

Preface

In general, policymakers use simultaneously the set of monetary, fiscal, and prudential policies that would ensure macroeconomic and financial stability. They believe that this arrangement would set the foundations of steady growth. These policies that are later combined together as macroprudential policy are recognized to adequately address the financial system risk. However, it has become clear that developments in the shariah-based financial system can be important for macroeconomic stability, even when inflation is low (i.e., as the objective of monetary policy) and stable and fiscal policy seems to be sound, because this system may be also exposed to the consequences of episodes of financial instability.

Several countries, as reported in Kashyap et al. (2011), have already been using a well-developed macroprudential framework to address systemic concerns before the episodes of financial instability. The discussion on this framework has reached a wide range of topics such as instruments, indicators, objectives, and systemic risk. These topics are the main components of transmission channel on the working of macroprudential policy. The practical model of macroprudential has also been applied in several countries such as New Zealand, Japan, and India. They have started to develop macroprudential toolkits for addressing financial systemic risk or have reconsidered and recalibrated existing tools in the light of their potential application at the systemic level.

Islamic financial system, which is relatively new Ibrahim and Ismail (2015), is given a mandate to be part of the financial system, and the regulatory bodies such as Islamic Financial Services Board and financial authority such as central bank and financial services authority are assigned to regulate and supervise the system. At the jurisdiction level, as mentioned in Ismail and Che Pa (2015), financial authorities have started to incorporate macroprudential considerations into standard practices for Islamic financial institutions.

Does each jurisdiction that practice the Islamic banking need to have a separate macroprudential policy? Before we could answer this question, we ask on what we know about macroprudential policy.

What Do We Know About Macroprudential Policy?

For any public policy, it should have its objectives, tools and indicators, and more importantly its mandate. All these elements will be discussed as follows.

Policy Mandates

What mandate does the financial authority have for implementing macroprudential policy? In some jurisdictions, such as Malaysia, Pakistan, and Indonesia, the financial authority is explicitly given the responsibility for financial stability or for contributing to financial stability—a responsibility that is usually implicitly or explicitly part of the financial authority’s mandate. For example, the Central Bank of Malaysia under the Article 27 of the Central Bank Act 2009 defines that “the financial system in Malaysia shall consist of the conventional financial system and the Islamic financial system.” It has significant effect on the development Islamic monetary policy instruments. In addition, under the Islamic Financial Services Act of 2013, the “ultimate objective” of supervision (i.e., microprudential policy) is to promote the “safety and soundness of banks and the banking system” and *Shari’ah* compliant banking.

Objectives

The normal ultimate objective of macroprudential policy is to avoid output and wealth losses in the long run by limiting the buildup of system-wide financial risk. One of the key purposes of macroprudential policy is to address negative externalities by acting as a countervailing force to the natural decline in measured risks in a boom and the subsequent rise in measured risks in the downturn. It also aims to mitigate risks linked to financial sector concentration and interconnectedness. It shows that macroprudential policy has both a time dimension and a cross-sectional (or structural) dimension.

However, in some cases, where the objective of banking supervision includes on an equal basis both the soundness of individual institutions and the safety of the banking system, confusion may arise as to who is ultimately responsible for addressing emerging systemic risk and what actions are needed to preserve financial stability. Therefore, the supervisor need to address the following two issues: first is the *risk parameter*—the microprudential supervisor, while taking decisions concerning individual banks, will need to take into account risks arising from the internal environment in which the bank has to operate, for instance, in the context of Islamic banks. Such *Shari’ah* risk assessments are a key element of the macroprudential policy objectives.

Second issue is the *institutional perimeter*—the more diversified a financial system is, the less the system itself is affected by the actions or the stability of an individual institution. In a highly diversified system (i.e., Islamic finance not only cover the Islamic banking institutions but also non-banking institutions such as *zakat* and *waqf* institutions, Islamic mutual funds, and Islamic microfinance institutions), supervisory action aimed at an individual institution or a few institution could have less systemic consequences. Hence, policy actions to address systemic risks would have less significant consequences for the few individual firms that make up the financial system.

It shows that the microprudential authority is concerned with risk concentration within individual institutions, while the macroprudential authority is concerned with similar portfolio holdings among institutions in the system, the holding of portfolios that would not erode the output and wealth in the long run. However, the objectives of macroprudential policy also need to consider the preservation of the *Maqasid al-Shari'ah* (Ngalim and Ismail 2014; Ngalim et al. 2015).

Tools

Basically, macroprudential tools vary among the jurisdictions. For example, in New Zealand (a good example of regulatory in place), countercyclical capital buffer (CCB), adjustments to the minimum core funding ratio (CFR), sectoral capital requirements (SCR), and restrictions on high loan-to-value ratio (LVR) residential mortgage lending are among the instruments of macroprudential policy. But in other countries, like India (an example of the presence of interconnected and diversified financial landscape), countercyclical measures such as investment fluctuation reserve and time-varying risk weights and provisioning norms to sectors such as housing, commercial real estate, retail, and equity; policies to address the cross-sectional dimensions of systemic risks such as dealing with interconnectedness and common exposures and monitoring financial conglomerates; and framework for the management of the capital account are used as macroprudential tools.

It implies that the varieties of tool instruments are used in response to differences in the structure of the financial system and the presence of a sound regulatory framework. Basically, the set of policy tools currently being considered is mostly based on existing microprudential and regulatory tools (i.e., caps on loan to value ratios, limits on credit growth, additional capital adequacy requirements, reserve requirements, and other balance sheets restrictions).

Moving Forward

Even though both the objectives and expected effectiveness of macroprudential policy are known, usage has often proceeded on an ad-hoc or experimental bases. Evaluations of usage to date, mostly aimed at affecting developments in financing

and housing markets and bank capital, suggest that some tools can help reduce financial pro-cyclicality and lower crisis risks. Therefore, caps on financing to value and debt service to income ratios seem; and asking for higher capital are important to help in reducing booms, and thereby busts, in real estate markets, and bank's insolvency that become the major sources of instability. Reserve requirements and targeted levies on foreign exchange exposures also help in reducing system-wide vulnerabilities. Macroprudential policies are also needed to reduce the systemic risks created by large financial institutions and social finance institutions. Questions arise on the best institutional (in line with the view given by Ismail and Ahmad (2006)) design for usage, e.g., who is made in charge of macroprudential policies. The major issue, closely related to institutional design, is how the political economy of macroprudential policies will play out. In addition, the way forward also has to look into the implication on the reporting requirement, which may suggest a next generation of balance sheets.

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