Zeti Akhtar Aziz: Financial stability – regional and global cooperation

Speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the 8th Islamic Financial Services Board Summit Luxembourg, Panel Session 2 "Financial Stability: Regional and Global Cooperation", Luxembourg, 12 May 2011.

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It is now more than three years since the onset of the global financial crisis. Yet, its repercussions continue to reverberate across the world. Efforts to return the global economy on a sustainable growth trajectory have been challenged by risks and uncertainties that continue to prevail in many parts of the world. Most of all, this crisis has demonstrated the greater degree of international interdependence arising from the increased international financial and economic integration. Global financial stability has therefore become a shared responsibility. In today's more interconnected financial systems and stronger economic interlinkages, the enormous challenge in securing effective and efficient functioning financial systems and financial stability will demand for unprecedented collective action and international cooperation.

It is my pleasure to be here in Luxembourg on this occasion of the 8th IFSB Summit on "Enhancing Global Financial Stability: Challenges and Opportunities for Islamic Finance". I am honoured to speak on the scope for international collaboration and cooperation in Islamic finance in our collective endeavor to safeguard financial stability.

The internationalisation of Islamic finance and its increased role in the international financial system

Since the turn of the millennium, the internationalisation of Islamic finance has accelerated**.** Its internationalisation is manifested by the increased presence of Islamic financial institutions in new jurisdictions, the increased international participation in Islamic financial markets and the increased cross border flows that are Shariah compliant. Today, there are more than 600 Islamic financial institutions that operate in more than 75 countries. The sukuk market in particular, has evolved as a major contributing factor driving the internationalization of Islamic finance. It has become an important avenue for international fund raising and investment activities, generating significant cross-border flows. Following the return of investor confidence reflected by the strong performance of financial markets in 2010, activity in the sukuk market also gained momentum. Islamic finance has become the fastest growing segment in the international financial system. Moving forward, the international dimension of Islamic finance is set to become even more pronounced in this post crisis-era.

With the intensification of this globalization process, we need to be mindful of the important lessons from the recent global financial crisis of ensuring the quality and soundness of the financial integration process. Whilst the growing internationalization of Islamic finance essentially reflects its ability to be competitive and its ability to meet the changing demands of businesses, its resilience has been important in supporting this trend. This resilience is essentially underpinned by two inherent strengths of Islamic finance. First, is its strength that is derived from the emphasis on having a close linkage between Islamic financial transactions and economic activity and from having built-in checks and balances which inherently make Islamic finance a stable form of intermediation. Second, are the initiatives that have been taken to strengthen the international infrastructure of Islamic finance to promote the sound and orderly development of Islamic finance. Importantly, these initiatives are being taken while the Islamic financial institutions and Islamic financial markets are still at a relatively early stage of development.

With its internationalization, Islamic finance will contribute to the more efficient mobilization and allocation of funds across regions. This trend will also strengthen the international financial and economic interlinkages between jurisdictions, bringing with it mutually reinforcing gains. It also influenced the patterns of global financial and economic integration, in particular, facilitating the revival of financial and economic integration between Asia and the Middle East and between emerging economies and the more established financial markets, thereby contributing towards a more balanced growth in the global economy.

Initiatives to strengthen the cross-border financial stability framework

As Islamic finance increasingly expands beyond national boundaries, it has called for ***developing the framework for cross-border financial stability*** to further strengthen the resilience of Islamic financial system and to address cross-border challenges in an integrated manner. This recent decade has seen such international cooperation and collaboration to safeguard financial stability in the international Islamic financial system be taken to a new level. This is to ensure its orderly evolution as an integral component of the international financial system.

Strengthening international financial infrastructure

The focus of cooperation has been particularly significant in the area of the development of the international financial infrastructure relating to financial stability. A key development since the setting up of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) in 1990 has been the establishment of the Islamic Financial Services Board (IFSB) as the international prudential standard setting body for the Islamic financial services industry in 2002. The important goal of strengthening the foundation of the global Islamic financial system was recently reinforced further following the recent global financial crisis, through the work of the IFSB-IDB Task Force of Islamic Finance and Global Financial Stability. In its report that was released in 2010, eight building blocks were identified to deal with the potential risks and vulnerabilities to the Islamic system in this now more challenging international financial environment. These include steps that need to be taken for the implementation of the prudential standards; the development of a liquidity management infrastructure; the introduction of strong financial safety nets; the development of an effective crisis management and resolution framework; the development and implementation of accounting, auditing and disclosure standards; the formulation of an effective macro prudential framework; the development of credible credit rating institutions and processes; and finally, to strengthen efforts for capacity building and talent development for the Islamic financial services industry. Given the global dimension of these building blocks, international cooperation and collaboration is significantly vital to advance these important agendas.

Regulatory harmonization

Commanding the highest level of international cooperation is particularly vital in the implementation of common prudential standards to safeguard the stability of the Islamic financial system. This will contribute towards the harmonization of the regulatory and supervisory framework in Islamic financial systems across borders. Of importance is advancing the international standards and best practices that takes into account the distinct characteristics of Islamic finance. Such prudential regulation that considers the unique mix of risks associated with Shariah-compliant financial business would enhance the effectiveness of the regulatory outcomes intended for Islamic finance.

Much progress has already been made by the IFSB in promulgating an extensive set of prudential standards for the Islamic financial services industry since its establishment in 2002. The IFSB has already introduced standards for capital adequacy, risk management, corporate governance and Shariah governance. This important work has been significant in promoting international uniformity of regulatory frameworks and international best practices for the Islamic financial system in different jurisdictions. Its significant progress has benefited from the strong international cooperation and collective support from its member countries and global institutions. Indeed, as an evolving global industry with varying stages of development across borders and various business structures and operating models used in the different markets, this close engagement has also allowed for the attainment of balanced views.

Whilst Islamic finance has demonstrated resilience during the recent crisis, the IFSB has moved quickly to review its existing capital standards for possible enhancements and to incorporate new liquidity measures in its ongoing work in developing liquidity standards for Islamic banking. This work is currently being addressed through the Working Groups for Capital Adequacy Standards and for Liquidity Risk Management. The overarching objective is to ensure that the salient features of Islamic finance are effectively and adequately addressed while taking into account the issues that had surfaced in the crisis in the conventional financial system.

The next stage is the ***implementation of these standards in the different jurisdictions***, which is just as important as the development of the standards itself. This is an area in which global cooperation and collaborative action is critical so as to ensure the consistent implementation of the regulatory framework. The full adoption of IFSB standards will eliminate the opportunity for regulatory arbitrage, in particular, regulatory arbitrage due to cross-sectoral differences, cross-border differences and the differences between conventional and Islamic finance. The more consistent implementation of these standards will also ensure greater certainty in the regulatory treatment of Islamic financial transactions, thereby enabling comparability among institutions as well as surveillance by regulatory authorities. This harmonization will not only contribute towards global financial stability, but will also promote greater transparency across borders.

The application and enforcement of the international prudential standards promulgated by the IFSB will contribute towards achieving these objectives. Technical cooperation programmes can be developed and designed for both ex-ante and ex-post implementation of the IFSB standards. In the pre-implementation period, structured technical programmes can be tailored to individual countries to enhance jurisdictional preparedness in adopting the standards if so required. Similarly in the post-implementation period, a framework for self-assessment can be developed to assess jurisdictional effectiveness in implementing the IFSB standards. These developments would potentially lead to the inclusion of the IFSB standards and rules for adherence and implementation across jurisdictions, along with the core principles and standards of the Basel Committee, IAIS and IOSCO within the context of the IMF-World Bank Financial Sector Assessment Program. This would further contribute towards the efforts of achieving global financial stability in the international financial system.

Cross-border supervisory cooperation

The increasing internationalisation of Islamic finance has a significant extent been facilitated by the expansion of the operations of Islamic financial institutions beyond their domestic borders, motivated by the search for new growth opportunities. In addition to the increased interconnectedness of Islamic financial markets, this trend calls for greater cooperation among supervisors to ensure financial stability of the Islamic financial system. The recent global financial crisis has in fact put to a test the strength of cross border supervisory cooperation. Challenged by information asymmetries due in part to the lack of arrangements for cooperation, supervisors faced the challenging task of understanding the extent of the systemic risk and its contagion across borders.

In the rapidly evolving world of Islamic finance, supervisors are also confronted with an even greater task, of keeping abreast with the pace of innovation, taking into account the uniqueness of Islamic financial contracts in addition to the universal scope of Islamic banking business. This warrants supervisors to recognise the different aspects of risk management in Islamic finance. Islamic financial institutions in most jurisdictions have evolved within the confines of the conventional system and have been accustomed to business practices in their respective jurisdictions. This could result in distinctly different business and risk taking activities. Collaboration among supervisory authorities of such internationally active Islamic financial institutions thus needs to become part of the overall supervisory framework.

These efforts would require ***regular engagement between home and host supervisors*** to ensure alignment of the supervisory oversight. This will allow for a more holistic evaluation of risks and vulnerabilities for Islamic finance businesses that operate across borders. Effective sharing of surveillance information and assessments of other supervisory issues on Islamic financial institutions is already taking place through bilateral cooperation between supervisory authorities and other informal arrangements. Going forward, a more structured framework for collaboration among supervisors is needed so as to enhance supervisory informational efficiencies, and ultimately, contribute to an effective assessment and early detection of any cross-border risk-transmissions from the group-wide activities. The home-host information sharing can be facilitated through the supervisory college arrangement as an institutionalised mechanism for greater cooperation.

The recent financial crisis has also revealed the failure to understand the inter-relationship between financial and the broader sector, particularly in understanding the potential spill-over and second-round effects that are transmitted between sectors. Post-crisis regulatory efforts have focused on macro-prudential measures to complement micro-surveillance and supervision. This entails horizontal assessment of risks across institutions, sectors and national borders, as well as risks in asset markets across time. This is particularly relevant for the Islamic financial services sector. Given the ***close ties of Islamic finance with the real economic sector*** through the various modes of Islamic financing contracts, a complete understanding of the entire risk spectrum often encounters much difficulties. It is therefore important for the regulators to also establish ***an integrated framework of macro surveillance for Islamic financial activities*** across jurisdictions. The global database for prudential Islamic finance statistics to be initiated by the IFSB, would therefore need to go far beyond ensuring standardised data collection among jurisdictions, but also to enable the generation of various macro and financial indicators, and global sharing of best practices in macro surveillance. The engagement by supervisors would also contribute towards the understanding of the systemic risk and its origins and would support the maintenance of timely and accurate economic and financial data. This would in turn contribute towards more effective surveillance and management of financial stability issues.

Indeed, developing an ***integrated surveillance mechanism, identification and prevention of emerging risks*** in the Islamic financial system, as well as the establishment of an ***integrated crisis management and resolution framework***, are crucial to the maintenance of financial stability in the global Islamic financial system. This would allow for a comprehensive and prompt response to a financial stress, and thus increase the prospects for an early recovery. This was the basis behind the setting up of the Islamic Financial Stability Forum (IFSF) in 2010, as a platform to build closer cooperation among regulatory authorities. More specifically, the IFSF carries the mandate of promoting international dialogue, engagement and cooperation in the area of financial stability. It also aims to broaden the understanding on the external repercussions of policy action or inaction in a given country on other national financial systems, and in considering the merits for collective action. Whilst effective international cooperation requires a framework for shared commitments, important in this process is the recognition of the remits of national autonomy given that financial regulation and intervention are subject to country-specific circumstances. This arrangement can contribute towards enhancing mutual understanding and prevent dilution of the commitment towards common objectives.

A concrete advancement in cooperation and collaboration that has paved the way for the development of yet another important international financial infrastructure is the establishment of the International Islamic Liquidity Management Corporation (IILM), in 2010. This landmark collaboration between 12 central banks and two multilateral development institutions represents a major breakthrough in strengthening the liquidity arrangements for the international Islamic financial system. This liquidity infrastructure is vital for the efficient and well-functioning of the Islamic financial system. The creation of IILM with the mandate to issue Shariah compliant liquid instruments is an important step forward in promoting more efficient cross-border liquidity management by Islamic financial institutions. The IILM will also be well-equipped to serve as a platform of global engagement on liquidity management in the Islamic financial system and on addressing cross-border systemic liquidity issues.

Conclusion

Let me conclude my remarks. This decade has been a defining era in the evolution of Islamic finance. It has been characterized by rapid global expansion and increased internationalisation. Of importance is that these trends have been supported by significant actions taken to strengthen the foundations of the international Islamic financial system involving the development of important international institutional arrangements and mechanisms. These tremendous achievements have been the outcome of strong cooperation and collaboration among the Central Banking community from both Islamic and non-Islamic countries.

Moving forward, it is essential for this strong cooperation to continue given the dynamic nature of the industry. In addition, the pace of internationalization can be expected to gain further momentum. As the international integration of Islamic finance intensifies, cross border financial flows and its associated challenges will also increase. This will call for an even greater degree of international cooperation and coordination. While this new decade beckons the prospect of immense opportunities in Islamic finance, our ability to realize this potential will be determined by the ability to recognize the shared responsibility it demands and to collectively advance forward the agenda of financial stability and resilience to achieve our ultimate goal of a shared prosperity.