

# Governor's Speech at the 4th IFSB Summit: "The Need for a Cross-Sectoral Approach in Supervision of Islamic Financial Services"

**Speaker** : Governor Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz

**Venue** : Dubai, U.A.E.

**Date** : 15 May 2007

**Language** : English

Your excellencies, distinguished guests. While having to urgently leave Dubai, I am not here in person, but most certainly I am here in commitment to the Islamic finance agenda. It is my honour to speak at this 4th IFSB summit hosted by the Central Bank of United Arab Emirates. The theme of the summit on "The Need for a Cross-Sectoral Approach in Supervision of Islamic Financial Services" suggests that a concerted and coordinated effort is needed to ensure financial stability in the Islamic financial system and to strengthen its role as a viable form of contemporary financial intermediation. The issue before us is how this cross sectoral approach is adopted so as to contribute towards increased global financial stability.

## **I. Dynamism of Islamic finance enriches the global financial architecture**

The significant growth of Islamic financial markets, the development of the supporting financial infrastructure and the standardised international prudential rules and regulations that are being issued by the Islamic Financial Services Board (IFSB) have considerably strengthened the international Islamic financial architecture, thus contributing towards ensuring the stability and soundness of the Islamic financial industry. The theme of this summit reflects the continuous attention being directed towards this important aspect in the development of Islamic finance.

## **II. Impact of "convergence" on market development and supervisory framework**

The unprecedented process of convergence and the transformation in the financial industry in this recent decade has constantly reshaped and reconfigured the landscape of the financial sector both domestically and internationally. Disintermediation and the blurring of traditional sectoral boundaries between banking, insurance and the securities industries are among the trends in the financial services industry. Driven by the pressure for efficiency, the convergence has been along several dimensions, including among the different types of financial institutions and across different national jurisdictions. While it has increased the value proposition for consumers, it poses new challenges for the supervisors in the course of ensuring the safety and soundness of the overall financial sector. These challenges, range from ensuring adequacy of the surveillance framework, addressing the complexity in assessing the quality of risk management practices, minimizing the potential for regulatory arbitrage and meeting the demands for consistent supervisory responses within and across jurisdictions.

Given the significant implications of convergence on the market development and supervisory framework, this aspect needs to be addressed for the rapidly evolving Islamic financial services industry. In most jurisdictions, Islamic financial institutions have evolved within the framework and parameters of the conventional system. It has however essentially required constant enhancement of the supervisory regime to ensure that it adequately addresses the risks that are specific to Islamic financial transactions. This becomes important for a contract-based system in Islamic finance, where the financial transactions by the financial institutions in the respective sectors often share common underlying contracts with comparable risk profiles being subject to separate sets of rules of the different respective financial sectors. This is evident in the efforts to maximize the competitive advantage of the Islamic finance in relation to the concept of profit and risk sharing. The application of this concept in the deposit taking activity of the Islamic banking institutions could conceptually result in a risk profile that resembles that of an Islamic fund manager and that of the securities market players. It involves a similar degree of fiduciary risk on the Islamic financial institutions in ensuring that the investment deposits funds are managed in the most effective and efficient manner. An unlevelled playing field could thus arise if different prudential rules in the areas of capital adequacy requirements, risk management practices, market conduct and rules of financial disclosure, transparency, governance and the Shariah framework are imposed solely based on traditional sectoral boundaries. It is therefore important to ensure that such similar risk profiles and regulatory issues are addressed in a consistent manner across sectors so as to maintain a healthy competition and so as to avoid any potential for regulatory arbitrage.

### **III. Towards optimal efficiency of a cross sectoral supervisory approach**

In recognizing the relevance of a cross sectoral approach for the supervision of the Islamic financial services industry, allow me to discuss three strategic issues that are key to charting the way forward for achieving optimal efficiency of a cross sectoral supervisory approach.

**Firstly, is the need for greater focus to be given to arrive at common vision on the future landscape of the Islamic financial services industry.** Clarity of the parameters of the scope and nature of business activities of the financial institutions and financial markets is paramount in achieving the objective of financial stability. Within the current Islamic financial landscape, across jurisdictions, there exist however disparities and a perceived lack of clarity in the specific scope and nature of the Islamic financial services that are permitted within each respective sector. The challenge for supervisors has been to formulate a comprehensive supervisory framework that adequately addresses the respective risk exposures for the Islamic financial institutions. Islamic banking institutions in Malaysia may for example have different parameters on the scope of business and permitted activities in comparison to Islamic banking institutions in other jurisdictions. This may result in a disparity in understanding among sectoral regulators and the industry players on the scope of business activities of Islamic financial institutions in different jurisdictions. There is therefore a need to be on the same wavelength within and across jurisdictions on the nature and scope of business activities of an Islamic banking institution, takaful operator or Islamic capital market player to serve as a guide for the orderly development of the industry. In essence, the structured development of the industry that is able to meet the new demands of the environment and to address the

newly emerging challenges are critical to ensure sustainable development of the Islamic financial services industry.

A recent joint effort by the Islamic Development Bank and the Islamic Financial Services Board has laid the foundation to achieve this objective with the impending issuance of the Ten-Year Strategy and Plan for the Development of Islamic Financial Services Industry with the establishment of the Standing Committee to oversee its implementation. The formulation of the ten-year master-plan for the Islamic financial services industry marks an important step in setting the blueprint for leading the development of Islamic finance in a structured and synchronized manner across jurisdictions to achieve the common goal of a vibrant and comprehensive Islamic financial system. This document will provide a framework for the national authorities to put in place a strategic plan for an orderly development of the Islamic financial services industry and thus facilitate greater understanding of the nature of the cross sectoral supervisory approach that is required.

**This brings me to the second issue relating to the need for a more collaborative effort to be garnered among the financial supervisors.** A structured collaboration among supervisors across sectors would provide a framework for rationalizing the key policies across sectors and allow for more efficient supervision of the Islamic financial institutions. Inter-agency coordination is important to address the common risks across sectors not only through the sharing of information, but also through the harmonization of prudential and market conduct rules, the adoption of consistent Shariah governance framework and the setting up of a comprehensive shared safety net. A structured collaborative approach for consultation on issues of common interest rather than ad hoc coordination would be more effective in addressing events such as crisis management and the effect of systemic contagion. A strong collaborative culture would contribute towards the development of more consistent rules and their application across sectors while leaving the discretion to each jurisdiction to determine the most appropriate supervisory model to be adopted based on the context and distinct environment of its own respective sector.

In Malaysia, a cumulative and comprehensive cross sectoral development strategy has been adopted from the inception of Islamic finance. Legislation covering Islamic banking, takaful and the capital market activities were enacted more than two decades ago to provide the legal and regulatory framework of Islamic financial services industry. A consistent Shariah governance framework is also in place for the Islamic financial industry. There is also a common membership of the Shariah Advisory Council at Bank Negara Malaysia and the Shariah Committee at the Malaysian Securities Commission to achieve coordination between the sectoral supervisors. The inter-agency collaboration has also been formalized with the execution of a Memorandum of Understanding between Bank Negara Malaysia and the Securities Commission. The recent formation of a high level inter-agency Executive Committee has also elevated further the collaborative arrangements to a wide involvement. The Committee comprises a high-level group of top officials from the key relevant Ministries, Government departments and agencies, financial and market regulators and the representatives from the banking, takaful and capital market sector. Through having a shared vision and commitment, this Committee is responsible for undertaking a review of all policies relevant for the comprehensive development and promotion of Islamic finance.

In Malaysia, Bank Negara Malaysia is mandated with the responsibility to oversee the operations of monetary policy and to safeguard the financial stability of the financial system. It is in this context that the overall management of the Islamic financial services sector remains within the functions of Bank Negara Malaysia. The Islamic financial services sector requires specific focus in the aspect of regulation and supervision of its contractual nature and unique characteristics of Islamic finance that has greater involvement of the Islamic financial industry in the real economic sector through the principles of murabahah, musyarakah and mudarabah in the Islamic financing contracts. In this regard, the management of risks in Islamic finance requires a different set of techniques and expertise. In reality, the contractual nature of Islamic finance has implications for monetary policy in terms of credit creation and in relation to the rate of return or asset yield. As such, the overall impact of this on the Islamic financial system and monetary policy has reinforced the taking on of these important mandates - a case of upholding the form rather than the structure, given this relationship between financial stability and the operations of monetary policy. To further reinforce this framework, the Central Bank in Malaysia has shifted from a sectoral regulatory approach, to one that integrates the Bank's regulation of the different financial institutions under its purview along functional lines to better position the Bank to ensure financial stability in the overall system.

**The third issue relates to global coordination which is key to the efficient supervision of the Islamic financial industry as its international dimension gains significance and as it becomes an integral part of the international financial system in an increasingly globalized environment. This can be achieved by leveraging on the existing international infrastructure and enhancing collaboration in the working arrangements.**

Best practices and rules in the financial services industry have been influenced by the international standards of the International standard setting bodies such as Bank for International Settlement (BIS), Islamic Financial Services Board (IFSB), International Association of Insurance Supervisors (IAIS) and International Organization of Securities Commissions (IOSCO) and the international accounting standards setting entities that are all aimed at ensuring best practices in the financial industry. There needs to be however a degree of consistency of the rules that are applicable in the international financial system. The efforts of the Joint Forum of the Basel Committee, IAIS and IOSCO in addressing the cross sectoral issues, such as the similarities and differences of the core principles [\(i\)](#), and in the cross sectoral regulatory and market differences [\(ii\)](#), have set the foundation for achieving such consistency in the rules across sectors at the international level.

For the Islamic financial services industry, the comprehensive mandate of the IFSB that covers the major components of the financial sector and the broad-based membership comprising the regulators and industry players of the respective sectors presents a platform for achieving such cross sectoral consistency. In undertaking its core role to promote prudent, transparent and the robust development of the Islamic financial services industry through the promulgation of international prudential standards, the IFSB with its wide network membership across sectors from more than 20 countries is well positioned to ensure that cross sectoral issues are rigorously addressed. The on-going work by dedicated working groups on the standards for corporate governance for the takaful industry and the industry-wide Shariah governance framework are a

manifestation of the broad mandate of the IFSB that transcends beyond the banking industry. In addition, the IFSB, through its linkages with other international bodies that includes the International Monetary Fund, Bank for International Settlements, AAOIFI, IAIS and IOSCO, will be able to create synergies in the future development of the international standards for Islamic finance. Greater engagement and collaboration would build the foundation for enhancing the understanding of the dynamics of the inter-linkages that is important in the sound development of Islamic finance.

The strong collaboration among supervisors is also important to address the home-host issues in cross border Islamic financial services. The application of consistent rules across jurisdictions, such as in the implementation of capital standards for Islamic financial services, will facilitate the orderly global development of Islamic finance.

The IMF, together with the World Bank in initiating the formation of the Joint Forum, have a potentially significant role in facilitating the cross sectoral initiatives for the Islamic financial services industry. Within the context of the Financial Sector Assessment Program, encouragement can also be provided for the adherence and implementation of the IFSB standards and rules across jurisdictions along with the core principles and standards of the Basle Committee, IAIS and IOSCO. This would indeed contribute towards the efforts of achieving global financial stability in the international Islamic financial system.

#### **IV. Conclusion**

Let me conclude my remarks. Aligning cross sectoral approaches is a key part of the process of building a viable and sustainable Islamic financial system. Efforts therefore need to continue to strengthen the international Islamic financial architecture and to enhance international cooperation and collaboration in addition to developing a strong domestic supervisory framework to deal with the changing configurations of a highly dynamic and rapidly evolving environment. It is our hope that this summit will contribute towards building greater collective efforts through multi-stakeholder deliberations and networking activities to improve our understanding on the cross sectoral issues in Islamic finance. Thank you.

---

*i Cross Sectoral Comparison of Core Principles, The Joint Forum, November 2001*  
*ii Regulatory and Market Differences: Issues and Observations, The Joint Forum, May 2006*