BANCA D'ITALIA
EUROSISTEMA

SEMINAR ON ISLAMIC FINANCE

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Concluding remarks by Giorgio Gomel

Ladies and gentlemen,

The seminar was very enlightening in deepening our knowledge and understanding of the Islamic financial sector and its relationships with the financial system in Europe and, especially, in Italy. Many further questions were elicited in the discussion.

Having in mind the relevance of this subject for Banca d'Italia's institutional duties, we focused on monetary policy and banking supervision issues, building on our earlier discussion on global trends in Islamic finance. In my remarks, I will select a few issues with no ambition to really sum up the discussion or come to definitive and operational conclusions.

I. Islamic Finance - Global landscape and current trends: opportunities and challenges

In the **first session** we were offered a detailed picture of the current state of Islamic finance from different perspectives.

Shamshad Akhtar from the World Bank offered a global picture from an international financial institution's perspective and pointed out to the prominence of the MENA region (Middle East and North Africa) in the business, chiefly Iran and the Gulf countries where the growth of Islamic finance outpaced that of conventional finance.

Then, **Professor Wilson** analyzed the current environment for **Islamic banking in Europe**, with a focus on the UK, where the first European developed marketplace for Islamic financial services is located. Limitations hampering both the retail and investment banking business in Europe were identified. **Different regulatory approaches** were mentioned, especially the FSA pro-active position and the Banque de France supportive attitude.

In the view of our speakers, the **current crisis** matters both for the European retail, securities (markets) and asset management segments, as the recession affected Muslim communities and capital markets recorded significant capital losses .

Finally, we turned to the prospects for **Islamic finance in Italy**. In this regard, despite the fact that no concrete experience of Islamic finance exists in Italy, a long-standing **academic research tradition** has been traced. The European framework for Islamic banking is quite complex, with a number of issues to be addressed, while the Islamic capital market seems to be more compliant with the European regulatory architecture. Changes in legislation and civil codes are called for in a number of countries.

Islamic banking has also been seen as a possible spur to the process of "**bancarisation"** in Italy, where, unlike in Great Britain and France, the Muslim population is fairly poor and with a low propensity to save in financial assets. On the supply side, drivers for the industry will be an improved know-how by European banks, the attractiveness of some financial markets (e.g. London for capital markets and Switzerland for asset management), and the Gulf countries' abundant liquidity.

II - Monetary policy and liquidity management

From a central bank perspective, the issues, addressed in the **second session**, of monetary policy and liquidity management, are very relevant.

Mr. Jobst suggested that a fragmented market system coupled with surplus liquidity seem to have sheltered Islamic financial systems from the credit crisis, but they have not escaped unscathed.

Liquidity management remains a key challenge. The picture emerged from the discussion is that of a thin and under-developed Islamic money market characterised by low liquidity and the shortage of shari'ah-compliant money market instruments due to prohibitions on debt investment and derivatives, which requires financial institutions to hold a large part of their assets in the form of cash and offers central banks limited options for open-market operations using shari'ah-compliant instruments.

Different possible solutions have been mentioned: the use of innovative more liquid and diverse asset classes, and, on the liabilities side, of more long-term funding sources to balance long-term exposures to real estate; lastly, the promotion of Islamic Government securities market and the use of such instruments in open-market operations.

As for the ***sukuk* market**, regional fragmentation persists and the secondary markets are still illiquid. The occurrence of defaults underscores the problem of the lack of an established body of case law for the priority of claims following a default.

Mr. Saidi argued, in a more general vein, that to become major players Islamic financial institutions will need to reform themselves while on the other side Governments and Central banks should strive to create a deeper money and financial market. In particular, he emphasized the opportunity to develop securities markets in the Middle East and the Gulf to absorb and invest locally excess liquidity, thus contributing to reducing global imbalances worldwide.

III – Third session: Regulatory and supervisory issues

Finally, we moved to the crucial issue of **the regulatory and supervisory framework**.

Islamic banks operating in Europe run a single business model, mainly retail. On the assets side, they do not make extensive use of Profit and Loss sharing contracts; on the liabilities side, the degree of freedom in managing PSIA is limited, so that their activities seem to be essentially no different from similar activities of many conventional banks. However certain risks are of greater significance compared to conventional banks. As our speakers pointed out, in addition to traditional banking risks, there are **risks peculiar to Islamic banking**: e.g. rate of return risk, displaced commercial risk and equity investment risk. The issue at stake is whether regulators and supervisors have the capacity to address and manage those risks.

Interesting proposals were made on ways to manage risks associated with equity-based transactions, i.e. Mudabarah (profit-sharing) and Musharakah (partnership) contracts.

In the view of some speakers, points of strength such as higher profitability, cheaper and more stable deposits, and higher customer loyalty than for conventional peers tend to be offset by weaker liquidity, greater concentration, and more heterogeneous and less rigorous regulatory, accounting and disclosure frameworks.

Different regulatory and supervisory perspectives were compared. Three basic Islamic banking and finance models are now in existence: 1) single Islamic financial system; 2) dual financial system; 3) conventional banks with Islamic windows and products.

Malaysia has developed a comprehensive dual financial system (Islamic banking, *takaful*, Islamic money market, Islamic capital market) with the adoption of an Islamic banking act in 1983 and the prominent role played by the central bank in issuing specific guidelines to IFIs.

Can this model be extended and exported to other jurisdictions? **Mr. Cardona** emphasized that in the European context no specific rules for Islamic banking are envisioned, in keeping with the principle of level playing field. However, it has been pointed out that some issues need to be addressed to ensure both the smooth functioning of this segment of the financial system and a non discriminatory regulatory and supervisory approach, in the areas of governance (Shari‘ah boards) and transparency towards customers and counterparts (to preserve reputation), the legal qualification of Islamic products, liquidity management, and some regulatory questions pertaining to operational and concentration risks. The co-operation between international Islamic institutions, domestic Islamic supervisory authorities and European supervisory authorities is a must to provide some answers.

A number of additional intriguing questions have been raised in the general discussion as the seminar purported to stimulate a debate, to raise the awareness of the complex and still partly unknown issues. As the Latin etymology "*seminarium*" suggests we have tried to breed the ground, to sow the seed with a number of open issues.

Finally let me **thank** our distinguished speakers for having shared with us their knowledge and experiences and all the participants for having attended this seminar and contributed to the general discussion. My personal and warm thanks go, at the very end of this endeavour, to the Bank of Italy’s staff who inspired and motivated me to launch this project, coauthored an internal report on Islamic finance, and worked very effectively toward organizing this seminar.