

## **Islamic Financial Industry: Facts and Challenges**

### **Kuwait's Experience**

**Distinguished Audience,**

I would like first, to thank the Central Bank of Oman and his Excellency the CEO of the CBO for their kind invitation, to join you in this significant event attended by prominent figures in the field of Islamic Financial Industry, and for the opportunity to address the facts and challenges of this industry and shed light on Kuwait's own experience in this area.

I would like also to avail myself of this opportunity to congratulate the Sultanate of Oman for launching the legislative and supervision regulation of Islamic banking activities towards the structural enhancement of this industry.

\* Speech of His Excellency, Governor of Central Bank of Kuwait, Dr. Mohammad Y. Al-Hashel, Oman 2<sup>nd</sup>. Islamic Banking and Finance Conference, held in Muscat - Oman, on 17,18 March 2013.

**Dear Colleagues,**

Islamic Financial Industry has already, successfully, passed the launching phase towards wider regional and international ranges. This success is obviously reflected by actual facts and practices. Islamic Financial Industry now has its own tangible worldwide presence on the banking and financial map. This significant presence can be easily noticed by the accelerating numbers of Islamic banking and financial institutions reaching 600, of around \$ 1.6 trillion at the end of Dec. 2012 (against \$ 1.3 trillion at the end of 2011). \*\*

Moreover, Islamic Financial Industry has enormous potentials for further growth and development. However, a number of present and future difficulties are still to be resolved in order to insure the targeted prosperity and sustained balanced growth.

Global events over the last years, necessitated our deep contemplation of the consequences of the financial economic global crisis of 2008, and of its present and future repercussions on the Islamic Financial Industry. We had, also, to learn from this crisis and its impact on the various challenges confronting this industry, noting that the crisis has deepened the pre-crisis challenges which were deemed to be normal considering the novelty of the Islamic Financial Industry.

\*\* Reference: Baytak Research Company.

Worth mentioning is that, the global crunch has drawn the attention of many international institutions and other concerned and specialized parties, to the need to review the global financial system. Hence, Islamic Financial Services Industry emerged as one of the potential alternatives that could possibly resolve the financial issues and prevent similar future crises.

In my opinion, the current situations still embody an appropriate opportunity for the Islamic Financial Industry, to demonstrate its competency and worthiness of the world's approval. This industry needs to validate its potentials through effective financial tools and products that are carefully structured and designed to have the added value, which would easily attract the concerned parties and investors, on the one hand, and act as the convenient replacement of the conventional financial instruments and products, on the other. This appropriate opportunity should make us intensify and speed up the current research and innovation activities carried out by a number of concerned parties in the area of risk management, deemed as one of the most serious difficulties confronting Islamic Financial Industry, given its weak measuring tools of risk management which is attributed to the lack of sufficient tools and expertise, compared with the conventional ones. In other words, it is the responsibility of Islamic financial institutions to develop the risk management and interior supervision systems, and adopt wise policies in terms of money markets and financial activities.

In the context of the lessons learned, it is necessary to point out the significance of the role that should be performed by the supervisory authorities through reasonable supervision of Islamic Financial Industry's institutions, while insuring adequate regulations for this important and relatively new sector. Due attention should be given to insure sound sufficient risk management and interior supervision systems of Islamic institutions, including developing the methods applied in risk monitoring and assessment, particularly the stress test methods intended to measure banks' capabilities to face future crises, which takes into account the particulars of Islamic banking activities and the risks involved, such as the risks resulting from operating in accordance with the provisions of the Islamic Sharia. Emphasize should also include the need for developed governance standards, which represent one of the priorities of economic departments in various parts of the world, as has proven by the consequences of the said global financial and economic crisis.

Moody's Corporation has demonstrated, in its analytical report - published in 2009, titled "The Liquidity/Leverage Trade – off for Islamic Banks, and its Impact on their Ratings" that the relatively low ratings of Islamic banks' financial influence, compared with other banks, were mostly attributed to the weak policies of assets and liabilities management, weak governance factors, and deficiency of risk management policies. In my opinion, the report was absolutely correct, for those issues still do exist.

Moreover, we need to adopt reliable early warning systems that enable us face any risks at the institutional and the general levels. This can only be

possible through studies addressing the developments in the macroeconomic indicators and their impact on financial stability, and linking such studies with the system applied.

Yet, another serious challenge is the deficiency in developing adequate Islamic markets for the financial and cash instruments issued by private and public institutions operating in accordance with the provisions of the Islamic Sharia, particularly active flexible liquidity markets that allow Islamic financial institutions and supervisory authorities to use it at the institutional and the general levels, in the context of liquidity management and attracting investors.

There is also a lack of capital structure instruments that can be used as subsidiary financing resource for Islamic banks and financial institutions, especially when it is not possible to increase capital through shares subscription, as is the case with the current global financial and economic crisis.

Despite the encouraging growth signs of Islamic Sukuk markets, reflected by the increasing volume of issued Islamic Sukuk to around \$ 131 billion during 2012 (against around \$ 85.1 billion in 2011) amounting to around \$229.4 billion at the end of 2012, quality Sukuk, mostly government Sukuk, are attracting the vast majority of investors and concerned parties, unlike Islamic banks and financial institutions, which are hence, obliged to

maintain high cash reserves entailing negative impact on their profitability and growth. Furthermore, Sukuk of those institutions are inactive in subsidiary markets as they are usually purchased for investment purposes or kept until maturity date.

It goes without saying, that such deficiency of Islamic financial instruments embodies one of the most urgent challenges facing Islamic banks in terms of fulfilling liquidity and other reform requirements of Basel III.

Worth mentioning is that, some of the challenges that are still hindering the Islamic financial industry are partially related to the need for a legislative and supervisory regulation that can define the framework of this industry's institutions on sound basis, taking into account the nature of their work and the supervisory methods. Likewise, there is an urgent obligation to train and qualify sufficient staff for this field, in order to avoid any potential shortages. Due attention should also be given to insuring adequate qualified legal supervisory staff for those institutions.

I would like in this respect, to express my appreciation of the persistent efforts made at all levels by the institutions embodying the basic structure of the Islamic Financial Industry, the supervisory authorities, and the banking and financial institutions for confronting those challenges and providing the influential basis for this industry. However, there is still much work to do in terms of research , development and innovation, being the driving force for

any entity towards upgrading its economic competency aiming to maintain this industry's accomplishments and insure its sustainable and balanced growth, targeting the world's approval and the compatible integration within the global financial system.

### **Distinguished Audience,**

I would like now to shed light on Kuwait's own experience with Islamic financing industry and its developments. Kuwait has, undoubtedly, been one of the pioneer countries in Islamic banking activities. The first Islamic bank -Kuwait Finance House- was established in 1977. Islamic finance institutions consist of investment banks and companies operating in accordance with the provisions of the Islamic Sharia, comprising five Islamic banks listed with the Central Bank of Kuwait -two of which were converted from conventional to Islamic banks- and one foreign Islamic bank, in addition to investment companies operating in accordance with the provisions of the Islamic Sharia ( they don't deal with deposits). Those companies have grown to (51 companies) during the last decade, of a total of (93) companies in the state of Kuwait, noting that Islamic finance activity is basically concentrated in Islamic banks, accounting for 96.5% of total financing as at the end of Dec. 2012.

There are in Kuwait now (106) investment funds, (54) of which operate in accordance with the provisions of the Islamic Sharia.

Total assets of Islamic banks and investment companies in Kuwait amounted to around KD 22.3 billion (equivalent to around \$ 78.6 billion) i.e. 37.7% of total domestic banking and financial market at the end of Dec. 2012, against around KD 18 billion (equivalent to around \$ 63.2 billion) i.e. 32.1% of total market at the end of Dec. 2008. Financing extended by those institutions amounted to around KD10 billion (equivalent to around \$35.3 billion) i.e. 35% of total financing by domestic banking and financial sector at the end of Dec.2012, against around KD7.1 billion (equivalent to around \$24.9 billion) i.e. 26.2% of total domestic financing at the end of Dec. 2008. Islamic banks accounted for 35.9% of total deposits with the domestic banking system at the end of Dec. 2012, as KD deposits amounted to around KD12.3 billion (equivalent to around \$43.4 billion) against 25% and around KD6.9 billion (equivalent to around \$24.3 billion) respectively, at the end of Dec. 2008.

The mentioned indicators reflect the proven successes of the Islamic financial industry in Kuwait. Over the relatively few past years, the number of financial institutions and their market shares have largely accelerated by all measures, assets volume, financing volume and balance of deposits with Islamic banks as earlier mentioned, and have become a cornerstone in the Kuwaiti economy and a significant resource for banking and financial activity in the state of Kuwait.

This success is attributed to a number of factors, most importantly, the adopted legislations and regulations which provided the competitive



environment and made space for new banks towards further competitiveness, and the financial institutions' efforts, particularly Islamic banks, aiming at developing their strategies and improving their performance, services and products to meet present and future requirements, while paying more attention to modern methods of banking and financial activity, in addition to the CBK's role pertaining to controlling and supervising the institutions and activities of this industry.

The CBK took interest in the legislative regulation of Islamic financing activities since the early 90s, following the establishment of a number of investment companies operating in accordance with the provisions of the Islamic sharia and supervised by the CBK. Kuwait Finance House was already operating in the market, however, it wasn't yet supervised by the CBK. In view of the increasing demand on products and services of Islamic banks, the need for the completion of banking legislations became quite urgent, in order to regulate banking activities and licensing new Islamic banks, to enhance competitiveness of Islamic banking services' market. Hence, law No.32/1968 concerning currency, CBK and banking regulation was amended by the issuance of law No.30/2003 which included Islamic banks.

Key points of this law are:

- 1- Regulate Islamic banks activities on sound basis taking in consideration the nature of their activities, and provision of necessary legal instruments for the oversight of banks.

- 2- Perform Islamic banking activities through institutions of independent legal and financial entity. Those activities are not permitted through windows or branches at conventional banks, in order to avoid money mixing.
- 3- Conventional banks are permitted to convert to Islamic banking activities by following the terms and conditions set by the CBK. Two conventional banks have completely converted to Islamic banking activities as per the CBK's terms and conditions.
- 4- Legal supervision is, basically, the responsibility of the legal supervisory authority of each bank. CBK's responsibility is to insure banks' commitment to submit all policies and products to the legal supervisory authority, and confirm banks adherence with issued decisions and fatawa, through onsite inspections, in addition to the auditor of accounts' role in this regard.

A major development in the legislative structure was the issuance of law No.7/2010 regarding the establishment of Capital Market Authority and regulating securities' activity, aiming at developing the (conventional and Islamic) instruments and institutions and regulating Kuwait's capital market, in accordance with the international standards applied, under the supervision of Capital Market Authority. In view of the new regulating framework, conventional and Islamic investment funds and companies are now supervised by the CMA. Whereas, the CBK's supervisory role regarding those companies, is limited to their financing activities. A new corporate legislation has

been lately issued, to replace the law issued in 1960, allowing companies to issue financial instruments (Sukuk) in accordance with the provisions of Islamic sharia, and establishment of new companies of specific purpose as per the requirements of Islamic (Sukuk) issuance.

Undoubtedly, the new regulation will positively affect the capital market of Kuwait and lead to the enhancement of instruments and performance of its conventional and Islamic institutions. We hope that it will pay-off in the near future.

The supervisory framework designed by the CBK for Islamic banks, took in consideration the applied international standards of banking activity, while maintained consistency with the ongoing development and dynamism of this industry in terms of innovation and high growth rates. Worth noting is that, the amended standard of Basel II regarding capital adequacy, became effective to Islamic banks as of 30.6.2009. The said standard, aims at urging Islamic banks to adopt the best practices related to various risks management and control. This standard also considers the general basis of Basel II amending the frame of capital adequacy in a way that doesn't contradict Islamic banks' activities, taking into account risk weights in the items concerning those banks, in accordance with the standards and guidelines issued by the Islamic Financial Services Board "IFSB".

The CBK has taken many measures towards boosting control on conventional and Islamic banks' activity, particularly, risk

management, through developing several methodologies applied in monitoring and assessing bank risks, emphasizing the importance of internal capital adequacy assessment process, providing banks with comprehensive guidelines on financial semi-annual stress tests, and adopting risk based supervision, in addition to keeping pace with international governance standards.

In the context of its efforts towards the application of international supervisory standards, immune the banking sector and boosting its ability to absorb economic shocks, the CBK is currently paving the way to introduce the supervisory standards of Basel III to conventional and Islamic banks.

Furthermore, the CBK applies wise whole and partial supervisory policies on conventional and Islamic units within an early warning system against systemic risks that may threaten the financial stability.

To conclude, I believe that Islamic industry future in Kuwait is very promising following the largely established regulatory and supervisory framework. Islamic industry's presence and development have become tangibly organized in terms of number of institutions and volume of market activity. It has become an effective resource of actual banking activity with a noticeable role in the economic and social development in the State of Kuwait.

Thank you for your attention.

17 March 2013