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**Keynote Speech by H.E. Dr. Mohammad Y. Al-Hashel**  
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Assalam-o-Alaikum! *Sabahal-khair* and a very good morning. It is a great pleasure for me to be here in Bahrain today to speak in this august forum. I am particularly thankful to H.E. Rasheed Mohammed Al-Maraj, Governor of the Central Bank of Bahrain for his kind invitation. The choice of venue for holding this World Islamic Banking Conference (WIBC) is appropriate indeed, given Bahrain's pioneering role in promoting Islamic finance. The country not only has a vibrant Islamic banking system but also houses a number of institutions that helped shape the development of Islamic finance. I would also like to congratulate WIBC for organizing this conference of great significance on the eve of their 20<sup>th</sup> anniversary celebrations.

As an industry, Islamic finance is no longer a novelty neither it is restricted to Muslim countries only. Over the last decade, the industry has transformed itself from being a niche market for devout Muslims to a viable alternative for the consumers of conventional finance, irrespective of their religious beliefs. The basic tenants of Islamic finance, like the idea of sharing profits and losses, investments only in ethically permissible areas, and the inseparable link of finance with real and productive economic activities, are understandably appealing to all. Estimates suggest that global market for Islamic financial services, as measured by Shariah compliant assets, has reached above USD 1.7 trillion by now, a quantum leap from a paltry USD 150 billion in mid 1990s. By some estimates, currently there are more than 600 Islamic financial institutions operating in 75 countries. At its current pace, the growth in Islamic finance stands sharply ahead of conventional finance which experienced significant deleveraging and slowdown in the wake of global financial crisis.

Moreover, sukuk or Islamic bond market has also leapt forward, with *sukuk* worth USD 140 billion issued during 2012 alone.

While these developments are indeed encouraging, there is no reason for complacency. The reality is, we have just passed the first phase by showing that Islamic finance is a truly viable business proposition. While the credentials of Islamic finance stand undoubtedly established, its presence yet needs to expand. After all, Islamic finance is still merely one percent of the global financial system. So it is not the end. Rather, as Churchill once said, albeit in a different context, “It is not even the beginning of the end. But it is, perhaps, the end of the beginning”.

The same could be said about the current state of Islamic finance. While we have every reason to celebrate the progress that has been made so far, we also need to recognize that we have a long journey ahead.

The next phase requires strenuous efforts to improve the capacity of all the key institutions involved in the development of Islamic finance. This applies not only to the academic, legal and regulatory bodies which have to continue to provide support and an enabling environment, but also to the Islamic Financial Institutions (IFIs) themselves. Without necessarily following a particular order, I would like to share my thoughts on each of these key institutions, assessing their progress so far and reflecting on the way ahead.

**First**, let me begin with the role of academic institutions as they are at the heart of our source of knowledge and wisdom. Conventional finance and economics has produced an enviable amount of literature for decades, comprehensively covering theoretical foundations and empirical evidence. In contrast, rigorous analytical work in the field of Islamic finance is still generally lacking. This state of affairs is partially a reflection of the subdued importance that has been ascribed to quality research, irrespective of the subject matter. No wonder that in ‘The Times World University Ranking of 2013’, not a single university from any Muslim country features among the top 200. This is truly unfortunate, given that our ancestors were pioneers in various academic disciplines ranging from alchemy to astronomy and mathematic to medicine.

Unsurprisingly, we have failed to identify and build upon even those areas of research which are inherently at the heart of Islamic finance. For instance, conventional finance theory did not formalize the importance of risk until the work of Irving Fisher in the early twentieth century. The entire foundation of Islamic finance, on the other hand, is primarily based on the premise of 'risk sharing'. If we had a vibrant culture of research at our universities, our academics would have developed these ideas much earlier than in conventional finance.

Let me acknowledge, however, that in the last two decades, considerable effort has been made to develop the theoretical foundations of Islamic finance. Still, most of this output is the result of personal dedication by a handful of scholars and not much by way of institutional efforts. But research is essentially a collaborative effort which requires the presence of appropriate incentives and adequate support. For instance, research led by Ricardo Hausmann at Harvard suggests that growth in a country is a function of knowledge—that of the society and not of individuals. So the implication is that unless we develop the institutional capacity for academic research, we would be unable to provide adequately trained human resource direly needed for further growth of Islamic finance. Barring a few notable exceptions, hardly any major university offers rigorous training in the subject, particularly at an advanced level. Similarly, we have not developed professional certification in the field that could be considered an equivalent of CFA, FRM or the likes in conventional finance. In the absence of cutting edge research in Islamic finance, we will continue to replicate the models of conventional finance.

Moreover, even in its current form, our research has generally failed to link *Fiqh with Finance*. While we have many notable scholars with profound knowledge of Islamic jurisprudence, many of them have limited exposure in modern finance. Likewise, our experts on conventional finance, in general, are poorly equipped to understand the implications of various Shariah injunctions. This dichotomy again highlights what I have mentioned earlier; a lack of capacity building at the institutional level which has led to individuals' efforts being divergent and uncoordinated. The result is a yawning gap of knowledge between two groups of experts, leaving us with only a handful of scholars who are well versed in both modern finance and *Islamic Fiqh*. It is, therefore, no

wonder that our banks struggle to find candidates for their Shariah boards who can suitably guide them in offering innovative products.

**Secondly**, I would like to talk about the legal institutions, which provide an enabling environment where Islamic finance can flourish. Let me first briefly explain why we should care about these institutions which essentially help protect property rights and enforce contracts.

Today we lament the fact that our Islamic banks appear quite similar to their conventional counterparts, saddled with bulk of debt-based financing while the share of equity and other partnership based instruments like *Musharakah* and *Mudarabah* remains negligible in their balance sheets. Although there are many reasons for this phenomenon, one potential explanation is the lack of an appropriate mechanism to enforce the contracts that ensure mutual trust. Indeed, an important puzzle in economic history is why risk-sharing methods of finance, despite their dominance for almost eight centuries, eventually lost their supremacy to debt-based financing. Some have argued that it was the deterioration in mutual trust over time which led to plummeting preference for risk-sharing finance. The significance of mutual trust, a key component of social capital, has been strongly established by research produced in the last two decades. This literature also highlights the role of appropriate institutions that help reinforce mutual trust in societies, with a particular emphasis on the institutions that help protect property rights and enforce contracts.

Given these findings, let us objectively examine where we stand at present. In the World Bank's latest ranking of 'enforcing contracts' as part of their 'Doing Business Report' of 2013, no Muslim country ranks among the top 25 in terms of contract enforcement. While global rankings have their own limitations, these findings underscore the need for strengthening our legal environment. Hernando de Soto, a Peruvian economist emphatically wrote about the countries with poor legal infrastructure arguing that: "*...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 contends that in the absence of effective legal institutions, inhabitants of such countries are just custodian of '*dead capital*'—'dead' because while they may own plenty of resources, either they can't prove legal

ownership or can't efficiently use them in various transactions, given the poor legal framework.

The upshot is that unless we create a legal environment that helps promote risk-sharing finance by reinforcing mutual trust, the practice of Islamic finance is unlikely to converge towards its theoretical foundations.

**Thirdly**, I would like to discuss the institutions that provide an enabling regulatory environment. Effective regulation of Islamic finance is a daunting task, particularly in the dual banking model where both Islamic and conventional institutions co-exist. Additionally, the peculiar nature of Islamic finance poses its own challenges in terms of designing a robust regulatory regime.

Positively, the coordination among regulators of Islamic finance has helped establish key institutions of Islamic financial architecture like the Islamic Financial Services Board (IFSB), the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and the International Islamic Liquidity Management Corporation (IILM).

The AAOIFI has endeavored in the last two decades to set accounting standards for IFIs that are in line with global norms like the IFRS. Additionally, the IFSB has, for the last 11 years, aimed to provide prudential norms for the industry by suitably tailoring international best practices for IFIs. And the IILM, in August this year, debuted its first issuance of sukuks worth \$490 million which were fully subscribed. Admittedly, this is just the start of providing highly liquid, investment-grade financial instruments that Islamic banks urgently need to more effectively manage their liquidity flows.

However, as industry expands and Islamic banks converge to their theoretical foundations, the unique requirements of Islamic finance would necessitate a more robust regulatory response than a mere tweaking of existing regulations. Furthermore, as Islamic banks continue to expand beyond domestic borders, collaboration between supervisors across the countries would assume greater significance. So the capacity of regulators in effectively supervising the increasingly complex and larger IFIs would be tested as the industry prepares itself for the next phase of growth. Performance of the industry since the global

financial crisis suggests that regulators have been generally successful in insulating IFIs from the shocks of financial meltdown, though second-round effects of the crisis have exposed higher concentration of risk among IFIs in certain countries.

**Lastly**, let me turn to the Islamic Financial Institutions, which are at the heart of this entire discussion. It is truly commendable that Islamic banks have successfully served millions of customers across Middle East, South-East Asia and beyond, offering variety of Shariah compliant products. Yet significant challenges remain.

Let us reconsider the growth numbers which I mentioned earlier. As we all know, part of the growth story is simple math—starting from very low base, growth is bound to be somewhat higher. But, in absolute terms, the share of Islamic finance in global financial assets is still small, barely around 1%. Moreover, Islamic banking market remains fragmented; the total assets of top ten Islamic banks were only 1 % of the asset of top ten conventional banks by end of 2010. After all, in terms of scale, we have not seen any Islamic Citibank or JP Morgan Chase, so to speak. Similarly, the size of the *sukuk* market with USD 237 billion outstanding is quite marginal, compared to a market of USD 78 trillion for conventional debt securities. Takaful, or Islamic insurance industry, is even smaller, representing a minor percentage of the global insurance industry.

Let us also examine the choices that our consumers are making. Industry statistics show that wherever Islamic banks co-exist with their conventional counterparts, it is still not a choice of majority in any Muslim country. To put it simply, no Muslim country with dual banking system has the share of its Islamic banks above 50%. One potential answer is perhaps that Islamic banks, in a race to mimic conventional model, have become so similar that consumers hardly notice the difference and are thus disinclined to switch over.

Moreover, it seems that Islamic banks are being content with serving the ‘high-end’ customers while a vast majority, particularly at the lower rung of the income ladder, remains grossly under-served— if not completely ignored. The World Bank’s data on financial inclusion for 2012 reveals that only 24% of the adult population has a bank account in South Asia, home to more than 700

million Muslims. Another survey, conducted in 2007 by Consultative Group to Assist the Poor (CGAP), an independent research center, revealed that in 19 Muslim countries, Islamic microfinance has a total estimated global outreach of only 380,000 customers, accounting for merely 0.5% of total microfinance outreach. These numbers collectively highlight that despite impressive growth, Islamic banks yet to reach out to millions. 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 exploitive informal money lenders.

Connected to above discussion is the need for promoting genuine innovation at IFIs. This can only be achieved if IFIs earmark considerable resources for rigorous research, working in liaison with the academic world. Leadership in business will remain a distant dream until IFIs establish their thought leadership first, which inevitably requires a vibrant culture for research and innovation.

**To conclude**, Islamic finance has made significant progress by successfully completing the first phase of its operations. But to grow further, while remaining true to the essence of Shariah, concerted efforts are required on part of all key institutions, ranging from academia to regulatory bodies and the IFIs themselves.

Developments in the last few years have brought to light the inherent instability of conventional finance. Additionally, the unfolding of events like rigging of the LIBOR and miss-selling of mortgages has intensified the debate about the role of incentive structures and ethics. In these testing times, the expansion of Islamic finance has the potential to offer an alternative model—a model that is ethically right, socially just, and economically productive.

I hope that the deliberations among industry experts and Shariah scholars during various sessions of this conference will offer valuable insights in addressing the issues I briefly highlighted today.

Thank you very much.