Regulatory and Supervisory Environment for the Islamic Banking Industry

I am delighted and honored to have been invited to this conference, and grateful for the opportunity to devote some thoughts to developing a regulatory and supervisory environment for the Islamic banking industry to initiate discussions and deliberations on the important topics of this conference.

During recent decades, Islamic banking and finance have flourished worldwide. Therefore, over 300 Islamic financial institutions (IFIs) are currently operating in more than 75 countries with combined total assets in excess of US$ 250 billion. During this rapid growth at remarkable annual rates, ranging from 15% to 20%, the nascent Islamic finance industry turned into an attractive and lucrative business. In doing so, it overcame a great number of obstacles and hurdles. However, daunting challenges still lie ahead and need to be confronted in order for the industry to retain its momentum and success, sustain its competitiveness and growth factors, and achieve the desired expansion and development.

Having said that, I want to focus here on the challenges ahead, and in particular on the need for a prudent regulatory and supervisory framework for the Islamic banking industry. Although the need for regulating and supervising this industry is quite obvious, many countries where this industry exists are still lagging behind in this area. Of course, the need to develop a legal framework for governing, supervising and regulating Islamic banking business is not limited to countries where this business has taken root and is constantly growing, but also for other forward-looking countries that may consider attracting this business to their markets.

Also, we know that establishing a proper regulatory and supervisory environment for the Islamic banking industry involves the resolution of many important issues regarding approach, instruments, and practices, as well as institutions and infrastructure. The development of a vibrant and dynamic Islamic banking industry that enhances wealth creation and promotes sustainable and balanced economic growth and social development requires well-defined strategies that focus on both building institutional capacity, and developing the supporting legal and financial infrastructure.

The establishment of this regulatory and supervisory environment is a requirement of and a challenge for the authorities as they face the dual task of understanding the industry and striking a balance between providing effective supervision and facilitating the industry's legitimate aspirations for further growth and development. At the same time, it is a requirement of the industry that demands a level playing field, effective infrastructure, functioning markets, and penetration of the global market. Therefore, both parties (the authorities and the industry) should work together to design such a regulatory and supervisory environment, in collaboration with other industry participants, such as the Islamic Development Bank (IDB), the Islamic Financial Services Board (IFSB), the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and other Islamic banking and financial institutions.

In my view, the role of government and supervisory authorities is not to shape evolution and development by imposing their will and dictating their views, but rather to facilitate evolution and development by creating a healthy competitive environment for all participants, and respecting their choices.

We must keep in mind that the objectives of any effort to establish a regulatory and supervisory environment for the Islamic banking industry should be to maintain confidence in the domestic banking system as a whole, protect customers, and promote public awareness. It follows that establishing a regulatory and supervisory environment for the Islamic banking industry should take a holistic view, by putting in place a comprehensive legal infrastructure. Enactment of an Islamic banking law would be an important part of this process. Existing legislation relevant to economic transactions would need to be reviewed in order to regulate and facilitate the Islamic mode of banking operations.

In addition, an integral part of the process of establishing a regulatory and supervisory environment for the Islamic banking industry is the development of the financial market infrastructure to ensure sustainability and effective functioning of Islamic banks. To achieve that, efforts should be focused on developing effective Shari'a-compliant instruments that facilitate proper cash flow management for Islamic banks through active participation in existing financial markets. Therefore, it is important to work on providing cost-effective alternative funding sources for users of capital (for example, public debt instruments), and wide-range alternative financial investment instruments, suiting different risk profiles for capital providers. Ancillary institutions, such as other financial intermediaries, Islamic insurance and investment companies for example, are also important to lend support to the development of the Islamic banking industry.

Last but not least, it is vital for a robust regulatory and supervisory environment to put in place a sound and effective framework of supervisory policies, standards, controls, and instruments that both conform to international best practices and comply with Shari'a requirements. This framework, like the one in place for conventional banks, should cover, with proper adaptations, all supervisory policies, standards, controls, and instructions that include, but are not limited to, capital adequacy, liquidity management, corporate governance, transparency, disclosure, market discipline, risk management, and customer protection.

Luckily, in the course of past developments in the Islamic banking industry, some important infrastructure institutions have been established that could aid in the evolution of this industry worldwide. I have mentioned some of these institutions, such as IDB, IFSB, and AAOIFI. They play an important role in promoting, disseminating and harmonizing best practices in accounting and auditing, and in regulation and supervision of Islamic banking. They set standards and principles for supervision and regulation consistent with Shari'a law, and coordinate with other standard-setters around the world. The point is that with the help of such institutions, it is easier now than ever before to establish a regulatory and supervisory environment for the Islamic banking industry. Now no one should ever have to start from scratch.

Let me now turn to our experience in the State of Kuwait which is, as you know, one of the handful of countries where Islamic banking had its earliest beginnings. The first Islamic bank in Kuwait (the Kuwait Finance House) was established some thirty years ago in 1977. Now we have two Islamic banks, and around 29 Islamic investment companies (which are non-deposit-taker financial institutions). Additionally, we now have a Kuwaiti conventional bank which will be converted in the near future into an Islamic bank. The reason for the small number of Islamic banks is that the necessary regulation was only enacted in the year 2003.

The Central Bank of Kuwait (CBK) has always thought that Islamic banking services needed to be regulated in order to bring Islamic banks legally into the fold of its supervision, and to enhance competition in this market. As domestic demand for Islamic banking services has increased, the CBK conviction has coincided with the growing consensus that has emerged among various stakeholders, including local banks and the National Assembly, on the need for legislation to regulate the Islamic banking business in Kuwait. Eventually, Law No. 30 of 2003 was issued, adding a special section on Islamic banks to the third chapter of Law No. 32 of 1968 concerning currency, the Central Bank of Kuwait, and the organization of banking business. This important piece of legislation provided the CBK with the required legal underpinnings for establishing prudent regulatory and supervisory policies and controls for Islamic banks in the State of Kuwait, consistent with relevant international standards. It also opened the door for more potential new entrants into the domestic Islamic banking market.

Considerable effort went into drafting that legislation. Available literature on Islamic economics in general and Islamic banking in particular was surveyed, the experiences of other countries in regulating Islamic banking were studied carefully, and views of various domestic stakeholders were gathered and discussed. Additionally, the advice and recommendations of international organizations concerned with the Islamic banking business were entertained and incorporated. Moreover, the CBK utilized its own 13-year experience in regulating and supervising domestic Islamic investment companies, as well as its 25-year experience of informal monitoring of the only Islamic bank in the country (the Kuwait Finance House).

The supervisory framework developed by the CBK concerning Islamic banking in Kuwait takes into consideration international best practices for effective supervision of conventional banking with adaptations to suit the Islamic banking business. For example, credit concentration ratios for a single customer do not generally differ in conventional and Islamic banks, while capital adequacy ratios have to be adapted to take into account the different asset-liability structures in conventional and Islamic banks. As in the case of conventional banks, the CBK has prepared a comprehensive regulatory and supervisory manual for Islamic banks, containing a detailed set of policies, standards, controls and instructions.

It may be noted that we need to be more responsive to the pressures of innovative developments and high growth rates in the Islamic banking industry. For that reason, the Islamic banking law offers the CBK enough flexibility to react and adapt to the dynamic nature of the Islamic banking industry.

Our Islamic banking law provides a level playing field, and gives Islamic banks the opportunity to coexist with conventional banks on an equal footing, subject to a prudent regulatory and supervisory regime. This is important for both the Islamic banks, as it inspires public confidence in their operations, and the CBK, as it ensures the soundness of the banking system.

Compared with conventional banks, Islamic banks bear certain additional risks associated with ownership of assets underlying some Islamic modes of operation and transactions. This requires greater attention to supervisory policies and tools. Moreover, Islamic banking is highly innovative; thus supervisory authorities will be hard pressed to continually develop their policies and tools to proactively respond to market dynamics and developments.

Also, we should keep in perspective the need to help our domestic Islamic banking market integrate into the global banking market by ensuring that the standards and policies followed by supervisory authorities with regard to Islamic banks in their respective jurisdictions are harmonized within the Islamic banking market and are, at the same time, aligned with international standards and policies. Of course, this task may be accomplished with some assistance from IFSB.

Finally, I will conclude my speech stating that the goal of establishing a robust regulatory and supervisory environment for the Islamic banking industry may appear daunting, but it is certainly not beyond reach. With good preparation, and close cooperation, any task can become easier to accomplish.