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IFSB INAUGURAL LECTURE ON FINANCIAL POLICY AND STABILITY

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Islamic Finance and Financial Policy and Stability: An Institutional Perspective

by **Datuk Seri Panglima Andrew Sheng** | *Adjunct Professor University of Malaya, Kuala Lumpur and Tsinghua University, Beijing*

ISLAMIC FINANCIAL SERVICES BOARD

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The views expressed in this publication are those of the author and not necessarily the views of the Islamic Financial Services Board.

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The IFSB is an international standard-setting organisation that 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 involves, among others, the issuance of exposure drafts, 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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I. Introduction

I am very honoured to have been invited to deliver the IFSB Inaugural Lecture. I should begin by congratulating Tan Sri Governor Dr. Zeti Akhtar Aziz on her appointment as the Chairman of the IFSB, and Professor Dr. Rifaat, under whose leadership the IFSB achieved new heights of achievement.

Islamic finance has grown by leaps and bounds since the early 1960s, when Malaysia first pioneered Islamic banking and insurance, and then other financial services through the Pilgrims Management Fund, the Islamic Banking Act of 1983 and *Takaful* in 1984. It is not my place to celebrate the achievements of Islamic financial markets; rather, I hope to contribute, in a small way, to the discussion on how one should think about the development of Islamic financial institutions and markets within the whole context of financial policy and stability.

I am speaking here today as a professor, no longer as a practising regulator.[1] The advantages are obvious: one has a greater degree of academic freedom to profess, to confess and to digress. Before I profess on the important but boring subject of financial policy and stability, let me confess and digress for a moment.

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[1] I am grateful to Prof. Rifaat, Gavin Bingham, John Pang and G.L. Tan for very insightful and helpful comments. All errors and mistakes are my own.

I would be the first to confess that I know little about Islamic finance. My shallow reading of the literature leads me to conclude that there is much to be learnt and understood about one of the fastest growing segments of the global markets. Some Western bankers categorise this phenomenon as the equivalent of financial innovation, as if insurance that meets the specific needs of a particular class of customers is a financial innovation. Since Islamic finance meets the financial needs of a particular class of customers – indeed, 1.3 billion of the Islamic faith in the world, or 20% of the world's population – it is just as mainstream as non-Islamic finance.

It is also not my place to debate the interpretation of *Sharī`ah* law in Islamic finance, for which I am not qualified and about which I have no particular insights. The first issue of the *International Journal of Islamic Financial Services*, published in 1999, contained an interesting and controversial debate on whether there is utility in using the empirical approach of Western economic literature in understanding Islamic financial markets.[2] This was quickly rebutted by Mohammad Ziaul Hoque and M.A. Choudhury,[3] who felt that "copying by Islamic economists and finance researchers from and of the premises of Western paradigms is not merely a fiasco; it is a non-starter for a truly Islamic economic, social and scientific thinking".

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[2] Humayon Dar and John Presley (1999), "Islamic Finance: A Western Perspective", *International Journal of Islamic Financial Services*, Vol. 1, No. 1.
[3] Mohammad Ziaul Hoque and Masudul Alam Choudhury (2003), "Islamic Finance: A Western Perspective – Revisited", *International Journal of Islamic Financial Services*, Vol. 5, No. 1.

Unfortunately, this is also not helpful, since it assumes that little of Western thinking can be used.

Since I come from the practical world where Islamic finance is already an increasingly accepted form of finance in Western markets, the doctrine that one discipline is not helpful in thinking about the other discipline cannot be, intuitively or in practice, right. Let me be bold enough to try to bridge the divide by narrowing the debate to where there may be common elements in current economic thinking and practice. This is in the area of institutional economics that is being led by Nobel Laureate Douglass North and others. The new body of thinking is less a theory of what happens in the real world, and more a way of thinking about how the real world evolves.

Let me start with where I think Islamic finance differs from the mainstream neo-classical model that underpins current Western economic theory. The work of El-Hawary, Grais and Iqbal[4] (2004) on regulating Islamic financial institutions "views the Islamic financial system as grounded in four basic principles:

a) risk-sharing
   terms of financial transactions need to reflect a symmetrical risk/return distribution for each participant to the transaction;

b) materiality
   a financial transaction needs to have a 'material finality', that is it is directly or indirectly linked to a real economic transaction;

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[4] Dahlia El-Hawary, Wafik Grais and Zamir Iqbal (2004), "Regulating Islamic Financial Institutions: The Nature of the Regulated", World Bank Policy Research Working Paper 3227, March.

c) no exploitation
a financial transaction should not lead to the exploitation of any party to the transaction; and

d) no financing of sinful activities such as the production of alcoholic beverages."

I look at the differences between traditional free market transactions and Islamic transactions much more simply and practically. My favourite quote of the Prophet on the business of trade is: "the most worthy of earnings are those of the merchant, who, if they are spoken to, do not lie, if they are trusted, do not betray, if they promise, do not fail, if they buy, do not condemn, if they sell, do not extol, if they owe, do not delay and if they are owed, do not press." In other words, the philosophy of Islamic finance carries an embedded element of morality or ethics. In contrast, the neo-classical underpinnings of the Western market economy are often offered up as a normative science that is supposed to be totally objective or value-free. This is of course not true, since many of the assumptions in neo-classical theory are heavily value loaded.[5]

Indeed, in its most extreme form, the neo-classical framework of perfect information, perfect competition and zero transaction costs that instantly clears all markets at an equilibrium price, including the price of money, has little room for institutions nor morality, except the further assumption that all market actors are perfectly rational and have only self-interest. This

[5] I am grateful to Gavin Bingham for pointing this out.

framework is so dominant in the doctrine of free markets that the main policy implication is “getting prices right”, which implies that interest rates, exchange rates and commodity prices would clear all markets with minimal government intervention. Since the Islamic religion rejects the taking of interest, or *riba,* it is small wonder that some Islamic economists reject the idea that the neo-classical framework can apply to Islamic economics and finance.

As someone who has applied economic theory to practice over 30 years, I have never failed to be amazed that every neo-classical economist acknowledges that the real world has imperfect knowledge, imperfect competition and high transaction costs, and yet, in a magnificent leap of faith, assumes that the neo-classical model can yield very useful policy application for the real world. Unfortunately, the model has been sold to many naive developing country economists who try to apply it in practice, often with disastrous outcomes. This is exactly what Keynes meant when he said that, “Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist.”[6]

The policy recommendation of “getting prices right” implicitly assumes that there is an institution or infrastructure for price discovery, with high search costs, information asymmetry and the existence of incomplete contracts. The real world is an institutional world, in which the neo-classical model is more like a doctrine that “corresponds to an extremely special, limiting case of a more general theory of markets”.[7]

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[6] John Maynard Keynes (1942), *The General Theory of Employment, Interest and Money* (Macmillan), p. 383.
[7] John Roberts (1987), “Perfectly and Imperfectly Competitive Markets”, in *The New Palgrave Dictionary of Economics* (Macmillan).

Thanks to the work of Douglass North and others, we are finally emerging into an area of theory of institutions that actually helps us to understand the real world better. It will also help us to understand that Islamic finance and markets face the same institutional constraints and challenges as any other group of institutions with its own class of products or services.

Organisations, as defined by North, "are groups of individuals bound by some common purpose to achieve objectives".[8] All economies and markets are path dependent, based on initial conditions shaped by geography, demography, history and culture. Different institutions and organisations evolve differently in response to changes in environment (competition/warfare, globalisation, global warming, etc.) and to social beliefs about how to respond to these changes. "Institutions affect the performance of the economy by their effect on the costs of exchange and production. The major role of institutions in a society is to reduce uncertainty by establishing a stable (but not necessarily efficient) structure for human interaction".[9]

The insight that members of organisations are bound by shared beliefs and values is crucial to an institutional view of the real world. There is no such thing as a value-free world, because in such a world, by North's definition, there are no institutions. Competition, which is key to the rise and fall of institutions, is not just competition between people, but really the competition of ideas, values and beliefs. This

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[8] Douglass C. North (1990), *Institutions, Institutional Change and Economic Performance* (Cambridge University Press).
[9] Douglass North (2005), *Understanding the Process of Economic Change* (Princeton University Press).

must be true irrespective of creed, religion, culture or even lifestyles.

II. Financial Policy and Stability: Some definitional thoughts

To sum up so far, the commonality between Islamic finance and current non-Islamic finance is the existence of financial markets as institutions and the desire for stable financial markets that protect the valuable savings of the people, irrespective of faith or religion.

I now come to the objectives of sound financial policy and stability, about which I am sure my good friend Josef Tosovsky will speak with greater authority. What I shall attempt is to re-interpret development economics through the lens of an institutional framework, drawing upon recent evolution in both theory and experience. I hope that those who wish to build strong, vibrant and innovative Islamic financial markets and institutions will find this framework useful.

The starting point of financial policy and stability is that both are means to an end – namely, the desire in the end that we will all live in a prosperous, peaceful and just society.

In definitional terms, policy is a wish, whereas stability is a condition. The reason why these two terms are often linked together is also proof that practical central bankers automatically link monetary policies with financial stability with its institutional context. For example, one of the objectives of Bank Negara Malaysia that is enshrined in the central bank law is to "promote monetary stability and a sound financial structure in Malaysia".

Indeed, many economists tend to see policy as an end in itself, spending considerable time figuring out what is the right policy, forgetting that the best policy is the one that can actually be implemented. Moreover, without the right institutional framework, many ideal policies cannot be implemented at all, or at least, are implemented with tragic results. I need not remind friends here that raising interest rates in an overleveraged environment would only send the economy into a tailspin, instead of bringing it back to its zero two-gap equilibrium.

What Douglass North has brilliantly reminded us of, is that economic change is a process that is path dependent. In order to get policies to work effectively, we often have to build the institutional building blocks, which implies that there is a policy objective or vision, an architecture, and a sequential path towards a situation or outcome where we can attain our objectives. Because we are bound in real life by many constraints, our existing institutional framework, our culture, resources, and internal and external vested interests, we cannot move from point A to point B without some process of change, either through deliberate policy, accident, crisis or "spontaneous order".

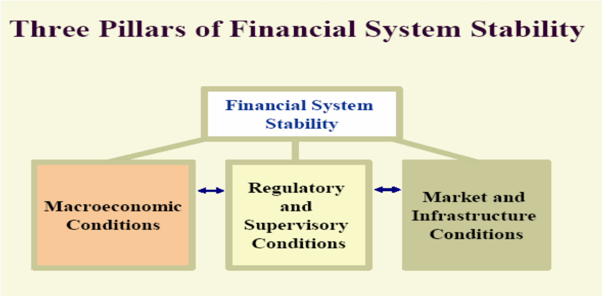
In short, the common element behind policy and stability is governance, because both policies and institutional stability must be managed. At least if you wish to have good policy outcomes and sound institutional stability or resilience, you must have good governance. These do not come by accident. This must be true irrespective of whether you are dealing with Islamic finance or non-Islamic finance.

Andrew Crockett rightly defines monetary stability as "the stability of the general price level", and financial stability as "the stability of the key institutions and markets that go to make up the financial system".[10] Gary Schinasi defines financial stability as the financial system satisfying three conditions: efficiency, ability to assess and manage risks, and ability to withstand shocks.

So, drilling deeper down to the meaning of financial policy and stability, we find that good financial policy and financial stability are necessary, but not sufficient, conditions for economic growth, prosperity and equity. Simply put, the necessary condition for sustainable financial stability and real sector growth is good governance.

This is the tenth anniversary of the Asian financial crisis, in the aftermath of which the global financial architecture has changed and international financial institutions (IFIs) have progressed significantly in their ability to assess and monitor financial stresses and strains. Gary Schinasi has encapsulated the view of the IFIs in the following figure showing the three pillars of financial stability (Figure 1).

Figure 1: Pillars of Financial System Stability



Source: International Monetary Fund (2005).

[10] Andrew Crockett (1997), "Why is Financial Stability a Goal of Public Policy?", Federal Reserve Bank of Kansas City, Fourth Quarter.

Since the crisis, the International Monetary Fund (IMF)/World Bank has produced a *Handbook on the Financial Sector Assessment Program* (FSAP), which tries "to achieve an integrated analysis of stability and development issues using a wide range of analytical tools and techniques that include the following":

Pillar I

- ***Macroprudential analysis***, including stress testing, scenario analysis, and analysis of financial soundness indicators and macrofinancial linkages.
- Analysis of ***financial sector structure***, including analysis of efficiency, competitiveness, concentration, liquidity and access.
- Assessment of observance and implementation of relevant international ***standards, codes*** and good practices in the financial sector.
- ***Analysis of specific stability and development issues tailored to country circumstances*** (e.g., role of public financial institutions, effect of dollarisation, reasons for low access or underdeveloped securities markets, etc.).

Pillar II

- ***Financial system supervision and regulation*** to help manage the risks and vulnerabilities, protect market integrity, and provide incentives for strong risk management and good governance of financial institutions.
- ***Good practices*** in most areas of financial system supervision and regulation are reflected in various international standards

and codes and the related assessment methodologies; for some areas of supervision and regulation, such as microfinance institutions, agreed international standards do not yet exist.

Pillar III

- ***Legal infrastructure for finance***, including insolvency regime, creditor rights and financial safety nets.
- ***Systemic liquidity infrastructure***, including monetary and exchange operations; payments and securities settlement systems; and microstructure of money, exchange and securities markets.
- ***Transparency, governance and information infrastructure***, including monetary and financial policy transparency, corporate governance, accounting and auditing framework, disclosure regime and market monitoring arrangements for financial and non-financial firms, and credit reporting systems.

Whilst the FSAP process is very useful to the IFIs for assessing financial capacity, and to some extent it helps the developing country under surveillance to understand its weaknesses and areas of vulnerability, very little work exists at the theoretical and practical front to help emerging markets build their financial infrastructure or markets effectively.[11]

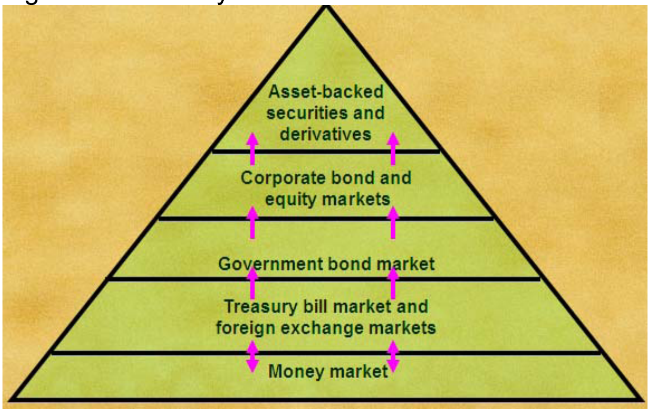
The reason for the lack of practical guidance stems from the underlying free market philosophy that there should be minimal government interference in the market, and from the fact that it is very hard to

[11] See Sheng (2006) and Davis (2007) on the difficulties faced in building Asian bond markets and using a menu approach.

generalise and design the sequencing of building market infrastructure for different countries with different initial conditions.

Karadeg, Sundararajan and Elliot (2003) gave an interesting paper on the proper sequencing of markets (Figure 2). In essence, the most basic markets to be built are domestic money markets, followed by inter-bank and foreign exchange markets, government bond markets, corporate bond markets, equity markets and, finally, derivative markets. The hierarchy of the markets lies in the knowledge intensity of the product market. Building on this and the Douglass North framework, I shall attempt here to develop a way of thinking about how to prioritise or sequence the development of domestic financial markets and infrastructure. This framework would apply to building Islamic financial markets or non-Islamic financial markets. I know I am attempting something that is extremely complex and difficult, but I hope that the way forward will be worth the effort.

Figure 2: Hierarchy of Domestic Financial Markets



We begin by accepting the Douglass North view that institutions are "any form of constraint that human beings devise to shape human interaction".[12]

In thinking about an economy as a system comprising institutions and organisations (of which people form the lowest unit of organisation), we can identify the following eight elements of the market as an institution of people (participants) and organisations (enterprises) bounded by interaction:

1. Values, beliefs and ownership
2. Property rights, resources and transaction costs
3. Information, knowledge, technology and wisdom/experience
4. Standards
5. Codes, rules and laws
6. Process and procedures (of change or transaction)
7. Structure, architecture or hierarchy (at a point of time)
8. Incentives and governance

Each element is broadly defined and there could be considerable overlap with other elements of an institution. For example, information is classified according to different standards. Different standards embody different values. Rules and processes both embody considerable social experience (positive and negative) and also create different incentive structures, depending on whether or not they are enforced.

(1) Values, Beliefs and Ownership: Every textbook on corporate governance emphasises the importance

[12] North (1990, p. 4) differentiates institutions from organisations in the rules of the game that shape the institutional framework.

of shared values, missions and beliefs. We also know that no organisational or institutional reform or change is possible without ownership of or a stake in that organisation. The stakeholding could be in a physical property right ownership (such as equity) or simply a shared belief (religion, philosophy or culture). Beliefs and values are often expressed in terms of objectives, missions, goals or general principles that are easily understood. Ownership also means that the approach towards reform should be inclusive, and that market participants in reforms must feel that they own the process.

(2) Property Rights, Resources and Transaction Costs: Markets transact or exchange property rights and obligations. Transactions also cost or expend resources. There are considerable costs in transactions in terms of the search for information, ensuring trust in transactions, and effecting legitimacy in property rights and their protection. The efficiency of markets is generally measured by the least amount of transaction costs available to create the maximum amount of output or value. Market A is more efficient than Market B if transaction costs are lower, leading to greater output. Market A is also more robust or resilient, if the property rights are protected with clear and transparent rules that are enforced fairly and at low costs. A primary condition of markets is therefore clearly defined and delineated property rights that are exchanged and protected at relatively low transaction costs.

(3) Information, Knowledge, Wisdom and Experience: The importance of access to reliable, accurate and verifiable information is now well understood in markets. The fundamental problem of all markets is information asymmetry. However, if we dig deeper, information is also a property right with value. The higher the level of information classification and intensity, the greater is the value of knowledge. Traditional economics is still not able to cope with how individuals and institutions learn. Information or knowledge may have little value if it is not “owned”, experienced or learnt. Wisdom is knowledge plus experience, leading to judgement.

Consequently, the need for investor and intermediary education is vital for rational and sophisticated markets. Because of the huge gaps in information, knowledge and experience with new products, processes and institutions, risks in new products such as Islamic finance are perceived as being higher than in conventional products that are already well accepted in financial markets. Mature markets are those that are experienced in market volatility, whereas emerging markets are subject to volatility because retail investors (including new institutional players) are inexperienced and can “herd” or panic at the slightest shock or surprise.

Investment in education in people (investors, market professionals and regulators) in new products is therefore a key building block of new markets. In this regard, the establishment of the International Center for Education in Islamic Finance is clearly an important step in the building of sound Islamic financial markets.

(4) Standards: Standards of measurement, behaviour, conduct and operations are also a vital part of human interaction. Common language, for example, is a standard that facilitates communications. The importance of international accounting and auditing standards only came to light after the Asian crisis and the Enron failure. Today, the Financial Stability Forum has already adopted core standards in areas ranging from monetary and fiscal disclosure to corporate governance. The creation of the Islamic Financial Services Board and the Association and Auditing

Organization for Islamic Financial Institutions (AAOIFI) to introduce standards for Islamic finance and accounting and auditing clearly would contribute to greater use of Islamic finance as it becomes standardised, saving considerably in transaction costs, consistency and transparency.

(5) Codes, Rules and Laws: Human interaction, exchange and transactions clearly need codes, rules, laws and meta-rules. Codes are informal standards of conduct that carry informal sanctions, but which are largely a matter of self-discipline. Rules and laws are formalised standards of behaviour that are enforced by third parties or the government and may even carry criminal sanctions. Meta-rules actually are cultural codes of behaviour or beliefs that are embedded in the rules. For example, *Sharī`ah* law over-rides the conventional business codes in Islamic finance transactions. An important institutional development in all markets is the creation of independent dispute resolution and rule interpretation mechanisms. These can range from arbitration panels to independent judiciaries or religious authorities, such as *Sharī`ah* courts.

Although most laws are still local, globalisation has created a whole range of codes, rules and legislative principles that are common for international commerce and trade, bank regulation, market practices, bankruptcy and insolvency, and the like. It is therefore relatively easy for emerging markets to adopt such international rules and regulations. For example, in establishing the Qatar Financial Centre and the Qatar Financial Centre Regulatory Authority, of which I am a Board member, a Court and Appeals Tribunal was established with renowned international experts to ensure that the legal framework for operations and transactions in the Centre would operate according to best international standards and rules.

(6) Process and Procedures: These are methods by which changes in institutions or transactions in property rights are effected. Processes and procedures can be informal or totally formalised. Processes and procedures can be highly specialised and knowledge intensive, with considerable accumulated technology and institutional experience and wisdom embedded in them. Simple processes may be easy to build and use, but they may not contain sophisticated control mechanisms that are needed to handle high turnover and maintain a robust system needed in modern financial systems. Moreover, processes and procedures are not simply "silo" (or vertical) processes that operate to complete a single function (such as share trading), but can be extremely complex, co-coordinating or (horizontal or cross-cutting) operating systems that manage several different specialised processes. Familiar examples are the Windows or Mac OSX systems that manage the separate software in a computer, or a central coordinating office to manage the different functional departments within a single ministry.

The emergence of IT and its formalisation of process and procedure have made clear that the model of IT process application can be applied not only at the level of a single firm, but across whole markets and sectors. There are already system standards, inter-connectivity and inter-operability to enable this networking of systems. Unfortunately, policy-makers who are usually economists and lawyers are not usually well attuned to the application of institutional change management on a macro-scale.

Because processes and procedures have become more and more complex and knowledge intensive, embedding standards, rules, and checks and balances are necessary and this would require operators or people with higher and higher skills. We can think of this as increasing the level of knowledge intensity (or technology) in human society. Societies advance because of their adaptive efficiency or the way they learn and adapt to new internal or external challenges through new processes and procedures, and if necessary, new institutional structures.

(7) Structure, Architecture or Hierarchy: Processes and procedures operate through organisational structures. Different processes require a different organisational structure, architecture or hierarchy. Such structural differences basically represent different alignments of authority or function within any particular institution or organisation in response to its functional needs. The creation, removal, or re-configuration of organisational or institutional structure can greatly change not just its behaviour and efficiency, but also its robustness (resilience to shocks) and adaptability to new environments (innovation).

The structure or hierarchy of financial markets is important because it is not necessarily true that one should build a market from scratch. For example, trying to build a corporate bond market ahead of a strong government bond market is likely to lead to unsatisfactory outcomes, since the corporate bond market needs a government benchmark yield-curve to price itself correctly. Moreover, evaluating corporate credit risk requires quite sophisticated credit rating and corporate governance rules to be in place.

(8) Incentives and Governance: Finally, I group incentives and governance together, since whether governance is effective in the end depends ultimately on whether the incentive structure is enforced effectively. Administration, coordination, implementation, enforcement, planning, design and management are all part of the functions of governance, but they all operate to shift incentives in a manner that determines the ultimate outcome of institutional efficiency, robustness and fairness.

The above brief summary of an institutional framework of markets indicates that even the simplest of financial markets carries extremely complex elements of beliefs, architecture, processes and incentives that ultimately shape its outcome.

I therefore conclude that the neo-classical framework of thinking about emerging markets as incomplete contracts, incomplete information and incomplete markets is too simplistic and naive to be of real use in the real world. It detracts from the need to understand that markets are scale-free, dynamic and ever evolving, and that in terms of efficiency, robustness and justice, it is not obvious that our present system is second-best or third-best relative to any other system that carries different values and standards.

III. Bounded Constraints

Understanding that information is not costless, resources are not infinite, and competition is neither perfect nor fair means that behaviour in real life is bounded by different constraints. Oliver Williamson[13] introduced the concept of bounded rationality in his work on transactional cost economics for his theory of the firm and institutions. The concept can be broadened to resource constraints, information or knowledge constraints, belief constraints and institutional constraints.

In other words, neo-classical thinking can easily

[13] Oliver E. Williamson, *The Economic Institutions of Capitalism* (The Free Press, New York, 1985).

mislead a policy-maker to think that almost everything needs to or can be done and that options for reform and change are infinite. This belief was so embedded in IFI thinking that as many as 100 loan conditionalities were included in IFI loans to developing countries, when in practice, the implementation capacity of the country for that project may not have been more than three to five conditionalities.

In reality, therefore, building or reforming a financial institution is subject to huge bounded constraints, like a linear programming model, so that the number of options for change and reform is highly limited. Under such circumstances, an emerging market that tries to develop a new market, such as Islamic finance, would be faced with restricted options under limited resources. These developments are not random walks, and therefore there must be a structured way of thinking how to sequence and prioritise change and reform.

The common-sense approach is to focus and prioritise, but common sense is not too common and, in reality, the vested interest and institutional inertia to change could be so strong that even focus and prioritisation would not work.

As I mentioned elsewhere,[14] we need a strategic approach towards market reforms and institution building. Given the fact that developing economies have turned from net importers of capital to net exporters of capital, there is much less of a resource constraint than before. Technology for trading, clearing and settlement software, and hardware that make up important market infrastructure is also readily available for purchase off-the-shelf. Global standards have also

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[14] Andrew Sheng (2006), "The Art of Reform", *Finance and Development* (International Monetary Fund, May).

been determined, including the codes, rules and standards of behaviour in markets. There are many consultants who have proven experience in building specific markets and products, including complete trading and payment and clearing systems.

Unfortunately, planning has become such a dirty word under the free market influence that many developing countries have downgraded their planning and implementation capacity within their government bureaucracy. Part of this was due to the fact that government implementation of projects led to too much government intervention in markets. However, it is quite clear that the recent trend towards public–private partnerships in the implementation of infrastructure projects can yield greater efficiency all round. This trend is also applicable in financial sector institutional building. Malaysia was successful in building up Islamic finance because it allowed non-Islamic financial institutions to promote and develop Islamic finance products, subject to the necessary *Sharī`ah* safeguards.

Given the complexity of markets, one easily forgets that markets and institutions are all about people, and that the biggest constraint that is stopping markets from growing faster is in reality the human capacity constraint. In this regard, the policy-maker faces the same problem that corporate marketing strategists face in opening up a new product or market. I now turn to the process for managing policies and institution building.

IV. Process of Financial Policy and Institutional Reform

At the risk of sounding like a management consultant, the process that incorporates the eight key institutional elements discussed above comprises several structured stages, as follows:

- Clarifying principles and objectives
- Stocktaking or diagnosing existing conditions, benchmarked against international standards, codes and rules, and institutional gaps
- Prioritising according to bounded constraints
- Picking one or two quick-wins, plus a "killer application" that is either a vital building block or a stumbling block to market development
- Creating an implementation team to deliver quick-wins and "killer applications"
- Implementing with allies and partners in a transparent, open, inclusive manner
- Evaluating results against principles and objectives, and moving on to the next phase.

Notice that I have not tried to recommend that one should pick for priority development product A or institution B, or follow model C, because these tend to be country specific.[15] Let me elaborate briefly on each of these steps.

(1) Clarifying Principles and Objectives: I assume that the principles and objectives of the financial policy and institutions reform would roughly include the following:

- Creation of a financial system that is efficient, transparent, fair and robust in supporting real sector growth and meeting the needs of the economy
- Raising the knowledge, skills and management/risk capacity of the financial system, particularly of consumers, investors, financial intermediaries and regulators

[15] See Davis (2007) for a menu of policy options and choices.

- Delineating, protecting and transfering property rights fairly, transparently and with low costs
- Being open to entry, innovation, competition and the orderly exit of market players
- Meeting standards and rules and regulations according to international standards
- Creation and enforcement of incentives towards lowering transaction costs, strengthening capacity to manage and absorb risks and shocks, and the fair treatment of customers
- Consistency with the values of society – e.g. *Sharī`ah* law.

(2) Stocktaking and Diagnosis: Most countries would already have undergone an FSAP, or at least an FSAP Self Assessment, and therefore should have a reasonable assessment of the quality of the three pillars of macroprudential policies, supervisory conditions and infrastructure conditions. The IFIs and countries should not treat FSAPs as a box-ticking exercise to quibble over whether this or that condition is compliant, partly compliant or non-compliant. The country should use the FSAP as a useful tool for (a) knowing your business, (b) knowing your counterparties (or peer competitors), (c) knowing your risks, and (d) knowing yourself.

The FSAP results will form an extremely useful basis for the consideration of Stage 3, the prioritisation of policies and institutional reforms.

(3) Prioritisation of Policies and Institutional Reforms: When governments are asked to do too much too fast without the capacity for implementation, the easiest option is to stay put. IFIs should therefore provide technical assistance to set up a framework for prioritising policies (or to build the institutional framework to enable implementation of policies).

Since decision-making under uncertainty is bounded by information, resource, political and bureaucratic constraints, this part of the exercise is in fact the most difficult but also the most necessary. Once the gaps and weaknesses in policies, standards, laws and institutions are identified under FSAP or its equivalent, there should be a gap analysis matched with a constraint analysis and an institutional analysis.

The constraints are clearly the following:

- financial resources;
- information resources (skills availability);
- ownership (buy-in not only by the implementing agency, but also by vested interests and the public generally);
- political or bureaucratic constraints (in the sense that a certain amount of political capital and bureaucratic goodwill will have to be sacrificed in order to achieve reform); and
- capacity constraint (whether it is possible to assemble a team that is able to implement, coordinate and push through reforms).

The institutional analysis, broadly based on work by Geoffrey Lamb[16] in the 1980s and probably largely forgotten by many IFIs, identifies four key questions in assessing the institutional side of policy-making:

- What are the key components of policy decision-making? Which functions belong where, and what is missing?
- Which institutions control critical aspects or phases of the policy process? This identifies where the

[16] Geoffrey Lamb (1987), “Managing Policy Change: Institutional Dimensions”, World Bank Discussion Papers No. 14.

bottlenecks or weak points are in the policy formulation and implementation process, and addresses the governance of policy formulation and implementation.

- How can different policies be managed in ways that are less institutionally intensive or demanding? This is the clearest statement of the high transaction costs of policy formulation and implementation.

- How can policies and projects be formulated and implemented together and in consulta tion with the private sector to ensure that there is ownership, skills, transparency and efficiency? This is the inclusive aspect of governance.

The choice or options clearly must be benchmarked against the principles and objectives enunciated at the start of the process. In general terms, I would personally suggest that the priorities of policies are those that generally reduce transaction costs in the financial sector, protect property rights and add to knowledge intensity.

By knowledge intensity, I mean financial products that require higher and higher knowledge, skills and experience to create, trade and protect. My own experience with market development is that too many emerging markets are impatient and leap straight to derivative markets that are highly knowledge intensive without building a strong foundation in their core markets, such as inter-bank, foreign exchange and government bond markets. The result is that domestic players are not ready for the next step forward in knowledge intensity and falter, so that derivative markets appear to be much more fragile and risky than needs to be the case.

Technology transfer, particularly in financial products, cannot be made in isolation, but should be done in stages, building on a solid foundation of a highly skilled human resource base.

In my experience, once the constraints analysis has been done, the number of options for policy reform and institutional reform actually becomes much more limited and manageable. Sometimes, it is necessary to retreat and prepare the ground for the next advance forward, rather than be bogged down in turf battles that block advances.

(4) Picking Quick-wins and "Killer Applications": Any reform project must have quick-wins and "killer applications" to win credibility and popular backing. Reforms that stall or take too long to implement usually end up with implementation fatigue and waning support. The idea that quick successes – or "low-hanging fruit" – should be harvested early is well accepted. What is less understood is the need for a "killer application", which is an IT term for a highly successful application that is immediately popular with the market. The best example is the search function that has made Google so successful. The "killer application" would create economies of scale, wide product recognition, and immediate removal of market prejudice and barriers to further product development.

What is needed is a strategic identification of a product or service that would be widely acceptable to the market. In many ways, the *Sukuk* bond has such characteristics in Islamic finance, but we have not had enough critical mass issues with global trading on a standardised basis to make a great leap forward. To complement the strategic identification, sufficient implementation resources, including management attention, are needed to make the big push in order to get the "killer application" moving.

(5) Creating an Implementation Team: In my experience, any reform project requires a crack team to design and implement it. The team should consist of highly experienced staff who have market credibility and sufficient confidence to make judgements on what trade-offs, concessions and tactics should be made at what time in order to get effective results. The team should also comprise experienced officials who have sufficient networks and credibility within the government bureaucracy to coordinate and ensure that projects move forward without undue obstacles and foot-dragging.

(6) Implementing an Inclusive Design and Implementation Process: All too often, policies and processes are designed in isolation without taking the pulse of the market and finding out what the market really wants. Having an inclusive process, whereby the private sector is brought in early to identify market concerns, perceptions as to why there are barriers to entry, competition and innovation, and ideas for implementation, is often a secret of success and market confidence. The market appreciates an open and transparent process of consultation into all new policies, standards, rules and possible institutional innovations. Proper feedback will ensure ownership and also knowledge transfers that benefit both the official and the private sector.

The project team must also articulate clearly to all vested interests why each new policy or institutional reform is beneficial and creates public good, sometimes at the expense of private loss. An open and inclusive process breeds ownership and reduces resistance to new ideas.

(7) The Outcome is the Objective: It goes without saying that the best policy is one that is effectively implemented with good outcomes. Hence, the project team must continually review its achievements and outcomes against its published objectives and principles. Through this process, the project team will be able to identify when and how it could move into the next phase of policy change and institution building.

V. Concluding Remarks

I apologise for this long and winding digression into the institutional elements of financial policy and stability. I have deliberately not discussed in-depth stability issues, because stability is, in my opinion, the natural outcome of good policies and good governance. To sum up, strong, vibrant institutions should automatically create good forms of governance that ensure high performance, good conformance with generally accepted standards, rules and ethics, and also sound robustness and resilience to shocks and risks.

Let me conclude by repeating that economic growth is a process of change. Our lessons from development experience suggest that the process is not a random walk, or at least it should not be, but a well-trodden, but often forgotten, common-sense and pragmatic path of evolution and creative change that members of a particular institution, organisation or society believe is good for them as a group.

In this world of different faiths, beliefs and values, it is not always possible to agree on everything. But the process of finding common elements of policies and institutions whereby we can all achieve prosperity with efficiency, stability and justice should be non-controversial.

I believe that Islamic finance will have a great future, because its successful growth will meet the financing needs not only of members of the Islamic faith, who number one-fifth of mankind, but also, as we are increasingly witnessing, the needs of the rest of mankind.

Thank you very much for your patience.

Kuala Lumpur and Beijing,
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