

**“Supporting the Further Growth of Islamic Finance in Asia and
Internationally”**
Keynote Speech by the Governor, Central Bank of Kuwait (*)

Good Morning. It is a great pleasure to be here in Singapore today. I want to thank the Monetary Authority of Singapore as well as the organizers of the World Islamic Banking Conference for their kind invitation to speak at this august forum.

Given the topic of my speech “Supporting the Further Growth of Islamic Finance in Asia and Internationally”, I will focus my remarks on the trends in Asia and Islamic finance, the opportunities for growth and the challenges ahead.

Let me start with an obvious common trait, in both Asia and Islamic finance---- the impressive pace of growth, by their respective standards.

Let us look at Asia first. The region, with a population of 4.3 billion, has been the key driver of global economic growth. Though Asia’s performance, by its own standards, has been somewhat subdued in 2012, growth is projected by IMF to pick up this year to reach about 5.75 percent. If that does not sound impressive, consider these facts: Europe is expected to grow by a measly 0.3%, with advanced Europe having no growth at all. Or take the Latin American region which is projected to grow by 3.5% or MENA that is forecasted to grow by 3.1%.

More importantly, despite persistent weaknesses in advanced economies, Asia is experiencing robust domestic demand driven by strong private consumption. Moreover, labor market conditions are favorable with unemployment at multi-year lows in many countries and trade links within the region are growing, thus reducing the dependence on demand from consumers of industrial countries. Unsurprisingly, the IMF expects Asia to lead what it calls a ‘global three-speed recovery’, where Asia is growing, countries like the US, Switzerland and Sweden are on the mend and Europe still has a long distance to travel.

(*) The speech of His Excellency Dr. Mohammad Y. Al-Hashel, Governor of the Central Bank of Kuwait, delivered at The 4th Annual World Islamic Banking Conference: Asia Summit, held in Singapore, on June 4-5, 2013.

Like Asia, growth has been equally stellar in the Islamic finance industry. Estimates suggest that the global market for Islamic financial services, as measured by Shariah compliant assets, has reached around USD1.6 trillion by 2012, registering an annual growth rate of 20.4% over 2011 and a quantum leap from merely USD150 billion in the mid -1990s. Currently, there are more than 600 Islamic financial institutions operating in 75 countries. At its current pace, the growth in Islamic finance stands sharply in contrast to conventional finance which has experienced significant deleveraging and slowdown in the wake of the global financial crisis. Moreover, sukuk or Islamic bond market has also charged ahead, with *sukuks* worth USD140 billion issued during 2012 alone, an all-time high.

Over the last decade, Islamic finance has transformed itself from being a novelty to a viable alternative to conventional finance. The basic tenants of Islamic finance, like the idea of sharing profit and loss, preference for ethically permissible investing, and the inseparable link of finance with real and productive economic activities, are understandably appealing to all. For instance, Warren Buffet, in an article published in Fortune Magazine this February, compared three types of investments; first, currency based investments which he considered the most dangerous though investors mostly consider them safe. Second, investment in assets that never produce anything, like gold. But he favored the third type; “investments in *productive assets*, whether businesses, farms or real estate”. But this is precisely what Islamic finance is all about—promoting investments in productive assets.

This emphasis on productive investments is particularly relevant in the aftermath of the financial meltdown that the conventional system has experienced during the last five years. No wonder that interest in Islamic finance is no longer confined to Muslim countries or communities—a fact reinforced by today’s conference here in Singapore. And I consider it a very promising trend because the greater involvement of well-established financial centers like Singapore will help further spur the growth of Islamic finance.

Now I would like to talk about trends and developments that have created **substantial opportunities** for further growth in Islamic finance.

First, despite the impressive growth in recent years as I just highlighted, Islamic finance still has significant opportunities up for grabs. While Islamic finance, given its principles of equity and justice, is not restricted to Muslims alone, the fact is that even this natural market is grossly under served. For instance, no

country in Asia, except Malaysia, has a significant share of its financial system committed to Islamic finance, defined in terms of 15% or above share in the overall financial system.

Second, both within Asia and the Middle East, there is huge demand for building infrastructure to cater to the needs of growing populations in some countries and mass urbanization in others. Since Islamic finance dictates that lending should be backed by tangible real assets, it has the potential to offer much needed funding for infrastructure building. Further, in the case of oil exporters in MENA, there is a strong need to invest the abundant liquidity that has been accumulated on the back of robust oil revenues in recent years.

Third, since the outbreak of recent financial crises, there has been an ongoing quest for financial stability. In these times of an increasingly uncertain world, Islamic finance can be a source of stabilization. Given the need for a clear link between financial transactions and the real economy, innovations in Islamic finance are considered useful only if they help generate genuine economic activities. So the speculative activities are curbed and excessive risk taking is despised, the elements that the financial world may consider adopting given the colossal cost it has paid for excessive risk taking.

Fourth, in the current global context, there has been a growing focus on investments that are socially responsible and environmentally sustainable. Broadly speaking, socially responsible investors focus on social justice and corporate governance with an aim to protect the environment and consumers. Moreover, socially responsible investors prefer to stay away from businesses involved in tobacco or gambling etc. Since these are precisely the types of businesses that Islamic finance also considers non-permissible, there is a natural connection between the business philosophy promoted by socially responsible investments (SRIs) and Islamic finance. Estimates suggest that as of 2010, around 12% of the \$25.2 trillion in total assets under management in the US is involved in socially responsible investing. With increasing preference for socially conscious and environmentally sustainable investments, this market segment is likely to grow further, offering Islamic finance a natural opportunity to expand. Since developing countries in Asia have far more opportunities for high return investments than in advanced economies, it will be beneficial to achieve future growth by promoting investments that are community oriented and socially beneficial.

Fifth, despite the impressive growth over the last decade, Asia is still home to two-thirds of the world's poor. ADB estimates suggest that around 1.7 billion people in Asia and the Pacific live on less than 2 dollars a day. As it can be well imagined, most of these people are hugely under-served by the existing set up of formal financial institutions, with many rather entirely un-served. No wonder financial penetration is fairly weak in Asia. The World Bank's data on financial inclusion for 2012 reveals that only 24% of the adult population in South Asia has a bank account. And even for many of the existing users, financial services being offered appear incompatible with the principles of Shariah. A survey conducted by Consultative Group to Assist the Poor (CGAP), an independent research center, in 2007 in 19 Muslim countries revealed that Islamic microfinance has a total estimated global outreach of only 380,000 customers and accounts for only 0.5% of total microfinance outreach.

Against this backdrop, there is a huge potential for Islamic microfinance that needs to be appropriately tapped. Lending to micro, small and medium enterprises would play an important role in promoting growth, generating employment and alleviating poverty. Furthermore, micro-takaful, the conventional equivalent of micro-insurance, can also be developed to provide life insurance, crop insurance, and insurance for damage caused by natural events for lower-income households. If appropriately designed and intermediated, micro-takaful can provide a hedge against unforeseen contingencies, protecting the most vulnerable segments of the society, as well as their businesses. It will also help mitigate the risks of financial institutions in lending to the poor, thus increasing their comfort in opening their doors to the otherwise unbanked or under-banked segments of the population. Islamic finance, given its principles of justice and fairness, also need to be inclusive, catering to the needs of all segments of society, including the poor.

In the foregoing discussion, I have mentioned some of the trends and developments that offer tremendous potential for growth in Islamic Finance. Let me now speak about some of the **key challenges** confronted by Islamic finance.

First, despite the impressive growth in various segments of Islamic finance, the size of Islamic finance in global financial assets is still trivial, by some estimates a meager 1%. Similarly, the size of the sukuk market, with USD 240 billion outstanding, is quite marginal when compared with the conventional debt securities market that has an estimated size of USD 78 trillion. Takaful or

Islamic insurance industry, is even smaller, a rather miniscule part of the global insurance industry.

These numbers suggest that notwithstanding the high growth in various segments of Islamic finance, which could be partly attributed to its lower base, the industry has not reached a critical mass yet. Total assets of the top ten Islamic banks were barely 1 % of the assets of the top ten conventional banks by end of 2010. After all, we have not seen any Islamic Citibank or JP Morgan Chase, so to speak. Even in GCC countries and Malaysia, where Islamic banks have a significant presence, their share does not exceed a third of total market share, except in Kuwait and Saudi Arabia.

So this failure to reach a critical mass coupled with a high level of fragmentation in Islamic banking has arguably led to margin erosion, denying banks an opportunity to reap the economies of scale & scope and improve operational efficiency. In fact, this fragmentation has rather increased in certain countries on the back of a growing number of Islamic banks. Further, some studies show that Islamic banks' profitability has been relatively poor, with many of the banks not 'consistently' profitable, partly because of structural factors, as products are complex and add to cost. Weaknesses in risk management and operational efficiency also play a role.

Second, and somewhat counter intuitively, despite the fragmentation in Islamic finance that I have just talked about, there is a certain type of concentration that has held the growth back. For instance, within the Islamic finance industry, assets are heavily concentrated in banks, accounting for around 83% of the industry assets. *Sukuks* make up another 12%, while the rest falls under Islamic funds and Takaful. So the structure of the Islamic finance industry is still highly bank-centric. Moreover, within Islamic banks, there is concentration in a few selected areas and products. While this pattern of concentration is not dissimilar to the overall pattern of the financial industry in the GCC and Malaysia, where Islamic finance has a stronger presence, underdevelopment of Islamic debt markets and lack of derivatives markets makes risk management a difficult task.

Third, and connected to the above point, is the issue of liquidity management. Despite significant efforts, there are still not enough rated and tradable short-term Shari'ah compliant instruments. Most of the available short-term instruments are unrated, non-tradable, or traded on a limited basis. Central banks' short-term sukuks, which could be the closest alternative, are not regularly issued in international currencies. Further, with the lack of depth and

breadth in secondary markets and amid limited opportunities for diversification, an effective portfolio management strategy is hard to implement. Recognizing these issues, the Central Bank of Kuwait, along with 10 other central banks and multilateral bodies, has played a leading role in establishing IILM--the International Islamic Liquidity Management Corporation based in Malaysia. As the IILM is expected to issue its first sukuk, we hope the problem of cross border liquidity management will be adequately resolved.

Fourth, the disparity between what Islamic financial institutions should ‘in theory’ be doing and what they do ‘in practice’ is fairly large. In terms of theory, Islamic banks should act like “pass-through” financial intermediaries, where profit or loss on the assets side is transferred to investors/depositors. Moreover, the risk sharing nature of Islamic finance prefers equity and partnership based financial instruments instead of debt based securities.

But when we look at the practice of Islamic banks, they appear quite similar to their conventional counterparts, saddled with the bulk of debt based financing. On the other hand, the share of equity and other partnership based instruments like *Musharakah* and *Mudarabah* is insignificant, which stands in sharp contrast with the true essence of Islamic banking.

What has led to this divergence in theory and practice? It is partially because Islamic banks, in an attempt to look alike, have essentially replicated the conventional model which has no place for instruments based on profit and loss sharing. But more importantly, it is quite difficult for banks to participate in any business venture without having enough expertise, given the information asymmetries involved. So some even argue that banks as financial intermediaries are ill placed to offer equity based financing. Whatever the cause, this disparity between theory and practice has made some potential customers skeptical of how closely the banks follow the true principles of Islamic finance. Moreover, it makes the link between bank financing and real economic activity weaker.

To conclude, Islamic finance has made great strides in the last decade, maturing itself from being a novelty to a material part of global finance. However, further growth would require distancing itself from mere replication of the conventional instruments and offering products which truly reflect the fundamentals of Islamic finance. This would also necessitate investment in human capital and research to help build the capacity for genuine innovation. Through codes of conduct, formal degrees and tailored certifications in Islamic finance that are

globally recognized for their rigor and quality, we can hone skills of industry participants and facilitate standardized development. By addressing the challenges noted above, Islamic finance will be able to strengthen its role in intermediation and financial inclusion, serving the entire spectrum of clientele, from sovereigns and corporates to small and medium enterprises and consumers alike.

I hope that the deliberations among industry experts and Shariah scholars during various sessions of this conference will offer valuable insights to help materialize the opportunities and address the challenges faced by Islamic finance in its quest for future growth.

Thank you all.