

Keynote Address:

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## **G20 Global Islamic Finance Conference: Benefits and Challenges** **Regulatory Challenges and Kuwait's Experience**

### **1. Introduction**

*Excellencies, Distinguished Guests, Ladies & gentlemen,*

السلام عليكم ورحمة الله وبركاته and a very good morning to all of you.

I would like to take this opportunity to thank Governor Basci for his kind invitation to deliver a keynote address in this conference. I am honored to have this opportunity of sharing my thoughts with such a distinguished audience.

The post-financial crisis era has brought to the forefront a range of regulatory issues concerning the stability of financial systems across the globe. Rising to this challenge, the international community, including the G-20 and the Financial Stability Board (FSB), has made concerted efforts to reform the international regulatory and financial architecture with an aim to improve its resilience and safeguard its stability. As a result, we have witnessed wide ranging reforms in the last few years.

In the case of Islamic financial institutions (IFIs), ensuring effective regulation has been particularly challenging, as I will shortly highlight in my remarks. In particular, regulators of IFIs face two distinct kinds of challenges - **foundational** and **evolving**.

### **2. Foundational regulatory challenges**

Let me start by briefly pointing out the regulatory challenges that are foundational in nature, as failure to address them would compromise the very survival of Islamic finance. Since a lot has been said about these issues at many forums, I will keep this discussion short and will cover these foundational issues only for the sake of completeness.

Promoting Islamic finance as a viable and competitive component of the overall financial system requires an enabling supervisory, regulatory and legal environment. The pillars of a well-functioning Islamic financial system include a sound financial system infrastructure, as well as regulatory and supervisory regimes (such as licensing, prudential regulation etc.), a suitable accounting and auditing framework and supportive legal and financial market infrastructures.

In a sense, these elements can also be viewed as pre-requisites for Islamic finance. Based on the industry's specific features, needs and risks, the development of the Islamic financial sector requires a supporting legal infrastructure, a systemic liquidity infrastructure as well as transparency, governance, and information infrastructures. Therefore, supporting laws and regulations, dispute resolution framework and *Shari`ah* governance regimes are necessary for the development of Islamic finance. It goes without saying that effective supervision, a strong *Shari`ah* framework and an efficient judicial system will promote confidence and ensure soundness in the Islamic financial system.

To achieve these objectives, serious efforts to improve the capacity of regulators and policy makers are required. Without such capacity building, a sound regulatory regime for Islamic financial institutions cannot be put in place.

I believe that regulators are well aware of these issues, and given the impressive growth of Islamic finance in many countries, it is obvious that regulators have taken serious steps in addressing these challenges upfront. However, improving legal and regulatory regimes is a continuous process and changing industry needs and economic environments necessitate regular fine-tuning of existing frameworks.

### **3. Evolving Regulatory Challenges**

In addition to the foundational issues I have just highlighted, we also face a number of regulatory challenges that are more evolving in nature, such as (i) ensuring a level playing field; (ii) implementing Basel III reforms; (iii) complementing micro with macro-prudential regulations; (iv) cross-sector and cross-border supervision; and (v) safety-nets and resolution regimes. While this list of challenges is not meant to be exhaustive, I believe they are possibly the most significant five issues that we face as regulators of Islamic financial institutions. Addressing these issues would not only resolve specific aspects of Islamic finance, but would also strengthen the foundational supervisory framework. Accordingly, my remarks will be focused on these evolving issues in particular.

#### **3.1 Ensuring a level playing field**

First, consider the issue of ensuring a level playing field.

Islamic finance is mostly present in a dual-banking system, which requires regulators to ensure a level playing field so that the Islamic financial institutions are not at a comparative disadvantage.

On the basis of 'principle of proportionality', it has been argued that Islamic banks may be given some relief in regulatory requirements because they are relatively new entrants in many jurisdictions and have smaller size, at least in the overall financial system if not individually. I must add that the principle of proportionality does not advocate that we should exempt a bank from its legal obligations; it only suggests a proportionate application of the rules in line with size and complexity of the institution.

Yet proportionate application of rules requires a certain degree of supervisory discretion. In order to exercise such discretion in a prudent and objective way, regulators need to fully understand the unique risks of Islamic banks. But this is a major challenge for supervisors, as availability of data and relevant research is fairly limited when it comes to Islamic finance.

In the case of Kuwait, Islamic banks make up around 39% of the overall banking system. This is the second highest share of Islamic banks in any country with a dual banking system –i.e. where Islamic banks operate in parallel with conventional banks. The strong presence of Islamic banks in Kuwait underscores the effectiveness of CBK’s endeavors in ensuring a level playing field for both types of banks and also provides customers a variety of choices to fulfill their banking needs.

In order to ensure a level playing field for Islamic banks, we have put in place enabling legal and supervisory framework and have provided *Shari`ah*-compliant liquidity management tools. Let me quote some specific measures that we have taken in these areas.

- I. To provide an adequate legal basis, we have added a special section of legislation on Islamic banks to the third chapter of Law No. 32 of 1968, which provides the CBK with the required legal underpinnings for establishing prudent regulatory and supervisory policies and controls for Islamic banks in our jurisdiction, consistent with relevant international standards.
- II. To ensure consistent supervisory approaches, we have prepared a comprehensive regulatory and supervisory manual for Islamic banks, containing a detailed set of policies, standards, controls and instructions. Moreover, we have ensured that the recent regulatory reforms are consistent with, and drawn from, the prudential framework of the Basel Committee on Banking Supervision (BCBS) and the Islamic Financial Services Board (IFSB), to provide level playing fields in the industry. For instance, among others, Basel III regulatory reforms such as capital, leverage and Liquidity Coverage Ratio (LCR), have been issued separately for conventional banks and Islamic banks after extensive dialogue with local and international stakeholders. Relevant ‘fit and proper criteria’ for corporate governance have also been issued in line with the specific needs of Islamic Banks.
- III. For *Shari`ah*-compliant liquidity management, we have made efforts to provide equal investment opportunities to Islamic banks in their day-to-day operations by conducting monetary operations using *Shari`ah*-compliant instruments. Moreover, to ensure availability of liquidity to Islamic banks in times of stress, we have also put in place a *Shari`ah*-compliant lender-of-last-resort (LOLR) facility.

### 3.2 Implementing Basel III Reforms

Second, let me highlight the challenge of implementing Basel III reforms, or the equivalent regulations issued by the IFSB. Here I am referring to Basel III just as the most recent example. In the broader context, the challenge of implementing global regulatory reforms is permanently there. Only the nature of this challenge has evolved as we have moved from Basel I to II, and now to III.

We are well aware that in the case of Basel III reforms, sufficient guidance is available when it comes to its implementation in conventional settings. However, for Islamic financial institutions, limited equivalent guidance is available, if at all. For the most challenging aspects of Basel III reforms, even the *BCBS* has virtually left it to the discretion of individual regulators to figure out how best to apply the proposed rules to Islamic banks.

This undoubtedly requires the use of discretion by regulators. But the use of discretion is bound to create differences across countries, and more so in the case of Islamic finance where the lack of consistency in *Shari`ah* interpretations makes the task even harder. While the global regulatory reforms have been meant to streamline regulations across the countries (with the potential outcome of greater convergence in regulatory regimes), the increasing use of discretion is likely to move us in exactly the opposite direction. We may witness diverging approaches to regulation of Islamic banks across jurisdictions, with the consequent risk of regulatory arbitrage.

Apart from these broader concerns, let me also point out a few of the practical issues in the case of capital and liquidity regulations under Basel III.

In the context of capital framework, while the new regulations have helped increase the quality, quantity, consistency and transparency of the capital base, we face some specific regulatory issues:

- First, meeting *Shari`ah* requirements for Additional Tier 1 and Tier 2 capital instruments by the Islamic banks is a major consideration for supervisors. Therefore, clarification and guidance is needed from national regulators regarding the instruments that are eligible for treatment as additional Tier 1 and Tier 2 capital.
- Second, issuance of new capital instruments under *Shari`ah*-compliant securitization has important implications for local currency debt markets/capital market activities. In particular, better coordination with other supervisory authorities on prudential treatment of such activities is required.

In the case of liquidity coverage ratio (i.e. LCR) related regulations:

- First, availability of *Shari`ah*-compliant High Quality Liquid Assets (HQLA) that can meet Basel III/IFSB's stringent requirements is a major issue. This tends to force many Islamic banks to hold a higher share of cash, thus negatively affecting their profitability. Moreover, trading in these instruments is limited as banks prefer to hold these instruments to maturity. The International Islamic Liquidity Management

Corporation (IILM) is positioned to play a major role in addressing the shortage of short-term HQLA.

- Second, the implementation of effective HQLA requires addressing other supportive liquidity and legal infrastructure such as: (i) developing the interbank market (ii) deepening funding and market liquidity through the availability of short-term and long-term liquid Islamic debt instruments, and (iii) establishing safety nets – such as *Shari`ah*-compliant Deposit Insurance and *Shari`ah*-compliant LOLR arrangements. I will discuss safety nets separately in a moment.

### 3.3 Complementing Micro with Macro-prudential Regulations

Third, we face the issue of how best to complement our existing micro-prudential framework with macro-prudential regulations.

The global financial crisis of 2007-08 has taught us that ensuring soundness of individual institutions does not by itself guarantee the stability of the overall financial system - thus requiring supervisors to complement micro-prudential supervision with macro-prudential measures designed to address 'systemic risk'. Whilst micro and macro-prudential policies share a number of instruments, they have a different, albeit *related* focus. Micro-prudential measures are aimed towards the soundness of individual financial institutions, while macro-prudential measures essentially help secure the safety of the financial system as a whole by preventing and mitigating systemic risks.

Proper application of macro-prudential policy is in itself a challenge even in conventional finance. When it comes to Islamic finance, we have very limited understanding of which tools would work best and under what conditions. In a dual banking system where both conventional and Islamic banks operate side by side, we still have scant understanding of how best to structure the macro-prudential policy framework for measuring and monitoring systemic risk. Equally important and challenging is the identification and calibration of tools and instruments suitable for Islamic banks.

While the research produced by the FSB, the International Monetary Fund (IMF) and other bodies can serve as a useful guidance, substantial work is required to adequately modify instruments that cater to specific local requirements and unique risks faced by Islamic banks.

In the case of Kuwait, we experienced these challenges on a practical level when we introduced measures to make debt servicing of the household sector more transparent, with the aim to help consumers make more informed decisions. In the case of conventional banks, it was fairly straightforward for them to provide the details of debt servicing to their customers. However, in order to apply the same rules to Islamic banks, we had to discuss with banks' *Shari`ah* boards to find a middle ground where transparency can be ensured but without compromising on the *Shari`ah* requirements of Islamic banks.

### **3.4 Cross-sector and Cross-border supervision**

The fourth key challenge is to ensure effective cross-sector and cross-border supervision.

A dual banking system with a sizeable Islamic banking component already complicates the job of the regulators in supervising two set of banking institutions with different risk characteristics. And regulators face additional challenges in ensuring a consistent regulatory regime with regards to other institutions such as non-bank financial entities.

A case in point is the supervision of financial conglomerates. Adopting a cross-sectoral regulatory and supervisory approach for Islamic banks is necessary to ensure effective oversight. Islamic banks may have a range of activities (e.g. restricted investment account holders fund management and *Takāful* by a banking group) that cross supervisory boundaries. Thus the supervisory authority must be able to assess the risks on a consolidated basis.

In jurisdictions where these activities are supervised by separate regulatory entities, there is strong need for close cooperation between supervisory authorities. To facilitate coordination between the authorities, frequent dialogues or memoranda of understanding may be needed to clearly establish their respective roles and responsibilities.

For unregulated entities (e.g. hedge funds, leasing, SPV, or factoring companies) and/or non-financial entities that are subsidiaries of a regulated IFI, the authority supervising the parent IFI should be in a position to assess whether the risks are being transferred from regulated to unregulated entities, or vice versa.

Although achieving coordination among different regulators within a jurisdiction is difficult, it becomes particularly challenging when regulators across the countries are involved. However, without effective coordination among regulators across jurisdictions, the risk of contagion remains significant as Islamic financial institutions have significant cross-border exposures. And with the growing trend of cross-border operations by Islamic banks, there is a strong need for cooperation between regulators to contain the risk of contagion across borders.

### **3.5 Safety-Nets and Resolution Regimes**

This brings me to the fifth key challenge of putting in place appropriate safety-nets and resolution regimes.

The set of measures that I discussed earlier, such as implementation of Basel III or macroprudential policy etc., are essentially measures of a preventive nature which would hopefully make our financial system more stable and resilient.

Though supervisors should ideally identify and mitigate risks before they materialize, no financial system can be fully immune from the possibility of facing a crisis. In the case of any serious financial turmoil, whether at the individual banks' level or at the level of the whole industry, the presence of essential safety nets will help contain the spillovers to other institutions.

For instance, to better handle situations of liquidity stress, or even failure, of an Islamic bank, it is essential to have an appropriate level of systemic protection in the form of safety-nets such as *Shari`ab*-compliant Deposit Insurance Schemes (SCDIS) and *Shari`ab*-compliant Lender-of-Last Resort (SLOLR) facilities. However, in the case of Islamic finance, safety nets and resolution frameworks remain significantly underdeveloped. Only a few countries with Islamic banks have put in place SCDIS and SLOLR facilities.

Regarding the SLOLR, the main challenge for supervisors is to set out clear procedures under which the central bank would act as an LOLR. Another key issue for supervisors is to identify the appropriate *Shari`ab*-compliant financial contract that should be employed to provide emergency liquidity assistance to Islamic financial institutions.

In the case of SCDIS, while the conventional deposit insurance system has been established in many jurisdictions, the business model of IFIs calls for certain adjustments in the way such a scheme should be structured and operationalized. For instance, designing appropriate protection for fund providers, mainly Profit Sharing Investment Account holders (i.e. PSIA) would require careful consideration of *Shari`ab* issues.

Designing such safety nets requires designing instrument that ensure level playing field and preserve the originality of Islamic finance. In Kuwait, we have developed specific instruments for SLOLR, and a list of *Shari`ab*-compliant high quality assets which can serve as a collateral for SLOLR. We are also working on the SCDIS.

Notwithstanding the presence of essential safety nets banks can, and do, fail. In such cases, while the SCDIS would cover small depositors, effective resolution regimes would enable other creditors (large depositors, shareholders etc.) to recover their funds through an efficient liquidation process. To develop effective resolution framework for Islamic banks, we need to bear in mind that:

- Stages and processes in crisis management may not adhere to *Shari`ab* rules and requirements as no clear precedent is available for such a framework for Islamic banks.
- There are different interpretations of *Shari`ab* rules and principles across jurisdictions including a *Shari`ab*-compliant view on transfer of ownership of receivables.
- There are issues in priority of claims due to the specific nature of contracts in Islamic finance, including the position of PSIA during insolvency proceeding.

Therefore, in order to effectively handle cross-border insolvency of an IFI:

- IFIs, on their part, should develop contingency funding as well as recovery plans, which should be subject to the critical assessment of supervisors as part of their on-going supervision, and
- Supervisors need to develop mechanisms for information sharing and cooperation with other authorities, both domestic and cross-border, to coordinate an orderly restructuring or resolution of a troubled IFI.

#### 4. Concluding remarks

Let me conclude with a few final thoughts.

In order to effectively address our evolving regulatory challenges going forward:

- First, we need to **strengthen our regulatory capabilities** by increasing our focus on high quality research, particularly on issues related to Islamic financial institutions to better design our regulations. At the same time, high priority also needs to be placed on building regulatory capabilities so that we are able to ensure that the presence of Islamic financial institutions strengthens the resilience and stability of the overall financial system. We should also continue our efforts in refining and improving the regulatory frameworks for Islamic financial institutions in line with the recommendations of both the BCBS and the IFSB.
- Second, we should **strive for convergence in regulatory regimes**. While the use of discretion is understandable in ensuring that regulations take into account the unique characteristics of Islamic financial institutions, leaving all key decisions to regulatory discretion would create divergence across jurisdictions. To avoid the risk of increasing divergence across jurisdictions and to mitigate the potential for regulatory arbitrage, regulators need to develop some broader consensus on how best and when to use discretion. Today's conference is one such valuable forum; likewise, the IFSB also offers a regular platform to discuss such issues and build consensus.
- Lastly, we should **work collectively and learn from the regulatory experiences of other countries**. While each country is unique, a lot could be gained from others' experiences. Therefore, it is essential that we benefit from the collective wisdom of the regulators in different jurisdictions.

While I have highlighted what I believe to be some of the key issues in my remarks, I am positive that we would have the opportunity later today for a detailed discussion on some of these aspects. I look forward to the valuable insights of the academic scholars and industry experts in the coming sessions.

Thank you for your attention.

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