

*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