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"RESHAPING THE INTERNATIONAL FINANCIAL ARCHITECTURE FOR BALANCED AND STABLE GROWTH"

I am pleased to join this distinguished gathering today to officiate at this historic occasion of the inauguration of the Islamic Financial Services Board (IFSB). To our foreign guests, I would like to add my personal words of welcome.

2. The birth of the I.F.S.B., the international standard-setting body for Islamic financial institutions, comes at a time when the global economic and financial outlook is clouded by escalating uncertainty. The anticipated recovery in world growth has not yet happened. Indeed the risks have intensified. In the advanced economies, corporate failures and financial reporting problems have adversely affected investor confidence, resulting in downward trends in the global equity markets. Property markets have also begun to soften. These developments in the asset markets have shaken consumer confidence. In addition, the risk of further exposure of corporate scandals or a deterioration in the Latin American situation could destabilise financial markets further. The weaker economic prospects and the resultant financial sector problems that could emerge would affect capital flows adversely. At the same time, macroeconomic imbalances remain an area of concern in some of the advanced economies. The current global scenario is also characterised by widening income disparities, in which 15 percent of the world's population controls 80 percent of its wealth, while 23 percent of the people in the developing world survive on less than US\$ 1 a day.

3. In the face of all these difficulties and inequities, there is a global recognition on the need to evolve an international financial system that will deliver greater stability and that will result in a more equitable distribution of the benefits of globalisation. There is now much support on the need to strengthen the global financial infrastructure to deal with the inherent tendencies for financial markets to become destabilised periodically. There is a recognition that markets are subject to excesses, including deliberate manipulations, which generally work against the interests of developing countries. There is a recognition that we need to develop an international financial regime that promotes more balanced growth; including greater equity in the distribution of income, less disruptive capital flows, and relatively more stable financial markets.

4. However up till now the progress in international financial reforms has been mainly focused on initiatives to encourage developing countries to adopt international standards and codes, enhance transparency and disclosure of information, and promote greater

private sector involvement in crisis resolution. Such initiatives are aimed at promoting more informed decision-making by markets. However, we also need to see that such efforts by the authorities to improve transparency and disclosure are matched by efforts by the market players to correctly and effectively utilise the information provided. Tendentious reporting, both by the media and the professional analysts serve only to confuse decision makers and result in wrong deployment of capital. More importantly the private sector including the hedge funds must be more transparent. Recent history has shown how hedge funds and corporate America can stray far from ethical paths. Unless something is done, more of the newly merged corporate entities are going to fall, dragging down with them other market players.

5. The assumption that the free market will be self-disciplined is erroneous. The market is managed by people whose primary aim is to make profits, for the corporations, and for the managers themselves. The welfare of society is not the concern of these people. The free market cannot therefore be left absolutely free. Governments must oversee the market closely and in many instances must provide necessary rules and regulations.

6. The complaint will be that the free market will not be free anymore. But so far the market has not proven the effectiveness of self-discipline. It has yet to come up with its structure for self-governance. If the lack of rules by the market to govern itself is regarded as an essential element of the free market, nothing that we have seen so far provides assurance that true discipline on the part of the market players will be upheld.

7. Thus while the hedge funds insists on Government enforced transparency for businesses, the funds themselves are not only opaque but have proven themselves quite devious. At least one such fund very nearly brought about the financial collapse of a major financial power. It took Government action to prevent this from happening. Left to the market we would have seen total financial disaster which could have affected the whole world.

8. The advances in information and communication technology have also dramatically changed the way business is done globally.

9. Used properly they will not only speed up business but also speed up the detection of fraud and other misdemeanours. If real transparency is practised by all, the market can follow transactions and the movements of funds and this will help to reduce the risks which investors face. Certainly Government will be able to react quickly enough to avoid any economic or financial catastrophe.

10. Recent initiatives to promote greater stability in financial markets have also included measures to enhance private sector involvement in crisis resolution, notably in the restructuring of debts. These have focused on measures to encourage all creditors to agree to a coordinated debt-workout scheme. The proposals that have been put forward include the use of collective action clauses (to prevent the derailment of an agreed debt restructuring plan) and the creation of a sovereign debt restructuring mechanism similar to a

global bankruptcy court. The aim of such initiatives has been to encourage more equitable burden sharing in crisis resolution by both the creditors and debtors. While both approaches have their merits, further consideration of the implementation details and implications are necessary to ensure that they do not impose undue burdens on borrower countries, especially in terms of higher borrowing costs.

11. Mounting challenges confront the global community. Indeed, the international community needs to come to terms with all these issues in order not only to promote stability but also to enhance the sharing of prosperity.

12. We would all like to benefit from the process of globalisation and liberalisation. We would like to trade more, open up markets and enjoy the higher incomes and increased welfare that globalisation is supposed to deliver. Stability in financial markets is essential for this to be achieved. We need an international financial system that is fair and rewards hard work rather than speculative activities that take advantage of the weak and the ill-informed. Speculation is really not business. It is a kind of gambling. It becomes worse when in an effort to ensure high returns, manipulative measures are utilised. Thus by creating an impression of oversupply it is possible to depress prices, and vice versa. The unfortunate thing is that the ordinary players, the small men, would always bear the losses, dragging down with them their banks. In the end the whole economy of a country would suffer. Islamic banking principles require financial transactions to be supported by genuine trade or business-related activities. By definition, therefore, financing for non-trade related activities such as currency speculation, derivatives and other unproductive financial manipulations are excluded. The basic tenets of Islamic banking prescribe a financial system that rewards productivity. There can be innovative financial products which facilitates business and reduces risks. The Islamic financial system is fundamentally based on the absolute proscription or prohibition of the payment or receipt of any predetermined, guaranteed rate of return, which in effect prohibits the concept of interest (usury). The lender must share the risks that the borrower is exposed to, although the real cost of management which should be variable and not predetermined is not within the definition of usury.

13. The other prohibition is on excessive profits, or profiteering through unprincipled manipulation of prices or supplies. Clearly Islamic financial injunctions are meant to create an equitable and fair social and economic order. They are only oppressive to those who wish to exploit society through their superior wealth. Well-administered the Islamic financial system will create a better social order while increasing the wealth of everyone. Together with the tithes (zakat) and obligatory charity the Islamic system must result in prosperity with stability.

14. It is therefore not too much to suggest that the international financial system can benefit from the adoption of at least some of the Islamic financial system. The lenders must be prudent and judicious because they would share in the profits or losses. Admittedly much skill and expertise in business will be needed if the system is to

work smoothly. These are not easily available today. It is imperative therefore that conventional systems be allowed also, if business and growth is not to be stifled. The option to use the Islamic financial system must be open and voluntary so as not to cause turmoil and economic regression, something which Islam does not wish to promote, which in fact it expressly forbids. It is imperative that Muslim countries remain stable and achieve prosperity in order to ensure the well-being of the ummah.

15. We now talk a lot about smart partnership and the win-win concept. The idea that someone must lose in order that someone else will gain is slowly being rejected. Because in the Islamic system risk is shared by the lender and the borrower, there should be a win-win situation, for obviously a smart partnership is involved. As a partner the Islamic bank must carefully scrutinise the honesty and reliability of the borrowers. Mistakes will happen of course but even with the present banking system injudicious lending takes place and banks suffer serious losses sometimes. Due diligence is therefore more essential in Islamic banking than in the present system, where the borrower can always be bankrupted and his collaterals etc. seized.

16. One has to remember that Islamic banking was enjoined because of the oppressive practices prevalent in those days when debtors who could not pay back the money they owed were made debt slaves of the lender. We can imagine the sufferings and the misery of these people. Today of course this practice has been outlawed universally. But debt slavery is not yet totally eliminated. Countries which are unable to pay their foreign debts, are actually being made debt slaves of the rich countries whose Government or banks had lent to them. Obviously if Islamic banking is practised in the International financial lending, this debt slavery of borrowing countries cannot happen. But of course the international community is not about to adopt Islamic Banking. They are not going to lend if they cannot gain control over their borrowers in order to recover their loans, irrespective of the misery this might cause. That they had been imprudent in their lending does not mean they should incur losses. Yet even in the ordinary banking system it is common for banks to take hair-cuts if for some unexpected reasons the loans go sour. Clearly debt slavery has not been fully abolished in the International Financial System.

17. Under the risk sharing principle of Islamic banking, banks have to share the losses incurred by an entrepreneur. Banks are not guaranteed to receive income when the enterprise makes losses. This arrangement enhances the long-term commitment to work together, as both sides would be accountable for the performance of the enterprise. Under Islamic banking, the issue of non-performing loans would not arise, as any losses would accrue immediately to the banks, as well as the entrepreneurs. Islamic banks, acting as business partners, would therefore go the extra mile to keep good companies afloat in good times and bad, instead of abandoning them by withdrawing credit lines at the first sign of distress. In this manner, the Islamic banking principle of risk-sharing embodies an in-built capacity that contributes to ensuring greater stability in the financial system.

18. Islamic banking emphasises the values of entrepreneurship. Entrepreneurs compete to become the agents for the suppliers of financial capital who, in turn, will closely scrutinise projects and management teams. As the financing is rewarded through sharing of profits (and losses), it encourages competition among entrepreneurs. The incentive to investors (or suppliers of capital) is the internal rate of return of the project (as opposed to interest). This encourages the entrepreneurs to be more truthful and transparent when making their applications for loans. Harebrained schemes and ideas which obviously have no reasonable returns are not likely to be entertained by Islamic banks. This may disappoint some borrowers but it will encourage greater care in the feasibility of a project or enterprise.

19. As a partner the Islamic banks must truly oversee the quality of corporate governance. This requires a great deal of expertise in the management of Islamic banks. And of course the management must have high standards of ethical, moral, social and religious commitments, qualities which enhance equality and fairness in the treatment of all transactions. In addition to the strict regulatory and supervisory precepts of conventional banking, Islamic banking principles are reinforced by the Shariah framework. The Shariah strengthens the governance of Islamic banking operations, based on the belief that justice or injustice will be appropriately rewarded or punished. Islamic principles uphold contractual obligations and the disclosure of information as a sacred duty.

20. All these principles promote financial stability, as a successful venture will result in a "win-win" situation to all participants in the financial system while an unsuccessful venture will spread the losses and not confine such losses to one segment of the financial system. Governance and transparency with the absence of interest would also ensure that contagion and systemic risks would be avoided, as players in the financial system would not react in an erratic manner or exhibit "herd behaviour" since players can evaluate individual fundamental strengths. In this regard, the work of the Accounting and Auditing Organisation for Islamic Financial Institutions will make a significant contribution to the promotion of more uniform practices of good governance in Islamic finance.

21. By replacing the interest element with profit-sharing as the reward for the use of capital, the speculative motive for the demand for money would not be entertained. Money cannot be traded as a commodity as the bank would have to be involved in the trade. The absence of interest also means that traders cannot take positions. Hence, the risk of herd behaviour of market players will also be avoided. Adherence to the risk-sharing concept in Islamic banking should accord lenders with the appropriate returns for their capital and would contribute to the growth process. A valuable outcome of this principle of sharing profits as well as losses is that Islamic banking prohibits lenders from withdrawing their capital in difficult times. This principle applies not only at the project level, but also at the national level. In the case of sovereign debt, the sharing of risks and rewards between lenders and creditors imply that creditors participate in the development of a country until the maturity of the

bond. The need for creditors to discuss with their debtors on the best, mutually agreeable options to resolve any debt problems prior to maturity of a bond, does not arise.

22. In other words, debt workout arrangements to share risks between creditors and debtors are already embedded in Islamic-based bond contracts. Under Islamic banking, therefore, private sector debt workout schemes for crisis resolution, as currently being discussed by the international community, would not be necessary. The basic principles of the proposal on collective action clauses (CACs) being promoted by the Organisation for Economic Cooperation and Development (OECD), the Bank for International Settlements (BIS) and other international financial institutions have already been embodied in the contractual obligations of sovereign Islamic bond issues.

23. Although the size of the international Islamic finance is still small (about US\$200 billion), it has expanded significantly at 15 percent per annum. The potential for growth is enormous, given not only the huge wealth of the global Muslim community, but also the interest shown by the international financial markets in this form of financial intermediation. To meet the projected increase in demand for Islamic financial instruments, there is a need to develop the range of Shariah-compliant financial instruments which are universally acceptable. The higher demand and the development of the financial market infrastructure would provide opportunities for Governments and corporations alike to utilise more sophisticated and diverse Islamic financial instruments to access the international financial markets. And as Islamic financial instruments have a wider investor base, such universally-accepted Islamic financial instruments would also draw a wide investor base, regardless of their religious background.

24. The establishment of the IFSB will reinforce the potential for the stability of the system. As a global authority for setting standards for Islamic banking and finance, it will ensure that Islamic banking incorporates international best practices and standards for the supervision and regulation of Islamic financial transactions, and that it is not only consistent with Islamic principles, but is also based on prudential standards that are on par with those observed in conventional banking. The subsequent improvements in supervisory standards of Islamic financial institutions will enhance the credibility of Islamic banking and finance in the financial world. All these developments point toward an important role for the I.F.S.B. in charting the future course of Islamic banking and finance as an integral part of the international financial system.

25. The launch of the Islamic Financial Services Board today represents an important milestone in Islamic financial cooperation. I am confident that the establishment of the I.F.S.B. as the global standard-setting authority for Islamic financial services will serve to enhance the development of Islamic financial products, for the benefit of the Ummah.

26. Malaysia is honoured to have been entrusted with the responsibility to host the Secretariat for the I.F.S.B. I would like to take this opportunity to congratulate the governors and senior

officials of the central banks and monetary authorities of Bahrain, Indonesia, Iran, Kuwait, Lebanon, Malaysia, Pakistan, Saudi Arabia, Sudan and the United Arab Emirates, as well as the Islamic Development Bank, the Accounting and Auditing Organisation for Islamic Financial Institutions and the International Monetary Fund. Your efforts over the past two years have culminated in the establishment of this important institution.

27. The road ahead for Islamic banking and finance is long and will be full of challenges. More so, in the current global financial environment characterised by volatile and unpredictable market dynamics, rapid advancements in technology and financial innovation, which have all culminated in increasingly more complex and heightened financial risks. With the continued cooperation and active participation of the central banks and the financial community, I am confident that the I.F.S.B. can become the pre-eminent global authority responsible for international Islamic financial services.

28. In the name of Allah, The Merciful, The Compassionate it now gives me great pleasure to officiate the inauguration of the I.F.S.B.