

## Ensuring Stability in Turbulent Times<sup>1</sup>

Your Excellencies, Distinguished Guests,  
*Sabah-al-khair* and a very good morning.

I am very delighted to be here today and I am grateful to H.E. Dr. Abdulrahman A. Al Hamidy for inviting me to speak before this august gathering. Thanks to the active collaboration of the Basel Committee on Banking Supervision, Financial Stability Institute, and the Arab Monetary Fund, these high-level meetings provide a valuable forum for exchange of views for the regulators and supervisors in the region.

The agenda of this conference adequately captures key developments, issues, and challenges that we need to focus our attention on. Today, I would like to touch upon two major forces that have swept across the financial world. First is the tech-driven revolution, which has brought its own set of risks and rewards. Second is the wide range of measures that have been introduced to strengthen the resilience of our banking systems.

Let me start with innovations first.

### **Innovation; opportunities and risks**

Tech-driven innovations have unleashed drastic changes in the way we conduct business, interact with each other, or consume various products and services. Financial sector, essentially an 'information industry', is experiencing a major transformation, fueled by advances in technology. Though the imprint of modern technologies is now ubiquitous, let me briefly highlight a few areas of finance where the developments are particularly significant.

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<sup>1</sup> Keynote speech delivered by His Excellency Dr. Mohammad Y. Al-Hashel, Governor, Central Bank of Kuwait in the 12<sup>th</sup> High Level Meeting for the Middle East & North Africa Region, jointly organized by the Basel Committee on Banking Supervision, the Financial Stability Institute and the Arab Monetary Fund, held on December 7, 2016 in Abu Dhabi, UAE.

To start with, technology is supporting the outreach of formal financial services to the millions of otherwise unbanked customers. According to the World Bank, the poorest 20% of the world population is more likely to have access to a mobile phone than to clean water and sanitation. Capitalizing on this opportunity, a number of countries have managed to swiftly expand access to finance in recent years. Globally, number of adults who were previously out of formal financial system has dropped by 20% during 2011-14 alone. As these encouraging trends suggest, digitalization offers an unprecedented opportunity to improve access to finance to the millions of people who have remained financially excluded so far.

Likewise, programing breakthroughs like blockchain are potentially transforming the way we verify transactions and enforce contracts. By allowing parties to transact without central intermediaries, blockchain can strip off costs, reduce inefficiencies, and enhance customer services.

Host of other innovations are reshaping the way we transfer money or obtain credit. For instance, mobile wallets are enabling payments by smart phones, peer-to-peer lending is providing new sources of financing, and robo-advisors are offering financial advice.

While undoubtedly exciting, these developments bring in their own unique risks and challenges. I would like to flag a few of them, particularly from the standpoint of financial stability.

First, cyber security risk is becoming an increasingly major part of banks' operational risk landscape. As various hacking episodes illustrate, now fraud can be perpetrated swiftly, remotely, and on a massive scale. Though such occurrences are still uncommon, the impact is substantial, given the high degree of interconnectivity of our systems and markets.

Second, fintechs are unbundling parts of the finance value chain, offering financial services directly to customers. Apart from increasing competition, and squeezing banks' profits, fintechs are moving part of the banking business to shadow banking which remains lightly regulated, if at all. Likewise, tech-enabled peer-to-peer lending and crowdfunding can further

expand the scale of shadow banking, and may also exacerbate procyclicality.

As this discussion indicates, innovations are by nature a disruptive force, causing a considerable degree of instability. Therefore, regulators face a daunting task of keeping financial systems safe and stable while continuing to ensure the convenience and efficiency that modern technologies offer.

To ensure that, we must strengthen our own capacity to identify, monitor, and mitigate the risks from technological innovations. This would require closer cooperation with the banking industry as well as among regulators, both within a country and across the borders. Yet that is not enough; we also need to leave our comfort zone and engage with other stakeholders, primarily the tech firms themselves.

Ultimately, as regulators, we wish neither to stifle innovation nor to undermine financial stability – and it is indeed a very delicate balance to achieve. Similar to when navigating unfamiliar domains, we need to remain agile, adaptive, and proactive – this will ensure reaping the enormous benefits of financial innovations, yet limiting their downside.

Let me now turn to the second part of my speech.

### **Regulatory reforms; costly but essential**

Banking regulation has been another major area witnessing far-reaching reforms. Driven by the experience of global financial crisis, banking regulation, under the able leadership of the Basel Committee, has witnessed a major overhaul. Strenuous efforts have been made to improve resilience of banking systems across the globe.

These measures are vitally important, given the increasing uncertainty of when or where the next shock would emanate from. Consider the stress that financial markets had to face in recent years. In 2013, it was the US taper tantrum, in 2014 it was the collapse in oil prices, in 2015 it was rebalancing in China, and this year it was Brexit, just to quote a few examples. These events were markedly different in geographical origin and root causes but were common in rattling the global markets.

Against this backdrop, ensuring a resilient banking system capable of withstanding a variety of shocks is no easy task. And these shocks are not only exogenous; the banking system itself is in a state of flux amid evolving risks, in part due to the very financial innovations I just talked about.

This calls for continuously upgrading our regulatory regime. Accordingly, we in Kuwait, like our colleagues in the region, have not only refined our existing regulations to reflect the best global practices, but have also introduced a host of new measures.

This journey brought its own set of challenges, and I would like to point out one in particular, to benefit from the presence of our esteemed colleagues from the BIS. Similar to other jurisdictions with dual banking system, we have a sizeable presence of Islamic banks in Kuwait. Yet we found limited relevant guidance for the application of Basel III on Islamic financial institutions, if at all. For the most challenging aspects of Basel III reforms, it has been left to the discretion of individual regulators to figure out how best to apply the proposed rules to Islamic banks.

However, the use of discretion, though well intended, is bound to create differences across countries, and more so in the case of Islamic finance where the lack of consistency in *Sharī`ah* interpretations makes the task even harder. Consequently, we may witness diverging approaches to regulation of Islamic banks across jurisdictions, with the risk of regulatory arbitrage.

Going forward, we also need to recognize that ensuring stability, of a constantly adapting banking system, cannot be left to regulation alone. Therefore, we need to strengthen our supervisory capacity, to suitably complement our revamped regulatory regimes. Only through effective supervision can we ensure that banks are truly compliant with our regulations. Moreover, better supervisory oversight would also give us the agility to mitigate emerging risks before they materialize.

Having said that, it must be acknowledged that we can't regulate every aspect of the banking system. Ultimately, banks should assume prime responsibility for their actions and behaviors. Being dependent on public confidence, banks can ill afford to operate with weak corporate governance

or poor risk culture. This necessitates that banks maintain robust corporate governance standards, duly supported by strong internal controls, and prudent risk management.

We are fully cognizant that these regulatory measures are costly for banks; nonetheless, costs of any financial crisis, both in financial and social terms, are far more substantial. Therefore, it is only wise and rational to strengthen the capacity of our banks in benign times. I believe our proactive approach has actually paid off, as banks in our region generally entered the low oil price environment from a position of strength.

Yet banks' resilience is not infinite and may come under severe pressure if necessary economic and structural reforms are dropped - or even delayed. Hence, we should not lose sight of the broader economic context in which our financial systems operate. After all, the banking sector is just a component of the overall economic landscape, though a very crucial one. While ensuring banking stability is critical, it is only a necessary condition for overall economic stability - and not a sufficient one.

Given the strong feedback loop between the overall economy and the financial sector, regulation can't be the 'only game in town' to maintain financial stability. Equally critical are economic and structural reforms that are essential for a stable macroeconomic environment where financial sector can flourish.

Towards that end, we, as central bankers, must continue to provide sound policy advice to our governments, supporting them in better addressing the challenges that our economies face, as only broader economic stability would ensure financial soundness and cement the gains of our regulatory reforms.

Thank you for your attention.

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