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Address by Paul M Koster - Chief Executive
Dubai Financial Services Authority (DFSA)
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Implications of International Regulatory Change for Islamic Finance

Your Excellencies, Distinguished Guests, Ladies and Gentlemen.

It is my pleasure to join you in the beautiful city of Kuala Lumpur as part of the IFSB's 3rd Public Lecture.

My thanks to Governor Zeti for hosting us as the inaugural event of this magnificent new Sasana Kijang facility. My thanks also to Professor Rifaat for his invitation to share my

reflections on the regulatory changes we are seeing as a result of the global financial crisis and their implications for Islamic finance.

I shall discuss first the developments in the international regulatory architecture, then the changes in national regulatory systems, and then the changes in the substance of regulation, before drawing some conclusions for Islamic finance. Because the changes have been so extensive, I shall inevitably have to be selective. There are some changes which, though important in themselves, have limited impact on Islamic finance and I shall not discuss these in detail.

1. Regulatory Developments

Introductory Remarks

Since 2007, we have witnessed extraordinary financial instability characterised by the failure of systemically important markets and institutions – events that would have been nearly incomprehensible even a year prior to their

occurrence. The collapse or near collapse of leading investment and commercial banks shocked the world while the seizing up of markets, particularly those used for funding financial institutions, challenged conventional modern finance orthodoxy. We have observed extraordinary government and central bank interventions to limit the fallout on other institutions and markets, which has created a heavy burden either direct or contingent, on the public in a number of advanced economies.

It is clear that we are at a crossroads in the development of the world financial system, but there is a risk that our decisions are driven by myopia. We may be so focused on the extremely rough terrain of the next hundred metres that we can see nothing beyond, and have completely forgotten what we once knew of the broader terrain.

The crisis exposed weaknesses in regulation and supervision, especially in advanced economies, weaknesses in risk management in firms, and weaknesses in market discipline.

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The former US Federal Reserve Chairman has expressed the "shocked disbelief" experienced by those who had "looked to the self-interest of lending institutions to protect shareholder's equity".[1] Limitations of the Basel II capital regime were exposed – in particular regulators had become too trusting of firms' ability to manage their risks with the use of sophisticated internal models. Liquidity standards and supervision had been weak, partly reflecting unfounded confidence that funding markets would always remain open. And it became clear that market discipline in relation to risk-taking swung violently between active encouragement and summary execution.

The crisis has also exposed the scope for regulatory arbitrage and gaps in coverage, and for behaviour which at an individual firm level would be manageable to have serious systemic effects when practised market-wide.

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1 Testimony of Dr. Alan Greenspan, C*ommittee on Oversight & Government Reform*, 23 October 2008

The latter issue prompted widespread recognition of the need for a macro-prudential approach to regulation. In contrast to micro-prudential regulation, which involves firm-by-firm supervision, macro-prudential regulation aims to focus on system-wide risks, by assessing common exposures and correlations among financial institutions, and acting to control their systemic effects.[2] Although the concept is simple, implementation is proving difficult, and no plausible toolkit has been described beyond the tools of macroeconomic policy generally. Perhaps for this reason, the word "macro-prudential" is being heard less often now than even a few months ago.

I believe that regulators and policy makers will need to be mindful of the limits of identifying, let alone managing accumulating macro-prudential risks. I think it is generally fair to say that no regulator had accurately forecast the timing and nature of the global financial crisis, even though some of

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[2] Adapted from: Marrying the micro- and macro-prudential dimensions of financial stability, *Bank for International Settlements,* 21 September 2000

them, like the UK FSA, put considerable effort into regular studies of the financial environment. Even with the acceptance of the need for improved macro-prudential surveillance we cannot be assured that such an approach will prevent another crisis in the future. We may well only increase our ability to foresee a crisis like this one. In Rumsfeldian terms, there will always be "unknown unknowns"[3] and regulators and international bodies engaged in surveillance will need to be careful to avoid giving a false sense of certainty to financial institutions, markets and the general public.

International Regulatory Structures

Arguably the most significant development in the global regulatory landscape was contained in the G20's April Declaration on Strengthening the Financial System.[4] The Financial Stability Board (FSB) was established, with an expanded membership and mandate relative to its

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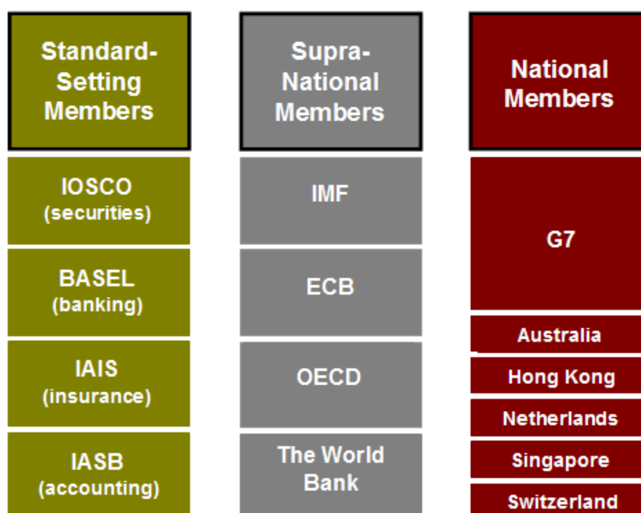
[3] DoD News Briefing - Secretary Rumsfeld and Gen. Myers [News Transcript], *US Department of Defense*, 12 February 2002

4 London Summit – Leaders' Communiqué, *G20,* 2 April 2009 [http://www.g20.org/Documents/g20_communique_020409.pdf]

predecessor, the Financial Stability Forum. Reflecting the belief that “a global crisis requires a global solution,”[5] the membership was expanded to include Spain, the European Commission and all G20 members – compared to only G7 members previously.

Financial Stability Forum Membership



In the same vein, the Basel Committee on Banking Supervision (BCBS) also expanded to include all G20 members.

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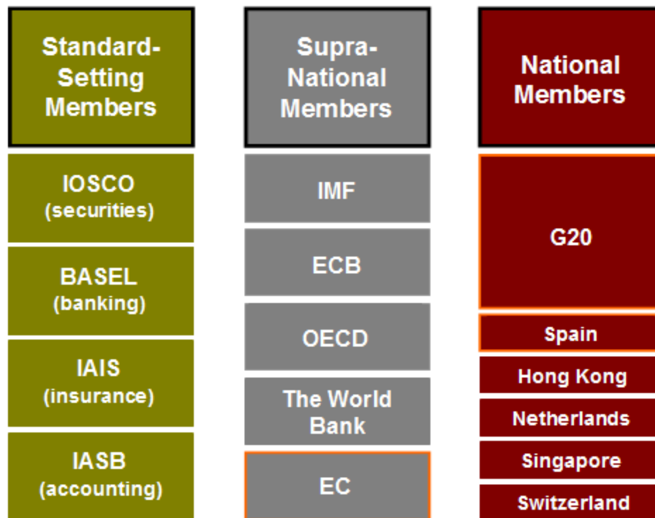
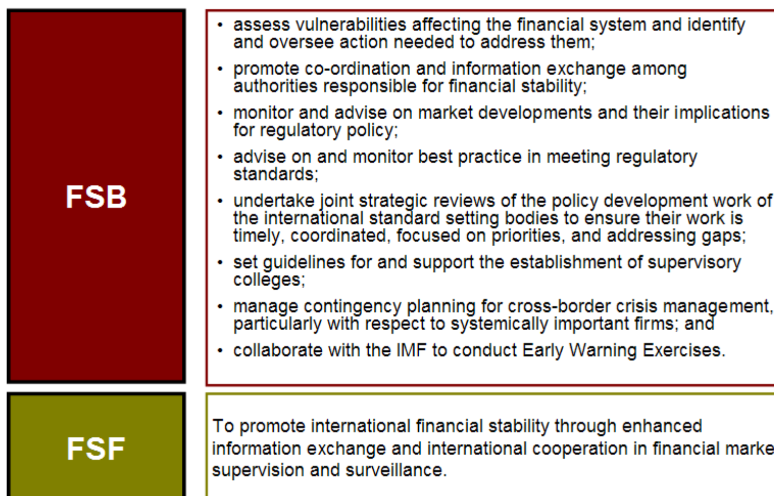
[5] The Global Plan for Recovery and Reform [Communiqué], *G20,* 2 April 2009

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

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This compares to the FSF's relatively modest mandate of "To promote international financial stability through enhanced information exchange and international cooperation in financial market supervision and surveillance."[6]

Broadly, the FSB will influence national regulatory settings via a range of standards to which members are committed. These include international accounting standards, and the Core Principles of the Basel Committee, International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS).

Heavy emphasis is placed on exchange of information and non-cooperative jurisdictions may be named and shamed by end 2010.[7] This will apply enormous pressure, as evidenced by the efforts countries made to be removed from the FTAF blacklist, or the OECD list of non-cooperative jurisdictions on tax matters. Adding further accountability to these FSB

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[6] Financial Stability Forum decides to broaden its membership [Press Release], *Bank for International Settlements,* 13 March 2009

[7] Progress since the Pittsburgh Summit in Implementing the G20 Recommendations for Strengthening Financial Stability, *Financial Stability Board,* 7 November 2009

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obligations are the on-going IMF-World Bank Financial Stability Assessment Programme (FSAP) and peer reviews of observance of these standards. FSB members will face monitoring of their implementation of FSB and G20 recommendations by the recently established FSB Implementation Monitoring Network.[8] Although the balance between FSAPs, thematic reviews, FSB peer reviews and other means of assessment is still being determined, it is clear that the G20, through the FSB, will be both assessing its own members quite rigorously and applying serious pressure to other jurisdictions to be assessed against the same standards.

It is clear that this will not be achieved without some resistance. The IMF recently published a remarkably revealing note of the Executive Board discussion on the FSAP programme, in which it was clear that significant differences of opinion remain on whether FSAPs should be voluntary or mandatory, whether all FSAPs should be published, and how

[8] Progress since the Pittsburgh Summit in Implementing the G20 Recommendations for Strengthening Financial Stability, *Financial Stability Board,* 7 November 2009

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far (voluntary) FSAPs should be linked to (mandatory) Article IV reviews.[9]

This resistance has led some to question whether voluntary compliance with standards is enough, or whether "a more formalised framework might be sensible", as the director of the UK FSA's international division recently suggested, offering the World Trade Organisation as a model.[10] Such a proposal is unlikely to be accepted, at least in the near future, but that it can even be made indicates how far we have come in the last few years.

Given the commitment of G20 countries to implement a range of international standards and accountability that follows, the work of standard-setters has become more influential. This is particularly true for the BCBS, IOSCO, IAIS and International Accounting Standards Board (IASB). But though their work

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[9] IMF Executive Board Reviews Experience with the Financial Sector Assessment Program, Options for the Future, and Complementary Reforms in Surveillance and the Assessment of Standards and Codes [Public Information Notice], *IMF,* 29 September 2009
10 European Banking Roundtable – Keynote Speech, 14 October 2009, http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/1014_vr.shtml

will become more influential, it is already clear that their agendas will be increasingly driven by the FSB, and some of them are already aware that they will need to raise their game to meet the FSB's expectations of them.

The IMF has also risen in prominence, after a period when some had questioned its relevance. Its mandate and membership are being reformed. In addition to its FSAP role, it will have a global "early warning" role, and will assist members to conduct mutual assessments of national policies to ensure that they are consistent with national and global economic stability.[11] The initial phase of these assessments will be conducted by April 2010 and we expect to get a first glimpse of what such an assessment will look like at the G20 Summit in Canada mid-next year.

There has also been discussion, though no definite conclusions have been reached, about the possibility of some international surveillance mechanism for new financial

[11] Progress since the Pittsburgh Summit in Implementing the G20 Recommendations for Strengthening Financial Stability, *Financial Stability Board,* 7 November 2009

products. Failure to understand the products we were dealing with was one of the major causes of the crisis. One issue for regulators is that new products may become established in relatively small niches of the market, generally between professional counterparties. In this context, they pose minimal risks. As they spread, the risks grow, but it then becomes politically difficult for any regulator to take unilateral action against something which others appear to accept. So there is much to be said for concerted international action to analyse the risks at an early stage.

National Regulatory Structures

I now turn to national regulatory structures. I shall mention the pan-European structures only briefly because they have limited relevance to today's theme.

First, the crisis does not offer clear evidence of the superiority of one regulatory structure over others. Examples of success and failure can be found within several structures. The one structure which has clearly failed is the highly fragmented

one of the US, but that was probably indefensible anyway. It remains to be seen whether a more coherent structure will emerge in that country, or whether we shall simply see a yet more complicated quilt, with even less coherence of design.

Elsewhere, however, the experience of regulatory gaps and arbitrage does appear to have reinforced a continuing move towards integrated regulation, on either a full integration or a twin peaks basis. Ireland has already formed a 'single fully integrated regulatory institution'[12] while France is currently considering the merging of banking and insurance regulators.[13] These developments appear to have been provoked by the global financial crisis. On the other hand, Egypt merged insurance, securities and some banking regulatory bodies earlier in the year as part of a plan that had been under consideration for 5 years.[14]

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12 Minister of Finance Brian Lenihan TD announces major reform of the institutional structures for regulation of financial services in Ireland [Press Release], *Department of Finance [Ireland]*, 18 June 2009

[13] French insurance, banking regulators likely to merge, *Emirates Business 24/7,* 28 July 2009

[14] *Egypt Regulatory changes:* Cairo's regulatory shake-up, *MEED*, 24-30 July 2009

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Even though there is no ideal regulatory framework in an abstract sense, divorced from the size and structure of financial services in the jurisdiction, there is certainly a determination to ensure that entities offering similar products and services irrespective in which jurisdiction they operate, receive the same supervision and oversight. That is, the 'substance over (legal) form' view is prevailing. Although some of the possible reforms under discussion in the UK and Germany may appear to go against this trend, I suspect their shape will change somewhat as the discussion moves from politics to practicality. Practicality is singularly important. For natural reasons, there has been strong political influence in the regulatory debate, but political influence is not always to the benefit of regulatory quality.

At national level also, there is pressure at least to define responsibility for macroprudential regulation, even though, as I have said, its methods and tools are largely undetermined. Because of its link to macroeconomic policy, the natural location in many jurisdictions will be the central bank. This

will tend to strengthen the claim of the central bank to be the integrated regulator, where one is being created, though there is concern in large jurisdictions about whether a single institution can manage fully integrated regulation, both macro and micro, as well as monetary policy. At the pan-European level, a sectoral approach to micro-prudential regulation will continue, and a new European Systemic Risk Board (ESRB) is to be created to "monitor and assess potential threats to financial stability and, where necessary, issue risk warnings and recommendations for action and monitor their implementation."[15] This body will be without any legal power and thus will rely on moral suasion. While this may be effective under normal conditions, we should not overestimate what it can achieve in a crisis, when real money is at stake and the natural instincts of Governments are to protect national interests and national treasuries. The saga of ABN AMRO and Fortis would offer a useful case study in this respect.[16]

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15 Brussels European Council 18/19 June 2009 Presidency Conclusions, *Europa*, 18 June 2009

[16] ABN Amro gets new 4.4bn-euro bail-out, *BBC News,* 19 November 2009

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Global Regulatory Standards

Before I deal with the substance of evolving standards, it may be worth highlighting challenges for standard-setters and regulators alike in the broader context. There is a need to avoid 'fighting the last war.' We have faced a crisis dominated by prudential failings, and we have a great deal of work to do in this area. But we must not wholly neglect other areas of regulation. Some have argued that certain regulators were so absorbed by conduct of business issues, following a set of mis-selling scandals, that they took their eyes off prudential regulation. Whether or not that is a fair criticism, it would be ironic if we were now to make the same mistake in reverse. The next crisis may be in an area none of us currently anticipates; for example some have suggested that it may be in clearing house regulation[17]; it could equally be in ETFs, or dark pools. We simply do not know.

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[17] This clearing house idea has to be put on a sound base, *Financial Times*, 6 November 2009

Related to this theme, we also need to be cognisant of the difficulty of anticipating the required reforms for tomorrow's regulatory challenges. The only conclusion I can draw is that we need a financial, and a regulatory, system that is resilient against a wide range of possible failures. Today's fighter aircraft fly on the very edge of instability. They can do so because their computer systems can sense any move into instability and correct instantly. Unfortunately, regulators are not so sensitive. They are more like old-fashioned human pilots. We cannot have a financial system that is like those aircraft; we need one that is inherently stable and capable of being managed and regulated by fallible humans.

With that note of warning, let me turn to emerging international standards.

Banking

In the banking sector, significant reforms to the Basel II capital framework are underway. Banks, both commercial and investment, have arguably been the worst affected

institutions in the financial crisis. In hindsight is it clear to see that banks failed to identify accumulating risks and consequently had insufficient capital to absorb large losses. Assumptions of continued access to wholesale funding, which supported the rapid growth of securitisation and liquidity, were proven to be terribly wrong.

In response to the crisis, the Basel Committee is proposing significant amendments to its capital framework. Among the proposals include standards to improve the quality of bank capital, create counter-cyclical capital buffers, and discourage excessive leverage.[18] It is ironic that in some cases these proposals represent a return to earlier practices, like the counter-cyclical buffers that existed in the Netherlands in the 60s and 70s. Securitisation practices have been targeted – perhaps not surprising given their role in the initial sub-prime housing phase of the crisis - and the G20 has proposed that financial institutions retain a share of securitised products they issue, to improve incentives, both for the initial due diligence

[18] Enhancements to the Basel II framework, *Basel Committee on Banking Supervision*, July 2009

purposes and post-issuance monitoring and reporting on underlying assets.[19]

The amended Basel II capital standards are to be calibrated by end-2010 following the development of “concrete” proposals by end-2009.[20] Full implementation is expected by major financial centres by end-2011 and by 2012 for other jurisdictions. In the years that follow, banks will no produce all kinds of ingenious schemes to reduce their effective capital requirements, and regulators will need to deal with these. The current fashion for contingent capital bonds – CoCos – is only the first example, and it is not at all clear that it will prove robust and free from unintended consequences.[21]

In addition to capital failings, the global financial crisis also exposed institutions’ shortcomings in relation to liquidity risk – in extreme cases prompting intervention from central banks. During the financial crisis, liquidity risk crystallised in a

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[19] Leaders’ Statement the Pittsburgh Summit, *G20,* 24-25 September 2009

[20] Improving Financial Regulation, *Financial Stability Board,* 25 September 2009

[21] Investors May Not Remain Sweet On CoCo Bonds, *Wall Street Journal,* 24 November 2009

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number of ways including the seizing up of interbank lending following the collapse in confidence in structured products and the unexpected increase in obligations as off-balance sheet liabilities came on-balance sheet. Further, in recent years banks had become more reliant on money market funding relative to retail deposits and many had not conducted sufficient liquidity stress testing to prepare for the strained conditions let alone over an extended period.[22] (I do not, however, want to imply that retail deposits are an impeccably safe source of funding; the classic pattern of a run on the bank is a retail one.)

In cases of extreme liquidity strain at individual banks (eg Lehman Brothers) systemic difficulties emerged prompting central banks around the world to engage in emergency liquidity injections. Central banks also engaged in direct support of credit markets and quickly established cross-border swap arrangements to ease foreign exchange liquidity shortages, particularly those for US dollars. Some of them

[22] Liquidity Risk: Management and Supervisory Challenges, *Basel Committee on Banking Supervision,* February 2008

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subsequently moved to quantitative easing. Governments also introduced or expanded deposit insurance arrangements to limit the risk of a traditional run-on-the-bank, dropping all their previous scruples about moral hazard. One effect of this was that, as one country extended its deposit protection others had to follow suit or risk a flight of capital.

In terms of a regulatory response to liquidity issues, the BCBS Working Group on Liquidity conducted a “fundamental review” of its guidance on liquidity risk management.[23] Work is also progressing on a Global Liquidity Standard to be introduced by year-end, capable of being applied in a cross-border setting.[24] It aims to ensure that global banks have sufficient high quality, liquid assets to withstand the sorts of stressful conditions observed during the crisis. It will include a stressed liquidity coverage ratio underpinned by a longer-term structural liquidity ratio. It is also noteworthy that central banks are looking to establish permanent foreign exchange swap

[23] Principles for Sound Liquidity Risk Management and Supervision, Basel Committee on Banking Supervision, *September 2008*

[24] Improving Financial Regulation, *Financial Stability Board,* 25 September 2009

lines to ease any foreign currency liquidity shortages in the future.

During the financial crisis, there were a number of traditional runs on banks (most famously Northern Rock) where depositors were seen lining up on the streets. This prompted a range of countries (Australia, Ireland, Germany, UAE, etc) to introduce deposit insurance to reassure depositors and thereby mitigate liquidity risks for banks. The limitations of deposit insurance have been highlighted in the crisis, most acutely by the failure of Icesave – the online savings account promoted by Landsbanki in the UK and Netherlands. Following its failure, UK deposits were subject to Icelandic deposit guarantees which in the event were not honoured for non-Icelandic deposits in a full and timely fashion. The US deposit insurance scheme has also been severely tested.

The Basel Committee on Banking Supervision and the International Association of Deposit Insurers have responded to issues raised by the crisis via the release of their Core

Principles for Effective Deposit Insurance Systems. The framework sets 18 principles for establishing or reforming deposit insurance systems. The IMF, World Bank and IADI are currently working on the development of an assessment methodology for the Principles[25] which may indicate their possible inclusion in assessments.

Insurance

The insurance industry was generally less affected than the banking industry in the global financial crisis. Nonetheless, the industry has faced significant distress throughout the crisis, driven by exposures to Credit Default Swaps (CDS) and general investment losses. In the US, this contributed to the US government bailing out AIG – one of the world's largest insurers and thus key to underpinning real economic activity. Some reinsurance companies have also faced significant distress.

[25] FSB Holds Inaugural Meeting in Basel [Press Release], *FSB*, 28 June 2009

The AIG saga also showed the pressures that increased demands for collateral can place on a firm's liquidity as its financial position declines. This will not be entirely new to reinsurers, who have been familiar with the effects of ratings triggers. It may well be that more work needs to be done in this area, and on the general relationship between solvency and liquidity.

Because the IAIS is a younger organisation than either the Basel Committee or IOSCO, its standards have tended to be less definitive and less well-implemented. Insurance also has a much weaker tradition than banking of information exchange and cross-border co-operation in supervision. It has, therefore, felt particularly strongly the pressure from the FSB to have clear standards, strong group supervision arrangements and a real drive to implement these.

The crisis will in particular put pressure on the IAIS's work to develop a common set of prudential standards. The work has proceeded in parallel with the EU's Solvency II regime, and

the two are closely related, though the IAIS version is less specific. Some of the differences between Solvency II and Basel II are instructive, particularly the reduced willingness to accept internal models. However, achieving a common solvency standard for insurance – or indeed achieving implementation of any standard at all – is much hindered by the lack of an authoritative US voice, able to commit that country's supervisors.

Although at present the IAIS has more pressing matters on its agenda, there is bound to be an interest at some point in the activities of the monoline insurers, whose diversification away from their traditional, largely municipal bond, business into guaranteeing more complex structures was cruelly exposed in the crisis. Of course, as we know, much conceptually similar business was done through other contractual forms, most conspicuously by AIG. It is a huge irony that the world's largest insurer was undone by business which some write as insurance but which it chose to do through non-insurance forms. The AIG case is of course a fine example of regulatory

arbitrage in the way that the firm was able to choose to have this business regulated by a weak and relatively unsophisticated regulator, and is a solid argument for integrated regulation. However, it is also an argument for a more unified capital regime, based on substance over form, and ensuring that similar risks are treated in a similar way.

Markets Regulation

In markets regulation, the collapse of Lehman Brothers highlighted the issues for global financial stability stemming from counterparty failures in over-the-counter (OTC) derivatives markets. These largely unregulated markets had grown to an awesome size - ≈USD600trn or roughly 10 times global GDP.[26] At the global level, the Committee on Payment and Settlement Systems and IOSCO have together pushed for the establishment of central counterparties for OTC transactions. They have published Recommendations for Central Counterparties regarding clearing arrangements and a working group is developing implementation guidance. Both

[26] Note the OTC market is estimated to be significantly larger than exchange-traded derivative markets

the US and Europe governments have promoted central clearing of OTC derivative products, consistent with IOSCO's recommendations. The US has been relatively more aggressive in its approach, also pushing for standardised OTC contracts to be moved on-exchange.[27] We should note, however, that the introduction of new central counterparties does not eliminate the systemic risk associated with these instruments, since the clearers themselves become new potential sources of systemic risk.

Separately, IOSCO released its final report regarding the regulation of securitisation and CDS markets in late September.[28] Among the recommendations was the promotion of standardisation and central clearing of CDSs, greater disclosure regarding underlying pools of assets for securitised products, review of customer suitability requirements and, as I have already mentioned, a

[27] Treasury Outlines Framework For Regulatory Reform, *US Department of Treasury*, 26 March 2009

[28] Unregulated Financial Markets and Products, *IOSCO,* September 2009

requirement for originators/sponsors of a securitised product to retain an economic exposure over the lifecycle.

Hedge Funds

Before the crisis, the regulation of hedge funds was the subject of considerable international debate. However, in the April Statement, the G20 called for "regulation and oversight to be extended to all systemically important financial institutions, markets and instruments" emphasising that this included hedge funds. IOSCO responded with its Principles for Hedge Funds Regulation, and it is now clear that some form of regulation is inevitable, though there are still arguments, particularly in Europe, about the form it should take. Some of the possible outcomes, especially if they also cover remuneration and taxation, could substantially affect the funds landscape, and it is unlikely that these impacts will be confined to hedge funds in any narrow sense.

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Accounting Issues

The global financial crisis has created a new momentum to align accounting standards. In April this year, the G20 called for efforts toward achieving "a single set of high-quality global accounting standards"[29] and in September the G20 called on the IASB and Financial Accounting Standards Board (FASB) to "redouble their efforts" to achieve convergence.[30] This came as signs of divergence emerged, with particular regard to the accounting treatment of financial instruments, provisioning and impairment, and off-balance sheet standards. Nonetheless, the IASB and FASB have since indicated that they remain committed to achieving convergence in accounting standards and have increased their accountability by publishing common principles and accompanying deadlines for various aspects of the work.[31] How difficult this will be, however, has been exposed by the recent skirmishes in the European Union on the subject of fair value and the adoption of IFRS 9. This is, incidentally, a

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[29] London Summit – Leader's Communiqué, *G20,* 2 April 2009
[30] Meeting of Finance Ministers and Central Bank Governors, United Kingdom [Communiqué], *G20,* 7 November 2009
[31] FASB and IASB Reaffirm Commitment to Memorandum of Understanding [Joint Statement]. *FASB & IASB,* 5 November 2009

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further illustration of how politicised regulatory standards have become.

Somewhere at the intersection between accounting and regulation is the issue of on- and off-balance sheet items. Throughout the crisis, we saw examples of banks bringing off-balance sheet exposures (which had built up significantly) on-balance sheet, driven by reputational considerations rather than contractual obligations. Also, liquidity lines were unexpectedly tapped. Accounting standards-setters may change the criteria for what is on- or off-balance sheet, but wherever the perimeter is drawn, there will be marginal cases and clever evasions. To some extent these will be handled by prudential regulators requiring capital to be held against off-balance sheet exposures. Amendments to Basel II involve increasing capital requirements for liquidity lines to certain off-balance sheet conduits and strengthening supervisory oversight and disclosure of off-balance sheet exposures.[32] However, it will be interesting to see how standards-setters

[32] Basel II capital framework enhancements announced by the Basel Committee [Press Release], *Bank for International Settlements,* 13 July 2009

manage to capture the moral obligations that may stem from off-balance sheet items such as special purpose entities particularly during times of distress. In this regard, they may actually have something to learn from Islamic finance, and from the way it has developed the treatment of displaced commercial risk.

Governance

Governance is an issue for all sectors of financial services, and there is a large amount of work going on at both national and international level. Prominent contributions include the Walker Report in the UK, due to be published in its final version this Friday. We are engaged with the IAIS's work to develop governance standards for insurers. Despite the current froth about remuneration, the key issue here is how to strengthen Board oversight of major financial firms. Although the economic theory of externalities is deployed to explain how firms acting in the best interest of their shareholders may nevertheless pose systemic risks, it is apparent that many firms in the crisis did not even act in the best interests of

shareholders. One has to wonder what the highly-paid boards of Bear Stearns, Lehmans, Citigroup and AIG were doing, not only as their firms crumbled around them, but in the years before that. This is a topic that would repay much greater study.

We should not expect too much from governance reforms. Every senior regulator knows how hard it is to challenge governance in an apparently successful company, perhaps led by a dominant individual who appears equally successful. But we can nevertheless expect a strengthening of the position of the board, and of the non-executive directors, both in challenging the executive and as channels of communication with shareholders.

Cross-Border Supervision

The increasingly global nature of financial services necessitates greater co-ordination between regulatory agencies. Insufficient exchange of information and oversight has resulted in increased financial and economic instability.

A related issue is the flow of funds between a parent company and overseas branches and subsidiaries. Host supervisors (particularly of branches) noted difficulties early on in the crisis in establishing the liquidity position at group level.[33] In a number of East European States, foreign banks were known to be withdrawing funds to their home country ('home bias') or to jurisdictions considered less risky, impeding the ability for credit provision in local economies. For example, in the case of Lehman Brothers it is understood that the US parent undertook a "cash sweep" of European operations before declaring bankruptcy and selling European operations a few days later.[34] In the UK, the Bank of England estimates that USD100bn worth of Russian deposits were withdrawn in Q4 2008.[35]

More specifically, within the European Union, the troubles of the Icelandic banks have raised issues about the passporting concept which lies at the heart of the single market. The

[33] Liquidity Risk: Management & Supervisory Challenges, *Basel Committee on Banking Supervision,* February 2008
[34] The great car crash, *The Sunday Times*, 14 December 2008
[35] Total Liabilities, *The Economist,* 5-11th September 2009

political weight it carries means that it will almost certainly survive in Europe, with strengthening of other parts of the system such as deposit protection regimes. Elsewhere we are likely to see more emphasis on establishing subsidiaries rather than branches. This may also be one of the consequences of requiring larger firms to consider how a failure would be handled – the so-called “living wills” concept. But we should fool ourselves if we believed that solved all our problems. See, for example, the way that AIG sucked liquidity out of its subsidiaries in an attempt to forestall its own failure. And by making firm failure a more predictable event, “living wills” may create new opportunities for arbitrage in the market.

Perhaps the most important completed work at a global level on cross-border initiatives is the Financial Stability Forum’s Principles for Cross-Border Co-operation on Crisis Management. The Principles focus on “making advanced preparations for dealing with financial crises and in managing them,” and suggest that home authorities coordinate with host

countries for “every cross-border bank identified by the FSF as having or going to have a supervisory college” (ie. firms of systemic significance) to eliminate any obstacles to coordinate actions in the midst of a crisis.[36] The November G20 Communiqué called for “the rapid development of internationally consistent, firm-specific recovery and resolution plans and tools by end-2010.”[37]

Another part of the Principles, as I have mentioned, concerns what have become known as “living wills” systemically important institutions. The Principles themselves are relatively innocuous. They say that regulators should “strongly encourage firms to maintain contingency plans and procedures for use in a wind-down situation (e g, factsheets that could easily be used by insolvency practitioners), and regularly review them to ensure that they remain accurate and adequate,” and “ensure that firms maintain robust, up to date, funding plans that are practical to use in stressed market

[36] FSF Principles for Cross-border Cooperation on Crisis Management, *Financial Stability Forum,* 2 April 2009
[37] Meeting of Finance Ministers and Central Bank Governors, United Kingdom [Communiqué], *G20*, 7 November 2009

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scenarios, including where large amounts of foreign currency are required."[38] I have to say, however, that the approach suggested by the UK FSA in its recent discussion paper appears much more complex and costly to maintain, and one must question whether the benefit in a real situation will be worth the cost.

Events over the past few years have elevated the role of supervisory colleges. According to the FSB, supervisory colleges are now in existence for all large, complex financial groups.[39] However, there is clearly work still to do, and being done, on making them more effective and extending their application to the next tier of firms and to single-sector groups. In addition to the work being undertaken separately in banking, insurance and securities sectors, the FSB will determine whether there is a need to develop board principles on a cross-sectoral basis. Again, this highlights the prominent role that the FSB is playing in this changed global regulatory landscape.

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[38] FSF Principles for Cross-border Cooperation on Crisis Management, *Financial Stability Forum,* 2 April 2009

[39] Improving Financial Regulation, *Financial Stability Board,* 25 September 2009

2. Impact on Islamic Finance Regulation

This has been a whirlwind tour of world developments, which has necessarily omitted many significant elements. I now turn to the implications for Islamic finance. Before I do so in detail, let me set an overall context.

Over the last few years, Islamic finance has consistently displayed double-digit growth rates but, depending on the sector and the data you use, is only around 1% of conventional finance. There is no Islamic financial institution of global systemic significance. However, the growth is driven by economic trends which appear sustainable: substantial petrodollar surpluses, especially in the Middle East, and a more general shift of economic power towards Asia. Furthermore, Islamic finance has in many places passed the credibility barrier. The recent $500 million sukuk issue by GE is a clear example of this. And once Islamic finance is seen as a credible alternative to conventional finance, whether by

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businesses seeking to raise funds or individuals seeking to invest them, then it has the potential to grow substantially.

The 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. There may still be considerable scepticism, but at least Islamic finance has an opportunity to show what it can do. There is also an opportunity for the institutions of Islamic finance (the IFSB, AAOIFI, Islamic Development Bank, and so on). To be frank, the conventional standards-setters have their hands so full with the crisis that even those that had previously been inclined to take an interest in Islamic finance have backed away. That gives the Islamic finance world time to get its house in order. But if it does not do so, then in a rather short time it will face more powerful conventional regulatory bodies that will do the job for it – and perhaps not in the way it would choose. There is real time pressure here.

I shall discuss the impacts on Islamic finance in the reverse order to that in which I discussed regulatory developments, beginning with the substance of the international standards. Here the impacts will be largely technical. They will be significant for the agendas of both the IFSB and AAOIFI, but many of them will be in some sense “business as usual”.

The Impact of International Standards

In the category of “business as usual”, I include most of the developments in accounting standards, and in the Basel regime. There will be work to do to adapt these to the specificities of Islamic finance. There will also be work in the area of group supervision and group consolidation. There has been very little work on how to consolidate Islamic entities at group level, and even less on how to consolidate them with conventional firms. But this is clearly the way the world is moving. These areas of standards development will be intellectually demanding, but it is work that, collectively, we know how to do.

There will be other areas where we shall need to watch the developments in conventional standards-setting, to ensure that they do not have unintended consequences for Islamic finance. For example, 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. So regulators with an interest in Islamic finance need to be engaged with the agendas of the conventional standards-setters.

They will also need to 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” for structured investment vehicles, as well as with the credit enhancement business to which I referred earlier. So, while acknowledging the importance in Islamic finance of the early Islamic contract forms, on which so much jurisprudence exists, I believe the global system will, nevertheless, expect accounting and

prudential standards that reflect the economic reality of the transactions, and disclosures that reflect the true economic risks. For example, if good Shari'a-compliant ways of providing third-party credit enhancement for sukuk become established, then the writers of that protection should account for it, and hold capital against it, in substantially the same way as their conventional counterparts.

There are three areas of standards-setting that perhaps deserve a little more attention. The first is deposit insurance. It is clear that deposit insurance schemes will become more widespread. Indeed, it is possible that they will in time become effectively a pre-condition for banks to do business across borders. How will they apply to Islamic banking, and what will be their coverage? In particular, will they apply to Profit Sharing Investment Accounts (PSIAs)? I have previously expressed the view that a PSIA is not a deposit, and I stick to that. But if that is the case, 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.

The second area which deserves more attention is liquidity. So far as liquidity standards are concerned, the issues are essentially technical, but demanding. For example, as Professor Rifaat recently noted, one issue will be the treatment of holders of PSIAs. If indeed they are 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, of course, be a largely conventional bank operating a window).[40]

At present there are no good liquidity standards either conventional or Islamic. However, they raise the much bigger question of how liquidity is to be ensured, and maintained in a crisis. This means that there must be effective tools for central banks to provide liquidity to Islamic financial institutions without raising the issue of *riba*. I believe this is possible, but the technical work needs to be done now, and

[40] INTERVIEW-Islamic finance board aims to set liquidity standards, *Reuters,* 5 November 2009

central banks need to have the instruments on their shelves ready to use, not be scrabbling around trying to draft the contracts when a bank is in trouble. But even more important, Islamic firms must have a wider range of options to manage their own liquidity, including a functioning Islamic money market. I also suggest that the Commodity Murabaha principle on which much short term funding is based needs to change, or at least to be supplemented by other principles. This is partly because of its inherently unsatisfactory nature, with a distinct air of “smoke and mirrors”, partly because of its inherent transaction costs, but also because there will come a point where commodity markets are overwhelmed, in the sense that even short-term real ownership of an actual commodity cannot be assured. When this happens, I suspect that the scholars will call a halt.

The money market issues are of course being addressed, and we have had an involvement with the IFSB’s work in this area. But what we now need 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.

The third area is governance. At first sight this may seem surprising, since the governance reforms under discussion do not seem obviously to impact on Islamic finance. However, Islamic finance has problems of its own. The IFSB's work on governance standards for collective investment schemes and Takaful shows how some Islamic structures have conflicts and incentives different from those of conventional finance, and proposes ways to manage these. In addition, there are of course the structures of Shari'a governance. There is a real risk in all this that Islamic finance will wind up with multiple – and expensive – governance structures, at a time when the core governance standards relating to Board responsibility are becoming more demanding. I do not have any easy solution to this, but I believe we do need to look again at governance standards.

We also need to reduce the burden, especially the cost burden, of Shari'a governance. This will involve both reducing the need for Shari'a approvals, for example through increased contract standardisation, and increasing the supply of scholars. This, I believe, will involve creating a more formal training framework and professional structure, perhaps like that of my own profession, accountancy. It may be that in the future the key Shari'a assurance will 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.

National Regulatory Structures

I now turn to the structures of national regulation.

First, whether or not you like the jargon of "macro-prudential regulation", it is clear that national regulators will have their eyes even more firmly on issues of systemic risk, and will be expected to ensure that no significant institution escapes their regulation. We occasionally hear calls for Islamic finance to be regulated by some specialist supranational body, rather

than by local, national regulators. It is more obvious now than ever that these are pure pipe-dreams. They will not happen.

But how will the trend towards integrated regulation at national level bear on Islamic finance. In principle, it should be helpful. It has been remarked many times that the structures and products of Islamic finance tend to cross traditional boundaries. A very obvious example is a PSIA, which tends to look very like a collective investment fund embedded within a bank. In principle, an integrated regulator should be able to deal more effectively with unusual structures and products, and this should be helpful to Islamic finance.

There are, however, two big reservations. The first is that any change in regulatory structures is inevitably disruptive. I saw the creation of the current twin-peaks structure in the Netherlands, and I know how long it took to make it work, to put staff in the right places, to establish working relationships, and so on. Some of my colleagues saw the creation of the

UK FSA. Any national regulatory change will in fact delay the development and implementation of new regulation for at least a couple of years, even if the eventual product is better.

The second, and more important, point concerns the standards that a new regulator will apply, and it is here that I must return to the subject of the international regulatory architecture.

The International Architecture

I observe first that, even though both AAOIFI and the IFSB have now generated a series of standards, they are relatively little applied. Many countries with substantial ambitions in Islamic finance have scarcely made a start in transposing those standards into their national regulatory regimes. In a way, this is not surprising. The same could have been said a few years ago about the standards of IOSCO and the IAIS. What changed the situation, and considerably raised the status of those bodies, was the FSAP programme, which started assessing jurisdictions against some of those

standards. It was a clear case of "What gets measured, gets done."

We are now moving into an era of still stronger external assessment, however the details play out. And what will get measured will be performance against the standards that the Financial Stability Board recognises. If these do not include specific standards for Islamic financial services, the impact will not be simply that in the future, as now, there is no real drive to implement such standards. It will be worse than that, because there will be a positive drive to implement conventional standards, and I predict that in many jurisdictions they will be applied across the board. In that case, the practical effect will be to force Islamic finance more firmly back into conventional moulds. For example, PSIAs are very likely to be treated as deposits, and Takaful firms like normal insurers. Furthermore, if it does become apparent that the moulds do not fit, it may well be the conventional standards-setters who are asked to adapt them. For example, if the drive from the FSB is to adopt IFRS

accounting standards, and there are problems dealing with Islamic contracts, to whom will the FSB look to fix those problems?

Similarly, if a new product surveillance regime is established, it will be almost bound to look at Islamic products, simply because this is an area of fertile innovation. What expertise will it bring to bear, and on what standards will it build when recommending a regulatory approach?

There are already some signs of the difficulties of conventional jurisdictions adapting regulations to accommodate to Islamic products and services. These issues are most prominent in Western European where London and Paris are vying to become the regional hub for Islamic finance and other countries, for example Germany, are seeking to serve their domestic Muslim minorities. But all these jurisdictions are having to do it largely within a regulatory framework set at European level. This will inevitably lead to their trying to force Islamic finance into conventional

pigeonholes, unless Europe itself recognises the differences. But the European Commission has been astonishingly silent on Islamic finance, and I do wonder whether this reflects a political reticence in the member states. In France, the Constitutional Council recently struck down legislation which would have facilitated the issuance of sukuk. Though the ruling appeared to be based on a procedural issue, it nonetheless highlighted a division in France with some claiming that the legislation 'would have compromised secular law.'[41] In the UK, the recent proposals to accommodate sukuk, sensible though they are in substance, go through extraordinary contortions to avoid using any terminology with the slightest religious connotation. Is either of those countries yet in a position to press Europe to create standards for Islamic finance? I doubt it – which brings us back again to the G20 and the FSB.

Of course we have now seen three Muslim majority countries (Indonesia, Saudi Arabia and Turkey) join the G20 and the

[41] France constitutional court strikes down laws legalizing Islamic finance instruments, *Jurist,* 16 October 2009

Financial Stability Board. That does offer an opportunity for Islamic finance to be considered seriously. But those countries are new to the top table, they will have a full range of issues to engage with, and they will have plenty to do if they are to make their influence felt. They are also at different points in the development of Islamic finance, and I do not know how far we can hope that they will act together.

I conclude that the bodies with a serious interest in Islamic finance need to find a way, individually or collectively, to engage with the Financial Stability Board, and specifically to be recognised as global standards-setters. That will not be easy. When the FSB itself is grappling with difficult issues, the temptation will be to ignore what can easily be seen as a small niche market. But the time is now. This is a point that I cannot emphasise too strongly. We now have, for the first time, a powerful central driver for both the creation and the implementation of standards. We also have ahead of us a huge amount of development of the standards themselves. If Islamic finance is not part of that process, it will always be

trying to live in a world created by others, with even less freedom of manoeuvre than it has now. Its ability to offer something distinctively different will have been lost.

If a real link into the FSB can be achieved, we should be under no illusion that the Islamic standards-setters will themselves have to change. Standards will have to be drafted in more definitive forms, capable of ready implementation. More members will need to commit more intellectual effort to ensure their quality, and possibly also to play a part in assessment processes. But this will be part of Islamic finance's growing up, another step in providing the infrastructure that is needed for it to play a significant part in the world economy at this critical juncture.

Thank you.

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