Christian Noyer: Global stability, the future of capital markets and Islamic finance in France

Speech by Mr Christian Noyer, Governor of the Bank of France, at the Euromoney Seminars, Islamic Paris Conference, Paris, 29 September 2009.

*   *   *

Ladies and Gentlemen,

It's a great pleasure for me to address such a distinguished audience today.

While conventional economies are still suffering from a deep crisis and some of our traditional economic thought is being challenged, this meeting is a great opportunity to discuss how alternative finance, and especially Islamic finance, can contribute to the economic recovery.

In the past two years, the French authorities, in active cooperation with the industry, in particular via Paris-Europlace, have introduced substantial reforms to make it possible to allow *Shariah*' compliant finance into France. As Governor of the Banque de France, which is in charge of the licensing of French banks, I would like to specifically highlight ongoing work aimed at licensing Islamic banks in a secure framework. I will come back to this point later…

To focus on the matter I was invited to speak about, I would like to address several issues:

- first, the links between the current overhaul of financial regulation and Islamic finance;
- second, the role Islamic finance could play in France;
- the third, the relationship between Islamic finance and financial stability;
- Finally, I would like to mention the conditions Islamic banks need to meet to ensure that their establishment in France is consistent with the smooth functioning of the banking system.

♦♦♦

The current crisis has illustrated the rapid contagion effect fostered by financial globalisation. However, it is important to emphasise that financial globalisation is not in itself the cause of the crisis, which has rather revealed failures in financial regulation. Indeed, the crisis has highlighted the need to better assess and prevent risks in the financial system as a whole, in addition to simply monitoring the risks of each individual institution. It has also shown that some features of the regulatory regime have had an amplifying effect on the economic cycle instead of mitigating it.

That is why the G20 has launched an ambitious agenda to reform financial regulation, covering four main areas: the strengthening of prudential standards, the redefinition of the scope of regulation, the revision of accounting standards and the strengthening of risk management. We will see later that these areas find a strong echo in Islamic finance, which has also to deal with issues linked to lack of transparency, of a level playing field and harmonised regulation. Thus, the overhaul of regulation in conventional finance should be an opportunity for Islamic finance to tackle these issues, and to better integrate into financial globalisation.

In France, in particular, Islamic finance has a role to play, which could be beneficial both to Islamic investors and to the French economy.

Indeed, the French economy offers major and diversified investment opportunities for Islamic investors in the financing of a wide network of often innovative firms and projects, or in real estate. These sovereign funds, corporates or wealthy individuals should have the opportunity to invest, either directly in individual assets or projects, or indirectly through funds or collective vehicles. It is up to banks to offer to these investors the type of *Shariah* compliant products and investment or financing tools they might wish to have.

Let me make a brief point on sovereign wealth funds (SWFs) and their link with Islamic finance. SWFs have attracted much attention recently but the oldest ones were set up back in the 1970s. Their expansion accelerated about a decade ago, when many emerging countries started to accumulate sizeable foreign exchange reserves, due to high oil and gas prices and to the conjunction of macroeconomic factors and foreign exchange policies. With assets managed by SWFs estimated at 3,000 billion dollars, this category of investors represents twice the value of assets managed by hedge funds.[1] It is estimated that they will continue to grow in the future, to reach from 12,000 to 15,000 billion dollars, depending on estimates, in 2015. Consequently, they play and will continue to play an increasing role in the global financial system.

As SWFs have long-term and diversified investment strategies and are not subject to sudden fund withdrawals by customers, they are usually considered to have a stabilising effect on the global financial system, despite their lack of transparency. Consequently, developed countries have an interest in attracting their investments. During the crisis, the behaviour of SWFs has differed according to the country of origin, but in general, it appears that their tendency to invest more than before in domestic and regionally close markets during the first stage of the crisis has come to an end, and that they have now resumed investing principally in OECD economies.[2] This is particularly true for Gulf sovereign funds, where diversified domestic investment opportunities are scarcer than for Asian sovereign funds, for example. In the first quarter of this year, Europe was by far the leading destination for Middle-Eastern and North African SWF investment.[3] Muslim countries, in particular oil-exporting ones, represent as much as 51% of total sovereign wealth funds' assets. While these funds do not invest only in Islamic finance products, being able to offer a large range of the latter would nevertheless represent a significant comparative advantage for the attractiveness of France.

Another possible development of Islamic finance comes from the retail sector, through investment of French residents of Muslim origin in banking or saving products which are *Shariah* compliant and distributed by local Islamic banks. It is difficult to assess the potential demand for Islamic retail banking products in France. Nevertheless, the potential target population in France, which is estimated at approximately 4 million Muslims, seems promising: this population is 2 or 3 times bigger than in Great Britain, where Islamic finance has been growing for several years. Moreover, according to a survey,[4] more than half of the respondents expressed their interest in Islamic financial products to finance their homes, cars and businesses.

Let me now address the question of the relationship between Islamic finance and financial stability, which is not an obvious one.

In the current context of economic crisis, some experts argue that the very nature of Islamic finance is an effective shield against excessive exposure, providing a much higher degree of security to the economy.

I doubt there is a definitive answer to the question as to whether Islamic finance in general and Islamic banking in particular, is, by nature, conducive or not to financial stability. Without claiming to be exhaustive on such an ambitious subject, particularly in front of an audience of

---

1 Source: *La finance islamique : une solution à la crise ? (2009)*, E. Jouini and O. Pastré, Economica.

2 Monitor Group and Fondazione Eni Enrico Mattei (August 2009), *Analysis of Sovereign Wealth Fund Transactions During Q1 2009*.

3 Monitor Group and Fondazione Eni Enrico Mattei (August 2009).

4 An IFOP survey, disclosed at the end of 2008, on the basis of interviews with 530 people of Muslim origin from various backgrounds, considered a representative sample of the French Muslim community.

distinguished Islamic finance specialists, it seems to me nevertheless useful to briefly recall the following points:

- The **fundamental principles** of Islamic finance can be seen in different ways as far as financial stability is concerned.

As you well know, Islamic finance prohibits the payment and receipt of interest at a fixed or predetermined rate. Instead, profit-and-loss sharing arrangements, purchase and resale of goods and services, and the provision of services for fees are the basis of Islamic finance contracts. Islamic finance is therefore systematically backed by real assets. Moreover, it prohibits speculation and the financing of production or trade in specific sectors.

On the one hand, these principles can be considered to provide stability for the financial system. Indeed, in Islamic finance, unbacked expansion of credit is precluded, and banks cannot initiate or accentuate a speculative process. Credit is based on real savings and savings can only earn a return if directly invested in creating activities. Finance and the real economy are closely linked. In the Islamic system, banks can neither carry highly leveraged exposures nor acquire risky financial structured products. By the way, even if the Islamic nature of their finance is not the only explanation, we can note that Islamic finance countries, compared with those of conventional finance, have been relatively less impacted by the crisis.

But on the other hand, Islamic banks pose risks to the financial system that in many regards differ from those posed by conventional banks, with respect, for example, to liquidity, operational and legal risks.

Indeed, Islamic banks face specific obstacles in liquidity management, as the prohibition of interest has led to the underdevelopment of funding sources.

Moreover, operational risk and legal uncertainty can be amplified by the lack of product standardization and the lack of harmonization of Islamic standards, with for example possible differences between *Shariah* scholars' interpretations, accounting standards, and so on.

In the same way, prohibition from financing specific sectors limits the kind of eligible assets for investment, which contributes to increasing the risk of concentration in potentially cyclical sectors such as real estate. This is what happened in certain Gulf countries.

- As the analysis of the principles of Islamic finance does not settle the issue of the relationship between Islamic finance and financial stability, it needs to be supplemented by an **empirical analysis**.

In fact, there is relatively little empirical analysis regarding the role of Islamic banks in financial stability. Nevertheless, a working paper of the International Monetary Fund was published at the beginning of 2008.[5]

The findings of this paper are to be viewed as preliminary. Nevertheless, it has the advantage of being, as far as I know, the first and, up to now, only cross-country empirical analysis of Islamic banks' impact on financial stability.

Even if the situation may in principle differ from country to country and even from bank to bank, the paper finds that:

- (i) small Islamic banks tend to be financially stronger than small commercial banks,
- (ii) large commercial banks tend to be financially stronger than large Islamic banks,
- (iii) small Islamic banks tend to be financially stronger than large Islamic banks.

---

[5] "Islamic Banks and Financial Stability: An Empirical Analysis" Prepared by Martin Čihák and Heiko Hesse (January 2008). The analysis is based on evidence covering 77 Islamic and 397 comparable commercial banks in 18 banking systems with a substantial presence of Islamic banking, over the 1993-2004 period.

One of the plausible explanations given by the paper is that it is significantly more complex for Islamic banks to adjust their credit risk monitoring system as they become bigger. Given their limitations in standardisation in credit risk management, monitoring the various profit-loss-arrangements rapidly becomes much more complex as the scale of the banking operation grows.

These findings are based on evidence drawn from banking systems with a substantial presence of Islamic banking. Therefore, they are not strictly transposable to France. Nevertheless, precisely because France is a conventional environment, I would like now to conclude my speech with some remarks on conditions Islamic banks need to meet to ensure that their establishment in France offers sufficient safety for their customers and is compatible with the smooth functioning of the French banking system.

This is primarily in Islamic banks' own interest and is also in the interest of the banking system!

Regarding licensing, the Credit Institutions and Investment Firms Committee *(Comité des Etablissements de Crédit et des Entreprises d'Investissement* – CECEI) will assess the same criteria as for any conventional bank: financial resources and suitability of the shareholders; integrity, qualifications and suitable experience of managers; level of own funds; business plan; capacity of the bank to achieve its development objectives and so on. Indeed, there is no specific criteria or requirement for Islamic banks in the French licensing framework.

But beyond these standard licensing criteria, banking authorities need to ensure that Islamic banks will interact with their conventional environment in France as soundly as possible. Therefore, some key issues need to be tackled before licensing an Islamic bank, regarding especially:

- their governance, with for example the role of the *Shariah*' Board,
- the legal classification of profit-sharing investment accounts and its consequences in terms of coverage by the French deposit guarantee scheme,
- and liquidity management and access to the Eurosystem funding, especially the issue of assets eligible as collateral.

Let me stop here. I would like to thank you very much, Ladies and Gentlemen, for your attention.