Islamic Financial Services Industry and the Global Regulatory Environment

Enhancing Market Discipline

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Why Market Discipline?

- Supervisor not alone to spot risky bank behavior
  - Markets always ahead of regulations
  - Setting measured expectations for public role
- Investor watch = "Thousands of Eyes"
  - Continuous aggregate processing of information -- creatively and anonymously
- Fostering investor responsibility
  - Limiting moral hazard

The Practice of Market Discipline

"For market discipline to be effective, four pre-requisites have to be met:

- *Market participants need to have sufficient information to reach informed judgments.*
- *They need to have the ability to process it correctly.*
- *They need to have the right incentives.*
- *They need to have the right mechanisms to exercise discipline."*

-Andrew Crockett, (Fmr) General Manager, BIS

Market Discipline: Based On Self-Discipline

- Creditor actions: instrument, not goal
  - Quantity and price changes should prompt management to cut back risk exposure
    - But management may lack incentives for quick action
- Board of directors must lead risk re-alignment
  - In response to market signals
  - To protect shareholders’ franchise value
    - Duty of care and duty of loyalty
- Supervisors step up vigilance on market signals
  - Enforcement helped by board effectiveness

Market Discipline In Islamic Finance

Foundations

- Quality and reliability of data
  - Needed anyway for specifics of Islamic finance
    - Quasi-equity intermediation
  - Attendant market infrastructure
    - Analysts, rating agencies,...
- Investor responsibility
  - Mutual fund-type rather than retail investor
- Credible systemic risk intervention strategy
  - Minimize use of taxpayer money
    - Ex-ante failed projects are least productive investment

Regulatory High-Level Principles

- Set accurate accounting and auditing standards
- Make disclosure the over-arching principle
  - As little proprietary data to supervisors as possible
- Enable creditor and counterpart watchfulness
  - Wholesale creditors preferable
    - Disclosure of their risk management practices
- Be unforgiving on self-discipline lapses

Caveat: Legacy issues condition regulatory stance

– But more flexibility in new financial segments

Supervisory High-Level Principles

- Board of directors accountable for stability
  - Knows best bank data because of on-going on-site work
- Supervisor focus: board risk management processes
  - Particularly when reacting to changed market conditions
- No forbearance on market-led corrections
  - Focus on systemic contagion (macro-surveillance)

Caveat: Supervisory practices shape board oversight stance

– To increase private sector monitoring: pushing a string

Islamic Finance: Pitfalls To Avoid

- "International Benchmark" (Basel 2)
  - This is a fresh start -- not legacy management
    - Prescriptive regulations kill innovation and stunt discipline
- "Resiliency" (pre-emptive supervisor credibility)
  - Do not promise more than can realistically be delivered
    - Hands-on involvement create expectations and weakens incentives
  - Act promptly on oversight lapses
    - Keep boards under relentless pressure to perform
- "Infant Industry" (retail depositor protection)
  - Strong investors should check management
    - Delegated principals are more effective monitors
    - Also minority investors should be protected

Conclusions

- Market discipline is not an option – is a must
  - The supervisor community acknowledges it
- It connects investors with their investments
  - Consistent with intrinsic nature of Islamic finance
- Regulator/supervisor responsibility: to ensure exercise of unfettered investor rights and duties
  - Implications for market structure, governance of financial intermediaries and regulatory focus
- Islamic finance industry has a chance to do it right!
  - It may benefit its prospects as a distinct industry