-sharing and providing support for genuine and productive economic activities. Technology can also widen access to and increase outreach of social finance instruments through digitisation of collection and disbursement of the proceeds. Fintech startups such as LaunchGood and SkolaFund are already making their name in social impact initiatives, which is a promising start.

Conclusion

Financial institutions need to look beyond short-term profitability. It is imperative for financial intermediaries to be seen fulfilling the needs of the economy, society and environment at large. Moving forward, 'change of mindset' is eminent. While considering profit, financial institutions should not forgo the element of being socially and environmentally responsible. I believe setting the 'Tone from the top' is key in this process.

The organisation of today's roundtable forum is indeed very apt. It serves as a networking effort while creating opportunities to exchange views, explore mutually beneficial opportunities, and most importantly, implement positive changes in the financial systems. It is not too far-fetched to envisage the generation of breakthrough thinking for future collaboration that is solution-driven; practical; and innovative. Collective effort is also key to success and the industry should aim to work closely with other key stakeholders. These include government agencies, civil societies and the public to increase awareness and encourage more active participation in supporting further development and offerings of sustainable financial solutions in the market. Strong technical know-how in dealing with the changing dynamics of the financial landscape and the arising risks is also essential for industry players to navigate itself in this journey.

To end, I wish to reiterate that **"sustainability is indeed a journey, and one that is best navigated collectively".** Sustainable development can be best served by re-connecting finance and element of value creation that is reinforced by bringing benefit to society, environment and prosperity. On that note, I wish all of you a beneficial and productive session today.

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1 Around 30 least developed and other vulnerable countries are exposed to debt distress – limiting their ability to invest in the sustainable development goals (SDGs).

2 Countries home to most people in the world and global growth in real wages is only 1.8% – the lowest since 2008 (Source: United Nation (2019). *Financing For Sustainable Development Report 2019*)

3 Air pollution was a cause of almost 5 million deaths worldwide in 2017 while 62 million people were affected by natural hazards in 2018, with 2 million needing to move elsewhere due to climate events (Source: NGFS (2019). *A call for action: Climate Change as a source of financial risk*).

4 Imam Al-Ghazali, Al-Mustasfa fi `ilm al-Usul, page 174.

5 Islamic banking assets has grown to 31.4% (RM916.7 billion) of total banking assets (as at end 2018, compared to only 14.1% in 2008)

6 A blockchain is a digital ledger that holds any kind of information (e.g. transactions, contracts, assets or identities) that can be stored in a digital format. Entries in the digital ledger are permanent, transparent and searchable.

7 Reference: The Edge Malaysia Weekly (4 – 10 June 2018). *Personal Wealth*. These challenges include lack of data (value of the endowment), limited transparency, lack of clarity in accountability, lack of proper auditing and poor planning for *waqf* assets development