

**Bank Negara Malaysia High Level Conference on Financial Stability
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**Session 1
Enhancing the Resilience and Stability of the Islamic Financial
System
Changing Regulatory Landscape to Sustain
Financial Stability**

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Distinguished Guests,
Ladies and Gentlemen,

I am very honoured to be invited to participate in this important Bank Negara Malaysia Conference on Financial Stability and this panel on the changing regulatory landscape. We are indeed in tumultuous times, when the regulatory framework that we have been familiar with is changing by the day. The changes are so fast that most of us are not able to digest what is happening, nor can anyone predict what will be the outcome of the major reform proposals that are currently before the US Congress and Europe. The debate over the whole regulatory and financial stability structure is so intense that I must reserve judgment on what will be the shape and prospects of the changing financial landscape.

First of all, there is no consensus on the causes of the current global crisis, although the effects are reasonably clear. General causes are excessively low interest rates, large capital flows, asset bubbles, lax supervision, excessive leverage, large fiscal deficits, bad incentives in the form of excessive compensation, greed, regulatory capture, poor credit ratings, financial innovation with little social value etc.

There is general agreement that with massive central bank intervention and state guarantees of the financial system, plus unprecedented fiscal rescue and stimulus packages, the financial panic stage of the crisis is over. Financial markets have recovered but the question remains whether the real sector crisis is only just

beginning. As trade growth still remains negative and unemployment is rising, it is not clear whether there will be more wealth losses ahead. Certainly, there is now increasing political temperature and rhetoric on how the cross-Pacific trade imbalance should be addressed and whether exchange rates play an important role. It reminds me of the Asian crisis 12 years ago, when there was a debate on either putting the blame on domestic reasons or blaming the foreigners.

My remit this morning is not to go into the causes, but to comment on what are the attributes of financial stability and implications for Islamic Finance. Let me begin by saying that the foundation of financial stability is real sector stability, which means that both the balance sheets and cash flows of the real sector should be in sound shape and sustainable. Since finance is a derivative of the real sector, finance is stable as long as the underlying assets are stable. This is a pre-condition of financial stability.

However, the tail can also wag the dog, as this crisis has shown. Financial sector instability in the form of highly leveraged financial innovation and under-capitalized banks relying almost exclusively on wholesale funding in the form of securitization, underwritten by central banks as lenders of last resort and implicit deposit insurance, was massively damaging to the global real economy. In the emerging markets, the main channel of transmission was through the trade channel, which collapsed after the Lehmans failure in September last year. Although there has been some recovery, the long term effects are unclear because of the massive deleveraging in the West and the corresponding rise in the savings rate.

In sum, the world is now in a state of shock, because there was excessive financial engineering in the advanced economies that is unwinding and the emerging markets have excessive real engineering in terms of production capacity. The real issue is that we are faced with a period of creative destruction that is further complicated by the long-run crisis of global warming. As the world moves towards a low-carbon green environment, many old smoke-stack industries will be destroyed and there will be a period of restructuring that will be quite painful. The whole global financial and real sector architecture will change because of that.

We should have no illusions about the possible challenges. Fiscal pump priming cannot ease all the pain of adjustment and indeed, there are limits to fiscal action. The exit strategy is very complex and delicate, because monetary policy is overburdened as interest rates have been reduced to near zero and fiscal policy has reached its limits, beyond which inflation will return, leading to further redistribution of pain and losses.

We now know that the huge bout of financial innovation in the form of complex financial derivatives was a highly leveraged Ponzi scheme, so that growing profits of the financial sector were basically achieved through exploitation of moral hazard. The fact that bankers can reward themselves fantastic bonuses in spite of government rescue and subsidy makes a mockery of the idea of social justice and questions the whole value structure of Wall Street. This is my personal opinion, but I feel very strongly that recent behaviour, including the revelation that Lehman management took out more than \$1 billion in cash and stock, and \$1.4 billion in the case of Bear Stearns, just before both failed, is an unacceptable model for the emerging markets to follow.

More than anything else, this crisis has demonstrated a crisis of moral values.

The question that I wish to ask myself today is whether the basics failed. A financial system has four basic functions and if these function well, the financial system should be relatively sound. The four basic functions are: resource allocation, price discovery, risk management and corporate governance. The financial sector, particularly markets, acts to help improve all four. But what has happened?

First, resource allocation has been distorted because as the financial system got more and more leveraged and apparently profitably, the system got more and more speculative. Who wants to be a real engineer when a financial engineer fresh out of college can earn significantly more and would not lose his job because the bank would be rescued by the state? Wall Street investment bankers are being paid nearly US\$800,000 per staff member, including bonuses, more than in the boom pre-crisis peak of 2007, after they were massively rescued by the state.

Secondly, how can price discovery be right when the price of money, the nominal interest rate, has been brought to zero in order to transfer resources to rescue an under-capitalized and troubled financial sector? The real sector is being taxed to restore the financial system to health and the next generation will pay for most of it in the form of large fiscal debt or possible inflation.

Third, the financial sector is supposed to help the real sector manage risks, but how much financial derivation is necessary to improve price discovery and hedge risks? How can risk spreads continue to decline just before the blowout and then stochastically shoot up to unprecedented levels? Risk management models have proved more than useless and risk transfer tools have added to risks, rather than hedging them. Quite a number of corporations have large losses to prove that.

Fourth, the financial sector is supposed to be the guardian of corporate governance, being lenders and custodians of public savings. Instead, by packing risky assets together and selling to the non-financial sector, it has worsened the corporate governance, rather than improved it. How can the financial sector claim to have good corporate governance, when the management pays itself more than the shareholders and the taxpayers who had to rescue their institutions? Increasingly, the investor and corporate clients are becoming aware that much of the advice that the Wall Street investment banks provide have conflicts of interest because they are not only intermediaries but they also trade on their own behalf.

So what is the solution to this? The issues are extremely complex, because fundamentally no one saw it coming, because we have approached the whole miracle of financial growth through fragmented lenses or in compartments. Banks are global in nature, but regulated in silos at the national level, and even within one nation, by at least three to four regulators, including the central bank, the ministry of finance and the financial regulators. We have to approach the crisis from a systemic basis, in which financial activities and their externalities are interconnected, inter-dependent and interactive..

It is now fashionable to talk about macro-prudential regulation. However, no regulation can be undertaken without understanding history, the macro-systemic

issues and the micro-institutional behaviour. We have to look at the crisis as a networked whole, rather than in parts. We have to approach financial regulation and financial stability from a system-wide, systemic perspective, not a partial, segmented basis, assuming that the risks that you did not identify is being taken care of by someone else or some other regulator or department.

Using this approach, we see that the real problem is that we have not understood the externality of individual institutional behaviour having systemic implications, especially at the global level. This means that regulatory co-operation and policy coordination is inevitable in a globalized financial world.

However, there is a major flaw in the global financial architecture. Most commentators attribute the flaw to the fact that we have a single dominant reserve currency and have recommended that we move towards global central banking and global financial regulation. I am afraid that such recommendations and suggestions are incomplete. What is really missing from the debate on the global financial architecture, which is at the heart of the question of financial stability, is that we need global public goods, but have no global fiscal system.

The current global financial architecture is funded essentially through equity (voting quota) and debt, rather than taxation. This means that global public goods are underfunded. Free market fundamentalism also drove tax on financial instruments down to zero to create frictionless financial markets, which meant that financial derivation could technically go to infinity with almost limitless leverage. This complexity made for opacity and eventually the collapse of the shadow banking system that was built on leverage and almost benign regulation.

One of the reasons why capital flows are so volatile is because most of the portfolio flows are actually highly leveraged and speculative, rather than for hedging purposes. The use of the leveraged carry trade to chase the differences in nominal rates cause momentum trading that are pro-cyclical in nature. Because the stability of financial markets are ultimately under-written by governments, either through deposit insurance or perceived central bank puts (lowering interest rates in the event of stock market crashes), the future losses of asset bubbles become ultimately fiscal debt.

This is unsustainable and cannot be stopped by current financial regulatory tools, such as counter-cyclical capital increases and dynamic provisioning. We have highly pro-cyclical leveraged capital flows that are creating bubbles that cannot be solved by flexible exchange rates and no capital controls. This is being exacerbated by the zero interest rate policies in the advanced economies.

The current financial architecture is like an insurance policy by the state without insurance premium, with the event risk underwritten by higher and higher fiscal debt. Thus, in order to stabilize the financial system, we need a turnover tax to act counter-cyclically to increase fiscal revenue (like an insurance premium that rises with risks) against future failure costs. The turnover tax would be combined with counter-cyclical regulatory tools that must also include enforcement of current rules against fraud, market manipulation and imprudent lending and excessive risk-taking. The policy and enforcement must work together to “lean against the wind”.

However, we must be realistic that ultimately, the defense against excessive greed and speculation must be good value systems. In this regard, Islamic finance is equity-based and also ethically based. Islamic finance recognizes that the relationship between borrower and lender is really between an investee and investor – losses by the investee dynamically pass to the investor. Hence the relationship is one of trust and mutual partnership. What remains to be seen is whether the tools of preventing moral hazard under Islamic finance can be more effective in practice compared with current non-Islamic finance.

The true challenge of Islamic Finance is therefore the evaluation of the trustworthiness and value system of investees and the due diligence undertaken by the investor according to Islamic principles. This is the work in progress that is still evolving.

My final comment is that the current financial crisis occurred because of excess complexity, a situation where no one understood the risks and therefore no one was accountable. We have to make the rules more simple, more transparent and the market participants more accountable. I would therefore recommend that emerging markets work together to put pressure on the international standard setters to simply

the standards and focus time and resources on implementation of these simpler rules, rather than trying to fix complexity with more complexity, fixing excess leverage with more public leverage.

I commend the work in trying to establish an Islamic Financial Stability Forum, because the old Financial Stability Forum focused too much attention on the standards and less on capacity building and implementation. This was exactly the failure of the Washington Consensus – where too much attention was put on ideal outcomes, without attention on how to get there. Islamic Finance is now an established product and it will be tested and perfected through the market test. Capacity building and the institutionalization of Islamic finance must be the priority, just as the practice of sound financial principles is more important than the theory.

This will not be easy, but if the emerging markets do not act together to have more voice, we may see a repeat of what happened in 2008.

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