

# 1 RESILIENCE AND STABILITY: SOCIOECONOMIC RESPONSE IN SOUTHEAST ASIA

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Islamic Banking and Finance (IB&F) is recognised by both Muslims and non-Muslims as an ethical alternative, protecting against the worst excesses of leverage whilst reinstating values, such as trust, which have been lost in conventional finance. Figures cited show that Islamic finance is growing in popularity as a result of the current crisis and there is scope for it to move into the financial mainstream with the sector estimated to reach US\$4,000 billion in the next 5 years.

However, the first defaults of Sukuk are set to expose the vulnerabilities of Islamic finance, with most investors expected to have no better legal redress than conventional bondholders as underlying assets have not been truly transferred to them.

Dr. Zeti Akhtar Aziz, the Governor of Bank Negara Malaysia, has drawn attention to the issue of the resilience of IB&F in confronting the financial crisis. The resilience of IB&F can be tested only if it is exposed to the current turmoil in the financial markets. Dr. Zeti has

stated that IB&F had proven to be resilient during the Asian financial crisis. These statements drew attention to the issue that whilst IB&F was able to withstand the Asian crisis, the Asian crisis was only confined to a certain region and, hence, the resilience of IB&F remained to be tested in the light of the present crisis, which is of a greater magnitude and wider geographical scope.<sup>1</sup> Undoubtedly, compared to the Asian crisis, the magnitude and scope of the current financial crisis is substantially greater owing to the processes of financial globalisation and liberalisation which have reinforced the global inter-linkages across the financial markets. Given that the Islamic financial system has evolved to become part of the global financial system, it is therefore timely and appropriate to deliberate the issues relating to the question: Is the Islamic financial system truly strong enough to weather the current economic and financial crisis?

The current financial crisis essentially emanated from the operations of the originate-to-distribute business model, in which large international banks originated loans (or underwrote loans originated by brokers) in the US sub-prime mortgage market, and then securitised the loans thus taking the credit exposure off their balance sheets. In contrast to conventional finance, in Islamic finance, lending on the basis of interest is prohibited by the Shariah. The Islamic financial system is driven by trade and production and is intimately linked to the real sector ('Main Street' and not 'Wall Street'). Islamic banks do not act as pure lenders; they have to be directly involved in trade and investment operations and assume direct ownership of real assets. This activity pre-empts unbacked expansion of credit and restricts speculation. Although Islamic banks have debt receivables on their balance sheets arising from credit sale transactions, they cannot securitise and offload these debt receivables, as the majority of Shariah scholars prohibit

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<sup>1</sup> Zeti, Dr. Akhtar Aziz, Governor, Bank Negara, Malaysia at IFSB and IIFC Conference, KL, November 2008.

the trading of debt except at par value. Even in the Malaysian case, where debt receivables are currently allowed to be securitised and traded, the securitisation process is limited to only a single-tier transaction. Shariah also prevents Islamic banks from purchasing instruments that carry debt-based credit risks.<sup>2</sup>

In addition, Shariah prohibits selling or leasing something which one does not own, and hence excludes the practice of speculative short selling from the Islamic financial system. In essence, the IB&F system derives its fundamental strength from the Shariah principles, which assure discipline and responsibility in financial activities that are necessary requirements for financial stability.

However, even with the strong fundamental Shariah underpinnings, the Islamic financial system is not immune to risks and can be susceptible to financial crises due to a number of reasons. First, as Islamic finance is closely linked to the real sector, unexpected adverse developments in the real sector may adversely affect the business activities and performance of Islamic banks in the absence of robust and effective risk management practices. Risks in the real sector have been declining consistently in the past decades, as shown by recent studies, while risks in the financial sector have been consistently increasing.<sup>3</sup> This suggests that financial institutions face less risks and instability than those that are not. Nevertheless real economic shocks of large magnitude may create systemic risks in the Islamic financial sector.

Second, Islamic banks may be influenced to pursue aggressive speculative investment strategies with higher risk and higher expected returns, particularly during economic upturns, without a concomitant adherence to fundamental and sound risk management standards. A key cause of the current crisis was the fundamental combination of aggressive lending and inadequate

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<sup>2</sup> Krichene, N. and Mirakhor, A. *Resilience and Stability of the Islamic Financial System — An Overview*, p. 47.

<sup>3</sup> *Ibid.*

risk management leading to a breakdown in confidence between counterparties.

These basic considerations confirmed the need for rigorous and consistently applied global standards of prudent risk management and other supporting infrastructure for safeguarding financial stability in the Islamic financial system. To date, the Islamic Financial Services Board (IFSB) has issued a whole spectrum of prudential and supervisory standards — covering risk management, capital adequacy, corporate governance, and transparency and market discipline — which together constitute the equivalent of Basel II in IB&F. These standards take into account international prudential standards across the banking, investment and securities market sectors and simultaneously cater effectively for the specificities of Islamic financial business, its risks and Shariah compliance.

Examples of these safeguards of the Islamic financial business model include the following: (a) the universal banking model that integrates commercial banking, investment banking and asset management activities that are carried out without clear and established legal, financial or administrative separation; (b) the transformation of risks in Islamic financial instruments; (c) direct investment in real estate activities for the objective of financing real economic activities, rather than speculative trading; and (d) the management of investment accounts which contractually share in the overall risks of assets funded by these accounts and managed by the bank. The management of investment account holders' funds also raises specific governance, transparency, depositor protection and investor protection issues, which have been addressed in the standards. The IFSB standards also deal with the unique operational risk aspects of Islamic banks arising from Shariah non-compliance risk and fiduciary risk towards current account and investment account holders, which may expose Islamic banks to reputation risk and thus adversely affect their market position, profitability, solvency and liquidity.<sup>4</sup>

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<sup>4</sup> Op. cit. in 1.

In October 2008, the IFSB Council approved the issuance of two additional standards, one on the governance of Islamic investment funds and the other on capital adequacy standards for Sukuk securitisations and real estate investments. In Sukuk structures, the discipline that Islam introduces theoretically prevents events such as the current credit crunch. For example, some of the Shariah rules and principles to be observed include: (a) the asset which is being sold or leased must be real, and not notional; (b) the seller must own and possess the goods being sold or leased; and (c) the transaction must be a genuine trade transaction with full intention of giving and taking delivery. The current credit crunch revealed that significant failures in risk management have been inherent in the way the originate-to-distribute business model has been implemented. The capital adequacy standard issued by the IFSB for Sukuk securitisations sets out different minimum capital adequacy requirements to address the specificities of risks underlying the different Sukuk structures. The standard also deals with issues surrounding the securitisation process, in particular as regards compliance with Shariah rules and principles. For example, Islamic asset-backed securities (ABS) must involve effective legal or beneficial transfer of ownership rights to the underlying assets, in virtue of which the Sukuk holders have an effective right of recourse to the assets in case of default. This is in contrast to conventional finance, where bond holders have the right to collateral over such assets, but no ownership rights.<sup>5</sup>

Another criterion which led to the current turmoil, according to Professor Karim, the Secretary-General of the IFSB was the surge in the global demand for US sub-prime mortgage debt, fed by unrealistically positive rating designations by the credit agencies. In the context of IB&F, the IFSB has issued a Guidance Note in Connection with the Capital Adequacy Standard.<sup>6</sup>

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<sup>5</sup> Karim, Professor Rifaat Ahmed Abdel, Enhancing the resilience and stability of the Islamic financial system, *IFSB and IIFC Conference KL*, November 2008.

<sup>6</sup> Ibid.

Recognition of Ratings by External Credit Assessment Institutions (ECAI) on Shariah-compliant financial instruments, which is intended to assist supervisory authorities in recognising external rating agencies as being competent for the purpose of allocating risk weighting to the assets held by the institutions offering Islamic financial services (IIFS). The Guidance Note emphasised the need to acknowledge Shariah-compliant financing assets as a distinct set of asset classes, for which ECAs should develop a dedicated rating methodology. This should contribute to ensuring that the rating of Islamic financial instruments would realistically reflect the specific features and risks of such instruments in a manner that would assist investors more appropriately to apply necessary market discipline.

Apart from the standards that have been mentioned above, work was also in progress for the preparation of 4 new standards, namely, on Corporate Governance for Takaful (Islamic insurance) Undertakings, the Solvency of Takaful Operations, Conduct of Business and Shariah Governance. The standard currently being developed by the IFSB on the conduct of business of institutions in IB&F addresses issues with respect to their treatment of clients, namely, customers, policyholders and investors. For these institutions, the code of ethical business conduct is derived from the principles of the Shariah. The observance of principles of good business conduct by Islamic institutions is both a religious obligation and in some cases, for example Islamic securitisation, a requirement in order for the transaction to be valid or for a contract to be enforceable. Indeed, the ethical crisis, which lies at the heart of the present crisis in the conventional financial system, involves issues of bad faith, corruption, concerns of fairness and lack of confidence.<sup>7</sup>

The IFSB was also developing a standard on the *Guiding Principles on Shariah Governance*, which complements the other IFSB

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<sup>7</sup> Akerlof, G. A. and Shiller, R. J., *Animal Spirits — How Human Psychology Drives the Economy and Why It Matters for Global Capitalism*, Princeton University Press, NJ, 2009.

prudential standards. The IFSB standard on Shariah Governance outlines the necessary structures and procedures that should be put in place for effective Shariah-compliance on both an *ex ante* and an *ex post* basis. This standard is crucial, as non-compliance with Shariah principles would erode confidence in IB&F and undermine the stability of IB&F. In addition, in order for the Shariah injunctions to function effectively as an in-built mechanism that promotes financial stability in the Islamic financial system, the Shariah principles must be upheld in their true essence.

Given that IB&F currently operates in a global environment that in most cases caters for conventional financial practices, financial innovation in Islamic finance at times involves emulating conventional financing techniques and products, for example multiple SPVs. This may expose IB&F to similar destabilising forces inherent in the conventional financial system. In this regard, the work of the IFSB is intended to create an enabling environment for Islamic financial practices to comply with Shariah principles in economic substance and not just in a legal form.

Further, the current financial turmoil has highlighted the significant and unexpected tensions in the major (uncollateralised) interbank money markets. Situations of massive illiquidity occurred in certain financial market segments such as those for complex structured products. The turmoil also underlined the importance of effective liquidity risk management for cross-border and foreign currency operations, owing to the increasing integration of financial markets and cross-border flows.<sup>8</sup> The development of a robust systemic liquidity management infrastructure for the IFSI is indeed an area that needs to be accorded priority. The IFSB has issued a *Technical Note on Issues in Strengthening Liquidity Management of Institutions Offering Islamic Financial Services*, which outlines a

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<sup>8</sup> 'Weaknesses revealed by the market turmoil: Where do we go from here?' Keynote address by Mr. Malcolm D. Knight, General Manager of the BIS, at the Chatham House event: 'The new financial frontiers', London, 29 April 2008.

comprehensive strategy for developing Shariah-compliant and tradable money market instruments and Islamic money markets, so as to ensure effective monetary management and foster financial stability in IB&F. The implementation of the above strategy involves extensive work and significant commitment at both national and international levels of the Islamic banking global community of all stakeholders.

Another equally important characteristic of the global financial system exposed by the sub-prime crisis is the high correlation and interconnectivity between the banking, insurance, investment and securities market sectors, where vulnerability in the securities market sector had a contagion effect on the banking and insurance sectors and as a result posed a threat to global financial stability. In essence, the turmoil accentuated the fact that enhancing the resilience of financial institutions and markets cuts across the financial sectors and even transcended national borders and hence required close cooperation among policymakers and financial supervisors with different mandates and in different jurisdictions. In the context of IB&F, the IFSB has emphasised the need for the adoption of a cross-sectoral approach to the regulation and supervision of IB&F that encompasses, in particular, the banking sector and the investment and securities market sector, and possibly also the regulation of non-financial activities of financial conglomerates. The design of the IFSB standards for IB&F takes into account the standards on banking issued by the Basel Committee, the standards issued by the IOSCO for the investment and securities market sector and the recommendations of the Joint Forum for financial conglomerates before adapting these standards to address the specificities of IB&F. For example, in designing the disclosure regime for IB&F, the IFSB drew on the disclosure standards for collective investment schemes — developed in accordance with IOSCO criteria — to complement the risk disclosures in IB&F in support of banking supervision as envisaged in Pillars 2 and 3 of Basel II.

The current ‘subprime’ period of major global financial distress has also revealed, among other things, significant weaknesses in risk management, as highlighted in the “Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations — Financial Services Industry Response to the Market Turmoil of 2007–2008”, issued by the International Institute of Finance. The banking and financial crises in the past 2 decades have also been triggered by fundamental inadequacies in risk management by financial institutions, especially in times of financial innovation.<sup>9</sup>

Given that IB&F is rapidly expanding globally with an increasing number of countries aspiring to become international Islamic financial centres, coupled with the fact that IB&F is not immune to risks, the Secretary-General of the IFSB believes that it is of the utmost importance to ensure that all the IFSB standards are promptly and properly implemented and effectively enforced in jurisdictions, where Islamic financial services are being offered. This would have the great benefit of enhancing the understanding by the stakeholders of IB&F, of the idiosyncracies of Islamic financial business and its risks, thus strengthening their ability to manage these risks effectively in order to achieve the desired outcome of financial stability in IB&F.

### **The Malaysian Response**

In response to this challenge, Malaysia, as a ‘first to market mover’ in IB&F which has a highly developed and regulated domestic market, has considered these issues.

To consider these issues in the context of the Islamic financial system, in particular whether Islamic finance as a form of financial intermediation could be vulnerable to such risks of instability. Dr. Zeti,

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<sup>9</sup> Opt. cit. 1.

the Governor of Bank Negara, Malaysia reviewed what were the possible steps that might be taken to strengthen the resilience and stability of the Islamic financial system, at least from the Malaysian perspective, as market leader in Southeast Asia.

Her position focused on the implications for the strategic direction of the Islamic financial industry taking into consideration the lessons learned from such past financial turbulences, and including the current crisis. As Islamic finance becomes an integral part of the international financial system, Dr. Zeti believes that it will be increasingly tested by such developments. History has shown that the world will continue to be plagued by such crises. The key for the Islamic financial industry is therefore to ensure that it would not be a source of such financial instability and be able to achieve a level of resilience that would ensure its sustainability.<sup>10</sup>

### **Financial Crisis and Islamic Finance**

In the midst of the unfolding of the global financial crisis, Dr. Zeti noted that it would be useful to review the foundation and structures of IB&F to assess its resilience in withstanding the impact of the current and future crises. In taking into account the dynamics of the crisis and the potential implications for Islamic finance, 2 important dimensions were key in undertaking the assessment.

The first key dimension highlights the inherent ability of the Islamic financial system to deal with the test of such a crisis. As previously stated, Islamic finance is well supported by 2 essential features, which serve as pillars to Islamic financial transactions. Firstly, Islamic finance encourages business and trade activities that generate legitimate profits, subject to an explicit requirement of materiality and validity of the transaction.

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<sup>10</sup> Op. cit. 1.

This requirement ensures that the funds are channelled into real financial business activities, reinforcing a close link between financial and productive flows. This reduces the Islamic financial system from overexposure to risks associated with excessive leveraging and imprudent risk taking. In Islamic financial transactions, money is not a commodity but a medium of exchange, a store of value and a unit of measurement. Money represents purchasing power and cannot be utilised to increase the purchasing power without any productive activity.

Secondly, it needs to be highlighted that Islamic finance encourages business transactions on a mutual risk sharing basis. The practice of risk sharing provides the impetus for the Islamic financial institutions to conduct the appropriate due diligence and maintain the explicit requirements for disclosure and transparency. These requirements thus serve to promote the adoption of sound risk management practices by the Islamic financial institutions.

By embracing these essential features and the objectives of Shariah in its entirety and by exemplifying the true practice of Islamic finance as required by the principles of Shariah, the resilience of the Islamic financial system is strengthened. It is therefore paramount that Islamic financial professionals, practitioners, scholars and regulators fully understand the inherent requirements of Islamic finance, which are in fact consistent with the international best practices and standards in the conventional financial services industry. It is the very elements of Islamic finance that provides an additional in-built mechanism that enhances its prospects for soundness and stability.

The second key dimension relates to potential risks for Islamic finance in a crisis environment. This could arise when the economic environment and the conditions in the financial markets turn adverse. The increased globalisation of Islamic finance and its greater integration with the international financial system increases the exposure of the system to a contagion effect from such developments.

In the dynamics of the financial crisis in the conventional financial system, this is referred to as the second round effects. The first round effects occur when developments within the financial system trigger (Wall Street) the financial crisis which in turn impacts the real economy (Main Street). The second round effects are when the resulting slower growth causes further strains to the financial sector.

The experience has shown that when such a crisis is not contained, the consequent deterioration in economic conditions results in a worsening of the financial crisis. For this reason, resolution had to take place quickly. For Malaysia, in the 1997–1998 crisis, every effort was taken to give attention to financial sector resolution so as to prevent the spiral that could have set in as economic activity became affected by the financial crisis.

In this indirect manner, Islamic finance can also be affected by such financial turmoil. Slower economic growth and the reduction in the global liquidity will affect those institutions that are heavily reliant on a business model that focuses on real estate and asset finance. Islamic financial institutions can also be exposed to increased inventory risk due to the increased volatility and the reduction in asset prices. Islamic financial institutions with a high proportion of their businesses in profit-sharing business (Mudaraba and Musharaka) may be exposed to losses due to equity investment risk, possibly by the inability of the enterprises in generating the expected returns. The absence of an Islamic money market infrastructure would also expose the Islamic financial system to higher liquidity risks.

### **Strategies to Strengthen the Resilience of the Islamic Financial System**

As innovation of Islamic financial products and services intensifies and as Islamic finance becomes more integrated with the international financial system, it becomes imperative that the foundations

upon which Islamic finance has been built remain intact. Dr. Zeti believes that this will be the key to sustaining the resilience of the Islamic financial system in this current and more challenging international financial environment.

The key to this is to embrace Shariah innovation in the development of Islamic financial products. In a highly globalised financial market, innovation has been a key differentiating factor to remain competitive. The current turmoil has, however, highlighted that highly complex, unbridled innovation can become highly destabilising resulting in major disruptions in a financial system. It is therefore important for financial innovation to have clear Shariah objectives and adhere to the requisite principles of Shariah. In this manner, Shariah-based innovation would contribute towards Islamic financial products that have distinct value propositions with in-built strengths arising from the essential features of Shariah.

To achieve this objective, it was important, according to Dr. Zeti, to have strong initiatives that promote Shariah-based innovation in Islamic finance. In Malaysia, several steps have been taken. The establishment of the International Shariah Research Academy for Islamic Finance (ISRA) aims to engage in applied research on dynamic Shariah-centric innovation. ISRA can provide a global platform for greater global engagement and research with the focus on innovation.

In addition, the central bank also embarked on the initiative to develop the Shariah Parameters to promote more consistent application of Islamic financial contracts. This initiative aims to determine the essential features of Islamic financial products derived from underlying key Shariah contracts. These features will serve as a guide for the application of the Shariah contracts for the Islamic financial products.

The second strategy has been to raise the bar in the status of the Islamic financial infrastructure that supports the risk management and governance of Islamic financial institutions. To ensure sustainability of the resilience of Islamic finance, it is important to have the

comprehensive enabling infrastructure that allows for the management of the risks peculiar to Islamic finance. There is a need for IB&F to have the capital requirements, effective risk management and strong governance that are fully equipped to manage the risks specific to Islamic financial transactions. It is also important for the institutions to spread the risks by having prudent asset allocation based on different Islamic contracts so as to ensure a sustainable revenue stream and to ensure the institutions that are in a position to absorb the extreme circumstances that occur during a crisis.

In the case of Malaysia, an additional capital requirement is required to cushion inventory risks of underlying assets and to cover the potential equity position risks that are embedded within the partnership contracts. This is also reinforced by the requirement on the appointment of board representatives in the invested entities under the partnership contracts so as to serve as a safeguard for the interest of the Islamic financial institution, thereby allowing for continuous monitoring and surveillance. Islamic financial institutions are also allowed to transfer the risk to investment account holders under Mudaraba, that is, profit-sharing and loss-bearing contract, if the institution can demonstrate the appropriate disclosure and governance practices that would ensure an effective risk transfer. Islamic banks are also permitted to set aside a portion of income derived from assets funded by Mudaraba contracts, in the form of profit equalisation reserves (PER) to sustain stable and competitive returns. Several of these requirements are based on the international standards that have been issued by IB&F. The implementation of IFSB standards across jurisdictions will be key in the continued robust expansion of Islamic finance.

While the above measures facilitate the managing of risks peculiar to Islamic finance, the legal, regulatory and supervisory infrastructure also needs to keep abreast with the evolution and rapid transformation taking place in the industry. As part of this infrastructure, there needs to be an integrated crisis management framework to ensure that any emerging crisis in the Islamic financial

system will be promptly managed. Such efforts, among others, need to involve 3 basic aspects. This includes having the mechanism and vehicle to preserve short-term liquidity, to remove troubled assets from the balance sheets of financial institutions and to recapitalise the Islamic financial institutions.

In the case of Malaysia, this infrastructure has been put in place. The central bank has a range of Islamic financial instruments to manage liquidity in the financial system. This is supported by a well-developed Islamic money market. In addition, the financial safety net framework in Malaysia encompasses the lender of last resort facility and a comprehensive deposit insurance system that provides coverage for both conventional and Islamic deposits. The Deposit Insurance Corporation has also been given sufficient statutory powers to ensure a prompt, effective and least cost resolution to safeguard the stability of the Islamic financial system. This entails, among others, the regulatory powers and mandate to ensure expedient resolution of financial institutions in distress. The supervisory oversight also subjects the Islamic financial institutions to periodical stress testing to assess whether the institutions would be able to cope in extreme conditions.

Global ramifications of the crisis also call for more concerted efforts at the international level to avert an escalation of the scale of a crisis. Central to this is to have coordinated initiatives, by having in place on-going assessments of any vulnerabilities in the Islamic financial system so as to avoid a crisis. As part of this, the close cooperation of the central banks would enable a swift response if it is required.

The infrastructure also has to assimilate the Shariah values in the realisation of benefit (Masalih) to the relevant stakeholders. Islamic finance industry may, by according attention to the preservation of good relationship with the customers and relevant stakeholders, avoid extreme solutions when severe deterioration has taken place. Consistent with this is the principle in Islamic finance to promote justice, fairness and shared responsibility. The focus of Islamic

finance thus transcends beyond just the pursuit of growth and monetary performance by emphasising ethical market conduct practices. Central to this is the adoption of a comprehensive consumer protection framework.

### **Conclusion**

These developments by the leading regulatory authorities IFSB and Bank Negara hold significance for Islamic banking and finance in Southeast Asia, if it is to position itself as offering an alternative, and not just a religious product. They may even hold the key to its long-term sustainability.