Zeti Akhtar Aziz: The changing landscape of financial regulation – implications for Islamic finance

Speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the 7th Independence Federal Savings Bank (IFSB) summit on Global Financial Architecture, Manama, 4 May 2010.

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It is my pleasure to be here on the occasion of the 7th IFSB Summit on Global Financial Architecture: Challenges for Islamic finance. I am honoured to be invited to speak on the ongoing regulatory and supervisory reforms being undertaken following the recent international financial crisis, focusing on its implications for Islamic finance particularly in the context of strengthening the financial stability of the Islamic financial system.

It was exactly 10 years ago in a speech here in Bahrain when I reflected on then the remarkable achievements of Islamic banking and highlighted that while the amount of funds managed in the Islamic financial system was only a fraction of the total assets of the international financial system, it represented that portion of financial activities that was truly supported by underlying productive capacity that generated growth of economies across continents, and that, it was this form of financial activities that we should encourage, as opposed to the financial flows that were destabilising and destructive.

Today, it is precisely this element in Islamic finance amongst others, that are highly relevant to the discussions on the reform of the national and international financial system so that we have a system of financial intermediation that is stable, sustainable and contributes to global growth. In ten years now Islamic finance has experienced accelerated growth and the financial landscape has undergone a major transformation with great progress achieved on many fronts. The transformation is particularly evident in three dimensions, firstly, Islamic finance has evolved into a complete and competitive form of financial intermediation, effectively serving consumers and businesses, both Muslims and non-Muslims. Islamic finance has become a competitive form of intermediation with several established conventional players now entering the Islamic finance industry, resulting in more diverse Islamic financial institutions with wide spectrum of product range.

Secondly, this recent decade has also seen significant milestones being achieved in the area of the international Islamic financial infrastructure of Islamic finance since the establishment of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) in 1990. In 2002, the Islamic Financial Services Board (IFSB) was established as an international prudential standard setting body for Islamic finance. The IFSB with a membership of now 50 regulatory authorities has since developed a number of standards ranging from capital adequacy requirements to standards for governance and risk management, taking into account the specificities of Islamic finance. There have also been notable achievements in the area of talent development with the proliferation of programmes and certifications which have focussed on Islamic finance offered by several major institutions of higher learning, professional entities, training agencies and industry groups around the world. More recently, platforms for greater engagement among practitioners, scholars and regulators have further added to international collaboration in Islamic finance.

And finally, the evolution of Islamic finance in this decade has been marked by its international dimension in which it is becoming an increasingly important part of the global financial landscape. The development of Islamic finance in emerging economies also reflects the changing global pattern of financial and economic integration. This is taking place with the strengthening of financial and economic linkages between Asia and the Middle East and the increased activity of Islamic finance beyond the traditional Muslim countries including the more established financial centres. Cross-border transactions are growing as more issuers consider Islamic finance as an attractive alternative means for raising capital, whilst investors are also increasingly considering it as a new asset class in their investment universe. This internationalisation and sustained global expansion of Islamic finance has taken place despite the more challenging environment presented by the global financial crisis, demonstrating the resilience of Islamic finance as a stable form of financial intermediation.

Global financial regulatory reforms

Ladies and gentlemen,

Much has been said and written about the causes of the global financial crisis. Efforts are now underway to address many of the shortcomings in the financial infrastructure that have contributed to the crisis. With the worst of the crisis now seemingly over, attention has turned to strengthening the global financial system. There is now an even greater need to restore confidence in the integrity of the global financial system given the loss of trust between society and the financial sector particularly in advanced economies . At the core of this reform agenda is the development of a new financial regulatory framework that would be more effective, one that is premised on greater emphasis on ethics, fairness, and accountability and that promotes global economic, social and environmental sustainability. It also needs to be anchored on a sensible balance of supporting growth while maintaining financial stability , and one founded on greater international coordination of regulatory approaches and supervisory oversight with a crisis management framework that will reduce systemic risk, and the severity of any such future financial crises.

Given the scale and magnitude of this recent crisis, the global regulatory reform being shaped is wide-ranging. Bold measures are being developed in various international forums with fundamental changes to the current approaches to financial regulatory and supervisory oversight. Some of these reform proposals have attracted intense international debate generating divergent views on these issues. A broad consensus however is emerging on the need to raise both the quantity and quality of regulatory capital, strengthen liquidity rules and improve market transparency. There also seems to be agreement for the extension of regulatory tools to address pro-cyclicality in the financial system through the creation of counter-cyclical capital buffers, dynamic loan-loss provisioning and greater alignment of incentives with long-term goals. This consensus reflects the objective of avoiding having incentives that would encourage the material build-up of leverage and the excessive appetite for risk. Other measures under consideration include the implementation of non-risk-based leverage limits to contain the build-up of leverage in the banking sector and the strengthening of the supervisory framework and the arrangements for dealing with oversight on cross-border financial groups and for resolution.

Implications for Islamic finance

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

Let me now focus my remarks on four major implications of the changing global financial regulatory landscape for Islamic finance – first, particularly in financial systems in which Islamic finance is being developed alongside the conventional financial sector in a dual system environment, (which is the case for most IFSB member countries), there will be a need to ensure that the reforms are undertaken in parallel. The concern is that there would be insufficient attention given for Islamic finance and consequently, the tendency for broadbrush application of regulatory measures intended for conventional finance on Islamic finance.

In developing the appropriate regulatory framework for Islamic finance, it is not uncommon to leverage on the established wisdoms of prudential regulation for conventional finance to achieve regulatory efficiency particularly in a dual system environment. Whilst it may be envisaged that it is not necessary to reinvent the wheel, it should not override the importance of addressing the specificities of Islamic finance where necessary. Such a prudential regulatory design that takes into account the unique mix of risks associated with Shariah-compliant instruments would enhance the effectiveness of the regulatory outcomes intended for Islamic finance. Although there is already a broad international consensus on the prudential areas that need to be enhanced, different regulatory parameters may be necessary to address the specific risks and unique characteristics of Islamic finance. The Islamic financial community thus needs to effectively respond to this, by strengthening their internal capability to make sound assessments on the need for making similar regulatory reforms that are specifically attuned for Islamic finance to achieve the common objective of financial stability.

With this in mind, I am pleased to inform you that following the recent completion of the work by the Task Force on Islamic Finance and Global Financial Stability, that was jointly formed by the Islamic Development Bank (IDB) and the IFSB in 2009, the Report has now been released following the endorsement by the IFSB Council in Khartoum, Sudan, in April this year. The Report examines the conceptual elements inherent in Islamic finance that form the foundation of its strengths and contribution towards financial stability. The Report also provides a preliminary assessment on the performance of Islamic finance during this recent international financial crisis. The final part of the Report outlines eight key recommendations to further strengthen the foundations of the Islamic financial system in a more challenging global environment. Although the Islamic financial services industry has generally performed well in the face of the recent global financial turbulence, there are clear lessons to be learnt from the crisis. The recommendations were therefore developed upon careful reflection on the conditions and financial practices that have contributed to the global crisis, as well as the current direction of the global regulatory reform.

A central theme of the recommendations in the Report is the need for greater collective efforts to be given to putting in place eight building blocks for strengthening the financial infrastructure of Islamic finance and its institutional capacity both at the national and international levels. The building blocks identified in the Report relate firstly to the global implementation of the IFSB prudential standards; second, the development of systemic liquidity management infrastructure; third, the establishment of strong financial safety nets; fourth, putting in place an effective crisis management and resolution framework; fifth, strengthening the accounting, auditing and disclosure standards; sixth, the development of an effective macro-prudential surveillance framework; seventh, having in place credible rating institutions; and eighth, to institute close international cooperation and coordination among countries in achieving financial stability. This also includes cooperation in the area of capacity building and talent development. Addressing these eight areas are highlighted in the Report as being fundamental to ensuring the continued development of a robust and resilient Islamic financial system, that can effectively preserve financial stability and contribute to growth and development.

This brings me to the second implication of the changing financial regulatory landscape in respect of preserving financial stability and the broader agenda of effective and efficient financial intermediation, taking into consideration the unique considerations in Islamic finance.

Ladies and gentlemen,

A sustained process of excessive financial deregulation and over reliance on market discipline particularly in advanced economies which led to a prolonged cycle of optimism and risk taking has been widely cited as part of the root cause of the recent global financial crisis. Indeed, the pre-crisis era was a period of exuberance in financial innovation and rapid development in the conventional financial landscape. Although it was argued that financial deregulation encourages innovation which in turn result in the more efficient allocation of resources, the recent crisis has shown that there is a need to balance between market discipline and regulatory oversight.

Whilst there is general support for the reform measures, there is also concern on the dangers of over-reaction by policymakers that could undermine the role of financial intermediation, and adversely affect the ultimate objective of economic growth and development. The concern is specifically on the unintended consequences of the regulatory reform. Financial stability is not an end in itself; it is a means towards achieving the ultimate goal of sustainable growth and shared prosperity. This presents the challenge for policymakers in finding the appropriate balance between preserving the resilience of the financial system versus maintaining the ability of the system to perform their intended function of delivering effective, efficient and innovative financing solutions to customers in the wider economy. Hence, the concern is that that the regulatory reforms would increase the cost of financial intermediation. A careful assessment needs to be made of the potential medium and long-term effects of the proposed reforms on market structures and behaviour. These considerations are equally relevant in the context of Islamic finance.

The assessment on the aims and relevance of each of the proposed reform measures needs to take into account the two important considerations in Islamic finance; the need to support sustainable and responsible innovation, and secondly, to leverage on its inbuilt strengths that set Islamic finance apart in performing its role in supporting the efficient mobilisation and allocation of resources to generate real economic activities. Given the damaging effects of complexity and opacity associated with the recent unfettered innovative activities in the conventional financial markets, it has resulted in a reassessment of the role and benefits of financial innovation. In Islamic finance, innovation is key in pushing the frontier of market development to generate the range of products and services, processes and functions. The key lies in preserving the benefits of innovative initiatives and activities whilst ensuring that they do not result in negative externalities.

In considering the relevance of the global regulatory reform to Islamic finance, there is therefore a need to consider the underlying elements that guide the process towards sustainable and more socially-responsible financial innovation. This comes in the forms of its strong paradigm in governance, disclosure and transparency, as well as its emphasis that innovations are anchored in the objectives of Shariah and thus are for the benefit of the people. Importantly, Islamic finance has the disposition to facilitate financial deepening without financial excesses through the fundamental Shariah requirement for Islamic financial transactions to be supported by an underlying economic activity. Moreover, the profit-sharing and risk-sharing characteristics of Islamic financial transactions strengthens the incentives for Islamic financial institutions to undertake the appropriate due diligence on the Islamic financial transactions to ensure that the profits are commensurate with the risks assumed. T he Shariah board of Islamic financial institutions additionally serve as a vital institutional safeguard to ensure that the inherent strengths of Islamic finance are fully realised. This accommodates innovative activities in a manner that achieves the objectives of protecting customers and the system on an ongoing basis. Islamic finance is essentially also consistent with the "equator principles", the voluntary guidelines governing social and environmental risk in project finance which are increasingly growing in prominence in this post-crisis era as an integrated approach to sustainable and more responsible banking and finance.

Ladies and gentlemen,

The third implication relates to the mobilisation of stronger international cooperation in the pursuit to preserve global financial stability, particularly in the light of an enhanced internationalisation of Islamic finance. This post-crisis era will usher in a new chapter in the development phase of Islamic finance. The trend of internationalisation can be expected to be more pronounced. As Islamic finance facilitates greater financial and economic interlinkages between jurisdictions, this enhanced international dimension will bring about a new set of challenges presented by the fundamentally different operating environment of heightened competitive dynamics, greater uncertainty, and more complexity. This will require greater collaboration and cooperation at the global level in the endeavour to preserve global financial stability.

The recent crisis has highlighted that financial integration across borders needs to be accompanied by international cooperation and coordination to prevent regulatory arbitrage across borders and the risk of implications for contagion. A stronger collective effort needs to ensure that Islamic finance is subject to consistent, high-quality regulation across borders through the application and enforcement of the international prudential standards promulgated by the IFSB. This would reduce the opportunities for regulatory arbitrage, which in turn, will contribute to a more successful international integration of Islamic finance.

Beyond the prudential standards, a higher level of cross-border vigilance is pivotal to allow for appropriate and decisive actions to be taken pre-emptively to deal with any imminent financial distress. This underscores the importance of adequate coordination and cooperation among supervisors across borders in strengthening their responsiveness to risks associated with markets interconnectedness. In particular, more transparency is essential towards understanding the ramifications of national actions or inaction and the potential spillover effects from one country to another, whilst equally important is to recognize that financial regulation and intervention are subject to country-specific circumstances and hence, must fall within remit of national autonomy. Regular information exchange and better coordinated oversight among supervisors to address home-host issues of internationally-active institutions, and to identify emerging systemic risks, are thus recognised to be the important focus of effective cross-border surveillance and crisis management.

Recognising the need to mobilise stronger international cooperation in the pursuit to preserve financial stability in an increasingly global operating environment, the Islamic Financial Stability Forum (IFSF) was recently established based on the recommendation of the Task Force of Islamic Finance and Global Financial Stability. The IFSF is to serve as a strategic platform for the regulators to deliberate common issues and to collaborate endeavours in achieving financial stability in the Islamic financial system. This represents yet another milestone in the development of the institutional infrastructure for Islamic finance, complementing the important roles and functions of the IDB, the IFSB and the AAOIFI.

As Islamic finance becomes a growing component of the international financial system, it will become important for the ongoing global engagement by the international community that is driving the financial reform agenda to be extended to the perspectives of financial stability in the Islamic financial system. The IFSF would be able to facilitate the process of greater interface between regulators of conventional and Islamic finance to take place given the common goal of preserving global financial stability.

Ladies and gentlemen,

Let me now turn to the final point on major implications of the global financial reforms on Islamic finance – in the area of liquidity risk management. The recent crisis clearly demonstrated a number of vulnerabilities both in the liquidity risk management in individual banks, and on a systemic basis. Uncertainty and the lack of transparency over the holdings of toxic assets led to general reluctance to provide funding to each other, resulting in the freezing of the wholesale money market in several developed economies. This resulted in short term liquidity to evaporate affecting participants that were too dependent on the market for funding. This largely stemmed from poor liquidity risk management practices, and has now prompted the Basel Committee to develop new proposals for global liquidity management standards. In the context of Islamic finance, the impact of the proposed Basel requirement to maintain sufficient cushion of high quality liquid assets needs to be carefully considered, as the infrastructure and tools for liquidity risk management by Islamic banks is still in its infancy in many jurisdictions. A very narrow definition of liquid assets that is currently proposed may exacerbate liquidity risks in many Islamic financial markets in which Islamic banks compete with conventional counterparts for the limited stock of shariah-compliant government securities. This will certainly increase compliance cost and render the market illiquid when the demand exceeds supply, placing Islamic financial institutions at a disadvantage.

The importance of a robust liquidity management infrastructure for Islamic financial institutions is well-recognised. The growing internationalisation and cross-border activities in Islamic finance in recent years further accentuates the importance to enhance the ability of the Islamic financial system to withstand shocks from externalities. Moreover, access to a robust liquidity management infrastructure will reduce the cost of intermediation which is an important enabler for a more efficient and competitive Islamic financial system. Recognising that liquidity management in the Islamic financial system is still under-developed, a Liquidity Task Force was established by the IFSB in 2009 with the aim to formulate an institutional arrangement to address this need. Significant progress has already been made in this endeavor with several key proposals now at the final stage for operationalisation. When operationalised, this liquidity mechanism will be another landmark development for Islamic finance.

Conclusion

The recent global financial crisis has spurred the resolve of the world community to chart a new course towards greater and lasting social and economic stability with fairness and accountability. Whilst this presents a unique opportunity for Islamic finance to transition into the next development stage of greater international integration, there needs to be a higher level of resilience to withstand the new challenges it will bring. This, in essence, requires the strengthening of the financial infrastructure to preserve the soundness and stability of the Islamic financial system. Indeed, our collective will to mobilise a higher level of global cooperation in promoting this outcome will enhance the prospects of Islamic finance to contribute towards securing global financial stability and a greater shared prosperity.