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CRISIS MANAGEMENT IN THE ISLAMIC FINANCIAL SERVICES INDUSTRY

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Your Excellencies, ladies and gentlemen, this session is largely an exercise in anticipation. We have yet to see a substantial crisis in the Islamic financial services industry, and although we have had a few problem institutions, we have generally been able to resolve them at national level and on a

fairly gentle timescale. So in thinking about how a real crisis might be handled, we need to draw on our experience in conventional finance. In my case, this was dominantly in Holland and later the UAE during the Global Financial Crisis, but some of you will have other relevant experience, for example from the Asian Financial Crisis.

Crises have different characteristics, depending on the sector involved, and the degree of interconnectedness. An insurance crisis typically plays out in relatively slow time. The crisis of the early 1990s, triggered by asbestosis and involving the near-failure of Lloyd's, brought down many insurers, but did so over a 5-10 year period. An individual company may fail overnight, but even

then the issues that need to be resolved quickly are generally limited to ensuring continuity of cover in critical areas like aviation. A banking crisis generally plays out faster, because of the critical importance of liquidity, the speed with which assets can be withdrawn, and the consequent importance of confidence. The Lehman's insolvency can be characterised as a securities crisis, in that the seizing up of elements of the market, and the long uncertainty about the outstanding balances between parties, became more important than the actual debts owed by the firm. This was a case where interconnectedness was critical. On the other hand, the practical experience has been that contagion effects in the insurance business have been very limited.

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Of course we cannot expect that the next crisis will be like the last one, and we should not assume that the characteristics I have identified are absolute for all time. After all, before the global financial crisis, most Western regulators thought that bank runs were essentially things of the past, or at least confined to less developed economies. They were wrong.

Another important variable in dealing with a crisis is the institutions involved. At national level, you may have a highly regulatory integrated system, as in Bahrain, or a highly fragmented one, as in the USA, or almost anything between. Whilst there is plenty of room for debate about the merits of different regulatory structures in general, in crisis the lines

between agencies are almost always problematic. Structural preparation, for example a co-ordinating committee can help. However, trust is critical, and is always in short supply when issues of responsibility or blame are likely to arise. In general, my preference would be for one agency to be given clear lead powers in such a situation to avoid prolonged paralysis.

These issues become hugely more difficult in a cross-border situation. Legal systems will be difficult, the macroeconomic situation may be different, and regulators will be answerable to different politicians and governmental structures. My own experience of this includes the rescue of Fortis, where even the Dutch and Belgian

regulators, close European neighbours, found themselves pulling in different directions. Another well-known example is Lehman's, where American hopes for a rescue by Barclays were frustrated by the British regulators' reluctance to have one of their banks take on a set of unquantified liabilities.

But the best example of which I have direct experience is the takeover of ABN AMRO by RBS/Fortis. This shows the need for a better model of collaboration and coordination between Regulators, including the need to communicate and pick up incipient signs of distress – and act on it in a truly united and timely fashion. When the bid discussions were announced, in April 2007 and in competition with an existing bid from Barclays, the

crisis was just developing. Its full dimensions were not recognised, but the largest US subprime lender had already failed, and during the bid process we saw the collapse of two Bear Stearns hedge funds, the rescue of Countrywide, and the run on Northern Rock.

When Fortis joined RBS & Santander to form a consortium to take over ABN AMRO, each regulator started to get involved in their respective countries. This was **not** a joint effort which it should have been from day one.

The banks on the commercial side had some serious restrictions in committing a **full** due diligence. RBS could not perform a full due

diligence due to prevailing market practice in the UK and the Netherlands and could not determine the quality of assets in ABN AMRO'S structured credit portfolios or the valuation of those positions. But that is the commercial side of the coin.

On the regulatory side much more information was available and it is imperative that a regulatory model allows the full body of information to be shared and discussed amongst the regulators.

Did the Dutch Central Bank know, as the UK FSA knew, that the RBS stake in the takeover at 38% represented 61% of RBS's reported Tier 1 capital? Conversely, did the FSA know about the volume of mortgage-backed securities, many of them just

above subprime, on ABN AMRO's books. Did the Dutch know in full the critical ratios of Fortis as known by the Belgian regulator?

Did the four regulators at any time from the start of the consortium offer in October 2007 confer with each other so their collective response could be founded on a deep understanding of the potential implications for each bank and their banking systems?

Furthermore, the expectations, roles and responsibilities of each regulator were not mutually understood and agreed. The FSA thought that the strategy, business model and key business decisions were matters for Boards, while the Dutch

Central Bank was tainted and hindered by association and comparison with the Italian Central Bank role in the takeover by ABN AMRO of Anton Veneta the previous year. The Dutch political intervention to accuse the Italians of bias and protectionism naturally led to similar accusations levelled against the Dutch Central Bank in its dealing with ABN AMRO a year later.

A further issue was the reluctance of regulators to recognise the full dimensions of the crisis into which they were heading. Dutch regulators were too sanguine about the quality of ABN AMRO's assets, so failed to recognise the potential problems. At other points – which I cannot discuss in detail – regulators did not question the financial standing of

certain major institutions, despite the fact that other well-known names were already in trouble. Regulators above all need to be sceptical, and ready to think the worst.

In addition, the question arises to what extent individual regulatory responses could have a destabilising effect on the market if the market reads too much into a regulatory intervention. When, during a developing crisis, a large bank makes an offer followed by regulatory action could that action be based on major concerns from the regulator about the capital and liquidity position of the bank? If the market believes it could, might it not itself cause the negative effect that is what the regulator is trying to avoid.

So the role of the regulator is very difficult in these kinds of circumstance. Any particular regulator is likely to have incomplete information, roles and responsibilities may be unclear, there will be political pressures, and there will also be pressures for impartiality – which is very much in the eye of the beholder.

This case shows that only close cooperation and joint approaches/information sharing will help in avoiding mistakes that ultimately might have contributed to the downfall of both Fortis and RBS.

In the aftermath of the Global Financial Crisis, the standard-setters, led by the Financial Stability Board (FSB), have attempted to define more closely responsibilities for group supervision, the arrangements that should apply in a crisis, and the legal regimes that should underpin them. One recent example was the FSB's publication in November of its "Key Attributes for Effective Resolution Regimes". However, none of these arrangements has yet been tested in the fire, and it remains to be seen how far they will help. Personally, I believe that a huge amount will still come down to relationships between regulators. It is also important to note that in general the new arrangements address issues at the firm or group level. They do not address contagion spreading from institution to institution, each with a different

international profile. Nor do they address crises that are essentially economic, for example how financial services regulators would behave if the Eurozone were to fragment.

What are the issues here for Islamic finance specifically? I start from the consideration that most Islamic institutions are relatively small. There are some systemically important conventional firms with Islamic windows or subsidiaries, but among predominantly Islamic firms few will be systemically important even at national level. Most do not have a strong multinational presence. In addition, Islamic securities firms have, for these purposes, a great deal in common with conventional firms. They may

of course be caught up in a crisis, for example if a central counterparty were to fail, but the handling of it for Islamic firms would be very similar to that for conventional ones.

Where a crisis involving an Islamic institution can be handled at a national level, the issues are essentially technical, though difficult. The first, for the banking sector in particular, is how to provide liquidity in a Shari'a compliant way, and against acceptable security. This is an issue to which many, including the IFSB, have devoted considerable attention, and I don't intend to spend time on it today. Authorities may also need to take steps to prevent a run. One element of this is a deposit protection scheme, which can help forestall

panic by retail customers at least. In the case of an Islamic bank, it will need to be clear what such a scheme covers. If the regulator takes the view that PSIA holders must, in Shari'a, remain exposed to the risk of loss, and therefore should not be covered, they will of course have every incentive to withdraw their funds in a crisis. And if the regulator leaves the question unclear, then the prudent investor will, again, withdraw his or her money as soon as rumours start to circulate.

Further issues arise if supervisors need to go beyond short term liquidity provision to resolve a failing institution. A straightforward "white knight" takeover involving the purchase of the whole institution will not be problematic. But in a real

crisis, a white knight may be difficult to find because of the uncertainties and the limited due diligence that can be done. In such a situation, in banking one approach will be to try to transfer at least retail deposits to another bank, and to buy some time to resolve other parts of the book. The new FSB proposals envisage the alternative approach of a strong resolution authority, which can seize the institution, continue its operations in the short term, sell or transfer elements, force some bondholders or creditors to accept losses, and so on. A structure like this will need to have a solid foundation in law, because when people are in danger of losing large sums of money, some of them will mount any legal challenge they can. This may go beyond their own contractual relationship with the institution. For example, a creditor that stands to lose may well

challenge the basis on which potentially profitable business was transferred to another institution.

In the case of Islamic finance, this means that the nature of each party's relationship with the institution needs to be crystal clear. For example, a person that has placed money with the institution under a Murabaha contract has, in Shari'a, a direct creditor relationship with the bank; he has sold some commodities to the bank on credit. But one that has placed it under Mudaraba or Wakala does not; he has placed money to be invested on terms under which it is at risk, but has a claim to a share of the assets in which it has been invested. Is this the position that the courts will take? And is it clear enough to those involved that supervisors can

withstand the political pressure of those who claim not to have understood that their funds were fully at risk?

Broadly similar issues would arise, though typically in slower motion, in trying to resolve a failing Takaful undertaking. For example, could the Takaful fund be transferred, with all its policyholder relationships, into a new operator that is willing to continue the business? If so, what becomes of any shareholders' funds remaining in the old operator? Can the regulator force these to be paid to support the Takaful fund, and if so, to what extent? How does any need to support this fund rank in relation to the operator's other obligations, for example to its staff?

Any legal uncertainty is also likely to give rise to private litigation. This may take unexpected forms. For example when The Investment Dar, from Kuwait, was in difficulty it found itself fighting Blom Bank, from the Lebanon, in an English court, and trying there to repudiate a contract on Shari'a grounds.

Issues like those I have described are important even if no case ever comes to court, because the legal position often underpins the negotiating position. If the supervisor is trying to negotiate a deal to resolve a troubled institution, the parties' negotiating positions are likely to be underpinned by what they believe they would get in an alternative

scenario. I do not believe that any of these issues is insoluble. But I believe there is more work to be done on them, and that this should be done ahead of any crisis.

When a crisis becomes international, life becomes much more complex. First, as I have already suggested, in a crisis the natural tendency of every supervisor is to protect its own jurisdictional interests. This can manifest itself in an ugly scramble to grab the assets first and argue afterwards. Even if this can be avoided, the firm may well have moved assets around the world to try to shore up its position; we saw this with both Lehman's and AIG. There is nothing peculiar to Islamic finance in this, but it means that issues need to be played out in the legal systems of multiple jurisdictions. This will remain true even if a local

operation is nominally separate, and if Islamic business is conducted through a subsidiary rather than a window. The issues will also be played out between supervisors with different knowledge of Islamic finance, and possibly different views of it. For example, two supervisors may differ about whether an intragroup placement creates a debt between one company and another. Or, in the context of rescue negotiations, they may differ about the basis and terms on which a Takaful operation could be sold.

Shari'a governance is a further complication here. This is of course an important underpinning of the normal operations of an Islamic firm. But how will it work when the firm and its supervisors are

negotiating the terms for its own survival. Those of us who have lived through crises are used to teams of lawyers negotiating through the night, while the boards of the firms are in continuous session, and teams of accountants crunch the numbers. Will there also have to be teams of scholars meeting? Is this possible, given the multiple commitments of the leading scholars, and how will any cross-jurisdictional differences be resolved?

The good news is that any single institution which is significant and complex enough for cross-border resolution to be a serious issue should already have its own college of supervisors. If it does not, we have a collective responsibility to make sure it does. Colleges inevitably, and rightly, focus mainly on the

current risks, but the Financial Stability Board is pressing them also to consider the issues of resolvability. I suggest that one of our duties as supervisors of Islamic finance is to ensure that these discussions take account of the Islamic dimension. We need to educate our colleagues, and ensure that the particular features of Islamic finance do not come as a surprise in crisis.

But we also need to do work among ourselves. Otherwise, we risk repeating the same thinking in each supervisory college, and getting different answers depending which supervisors are represented there. One starting point might be for some of our staff to meet for a couple of days to run

an intensive scenario exercise, based on a real crisis but with an Islamic dimension.

Finally, I have so far spoken about single firm, or at least single group, crises. I have said very little about sector-wide crises, or contagion issues. This reflects the fact that the shape of any such crisis is very difficult to predict. No-one, in either the conventional or the Islamic world, has defined how a multi-firm crisis would be handled, simply because that depends too much on which firms are involved and how they are linked. All one can confidently say is that the complexities will multiply as different groups of supervisors and other professionals interact, typically trying to protect the interests of

one firm against others, and as political authorities become involved, as they inevitably will.

In summary, therefore, I have sketched a number of questions that need further work. Whereas in conventional finance the issues are mainly about how to prepare for and manage crisis, within largely known legal parameters, in Islamic finance there is real uncertainty about those parameters, and how they will operate in a crisis. We need to do more work amongst ourselves to address these questions, to achieve as much consensus as possible, and to share it with conventional regulators. In the meantime, we can still make progress with our own resolution regimes, along the

lines recommended by the FSB – and of course try to ensure that the next crisis is a long way off.

Thank you.