Zeti Akhtar Aziz: The transformation of the international financial system and the role of the Islamic financial system

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This is a time of extraordinary global economic challenge and uncertainty. The recent unprecedented global financial and economic crisis has resulted in tremendous damage across the world. The meltdown in the global financial system resulted in several setbacks including bank failures, a credit crunch, a collapse of asset markets, massive wealth destruction, a sharp decline in trade and financial flows and widespread unemployment in many parts of the world. To contain the effects of the financial crisis on the economy, extraordinary and exceptional measures were taken by policymakers around the world. With the global economy now on the road to recovery, attention has turned towards securing a more permanent solution in shaping the global economy of tomorrow that would avoid such crisis of such proportions in the future.

Significant steps are being taken by the international community to intensify efforts to reform and strengthen the international financial system. The aim is to build the foundations for a stronger and more inclusive global economy – built on the premise of sustainable growth and a greater shared prosperity. This global resolve is in fact, fundamentally in congruence with, and accentuates the role and relevance of Islamic finance on the global economic stage in this post-crisis era. Islamic finance, through its emphasis for the attainment of socio-economic goals based on the objectives of Shariah, provides the discipline that enhances the prospect of strengthening the global economy and overall financial stability.

The relatively better performance and the sustained momentum of the growth in Islamic finance during this period of global financial turmoil exemplifies its inherent strengths – its emphasis on a strong linkage to productive economic activity which predisposes the economy to financial deepening without the excesses, its emphasis for accountability, disclosure and transparency and its inbuilt checks and balances, all of which underpin Islamic finance as a stable form of financial intermediation that strengthens its prospects as a contributor to economic growth and financial stability.

While the amount of funds managed in the Islamic financial system is still only a fraction of the total assets of the international financial system, it represents that portion of financial activities that is truly supported by underlying productive capacity that generates growth of economies across continents. It is this form of financial activities that we would want to encourage, as opposed to the financial flows that are destabilising and not contributing to generating real economic activity.

The efforts to reform the international financial system by the international community have aimed to address the broad range of flaws and weaknesses that has contributed to this recent crisis and to restore confidence in the integrity of the global financial system. At the core of this reform agenda is the development of a new financial regulatory framework that would be more effective and that is premised on a greater emphasis on ethics, fairness, and accountability and that promotes global economic, social and environmental sustainability. It also needs to be anchored on a balance of supporting growth while maintaining financial stability, and one that is founded on greater international coordination of regulatory approaches and supervisory oversight with a crisis management framework that will reduce systemic risk and the severity of any such future financial crises.

These reforms include measures to raise the quality and level of capital held by banking institutions, strengthening the liquidity risk requirements and management, implementing forward-looking provisioning standards, and aligning compensation practices with long term performance. Further measures also include the improvement in transparency and strengthening of the supervisory frameworks and arrangements for dealing with cross-border oversight on financial groups that operate beyond domestic shores. This has also been reinforced by the strengthening of macro-prudential regulation. The crisis had demonstrated that the collective behaviours of banking institutions and other highly leveraged institutions had contributed to the material build-up of risks in the financial system which ultimately in turn undermined financial stability. It was also recognized that the existing regulatory framework was insufficient to address systemic risks. This has prompted a more integrated approach to the regulation with substantial strengthening of the macro-prudential elements of financial regulation.

A major concern on the calibration of the regulatory reforms is its unintended consequences that could materially impair the vital role of the financial sector in the economy. Of concern is that the cumulative impact of the new measures may affect the cost and availability of financing to the wider economy. There needs to be a balance between long run financial stability and its potential increased costs to financial intermediation. This balance needs to combine regulatory and supervisory systems that are more forward looking and responsive to risk; while having in place appropriate incentive structures for financial institutions to prudently manage risks and strengthen conditions for market discipline to take effect.

While the Islamic financial system has generally performed well during this global financial crisis, several valuable lessons can be drawn from this crisis in our efforts to strengthen further the Islamic financial infrastructure for a more resilient and stable financial system. In 2009, a Task Force on Islamic Finance and Global Financial Stability was formed by the IDB and the IFSB to undertake an assessment of Islamic finance during the global financial crisis and to identify the further building blocks that are necessary to further strengthen the foundations of the Islamic financial system. The report examines the conceptual elements inherent in Islamic finance and their effects on financial stability and considers eight further areas of development in the Islamic financial architecture to enhance its ability to deal with a more challenging future operating environment. This Report completed in April this year aims to support the international efforts towards providing a strong foundation for financial stability in the global financial system.

The eight areas for strengthening the financial infrastructure of Islamic finance address the institutional capacity both at the national and international level with the aim of contributing to global financial stability. These building blocks which address the core foundations for the development of Islamic finance include, first, ensuring the effective implementation of the prudential standards; second, the development of systemic liquidity management infrastructure; third, the establishment of strong financial safety nets; fourth, putting in place an effective crisis management and resolution frameworks; fifth, strengthen further the accounting, auditing and disclosure standards; sixth, having an effective macro prudential surveillance in place; seventh, having credible credit rating institutions and processes; and finally eighth, enhancing close international cooperation and coordination among countries including in capacity building and talent development to support efforts at the national level to ensure financial stability.

Islamic finance does not exist in isolation and as it becomes an increasingly important component of the global financial system, it will inevitably be impacted by the changing global landscape of financial regulation. This is particularly important as its growth gains momentum both in terms of number of service providers and in terms of business volume and as the internationalisation process continues. The global call for improved regulation and increased oversight in an international financial environment that is fundamentally different will thus also require us to intensify the efforts that have already been undertaken to strengthen the financial regulation for Islamic finance.

The financial reforms in Islamic finance to support sustainable and responsible innovation , in particular, need to leverage on its inbuilt strengths that set Islamic finance apart in performing its role in the mobilisation and allocation of resources to generate real economic activities. In Islamic finance, innovation is key in pushing the frontier of market development to generate the range of products and services, processes and functions. The key lies in preserving the benefits of innovative initiatives and activities whilst ensuring that they do not result in negative externalities. This comes in the forms of its strong paradigm in governance, disclosure and transparency, as well as the emphasis that innovations are anchored in the objectives of Shariah and thus are for the benefit of the people.

Importantly, Islamic finance has the disposition to facilitate financial deepening without financial excesses through the fundamental Shariah requirement for Islamic financial transactions to be supported by an underlying economic activity and for socially-responsible financial innovation. Moreover, the profit-sharing and risk-sharing characteristics of Islamic financial transactions strengthen the incentives for Islamic financial institutions to undertake the appropriate due diligence on the Islamic financial transactions to ensure that the profits are commensurate with the risks assumed. The Shariah board of Islamic financial institutions additionally serve as a rigorous process of endorsement of the experts, thus representing a vital institutional safeguard to ensure that the inherent strengths of Islamic finance are fully realised. This ensures that the products are offered with the intention to achieve real benefits for the investors. It would therefore reduce the tendency for extreme behaviour in the financial system.

More recently, the world's attention had shifted from troubled banks to troubled countries with rising sovereign risks, leading to further rescue packages and increased anxieties over contagion to financial markets in other parts of the world. Whilst these challenges continue to be addressed by the developed economies, the emerging economies have emerged from this crisis with stronger growth performance. The Asian region in particular, has entered the crisis with solid economic fundamentals and more resilient financial systems and institutions. This has in turn substantially limited the consequences of the contagion. With the internationalisation of Islamic finance in this decade, it has further reinforced the trend of greater financial integration in emerging economies. This has reinforced the changing global pattern of financial and economic integration as financial and economic linkages strengthened between the emerging economies.

In the more recent period, with the enhanced international dimension of Islamic finance, it has become an increasing form of intermediation that has facilitated economic linkages between emerging economies. In addition, it has also drawn the participation by the more established financial centers to forge stronger financial linkages with the dynamic growth regions of Asia and the Middle East. Indeed, this would contribute towards more efficient mobilisation of funds across regions, reinforcing the significance of Islamic finance as an increasingly important channel for a globally more inclusive economic development. In the aftermath of the crisis, Islamic finance will continue to spur new connectivity among nations as its role and relevance gains more significance, thereby contributing to a more balanced global growth.

Conclusion

In conclusion, it is the very premise on which Islamic finance performs its intermediation function that strengthens its potential role and relevance in advancing the growth and development agenda towards preserving financial stability and towards strengthening economic and financial linkages between nations. By operating in accordance with the rules of Shariah, Islamic finance draws its strengths from its direct link to economic activity and its inherent requirement for prudent risk management and explicit disclosure and transparency thereby ensuring the viability of the activities in generating sufficient wealth to compensate for the risks involved. These inherent strengths will continue to be the catalysts driving its transition into a new era of growth and development in this post-crisis world.

As Islamic finance transitions to its next stage of development with greater international integration, the immense benefits that will be unleashed need to be accompanied by a higher level of resilience to be well positioned to manage the new challenges that the future will bring. Our collective efforts to mobilise a higher level of global cooperation in promoting this outcome will also enhance the prospects of Islamic finance to contribute towards securing global financial stability and a greater shared economic prosperity.