Anwar Khalifa Al Sadah: Challenges facing the Islamic financial services industry

Welcome address by His Excellency Mr Anwar Khalifa Al Sadah, Deputy Governor of the Bahrain Monetary Agency, at the 8th AAOIFI Annual Conference on Islamic Banking 2006, Manama, 11 June 2006.

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Your Excellencies, Ladies and Gentlemen,

First, may I take this opportunity to express my thanks to AAOIFI and especially to the Chairman of the Board of Trustees of AAOIFI, H.E. Shaikh Ebrahim bin Khalifa Al-Khalifa, for the opportunity to speak here today. No doubt, AAOIFI has performed an invaluable role in enhancing and standardising accounting and auditing practices in the Islamic finance industry, thereby giving credibility and international acceptance to the financial statements of Islamic institutions. The BMA recognises the importance of AAOIFI's role as a standard setter in the development of the Islamic financial industry. In fact; the Agency's vision to develop the Islamic financial sector as a major player in the global economy would not have been possible without AAOIFI. Bahrain is the hub of Islamic finance, and this has been achieved through the proactive relationship between the BMA and the industry participants. A host of other institutions must also be mentioned for their important work in the growth and development of Islamic finance. The BMA recognises the role IFSB plays in harmonising regulatory practices, and also the work of the International Islamic Financial Market, the International Islamic Rating Agency, and the Liquidity Management Centre.

In the short time available to me this morning, I wish to look back over the last fifteen years since the establishment of AAOIFI in 1991 and to look forward at the challenges facing the Islamic financial services industry.

Since its inception, AAOIFI has issued 24 financial accounting statements and standards, five auditing standards, four governance standards, 17 Shari'a standards and two codes of ethics. We and other players in the market including IDB and other Islamic banks have worked hard with AAOIFI on developing new standards and applying the AAOIFI standards on financial institutions. All Islamic banks in Bahrain are required to follow AAOIFI standards and many other regulators in the region either recommend AAOIFI standards or have based their own standards upon AAOIFI standards.

We also appreciate and value the proactive role played by the IDB in developing the industry. As far as regulatory issues are concerned, the Agency, in consultation with the industry, also developed a regulatory framework in 2001 for Islamic institutions, known as the Prudential Information and Regulations for Islamic Banks or "PIRI", which implements both the standards developed by AAOIFI and the Basel Committee"s various guidelines. We realised that Islamic banks needed a credible and Basel compliant framework if Islamic banks were to become more than niche players and interact in conventional markets. The PIRI framework covers:

- Capital adequacy;
- Asset quality, including large exposures and related party exposures;
- Regulatory treatment of investment accounts;
- Prudential requirements concerning liquidity management;
- Analysis of earnings quality; and
- Corporate governance and risk management systems.

The PIRI rules became the backbone of the BMA Islamic Banking Rulebook in 2005.

Also the BMA, since it became the single regulator for the entire Financial System in 2002, has given special attention to Takaful insurance by developing a healthy environment for Islamic insurance companies to work in. The Agency introduced a comprehensive regulatory framework for Takaful and Retakaful in 2005 for the business of Islamic insurance licensees; a framework that follows best international standards and yet accommodates the special nature of these companies. BMA Islamic Insurance licensees must comply with the accounting and Shari'a standards set by AAOIFI, like their banking counterparts. There are currently 12 Takaful companies licensed in Bahrain. Global annual revenues for Takaful are over $2bn with forecasted growth to $11bn in 2015, based on the current growth rates of 8% per annum for general Takaful and 20% for Family Takaful.

For banks, we are working on applying Basel 2 in an Islamic banking context, and will be releasing new Basel 2 compliant capital adequacy rules later this year for implementation in 2008. We have also very recently streamlined our bank licensing requirements, meaning now that Islamic and conventional banks are divided into two categories, wholesale and full commercial banks. The wholesale category replaces the investment and offshore categories of licence. This is not a re-labelling exercise, but reflects the Agency’s focus on the regulation of institutions according to their activities. I would urge attendees to refer to the Agency’s website for details of the single licensing framework. The new Volume 4 of the Rulebook introduces a comprehensive regulatory framework for investment business, in line with international standards. Volume 4 provides for 3 categories of investment firms licensee, depending on the nature of activities they undertake.

Category 1 investment firms may undertake all types of investment banking activities (except accepting deposits or investment accounts). Category 2 firms may undertake all types of activities except dealing as principal. Finally, Category 3 firms are limited to advising and arranging deals. All three categories may handle Islamic financial instruments such as Sukuk, either in a trading or advisory capacity.

Capital adequacy is however, not the only area where we have worked with AAOIFI. In 2001 the Bahrain Monetary Agency (BMA) began issuing Islamically structured short-term government bills (Al-Salam Sukuk) and three and five year Ijara leasing certificates. In doing so, the BMA became the first central bank to issue such Shari’a compliant certificates.

As at March 2006, approximately US$1.3bn of Ijara and Sukuk certificates were outstanding, providing much needed Shari'a investment and liquidity possibilities for Islamic institutions and conventional banks alike in the local market.

The BMA has also developed a standard murabaha agreement for its own dealings with banks, and launched last year standard murabaha contracts for banks dealing in commodities, notably through the London Metals Exchange ("LME"). This process has culminated in the BMA signing an MoU with the LME in July 2003, and subsequently signing an MoU with the Tokyo Commodities Exchange to develop a framework to enable institutions and brokers to conduct Shari'a compliant transactions on the Exchange.

Corporate Governance is the other major arena where we have worked with and supported AAOIFI. The Agency recognises the need for explicit rules for banks to act clearly in the interest of investment account holders and demonstrate how that responsibility fits in with the bank’s responsibility to its stakeholders. That is why we have required banks to follow not only the auditing standards set by AAOIFI but also its governance standards. The role of the Shari'a Boards needs to be further developed by applying greater and more effective governance standards. Also, the subject of Shari’a compliance needs to show further convergence. Shari’a judgements (or Fatwas) are as important to Islamic finance as accounting standards or legal opinions. That is why we support the role of AAOIFI’s Shari’a Board in harmonising the Fatwas of individual banks. There must be uniformity of not just accounting and regulatory standards, but also of Shari’a judgments. We will continue to work with AAOIFI in this area in the future.

However, Islamic banking is dominated by small institutions. If Islamic banking is to grow successfully, we do not need more small Islamic banks. We need bigger Islamic banks that can compete successfully and handle large projects. We need consolidation and convergence in the industry. The need for convergence applies not just to the number and size of banks, but also to convergence of procedures and practices. There is clear evidence that we are experiencing a convergence of regulatory and auditing standards for Islamic banks and their products. The regulators, the auditors, the standard setters and the Islamic institutions banks have a mutual interest in the continuing development of a stable well governed and sound Islamic financial services industry. In this respect, the next fifteen years are likely to bring greater challenges, rewards and greater penetration by Islamic institutions of the global market.

In conclusion, I wish you all, a very successful conference. Thank you for your kind attention.