

**Standards for Regulations and
Supervision - Soundness and Stability**

**Symposium on Risk Management in Islamic
Banking Services**

**A Speech by H.E. the Governor of SAMA
in Riyadh on 24th February 2004**

I am delighted to be here at this important symposium on " **Risk Management in Islamic Banking Services** " .

Given the rapid growth in the size and scope of Islamic financial services in many countries, this topic is of increasing attention for many policy makers concerned with financial stability, including International Financial Institutions such as the IMF, various development banks and the Basle Committee in addition to supervisory authorities in the countries where these banks are working. These authorities are taking a keen interest in the development and expansion of Islamic Finance and its impact and implications for the global financial markets.

The increasing global interest in Islamic Banking is due to a phenomenal and rapid growth of Islamic Finance in the Islamic countries as well as other parts of the world during the past two decades and its presence now extends to over 25 countries in Asia and Africa. It has also emerged in many financial centres in Europe and North America where even major international banks and specialized financial institutions offer Islamic products catering to growing muslim presence in these markets and even in the markets of Islamic countries. Currently the assets of Islamic banks are estimated at US\$ 250 billion . In addition, there are billions of dollars Islamic financial transactions done by conventional banks and financial companies.

Islamic banking has its own risks which pose a challenge to banks and supervisory authorities. Islamic banks like their conventional counterparts are financial intermediaries offering services to depositors and investors on one side and providing loans and funds to companies, entrepreneurs and the public sector on the other. Therefore, they are exposed to many risks that are similar to those of conventional banks. However, in addition, Islamic banking entails special risks that need to be recognized. In principle, there is a variety of activities that Islamic banks can carry out in many ways to provide funds. These ways need to be adapted to be consistent with the principles on which Islamic banks conduct their business. Therefore, there is an urgent need for identification, measurement, management and supervision of such special risks. This should not be left to the initiative of Islamic banks only ; the supervisory authorities should undertake a key role in this respect.

Looking to the funding side, the dominant sources of funds for Islamic banks are zero return current accounts and various-term investment accounts on the basis of profit and loss sharing. Consequently, the risk profile of these two funding sources is quite different.

With regard to the assets side, various financial contracts based on Profit and Loss Sharing (PLS) principle, also display distinctive risk characteristics which are quite different from normal lending contracts.

The special character of these risks raises unique issues of valuation related to underlying assets and inventory, the timeliness of income and loss recognition, the adequacy of collateral etc. Beyond these specific product related risks, there is added vulnerability due to lack of a mechanism for hedging such risks which is available to conventional banks. Therefore, Islamic banking has yet to develop hedging instruments that are consistent with Islamic principles.

However, liquidity issues in Islamic banking can take several forms. For example, Islamic banks at present have a comparatively limited range of instruments

available to manage their liquidity. They may not invest in government and corporate bonds, treasury bills and commercial papers. Also, the absence of an inter-bank market and the lack of access to repo windows with a Central Bank can hamper their liquidity. Thus Islamic banks need to hold a large proportion of their assets in reserve with Central Banks or in liquid assets form which negatively affects their profitability. In recent years some Central Banks and IDB have recognized this need and established an Islamic Money Market to cater to the needs of Islamic banks.

It is often argued that Islamic banks are less vulnerable to insolvency as they can share their profits and losses with the depositors and investors according to their joint contracts. This is sometimes raised as an argument for lower capital adequacy ratio for Islamic banks. However, the counter argument is that Islamic banks are subject to greater fiduciary and operational risks and therefore must provide adequate capital to reflect these.

These special characteristics and risk features of Islamic banking have been recognized by a number of Central Banks. Consequently, they are already developing ways to supervise and regulate these risks. They are also aware of the need for international collaboration and are joining hands in developing standards that can form the basis of a strong infrastructure for Islamic banking.

On the question of adaptation of existing international norms and practices for Islamic banks, I note there are many areas where Islamic banks are similar to conventional banks. It is perhaps most practical, cost effective and efficient to adapt relevant standards to Islamic banking. The Basel Committee on Banking Supervision has issued standards and principles in risk areas including credit, liquidity operations, consolidation, capital adequacy etc. Many of these standards are equally relevant and applicable to Islamic banks.

Just to illustrate this point, I would like to highlight an area of increasing importance to all financial institutions. This is Corporate Governance, where much work is currently being done for enhancing international standards. This requires that

owners and managers of banks be fit and proper; their Board of Directors must be effective and accountable. They must have independent external auditors and regular internal control systems , and should comply with other relevant principles that would ensure efficient corporate governance. In my view there is no reason for exceptions to be made for financial or even non-financial institutions.

Consolidation of financial statements of a bank with all its associated and subsidiary companies is another standard that should be applied to all banks. It is necessary to provide consolidated supervision by the supervisory authorities in the home country.

A major focus of all standard setters these days is Transparency and Disclosure of quantitative and qualitative financial and operational information. For Islamic banks, transparency is an important supervisory pillar and has considerable relevance for enhancing their ethical responsibility and credibility, thereby, contributing to their greater acceptance, and elimination of any misconceptions of their activities.

Now let me address the important question on the way forward. Policy makers in countries with Islamic banks have recognized that ultimately it is their responsibility to promote development of supervisory standards for Islamic banks. This recognition has been translated into reality by the establishment of the Islamic Financial Services Board. The Central Banks of Saudi Arabia, Malaysia and 6 other Islamic nations and the Islamic Development Bank have joined hands to become its founding members. A number of other Central Banks of Islamic countries have become members while many International Financial Institutions have joined as Associate Members. The primary objective of this institution is ‘to promote the development of a prudent and transparent Islamic financial services industry through introducing new or existing international standards consistent with Shariah principles’.

IFSB is guided by a Council of Central Bank Governors.

In conclusion, I firmly believe that Islamic banking systems and institutions have a bright future. Development of standards for Islamic banks through IFSB and development of institutional support by Central Banks will go a long way towards making Islamic Banking an accepted and respected form of financial intermediation on the global scene.

I thank you for your attention.

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