Development & Integration of Islamic Finance

I am honored to address such a adistinguished gathering of policy makers, practitioners, and academics. I would like to express my thanks and appreciation to "MEGA" Middle East Global Advisors, the organizers of this event, for selecting the State of Kuwait as the venue for this important conference. In my opening remarks, however, I will touch upon certain aspects of development and integration of Islamic finance. Let me first begin with a brief focus on the development of Islamic finance in the State of Kuwait.

We are among those who have had pioneering experience in this field. Islamic finance in Kuwait dates back to 1977 when the first Islamic bank, the Kuwait Finance House, was established. Islamic finance institutions (IFIs) in Kuwait now consist of two Islamic banks and 31 Islamic investment companies with a combined market share of more than 26% of the domestic banking and financial sector. They also manage an additional 11% of total off-balance sheet accounts in that sector. One more Islamic bank is in the pipeline and will soon enter the market. It is a conventional bank converting into an Islamic bank.

While an increase in the number of Islamic banks enhances competition in the local banking market, the current number of Islamic investment companies is perhaps disproportionate. This does not mean that the Central Bank of Kuwait

(CBK) will stop licensing new Islamic investment companies, but rather it reflects the CBK's view that the market may have become saturated, and the CBK encourages consolidation by local and cross-border mergers and acquisitions, which also reinforces integration on domestic and regional levels.

From a supervisory point of view, the Central Bank of Kuwait (CBK) has been involved in the regulation of Islamic finance since the early 1990's, when several Islamic investment companies were established under its supervision. Moreover the CBK sought a legislative framework to establish prudent regulatory and supervisory policies and procedures for Islamic finance in general and Islamic banking in particular. This was accomplished, after considerable efforts and a long-drawn-out process, when the National Assembly finally enacted the initial CBK draft Law No. 30 of 2003, adding a special section on Islamic banks to Law No. 32 of 1968 concerning currency, the Central Bank of Kuwait, and the organization of banking business.

This legislation enabled the CBK to bring Islamic banking, which had not been regulated for 16 years until then, into its supervisory fold. It also allowed more Islamic banks to be established, and the CBK to formally develop its supervisory framework concerning Islamic banking in Kuwait in conformity with international best practices and standards for conventional finance, with adaptations to suit the Islamic finance business. This framework is flexible and responsive to innovations and the dynamic nature of this business.

The growth of the Islamic finance industry in Kuwait so far has only been possible with the help of creativity and innovation, and I believe that your discussions and deliberations hopefully will help in availing the opportunities of further growth.

Let me now touch on the core of the main issues related to the subject of this conference.

We have all seen the remarkable developments in the Islamic finance industry. The phenomenal double-digit growth during the past decade or so by this young industry shows its enormous potentialities for further growth and development in the future. These potentialities did not escape the sharp eyes of international financial institutions and their regulators. Islamic finance is now an unmistakable presence in the global arena, and is emerging as a major source of wealth creation and an attractive vehicle for investment. Not only has Islamic finance gained strong footholds in major financial centers of the world, but it is also assuming increasing importance within mainstream international finance.

While IFIs are growing in number and carving out larger slices of their OIC-based home financial markets, and are attempting to proliferate in the international financial markets to meet the growing global demand for Islamic finance, we have seen that an increasing number of multi-national banks and financial institutions, being unable to ignore or resist this important growing business, are tapping into investor demand for Sharia-compliant products. For this purpose, they are using either their "Islamic windows" or fully-fledged Islamic finance units.

The world interest in Islamic finance is not limited only to international financial institutions eager to profit from this lucrative Islamic finance business, but in fact, some international financial centers are now competing to attract Islamic finance business and serve as a hub for it. Recently, UK regulators has taken some initiatives to introduce and to attract the business of issuing Sharia-compliant products such as Islamic bonds, or, as they called, Sukuk, in London. These initiatives have been well received by the UK parliament,which is studying a new regulatory framework and tax reforms concerning the above issue. Commodity Murabahas are now traded in large volumes in the London Metals Exchange (LME). Similarly, elsewhere efforts are underway to create an attractive enviromental and regulatory framework for the promotion, distribution and trading of Sharia-compliant products in secondary markets.

Although Islamic finance structures are well recognized in many financial markets worldwide, penetration of these international markets and integration into the mainstream global financial system is not without hurdles. These hurdles are summarized by the theme of this conference in one challenge, which is "Capitalizing on Emerging International & Regional Growth Opportunities", which rightly views these hurdles as opportunities that could provide new impetus for the growth and expansion of Islamic finance.

This conference will surely discuss these hurdles, or I should say opportunities, in great detail and elaborate on how to turn them into added growth drivers. What I would like to point out here is that understanding these opportunities is the key to utilizing them, and that is why we are all gathered here.

I have to emphasize that opportunities left untaken are not opportunities. Therefore, we all should work to avail ourselves of the opportunities to elevate the efficiency and competitiveness of existing IFIs, harmonize industry best practices and standards, and create linkages with international markets by forging strategic alliances and smart partnerships.

In the area of elevating IFI's efficiency and competitive–ness, for example, there is a constant need for product development, or in other words, innovation. Of course, innovation has been the driving force behind the growth of Islamic finance so far. Innovation applies not only to creation of new products, but also to enhancing existing products. It encompasses development of Sharia-compliant products, derivatives, and the more complex structured products that involve finacial product engineering and execution procedures.

Recent innovations in Islamic finance have made it possible to provide attractive Sharia-compliant alternatives to conventional financing requirements for both corporate and retail customers, and across the full range of financial services. However, innovation is still required to continually develop products to satisfy the increasing demand for even more sophisticated Sharia-compliant products emanating from the unprecedented growth of the Islamic finance market. Innovative solutions are needed to improve the trading capacity of these products to increase liquidity and improve asset-liability management, and to enhance product features to accommodate changes in market dynamics.

It is understood that Islamic financial instruments without markets will only be a drag on Islamic finance development. Market development is needed for proper risk management as well as for cash-flow management. Elements of diversity and depth require careful attention in primary market development. Islamic finance products issued in primary markets are held to maturity if there is no secondary market that attracts demand for these products, thus reducing the liquidity of holders of such products. The Islamic finance market also requires solid pricing benchmarks. Additionally, the current landscape of the Islamic finance market is highly fragmented, making consolidation a plausible eventuality to improve cost efficiencies from economies of scale, benefit from revenue synergies of combined operations, gain brand reputation, acquire instant credibility, and create regional or international players and markets. Obviously, barriers to consolidation need to be done away with. Moreover, the Islamic finance market needs prudent regulation and oversight.

Regulation and oversight development is needed to ensure the smooth functioning of Islamic finance institutions (IFIs). The regulatory and supervisory authority should not be a constricting factor, but rather a facilitator of sound growth, a promoter of creativity and innovation, a provider of a level playing field, a builder of institutional capacity, a contributor to functional markets, and a supporter of effective infrastructure. Of course, regulation and supervision need to be flexible and effective, due to the evolving and dynamic nature of the finance industry in general.

Another requirement is needed, which is the development of corporate governance in IFIs. Laying the foundation of good corporate governance is imperative for IFIs. Its importance stems from two principal elements:

The first element is the unique features of IFI operations and transactions, and their contractual arrangements and instruments that require identification of associated risks, and resolution of perceived conflicts of interest between parties and stakeholders. The second element is the pivotal role of market discipline and transparency in expanding Islamic finance markets and bolstering public confidence in IFIs, given that both market discipline and transparency are integral components of the architecture and texture of good corporate governance.

Moreover, the Islamic finance industry needs to intensify human resources development to ensure the substantial pool of talent and expertise that is necessary to sustain the long-term growth of the industry. Specialized training is required to produce high-calibre practitioners and professionals in Islamic finance, as well as specialists and researchers in the disciplines of Islamic finance.

Also, supporting institutional infrastructure development is required to create a healthy competitive environment for the Islamic finance industry and sustain its efficiency and growth. Luckily, many such institutions have already been created, and in many cases, of course, it may not be necessary to establish new institutions, but rather to modify existing infrastructure supporting the conventional finance industry to provide support to the Islamic finance industry as well.