Good morning, Sabah Alkhyr, and welcome to this important conference on Islamic Finance.

Let me start by thanking the Central Bank of Kuwait and His Excellency Governor Mohammad Yousef Al-Hashel for hosting and co-organizing today's conference. I would like to commend His Excellency for his relentless efforts and enthusiasm in promoting Islamic finance. I would also like to thank the Middle East Center for Economics and Finance for co-organizing today's event.

It is a pleasure to be back in Kuwait, to see all of you gathered here today to discuss Islamic finance. We have a great day ahead of us, with promising panel discussions. We at the IMF are keen to participate, to listen, to collaborate, innovate, and develop the promise of Islamic finance in a sound and sustainable way, by managing risks appropriately and ensuring financial stability. We see this conference today as the opportunity to do so, as the gateway for action to help lift Islamic Finance to full potential. I would like to touch on a few issues that are, in my view, central to our deliberations today.

Before discussing the ongoing challenges that we need to tackle to unlock the promise of Islamic Finance, we should recall what promise Islamic Finance holds—to foster inclusive growth and support the livelihood and aspirations of the people in the region and beyond. And we know, inclusion is key to promote invigorating, reinforcing growth and shared prosperity.

1. The Promise that Islamic Finance Holds

So let me turn to the promise that Islamic finance holds: while Islamic Finance is not new and has been practiced for centuries around the world, it has gained in popularity of late. Total Islamic finance assets are estimated at around $2 trillion, practically a ten-fold increase from a decade ago, and outperforming the growth of conventional finance in many places.

It is easy to see the appeal of Islamic Finance. Here are just two:

First, Inclusivity: Islamic finance has the potential to contribute to higher and more inclusive economic growth by increasing access of banking services to underserved populations. To this day, a large segment of the Muslim population—who are a primary, but not the only, market for Islamic finance around the world—remain financially underserviced, with only one-quarter of adults having access to bank accounts.

In addition, Islamic finance's risk-sharing features and the strong link of credit to collateral means that it is well-suited for Small and Medium-Sized Enterprise (SME) and startup financing—which we know can promote inclusive growth. For the same reason, Islamic finance has shown its value in infrastructure investment, which can spark productivity gains and catalyze high value-added growth.

Second, Stability: Islamic finance has, in principle, the potential to promote financial stability because its risk-sharing feature reduces leverage and its financing is asset-backed and thus fully collateralized. In addition, besides deposits, Islamic banks offer profit-sharing and loss-bearing accounts that can help mitigate losses and contagion in the event of banking sector distress. This leads, de facto, to higher total loss-absorbing capital, one of the key objectives of the new global regulatory reform.

I think it is also fair to say that Islamic finance's underpinning principles of promoting participation, equity, property rights and ethics are all “universal values”.

And yet, despite these important benefits and the clear potential, there is still a long way to go to fulfill the maximum potential of Islamic finance. Today, it represents less than 1 percent of global financial assets and is still very much concentrated in a few markets. So there is clearly room to grow, especially given that the features of Islamic products can appeal to a much wider group.

Of course, as Islamic finance expands and takes on greater importance in countries’ financial systems, it will be important to nurture this development in a safe and sound manner. There are also a number of important policy issues that will need to be tackled to reap its full benefits.

Let me turn to that now.

2. Unlocking the Potential of Islamic Finance

What are the key elements required to unlock the full potential of Islamic finance in an effective and prudent way? I see several priorities:

(a) Creating an Enabling Environment

The first priority is to level the playing field and create an enabling environment for Islamic finance to develop, while being mindful of risks.

This means adapting financial regulations that take into account the defining features of Islamic finance and do not disadvantage Islamic banks. For example, capital requirements for banks should be adapted to account for Islamic finance’s risk-and-profit sharing model—which allows for some loss-bearing by investors and reduces

risk weights applied to equity-like financing.
Leveling the playing field also means harmonizing the tax treatment of Islamic finance products with similar conventional contracts. Income tax systems typically recognize interest gains on debt instruments as a deductible expense. This debt bias puts Islamic finance at a competitive disadvantage and discourages risk-shared financing. Some countries can already remedy this disadvantage under their existing tax systems, but others still have to review their tax legislation.

We also need greater consistency in the application of regulation and supervision to Islamic banks and governance across jurisdictions. Islamic standard setters—including the Islamic Financial Services Board and the Accounting and Auditing Organization for Islamic Financial Institutions—have done an impressive job in establishing the rules of the road. In so doing, they have cultivated closer cooperation with conventional financial standard setters, which bodes well for global financial stability.

More needs to be done to enforce these rules. IMF surveillance suggests that the current standards are not being applied consistently across countries. This could stifle the development of Islamic finance, or encourage its growth in a manner that creates systemic vulnerabilities.

I look forward to hearing your views on how to implement these necessary changes both at the national and global levels.

(b) Developing the industry and markets

The second priority for policymakers is to further develop the industry and markets. What do I mean by that? Many countries could encourage further improvements in Islamic banking to boost financing for small- and medium-sized enterprises.

For instance, information about the creditworthiness of SMEs needs to be strengthened, including collateral availability. More efforts are needed to train well-qualified staff, who can help meet the high demand for Islamic finance products. And Islamic banks need to bolster their risk management capacity for SME lending.

Some of these initiatives will be led by the industry itself. Others will also need to play their roles—with regulators ensuring that adequate credit risk systems are in place, with development banks partnering with Islamic banks for SME financing and capacity building, and with governments fostering financial education and literacy.

In addition to strengthening the industry, many countries could further develop Islamic financial markets.

Think of the growth potential of Sukuk. Over the past decade, total outstanding Sukuk assets have seen a ten-fold increase to about $300 billion. Most of these assets remain concentrated in the Gulf States and Malaysia. But interest has been growing in other parts of the world. Luxembourg, Hong Kong, South Africa, and the United Kingdom are among a growing number of other countries that have issued Sukuk bonds in recent years.

The challenge for policymakers is to help this market reach its full potential.

For example, more regular sovereign issuance is needed at different maturities to help establish benchmarks and develop secondary markets. Sovereign Sukuk plans need to be embedded in governments' debt management strategies. And the market needs to be supported by strong legal and regulatory frameworks. The latter would help address persistent uncertainty over investors' rights. Many countries also need to develop money and interbank markets for Shari'ah-compliant instruments to help Islamic banks manage liquidity needs more effectively. An underdeveloped market forces Islamic banks to hold excess liquidity buffers. It also limits central banks in the conduct of their monetary policies, particularly in countries with large Islamic banking systems.

Here, I would like to commend the role of the International Islamic Liquidity Management Corporation. It was successfully established by your central banks to create and issue short-term Shari'ah-compliant instruments to facilitate effective cross-border liquidity management.

(c) Ensuring financial stability

The third priority for policymakers is to further strengthen regulation and supervision to ensure financial stability.

I already stressed the need for greater international consistency in the application of regulatory and supervisory standards. This is essential not only because it helps level the playing field, but because it helps manage the specific risks associated with Islamic finance and prevents regulatory arbitrage.

At the same time, we should ensure that Islamic financial institutions are not under-regulated or over-regulated, and that standards are adapted to take into account the specific features of Islamic products.

The gradual implementation of the Basel capital and liquidity requirements adapted for the features of Islamic finance will be key. This transition may not be easy for Islamic banks, particularly regarding liquidity. But it can be seen as an opportunity for development of new instruments and markets, and will need to be completed to ensure the resilience of national banking systems. Already Islamic finance is considered systemically important in 10 countries, where it accounts for more than 15 percent of total financial assets. Of course, with increased clout comes increased responsibility on the part of Islamic banks—and a growing need for oversight. Financial safety nets—including deposit insurance and lender-of-last-resort facilities—also need to evolve to take into account the specific features of Islamic finance. Without these upgrades, countries may not have the tools to adequately respond to shocks to individual financial institutions. Nor would they have the capacity to prevent spillovers to the conventional banking system.

From the IMF's perspective, we are also looking to raise our game. As you know, financial stability lies at the heart of the IMF's work. We have, over the past year, done a large amount of analytical work to deepen our understanding of Islamic finance's implications for financial stability and economic growth. We are keen to pursue this agenda and to further strengthen our policy advice by incorporating best practices for Islamic banking and finance into our surveillance work.

3. Conclusion

So, let me conclude by quoting Ibn Khaldun, the great 14th-century scholar, once said: "He who finds a new path is a pathfinder, even if the trail has to be found again by others; and he who walks far ahead of his contemporaries is a leader, even though centuries pass before he is recognized as such."

Unlocking the true potential of Islamic finance requires this strong leadership. It also requires strong cooperation among all stakeholders—from the Middle East to Asia and beyond; from Islamic banks to policymakers, to regulators, to international financial institutions such as the IMF, the World Bank and the Financial Stability Board.

We all know that effective cooperation yields success. The IMF has worked closely with key standard-setters to assist them in developing international norms for Islamic financial institutions, and has helped with the establishment of the Islamic Financial Services Board.

We continue to work on a bilateral basis with our member countries—providing technical assistance in areas such as Islamic bank regulation and supervision, the development of Sukuk markets, and monetary policy implementation in countries with a large Islamic finance presence. We also aim to cover Islamic finance more systematically in our bilateral surveillance of countries where it is important.

At the same time, we have benefited greatly from the guidance of the major Islamic finance standard-setters and multilateral institutions in our analytical and policy work on Islamic finance. They now form an External Advisory Group for our work in this area, which we highly value. I am also very pleased that the Islamic Development Bank and the IMF have agreed to expand our partnership to support capacity development in Islamic Finance.

So cooperation has already been quite successful, and has yielded important results. We are keen to deepen our engagement—by listening to your views and by building on today's conference.

Together, we can foster a 21st-century version of Islamic finance that can deliver on all its promises. That is to promote financial inclusion and stability, meet the needs of financially underserved populations, lift potential growth, and create better opportunities of all people.

Thank you—Shukraan.

***Christine Lagarde**, Managing Director, International Monetary Fund at the Islamic Finance Conference, Kuwait City, November 11, 2015*