

The impact of the financial crisis on Islamic finance

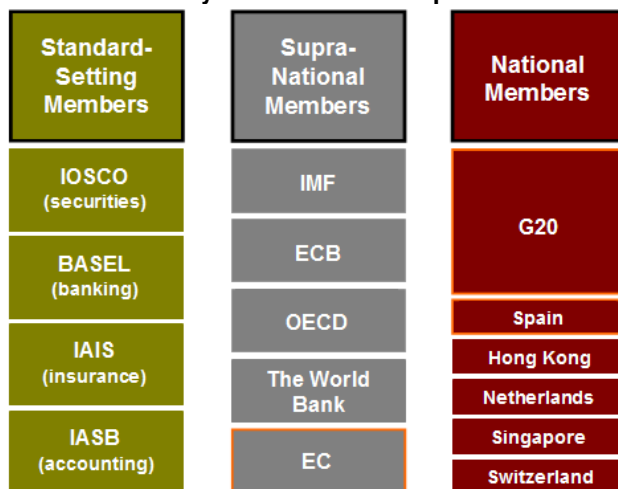
Regulatory Developments

- Observed extraordinary government and 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 had been 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.

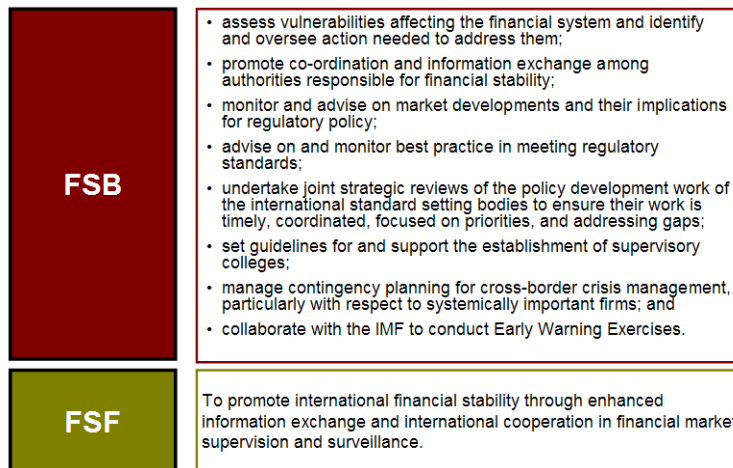
International Regulatory Structures

- Financial Stability Board (FSB) established at G20's April (2009) Declaration on Strengthening the Financial System with an expanded membership and mandate than its predecessor, the Financial Stability Forum (FSF).
- Membership expanded to include Spain, European Commission and all G20 members.

Financial Stability Board Membership



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



Source: Financial Stability Board/Financial Stability Forum

- FSB will influence national regulatory setting via a range of standards including:
 - International accounting standards
 - Core Principles of the Basel Committee
 - IOSCO
 - IAIS
- Emphasis placed on exchange of information and non-cooperative jurisdictions to be “named and shamed”.
- Held accountable by on-going International Monetary Fund-World Bank Financial Stability Assessment Programme (FSAP) and peer reviews.
- Monitoring of FSB and G20 recommendations by FSB Implementation Monitoring Network.
- Standard-setters have become more influential eg:
 - Basel Committee on Banking Supervision (BCBS),
 - International Organisation of Securities Commissions (IOSCO)
 - International Association of Insurance Supervisors (IAIS)
 - International Accounting Standards Board (IASB)
- IMF to have a global “early warning” role assisting members to conduct mutual assessments of national policies consistent with national and global economic stability.
- International surveillance mechanism for new financial products may be introduced.
- Failure to understand some products was one of the major causes of the crisis
- Concerted international action to analyse the risks at an early stage – “preventative medicine”.

Impact on Islamic Finance Regulation

- Islamic finance consistently achieved double-digit growth over last few years.
- Still only 1% of conventional finance.
- Growth driven by sustainable economic trends - petrodollar surpluses (Middle East) and shift of economic power to Asia.
- Once Islamic finance is recognized as a credible alternative to conventional finance, then it has the potential to grow substantially.
- GFC provided an opportunity for Islamic finance – providing an alternative to conventional finance.
- Islamic finance has an opportunity to show what it can do.

The impact of international standards

- Lots of work to do to adapt to specificities of Islamic finance.
- Very little work done on how to consolidate Islamic entities at group level and how to consolidate them with conventional firms.
- Need to ensure they do not have unintended consequences for Islamic Finance.
- Regulators in Islamic finance need to be engaged with conventional standards-setters.
- Need to account for growing “substance over form” consensus in conventional world.
- Three areas of standards-setting:

- **Deposit Insurance** – will they apply to PSIA – Islamic bankers will have to be clear.
- **Liquidity** – needs to be effective tools for central banks to provide liquidity to Islamic finance institutions without raising issue of riba:
 - Islamic firms must have options to manage their own liquidity, including a functioning Islamic money market
 - Commodity Murabaha principle needs to change or be supplemented by other principles
 - Islamic finance needs to develop its infrastructure if it wants to grow from 1% of world market
- **Governance** – IFSB's work shows some Islamic structures have conflicts and incentives different from conventional finance.
 - structures of Shari'a governance – risk of multiple, expensive governance structures
 - need to reduce cost burden of Shari'a governance:
 - increased contract standardization
 - increasing supply of scholars
 - will involve creating a formal training framework and professional structure
 - Shari'a governance may come from firms rather than individuals in the future

National regulatory structures

- Calls for Islamic finance to be regulated by specialist supranational body, rather than local, national regulators – *This will not happen.*
- Islamic finance structures and products tend to cross traditional boundaries.
- Integrated regulators need to be able to deal effectively with unusual structures and products.
- Changes to regulatory structures is disruptive - a national regulatory change will delay development and implementation.
- Standards that a new regulator will apply - the international regulatory architecture.

The international architecture

- AAOIFI and IFSB have created a series of standards, but very little applied.
- FSAP programme started assessing jurisdictions against those standards and raised the status – “what gets measured, gets done”.
- If performance measurements against FSB standards do *not* include specific standards for Islamic finance services – there is *no* incentive for implementation.
- If conventional standards are applied across the board, Islamic finance will be forced back into conventional moulds.
- If moulds do not fit, conventional standards-setters will be asked to adapt them.
- New product surveillance will be bound to look at Islamic products.
- Signs of difficulties in adapting regulations to accommodate Islamic finance.
- May inevitably lead to forcing Islamic finance into conventional pigeonholes unless differences are recognized.
- Indonesia, Saudi Arabia and Turkey have joined G20 FSB
 - This offers an opportunity for Islamic finance to be considered seriously

Conclusion

- If there is 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.
- There is a powerful central driver for creation and implementation of standards.
- There is 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 will need to commit.
- More intellectual effort to ensure quality and assessment.
- This is an opportunity for Islamic finance to play a significant part in the world economy.