Heng Swee Keat: Ensuring stability – international perspectives on creating an effective regulatory framework

Remarks by Mr Heng Swee Keat, Managing Director of the Monetary Authority of Singapore, at the Inaugural Plenary Session, World Islamic Banking Conference, Bahrain, 24 November 2008.

* * *

Introduction

Good morning, ladies and gentlemen.

I am honoured to speak at this opening plenary, following the keynote remarks by His Excellency, Governor Rasheed Al-Maraj.

I am also delighted to be in Bahrain, recognised globally as one of the leading centres for Islamic Finance. Besides having a core of active Islamic financial institutions, Bahrain also plays host to a number of organisations central to the development of Islamic Finance, including AAOIFI, the LMC, IIFM and the IIRA, and of course, this WIBC.[1] The Central Bank of Bahrain ["CBB"], a highly regarded regulator, has played a key role in spearheading the development of Islamic Finance. The CBB has scored many "firsts", including the first central bank sukuk in 2001[2] and being the first country to develop and implement regulations specific to the Islamic banking industry. The CBB has also established the Waqf Fund to finance research, education and training in Islamic Finance. There is much that the MAS can learn from the CBB.

The current global crisis – some root causes

The theme of this session – having an effective regulatory framework – is of great relevance given the on-going financial crisis. The current financial crisis is unprecedented in terms of its scale, complexity, and speed of transmission. While the series of coordinated actions by financial authorities and Governments have helped to stabilise the markets somewhat, sentiments remain fragile, and many of the underlying problems remain.

Many reasons have been offered about the root causes of the current crisis. Let me just highlight a few of these.

The first is the unprecedented levels of leverage taken on by global financial institutions coupled with very loose lending standards in the credit markets. Consumers in the US were also highly leveraged. The high leverage enabled asset values and consumption to be raised to unsustainable levels. When sentiments finally turned, there was massive deleveraging.

The second is that complexity magnifies risks. The proliferation of complex securities and derivatives had not diversified risk amongst different counterparties as was originally intended, but instead increased aggregate systemic risk throughout the financial system. Not only banks and investment banks were affected but a whole range of players including credit insurers, hedge funds and investors in asset-backed commercial paper have also suffered major losses.

---

1 Source: CBB website, http://www.cbb.gov.bh. AAOIFI - Accounting and Auditing Organisation for Islamic Financial Institutions; LMC - Liquidity Management Centre; IIFM - International Islamic Financial Market; IIRA - Islamic International Rating Agency; WIBC – World Islamic Banking Congress.

2 CBB was then known as the Bahrain Monetary Agency.

The third is the inadequate assessment of risks and compression of yields. Many of the assessments were based on complex modeling and did not give sufficient regard to the tail risks in these financial products including the illiquidity risk. In some instances, there may not have been sufficient diversity of views of the risks and pricing of structured credit, with a heavy reliance on rating agencies.

Against these key causes, we must include the backdrop of unsustainable macro-economic imbalances that were building up in the global economy, and policy responses which effectively allowed yields to fall to very low levels. The aggressive search for returns also led to severe compression of yields which distorted investor behaviour and long-term valuations.

The interaction of high leverage, excessive complexity and compression of yields meant that when sentiments turned, the magnitude of price falls across asset classes have been sharp, and the dynamics of the deleveraging process unpredictable. Financial institutions and markets have also become so highly interconnected that an event in one area sets off a chain of events that magnify and exacerbate the initial shocks.

The shocks in the financial markets have now been transmitted to the real economy in the developed countries. Through both the financial as well as the trade and investment channels, these shocks are also propagated to emerging economies. The negative feedback loop between the deterioration in the real economy and sell-offs in financial assets have added to the uncertainty. It will take some time before the crisis runs its course.

Policy agenda

Our immediate focus must be to limit the damage of the financial crisis on the real economy, and stop the downward spiral created by the negative feedback loop. Policy measures must include not just fiscal and monetary policy stimulus, but also an acceleration of structural changes to correct the underlying imbalances, to put the global economy on a sounder footing for renewed growth.

There has also been much discussion about regulatory reform. Reform is certainly necessary, but we must avoid swinging the regulatory pendulum to the other extreme. While the present system has major flaws, it is not fundamentally broken. Fixing these flaws demands thoughtful and pragmatic changes at the global level. Piecemeal quick fixes, which may be logical and perhaps even headline grabbing, may end up creating unforeseen and unintended consequences. It would be a mistake, for instance, to swing towards overly prescriptive rules, or to severely restrict all forms of securitisation and financial innovation. As financial markets are at different stages of development in various countries, we must also avoid a "one-size-fits-all" approach. Certainly, we will need greater international cooperation, and the work of bodies such as the IMF, FSF, BCBS, IOSCO, IAIS,[3] and initiatives sponsored by groupings such as the G20 will be important in this reform effort.

An effective regulatory framework for Islamic finance

The current global crisis has posed a series of extreme stress tests on financial systems and our regulatory approaches, and offers many important pointers for the development of Islamic Finance. Allow me to highlight a few.

[3] IMF – International Monetary Fund; FSF – Financial Stability Forum; BCBS – Basel Committee on Banking Supervision; IOSCO - International Organisation of Securities Commissions; IAIS - International Association of Insurance Supervisors.

First, one of the most significant lessons about the crisis is also the most basic, that is, finance needs to return to its basic function of allocating scarce capital to the most productive uses, with the capital earning an appropriate risk-adjusted return.

In this regard, the underlying Shariah precept in Islamic Finance of not using capital for speculation, but to build productive capacity and generate sustainable economic growth, takes on great relevance. By adhering to this basic precept, I am confident that Islamic Finance will assume a more prominent role in the coming years.

Second, whatever the forms of intermediation, we must remain focused on the types and nature of risks, and how these risks are distributed among the players. Before this crisis, the main focus was on risks posed by hedge funds. As it turns out, a large part of the risks were sitting in the core banking system, in the form of off-balance sheet items held in SIVs. Mortgage lenders which originated subprime mortgages were outside the regulatory ambit. The main lesson here is that we have to examine risks holistically, across the value chain of activities and across different asset classes and markets, and not be blinkered in pre-judging where risks sit. For tail risks in particular, the dark corner where we shine the light may not necessarily be the place where those risks reside.

Many of the risks inherent in Islamic Finance are similar to those of conventional finance, including credit risks, market risks, market conduct risks, operational and reputational risks. However, the exposure to those risks could differ between conventional and Islamic finance. For instance, Islamic banks are generally exposed to substantially more liquidity risk than their conventional counterparts, as the range of liquid instruments and hedging instruments are more limited. Islamic banks tend also to be more exposed to the property and infrastructure sectors, in part because these are the prevalent asset classes in the Gulf and also in part because Islamic finance has to be based on physical assets. Given the “large and lumpy” nature of such transactions and the tendency for asset bubbles to build up quickly, it is a risk that merits special attention.

In addition, there are also risks unique to Islamic Finance such as Shariah-compliance risk. If products are later found to be non-Shariah compliant, the institutions not only face reputational damage, but also costly unwinding of such structures, with possible losses to investors.

The third point is that to achieve a good outcome, an effective regulatory approach needs to embrace a tripartite approach. Regulators, financial institutions and investors all have a role to play.

Allow me to share briefly the approach that MAS takes. As a regulator, MAS looks at both the micro-prudential aspects, looking at the safety and soundness of individual financial institutions, as well as macro-prudential aspects, looking to see if system-wide risks have been built up in the aggregate.

In doing this, we adopt a risk-based approach towards supervision and regulation, in order to promote sustainable development of the sector. For example, we set appropriate limits and capital charges to address the credit, market and other risks. The standards of governance and risk management are set at levels commensurate with the activities and the risks being taken. Sometimes we are accused of being overly conservative, but this prudence has served us well.

In all instances, we seek to find the right balance between “principles-based” and “rules-based” regulation; to avoid being over-prescriptive in rule-making or being over-reliant on market discipline alone to curb excessive risk-taking. Similarly, market conduct measures focus on upholding principles of fairness and transparency, for instance, through requirements on disclosure to investors and a fair-dealing sales process.

The second leg of the tripartite approach is to put the primary responsibility for sound risk management and oversight of each institution on the board and senior management, which must set the right tone and culture. The third leg is to promote greater awareness among investors of their financial needs, encourage financial planning and promote deeper understanding of the risks and returns of different products, through educational programmes such as MoneySENSE.[4]

The fourth pointer from the current crisis is the importance of preventing regulatory arbitrage, and ensuring a level playing field. With regards to Islamic Finance, in particular, MAS seeks to ensure a level playing field between the conventional and Islamic financial players. Where the economic substance and risks are similar, the same regulatory treatment is accorded, regardless of whether the product is a "conventional" or "Islamic" product. For example, Singapore-based banks treat murabaha-based[5] asset financing as a credit risk exposure to the customer for the purpose of maintaining regulatory capital. As Islamic Finance grows, our regulatory framework must continue to evolve to maintain regulatory consistency in managing the underlying substance of the risks.

International collaboration

The fifth and very crucial point that emerges from the current crisis is the importance of international collaboration. As Islamic Finance grows, cross border transactions will multiply. We must therefore take an international perspective in preventing and resolving problems right at the outset. Allow me to suggest three areas where regulators can work closely.

The first area is that legal, regulatory and supervisory frameworks that are developed should be based on internationally recognised principles and standards. The work done by international standard-setting bodies such as the IFSB, IDB, AAOIFI and IIFM[6] is instructive in this regard. For example, "The Ten Year Framework and Strategies" co-issued by the IFSB and IDB is a thoughtful blueprint. AAOIFI has also produced standards in areas such as accounting, auditing, ethics, Shariah compliance and governance. Today, the applications of Shariah precepts differ somewhat in certain areas. It will eventually be desirable to have some standardisation to enhance consistency and to remove one source of regulatory risk.

However, our goal should be to achieve a gradual harmonisation of standards and approaches to regulation, rather than immediate convergence. Even in conventional finance, regulatory approaches and standards differ across different jurisdictions. A flexible, risk-based approach will also allow continued innovation to take place, while ensuring the resultant risks are appropriately managed.

Second, we need to develop a wider range of tools to detect and mitigate risks. In conventional finance, work is underway in reviewing shortcomings in capital adequacy and liquidity management in the Basel II framework, as well as the provision of clearing and settlement infrastructure for derivatives. For Islamic Finance, we need to continue to develop instruments that help to mitigate risks. Bahrain's initiative in developing the Liquidity Management Centre[7] is an excellent example of such an effort.

In this regard, I am pleased to announce that the Monetary Authority of Singapore is now in the final stages of setting up a sukuk issuance facility. I had announced, at this May's Islamic

---

4 MoneySENSE is a national financial education program in Singapore covering three tiers of financial literacy – basic money management; financial planning; and investment know-how. Details on MoneySENSE are available at www.moneysense.gov.sg.

5 Murabaha-based asset financing refers to mark-up asset financing, commonly used in home financing and car financing. In such a transaction, banks generally purchase the asset to be financed, and then sells it to the customer at a mark-up, to be paid on a deferred basis.

6 IFSB - Islamic Financial Services Board; IDB – Islamic Development Bank; AAOIFI - Accounting and Auditing Organisation for Islamic Financial Institutions; IIFM - International Islamic Financial Market.

7 The Bahrain Monetary Agency was the primary sponsor in establishing the Liquidity Management Centre.

Financial Services Board Summit, Singapore's plan to set up a facility to provide Shariah-compliant regulatory assets to these financial institutions as part of our efforts to promote the growth of Islamic Finance in Singapore.

The sukuk structure is based broadly on the Al-Ijarah structure, or the sale-and-leaseback of an underlying property. Sukuk issued by the facility will be given equal regulatory treatment as Singapore Government Securities, or SGS, and returns will be tied to the risk-free yield of SGS of equivalent tenor. The facility is open to all financial institutions that plan to or are currently carrying on Shariah-compliant financial services in Singapore. We are issuing on a reverse enquiry basis, which means we can size and time the issuance according to the needs of the financial institutions. A number of financial institutions have already expressed interest and we expect the first issue to take place at the start of next year. We invite eligible and interested financial institutions to approach MAS as we work towards a formal launch.

Last but not least, efforts to further international collaboration will need to be supported by a solid platform for co-operation and information sharing amongst regulators. Formal agreements between regulators on the scope of cooperation and information sharing will be helpful in this regard. Singapore, as a full member of the IFSB, and a signatory to MOUs with various GCC countries, is keen to explore further avenues for cooperation and collaboration.

Underpinning all these, of course, is the need to continue to broaden and deepen knowledge and expertise on Islamic Finance among regulators and industry players. An investors' education platform to promote risk awareness of Shariah compliant products will also serve to reinforce market discipline by raising awareness of the characteristics and risks of Shariah products, as well as boosting demand for such products.

Conclusion – opportunities for Islamic finance

I would like to end on an optimistic note by reiterating the opportunities available in Islamic Finance. While we must expect the global economy and financial activities to slow in the coming months, the long-term structural improvements in Asia and the GCC will continue. Between Asia and the GCC, for instance, total trade grew by 17% annually since 2000 to exceed US$328 billion in 2006.[8] Total cross-border capital flows between Asia and the GCC are also predicted to increase from US$15 billion at end 2006 to US$300 billion by 2020.[9] Even if only half of these projections are realised, growth is still sizeable. It is thus crucial that we remain focused on enabling long term growth and development even as we tackle the current crisis.

There are many productive areas for the private sector to work in close partnership. I look forward to working closely with our colleagues in the Middle East to further promote cooperation in financial services and Islamic Finance, which will serve as key pillars for promoting long-term, sustained economic development and cooperation in our two dynamic regions.

On that note, I would like to thank you all for your kind attention this morning, and I wish everyone a fruitful conference.

---

8 Based on IMF and CEIC statistics.

9 Source: http://archive.gulfnews.com/articles/08/05/25/10216034.html.