The Regulatory Framework of Islamic Banking in the State of Kuwait

It gives me great pleasure to welcome you to this seminar on the "Design and Regulation of Islamic Financial Instruments", which -by facilitating an exchange of experiences and views among us- will seek insights into the regulation of Islamic banks and development of Islamic financial instruments.

This gathering is being held against a backdrop of developments in the Islamic banking industry, the evolution of Islamic financial services and instruments, an increasing demand on Islamic banking services, and a growing interest among regulators worldwide in its growth and activities. In retrospect, when Islamic financial institutions emerged about two decades ago, they were confronted by many difficulties as a result of insufficient regulation and experience. Nevertheless, they have enhanced their activities and organization and increased their market share, although certain fundamental difficulties remain to be resolved, particularly in the areas that will be the subject of discussion in this seminar.

I would like to focus attention on the development of the regulatory framework of Islamic banking in the State of Kuwait and relevant issues that need to be considered.

I am sure you all agree that for Islamic banking to be successful it requires, among other things, the establishment of an appropriate regulatory framework specifically tailored or adapted to its activities. This framework must be based on sound principles and a clear definition of Islamic banks' activities and their relationship with the supervisory authorities. **A question may be raised here. Do we really need to regulate Islamic banks?** This is a valid question, especially from the regulators' point of view.

In our view, Islamic banks constitute an indivisible part of the national banking and financial system, as long as they play the role of financial intermediaries between surplus and shortage economic units, and of providers of typical financial and banking services. Additionally, these institutions handle a portion of the national wealth, which ought to be safeguarded and protected from excessive risks. On the other hand, for the Central Bank of Kuwait (CBK) to effectively pursue its goals and implement its monetary policy, it should be able to supervise and regulate the activities of all units of the domestic banking and financial system, including Islamic banks. Hence, it has become necessary to codify these concerns into a regulatory framework and subject Islamic banking activities to CBK supervision.

The regulatory framework of Islamic banking in the State of Kuwait will complement current banking and financial legislation. The CBK has contributed to the efforts leading to the shaping of Islamic banking legislation by preparing a draft law organizing Islamic banking activities. In undertaking this task, the CBK has drawn on the experience of local Islamic banking and financial institutions, as well as on other countries' experience and available research in this field.

This draft law is prepared in such a way as to provide it with the required flexibility and adaptability:

First: It takes into account that Islamic banking units may engage in the activities of either commercial or investment banks, or both types of activities combined within the concept of "universal banking".

***Second*:** It is specifically adapted to the nature and type of current Islamic banking operations, such as those involving temporary acquisition of real estate assets for financing purposes.

***Third*:** It allows the CBK to develop financial instruments that comply with the provisions of Islamic *Shari'a*.

Fourth: To ensure that the activities of Islamic banks are conducted according to the provisions of Islamic *Shari'a*, it entrusts this task to independent bodies -in the form of *Shari'a* Boards- within the Islamic banking units.

To elaborate more on this last feature of the draft law, I would say that having *Shari'a* Boards within each of the Islamic financial and banking units, rather than a central body within the CBK, ensures the compliance of their activities with the provisions of Islamic *Shari'a* and enhances the moral confidence of the public in the activities of these units in terms of their adherence to Islamic *Shari'a.* Also, this approach fosters dialogue about *Shari'a* interpretations (fatwa), thus paving the way to consensus, especially since interpretations are numerous among Islamic *Shari'a* scholars and lie beyond our jurisdiction as a central bank. Moreover, such an approach, without CBK interference in the fatwa process, allows for the flexibility needed at this important stage of Islamic banking, while the organization, appointment and role of *Shari'a* Boards conform with the draft Auditing Standard No. 4, recommended by the *Accounting & Auditing Organization for Islamic Banks*.

It is worth mentioning here that supervising Islamic financial institutions is not totally new to the CBK. In fact, it already supervises the operations of domestic Islamic investment companies. The regulatory development that we are addressing here concerns extending our supervision to encompass Islamic banking operations, as well. Furthermore, supervision over Islamic banks pursues the same objectives as supervision over traditional banks, namely promotion of a proper depository environment, maintenance of efficient payment and settlement systems, provision of appropriate banking services by Islamic banks to their clients, and support for general economic policies. These objectives could be attained by supervisory authorities through the adoption of proper policies and measures, pertaining mainly to the following areas:

First : Capital Adequacy Adjusted to Market Risk:

Islamic banking supervisory policies should develop criteria for the assessment of capital adequacy, which correspond to those, set forth by the Basle Committee. Such criteria should be consonant with the particular relationship between Islamic banks and their clients, namely that of participating in profit and loss, and the nature of their operations.

In this regard, I appreciate the role of the *Accounting & Auditing Organization for Islamic Financial Institutions,* which has formed a committee to develop a capital adequacy standard for Islamic banks that is deploying serious efforts in this area.

Second : Bank Liquidity:

As you know, most financial resources of Islamic banks are in the form of short-term investment deposits, while the forms of their usage tend to be of longer terms. This may create abnormal liquidity risks due to the mismatch in the maturity structures of assets and liabilities. At present, the management of each Islamic bank, independently and at its own discretion, controls bank liquidity to meet customer withdrawal demands. We believe that supervisory authorities need to regulate liquidity in Islamic banks, as in traditional banks, due to its implications that extend beyond the individual institutions and the associated systemic risks. Thus, it is critically important for Islamic banks and their regulators to develop a system for the measurement and control of liquidity that takes into account the nature of Islamic banking operations, especially the aspect of risk sharing with depositors.

Third: Credit and Investment Concentrations:

Although the relationship of an Islamic bank with its clients is theoretically considered that of partners, in reality it does not limit the responsibility of these banks and their regulators to ensure that excessive risks associated with the bank's credit and investment concentrations are being contained. To maintain confidence in the financial soundness of Islamic banks, it is necessary to develop standards and policies pertaining to these concentrations in Islamic banks.

I would like to stress that efforts currently exerted in developing these supervisory policies and measures need to be carried on and given proper attention by all parties involved in or concerned with Islamic banking, particularly Islamic financial and banking institutions and their supervisory authorities. These concerted efforts are indispensable to overcome the challenges facing the relatively new Islamic banking, as opposed to traditional banking, which has developed over centuries and has established internationally accepted operational concepts and supervisory methods.

To do that, all concerned parties in the Islamic world should work together to elucidate and firmly establish Islamic banking concepts and related *Shari'a* provisions, through cooperation, exchange of information, and development of markets. Moreover, if we want to gain the endorsement of the international community at large with regard to the regulatory principles of Islamic banking, we should base our policies and measures on internationally recognized rationales and criteria. Equally important is the combination of effort in the areas of research, product development and training, along with the convergence of operational and accounting systems, and continual coordination and cooperation among Islamic banking and financial institutions at the local, regional and international levels.

On the other hand, in light of the present evolutionary stage of Islamic banking, there is a need for a broad range of financial instruments compatible with the Islamic *Shari'a*, and the development of efficient secondary markets for such instruments. Naturally, the Islamic financial and banking institutions are partly responsible for ensuring the success of such an undertaking through promoting and extending the use of these financial instruments. In spite of the fact that Islamic financial and banking institutions have already developed some of these instruments, I think there is still room for further progress to give their markets the needed depth and diversity.

I hope that your participation today and your deliberations in this seminar will go a long way towards opening up new horizons in the important issues before you.