Islamic Finance Seminar
Bank Italia

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Ladies and gentlemen, I would like to express my appreciation to the Banca d'Italia for organizing this seminar. Clearly the program will make a significant contribution to promoting a better understanding of Islamic Finance in Europe.

Growth in the Islamic finance (IF) industry has been impressive in a number of dimensions: the rise in number of institutions, the growth in deposits and loan assets and the development of core regulatory and institutional infrastructure. However, the scale of IF operations as a proportion of the total global finance industry is still below one percent. IF has made greater inroads in the banking sector than in capital markets, although asset backed securities markets have kicked off with the evolution of a wide diversity of Sukuks. It is important to achieve a wide diversity of product mixes and structures --and the significant rise in Islamic funds sets the stage for future growth and innovation in this area.

The strengths of IF are best demonstrated by the qualitative changes occurring in the industry. Rather than becoming entangled in ideological debates, practitioners have innovated to create new product lines that are now available for investors, the corporate world and wealth managers. As with everything else, the global economic and financial crisis, given its size and dimensions, did distract attention of IF industry from long term development to addressing short term challenges. While not immune from the crisis, IF --given its unique characteristics-- has illustrated a degree of resilience and stability.

In my remarks this morning, I propose to provide perspective on three aspects of IF:

- First, I will discuss developments in IFs in the MENA region—a region I represent in my current job;
- Second, I will touch upon how IF has fared during the current crisis that has implications for its future positioning; and
- Third, I will provide a brief insight into how the World Bank is positioning itself to play a nurturing role in this industry.

While Southeast Asia had an early lead in IF, the MENA region now accounts for three-fourths of global Sharia-compliant assets. This dominant position is often obscured by the fact that developments in the region have been uneven. The GCC appears to be taking the lead on the operational side, promoting profit-and-loss sharing partnerships:

- Within the GCC as a whole, IF now accounts for 10% of the region's project finance; Saudi Arabia and UAE together accounted for almost one half of the global sukuk issuance in 2008.

- Growth in GCC IF assets has outpaced that of conventional assets and, within the GCC, notable is the lead of Saudi Arabia, which accounts for 55% of total GCC IF assets. Saudi Arabia is followed by UAE (19%), Kuwait (16%), Bahrain (7%) and Qatar (4%).

- IB in the GCC exhibits high concentration --the GCC Islamic banking sector is dominated by three banks, the Al-Rajhi Bank of Saudi Arabia, the Kuwait Finance House and Dubai Islamic Bank with combined assets of nearly $90 billion. In total, IB in the GCC accounts for over 15 to 30 percent of the total GCC banking system and IF accounts for 15% of the region's market capitalization.

- What is equally impressive are emerging deals to finance mega infrastructure projects. A case in point is Abu Dhabi's recent project financing for a $1.6bn independent power and water plant at Shuweihat that included a significant Islamic tranche providing. This deal stands out for the longest tenor for any IF deal in the region at 20 years.

Within MENA and worldwide, Iran may be the single largest market for IF. The country opted early on to adopt a fully Islamic financial system and requires products to be Shaira compliant as defined by authorities. Iran's banks account for six of the top 10 Islamic institutions worldwide. Iranian banks now hold more than a third of total sharia-compliant assets worldwide –more than any other country. In 2009, the return on those assets fell from a reported 0.7% to 0.42%.

Elsewhere in the MENA region, IF varies from having a strong presence to a small hold:

- In Yemen, Islamic banking represents about 30 percent of assets and 45 percent of loans. As with Iran, returns on those assets can be disappointing –in 2007, Islamic banks saw lower returns than the conventional sector.

- Jordan's Islamic finance industry is thought to be around $5bn, accounting for about 10 percent of the total financial industry.

- Egypt was an early starter but given the collapse of a number of Islamic money management firms in the 1980s, has been cautious with regarding to jumping into the latest wave of IF. Islamic banking has about a 7% market share.

- Syria has three Islamic banks that were established in 2006 after the sector was opened to private enterprise. It also has two Islamic insurance firms. But the Islamic share of the banking market is only a little above one percent.

- Tunisia's first domestic Islamic Bank will be opened in the first quarter of 2010. At the moment, only one Saudi bank is active in the sector of Islamic finance in Tunisia.

- Like Tunisia, Morocco only recently authorized fully-fledged Islamic Banking. As of 2008 the country only allowed conventional banks to offer Ijara leasing products, Murabaha contracts to buy and re-sell an underlying goods and Musharaka – co-ownership financing structures. The government also imposed

MENA stands out for its industry-driven approach to IF relative to a high dependence on a regulator-led model in some other countries. While this has promoted real progress in attracting global players, there are concerns regarding a lack of core regulatory infrastructure development. For instance, some MENA countries do not have a specific IF policy for regulators or laws mandating Shariah compliance or regulation for the IF industry, nor have they adopted Islamic banking regulations. As such, IBs are regulated and supervised in the same way as traditional banks on conventional prudential regulatory frameworks. Exceptions include the UAE and Bahrian,[1] who have pursued IF as a niche segment in their economic diversification strategy and is now home to the largest concentration of IF assets. Both have strived to become regional financial centers, keeping their markets open to foreign banks.

Whatever the state of industry or differences in regulatory models for conventional and IBs, initial reports from across the region were that majority of IBs were relatively immune to the crisis. This was largely because IBs did not have exposure to the sub-prime or credit default securities and returns on Shariah-compliant equity funds before and after the crisis were found to be more stable and in some cases better than the conventional counterparts. Neither did the region have a significant bank run or failure of an Islamic Finance Institution. In 2008, The Islamic International Rating Agency (IIRA) analysis indicated that key IBs had suffered an impact on their balance sheets from declining real estate prices. Nonetheless, the IIRA asserted that the evaluated IBs were less likely than conventional banks to suffer negative outcomes beyond their capacity to sustain core profitability and capital.

Stress on IF markets started to build up during late 2008, as business and product issuance, including Sukuks, slowed down largely because the second round impact of the global financial crisis deepened and resulted in a sharp contraction of real economic activity. In the first half of 2009, figures of GCC banks – the major hub of IF worldwide – reported a sharp decline in the profitability of IB relative to their conventional counterparts. This was because of higher exposure of IBs to the real estate and construction sectors. Given their larger capital and liquidity buffers, IBs did still report higher capital adequacy ratio relative to conventional banks (except in the United Arab Emirates). The risk-sharing aspect of Shariah-compliant contracts adds to this buffer as banks are able to pass on some losses to investors.

This emerging evidence suggests that while the unique features of IB may provide additional robustness to risk and uncertainty, they still face many of the same credit risk exposures. This is because, at the core of the business, IBs operate on similar lines to conventional banks in terms of raising cash flow resources and recycling them.

It should be acknowledged that IF "exclusion principles," such as the ban on certain type of transactions and activities such as prohibitions on interest based, speculative products, do keep IBs' risks contained. The prohibition of interest-based debt finance helps discourage leveraging and so interest rate risk, while IBs' close

[1] Bahrain is not only actively promoting Islamic finance through a Shari'a-compatible regulatory framework but has established a range of national and international institutions to promote development of the industry.

association with asset-based transactions allow them an opportunity to monitor underlying assets. Other features of IF can also reduce risk, for instance:

(i) PLS accounts allows transfer of part of the transaction's credit risk from the IB's balance sheet to the borrower (proportionate to the agreed formula for risk sharing);

(ii) Options for trading of goods and services in IB offers diverse and prudent financing options, be they asset-backed or equity-based; and

(iii) large-scale development of blended instruments, while creating risk management complexities, allow IBs flexibility to apportion risks in different ways among participants.

To the extent IBs have embraced these features of IF, they will remain in a better position to withstand crisis.

However, this should not be a source of complacency as IBs do face risks that vary in specifics and substance. Let me spell out some of these briefly.

(i) The simultaneous commodity buy and sell system under Murabah entails transaction costs, counterparty credit risk and potentially price, market and exchange rate risks. Murabahs also pose unique liquidity risks;

(ii) Since the value and returns of investment deposits are not guaranteed, banks may face moral hazard in terms of an incentive to invest in high risk assets.

(iii) In practice, IBs have so far not exercised the option to deny returns on the basis of poor performance of the underlying asset due to the perceived reputational or redemption threats. If banks opt not to share losses, they end up with "displaced commercial risk" as equity holders must fund payments to investors.

(iv) A comparatively small and concentrated market in Shariah-compliant products leads to the concentration of risk. For example, some IBs exhibit high dependence on a few products such as murabaha and ijara. Other institutions have achieved a degree of product diversification by exploiting Sukuks, Muasharaka and other PLS variants. But these are riskier and more volatile assets. For example, Sukuk structures, backed by properties, real estate and other projects, involve a varying quality of assets and their associated risks.

(v) Real asset transactions required by IBs are complex and costly, while involving greater bank risk exposure to the underlying tangible assets. This was apparent during the current financial crisis given IF's greater exposure to properties and real estate (which are typical to asset-based structures).

(vi) Unrecognized legal and transactions risks in IBs could be higher if banks are involved in newer Sharia-compliant products and services.

(vii) Almost all IBs face Shariah compliance risks that are subject to different interpretation depending on the Islamic jurisprudence followed.

It is also worth noting that while PLS financing provides an option to diffuse some degree of credit risk from banks' balance sheets, this risk is passed on to investors. And the credit risk of transaction in PLS arrangements cannot be backed by collateral and guarantees. Given individual investors are likely to be less diversified than a bank and cannot hedge risk, this risk pass-through may increase the risk of economic crisis following significant asset price declines.

In view of the recent events and the risks identified above, it is important to launch a sustained effort to strengthen regulatory and supervisory infrastructures. In this regard, IFSB has played a valuable role in developing an Islamic financial regulatory and supervisory infrastructure and is now providing capacity building to its members.

Finally, I would like to share with you that the World Bank group recognizes the potential of the IF industry. Besides support to the IFSB – the international standard setter for the Islamic Finance industry --for its technical work and advocacy, the Bank group has been selectively supporting specific transactions with the objective of promoting innovative Sharia-compliant financing vehicles and the development of regulatory systems and corporate governance to underpin their operation. Within the Bank group, International Finance Corporation (IFC) was the first to facilitate establishment of Mudarabas (engaged in leasing business) in Pakistan. Recently, the IFC has issued its first $100 million Sukuk in Dubai and Bahrain markets, the first partial credit guarantee that complies with Islamic finance principles and invited Yemen's Saba Islamic Bank to join the IFC's global trade finance program as an issuing bank. Overall, the IFC has signed a total of 18 IF deals. The Multilateral Investment Guarantee Agency (MIGA), which deals with providing investment guarantees against political risk, was tapped to provide political risk insurance for a critical project in Djibouti that was being funded through an Islamic financing structure. The $427 million guarantee announced in January 2008 supports investments into a new container terminal in Djibouti.

The World Bank has set up an Islamic Development working group to promote Islamic finance. The Bank will work with regulators and with banks to promote the introduction of Sharia-compliant financial services --in particular examining ways on how to exploit IF to promote access to development, product development and infrastructure financing. Within the MENA region, we are exploring options to establish an Islamic Infrastructure facility to promote development of public private partnerships and regional infrastructure projects.

In conclusion, IF has been developing rapidly worldwide and in the MENA region in particular. In the last few years, significant investments in institutions and infrastructure have helped to evolve and exploit the potential of the industry, while laying the foundation for a core regulatory infrastructure. Notwithstanding this progress, approaches and the size of the industry vary considerably across jurisdictions --with some opting for a regulator-led development path and others leaving markets to drive the growth and momentum of the industry. Irrespective of the model followed, given the depth and breadth of the global financial crisis, it is unsurprising that the IF industry has not fully escaped the crisis, and that IBs have been impacted because of their higher exposure to real estate and the economic slowdown. Furthermore, the concentration of the industry in a few simple products and limited reliance on risk sharing or equity based transactions has limited the scope for the industry to take full advantage of the IF features that have some inbuilt safeguards. In parallel, the lack of adoption of a properly tailored regulatory and supervisory system that recognizes the special features and risks of IF carries with it its own attendant risks. The World Bank Group will continue to play its role through Financial Sector Stability Programs to perform surveillance on the IF industry, to assist in the strengthening of regulatory architectures, and to catalyze project financing and access to development finance through various WBG windows and instruments.