Ignazio Visco: Islamic finance and the European challenge

Opening address by Mr Ignazio Visco, Governor of the Bank of Italy, at the IFSB Forum "The European challenge", organized by the Islamic Financial Services Board (IFSB) and hosted by the Bank of Italy, Rome, 9 April 2013.

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Ladies and gentlemen,

I am pleased to welcome you today to this Seminar, organized by the Islamic Financial Services Board and hosted by Banca d'Italia on the subject of Islamic finance. As you know, the main prescriptions relating to financial transactions in accordance with Islamic religious law are the ban on paying interest and the prohibition of excessive uncertainty and speculation in contractual arrangements. This is predicated on the principle that profits should be generated from fully sharing in the business risk of an investment (the so called "profit and loss sharing principle"). The asset-backing requirement complements these prescriptions, providing for the link between each financial transaction and an identifiable underlying asset.

A few weeks ago I gave a lecture on the financial sector after the crisis. On that occasion, it occurred to me that the renowned economist and philosopher – and eventually Nobel laureate – Amartya Sen had given in these same rooms the first of our scholarly lectures entitled to the memory of our late governor Paolo Baffi. Sen's lecture was on "Money and Value: on the Ethics and Economics of Finance". It is of course an interesting and good read in these difficult days. But what I was most intrigued by was Sen's question: "How is it possible that an activity that is so useful has been viewed as morally so dubious?"

There are indeed a good finance and a bad finance. While we may have some differences in ideas and perceptions on the goods and the bads, I think that what is most important is really to focus on the link between financial transactions and underlying assets, to conclude, with Sen, that "finance plays an important part in the prosperity and well-being of nations". Indeed, it is crucial for sharing and allocating risk, especially for poorer societies and people. It is crucial for transferring resources over time and removing liquidity constraints. It is very important for fostering innovation and promoting economic growth.

But it has to be certainly "ethical" and certainly transparent.

An accurate measure of Islamic financial services is difficult, due to the lack of official statistics. However, some private estimates assess the current size at about 1.6 trillion dollars, in terms of assets. While Islamic finance still constitutes a small share of the industry, roughly 1 per cent of overall global financial assets, it has witnessed a rapid expansion over the last decade, with annual growth rates in the range of 10–15 per cent. It has also gained further momentum following the financial crisis.

Islamic banking accounts for about 80% of total Islamic financial assets but the development of Islamic securities, notably the *sukuks*, has also contributed to increasing this sector's activity in international capital markets.

The industry has seen a wide dissemination across countries, beyond its traditional centres of gravity in the Middle East and South East Asia. According to available estimates, Islamic financial institutions are currently operating in around 70 countries.

Europe has also been part of the process, with the opening of Islamic banks in the UK, the issuance of a *sukuk* bond by a German Land, an increased activity in the field of Islamic investment funds, some tax and regulatory changes introduced in France to facilitate the use of Islamic financial products.

This global expansion is expected to continue also in the near future: some market estimates foresee that by the end of this year Islamic financial assets will have reached 1.9 trillion dollars.

Several factors underlie growth in this sector: the need to invest the abundant liquidity acquired by oil exporting countries; the search for risk diversification and for *shari'ah* compliant/ethical investments; the increased need for funding for socio-economic development in Islamic countries; and support from regulatory and supervisory authorities. Part of this trend can also be attributed to the growing interest in the industry coming from non-traditional markets, like the EU, the US, South Korea, Hong Kong, etc.

In Banca d'Italia we are interested in deepening our knowledge of this subject, in view of its relevance for the Bank's institutional duties, as a member of the Eurosystem and as the Authority for banking and financial supervision in Italy. A Seminar on Islamic Finance was organized here in 2009 and a collection of research papers on Islamic finance vs. conventional financial systems, focusing on supervision and the implications for central banking activity was published in 2010. Hosting this IFSB seminar is a fruitful occasion to further improve our knowledge and to share it with our financial community and academia.

The opportunity to attract foreign capital to underpin economic progress, on the one hand, and the intensity of the commercial and financial links with the southern shores of the Mediterranean, on the other, make it increasingly important for our country and its financial system to be equipped with the knowledge and the operational instruments needed to interact with financial systems complying with *shari'ah* principles. It is interesting to note that in the countries where Arab revolts occurred and Islamic-oriented political parties are now in charge of government, after the collapse of previous authoritarian regimes, the development of Islamic finance is gaining momentum. Very recently the Egyptian Legislative Council has adopted a project to issue *sukuk*.

Even a cursory look at today's program shows that Islamic finance and its interactions with conventional financial practices are a source of numerous intriguing questions. I am therefore confident that the subject will stimulate the interest of participants, and most grateful to the speakers who have accepted to join the 4 panels.

The overview of the industry, to which Session 1 is devoted, will show that the growth of Islamic finance in recent years is one aspect of the increased role being played in the global financial system by a number of emerging economies. This opens up new opportunities for channeling financial resources both to these countries and other markets but it also adds to the complexity of the system, calling for enhanced international cooperation by policymakers and regulators, lest the benefits of a financial system which is dynamic and prone to healthy innovation are jeopardized by instability.

In the European context, some additional drivers can be identified: on the demand side, the growing resident Muslim community potentially requesting more retail banking services, and on the supply side, an improved know-how on the part of European intermediaries, together with the already mentioned attractiveness of some financial markets for the investment of Gulf countries' liquidity, and the potential use of Islamic finance products to broaden funding sources to finance public debt.

The question of public debt financing takes us to the subject of another Session – Session 3 – where the issuance of *sukuk* bonds, whose total outstanding volume reached $230 billions in 2012, will be discussed, together with their increased role in international capital markets.

Growing attention is devoted in Europe to the possibility of issuing sovereign and corporate *sukuk* and we are pleased to have as Chairperson of this session Ms. Maria Cannata, Director General of the Public Debt, Department of the Treasury of our Ministry of Economy and Finance.

Coming to challenges and opportunities in the European framework, which will be discussed in Sessions 2 and 4, let me conclude by only mentioning in passing some issues that may inhibit the development of Islamic finance. First, in the field of monetary policy, the Eurosystem operational framework is, of course, relying on interest-based instruments. Second, in the area of prudential regulation and supervision, all European banks have the obligation to join deposit insurance and/or financial services compensation schemes, whereas, according to the Islamic jurisprudence prevailing in various Islamic countries, Islamic bank "investment" deposits (which follow the "profit and loss sharing principle") cannot be covered by deposit guarantee schemes. Moreover, there exists a prominent issue of corporate governance related to the role of the *shari'ah* boards. In Italy for instance the Board of a bank is required to take full responsibility for the bank's management decisions, which cannot obviously be "shared" with another body such as the *shari'ah* board. Let me leave you with these queries trusting that the debate in this forum will shed light on the issues.