

BANK NEGARA MALAYSIA HIGH LEVEL CONFERENCE ON FINANCIAL STABILITY

Kuala Lumpur, 24 November 2009

ENHANCING THE RESILIENCE AND STABILITY OF THE ISLAMIC FINANCIAL SYSTEM: Fostering Global Integration in Islamic Finance – Strengthening the Home Host Supervisory Framework

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I. Introduction

H.E. Governor Dr. Zeti Akhtar Aziz, honorable panel members,

Ladies and gentlemen:

Good morning and Al-Salamu Aleikum Wa Rahmatullah

Wa Barakatuh,

It is indeed my pleasure to be here today to share my thoughts during this session dedicated to the Regulators. Ensuring financial stability is the responsibility of the Regulators which cannot be discharged effectively unless they work in tandem with the market players. So I

am pleased to note that the next session of the Conference has been dedicated to the Industry providing them an opportunity to express their views as the practitioners.

The stability of the financial system is critical to a healthy economy. When we talk about financial stability, we should be clear about what do we mean by it. Generally speaking, financial stability encompass the safety and soundness of financial institutions and stability of the overall financial system. But this does not mean that the central banks and supervisory authorities must prevent failure of every institution to achieve financial stability. According to the economist Allan Meltzer “Capitalism without failure is like religion without sin. It does not work”. The central banks must set clearly defined and feasible objectives for financial or systemic stability. The ultimate objective should be to promote a resilient financial system and reduce the systemic risks that may be created by failure of a systemically important institution.

II. Islamic Finance and Home host coordination

Islamic Finance is growing at a phenomenal pace inspite of the recent global financial crisis. According to a recent survey from The Banker Magazine and a unit of HSBC, assets held by Islamic banks or Shariah banking arms of conventional banks rose by 29% this year to US\$ 822 billion. The Gulf states account for 43% of the total global aggregate. This impressive growth has also posed the challenge of promoting financial stability across the Islamic Financial Services Industry. Several initiatives have already been taken in this regard to lay down sound foundations for a sustainable growth of the industry.

In the wake of globalization and transformation of global financial markets, Islamic financial institutions have embarked on expansion across borders. The leading Islamic banks have now presence in many jurisdictions. They have also established various subsidiaries and associates to diversify their business and meet the growing financial services needs of their customers. Islamic banks are thus

moving out of their domestic markets and gradually integrating into the global financial system. This has raised the issues of consolidated supervision and home host coordination for their supervisors.

While Islamic Finance has its peculiar characteristics, Islamic Financial Institutions(IFIs) are operating in the same financial markets as conventional banks and largely within the same regulatory environment. Thus the issues of home host coordination in the supervision of conventional banks are equally important in the case of IFIs. Basel Committee on Banking Supervision(BCBS) has issued Principles for home host supervisory cooperation and allocation mechanisms in the context of Advanced Measurement approaches(AMA) for operational risk. BCBS has also issued a paper on home host information sharing, which sets forth general principles for sharing of information between home country and host country supervisors for effective implementation of the Basel-II Framework. Islamic Financial Services Board(IFSB) is also looking into the home host issues specific to the IFIs.

III. Challenges in Home Host coordination

The recent global financial crisis has again triggered a debate on strengthening home host cooperation and information sharing. Let me highlight few challenges faced by supervisors in maintaining cordial home host relationship:

1. Conflicts of interest

The statutory objectives of bank supervision may vary from country to country. Some supervisors focus on financial system stability while others have deposits protection as their primary goal. Some home countries discourage flight of capital and require their banks to maintain capital at head office whereas the host country may require part of the capital to be maintained locally. Such conflicts of interest complicates the home host relationship.

2. Coordination in crisis management

The home and host supervisors may have different approaches to deal with crisis situations. Their respective laws may have limitations to effectively respond to the crisis. As a result, home and host supervisors may adopt different techniques to rescue a distressed bank. This lack of coordination may threaten stability of the financial system particularly if the troubled bank is systemically important.

3. Unclear roles and responsibilities

Basel standards on home host coordination have broadly defined the roles and responsibilities of home and host supervisors in supervising the internally active banks. However, there is no formal international framework providing for the specificities of cross-border interventions in distressed situations.

4. Complacency of host supervisor

Some of the home supervisors are quite proactive in supervising cross border operations of their banks. This may cause the host supervisors to become complacent or divert their supervisory resources to domestic banks. In the event of crisis, however, such home supervisors may focus on safeguarding the interest of domestic depositors and leave the foreign depositors to suffer for the complacency of host supervisor.

5. Issue of systemic importance

Under a risk based supervisory approach, both home and host supervisors tend to focus on systemically important institutions. But they might have different perceptions of which institutions are systemically important or when the crisis are of systemic importance. This may result in variant approaches in dealing with similar situations.

6. **Tendency of Matrix management**

There is an increasing tendency of matrix management whereby banks are centralizing the control and support functions like risk management, internal audit, information technology, compliance, etc. at their head offices. Furthermore, they are also resorting to outsourcing of support functions. This may enable the bank to control costs and bring efficiency, but at the expense of host supervisor losing oversight of these important functions and becoming reliant on home supervisor.

7. **Reluctance in information exchange**

Open communication and exchange of information is critical for effective home host coordination and conducting consolidated supervision. Reluctance on the part of either party to share information can derail the coordination process. This has to be a two way process, otherwise it will not work.

Given the above challenges, there is a need for greater coordination and strengthening of the home host relationship. In this regard, Financial Stability Board has recently reviewed the existing supervisory college arrangements. BCBS is also working to develop a set of principles to assist the efficient operation of supervisory colleges and sharing of information. The principles will also identify effective links between supervisory colleges and crisis management .

IV. Saudi Experience in Home Host relationship

Let me now share the Saudi experience in maintaining home host relationship. Many Saudi banks have established subsidiaries and branches abroad and a number of internationally active banks have their presence in Saudi Arabia. SAMA has been proactive in maintaining cordial relationship with foreign home and host supervisors. We have adopted a four pronged strategy in this regard:

- First, as a home supervisor, SAMA conducts a group-wide consolidated supervision thereby evaluating all material risks of a Saudi financial group. For this purpose, we conduct off-site as

well as on-site surveillance of their local and foreign operations and closely coordinate with the host supervisors;

- Second, as a host supervisor, SAMA seeks no objection from the home supervisor for granting a new license and expect the home supervisor of a foreign subsidiary or branch in Saudi Arabia to conduct consolidated supervision of the entire group in accordance with the international standards;
- Third, SAMA encourages communication and exchange of information, in accordance with Saudi banking laws, with foreign supervisors on matters of mutual interest;
- Fourth, SAMA enters into memoranda of understanding with foreign supervisory authorities, if needed and subject to meeting of the prescribed criteria, for exchange of information and conducting consolidated supervision.

Saudi banks have implemented Basel-II and other standards and principles issued by BCBS. SAMA has adopted the Risk Based Supervisory Approach to assess the overall condition of banks and to evaluate their credit, market, operational, liquidity and other risks.

We have implemented Basel standards with regard to home host coordination. We have encouraged banks to adopt best methodologies for stress testing and make effective use of stress testing results to proactively manage their risks. SAMA is also actively participating in deliberations of BCBS,FSB and their working groups and other international platforms to strengthen home host coordination. In addition, SAMA has been participating in supervisory colleges established by the home supervisors of Saudi banks.

V. Conclusion

Let me conclude by saying that financial stability is not the only but an important responsibility of any central bank. In order to effectively discharge this responsibility, central banks and supervisory authorities from around the world must have to coordinate and cooperate to prevent crisis situation that may undermine financial stability. They must have the capacity to maintain a robust financial

system and to deal effectively with any financial crisis. It is heartening to note that supervisory coordination is underway under the auspices of Financial Stability Board and the BCBS. Several initiatives have been launched by them to strengthen bank supervision and achieve global financial stability. This should not, however, become a cause of concern for banks as all such initiatives are aimed at ensuring their soundness and systemic stability. In order to promote cross border banking and maintain resilient financial systems, it is in the interest of all stakeholders to strengthen home host coordination.

Thank you for your attention.

bnm/homehost/

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