Islamic Banking From A Regulator's Perspective

It is a great pleasure and honor to take part in this important and distinguished gathering of prominent policy makers, regulators, business leaders, financial experts, academicians and representatives of some international organizations. Such gatherings are meant to provide deep insight into debated issues, and clear vision of future trends. The issues debated and discussed in this conference may have enormous bearing on shaping modalities of Islamic financial innovations, harmonizing current Islamic banking practices, and consolidating supervisory regulation of this relatively new industry.

The phenomenal growth of Islamic banking and finance during the last two decades has led to increased challenges. Islamic banking and financial institutions need to respond to ever growing demands and expectations of higher quality and broader diversity of their products and services. Regulators, on the other hand, need to develop sophisticated supervisory policies, and maintain a high standard of regulation as well as a competitive business environment.

However, Islamic banking has not yet come out of its infancy. In spite of past accomplishments and achievements, relentless concerted efforts are required to groom this industry until it reaches maturity. The task ahead is immense. Past successes and global acceptance make it even more imperative to further develop this industry, and fully integrate it into the international financial system. Intensive researches and endeavors are called for to bring about harmony, consistency, and uniformity of operational concepts and standards of Islamic banking as well as its supervisory policies and methods. "Innovation and consolidation", the rightfully chosen theme of this conference, should be the guiding spirit for all of our contributions to this end.

As a central banker, my thoughts and views today tend to focus mainly on supervision and regulation of Islamic banking rather than product offerings and bank management.

Cooperative and concerted efforts by all concerned are essential to establish a more harmonized framework for Islamic banking business, uniform concepts, prudent supervisory policies, and accepted accounting standards. As you all know, efforts by all concerned are underway in this regard. This conference is undoubtedly one example. Another illustration of such efforts is the expected establishment of an Islamic Financial Services Organization (IFSO), to develop uniform standards for disclosure and supervision of Islamic financial institutions, and coordinate with other international standard setting institutions to ensure consistency with internationally accepted standards. As you may remember, during the conference on Organization of Islamic Banking that was held in Bahrain in February last year, a policy group meeting of governors of central banks and monetary agencies of certain Islamic countries recommended the establishment of IFSO. A number of steps have been taken since then to prepare for the establishment of IFSO. A preparatory committee has been established, which has held a number of meetings to discuss the matter. It is therefore expected that the IFSO will come into existence in the near future.

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has exerted commendable efforts in developing accounting and auditing standards for these institutions. A statement outlining the capital adequacy standard calculation for Islamic banks has been issued by AAOIFI. It has also laid out some juristic standards and requirements for Islamic investment and finance modalities. Such efforts are needed to complement the targeted objectives of IFSO in the area of supervisory policies for Islamic financial and banking institutions, and development of harmonized and functional accounting standards.

It must be emphasized that a consensus is required on the scope of Islamic banking business. Determination of this scope is vital for the organization of Islamic banking business and its supervision. Our view is that this scope should not extend beyond commercial and investment banking activities using Islamic banking modes and methods. It should not, however, span other types of economic activities, which can still be carried out by Islamic banks off-balance sheet using innovative instruments of lower risks.

Banks, as institutions of a distinct nature, are by definition financial intermediaries that facilitate the movement of funds between those who have a surplus and those who are short of funds. Since the efficiency of this role is vital for economic growth, and these funds are part of the national wealth, it is therefore the responsibility of national authorities to ensure the safety of these funds and the soundness of that role, so as to avoid potential high risks by means of organization and supervision of these banks.

Be it a traditional bank or an Islamic bank, the essence of their business is financial intermediation with third party funds. Therefore, it would not be right for an Islamic bank to engage directly in all types of economic activities and businesses under the pretext that it is permissible in Islamic law. High-risk non-banking activities, such as merchandise trading, property trading, construction and manufacturing, should not be directly assumed by Islamic banks themselves.

Islamic banks are normally exposed to all the types of risks that are faced by traditional banks, with the exception of interest rate risk. It is believed that these and other extra risks are higher in Islamic banks, which currently lack effective hedging instruments such as Shari'a - compliant financial derivatives. This view only reinforces the need for stringent risk management and internal control systems for Islamic banks. It should also prompt us to dedicate more time and effort to innovate and develop diverse and effective Islamic hedging instruments.

Moreover, liquidity issues in Islamic banking are often more complicated than in traditional banks. Fund resources in Islamic banks usually mismatch the maturity structure of fund uses, with shorter-term funds and longer-term uses increasing liquidity risks in Islamic banks. What makes liquidity management in Islamic banks more difficult is that usable financial instruments are in short supply, and available financial markets lack both depth and breadth. Liquidity problems, if aggravated, may develop into solvency problems due to increased risks and mismanagement. Lessons must be drawn from the recent Asian financial crisis, where traditional banks expanded their long-term lending using short-term funds.

Although Islamic banks operate on the basis of sharing risks with their clients according to the rule of "Al-Ghunmu bil Ghurm", regulators' perception of risk should not be limited to determining the bearer of risk, but rather extend to protecting the assets in which depositor funds are invested from any losses.

Current international risk measurement and management systems for banks stress a broad perception of risk, both in supervision of banks by regulators and in rating banks by rating agencies. For example, market risk was recently added by the Basle Committee to its capital adequacy standard, which was previously limited mainly to credit risk. Systemic risk assessment is now considered more intensively by international rating agencies.

Therefore, expanding the scope of permissible Islamic banking business activities to non-banking areas of merchandise trading, manufacturing, or agriculture may hinder the ability of many Islamic banks to maintain a sufficient level of capital adequacy.

Furthermore, elevation of the performance efficiency in Islamic banking institutions requires overcoming two important challenges. The first involves improving corporate governance in all traditional and Islamic banking institutions, and more so in Islamic banking institutions due to their relatively young age. The Banking Supervision Committee at the Bank for International Settlements (BIS) issued in September 1999 a set of guidelines to improve corporate governance in banks, which can also be used and adapted to Islamic banks. The second challenge is that of developing Islamic financial markets. Although some countries have actually developed a number of Islamic financial instruments, the challenge remains to increase quality, quantity, diversity and maturity of these instruments in order to develop efficient Islamic financial markets.

Finally, I would like to thank the Bahrain Monetary Agency for sponsoring this conference and for inviting me to participate in it. Although the subject of Islamic banking is a vast one, I have tried in this short speech to raise what are, from a regulator's perspective, certain important points and issues, and to open up venues for discussion. I am confident that this conference is an indispensable source of information, inspiration, and instruction for us all.