**KEYNOTE ADDRESS BY
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***Plenary Session 2:*** ***Islamic Banking and Finance in Emerging Markets – Seizing Opportunities, Overcoming Challenges***

Assalamualaikum Warahmatullahi Wabarakatuh.

Good afternoon, ladies and gentlemen.

I am delighted to be in Astana to participate in this very important forum, and it is an honour for me to address this distinguished gathering on the subject of Islamic finance. It is particularly gratifying because I feel that this is a form of international recognition of Malaysia's leadership and success in developing Islamic finance. Admittedly, I do feel a little bit like someone tasked with bringing the proverbial "coal to Newcastle" since my audience comprises some of the world's most eminent practitioners and scholars of Islamic finance. The disillusionment and disenchantment with the world of finance in the aftermath of the global financial crisis is what makes independent views of passionate supporters of Islamic finance much sought after, thus adding to the challenge that is before me.

2. Please allow me to briefly reflect on the progress made by Islamic finance, and what I observe of the present state of the industry and some of the challenges it faces. I will then offer some thoughts on how Islamic finance can move forward giving particular attention to emerging markets.

3. Before the inception of an Islamic finance industry, there was what we could call a "market failure" in the conventional financial system, as there was substantial unmet demand for *Shariah*-compliant financial products. Since the 1960s, Muslim scholars advocating the development of an Islamic finance system, emphasised the rejection of *riba* contracts and their replacement with risk-sharing contracts. The industry pioneers, most of whom had been operating in conventional finance, were interested in creating a financial system that caters to the needs of Muslims through the introduction of *shariah*-based financing for home ownership, savings funds for pilgrimage and *takaful*. The essential function of that financial system was to spread risk among market participants rather than allowing it to concentrate among the borrowing class. Conventional finance provided the basis of comparison. As a result, instruments of conventional finance became subject to replicating, retrofitting and reverse engineering for *Shariah*-compatibility. This was catalytic to sustaining the Islamic finance industry's early progress.

4. From its success in mobilizing previously untapped funds, the need arose to ensure there were avenues in which those funds could be channelled. Investment products like *shariah*-compliant stocks and bonds, mutual funds, Islamic leases and REITS were gradually introduced, and it gave Muslims in many parts of the world even greater access to *shariah*-compliant banking facilities. There were considerable efforts in Muslim as well as non-Muslim countries to remove regulatory and tax impediments to the development of Islamic finance within their borders. Regulatory organizations such as the

International Organisation of Securities Commissions (IOSCO) and the International Monetary Fund (IMF) contributed to ensuring Islamic finance operated in compliance with regulatory and prudential principles. These efforts have promoted the universal acceptability of Islamic finance and underpinned the tremendous growth of the industry in recent years.

**From retail to high finance**

5. Islamic finance quickly matured beyond providing financial inclusiveness and simple retail banking facilities towards more sophisticated investment products. And it can be said that this occurred as a matter of necessity. The success of Islamic financial institutions in mobilizing retail savings naturally led to a substantial demand for large-ticket *Shariah*-compliant investments. This demand was given a further boost by the increasing oil wealth and the birth of large sovereign wealth funds in Muslim countries.

6. This newfound liquidity brought Islamic finance to the attention of international borrowers, who began to realise that Islamic financial institutions with sizeable funds had limited options because of their inability to invest in conventional debt instruments. The surplus liquidity was unlocked mainly through large-scale *sukuk* issuances. The global *sukuk* market grew in popularity, not just among issuers from Muslim countries, but also among other issuers in the major international financial centres. Conventional financial institutions, with their leading edge financial engineering capabilities and far-reaching marketing channels, became big players in this new arena.

7. Having captured the interest and imagination of the international financial community, the wholesale segment of the market continued to expand with the introduction of more innovative *sukuk* products. These were often adaptations of conventional financial products because maintaining a similarity with

conventional products made for the ease of participation by the international financial community.

**The challenge of "financialisation"**

8. Therefore, just as conventional finance is said to have migrated from 'Main Street' to 'Wall Street' in developed markets, it can be said that Islamic finance is gradually moving from the realm of retail finance into the world of 'high finance'. Arguably, in this context, Islamic finance is becoming more exposed to the risk of "financialisation".

9. Since around 1980, the global financial sector has grown at a far more rapid pace than other segments of the economy. To illustrate, in 1980, global trading on foreign exchange was estimated to be 11 times the value trade in goods and services. In 2009, it was 73 times[1]. Increasing financialisation of economies is generally perceived to be a major source of instability not least due to the vulnerabilities caused by over-leveraging. There is no better reflection of this than in the recent financial crisis.

10. The real risk of financialisation derives from a de-coupling of global finance from the real economy. If substantial profit can be made from financial transactions over the short-term, then the willingness to commit capital and labour into the real economy over the long-term will be weakened. The focus on short-term profits creates incentives to indulge in speculative trading, and excessive speculation harms the capital formation process, ultimately reducing the potential for long-term economic growth.

11. There are important lessons to be learnt from this for emerging markets and for the continued development of Islamic finance. While Islamic finance has

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[1] McDaniel, Charles (2011), Distinguishing the "Real" from the "Fiduciary" Economy: Faith-based Investment after the Crisis, (Baylor University).

escaped relatively unscathed from the full onslaught of the global financial crisis, it is worth bearing in mind that Islamic finance is by no means insulated from the risks of excesses that wreaked havoc in the conventional financial system.

12. Islamic finance is making very good progress in emerging markets. As interest and demand grows, it is to be expected that emerging markets can expedite the development of their respective Islamic financial centres by learning from the experience of others.

13. However, imitating structures that have been devised in the name of financial innovation and sophistication could ultimately make it more and more difficult to distinguish between real production and financial sophistry. One cannot help but notice how contemporary Islamic finance is becoming more and more disengaged from its socio-economic aspects, and this threatens to dilute the true essence of Islamic finance predicated on the economic principles of Islam. Replicating conventional structures can also be destabilising in the long run, especially since the quantum of risk in the Islamic structure is very much different under *Shariah.* The global financial crisis is again a prime illustration of the probable disruptive effects that could arise should the adaptation of conventional models go unbridled.

14. To develop a strong and sustainable Islamic finance industry, financial engineering and innovation on their own will not be enough. It is important to always be reminded that an Islamic financial system is one based on real assets. The financial sector can only expand in tandem with the growth of the real economy. In my own country, rapid economic development provided the impetus for the growth of Islamic finance industry, which in turn has contributed to the country's further economic growth. A virtuous cycle of economic and financial development provides the foundation for sustainable growth.

**From a *Shariah*-compliant to a *Shariah*-based Islamic financial system**

Ladies and Gentlemen:

15. There is a need to extend the focus of developmental efforts in Islamic finance beyond the legal form and towards the economic substance of financial transactions. This means moving beyond the path of adaptation and compliance and towards *Shariah*-based approaches that will strengthen the nexus between Islamic finance and the real economy. The strength of Islamic finance is rooted in its philosophy that rejects debt financing, prohibits speculative activity and favours the apportionment of risk between the provider of capital and the entrepreneur, thereby encouraging entrepreneurship and the creation of real economic wealth. Islamic finance, which has as its core pillars social justice and equity, can and should do more to meet the needs of the poor and the marginalised.

16. Let me now put forth some of the opportunities for strengthening Islamic finance and bringing it closer to achieving the ideals of Islam for a more just and equitable society.

17. First, there is a need for intensified efforts to promote financial inclusiveness in Muslim countries around the world. The 1.6 billion Muslims account for at least 20% of the world's population and yet only approximately 14 percent have access to or use financial services. The Muslim world accounts for about 8 per cent of nominal gross domestic product, yet Islamic finance represents just 1 per cent of the global financial market. Addressing these discrepancies requires global collaboration and coordination to promote savings mobilization and develop financial intermediation in markets where they are currently lacking. The industry's present growth is largely being driven by its expansion in the emerging markets of China, Central Asia, Russia and Africa.

18. The second part of the process is to channel savings into investments that create businesses and jobs. In this context, there are opportunities to promote greater capital flow from surplus Muslim countries to deficit Muslim countries through the Islamic financial system. On one hand, many Muslim countries are rich in natural resources or have a large agricultural sector – which provides a natural collateral base for *Shariah*-based financing. On the other hand, several other Muslim countries have huge surplus savings or are rich in talent, which can be deployed to greater effect. There is a pressing need to organise capabilities and resources to promote financial inclusion and generate widespread economic growth.

19. Third, there remains the need for greater research and development into creating arrangements and structures that bring about socio-economic improvement. Innovation in these arrangements or products should facilitate greater private sector participation to complement government efforts in growing the economy.

20. Along these lines, there are opportunities to incorporate Islamic principles like *zakat, sadaqah, qardhul hassan* and the like to channel trade and long-term financing to small and medium-sized enterprises (SMEs) and enhance models of micro-financing. The development of *Waqf* can enable the endowment of property or assets for social objectives, such as for building schools, universities and hospitals. These efforts will not be pursued by financial engineers and investment bankers, but by scholars and economists in emerging markets, supported by facilitative government policies.

21. In Malaysia, the recently launched Capital Market Masterplan 2, which charts the developmental path for the Malaysian capital market for the next 10 years, emphasises socially-responsible financing and investment. In particular, priority will be given to nurturing Islamic fund management services with high

value-add such as venture capital and private equity that invest based on the principles of active partnership, risk-sharing and social responsibility. The Islamic fund management industry is expected to play a key role in developing more products and services that reflect the ethical standards and value proposition of Islamic finance.

**Concluding remarks**

Ladies and Gentlemen:

22. As the Islamic finance industry advances in emerging markets, it is imperative that its developmental perspective be given greater emphasis so as to fully embrace and reflect the link between Islamic finance and societal needs. As equity-based and asset-backed financing grows, the fruits of globalisation can be distributed more widely and more equitably among participants. It is up to regulators and practitioners to fully harness this opportunity for the betterment of the people in emerging economies and the *ummah* as a whole.

Thank you.