



Forum Theme

Financial Reforms in Response to the Global Financial Crisis: Lessons for Islamic Finance in Ensuring Financial Stability

Paper by:

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ISLAMIC FINANCIAL SERVICES BOARD

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ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which includes the issuance of exposure drafts and the holding of workshops and, where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

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FINANCIAL REFORMS IN RESPONSE TO THE GLOBAL FINANCIAL CRISIS: LESSONS FOR ISLAMIC FINANCE IN ENSURING FINANCIAL STABILITY

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Introduction

It is my honour to be here in Doha to speak at this 7th Islamic Financial Stability Forum on “Financial Reforms in Response to the Global Financial Crisis: Lessons for Islamic Finance in Ensuring Financial Stability”. Efforts to implement international regulatory reforms to strengthen the global financial system are now well under way. Today’s forum provides us with an opportunity to reflect on these reforms and to discuss the lessons that can be drawn in our efforts to ensure the resilience of the Islamic financial industry in this more challenging environment.

Many of the international regulatory reforms have focused on addressing the issues that have contributed to, or that have amplified, the global financial crisis. They include structural reforms aimed at strengthening the fundamental link between financial systems and the real economy – in particular, to protect insured deposits from excessive risk-taking, over-leverage and unfettered innovation. Leading up to the crisis, banking institutions took on risks that were not sufficiently captured by the prudential regulatory frameworks’ oversight systems. The resulting consequences were compounded by the over-reliance on self-regulation and market discipline to correct distortions, which proved to be greatly misplaced. In addition, the incentive and value systems had become excessively preoccupied with short-term gains. In response to these issues, the existing prudential regulatory framework has been strengthened, notably through the Basel III reform package and reforms to compensation practices. The reforms have also focused on addressing gaps in the regulatory framework with the growing significance of non-bank and shadow banking activities. This has also been reinforced by moves to strengthen the macro-prudential orientation of regulation to complement micro-prudential supervision in order to manage the risks arising from the interdependencies within the financial system.

The cross-border dimension of finance has also raised new challenges particularly in the area of resolution, leading to efforts through the Financial Stability Board to develop effective resolution regimes to resolve systemically important financial institutions in an

orderly manner. A continuing challenge for the global reform agenda, however, has been the need to address issues that are national in nature but global in scope for the financial institutions and markets. This has increased the need for clear mandates and effective coordination arrangements between national authorities, both within jurisdictions and across borders.

Regulatory reforms to strengthen the global financial system

With the focus of the advanced economies shifting to achieving a durable recovery, maintaining the momentum in implementing global regulatory reforms has become more challenging. Following the financial meltdowns and disruptions experienced during the recent global financial crisis, the Islamic financial industry has fared relatively well. In fact, despite the challenging environment during the past six years, Islamic finance has experienced vibrant growth. Strong performance has been recorded in several countries, with total Islamic banking assets growing at a compound annual rate of more than 40%. While there are certainly wide-ranging lessons that Islamic finance can draw from the global financial crisis, there may also be lessons that Islamic finance can offer in evolving financial systems that will effectively serve those economies.

The strong performance of Islamic finance has been underpinned by its inherent strengths. In encouraging business and trade activities that generate fair and legitimate profit, Islamic finance is subject to an explicit requirement of materiality and validity of transaction. This requirement ensures the channelling of funds into real business activities, thus reinforcing the link between financial and productive flows and reducing the risks associated with highly leveraged activities. The practice of risk-sharing in Islamic finance also strengthens the incentives for Islamic financial institutions to conduct the appropriate due diligence, reinforced by high standards of disclosure and transparency, and more prudent risk management practices. This, in turn, raises the bar for governance practices in Islamic financial institutions.

These foundations in Islamic finance have also been reinforced by the global efforts to strengthen the international financial architecture of Islamic finance. The Islamic Financial Services Board (IFSB), since its establishment in 2002, has been at the forefront of the international efforts to increase regulatory cooperation and encourage uniformity of regulatory frameworks and enhanced monitoring of financial risks in the different jurisdictions in the Islamic financial system. The IFSB has introduced prudential standards for the Islamic financial services industry – in the areas of capital adequacy, risk management, corporate governance and *Shari'ah* governance. The Accounting and Auditing Organisation for Islamic Financial Institutions has also to date contributed to the

issuance of more than 80 standards in the areas of *Shari'ah*, accounting, auditing, ethics and governance for the international Islamic financial industry.

Following increased liberalisation, the role of Islamic finance is now becoming significantly more globalised. This trend has resulted in a strengthening of global financial and economic linkages, particularly among the emerging economies. Total global asset size of the Islamic financial system has now surpassed the USD1 trillion threshold. This trend has not only supported domestic demand but has also facilitated increased trade and investment flows across borders. Increased globalisation and greater international integration of Islamic finance, however, are associated with correspondingly higher risks arising from the contagion effects from external developments. This requires the current framework for regulation and supervision of Islamic finance to be broadened to address the new challenges that have emerged. In this respect, lessons can be drawn from the recent international financial reforms to address the international dimension of finance, both for financial institutions and financial markets. Equally important is the governance structure and practices for the effective coordination of efforts to secure financial stability within the national and international financial systems.

Key dimensions for improved regulation and increased regulatory oversight for Islamic finance

Let me touch on key dimensions of financial regulation that have been the focus of the recent global regulatory developments, and which have a particular significance for Islamic finance. The first aspect relates to the effective implementation of the international regulatory and supervisory standards and best practices to secure financial stability while promoting more consistent regulatory and supervisory frameworks across borders. In Islamic finance, these standards have taken into account the distinct characteristics and specificities of Islamic finance and the unique combination of risks associated with *Shari'ah*-compliant financial business.

Several jurisdictions have already commenced implementation of the cross-sectoral prudential standards that have been issued by the IFSB. The effective implementation of these standards in different jurisdictions will also chart the path for greater harmonisation of prudential standards that promote the soundness and stability of Islamic financial institutions. A survey conducted by the IFSB in 2011 indicated that nine countries had implemented the various standards issued by the IFSB, and 18 countries were expected to implement them within the next five years. The next stage is to ensure consistent implementation of these standards to obtain greater certainty in the regulatory treatment of Islamic financial transactions. Greater global cooperation and collaborative action is

vital to this process by enhancing regulatory harmonisation and promoting the full adoption of the IFSB's standards. Full adoption would reduce the opportunity for regulatory arbitrage arising from cross-sectoral differences and cross-border differences, including the differences arising from the regulation of the conventional and Islamic financial sectors.

Fundamental to the application and enforcement of these standards is a clear understanding and interpretation of the standards across jurisdictions. This needs to be supported by capacity building to enhance jurisdictional preparedness prior to the implementation of the standards. Post-implementation, a transparent and credible assessment process can be developed to assist jurisdictions in evaluating their level of compliance with the international standards and to make recommendations for improvements. These developments would, over time, lead to strengthening of the domestic regulatory framework to bring it into line with the IFSB standards, alongside the core principles and standards adopted by the Basel Committee, the International Association of Insurance Supervisors and the International Organization of Securities Commissions. Indeed, with the growing global significance of Islamic finance, assessments such as those by the International Monetary Fund–World Bank Financial Sector Assessment Program (FSAP) would be incomplete without an assessment of the regulatory and supervisory system for Islamic finance. Going forward, the implementation of and compliance with the IFSB standards at the national level should form part of the FSAP assessments.

A second aspect of financial regulation is the importance of the macro-prudential dimension of regulation in preserving financial stability. New or strengthened mandates for macro-prudential policies are being established in a growing number of jurisdictions, with central banks and other financial authorities now being vested with the powers and tools to manage excesses and imbalances in the financial system. Post-crisis, there has been greater attention paid to the role of macro-prudential measures as a complement to micro-surveillance and supervision. This involves the incorporation of horizontal assessments of risks across institutions, sectors and national borders, including the risks in asset markets.

The global financial crisis has also demonstrated the need for central banks and other regulatory authorities to have the means for addressing risks from the shadow banking system. For some jurisdictions, this segment has grown to be even larger than the traditional banking sector. While entities in this sector have an important role in complementing banks and other regulated financial institutions in supplying credit and liquidity to the economy, their activities, if not adequately regulated, may have a disruptive impact on the overall financial system. Surveillance and monitoring

frameworks are therefore being significantly enhanced to better capture the risks and vulnerabilities emerging from areas beyond the traditional perimeters of regulated financial institutions and markets. This is of particular importance in the context of Islamic finance. In this respect, there is a need for heightened surveillance over real estate and commodity markets. Also important is a greater understanding of the interrelationships between the financial and the real sector, including the potential for the second-round effects that are transmitted within and across sectors of the economy.

The third aspect of financial regulation is the role of financial safety nets that would promote certainty and public confidence, particularly in times of financial stress and crisis. In addition, there is a need for a comprehensive and effective resolution regime. In the conventional system, this regime is gaining traction at the global level, including instituting changes to the legal framework to support the development of the resolution mechanisms so as to provide timely, effective and cohesive responses to the financial distress produced during a crisis. Well-developed legal frameworks would also secure the appropriate protection of depositors, which is critical to preserving confidence in financial institutions and the system as a whole. In Islamic finance, it is important that such legal frameworks provide for court recognition and acceptance of Islamic contracts within the common and civil law systems, with a consistent approach of interpreting the rights of the contracting parties based on *Shari'ah* principles. A legal framework that considers the specificities of *Shari'ah* contracts would assist in ensuring greater certainty in the legal and regulatory treatment of Islamic financial transactions.

In Malaysia, a new legal framework for Islamic banking and *Takaful* will come into force this year and pave the way for the development of an end-to-end *Shari'ah*-compliant regulatory framework for the conduct of Islamic financial institutions. This new framework clarifies the fundamental requirements of *Shari'ah* that must be adhered to for the contractual arrangements between the financial institution and customer to remain enforceable. The framework also outlines the operational requirements that would support the effective application of *Shari'ah* principles in the conduct of Islamic financial institutions. This is to strengthen their risk management practices to address the distinct risks beyond the traditional credit, market and liquidity risks, so as also to include inventory risk, ownership risk and *Shari'ah* compliance risk. The legislation also provides for the resolution of Islamic financial institutions to be in line with distinctive elements of the relevant Islamic contracts, thus improving the legal and procedural aspects for the orderly resolution of Islamic financial institutions.

The fourth aspect is the increasing importance of the cross-border dimension of financial regulation. In the world of conventional finance, there has been an unprecedented intensification of cross-border collaborative efforts in the aftermath of the global financial

crisis. Supervisory authorities have significantly increased the focus on developing a more holistic evaluation of risks and vulnerabilities confronting institutions that operate across borders, resulting in the strengthening of these oversight arrangements to manage these risks. In Islamic finance, the close linkages with the real economic sector, including across borders, that are undertaken through the various modes of Islamic financing contracts can present specific challenges for supervisors wishing to obtain a complete understanding of the entire risk spectrum. Given the added considerations for the supervision of risk-taking activities by Islamic financial institutions that are undertaken across jurisdictions, collaboration among supervisory authorities has to become an integral part of the overall supervisory framework. Regular engagement between home and host supervisors to share information and supervisory assessments is particularly important to ensure effective supervisory oversight as Islamic financial institutions become more international in their operations.

Such cooperation is already taking place through various informal arrangements. The growing interconnectedness in the global Islamic financial system, however, will benefit from having a more structured framework for collaboration among supervisors to improve the efficiency of the supervisory processes and to allow for early detection of cross-border transmissions of risk from group-wide activities. The supervisory college arrangement has, for example, been particularly useful in facilitating better information flows and coordination between home and host supervisory authorities. Such platforms can also prove useful in evolving the supervisory framework for cross-border operations of Islamic financial institutions. The level of cooperation can also be extended to include arrangements for responding to crisis situations, including those that concern the resolvability of large and complex Islamic financial institutions.

A strategic platform for constructive dialogue among the regulators of the international Islamic financial system to discuss the risks and vulnerabilities facing Islamic financial institutions can also be part of the structured framework for collaboration. Existing arrangements such as this Islamic Financial Stability Forum can be leveraged upon to serve as this platform, to facilitate better understanding of emerging developments in the Islamic financial system and their implications for national and global financial stability.

Conclusion

Let me conclude my remarks. The effective implementation of the wide-ranging global financial reform measures remains an important imperative to ensure financial stability. Despite its resilience during the recent crisis, aspects of these reforms are equally relevant to Islamic finance so as to avoid the weaknesses that plunged the international financial system into its deepest crisis in decades. Continuous efforts to advance the implementation of the reform measures, particularly the prudential standards for the Islamic financial industry, and to enhance further the rigour of the monitoring and assessment process would greatly reinforce the foundations for Islamic finance and its prospects for preserving financial stability. At the same time, by upholding the fundamental tenets of *Sharī'ah*, the true practice of Islamic finance is exemplified. This, in turn, resonates with the global call for building stable financial systems that will achieve their intended purpose of effectively serving the functioning of economies and the well-being of societies.



H.E. Dr Zeti Akhtar Aziz
Governor, Bank Negara Malaysia

H.E. Dr Zeti Akhtar Aziz was appointed Governor of Bank Negara Malaysia (The Central Bank of Malaysia) in May 2000. As Governor, she has a key role in monetary policy formulation and implementation, and in ensuring the stability of the Malaysian financial system. In addition, she has overseen the successful transformation of the Malaysian financial system into one of the most developed and resilient financial systems among the emerging economies. In particular, she has been involved in leading the development of the Financial Sector Blueprint, which charts the direction of Malaysia's financial sector development over the next ten years; spearheading the development of Islamic finance, domestically and globally; and participating in efforts to enhance the contribution of small and medium-size enterprises to the Malaysian economy. H.E. Dr Zeti is also actively involved in shaping the future of financial cooperation in the Asian region, and has been an important voice for the emerging economies in the international financial fora.

To strengthen regional integration, H.E. Dr Zeti chaired the Executives' Meeting of the East Asia-Pacific Central Banks (EMEAP) Taskforce on "Regional Cooperation among Central Banks in Asia", which was tasked with drawing up the blueprint for future financial cooperation in the region. She is also Co-chair of the Financial Stability Board's Regional Consultative Group for Asia, together with the Bank of Korea. H.E. Dr Zeti is a member of the South East Asian Central Banks (SEACEN) Board of Governors and the Chairman of the SEACEN Board of Directors. She has also been a member of the Bank for International Settlements (BIS) Central Bank Governance Group since 2001, and is one of the founding members of the BIS Asian Consultative Council.

H.E. Dr Zeti has been actively involved in the development of Islamic finance in both the domestic and international arenas. She chaired the Steering Committee for the establishment of the Islamic Financial Services Board (IFSB) and served as the IFSB Council Chairman for the 2007 term. She was also Chairman of the international taskforce on "Islamic Finance and Global Financial Stability" and of the taskforce on "Liquidity Management", tasked with developing a mechanism to facilitate cross-border liquidity management. H.E. Dr Zeti is currently Chairperson of the International Islamic Liquidity Management Corporation Board Executive Committee. She also served as Chairperson of the Governing Board of the International Islamic Liquidity Management Corporation (IILM) until 2011. H.E. Dr Zeti has played a leading role in developing Malaysia as a centre for the origination, distribution and trading of *Sukūks* under the Malaysia International Islamic Financial Centre (MIFC) initiative. In 2002, she led a team that launched the Malaysian global Islamic *Sukūk*, the world's first Islamic *Sukūk* to be issued by a sovereign country.

H.E. Dr Zeti has served as a member of the United Nations General Assembly Commission of Experts on Reform of the International Monetary and Financial System, a high-level taskforce established to examine possible reform of the global financial system.

H.E. Dr Zeti received her Bachelor of Economics (Honours) from the University of Malaya and her PhD from the University of Pennsylvania.

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