The impact of the financial crisis on Islamic finance

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Agenda

- Whirlwind tour of world developments
- Developments in international regulatory change for Islamic Finance
- Changes in national regulatory systems
- Changes in the substance of regulation
- Impact on Islamic finance regulation
- IFSB Building blocks
- Conclusions

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Regulatory developments

- Extraordinary government & central bank interventions to limit fall out of global financial crisis.
- Crisis exposed weakness in regulation and supervision, risk management of firms and market discipline
- Limitations of Basel II capital regime exposed
- Liquidity standards and supervision weak
- Market discipline in risk-taking extreme
- Exposed the scope for regulatory arbitrage and gaps in coverage
- Prompted the need for a macro-prudential approach to regulation to focus on system-wide risks.
- No guarantee to prevent another crisis in the future, but can increase our ability to foresee a crisis like this one.
- Regulators and international bodies must avoid giving a false sense of certainty to financial institutions, markets and general public.

International Regulatory Structures

- Financial Stability Board Membership

Standard-Setting Members	Supra-National Members	National Members
IOSCO (securities)	IMF	G20
BASEL (banking)	ECB	Spain
IAIS (insurance)	OECD	Hong Kong
IASB (accounting)	The World Bank	Netherlands
	EC	Singapore
		Switzerland

FSB Agenda is much broader

- Reflecting a number of regulatory shortcomings exposed by the crisis, the agenda of the FSB is wide-ranging:

FSB

- assess vulnerabilities affecting the financial system and identify and oversee action needed to address them;
- promote co-ordination and information exchange among authorities responsible for financial stability;
- monitor and advise on market developments and their implications for regulatory policy;
- advise on and monitor best practice in meeting regulatory standards;
- undertake joint strategic reviews of the policy development work of the international standard setting bodies to ensure their work is timely, coordinated, focused on priorities, and addressing gaps;
- set guidelines for and support the establishment of supervisory colleges;
- manage contingency planning for cross-border crisis management, particularly with respect to systemically important firms; and
- collaborate with the IMF to conduct Early Warning Exercises.

FSF

To promote international financial stability through enhanced information exchange and international cooperation in financial market supervision and surveillance.

Source: Financial Stability Board/Financial Stability Forum

National Regulatory Structures

- Examples of success and failure found within several structures
- A continuing move towards integration regulation eg:
  - Iceland formed a ‘single fully integrated regulatory institution’
  - France considering merging banking and insurance regulators
  - Egypt merged insurance, securities and some banking regulatory bodies
- Entities offering similar products and services irrespective of jurisdiction, receive the same supervision and oversight.
- Pressure to define macro-prudential regulation responsibilities at a national level
- Natural location in many jurisdictions will be the Central Bank.
- Concerns in large jurisdictions whether single institution can manage all regulatory responsibilities
- Pan-European structure has created a new European Systemic Risk Board (ESRB) to:
  - Monitor and assess potential threats to financial stability
  - Issue risk warnings and recommendations for action
  - Monitor implementation

Global Regulatory standards

- Challenges for standard-setters and regulators – need to avoid 'fighting the last war'
- Can be argued that regulators took their eyes off prudential regulation whilst dealing with other issues.
- Has been suggested that the next crisis may be in clearing house regulation, ETFs or dark pools?
- Difficult to anticipate the required reforms for tomorrow's regulatory challenges
- Need for a financial and regulatory system resilient against a wide range of failures
- Needs to be inherently stable and capable of being managed and regulated by fallible humans

Impact on Islamic Finance Regulation

Context

- Over last few years, Islamic finance has consistently shown double digit growth rates but
  - still only c. 1% of conventional finance
  - no Islamic financial institution of global systemic significance
- Growth driven by sustainable economic trends
  - substantial petrodollar surpluses
  - more general shift of economic power towards Asia
- Global financial crisis has provided an opportunity for Islamic finance, in that the obvious failures in the conventional financial system have at least created a willingness to listen to alternatives

Key message

- Still considerable scepticism, but at least Islamic finance has an opportunity to show what it can do
- Opportunity for the institutions of Islamic finance (IFSB, AAOIFI, Islamic Development Bank)
- Real time pressure
  - conventional standard-setters distracted by financial crisis – time for Islamic finance world to get its house in order.
  - complacency could lead more powerful conventional regulatory bodies that will do the job for it –perhaps not in way it would choose.

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Impact of international standards

Business as usual

- Most of developments in accounting standards and Basel regime
- Work to do to adapt these to the specificities of Islamic finance
- Work in the area of group supervision & group consolidation
  - To date, very little work on how to consolidate Islamic entities at group level, and even less on how to consolidate them with conventional firms
- Clearly the way the world is moving
- These areas of standard development will be intellectually demanding, but it is work that, collectively, we know how to do.

Business as usual – standard setting

- Watch the developments in conventional standards-setting, to ensure they do *not* have unintended consequences for Islamic finance
  - some of the developments in the regulation of asset-backed securities could easily be drafted so as to have unintended consequences for the sukuk market.

Business as usual – standard setting

- Take account of the growing "substance over form" consensus in the conventional world.
  - Conventional finance has had its fingers burnt more than once by "form over substance" approaches, for example with finite reinsurance and "liquidity guarantees" and credit enhancement business
  - So while acknowledging the importance in Islamic Finance of the early Islamic contract forms, on which so much jurisprudence exists, the global system will nevertheless expect accounting and prudential standards that reflect the economic reality of the transactions, and disclosures that reflect true economic risks.
    - Eg. If good Shari'a compliant ways of providing ………

Standard setting – deposit insurance

- Clear these will become more widespread
- Could become a pre-condition for banks to do business across borders
- How will they apply to Islamic banking, and what will be their coverage. Will they apply to PSIA?
  - Many think PSIA is not a deposit – if so, then Islamic bankers will have to be very clear on the point, and both regulators and customers will need to be clear that PSIAs are *not* covered by deposit protection schemes

Standard setting - liquidity

- Issues essentially technical, but demanding
- Key issue is treatment of PSIAs – if not depositors, and bear investment risks associated with their accounts, to what extent can they be expected to bear liquidity risks arising elsewhere in the bank (which may be a largely conventional bank operating a window).
- Raise bigger question how liquidity is to be ensured, and maintained in a crisis
  - must be effective tools for central banks to provide liquidity to Islamic financial institutions without raising the issue of riba
  - Possible, but technical work must be done now!
  - central banks need to have instruments on their shelves ready to use, not to be scrabbling around trying to draft the contracts when a bank is in trouble.

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Standard setting – liquidity 2

- Islamic banks need a wider variety of options to manage their own liquidity, including a functioning Islamic money market
- Commodity Murabaha principle on which much short term funding is based needs to change, or at least be supplemented by other principles.
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- Commodity Murabaha principle on which much short term funding is based needs to change, or at least be supplemented by other principles. Why?
    - inherently unsatisfactory nature, with a distinct air of "smoke and mirrors";
    - inherent transaction costs;
    - come a point where commodity markets are overwhelmed, in the sense that even short-term real ownership of an actual commodity cannot be assured.

Standard setting – liquidity 3

- Money market issues are being addressed, and DFSA has been actively involved with the IFSB.
- What we need now is a real will to implement. If Islamic finance is to grow from 1% of the world market to 10%, or even 3%, it desperately needs to develop its infrastructure, of which a functioning money market is just one part.

Standard setting – Corporate Governance

- IFSB's work on governance standards for cis and Takaful shows how some Islamic structures have conflicts and incentives different from those of conventional finance, & proposes ways of managing these
- Structures of Shari'a governance
- Need to reduce burden, especially cost burden, of Shari'a governance
  - Increased contract standardisation
  - Increasing supply of scholars
  - Need to create formal training framework and professional structure
- In the future, the key Shari'a assurance may come from firms rather than individuals, though of course the reputation of any firm will depend on the quality of the leading individuals within it.

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National regulatory structures

National regulatory structures

- Jargon of macro prudential regulation
  - national regulators focus on issues of systemic risk, and will be expected to ensure that no significant institution escapes their regulation.

- Calls for Islamic finance to be regulated by specialist supranational bodies rather than local, national regulators – ***this will not happen***
- Islamic finance structures tend to cross traditional boundaries
- Integrated regulators must be able to deal with unusual structures
- National regulatory change will delay development and implementation
- Standards that a new regulator will apply – the international regulatory architecture

The international architecture

The international architecture

- AAOIFI and IFSB have created series of standards – very little applied
- FSAP - “What gets measured, gets done”
- If performance measures don’t include Islamic finance services – no incentive for implementation
- Conventional standards may force Islamic finance back into conventional moulds
- New product surveillance bound to look at Islamic products
- Signs of difficulties accommodating Islamic finance
- Islamic finance forced into conventional pigeonholes unless differences recognised?
- Indonesia, Saudi Arabia and Turkey joined G20 FSB
- Opportunity for Islamic Finance to be considered seriously

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Islamic Finance and Global Financial Stability

Three key areas of priority

a) Strengthening the infrastructure building blocks of the Islamic financial services industry to further enhance the industry's resilience

b) Accelerating the effective implementation of Shari'a and prudential standards and rules to facilitate the creation of a more stable, efficient and internationally integrated Islamic financial services industry; and

c) Creating a common platform for the regulators of the Islamic financial services industry to enhance constructive dialogue

1. Comprehensive set of cross-sectoral prudential standards

- Take into account the specificities of the Institutions offering Islamic financial services (IIFS)
- Equivalent of Basel II in Islamic finance
- Efforts to issue comprehensive prudential standards for Islamic banking sector equally robust as conventional banking
- Attention needed to expedite work on a comprehensive set of prudential standards for the Takaful sector
- Ensure closer cooperation among policymakers and financial supervisors with different mandates in different jurisdictions in order to enhance the resilience and stability of the IFSI
- Coordinated cross-sectoral approach to the regulation and supervision of IIFS
- Regulation of non-financial activities of financial conglomerates needs to be appropriate structured to address contagion risks

2. Development of a liquidity management infrastructure

- Development of a robust national and international liquidity infrastructure to include monetary policy and money market operations:
  - Reduce the cost of intermediation
  - Influence the level of liquidity
  - Effective management of monetary policy
- Help preserve financial stability for central banks to perform the lender of last resort function and provide liquidity to market
- Tools for liquidity risk management remain rudimentary and markets are insufficiently liquid
  - leading to inefficiencies (low returns on liquid assets) and systemic risk
- IFSB has established a High Level Taskforce on Liquidity Management (HLTF)

3. Strengthening financial safety nets

- LOLR facilities, emergency financing mechanisms, deposit insurance - compatible with Shari'a principles
- Development of adequate more efficient processes for LOLR and emergency financing operations consistent with Shari'a principles
- Deposit insurance, prudential supervision and LOLR are key components
- Implementation of Shari'a compliance deposit insurance scheme is challenging re funding structure of IIFS

4. Effective crisis management and resolution framework

- An integrated crisis management framework is essential
- Must include:
  - Bank insolvency laws
  - Dealing with non-performing assets
  - Asset recovery and bank restructuring
  - Bank recapitalisation
- Legal challenges whether conventional legal systems, common law jurisdiction and codified systems address bank liquidation in insolvency issues* arising from Shari'a compliant financial transations

* Legal risks have been highlighted in a *IFSB paper, Islamic Finance:Global Legal Issues and Challenges (2008)*

5. Accounting auditing and disclosure standards

- Enhance financial reporting to facilitate monitoring and assessment of Islamic financial institutions
- IFSB developed a standard on Shari'a governance systems
- IFSB designed transparency and disclosure framework
- Progress needed in updating accounting and auditing standards for IIFS to an international standard
- Monitoring and assessment mechanism needed to encourage implementation

6. Macro-prudential surveillance

- Financial stability analysis integral to building resilience and minimising risks of Islamic financial system
- Traditional micro-prudential approach not effective in addressing system-wide stress due to common exposures of financial institutions
- Development of indicators to provide basis of assessment of financial stability and risk vulnerabilities
  - also facilitate analysis of how indicators interact with the broader macroeconomic developments
- IFSB to establish a global database of prudential Islamic finance statistics
- Information technology advancements required to cater for unique features of Islamic finance

7. Strengthening rating processes

- Review rating process for Islamic institutions by improving related core processes to encourage greater transparency
- Rating agencies need to appreciate unique features and characteristics and risk profiles of Islamic institutions and instruments
- Rating and methodology process needs to be re-examined
- Rating process should emphasise management of risk sharing in certain products and services

8. Capacity building and talent development

- International Islamic bodies to consider more involvement in capacity building to promote global financial stability
- Highly qualified and skilled practitioners and stakeholders are needed
- Imperative to enlarge human capital pool

Conclusion

- if serious interest in Islamic finance then regulatory bodies need to find a way to engage with the FSB and be recognized as global standards-setters
- a powerful central driver for creation and implementation of standards
- a huge amount of development of the standards themselves
- if Islamic finance is not part of process it will live in a world created by others with less freedom of maneuver
- Islamic standards-setters will have to change:
- standards drafted in more definitive forms, capable of implementation
- more members need to commit
- more intellectual effort to ensure quality and assessment
- opportunity for Islamic finance to play a key part in the world economy