Shamshad Akhtar: Financial globalization and the Islamic financial services industry

Speech by Dr Shamshad Akhtar, Governor of the State Bank of Pakistan, at the 5th Annual Summit of the Islamic Financial Services Board, Amman, Jordan, 13 May 2008.

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1. Financial globalization has grown in size and scale. There is now a broad consensus that an effectively managed financial globalization has the potential to benefit from and contribute to:

- Growing world trade integration,
- Easing of investment and cross-border capital flows as economic liberalization gains momentum,
- Development of interdependent production structures that have evolved to maximize comparative advantage, and
- The revolution in information technology and institutional reforms.

2. These factors have deepened and diversified financial markets. However, the benefits of financial globalization have often come under test. This is largely when market distortions and risk management standards are compromised; these adversities, with leads and lags, usually result in failures and losses for financial markets and institutions. While the world has witnessed recurrent episodes of financial crisis, global developments since 2007 have had a profound and multiple impact given the multi-dimensional nature of the ensuing crisis. First, the financial market turmoil in the subprime mortgage market unfolded itself in the form of an unprecedented global liquidity crunch triggering huge financial and economic losses. Second, the world is now realizing the stress of growing global imbalances that have, for several months now, manifested themselves in the rising global commodity prices and have fuelled inflationary pressures.

3. While there are multiple lessons to be learnt from these developments, in principle, these events are a fresh reminder of the risks associated with over-leveraging and reckless off-balance sheet transactions given the weaknesses in regulatory and supervisory oversight of key segments of markets, and the excesses in consumption trends of the global economy which have compounded global imbalances and inequalities.

4. These events have again provoked debates regarding the pros and cons of financial globalization, the impact of which is incrementally visible, resulting in : (i) slowdown of world economy and consequently in trade in selected products and markets, (ii) volatility in equity markets which in some cases generated losses, and (iii) easing of liquidity in a number of ways by the affected central banks, which is now compounding inflationary pressures otherwise building up because of the international rise in food and oil prices. Corrective actions are underway and lessons being drawn from the unfolding events.

5. Good news is that the Islamic Finance (IF) industry has generally remained insulated from the recent episode in financial markets. This is because Islamic banks' transactions are backed by real economic assets and risk management, benefiting from the application of and compliance with Shariah principles and guidelines, wherein the banks and investors have to share the profit and losses in accordance with the risks taken. While in conventional finance, risk-free capital encouraged over-leveraging and overexposures by transferring transactions to off-balance sheets conduits. IF services drive their inherent strengths from the Shariah guidelines and principles. Notwithstanding, IF services, like all businesses, could be impacted if the global slowdown deepens.

6. Abstracting from the current scenario which is still unfolding, broad evidence confirms that financial globalization, with adequate safeguards, promotes economic growth and development. Financial globalization has the potential to promote and reinforce IF by ensuring its conformity with conventional finance by fostering newer and better linkages with the regional and global financial markets. IF in turn can reinforce and support globalization by bringing to it financial innovation and stability, provided it is properly nurtured and developed in conformity with the internationally well-accepted and tested financial sector prudential and regulatory frameworks. In order to achieve a deeper and sustainable impact, IF would benefit by aligning and positioning itself in a way that it takes full advantage of financial globalization.

7. Notwithstanding, it has to be recognized that financial globalization can have unintended negative consequences. However, empirical evidence confirms that this happens under specific conditions. Without going into an elaborate debate on this subject, suffice to point out that this happens in cases where the financial systems lack diversification or are under- or weakly regulated, and when financial globalization marginalizes the developing markets and people. If IF is positioned to address these areas upfront, it will in fact help reinforce and augment conventional finance with its inherent principles and guidelines that place emphasis on supporting economic transactions, avoiding speculation and depending on proper alignment of the risk-reward equation.

8. Given these considerations, there are ways in which IF can benefit and enrich the process of financial globalization so as to mitigate or reduce its negative consequences. For instance,

- IF's potential to promote different types of risk-sharing methods, supported by emphasis on equity and asset backed financing, can help promote risk diversification and mitigation.
- IF's strong ethical principles for stakeholders can help distribute, widely and equitably, the fruits of financial globalization among the participants than has happened thus far.
- Under IF, the lender supports transactions that are real and backed by tangible assets with profits linked with the risk taken, rather than encouraging deployment of riskless capital investments (interest and rent-seeking).
- Greater reliance on profit and loss sharing enables IF to structure equity partnerships which carry identifiable risks and discourage speculation.
- Internationalization of Sukuks and their flotation, expected to hit the $100 billion mark soon, is helping IF to better integrate itself with the global financial world; this will not only meet the region's massive infrastructure project financing requirement, but will also help diversify financial markets. A number of sovereigns and developed markets are now floating sukuks which is fostering financial globalization through geographical and investor base diversification in IF products, while helping engineer and improvise sukuk structures to suit the funding needs – this flexibility is helping the Sukuk structure to gain recognition as a global product.

9. Globalization of IF will magnify along with its growing acceptance as a viable alternative financing mechanism as it illustrates its capacity to co-exist and compete with conventional finance. As highlighted above, internationalization of IF is growing but this is happening in a number of ways which will in due course set the stage for deepening the dynamics and interface between financial globalization and the IF industry. Some of these developments are discussed below.

10. Aside from widespread growing interest and investment in IF, its growth at one level has been catalyzed by the growing global imbalances as oil rich economies accumulated capital from the persistent rise in international oil prices. It is the accumulated surpluses and wealth of the oil exporting members of the Middle East, including the Gulf Cooperation Council (GCC), that have helped the global financial players to develop IF markets. Over 2002-2006,

GCC capital outflows, as reported by the International Institute of Finance (IIF), rose to $530 billion: of this $300 billion outflows went to US, $100 billion to Europe and remaining to Asia and other destinations.[1] Reportedly, GCC net foreign assets rose to $1.8 trillion or 225% of the region's GDP.[2] Standard & Poor's estimate suggests that investible Arab capital now exceeds $2.3 trillion.[3] Boston Consulting Group estimates that Middle East investment entities' combined asset pool is around $10.2 trillion.[4] Currently this wealth has been deployed across the private banking departments of global financial players such as UBS, Citigroup, Standard Chartered and HSBC etc. If the IF industry augments its absorptive capacity to cater to the growing demand for IF products, more and more capital being currently directed into conventional finance, will be invested in IF.

11. Emerging financial joint ventures and alliances between GCC and Europe, as well as Asia, have already kick-started the process of IF globalization. Islamic banks are at the centre of developing these financial linkages between the Arab world and Europe/Asia.

Cross-border alliances among financial players have encouraged global banks to invest in IF, both in Europe and through their network in GCC and Asia. Also, the establishment of newer IF hubs and centers are likely to help retain the emerging capital flows from GCC within Asia. Leading Islamic finance houses, old and new, are investing in regional financial hubs aggressively to broaden their reach to capture the high net worth investments into IF. Extending the outreach, interest in IF is now emerging in US, Japan, China and Australia etc. Directional change in flows is already emerging, but meeting the demand for IF is critical for enhancing the competitiveness and sustainability of the IF industry and institutions, while raising their standing in global finance.

12. The large global financial players have been instrumental in fostering linkages and product innovation. This is largely because the investor community worldwide is being attracted by the "risk-return" and other innovative features of Islamic products, the product range IF offers, and the ethical investment philosophy and governance structure it promotes. Worldwide demand for Islamic financing is also gaining momentum as IF conforms itself to conventional finance by adopting proper regulatory and supervisory frameworks. Recognizing the implications of financial globalization on IF and IF's implications for global finance, Multilateral Development Institutions have been supporting the Islamic Financial Services Board (IFSB) to ensure effective alignment in the regulatory frameworks, while accommodating modifications and refinements of the special features and modalities of IF.

13. Investments, partnerships and alliances between the public and private sector, and among global and regional financial hubs, have allowed a two-way transfer of capital flow and knowledge-sharing that is steadily promoting the integration of IF with global finance, while encouraging the required financial engineering and product innovation which will enhance IF standing and legitimacy, while enriching the world of global finance.

14. While the industry has the potential to grow by 20-30%, there are concerns that IF is fraught with diversity, fragmentation and heterogeneity. To foster IF to integrally benefit from, and contribute to, financial globalization, there is a need for countries to launch a coherent, coordinated and synchronized development of the IF industry at national levels which feeds into and reinforces the implementation of the IF strategy, approved by the Council of Governors of IFSB last year. To support and withstand financial globalization, IF needs to reorient itself to:

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1 "Tracking GCC petrodollars: how and where they are being invested around the world", Institute of International Finance (2007).

2 Economic Report on Gulf Cooperation Council Countries, Institute of International Finance, January 2008.

3 "Globalization of Islamic funds", Islamic Banking & Finance, Issue 11, August 2007.

4 "Globalization of Islamic funds", Islamic Banking & Finance, Issue 11, August 2007.

- Consolidate and merge IF institutions to have the scale, efficiency and cost effectiveness to compete globally;
- Promote “globalization” of IF modes and instruments that are now meeting the finance and investment needs for the different sectors;
- Promote and adopt Islamic financial architecture that encourages standardization of legal structure and contracts, prudential regulation and supervision supported by appropriate risk management of the special features and structure of the new products, and accounting practices in line with AAOIFI standards;
- Encourage harmonization and convergence of religious views (emerging from differences in interpretations of Fiqh-ul-Muamalat i.e. the Islamic law relating to financial transactions) to minimize Shariah risks associated with the IF products, operations and systems. Generally, IF instruments and practices adopted by one institution can be eroded if the Shariah board of another institution question their compatibility with Shariah. As the confidence of local and the worldwide potential market for IF rests critically on Shariah compliant mechanisms, there is a strong need for coherence amongst different schools of thought, and mutual acceptability of product within and across countries, while recognizing that diversity in Shariah opinions (fatwas) is enshrined in Islamic legal history and will thus remain a feature of the market.
- Cultivate the IF industry as a multi-dimensional and multi-product market by exploiting scores of opportunities in fund, assets and wealth management, as well as proper financial engineering and innovation to support project and infrastructure financing, structured financial derivatives, and private equity, retail banking and Islamic mortgages.
- Develop suitable frameworks and applications of PLS-based products. At present, the share of equity investment in IF ranges from 0 to 24% of the banking books of Islamic banks. PLS modalities like mudaraba and musharaka, based on equity partnership arrangements, offer interesting options for innovation. However, weaknesses in legal, regulatory and policy frameworks have impeded their growth. Some of the constraints of its effective application[5] include (i) equity holders and investors’ aversion to risk, given the uncertainties over return in PLS arrangements, (ii) absence of effective property rights in most countries, (iii) long term nature of PLS financing and (iv) higher taxation, compared to interest income, on equity transactions underlying PLS arrangements. Nevertheless, promoting PLS arrangements will not only offer new products but will also address the serious mismatch of assets and liabilities which has aggravated due to the heavy reliance of IFIs on short-term, low profit and fixed income assets.

15. **In conclusion,** it has to be recognized that IF services have been transformed from being a peripheral activity to a sizeable industry which is attracting global interest. Evidence and arguments presented above make the case that financial globalization will foster IF and given the inherent features and richness of Islamic principles, modalities and products’ growth in IF will be beneficial for supporting the process of regional and global financial deepening. Although currently the size of IF is small relative to the global financial system, it has promising growth prospects. Well-developed and integrated Islamic money, capital, and foreign exchange markets will not only be beneficial for borrowers and institutional investors, they can also further enhance the stability of IF institutions, providing them with improved portfolio, liquidity and risk management tools. The challenge for the industry is to consolidate

[5] “*Lack of Profit Loss Sharing in Islamic Banking; Management and Control Imbalances”,* Humayon Dar and John R. Presley (2001).

itself to be able to better compete with global players through achieving scale, efficiency and cost effectiveness in addition to rapidly building its capacities to standardize regulation and supervision, and accounting practices, while strengthening the governance of the industry.