The Mauritius Islamic Finance Forum - Premier Event in Islamic Finance

Address by Mr. Rameswurlall Basant Roi G.C.S.K., Governor, Bank of Mauritius

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Hon. Deputy Prime Minister, Minister of Finance and Economic Development
Hon. Minister of Arts & Culture
Director of the Islamic Cultural Centre
Members of the Diplomatic Corps
Ladies and Gentlemen

Good Morning

I am very pleased to be here with you this morning for the Premier Event in Islamic Finance in Mauritius. May I first of all express my deep appreciation to the Islamic Cultural Centre for having taken the initiative to promote awareness in Islamic Finance in Mauritius. I do fervently hope that the two-day forum will provide an excellent opportunity to share views and ideas on the principles underlying Islamic finance and the way forward towards the promotion of Islamic financial services.

The concept of Islamic finance dates back to ancient times. However, formal Islamic financial institutions are known to have been in existence for over 30 years. In the recent past, the growth of Islamic financial services worldwide has gathered momentum. Islamic financial institutions are today present in more than sixty countries across the world with total assets running in hundreds of billions of US dollars. The services are certainly not confined to Islamic countries. They have increasingly expanded beyond the frontiers of Muslim countries and are slowly taking roots in western financial systems. I am sure that all of us here are aware that Islamic laws, or the *Shariah*, strictly prohibits fixed or pre-determined rate of interest, the *Riba* as it is referred to, on financial instruments or such interest arising from dealings and transactions in risk instruments. Here, in Mauritius, we do have bank customers of

Islamic faith not claiming interest rates on their deposits. In fact, as of today, there are about 260 holders of deposit accounts who do not claim interest. This is not a recent phenomenon. It is a feature that has marked our banking industry for several decades and relatively unknown to the general public in Mauritius. It obviously follows that issues relating to Islamic banking need to be discussed and fully appreciated by all of us who are in one way or the other concerned with banking in Mauritius.

Before I proceed further with my remarks, let me underline one aspect of Islamic finance that could give rise to ill-conceived interpretation. Financial institutions in general keep adapting to changing socio-economic environment. Finance does not have to do exclusively with any specific ethnically or religiously defined groups. Islamic financial products are suitably carving out a market. There is indeed a market need for these products and that market is expanding quite fast. Be they Muslim or not, individuals and corporate bodies in western markets are increasingly purchasing, for instance, *Sharia*-compliant mortgages thus supplying funds to Islamic financial institutions to create more and more *Sharia*-compliant mortgages. The *Sharia*-compliant mortgage is a product that is not subject to the vagaries of interest rate volatility and as such this instrument is found to be the most appealing to bank customers.

Having said that let me give a very broad brush-stroke of recent trends in Islamic banking. In a few countries the entire banking system has been converted into Islamic banking; in some others the banking system is dominated by conventional banking institutions operating alongside Islamic banks. Over 250 Islamic financial institutions are presently operating worldwide. Several international banks like the Citigroup, HSBC and Lloyds TSB are offering Islamic financial products and services either through 'Islamic Banking Desks' within their conventional banking businesses or the establishment of separate banks or subsidiaries that specialise in financial products. Indeed, these banks have successfully added targeted services to their broader platform.

The sources of funds of Islamic financial institutions as well as the types of financing proposed by Islamic financial institutions have evolved over time. The main sources of funds are classified broadly into current accounts, savings accounts and investment accounts – such as in the form of *Amanah* and *Qard-hasan* deposit understood as conventional deposit for safekeeping the face value of which has to be guaranteed by the financial institutions. *Mudarabah*, refers to contracts in which a financial institution purchases goods upon the request from a client and the profit or loss is shared between them at an agreed upon ratio. This is classified as a loan. *Participation term certificates* and *Profit and loss sharing certificates:* these certificates resemble shares in a company and are generally classified as deposits. The principal types of financing are generally categorised into investment financing, trade financing, lending and services – in the form of *Qard-hasan* loans, *Murabaha*, *Musharaka*, *Ijara, Ijara Wa Iktina and Salaf.* These are but a few of the financial products.

The modes of financing in Islamic banking emphasise principally profit-and-loss sharing, although there are also some non-profit and loss sharing modes of financing. Theoretically, Islamic banks are relatively more concerned about the feasibility and profitability of a project while conventional banks tend to rely more on collaterals. This is one of the features of Islamic banking that could be of tremendous assistance to small-scale businesses. Conventional banking requires comprehensive criteria that need to be satisfied for an applicant to become eligible for loans. Small-scale enterprises throughout the world generally face greater difficulties in obtaining finance than large-scale enterprises do. The services sector is made up of a large number of small entrepreneurs who usually do not have ready access to finance. It is a matter of fact that small entrepreneurs who were able to obtain credit facilities on the basis of collateral in the past are now finding it difficult to raise funds for their operations. With the implementation of Basel II in the years ahead, there does exist a potential risk that conventional banks would be less inclined to lend to small-scale enterprises. Given the characteristics of Islamic banking, the small and medium enterprises is an economic sector where Islamic banking could play a central role in giving a fillip to entrepreneurship.

In short, Islamic banks can play a catalytic role in fostering economic development although it has been observed that, in practice, Islamic banks tend to favour short-term projects and trade finance - which are less risky. This is principally due to a lack of adequate techniques for project appraisals in an Islamic banking context. Because of these weaknesses, it is advisable to address the need for having staff with the required skills to learn the new processes for operating Islamic banks.

The provision of Islamic financial products and services has expanded beyond the market for households, businesses and institutions to governments. They have made inroads into capital markets. The *Sukuk* bonds – which differ from ordinary bonds to the extent that they are *Shariah*-compliant – have gained prominence. The market for *Sukuk* bonds is expected to register rapid growth in the years ahead as more and more conventional financial institutions are expressing keen interests and are actually participating in it.

The expansion of Islamic banking across the world has inevitably drawn the attention of central bankers and regulators in the Middle East and elsewhere to the risk factor associated with it. Like conventional banks, Islamic banks also need to be effectively regulated and supervised. Their strength and soundness are unequivocally as critical as for conventional banks. However, the nature of risks associated with Islamic banking business brings forward an array of issues in risk measurement, income recognition, adequacy of collateral and disclosure standards. Effective prudential supervision for Islamic banks the world over is still in its infancy.

The very fact that Islamic banking differs from conventional banking in important ways poses regulatory and supervisory problems. The risks taken by Islamic financial institutions are not directly comparable to those of conventional financial institutions. In most of the countries where conventional banks operate alongside Islamic banks, the same regulatory and supervisory standard is being applied to the extent possible. So far the tendency has been to apply the standard set by the Basel Committee on Banking Supervision. It is however recognized that the same standard as is applicable to conventional banking cannot be made rigorously applicable to an Islamic banking framework. Designing a comprehensive set of standard regulatory prescriptions and supervisory norms for an Islamic banking framework that are valid for all countries is a task yet to be accomplished. A prominent obstacle in the accomplishment of this task is the lack of uniformity in specific forms of Islamic principles in Muslim countries. Certain Islamic banking procedures and financial instruments that are accepted in one Muslim country may be rejected in another

Muslim country. The variants of Islamic banking practices make generalisation difficult as to what constitute standard and universally acceptable Islamic banking principles. It is deemed imperative to reach a paradigm version of Islamic banking that could be used as a benchmark for the crafting of an effective regulatory system and supervisory norms.

In short, the regulatory challenges raised by Islamic financial institutions are yet to be resolved in a comprehensive manner. Some regulatory authorities have already started looking into the appropriate regulatory framework. However, there is still quite a distance to travel before regulatory authorities could come up with a standard and comprehensive set of regulatory prescriptions and supervisory norms for Islamic banking.

Recognising these facts, the IMF supported and facilitated the establishment of the Islamic Financial Services Board (IFSB) in 2002 with a view to promoting, disseminating and harmonizing best practices in the regulation and supervision of the Islamic banking industry. The IFSB also aims at promoting good practices in Islamic financial institutions in risk management through research, training and technical assistance. It recently released exposure drafts on risk management standards for Islamic financial institutions. The work of the Accounting and Auditing Organisation for Islamic Financial Institutions is also of crucial importance. In the same vein, the work carried out by *Shariah* supervisory boards for Islamic financial institutions is of commendable importance for regulatory authorities.

In conclusion, let me reiterate that banking is a universal concept that knows no boundaries – be they geographical, ethnic or religious. Any form of banking, so long as it is conducted within the parameters of the laws and regulations to provide services in the best interests of society, is most welcomed. May I wish all the participants in the Forum fruitful deliberations. To the distinguished visitors participating in the Forum, I wish them a pleasant stay in Mauritius.

Thank you.

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