SEACEN 30th Anniversary Conference "Greater Financial Integration and Financial Stability" Kuala Lumpur, 20 October 2013

Opening Remarks by

Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz
Governor, Bank Negara Malaysia

Bank Negara Malaysia is honoured to welcome you to the SEACEN 30th Anniversary Conference on "Greater Financial Integration and Financial Stability". We are especially honoured by the presence of Governors and senior officials who are here today, despite the pressing demands on our institutions during this period of persistent uncertainties in the global financial and economic environment. We continue to face challenging and often testing times. Over the recent five years, we have been confronted with recurring episodes of turbulence, followed by phases of transitory recoveries. We have seen, and have been part of, extensive collaborative measures and reforms pursued at both the regional and global level. Yet, the calm after the storm continues to evade us.

The SEACEN and Asian economies have seen significant structural adjustments and wide ranging financial reforms in this decade. During this period intra-regional trade activity has rapidly increased, signifying the deepening of economic ties within the region. Intra-regional trade in East Asia has expanded from an average of 44% of total trade in 1995, to 50% in 2012. Intra-regional investment activity has also been on an uptrend. Asia's young and increasingly urban and increasingly more affluent population, supported with policy initiatives to strengthen social safety nets – including for healthcare and retirement - will further enhance domestic demand in the region. This will further unlock our trade and growth potential. Our diversity also continues to be an important source of strength for the region. The complementarities between the economies in the region provide significant opportunities for greater shared prosperity and mutually reinforcing regional growth. The progressive liberalization of the domestic financial sectors, the development of domestic capital markets and the integration of payments and settlement systems have opened up new channels for regional financial institutions and markets to intermediate funds across borders. These developments have facilitated the recycling of surplus funds from the region for economic development in the region, while also enabling greater diversification of risks.

The lessons drawn from the Asian financial crisis more than 15 years ago also continue to shape our financial sector reforms, liberalization and economic and financial integration in the region. The focus is on developing a financial sector that serves the needs of the real economy, and which is built on solid foundations of sound risk management and strong financial buffers. An important precondition for financial liberalization and integration in the region has been ensuring that we build the capacity and financial infrastructure that would enable us to respond to emerging risks while also minimising their contagion effects. The recent global financial crisis and its aftershocks remind us that these lessons remain relevant and that we need to stay firmly on course in strengthening our foundations and resilience. A gradual and phased approach to financial liberalization and integration has served the region well, allowing time for the building blocks to be put in place, and flexibility to set the pace at which our financial systems can continue to grow and expand in line with the capacity to manage the attendant risks of a more open and interconnected financial landscape.

To date, financial integration in Asia has mainly manifested itself in the form of the increased regional presence, with increase participation of indigenous Asian banks in the regional financial system and increased participation

in regional financial markets. The prospects for such greater regional financial integration are significant given that large flows of capital currently continue to be directed to developed economies outside the region. This is in contrast to the trade patterns in the region where intraregional trade flows account for more than half of total trade in the region. Promoting greater financial integration in Asia will not only serve to reinforce economic integration, but also enhance the depth and breadth of Asia's financial markets, contribute to the development of more sustainable funding sources for economic development, and potentially improve terms of trade by reducing transaction and information costs.

The strategy and path towards greater financial integration in Asia seeks to preserve the strengths inherent in the diversity of the region, while raising the standards which promote financial stability in the region. Recognizing the various stages of development across our economic and financial systems, the Asian financial integration model for the ten ASEAN economies is focused on: (i) strengthening preconditions through collective capacity building to promote more open market access; (ii) progressively reducing barriers to facilitate cross-border trade; (iii) developing the market infrastructure and an enabling environment to promote the efficient and effective intermediation of cross-border financial flows; and (iv) establishing appropriate safeguards for financial system stability. Two distinct elements of this process are important. The first is that it allows for different speeds of integration depending on the state of readiness of respective member countries. The second is the commitment of members to support each other in developing the preconditions that would make financial integration viable for the group as a whole in the long run. These elements are important for achieving a process and outcomes that will be sustainable.

The modernization of Asian financial systems during this period has also been accompanied by significantly strengthened regulatory and supervisory frameworks, improved financial safety nets, more effective surveillance of financial stability risks and stronger legal underpinnings. These reforms supported the transition towards more market-oriented financial systems that are anchored in stronger institutions, risk management capacity and governance. Today, our financial markets are better able to intermediate volatile financial flows and our financial institutions are supported by stronger financial buffers to withstand adverse developments and shocks. Significant strides also continue to be made in strengthening consumer protection frameworks, promoting financial inclusion, and enhancing market discipline. These developments continue to support the region through the recent episodes of turbulence in the global financial markets.

The region has also made important strides in enhancing monetary and financial cooperation arrangements to address regional financial stability issues and global policy spillovers. Much has been accomplished in the areas of surveillance arrangements, financial safety nets and crisis prevention, management and resolution. We have already experienced the important benefits of having these arrangements in place as the region came together to respond where needed to events that were unfolding during the global financial crisis. The authorities in the region remain committed to build on these foundations to bring regional cooperation to higher levels not only to reap its benefits but to also preserve financial stability in the region. In this effort, the current priorities for cooperation include improving information flows on risk assessments; advancing regional financial infrastructure and capacity building; and providing a regional voice on key international developments that may affect the region.

As financial integration gains pace, the demand will increase for greater convergence in regulatory and supervisory approaches and standards, including their implementation across borders. An important objective of such regulatory convergence is to ensure that cross-border financial linkages act to foster regional growth, while mitigating the propagation of systemic risk across borders through such linkages. The convergence of standards has proceeded in different ways in different parts of

the world. In Europe, regulatory convergence has been driven by EU-level bodies and agencies, including the European System of Financial Supervisors and the European Systemic Risk Board. The EU-wide prudential rules are formulated and implemented through directives and regulations legislated by the European Parliament and European Council, with limited room for member states to apply "national discretion". Recent proposals to establish a single supervisory mechanism for banks led by the European Central Bank, and a single resolution mechanism, will further reinforce the role of EU-level institutions in the management of financial stability in the Euro area.

With significantly more diverse economies and financial systems, promoting greater regulatory convergence in Asia is more likely to proceed on the basis of a set of shared principles for developing and maintaining sound financial systems, while providing for the unique and distinct legal, financial, social and economic structures of individual countries within the region. It will be important to have clarity around the key principles, an inclusive process in agreeing on these principles, and mechanisms that support their effective implementation in individual countries. Under such an approach, individual countries will have the necessary degree of flexibility to tailor national implementation approaches to reflect the specific characteristics of their respective economies, while committing to uphold the essential regulatory and supervisory principles that underpin financial stability.

With Asia's varied experience in weathering financial crises, in developing our financial systems and in implementing the various regulatory reforms, valuable lessons can be drawn from the region to advance the progress and development of our respective financial systems and of the region as a whole. SEACEN has had an instrumental role for more than 30 years in the efforts to share this knowledge and experience widely among its members through providing a platform for such information sharing and through its research, training and capacity building initiatives. Today, SEACEN takes yet another important step forward in advancing this agenda with the launch of the **SEACEN Financial Stability Journal**. We live in a world in which the management of financial stability is a highly complex undertaking, and its dimensions have continued to evolve in an environment that is rapidly changing. It is hoped that the Journal will contribute ideas, perspectives and insights and thus generate the intellectual dialogue and discourse on financial stability issues. As a region, Asia has many unique perspectives and experiences to share with others facing similar challenges in managing financial stability. I congratulate the SEACEN Centre on this important initiative. I wish it every success and look forward to contributions from SEACEN members and from the other parts of the world. The Journal can have a significant influence in drawing attention to the financial stability issues that are most important and thus contribute towards the thinking and responses on these issues. It is a process that should have an inclusive participation in this important agenda of financial stability.

SEACEN-CEMLA Conference on 'New Paradigm in Central Banking' "Central Banks and Sustainable Growth" Kuala Lumpur, 21 October 2013

Opening Remarks by

Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz
Governor, Bank Negara Malaysia

It is my honour and great pleasure to welcome you to Kuala Lumpur for the 3rd SEACEN-CEMLA Conference. Since the onset of the Global Financial Crisis more than five years ago, significant attention has been focused on central banks – in both the advanced and emerging economies – from our roles in crisis management and resolution, to engineering and supporting an economic recovery. Amid the considerable number of challenges that have confronted the global recovery process, there has been profound shifts in the expectations of what central banks should do in navigating the recovery path. There has been much debate on what central banks can do, against what central banks should do. In the midst of carrying out our mandates, it is often overlooked that all central banks ultimately share a common ultimate objective – that is, to ensure an environment that is conducive for sustainable, balanced and inclusive growth. My remarks this evening will discuss the role of central banks in achieving sustainable growth, in a more complex and constantly evolving global landscape.

Globalisation is not new. What is new is the speed and pervasiveness of globalisation, where technological advancements, and economic and financial liberalisation, have accelerated economic interactions and the cross border integration of financial markets. Post-crisis, the world has entered into a new phase of globalisation. Firstly, amid the uneven pace of growth in the advanced and emerging economies, the global environment has become more multi-polar. In 2012, the emerging economies accounted for half of global output, and almost half of this share was from the SEACEN-CEMLA economies. Secondly, while the growing inter-connectedness of economies within and across regions has presented considerable benefits, risks associated with globalisation have also intensified. Following the crisis and its management in the major advanced economies, heightened uncertainty has amplified the volatility in the global economy and the international financial system. The slow and uncertain recovery in several of the major economies and the recent developments in the global financial markets exemplify these trends with its reverberations being felt significantly in most emerging economies.

The most pressing challenge for policy-makers in this current global environment is to generate sustainable growth. In the developed world, the financial crisis has resulted in tremendous damage to their economies. Five years hence, a sustainable recovery has yet to be secured. While most emerging economies have experienced strong growth during this period, the slowdown in world trade in 2013, and the policies by several emerging economies to rein in excesses and emerging imbalances following the surges in capital flows have resulted in a more moderate pace of growth. Most emerging economies nevertheless continue to remain on a solid growth path with sound and resilient financial systems.

Amid this changing global landscape, much attention has been placed on the role of central banks. Fundamentally, the goals and objectives of central banks have not changed. Notwithstanding varying institutional arrangements, central banks share a common goal of facilitating an environment that is conducive for sustainable growth. The recent global financial crisis however, has offered alternative perspectives of sustainability. Prior to the Global Financial Crisis, the focus of central banks was primarily on containing

inflationary pressures amid the growth phase of the business cycle. The crisis has however shown that financial imbalances can build up even in an environment of price stability and which can present significant risks to financial stability and thus to economic growth. In addition, not only has the experience shown that there are limits to what monetary policy can achieve, but that an over-reliance on monetary policy could also lead to unintended consequences. A prolonged low interest rate environment could in fact delay the necessary structural adjustments and encourage a build-up of financial imbalances. As a counter-cyclical tool, monetary policy also cannot address structural issues, such as impaired balance sheets and economic competitiveness.

In the aftermath of the crisis, the mandate of Central Banks has become broader. Beyond macroeconomic stability, there has been increasing emphasis on the role of central banks in ensuring financial stability, containing the build-up of financial imbalances and in the management of financial crisis. In emerging economies, particularly in Asia, the mandate is even broader, to include financial sector development, including the financial infrastructure and payments system and the development of financial markets, the implementation of financial reforms and initiatives involving deregulation and liberalisation, and measures to achieve a more balanced and inclusive growth. As with central banks in the developed world, the expectation is that central banks will also have a major role in managing risks arising from a more integrated global environment, and containing and managing a financial crisis.

Increasingly, it is recognised that a comprehensive approach is needed to achieve sustainable growth. There is tremendous calls for structural adjustments and reforms by the international communities to the emerging economies as being important for achieving such sustainable growth. Indeed, such structural adjustments are also relevant for the developed economies. These adjustments will generally however, involve costs to growth in the immediate and short-term. Other pro-growth policies therefore needs to be pursued to support growth during such periods. During the Asian Financial Crisis, priority was given to policies that enhanced the flow of credit, particularly to small and medium-sized enterprises. This included the introduction of new institutional arrangements, mechanisms and schemes for funding, guarantees and credit enhancements, and debt restructuring and resolution. Other measures by the public sector have ranged from temporary measures to promote private sector consumption and investment activity. Projects that generate jobs, including retraining the unemployed with new skills, have been important during such periods of transition and transformation.

Beyond macroeconomic management and such short-term measures, central banks are in a position to contribute meaningfully to raise the long-term economic potential through financial sector development. The mandate to develop a strong, efficient and effective financial system is not uncommon for central banks in the emerging economies. This broadly includes institutional building, financial market development and the strengthening of financial infrastructure, including the payment systems and legislative framework. Efforts to broaden and deepen the financial sector will contribute towards facilitating the more effective and efficient intermediation of funds towards productive investments in the economy. As the financial sector develops in sophistication to provide a wider array of financial products and services, the ability to cater to the more varied and complex needs of households and businesses would also better support economic activity. A more developed financial system also reinforces monetary and financial stability. For Asian economies the more developed financial systems and better developed financial markets are now able to better intermediate larger and more volatile volumes of financial flows, with little disruption to financial intermediation and the functioning of our markets. The more diversified financial systems also reduce the over-concentration, and thus vulnerability, of any particular segment of the financial sector.

Financial inclusion is also a key development agenda. Amid efforts to develop a financial sector that best serves the economy, considerable emphasis has also been placed to ensure that the financial system is inclusive.

By creating opportunities for wider economic participation and wealth creation, greater access to financial services contributes to enhance the long-term sustainability of growth. The recent crisis and ongoing reforms have placed much attention on the need to minimise the disproportionate impact on various segments of society. Equally important is to ensure that households and small businesses are not marginalised or excluded by market forces during periods of relative stability. Beyond the provision of improved access to financing, the financial inclusion agenda has also made progress on two fronts. First, to ensure that financial services meet the changing needs of an individual, and, thereby, are effective in improving individual welfare. Second, to reduce the risk of vulnerable groups from being financially excluded, particularly in a rapidly changing financial and social landscape.

With financial sector development also comes greater financial innovation. Commensurate regulatory and supervisory oversight is therefore needed to avoid a build-up of systemic risks emanating from such financial innovation. Such supervisory frameworks including the surveillance arrangements and enforcement powers of central banks will need to be enhanced and modernised, to remain relevant and effective in a changing financial landscape. Our own experience has shown that this needs to be complemented by high standards for responsible lending practices, an effective consumer protection framework and enhanced financial education. This is to not only ensure that financial innovation is undertaken in a responsible manner, but would also protect the financial system against systemic risks and support greater financial inclusion.

Given the greater demands on central banks, SEACEN and CEMLA, as learning institutions and repositories of knowledge, can have an important key role in preparing central bankers for the challenges ahead. The operating environment is rapidly evolving, and the challenges confronting us are unlike those that we have faced before. Central bankers need to be equipped with new skills and knowledge to navigate through the challenges ahead. Certainly, greater agility will be required to cope with a more dynamic and ever changing landscape, and to enable us to carry out our task of fostering sustainable economic growth effectively. Indeed, we need to stay ahead of developments to shape the economic and financial environment.

SEACEN and CEMLA can reinforce each other in progressing this agenda. The active exchange and accumulation of knowledge provides a solid foundation for supporting and strengthening further the foundations of our Central Banks. Asia and Latin America have a wealth of experience in macroeconomic management, safe-guarding financial stability and, collectively, the regions have endured many forms of economic and financial challenges. We have emerged from these challenges stronger, and our economies and financial systems have become more resilient. There is much that can be learned from sharing these experiences. SEACEN and CEMLA Governors have agreed on three initiatives namely to have a joint website to share experiences, to conduct joint research initiatives, and to provide cross-regional technical assistance. We look forward to the introduction of these initiatives.

Conclusion

Allow me to conclude. As our economies become more integrated in the global economy, through our policies that deliver sustainable growth, the SEACEN-CEMLA central banks can enhance its potential role to support the overall global economic growth process. Beyond macroeconomic management and promoting financial stability, the Central Banks in our regions can contribute meaningfully to increase economic potential through financial sector development and facilitating the financial inclusion agenda. Through the friendship and partnership that we have forged with our counterparts in Latin America, let us carry this forward and find ways to deepen our mutual learning from each other's experiences. As learning institutions that are both originators and repositories of knowledge relevant to central banks, SEACEN and CEMLA are critical channels that can work together to spread experiences and ideas. Such cooperation will also greatly facilitate the member central banks in their quest to achieving sustainable growth.

Opening of the BNM Beijing Representative Office
Beijing, 18 November 2013

Opening Remarks by

Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz
Governor, Bank Negara Malaysia

It is my great pleasure to welcome you to this official opening of Bank Negara Malaysia's Beijing Representative Office. The opening of this representative office today is an occasion of unprecedented significance for us. This Beijing office is Bank Negara Malaysia's very first presence in Asia. This is a reflection of the growing importance of China in the global economy and the international financial system and the very significant and longstanding financial and economic ties between Malaysia and China. This momentous occasion also marks the dawn of a new chapter as our bilateral relations transitions and evolves reflecting the significant changes taking place in our respective economies and financial systems.

For many decades now, the foundation underpinning the strength and dynamism of our relationship is our ability to continually harness the complementarities that exists between our economies. While bilateral trade has consistently been expanding at double digit growth rates over the recent two decades, the breadth and depth of our relations have also evolved and expanded into greater financial linkages. In parallel to our growing economic ties, our financial institutions have also ventured into each financial systems, further strengthening our financial and economic connectivity. Currently, two of China's biggest banks, namely Bank of China and ICBC have operations in Malaysia while Malaysia's two largest banks, Maybank and CIMB have established their presence in China.

Our Beijing Representative Office, being inaugurated today, also signifies an important milestone in the cooperation between the People's Bank of China and Bank Negara Malaysia. Our two central banks have long cooperated in many areas of common interest in particular in the area of financial cooperation. In July of 2005, our currencies transitioned into a more flexible exchange rate regime at the very same moment. This enabled Malaysia to transition to this new regime effectively and efficiently. Bank Negara Malaysia has for more than a decade also participated in the fixed income market in China. We were among the first central banks in the world to be awarded the Qualified Foreign Institutional Investor (QFII) license to invest in China's fixed income onshore financial markets and to be granted access to the China Interbank Bond Market. Our close central bank cooperation is also reinforced through the various regional platforms, including ASEAN+3, EMEAP and SEACEN.

More recently, a series of measures have been undertaken to encourage the use of renminbi in the settlement of our bilateral trade and investment. In 2009, Bank Negara Malaysia entered into a Currency Swap Agreement (CSA) with the People's Bank of China, which was renewed in 2012 with an expanded amount of RMB180 billion, with the objective to ensure a ready supply of renminbi in the domestic financial markets to meet the demand by businesses. Efforts were also made to enhance the transparency in the exchange rate between renminbi and ringgit transactions. In 2010, a direct market quote of renminbi against the ringgit was initiated in the Kuala Lumpur interbank market as well as in the interbank foreign exchange market on the China Foreign Exchange Trade System (CFETS). With these developments there is now a direct renminbi/ringgit quotation in the spot market and a renminbi/ringgit forward exchange rate for the Malaysian market. To further facilitate transactions, the real time gross settlement (RTGS) payment system in Malaysia has also been expanded since 2012 to include settlement services in renminbi.

The size of renminbi trade settlement in Malaysia is expanding progressively reflecting the shift among both Malaysian and Chinese companies across the commodity, manufacturing and services sectors. There are also now 19 financial institutions that facilitate renminbi trade settlement, double the number in 2009. There is also a growing interest in raising financing in renminbi in the Malaysian bond market. In 2011, Khazanah Nasional Berhad successfully issued the world's first offshore renminbi sukuk in 2011 and subsequently Axiata Group Berhad issued the world's first rated renminbi sukuk in 2012.
Today, in conjunction with the opening of the Beijing office, Bank Negara Malaysia wishes to announce further measures to reinforce the progress that has been made, and as part of the efforts to promote bilateral trade and investment.

i. To facilitate more effective renminbi liquidity management by our financial institutions in Malaysia, Bank Negara Malaysia is introducing of a Renminbi Liquidity Facility (RLF) to licensed onshore banks. This facility aims to enhance renminbi liquidity in the domestic market by providing an additional avenue for the licensed onshore banks to obtain or invest RMB with the Bank. The Bank, through its own access to the interbank market in China, will offer these liquidity facilities via the renminbi/ringgit foreign exchange market, and the renminbi money and repurchase markets in the Malaysian interbank market;

ii. Second, non-resident financial institutions that meet the prudential requirements will be permitted to offer ringgit trade financing, in collaboration with resident financial institutions. In this regard banks in China will also be allowed to provide ringgit trade financing in China; and

iii. Finally, in recognition of the growing significance of regionally active financial institutions and the increased financial inter-linkages between our two economies as well as in mutual recognition and acceptance of each others' securities, Bank Negara Malaysia and the People's Bank of China has today signed a Memorandum of Understanding to establish a cross-border collateral arrangement that will enable financial institutions access to the central bank's liquidity facilities.

Let me now conclude my remarks. The most pressuring challenge for the world economy is to achieve a sustained and inclusive economic growth. Beyond the short-term volatility in the international financial markets, the prospects of the Asian region are well anchored on solid fundamentals, and underpinned by our economic and policy flexibility and years of reforms. Collectively, the Asian region will be an important growth center in the world economy contributing to global stability. China in particular has been successful in rebalancing its economy amidst structural adjustments and reforms that brings its economy to a sustainable growth trajectory. With the progressive move by China towards the internationalisation of their financial system in the years to come, there will be increased interconnectedness of the Chinese financial system with the rest of the region and the world and consequently, a wider role of the renminbi as it continues to grow in importance in international trade and financing activity.
It would be inevitable that the renminbi will become an important reserve currency in the international financial system.

Against this development, the opening of the Bank Negara Malaysia's Beijing Representative Office builds on the deep ties that has already been forged and signifies our confidence and commitment to this future. The Beijing office will also serve as a key point for the Chinese financial community to engage Malaysia and understand the opportunities available in our countries. Finally, I would like to express our great appreciation to the People's Bank of China for their approval and support for the Bank's representative office.

Islamic Development Bank (IDB) Prize Lecture on Islamic Finance: Financial Stability, Economic Growth and Development Jeddah, 27 November 2013

Opening Remarks by

Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz
Governor, Bank Negara Malaysia

It is my honour to be invited to deliver this lecture on Islamic Finance: Financial Stability, Economic Growth and Development, here in Jeddah. I wish to thank the Islamic Development Bank for the invitation. The Islamic Development Bank has been pioneering and instrumental in the development of Islamic finance and has been an inspiration in driving its progress and evolution. It is indeed a privilege for me to be part of this journey, and to have witnessed the increasing dynamism of the Islamic financial industry amidst a highly challenging economic and financial international environment.

Global financial and economic adjustments

My remarks today will focus on the relevance of Islamic finance in modern market economies, taking into account the knowledge that we have today about the vulnerabilities of finance, its causes and its wider economic ramifications. Five years on after the global financial crisis erupted, the most pressing challenge confronting the world economy continues to be securing financial stability and generating growth and employment. While regulatory reforms both at the global and national levels have been extensive to strengthen financial systems, there has been less progress on the recovery in growth. While conditions in the world economy have improved, the growth prospects going forward is expected to remain modest for an extended period of time.

Several important lessons have emerged from this recent global financial crisis. The first relates to the exponential expansion of the financial system which did not commensurate with the expansion in economic activity. This resulted in a significant disconnect between the financial sector and its role in serving the economy. A number of factors contributed to the weakening of the link between financial intermediation and productive economic activity. Deregulation had opened up new opportunities for financial institutions to expand the scope of their activities. Increased competition, reinforced by advances in technology intensified the pace of innovation. And, the extended period of low interest rates in an environment of low inflation also prompted greater risk taking which in turn contributed to the significant build up of financial imbalances.

The role of leverage in the global financial crisis, both in the public and private sectors, was also a particularly important contributing factor. It has also become a factor that is now holding back growth. At the height of the global financial crisis, the total leverage in the major industrial economies increased significantly. In the US, private sector leverage alone had reached over 200 percent of GDP in 2008. Other reports place the average debt level to GDP of major advanced economies at over 300 percent in 2010. The current process of deleveraging in the private sector remains incomplete, while pressures on fiscal sustainability in these economies also continue to weigh on confidence and growth. Significant challenges continue to be faced in the implementation of the structural adjustments which in turn is affecting the process of fiscal consolidation. This has further restrained the policy flexibility to support growth. The extraordinary and exceptional monetary measures taken by central banks in these economies have provided support to their economies, but they have also come at a cost to savers with growing risks of market distortions and financial imbalances the longer these measures are held in place.

In efforts to build stronger defences against a repeat of the events that precipitated the 2008 global financial crisis, the global regulatory reform agenda has placed significant focus on addressing elements of the regulatory and supervisory systems that allowed the build-up of excessive leverage. These elements include the unfettered innovation by financial institutions and the prevailing incentive system. Financial engineering had led bankers and investors to lose focus on their risk exposures when they failed to understand the increasingly complex products that purported to reduce the risks. The weak regulatory regime and supervision also failed to rein in such unbridled innovation. Misaligned incentives then fuelled excessive risk taking both at the institutional and individual levels. The inadequate financial buffers held by banking institutions against risk, a growing disconnect between the creation of credit and its use for productive economic activity and a highly interconnected system of financial intermediation ultimately combined to give rise to risks that disrupted credit flows to the economy. Over time, these trends were substantially amplified.

The global reform agenda has made important progress in efforts to reduce the fragility of the financial system and to strengthen its resilience. Substantial work has already been advanced and largely completed on the development of global liquidity standards, the adoption of leverage ratios, and the significantly strengthened capital regulations which are important components of the reform effort. Greater focus has also been placed on strong supervision, effective resolution regimes and arrangements for the oversight of systemically important financial institutions. While the effective implementation of these reforms is crucial, the world continues to seek more enduring solutions that will place financial institutions firmly back in the service of society. In some countries, fundamental structural changes are being pursued to reduce the complexity of banking and to protect banking services from such higher risk-taking activities. The challenge however, is how this might be achieved in a sustainable manner without undermining growth and development, and erasing the important efficiencies in financial management.

A Model to Reanchor Finance to the Real Economy

While the global financial stability efforts have made progress in generating an enabling environment for a new equilibrium of financial stability, a key consideration as we move forward is the need to redefine the fundamental character of modern finance and how it would interface and interact with the economy and the broader society. New considerations that prioritise justice and fairness, sustainability and inclusion have also become essential underpinnings of such a financial ecosystem. The recalibration of finance should aim to serve the needs of the real economy and more importantly the broader society. This would generate positive externalities that would in the medium term lead to more sustainable financial systems, and in turn contribute positively to growth and development.

A core underpinning of Islamic finance is the tenet that requires Islamic financial transactions to be supported by genuine productive economic activity. Islamic finance is also a financial regime that places emphasis on risk-sharing, thereby strengthening further the link of finance to the real economy. Thus, it provides a greater understanding on the fundamental relationship between the financial sector and the real economy. The concept of risk-sharing in finance is not new. While risk-transfer activities currently dominate the conventional financial systems, risk-sharing in the form of equity has long been a cornerstone of capital markets with vibrant stock exchanges. Techniques used by venture capital financiers also have similarities to risk-sharing contracts in Islamic finance. The development towards a more equity-based financial system where risk-sharing takes place reduces the over-reliance on debt funding, thus avoiding excessive debt and speculation and thus financial system fragility. In Islamic finance, this is further reinforced by Shariah principles that strongly discourage excessive debt given its detrimental effects on society.

The use of risk-sharing transactions and undertakings under participatory finance models in Islamic finance thus offers the potential to reinforce the links between

finance and the real economy. The contractual arrangements between the financier and the entrepreneur place strong emphasis on the value creation and economic viability of the enterprise. This results in a close link between the growth of the financial sector and real sector activities in which the expansion or contraction of credit is dependent on developments in the real sector. This would provide a restraint on financial engineering and innovation as financial transactions need to be supported by real assets, thus aligning innovation to productive economic activities. As a result, the dangers of unbridled innovation are also substantially reduced.

The move to embrace the risk-sharing dimension of Islamic finance also presents new opportunities for financial management. 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 transactions to ensure that the profits are commensurate with the risks assumed. The explicit risk-sharing element between the financier and customer instils greater discipline and responsibility, given the obligation and economic incentives created for participants to the contract to evaluate the risk profile of the product or investment proposition, the underlying trends in earnings and cash flows, and its income-producing potential. Such a process strengthens safeguards against the widespread mispricing of risks. The strong incentives for financial institutions to understand the nature and level of risk and leverage that is embedded in the Islamic financial instruments would in turn lead to more responsible innovation. This ensures that the products offered are aligned in delivering real benefits for the investors. Reinforced by a combination of stronger governance, enhanced transparency and more robust risk management, the trust-based relationship that underpins Islamic finance is therefore strengthened, thereby promoting overall confidence in the intermediation process.

More recently, in this decade, the greater use of equity-based models has been most evident in the sukuk market, with Shariah structures evolving from predominantly lease-based (Ijarah) and mark-up sale (Murabahah) structures to profit and loss sharing partnerships (Musharakah), as well as convertible and exchangeable trusts. The evolution of asset-backed and asset-based sukuk provides further options for investors to diversify their portfolio. Asset-backed sukuk,, has profit and loss sharing elements that thus offers investment sustainability. The possibility of a default is minimised, as investors of asset-backed sukuk are not guaranteed to receive income or capital gains, and profits are paid by the issuers only when the underlying assets earn profits.

Risk-sharing transactions and undertakings under the participatory finance models in Islamic finance also enhances prospects for increasing financial inclusion and in bringing the financially unserved into the economic mainstream. In many IDB member countries, studies have shown that economic development is constrained by the lack of access to finance, given that only about 30 percent of the adult population use formal financial intermediaries. Greater outreach to small and medium enterprises (SMEs) and microenterprises can be achieved through the wider application of equity-based structures in financing for SMEs and Islamic microfinance given their strong emphasis on promoting entrepreneurship and value-creating activities. This contributes towards the overall objective of generating inclusive growth that enhances the prospects for job creation. Integration with other financial products such as microtakaful and social welfare arrangements such as endowment (waqf) can also provide a total financial solution for the lower income groups and small businesses.

Risk-sharing in Islamic finance also extends to the creation of a more equitable and just distribution of wealth. Redistributive instruments such as obligatory alms giving (zakat), endowment (waqf) and charity (sadaqah) complement risk-sharing financing tools to form part of a comprehensive approach to address poverty and promote social justice within the community, aspects that are important in increasing the potential for a more balanced economic growth.

Another important dimension of risk-sharing that enhances financial inclusion lies in the potential for Islamic finance to become a powerful tool that can enhance financial access for emerging economies, in particular the less developed countries that have been marginalised by modern finance. Debt financing or risk-transfer activities are heavily dependent on conventional measures of financial and economic performance. In contrast, equity financing, with its risk-sharing elements, can provide the required financial solution that is not dependent on such conventional assessments. This will allow those countries which are less developed but have assets and resources to access finance. The strong emphasis on governance and risk management in risk-sharing contracts will also have an important role in catalysing broad-based improvements in standards of oversight and financial discipline in these countries as safeguards against irresponsible practices. Taken together, these elements of Islamic finance offer enormous potential for less developed countries, more so those that are rich in resources, to mobilise and channel economic resources to finance growth and development, and sigificantly raise standards of living for their communities.

In the sukuk market, sukuk structured in profit and loss sharing partnerships (Musharakah) represents one of the majority in global sukuk issuances and outstanding. The emergence of sukuk as an alternative fund raising and investment instrument has opened up an important new source of funding for long term development projects. Many Asian countries have leveraged on the sukuk market to raise funds for infrastructure development in the healthcare, transportation, telecommunications and education sectors that contribute towards generating broad-based growth. There is a seemingly good fit between sukuk and infrastructure project financing that requires large capital outlays with long gestation periods. This can significantly benefit IDB member countries which can tap into the sukuk market to meet the strong current and future demand for infrastructure financing, particularly for countries that face large funding gaps for infrastructure development. Indeed, it is encouraging that developing economies in Africa have already begun to leverage on the sukuk market for infrastructure financing particularly those that have progressed further in laying the legal groundwork to enable sukuk issuances.

Globally, the performance of the sukuk market has exceeded expectations. From an outstanding amount of US$33 billion in 2006, the sukuk market has expanded more than eightfold to US$292 billion by December of 2012. Future growth prospects for the sukuk market is supported by the positive growth prospects in both the GCC and Asian regions and the increasing funding needs for infrastructure projects in these regions. In the Asian region, it is estimated that US$8.3 trillion is required for infrastructure development until the year 2020. Infrastructure spending has also been one of the key drivers of economic growth in the GCC in the recent decade. In the MENA region, the changing energy landscape towards more renewable energy and clean, efficient technologies presents significant potential for the use of sukuk to meet such financing requirements.

With its growing international dimension, Islamic finance has assumed an increasingly important role in facilitating regional and international trade and investment flows thereby intermediating significant cross border financial flows. More recently, international financial centres such as London and Hong Kong have been increasing their connectivity with the Middle East and Asian regions, two important growth centres in the global economy. The increased international dimension of the sukuk market, in particular has facilitated the movement of funds across borders from jurisdictions with surplus funds to regions with investment opportunities thereby enhancing its potential as a vehicle to foster greater trade flows and investment and thus facilitating growth and development.

The development of Islamic finance and its risk-sharing and equity financing aspects could be significantly rewarding for countries that venture into this alternative form of financial intermediation. However, to fully realise its potential, different elements of the financial system must evolve in tandem to provide the enabling conditions for this to occur. In such

a system, it is essential for both investors and entrepreneurs to embrace different approaches in managing risk and return relationships that are embedded in the many variations of Shariah contracts. It is important that these relationships are well understood by the parties involved, and aligned with the clear contractual and operational requirements.

Islamic finance: Financial Stability Issues and Challenges

It is imperative that the lessons of the global financial crisis are not lost as the growth of Islamic finance gains further traction. Having already achieved remarkable growth and development over the recent decade, the continued success and viability of Islamic finance will also depend critically on ensuring focus on preserving financial stability. While contractual relationships and obligations may be different under Islamic finance, thus requiring different risk governance arrangements and skill sets, both conventional and Islamic financial institutions are exposed to similar risks including credit, market, liquidity and operational risks. For these reasons, the relevance of reforms to strengthen capital and liquidity buffers such as that under Basel III also extends to Islamic financial institutions and their universal implementation is important to avoid competitive distortions and regulatory arbitrage.

Beyond prudential standards however, ensuring strong adherence to Shariah principles is central to delivering the financial stability benefits that were found wanting in conventional financial systems prior to the global financial crisis. In addition, the agenda to promote fair, responsible and professional conduct by Islamic financial institutions and more empowered consumers must be equally advanced. In Malaysia, the new legal framework for Islamic banking and takaful that recently came into force is set to pave the way for the development of an end-to-end Shariah compliant regulatory framework, reinforcing the effective application of Shariah principles in the conduct of Islamic financial institutions.

It is encouraging to see that substantive progress has been made in respect of the development of prudential standards for Islamic financial institutions and the cooperation arrangements that are taking place to facilitate the implementation of these standards at national levels. Since its establishment in 2002, the Islamic Financial Services Board (IFSB) has introduced prudential standards for the Islamic financial services industry in the areas of capital adequacy, risk management, corporate governance and Shariah governance. Nine countries have implemented these standards and 19 more are expected to implement them within the next few years. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has also contributed to the issuance of more than 80 standards in the areas of accounting, auditing, governance, ethics and Shariah for the international Islamic financial industry.

Further progress on two fronts remains important. The first is to continue to evolve a more refined distinction within prudential and financial reporting frameworks to reflect the different nature and profile of risks under risk-sharing contract arrangements. The second is the need to accelerate efforts to further strengthen the infrastructural underpinnings for the development of the overall Islamic financial system. While the broad regulatory principles and standards developed in the aftermath of the global financial crisis can be applied to most Islamic finance transactions, a broad-brush application of these rules would limit the ability of Islamic financial institutions to implement the more unique risk-sharing contract arrangements. The stage of development of the overall financial system in which Islamic finance operates must also be considered to ensure that the effective application of global standards can be achieved without unintended consequences, given the prevailing associated constraints. Islamic banks today continue to be confronted with limitations in the availability of a sufficiently deep and diverse pool of Shariah compliant instruments - in both domestic and international currencies - in which they can invest. Under the strengthened international capital and liquidity standards, this can result in higher costs of compliance, inefficiencies in funding structures and increased risks of funding mismatches.

Strengthening prudential standards alone would therefore be an incomplete response to building

a strong foundation for the future of Islamic finance. Beyond the more stringent capital and liquidity standards, a further response to strengthen the global Islamic financial system should therefore also include measures to strengthen the infrastructural underpinnings and building blocks of the industry. It is equally important that initiaves such as the establishment of the International Islamic Liquidity Management Corporation (IILM) to support cross-border liquidity management by Islamic financial institutions, continue to be pursued. The recent sukuk issuance by IILM represents a major breakthrough in global cooperation on Islamic finance which has made available short-term USD Shariah compliant instruments in the global market to Islamic financial institutions to facilitate more efficient management of their cross-border liquidity requirements.

As Islamic finance further evolves and advances, more fundamental questions on the framework for financial stability in the context of Islamic finance will need to be addressed. At a national level, such questions will include the relevance and design of financial safety nets such as deposit insurance and lender of last resort facilities in an Islamic financial system. To a large extent, these safety nets have in mind the traditional roles played by conventional banks - the acceptance of deposits which are payable on demand and which enjoy principal protection for the depositors. In a risk and profit sharing model with participatory or equity-based contracts that support ventures involving entrepreneurship endeavours, savers and fund providers stand to bear the losses in such ventures, similarly to gaining profits from such ventures. A main challenge would be in structuring financial safety nets which honour the true nature of Islamic contracts, while preserving confidence in the financial system given the entrenched expectations of consumers. Consumer protection and education initiatives are also essential to further deepen the understanding and awareness of consumers on the associated risks and rewards in the Islamic financial contracts. In addressing these questions, there is much to be gained from sharing experiences and strengthening cooperation in research initiatives.

At the global level, the framework for financial stability in the context of Islamic finance needs to interface with the arrangements that exist for the conventional financial systems. As conventional frameworks for financial stability are being strengthened and in some areas being fundamentally revisited, it is timely to take the opportunity to elevate the level of engagement and coordination between global standard setting bodies in international standard setting and implementation activities. Closer coordination will be increasingly important to avoid fragmentation in regulatory frameworks and improve the surveillance of risks to global financial stability. As lessons from previous crises should teach us, we would be well served to ensure that the growth of Islamic finance - on a global scale - is well supported by the strengthening of our collective capacity to understand, monitor and manage the attendant risks.

Conclusion

In concluding, Islamic finance, through its emphasis on risk-sharing for the attainment of socio-economic goals based on the objectives of Shariah, provides the discipline that enhances the prospect of strengthening the link between finance and the real economy, thus contributing towards overall financial stability. With the global economy now on the recovery path, Islamic finance offers enormous potential in supporting a more inclusive and sustainable economic growth. Developing and emerging economies in particular stand to reap the largest benefits from this potential. To fully realise this potential, regulatory priorities in strengthening financial stability taking into consideration the specificities of Islamic finance will ensure its continued resilience and its potential to effectively service the functioning of economies and the economic wellbeing of societies.