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*The Legal Issues in the Islamic Financial Services Industry*

It is with much pleasure that I welcome the opportunity of addressing you today. I would like first to welcome you to Kuwait, and I wish you successful deliberations and fruitful discussions during this seminar on “The Legal Issues in the Islamic Financial Services Industry”. The theme of this seminar represents a subject of great relevance in our quest to strengthen the foundations of that industry and ensure its sustained development, especially under the increasing challenges and competition in today’s global financial markets.

The Islamic financial services industry has come a long way over the last three decades. Today, it is an established industry with a broad array of services and products, operating in nearly 75 countries, managing a global portfolio estimated at more than US\$ 250 billion, and still expanding into new geographic areas. As an example of this outstanding growth, the Islamic financial services industry in Kuwait has witnessed swift growth. At end of the year 2000, there were 10 investment companies operating according to Shari’a principles, with about US\$ 1.4 billion in total assets. Currently, the number of these companies has reached 14 and their total assets have more than tripled to over US\$ 5 billion, all in a short four-year period.

Understandably, the key driving force behind this brisk expansion has been the growing demand for Shari’a-compliant financial services and products, in both Islamic and non-

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Islamic countries. This growing demand has resulted in a large number of institutions entering the Islamic banking and financial arena for the first time, some of which have been conventional banks eager to capture a share of that promising market. Meanwhile, innovation and development of new Islamic financial products has been gathering pace in recent years, with a view to devising Islamic counterparts of conventional financial products. This drive for innovation is continuing, and has so far yielded more sophisticated Islamic financial products, with more challenging risk profiles. Therefore, the availability of an appropriate legal and regulatory structure is particularly important for Islamic financial institutions.

In general, the presence of an appropriate legal and regulatory structure is vital for an “enabling environment” which provides for healthy development and growth of financial markets. This is especially relevant to the Islamic financial services industry, where the complex nature of Shari'a-compliant investments and continual innovation of financial products imply varied types and degrees of risk. Moreover, the availability of an appropriate legal and regulatory framework for Islamic banks and financial institutions can contribute to improving their soundness, and accordingly, provide better support to the regulator's role in the regulation and supervision of these institutions. Also, monetary authorities can more effectively execute and manage their monetary and credit policies. Therefore, it could be said that an appropriate legal and regulatory framework for the Islamic financial services industry can nurture an environment that supports its growth, fosters its stability, and safeguards the gains it has realized so far.

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Perhaps one of the most important challenges facing this industry today is that only a limited number of countries have issued specific laws governing Islamic banking and finance. The need is therefore pressing for countries which have introduced “Islamic banking” to issue such laws. Today, through the consultative process and exchange of views in this seminar, we hope to contribute one more step towards that end.

Having established the need for, and benefits of, a legal and regulatory framework for Islamic banking and finance, one must address its desired features. A key aspect of the needed legal and regulatory framework for Islamic banking and financial institutions is that it should correspond to their particular nature, while at the same time addressing the broad issues common to all financial intermediation, such as the management of contracts, bankruptcy, collateral, and asset recovery. In particular, in regulating the Islamic financial market, the needed legal and regulatory framework must provide a clear definition of an Islamic financial services institution, along with specifying the licensing requirements, particularly with regard to capitalization, scope of activities, prudential dispositions and relationship with the regulatory authorities. Additionally, this legal and regulatory framework needs to allow for both the dynamic nature of Islamic financial services, and the broad objectives and responsibilities inherent in the supervision and oversight of the banking and financial system as a whole.

On the application side of this framework, it is to be noted that since Islamic financial institutions enter into diverse

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contractual relationships, each with its own risk profile, the supervision and oversight of Islamic banking and finance needs to address the particular nature of these operations. As we all know, in Islamic banking and finance, which is based on an investor-entrepreneur relationship, supervisory practices regarding risk are more complex than in the conventional debtor-creditor relationship. This calls for a specialized and comprehensive framework for the identification, assessment and management of risks inherent in the activity of Islamic financial institutions. Worth noting here is that the Basel Committee's latest recommendations on the identification of credit, market and operating risks may provide useful guidance in this regard.

Similarly, it should be noted that the establishment of the Islamic Financial Services Board (IFSB) in November 2002 was a prominent landmark on the road to the development of prudential, regulatory and supervisory standards specific to the Islamic financial services industry. Since its establishment, the IFSB has attracted growing participation; its membership currently encompasses 15 full members, represented by the regulatory authorities of countries allowing the licensing of Islamic banking and financial institutions, and the Islamic Development Bank, along with 15 associate members and 40 observers. The laudable efforts that the IFSB deploys in providing regulatory advice for the supervision of Islamic banking and financial institutions, along with its quest to achieve convergence in that area, will further promote the development of a prudent and efficient Islamic financial industry with sound practices, and support its further integration into the global financial market.

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Quite important in this regard, too, is cooperation and coordination among supervisory authorities in laying down the needed regulatory and supervisory rules and regulations for Islamic banking and financial institutions, along with exchanging relevant experiences.

Allow me now to turn to the experience of the Central Bank of Kuwait in setting up the legal and regulatory framework for Islamic banking activity. Regarding the legal framework for Islamic banking activity, a law was issued in 2003 to regulate the licensing and activity of Islamic banks. Worth noting here is that this law was not issued in separation from the legal and regulatory setup for conventional banking and financial activities, but as an addition to it. It introduced a special section on Islamic banks to the existing Law No. 32 of 1968 concerning currency, the Central Bank of Kuwait and the organization of banking business. This illustrates our view that Islamic banking, while unique, remains an integral part of the financial intermediation industry.

The current law, in its main features, provides a clear definition of an Islamic bank, the requirements for its establishment, and its relationship with the Central Bank of Kuwait as a supervisory authority. Regarding licensing, the law sets forth the requirements for setting up new Islamic banks, allowing foreign Islamic banks to open branches in the State of Kuwait, and introducing Islamic banking services at local conventional banks through subsidiary companies. Minimum limits for adequate capitalization are defined by that law to ensure the soundness and competitiveness of local Islamic

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banking units under prevalent market conditions. The law also defines the scope of activities of local Islamic banks, and entrusts the Central Bank of Kuwait with all regulatory dispositions for the prudential supervision of these activities.

On the regulatory front, the Central Bank of Kuwait has prepared a comprehensive manual encompassing the rules and regulations for the supervision and oversight of Islamic banks. This manual is the counterpart of the Central Bank of Kuwait's supervisory manual for conventional bank supervision, with the distinction that it grants due consideration to the special nature of Islamic banks and their varied areas of activity.

Today's heightened uncertainties and greater volatility in financial markets require - more than ever - the cooperation of all concerned parties to guide the development of legal and regulatory standards which will secure the development of efficient and competitive Islamic financial institutions, well integrated into the global financial markets. This goal is best served through the concerted efforts of the IFSB's universal membership, and the exchange of views in international forums like this seminar.