Islamic Finance: Past, Present and the Future[1]

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His Excellency Anas Khaled Al Saleh, Deputy Prime Minister and Minister of Finance.

Her Excellency Madame Christine Lagarde, Managing Director of the IMF.

Excellencies,

Distinguished guests,

Ladies and Gentlemen,

Assalam-o-Alaikum!

At the outset, I am honored to express my gratitude to His Highness the Amir Sheikh Sabah Al-Ahmad Al-Jaber Al-Sabah for kindly patronizing this conference on Islamic finance. I would also like to convey my special thanks to the representative of His Highness the Amir, His Excellency Sheikh Sabah Al-Khaled Al-Hamad Al-Sabah, Acting Prime Minister and Minister of Exterior, for being with us today.

Also, I would like to express my thanks and appreciation to H.E. Anas Khaled Al Saleh, Deputy Prime Minister and Minister of Finance for his kind support and valuable participation in this special Forum.

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Your Excellencies, Distinguished guests, Ladies and Gentlemen,

A very good morning - it is a great pleasure for me to welcome you all.

[1] Keynote Speech delivered by His Excellency Dr. Mohammad Y. Al-Hashel, Governor, Central Bank of Kuwait, on the occasion of IMF-CBK Global Islamic Finance Conference, 11th November, 2015, Kuwait City.

I am deeply indebted to all the honorable ministers and governors of central banks and other distinguished guests for joining us today on this auspicious occasion. In particular, I would like to warmly welcome and thank Madame Christine Lagarde, Managing Director of the International Monetary Fund (IMF) for graciously supporting this endeavor and personally attending this conference.

I would also like to sincerely thank the staff of the IMF, the staff of the Center for Economics and Finance in Kuwait and my dedicated colleagues at the Central Bank of Kuwait (CBK) for their efforts in making this conference a success.

It is the first time that the IMF is co-hosting a conference on Islamic Finance such as this, and the Central Bank of Kuwait is privileged to be a partner in organizing this historical event.

Taking this opportunity, I would like to share a few thoughts on the progress of Islamic finance in a historical context.

My speech is set against three different times, covering the past, the present and the future. I will start with a very brief history of Islamic finance, particularly in the context of Kuwait, then turn to cover the present~~,~~ and finally reflect upon its future.

This broad sweep through history will hopefully help us see where we started from, how far we have reached and where we are heading next.

1-Islamic finance of the past; a humble beginning

Let me start with the past.

Around 38 years ago, in the same city as we are meeting today, a pioneer, Sheikh Ahmed Al-Yasin, envisioned the possibility of establishing an Islamic bank. Back in the mid-1970's, many would have considered it mere daydreaming. After all, there was hardly any role-model of Islamic finance to emulate.

In the words of Sheikh Al-Yasin himself, thinking of establishing an Islamic bank was *'like swimming against the tide'*.

It was a time when only conventional banks were in vogue; we ourselves had six of them in Kuwait. So it required a big leap of faith to establish an Islamic bank when there was virtually no example to learn from.

Despite these challenges, Kuwait witnessed the establishment of Kuwait Finance House (KFH) - not only the first Islamic bank in Kuwait - but also one of the very first established anywhere in the world.

It was a humble start; with only four employees, KFH opened its doors to the public for the first time on August 31st 1978. I doubt anyone imagined that it would one day become a leading Islamic bank, with 8,000 employees and operations spanning across seven regions of the world.

The growth of Islamic finance as an industry is equally impressive.

This is however hardly surprising, as the basic principles of Islamic finance deservedly have a universal appeal, irrespective of religious beliefs.

Adam Smith, the father of modern economics, argued that it is the pursuit of self-interest by individuals that leads, somewhat unintentionally, to the welfare of society as a whole. Islamic teachings, however, offer~~s~~ a more encompassing guide by making the broader interests of society central to our efforts.

Fourteen centuries ago, the Prophet Muhammad (peace be upon him) said: أَحِبَّ لِلنَّاسِ مَا تُحِبُّ لِنَفْسِكَ *‘Wish for mankind that what you wish for yourself*.’

This is the ‘golden rule’ of a good society, a principle that has been conveyed by almost every major religion and ethical tradition. It goes beyond Adam Smith’s idea of the *invisible hand* in the sense that society’s welfare is not an accidental outcome. Rather, the golden rule requires that anything that harms a society is prohibited, even if it is beneficial for the individual.

And the golden rule epitomizes the concept of justice which is central to Islamic finance. Justice, in economic context, requires at least two things; proper allocation of resources for the welfare of the entire society, and sharing of risk and reward.

Since banks mobilize savings from a large group of people and lend to relatively fewer borrowers, there is an element of asymmetry in banks’ resource mobilization on the one hand, and resource allocation on the other. This necessitates that banks, in the world of Islamic finance, lend to those who can use these savings to benefit the whole of society – by making productive investments and creating more jobs.

However, in recent years, excessive liquidity amid unconventional monetary policies has mostly fueled asset growth, with limited impact on real economic activity.

As Madame Lagarde rightly pointed out in one of her speeches last year, '*there is too little economic risk-taking and too much financial risk-taking'*.

Islamic finance, by establishing an inseparable link between finance and the real economy, encourages economic risk taking that helps improve growth and create jobs. It requires that credit must be provided for productive investments, not for conspicuous consumption or speculative activities.

And such a business philosophy makes perfect sense, regardless of religious beliefs. Warren Buffet, the legendary investor of our time, was once quoted in Fortune Magazine, comparing three types of investment:-

First, currency based investments, which he considered '*the most dangerous though investors mostly considered them safe*'.

Second, '*investments in assets like gold that never produced anything*'.

Yet he favored the third type; '*investments in productive assets, whether businesses, farms or real estate*' - and this is precisely what Islamic finance also requires banks to do - to promote investments in productive assets so that the entire society can benefit.

More importantly, Islamic finance goes a step further, as it also requires the sharing of profits and losses. That is not only important from the justice standpoint but also to ensure financial stability.

Lenders would have the incentive to monitor the quality of investments being made if they have to share the risks and rewards.

Therefore, Islamic finance, in its true spirit, not only curbs speculative activities but also discourages excessive risk taking. Moreover, it promotes the kind of economic risk taking which benefits all of society, not just affluent investors.

2-Islamic finance of the present: a niche market with huge potential for growth

Let me now turn to the present state of Islamic finance.

From the establishment of the first Islamic bank in Kuwait around four decades ago, we now have five domestic Islamic banks that collectively account for 39% of domestic banking assets.

This is the third highest share of Islamic banks operating in any country with a dual banking system - where conventional and Islamic banks operate in parallel. Globally, Kuwait has the fifth largest share of Islamic banking assets and the third largest share of Islamic funds.

And it is not only in Kuwait that the Islamic finance industry has taken off in recent decades.

Estimates suggest that the global market for Islamic financial services, as measured by *Sharī`ah* compliant assets, has crossed USD 2 trillion by now, a quantum leap from USD 150 billion in the mid-1990's.

Last year, the *sukuk* market witnessed debut issuances from the governments of four non-OIC countries -- the UK, Hong Kong, Luxembourg, and South Africa which indicates the growing popularity of *sukuk* beyond the Muslim world.

As these trends highlight, Islamic finance is neither a novelty nor is it restricted to Muslim countries only.

Over the past decade, the industry has transformed itself from being a niche market to a viable alternative for consumers of conventional finance, irrespective of their religious beliefs. Today Islamic banks serve millions of customers across the Middle East, South-East Asia and beyond, offering a variety of *Sharī`ah* -compliant products and services.
While it is indeed a remarkable achievement, Islamic finance has **significant potential** for further growth.

Let me very briefly point out three such areas:-

First, both within Asia and MENA, the regions where Islamic finance has a greater footprint, there is substantial scope for investments in infrastructure. Amid the growing populations in some countries and mass urbanization in others, the needs for a modern infrastructure are immense, ranging from airports to power plants and dams to highways. These investments are invariably backed by tangible real assets and thus ideal candidates for Islamic finance.

Second, the world is increasingly recognizing the importance of investments that are socially responsible and environmentally sustainable. And given the similarity in their business philosophies, Islamic finance can be a natural choice for socially responsible investments.

Third, in many developing countries a majority of the public still remains hugely under-served by a formal financial system, if not entirely unbanked.

For instance, World Bank data on financial inclusion for 2015 reveals that only 45.5% of the adult population has a bank account in South Asia, and merely 14% in the MENA region - incidentally, these two regions are home to more than 1.3 billion Muslims, around 82% of entire Muslim population.

These numbers collectively highlight that Islamic banks have the potential to reach millions of un-served customers. A banking model inspired by the philosophy of social justice can ill-afford to ignore its responsibility in serving the millions which are otherwise possibly at the mercy of exploitative, informal money lenders.

3. Islamic finance in the future; building institutional capacity for further growth

Let me now turn to the future.

Neils Bohr, Nobel laureate in Physics, said a century ago: '*Prediction is very difficult, especially if it is about the future*'. And may I add; prediction is even more difficult, if it is about the future of finance.

So, instead of attempting to predict the future, I would like to discuss what needs to be done to help the Islamic finance industry reach its potential. In this regard, the role of four types of institutions is critical not only in providing an enabling environment for a sustainable and resilient industry, but also in bringing current practices closer to the true spirit of Islamic finance.

First, consider the **legal institutions**, which offer the necessary infrastructure that, among other things, helps protect property rights and enforce contracts.

Hernando de Soto, a Peruvian economist emphatically wrote about the countries with poor legal infrastructure arguing that: "…*the majority of entrepreneurs are stuck in poverty, where their assets – adding up to more than US$ 10 trillion worldwide – languish as dead capital in the shadows of the law*".

He contended that in the absence of effective legal institutions, inhabitants of such countries are just custodians of '*dead capital'*---'dead' because while they may own plenty of resources, either they can't prove legal ownership or they can't efficiently use them in various transactions, given the inadequacy of legal institutions.

Both for their social and economic implications, Islamic principles lay great emphasis on honoring obligations and fulfilling commitments. The holy Quran specifically exhorts us by saying, يَا أَيُّهَا الَّذِينَ آمَنُوا أَوْفُوا بِالْعُقُودِ '*O believers*, *fulfill your obligations*'.

Strong institutions ensure it does happen, by protecting property rights, enforcing contracts and thus helping reinforce mutual trust in societies.

Second, take the role of **academic institutions**.

Muslim societies were once recognized for their contribution to various academic disciplines, ranging from alchemy to astronomy and mathematics to medicine. Today, the scholarly work being produced in our societies is more of an individual effort than anything at the institutional level.

Due to this lack of capacity building at the institutional level, efforts of otherwise dedicated individuals have remained divergent and fragmented. Many with profound knowledge of Islamic jurisprudence know little about modern finance. And our experts on conventional finance, in general, are inadequately equipped to understand the implications of various *Sharī`ah* injunctions. A study reveals that the top ten scholars in Islamic finance account for 67% of all chairman positions of *Sharī`ah* boards.

No wonder that Islamic banks struggle to find candidates for their *Sharī`ah* boards who can suitably guide them in offering innovative products.

Third, consider the **regulatory institutions**.

Effective regulation of Islamic finance is a daunting task, particularly in a dual banking system. Additionally, the peculiar nature of Islamic finance poses its own challenges in terms of designing a robust regulatory regime.

Take the case of Basel III reforms for example, where detailed guidance has been provided by the Basel Committee for Banking Supervision (BCBS) for the implementation in a conventional setting. However, for Islamic financial institutions, limited relevant guidance is available, if at all.

This undoubtedly requires the use of discretion by respective regulators. But the greater use of discretion is bound to create differences across countries and may increase the risk of regulatory arbitrage, yet importantly such reforms were meant to foster a high level of convergence among regulatory regimes.

Fourth, high responsibility also falls on **Islamic financial institutions** to make efforts in offering products and services that reflect the spirit of Islamic finance and are not just merely compliant with *Sharī`ah* requirements. This requires building capacity to do better research and offer innovative services. Moreover, Islamic financial institutions need to operate with the aim of promoting social justice in their allocation of resources.

Given these challenges, it is not possible for any one of these four types of institutions to make a meaningful difference on its own. Each institution, from academic to regulatory and legal to financial, has a distinct yet mutually reinforcing role to play. While individually insufficient, collectively these institutions provide the very foundation for a dynamic and resilient Islamic finance industry and are thus the pre-requisites for its sustainable growth.

Finally, allow me to share a few **concluding thoughts**.
Current economic and financial trends are a constant reminder that the world needs a better system. The inherent fragility of modern finance is quite evident. And in recent years, the unfolding of events like manipulating currencies, rigging LIBOR and miss-selling mortgages has intensified the debate about the role of incentive structures and ethics.

Amid the growing concerns about excessive risk taking and ethical drift, Islamic finance can play a role by offering a financial system based on strong underlying principles. A system, which if implemented in its true spirit, will bolster growth, create jobs, reduce poverty and address inequality. A system, which will channel credit into productive investments - not into speculative activity or wasteful consumption - and a system, which will promote investments that are socially responsible and environmentally sustainable.

However, for such a system to deliver, we must shift our focus from a *Sharī`ah* -compliant model to a *Sharī`ah* -based model.

Compliance is easy and can possibly be achieved without reforming institutions. But ensuring a *Sharī`ah* -based financial system will require fundamental changes not only in the finance industry but also in the very way our societies function. And that is why building institutional capacity is of paramount importance.

Undoubtedly, it is an uphill task, but not an impossible one and collectively we surely can. As Tagore once wrote, '*You can't cross the sea by merely standing and staring at the water*'.

All of us need to play our part in achieving that enviable goal, the goal of putting together a system that is ethically right, socially just, financially stable, and economically productive.

Thank you very much.