FOSTERING STABLE AND INCLUSIVE FINANCIAL SYSTEMS

CENTRAL BANKS AND MONETARY AUTHORITIES OF THE OIC MEMBER COUNTRIES

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Presentation Plan

- Introduction
- Impact of finance on inclusive growth
  - Growth, Entrepreneurship, Inclusive growth, Discrimination
  - Financial innovation
- Effective regulatory strategies
  - Worst strategies
  - Best strategies
- Re-evaluation of strategies
- Islamic Finance and Inclusive Financial System
- Conclusions

Introduction

- Financial system influences the decisions of efficient resource allocation
- Inclusive financial regulatory strategies-
  - Support fair competition
  - Ensure transparency
  - Eradicates harmful policies
  - Provide credit to support best and brightest ideas
- Activist financial regulatory strategies-
  - Foster politically favored ends
  - Greater Government influence
  - Create opportunities for corruption
  - Support wealthy and politically connected people

Impact of Finance on inclusive growth

Finance and Growth

Better financial systems bring faster financial growth

Rouge financial systems discourage investments, increase risks, decrease returns

Efficient Financial systems mobilize savings, prioritizes allocation, and diversify risks

Study shows operation of financial systems have direct impact on long run economic growth

Impact of Finance on inclusive growth

Better functioning financial systems (BFFSs) reduce interest rates, ease both collateral requirements and information asymmetry problems

BFFSs (a) bring new firms with innovative ideas and growth potentials to market, and (b) expedite exit of low-quality firms

Finance and Entrepreneurship

BFFSs reduce the influence of wealthy people to shape credit allocation and increase flow of credit to better ideas

Improvements in financial systems improve quality of financial services and quality of entrepreneurship

Impact of Finance on inclusive growth

The relationship between Finance and inclusive growth is not as obvious as this is between finance and growth

Research finds a negative relationship between financial development and both reduction in poverty and income inequality

Finance and Inclusive Growth

Growing body of research proves increasing competition and BFFSs bring positive impact on low-income families

One body of research shows deregulation as part of BFFSs increase competition and improve financial services

Impact of Finance on inclusive growth

Finance and Discrimination

Discrimination affects financial inclusiveness

Financial inclusion increases competition throughout the economy and reduce racial discrimination

Research finds financial reform intensifies competition and reduce wage gap between races and income groups

Intense competition reduces profit margin, which ultimately lower the cost of discrimination ensuring identical pay

Impact of Finance on inclusive growth

- Financial innovation is essential for economic development
- Financial innovation fosters both entrepreneurial and economic opportunities

- Not all financial innovation happen for the well-being of the society
- Sometimes innovation happens simply to evade regulations

Financial Innovation

- Financial innovation influence human life by shaping the quality of financial services

- Regulators must make sure that financial innovation are well-intended - not ill-intended

Effective regulatory strategies

- Worst Strategies:
  - Too much Government intervention
  - Regulatory authorities and their officials get extreme power over allocation of resources
  - Politically influential groups manipulate policies to satisfy their own interest
  - Ill-intentioned financial strategies favor large firms
  - Several studies in India, Pakistan, USA, Italy support the finding that Govt owned/Govt protected banks lend more to politically connected large firms where private banks lend more to SMEs

Effective regulatory strategies

- Worst Strategies:
  - Evidence from Cole's (2009) study in India shows credit from Govt Banks flow more to politically important areas, i.e. election areas
  - Dinc's (2005) cross-country study shows Govt banks increase lending in election years compared to private banks
  - Though Govt banks are financially and socially more capable than private banks, well-intentioned Govt initiatives are commonly captured by politically ill-intentioned groups

Effective regulatory strategies

- Best Strategies:
  - Financial regulators focus on fair competition and transparency
  - Limited government intervention in the financial systems
  - Shareholders and creditors have the power and ability to monitor financial intermediaries
  - Participants in the financial systems compete for profit
  - Existence of mechanisms that remove perverse incentives

Re-evaluation of Strategies

- The USA has both growth-enhancing and growth-hindering policies (Barth, Caprio and Levine, 2011; Levine, 2010a, b)
- Many policies in the US lack transparency, hinder shareholders and creditors ability of effective monitoring of intermediaries, encourage excessive risks
- Causes of many past financial crisis can directly be attributed to the wrong type of regulations

Re-evaluation of Strategies

- Regulatory failure Example 1: Opaque markets transactions of CDSs and other derivatives
  - Regulators and policymakers intentionally kept Multi-trillion dollar OTC derivatives markets opaque in 1990
  - No regulatory agencies had any clue of the collapse of long-term capital management (LTCM) in 1998, which traded in opaque market
  - Instead of shedding light on OTC market after LTCM demise, Commodity Futures Modernization Act of 2000 increased opacity by keeping OTC and CDS market from Govt oversight

Re-evaluation of Strategies

- Regulatory failure Example 2: SEC's supervision of investment banks
  - In 2014, SEC enacted rule to consolidated supervised entities" (CSEs) that included five major investment banks
  - In addition to its other numerous supervising responsibilities, SEC was also responsible to oversee CSEs, which was systemically important and difficult task
  - SEC's public disclosures of effective monitoring of CSEs weakened incentive for private investors to monitor risk taking of those financial institutions
  - SEC had only 7 staff to examine $4 trillion assets of those investment banks and failed to complete a single inspection of any major investment bank in 2005

Re-evaluation of Strategies

- Regulatory failure Example 2: SEC's supervision of investment banks:
  - Year and a half later of 2005, all those five major banks collapsed and govt bailed out all of them
  - It became very costly for private investors when regulatory policies and advertisement reduced investors incentive to monitor those failed investment banks
  - It is not a case of free-market failure, rather a failure to focus on incentives

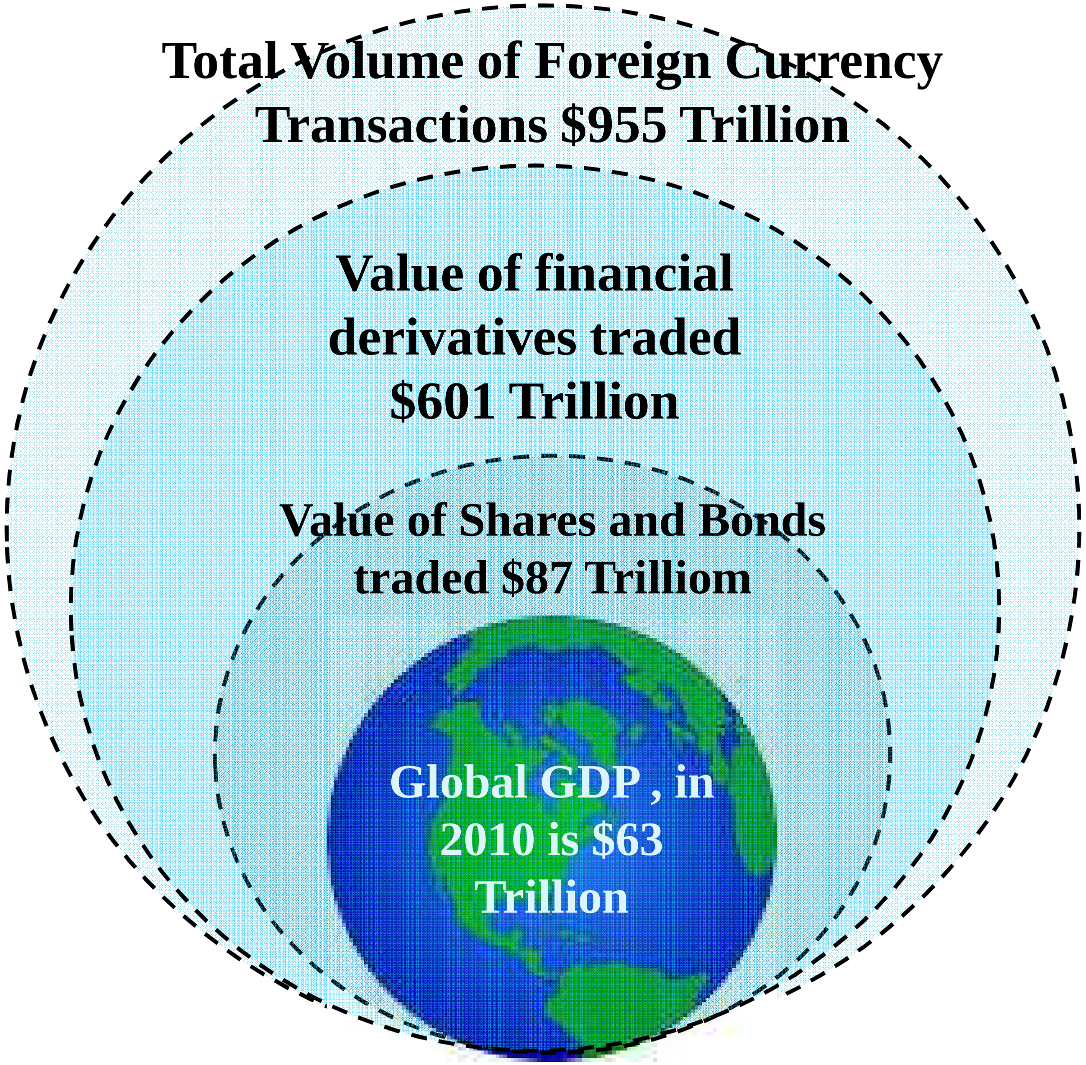
Foundational Principles of Islamic Finance

Routed in Divine Law	Prohibition of harmful transactions
Economic Justice	Economic justice for all humanity
Circulation of Wealth	Interests concentrates wealth
Commoditization	Backed-by real assets for real growth
Risk Sharing	Does not transfer risks to the borrower

Foundational Principles of Islamic Finance

Lending (in a debt based economy)	vs.	Investing in an ethical equity based economy
Win-Lose Framework		Win-Win Framework
Creates Debt		Invests in Real Assets
Risk Transferred		Risk is Shared
Unfair gains from profits and losses		Just and fair profits and loss sharing
Rich gets richer Poor gets poorer		Justice and Equity

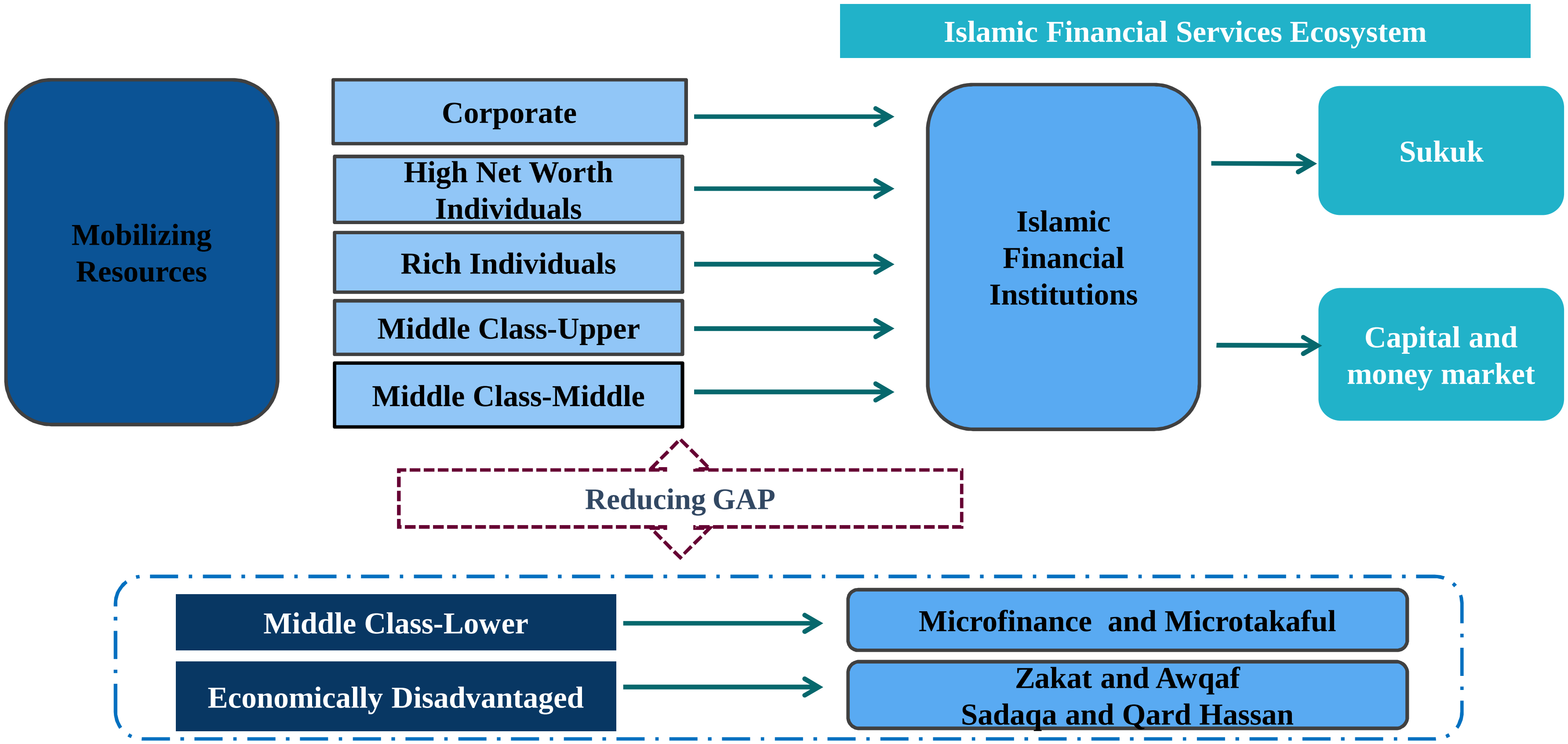
An Economy of Bubbles & Bursts



Fictional financial economy is over 26 times larger than everything else produced on earth.

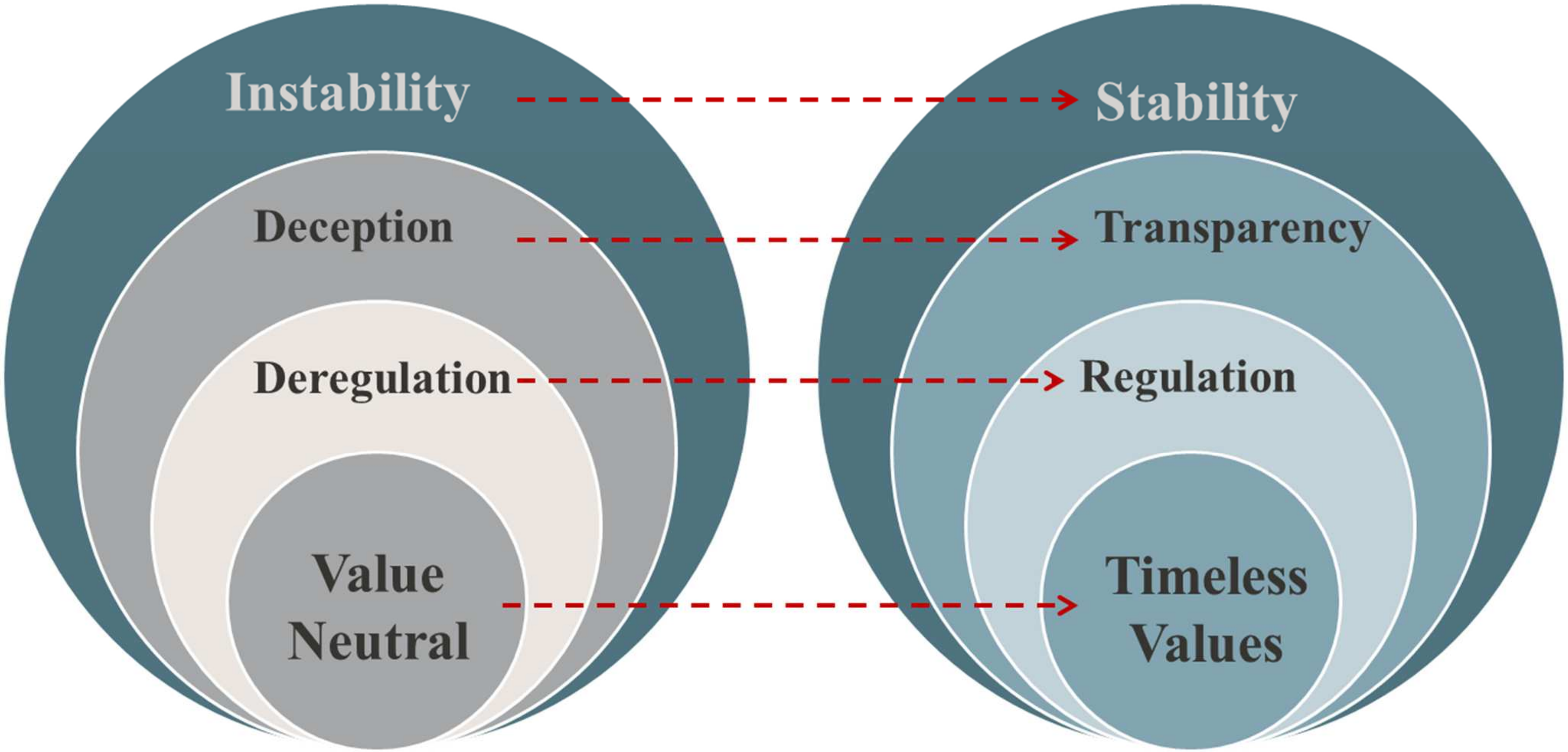
Data sources: April 2010 figures from IMF, BIS and WFE

Islamic Finance: A comprehensive system



Islamic Finance | Reduced Inequalities

The Paradigm Shift



Esham: Merging Sukuk and Waqf

	Sukuk	Esham
Underlying Asset	Physical asset	Physical asset
Revenue Stream	Fixed Annuities generated by income of leasing back the underlying asset to its operator	Fixed Annuities as a percentage of income generated by the underlying asset
Redemption	At maturity	No maturity, the borrower can redeem the Esham certificates when it is convenient
Principal repayment	At maturity	No principal repayment required
Transaction Costs	High transaction costs because of the SPV	Low transaction costs

Esham Application

In practice, Esham instruments have been recently used. However, the are being referred to as Sukuk.

Malaysian Airlines (2012)	Abu Dhabi Islamic Bank (2012)
RM 2.5 Billion was raised through Sukuk. No maturity date : like Esham, No 3rd party guarantee, No fixed annuities, No obligation of principal repayment.	Raised USD1 Billion through perpetual sukuk. Redemption possible (if ADIB should chose so) after 2018, Issued to meet Basel III Tier 1 capital requirements
This sukuk is considered equity and does not negatively affect the issuer's gearing ratio. Expected to pay 6.9% of profits semi annually.	Private Banks allocated 60% of the Sukuk while the public was allocated 40%. Inclusion of the growing middle class through this instrument.

Conclusion

- Well-intentioned financial systems ensure efficient allocation of credit and opportunity to the best and brightest
- Ill-intentioned financial systems funnel credit and opportunity to wealthy and politically influential groups
- Though both in developed and developing economies, cost of financial crisis is huge, financial regulation is not all about managing financial stability and systemic risks – it is also about growth and opportunity
- The challenge we encounter is to create regulatory agencies which have the ability and willingness to promote transparency, competition, and sound incentives