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Effective Regulatory Initiatives to Strengthen Industry Foundations

Ladies and gentlemen, I am very pleased to have the opportunity to speak to you today. Your industry has a remarkable record of growth, though from a very small base, and all the forecasts are for that growth to continue at rates which those in the conventional financial services industry can only envy.

But growth brings risks and responsibilities. If Takaful is to move outside a small niche in a relatively few countries, it will inevitably engage the attention of regulators in a way it has not in the past. And it will do so within a regulatory environment that has been fundamentally changed by the global financial crisis.

That crisis, of course, was one in which insurance played a rather small part. Apart from the specialist monoline insurers writing financial guarantee business, mainly in the US, insurance firms as such played very little part in the markets most affected. Although most of them inevitably saw the values of their investments decline, we have not seen a rash of failures, even among those insurers most exposed to economic turbulence, like those in the payment protection business.

This will not be too surprising to those who have seen the recent report by the Geneva Association on systemic risk in the insurance industry. That report argues, quite plausibly, that apart from financial guarantee business, insurance tends to be a source of stability in the financial system, that any failures can be handled in an orderly way, and that there is no insurer that currently poses a systemic risk. Some elements of this argument depend on good management rather than the inherent features of insurance. It is not difficult to imagine a situation in which the interconnectedness of the industry becomes a source of weakness rather than strength. But, so far, when the industry has been severely stressed, most conspicuously by the attacks on the World Trade Centre, the evidence shows that it had indeed managed to spread risks rather than concentrate them.

At this point, I am sure someone here will be silently screaming, "What about AIG?" But what brought down AIG was not its insurance activities but the quasi-banking activity conducted by AIG Financial Products.

So if insurance was a relatively innocent party in the crisis, why am I here discussing its lessons?

The fact is that the crisis has changed the international regulatory landscape in ways that affect insurance almost as much as other financial services. The G20, through the Financial Stability Board, has a new determination to see global standards created and implemented.

The conventional standards-setters are under great pressure to deliver or update standards, and this is particularly true in insurance. There is a widespread belief at the highest levels that insurance standards have lagged behind those in banking and securities. The International Association of Insurance Supervisors - the IAIS - is being pressed to accelerate its standards development, including developing an insurance solvency standard that will have the same status in insurance that the Basel Accords have in banking. This remains work in progress, but the high level principles are clear, and incidentally they are consistent with the European Solvency II work, which has proceeded in parallel.

Although the arguments of the insurance industry about systemic risk, and their role in the crisis, may be sufficient to protect them from some elements of new regulation, they will not escape this drive for new standards. All serious thinkers in the regulatory world are uncomfortably aware that the next crisis will be different, so they are determined to ensure that all major financial services players are subject to strong and consistent regulation. There were deficiencies in insurance regulation, for example the inability of any regulator to get a comprehensive view of the AIG group. And, lest we forget, that industry has had crises of its own, for example the near-failure of Lloyd's, and the actual failure of many other companies, in the mid and late 1990s.

So insurance is caught up in the drive for better and more complete global standards. But in addition the G20 and the Financial Stability Board are determined to see standards implemented, and a full system of assessments. All G20 members are committed to have and publish appraisals under the IMF/World Bank FSAP programme, and to undergo periodic peer reviews. The FSB will "encourage" non-FSB members to undergo similar evaluations. They are pressing the international standards-setters also to play a role in bringing their members into adherence.

The Takaful industry will thus have to operate in a world of stronger international standards-setting and implementation. Whether those standards will give any recognition to Islamic finance is at present unclear. This is important for Takaful, because the typical structure of a modern Takaful company, with separate pools of shareholders' and policyholders' funds within the same legal entity, does raise regulatory issues of its own. These span all the traditional areas of regulatory interest, including governance, disclosure and prudential regulation. The Islamic Financial Services Board has done a lot of good work trying to create standards in these areas, and we have been heavily involved in it. There is already a standard on governance in Takaful, and an exposure draft on Takaful solvency. These are solid pieces of work, building on the standards which are emerging from the IAIS. But what we need now is implementation.

It is in this area that I discern a real threat to Islamic finance. As I have said, the G20 and the Financial Stability Board are driving the creation and implementation of regulatory standards, and supporting that with a programme of assessments. Many jurisdictions will be looking at their regulatory regimes, and trying to bring them up to scratch. It is all but certain that the standards on which they will be focusing will be those which the FSB recognises, and at present those will be the standards of the main conventional standards-setters. A few countries will be committed to Islamic finance, and will make special provision for it, regardless of international pressures, but many will not. If that happens, Islamic finance will be forced more and more into conventional moulds.

As just one example, I suspect that in insurance the European Solvency II model, which is consistent with the emerging IAIS standards, will be adopted well beyond Europe. Will that model make provision for Takaful? At present there are no signs of it. So on what basis will your industry reach the relatively prosperous Muslim minorities of Europe?

I believe that Islamic finance needs to engage with the new international regulatory structures at the highest level. Its aim should be for the Financial Stability Board, the IMF, the World Bank and the main conventional standards-setters to recognise that Islamic finance has special features which need to be reflected in standards, and in national regulatory frameworks. That recognition in itself would be important, because it would legitimise some divergence from conventional regulation. The next step would, of course, be to define what standards should apply. This could be done either by creating some presence for Islamic finance at the top table, by the conventional standards-setters in some way "recognising" Islamic finance standards created by the specialist bodies, or indeed by their engaging with the issues themselves. It may be that there will be different answers in different areas; the answer for accounting standards may not be the same as for banking regulation, for example.

Indeed, accounting standards are at a particularly interesting stage. The specific features of Islamic finance led to the creation of AAOIFI to create accounting standards for Islamic finance building on those in the conventional world. In that conventional world, the IFRS have emerged as the leading standards, and the pressures of the crisis have led both to some important and rapid developments in those standards and increased impetus for their international adoption. I hear an increasing number of people saying that the AAOIFI standards are not keeping pace.

There are broadly three ways this could play out. First, the world in general may adopt IFRS without any adaptations for Islamic finance except, perhaps, in the few most committed countries. Second, some of those countries may persuade the International Accounting Standards Board to make its own interpretations or adaptations for Islamic finance. Third, the AAOIFI standards may be accepted, either directly by the Financial Stability Board, or by some kind of agreement with the IASB. For this to happen, AAOIFI will need to raise its game in technical terms, as we are trying to persuade it to do. But it will also need to acquire real influence and credibility in international accounting circles. If it cannot do that relatively quickly, then the Islamic finance world will need to engage with the IASB or risk the worst outcome - an IFRS which, again, tends to squeeze Islamic finance back into conventional moulds.

I have quoted accounting standards as an example of the general issue of standards, though one particularly close to my heart. But what is the role of the industry in all this? Fundamentally, it needs to encourage and participate in the standards development - as a few firms have already done very effectively. Where firms have links to the conventional standards-setters, they should at least signal to them the fact that Islamic finance needs special treatment.

I do sometimes have the impression that people in the Islamic finance business hope that they can cocoon themselves from regulation or at least – to change metaphor – that they can fly under the radar. Sometimes this is based on the idea that the principles of Islam will be sufficiently protective in themselves. This might have been partly true when Islamic finance was solely the preserve of committed idealists. But those times are already past. As the industry grows it will increasingly employ people whose ethical standards are no better and no worse than average. Sometimes the argument is that Islamic finance is a nascent industry, and needs some regulatory slack on that basis. But this is a tricky argument. If it means lower prudential standards, for example, the implication must be that a Takaful firm is more likely to fail than a conventional firm of similar type. Is that something you really want to disclose to your customers?

Even if these arguments have merit, however, they are beside the point. The future regulatory landscape is being created now. If Takaful, and the Islamic finance industry in general, stands apart from that creation, it will have to live with what others have made. You are a nascent industry, but one consequence of the economic crisis is that you may have to show a maturity beyond your years. I hope you can do it, and grow into a world that you have helped to shape.

Thank you.