The First Islamic Finance & Investment Forum for the Middle East

Control and Supervision: The Jordanian Experience

by

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Good morning, ladies and gentlemen,

It gives me great pleasure to address this honorable and distinguished attendance at the First Islamic Finance & Investment Forum for the Middle East, which, I am confident, will provide a good forum for participants to share views on Islamic Finance and Investments industry.

It is a true honor to have the opportunity to address this distinguished gathering today and to speak about the **Control and Supervision: The Jordanian Experience.** It is also a great pleasure to have all of you here in the Dead Sea. I hope that you really feel at home.

Ladies and Gentlemen

It is a well-known fact that over the past three decades there has been a rapid evolution and expansion of the Islamic Financial and Investment industry both inside and outside the Muslim world. In fact, Islamic Financial Institutions (IFIs) have been recognized globally as a viable and competitive form of financial intermediation, especially in uncertain international financial markets as underlined by the current global economic and financial crisis. More recently, this trend has accelerated with the emergence of a substantial pool of oil-driven liquidity in the Middle East, which currently hosts more than two-thirds of Islamic Financial business.

Although Islamic Financial industry is growing rapidly and the potential for the industry to grow is great, it is nonetheless still undergoing substantial adaptations and innovations. Advancing the Islamic Financial industry to its next mature level of development requires comprehensive work on several dimensions.

Despite the achievements that have been secured this far, IFIs need to enhance their capacity and capability so that they will be compatible with global institutions in terms of prudential regulations and risk management. It is therefore imperative that standards of documentation, governance structure and practices, levels of transparency and disclosure are outlined against existing international standards, best practices and codes.

While the financial prudential regulation and supervision of IFIs would be similar to the conventional institutions, the areas such as capital adequacy, risk management and the liquidity framework have to take into account the unique risk characteristics of the Islamic models. The issue of capital adequacy and has it complement with the approach of the Basel II Accord should be given priority. Islamic Institutions fear their particular financial instruments are not harmonized in the Accord. As a result, they believe, such products can not be fully inserted in the Basel Accord. Thus, we need to formulize the risk profile of Islamic Institutions and set common acceptable standards.

Distinguished guests, ladies and gentlemen

For the foreseeable future, supervisory authorities will continue to face the dual challenges of understanding the Islamic industry and striking a balance between providing effective supervision and facilitating the industry's legitimate aspirations for further growth and development against the conventional finance.

The recent episode of the financial crisis has reminded us that financial globalization makes the safeguarding of the whole financial stability, requiring effective coordinated international action aimed at addressing financial system vulnerabilities.

As for Islamic banks, thanks to their ethical low-risk approach, they have managed to weather the global financial crisis, achieving high growth rates in 2009, a new study has found. "A conservative approach to risk and close links between the financial sector and real assets has helped shield the sector from the worst of the credit crisis," Brian Caplen, editor of the Banker Magazine, said in the study cited by France Press Agency.

The study, commissioned by the London-based magazine and a unit of HSBC Bank, said Islamic finance institutions have overcome the crisis that harshly hit conventional banks. The study attributes success of the Islamic banks to rules that forbid investing in collateralized debt obligations and other toxic assets that caused the financial crisis. Due to its safety, the Islamic finance industry is building a “solid track record," on the global market, the study states. “At the moment there is a great demand for capital guaranteed or capital secured products," David Dew, Deputy CEO of HSBC Amanah, told Reuters. The study notes that assets held by Shari`ah-compliant banks or the Islamic units of conventional banks rose by 28.6 percent to 822 billion dollars in 2009, up from 639 billion dollars in 2008.

This contrasts sharply with the stagnation in the conventional banking sector. A Banker's survey of the top 1,000 world banks published in July 2009 showed annual asset growth of just 6.8 percent. Islamic finance is one of the fastest growing sectors in the global financial industry.

Ladies and Gentlemen

In Jordan, we were able to weather the storm in the international scene with minimal damage, thanks to a responsible macroeconomic policy setting, to generally conservative financial regulation and effective supervision and also to prompt response in terms of providing liquidity to financial markets, announcing a blanket deposit guarantee until the end of 2010.

Over the years, the Central Bank of Jordan (CBJ) has taken many steps to improve the quality of supervision, through clear guidelines and instructions. A Prompt Corrective Action Framework was introduced, and guidelines were issued aiming to improve the banks' corporate governance and enhance risk management systems. The CBJ is also using the advent of Basel II to promote banks' own self evaluation of risk and oversight roles. It is requiring banks to develop roadmaps to achieve the objectives set forth in CBJ and Basel II requirements. The CBJ issued licensing criteria and regulation of acquisition of effective interest in Jordanian banks capital which specify "Fit and proper" standards for both board of directors and management. Furthermore, the CBJ has increased its interaction not only with the management but also with the boards in order to convey the importance it places on sound oversight and management processes. The CBJ tends to continue this trend.

Jordan’s banking system financial soundness indicators remain strong. The capital adequacy ratio, on average, stands today at 19.3%, which is significantly above our minimum requirement of 12% and the Basel requirement of 8%. Similarly, liquidity of banks is over 150%, again, well above the 100% requirement of the central bank. Total loans to deposit ratio for our banking system continue to be around 75%. Due to the global crisis, the ratio of non-performing loans to total loans rose from 4.2% in 2008 to 6.4% as of end 2009. The important point to emphasize is that most banks have more than adequate provisions for the tune of around 50%.

It is important to know that the Central Bank regulations impose caps on the exposure of Jordanian banks to regional and international markets. These regulations did prove to be well placed. The regional and international exposures of our banks turned out to be minimal. In line with central bank regulations, banks disclosed any such exposure and made adequate provisions against it.

Ladies and Gentlemen

My final point relates to the Jordan experience with Islamic banking. Consistent with other countries in the region, banks dominate Jordan’s financial sector. The number of operating banks in Jordan rose to 23 by year-end 2009. The sector includes thirteen Jordanian commercial banks, two Jordanian Islamic banks, and eight foreign banks. The Jordan Islamic

Bank was established in 1978 and the International Islamic Arab Bank was established in 1997.

At present the assets of the two Jordanian Islamic banks amount to around 11% of total assets of the banking system and the deposits with a market share of around 12.5% of total bank deposits and the credit facilities accounting for around 15% of total bank credit.

Additionally, two new Islamic banks were granted licenses to operate in Jordan (Jordan Dubai Islamic Bank and Al Rajhi Bank). Jordan Dubai Islamic Bank started its operations in Jordan on the 3rd of January 2010, and Al Rajhi is expected to operate within the next half of 2010.

The issuance of new Islamic banking licenses to qualified foreign financial institutions will allow for the presence of foreign Islamic banking players to act as a bridge between Jordan and other global Islamic financial markets and increase the potential to tap new markets and growth opportunities. It will also contribute to spur financial innovation as well as facilitate international trade and investment flows between Jordan and the rest of the world. As Islamic finance keeps expanding, the CBJ will have to ensure that these new banks become fully integrated with the rest of the banking system. The integration process will not only entail allowing Islamic banks to operate, but will also provide a comprehensive regulatory framework, as well as develop a supportive financial infrastructure.

Currently, the CBJ undertakes similar supervisory and regulatory functions regarding Islamic banks as the one already performed vis-à-vis conventional banks. In fact, the CBJ applies a single regulatory framework to both conventional and Islamic banks because our regulations address prudential issues of liquidity, credit, market, operational and concentration risks. These are relevant to both conventional and Islamic banks. At the same time and while Islamic funding and financing structures are different, we consider the substance of the underlying risk of these structures, and apply the regulatory treatment that is consistent with the risk.

In this regard, the Banking Law No. 28 of the year 2000 includes a separate section that addresses Islamic Banks activities. Moreover, CBJ adapted the Accounting, Auditing and Governance Standards for Islamic Financial Institutions, Islamic Banks are required to adhere to such standards. It's also worth mentioning that CBJ is a full member of the IFSB.

Moreover, and in order to ensure that the liquidity ratios accurately reflect the liquidity position of Islamic banks, and to accommodate the specific nature of Islamic banks' operations, the CBJ issued in November 2007 legal liquidity regulation for Islamic Banks; this regulation considered Commodity Murabaha transactions as inter-bank money market transactions (i.e. part of liquid assets) and added Islamic Sukuk and Islamic Mutual Funds according to the issuer rating to the liquid assets.

For the purpose of enhancing the ability of the Islamic banks to meet its obligations and to ensure that these banks have ample liquidity and a solid financial position, the CBJ issued in August 2008, the regulation for liquidity according to the maturity ladder for Islamic Banks, which added Al Qard Al Hasan to the assets, and gave real estate investments a 50% discount. Furthermore, Islamic Banks unlike conventional banks are allowed to acquiring, selling, and investing in leasing, and renting movable and immovable properties. Finally, the CBJ is in the process of issuing capital adequacy regulation for Islamic banks.

Ladies and Gentlemen

As for the challenges and difficulties faced by the Jordanian Islamic banks:

1. The absence of the secondary market for Islamic financial instruments as well as an inter-bank Islamic money market is also among the most difficult obstacles in the development and expansion of Islamic banks. They are under a constraint to maintain liquidity that is higher than what conventional banks normally keep. This has an adverse effect on their profitability and competitiveness. Moreover, Islamic banks do not engage in open market operations conducted by the CBJ on behalf of the Jordanian government. There are proposals from bankers that suggest the founding of a Shariah compliant instrument, like Islamic sukuk, that participate in funding certain development

projects owned by the government that are based on Profit Loss Schemes, and do not carry interest.

2. The lack of lender of last resort and thus deprive the Islamic banks to get cash when they need it, forcing them to maintain high liquidity levels at the CBJ in order to be used when a crisis occur, or to meet the requirements imposed ratios by the CBJ such as liquidity and capital adequacy ratios.

3. Lack of qualified and trained personnel on the work of Islamic banks, whether Islamic banks’ staff and / or the staff of regulatory authorities and / or oversight bodies while most bank employees are polarized of the conventional banks.

4. The CBJ must have an understanding of whether Islamic banks’ activities are compatible with the Shariah. Islamic banks in Jordan have their own Shariah advisors. However, setting up a Shariah consultative board at the CBJ would be beneficial in Jordan where Islamic banks are present.

Ladies and Gentlemen

In a world of increasing globalization, it is important for Islamic financial business to develop unified international standards and approaches that allow greater cooperation across countries. We can see international best practices and standards being adopted and implemented across not only different borders but also different regimes. Such standards as the Basel II for banking supervision are helping to promote soundness, stability and growth of the global financial system. Unified frameworks will support the Islamic financial industry to take full advantage of, and keep pace with, the evolution in conventional financial services. They will also help to mobilize resources and funds to current and potential clients of Islamic finance.

Resolving these important issues requires the combined efforts of all related parties, to ensure that the desired outcomes are achieved. It is important that we resist the impulse to do it alone and instead to work together in partnership, not least because there is much to do for the Islamic industry to catch up and keep pace with the conventional system. Indeed, working together is not only desirable, but necessary in this demanding and highly competitive world.

Your presence here today is a good step towards realizing our shared vision for Islamic finance. I look forward to seeing the outcome of your deliberations on options to close the gap and to build bridges towards greater economic prosperity for our countries and for future generation.

Thank you for attention