



ORGANISATION FOR ECONOMIC
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MEETING KEY CHALLENGES FOR FINANCIAL
SECTOR DEVELOPMENT IN THE MENA REGION
THE ROLE OF ISLAMIC FINANCE

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Key Economic Challenges in the MENA Region

- **Diversification** - remains a key issue, particularly in the Gulf region
- **Employment Creation** - regional unemployment estimated at 13-14 percent
- **Entrepreneurship** - Significant efforts undertaken by governments across the region, but the availability of capital on reasonable terms still poses a problem
- **Innovation** - How can finance contribute to fostering innovation in the region?

Financial Sector Prerequisites to Meet these Challenges

A large, solid black downward-pointing arrow that points from the prerequisites section to the objective section.

**Development of
innovative financial
products and services**

**Improved Corporate
Governance Standards**

**Liquid and Efficient
Capital Markets**

**Objective: Finance to support innovation, entrepreneurship and
growth**

- Sources of finance to emerging enterprises weak, particularly in Egypt, Morocco, Tunisia, Jordan
- Weak bond markets, absence of long term government yield curve
- Explosion of private equity/venture capital activity in the Gulf
- Rapid raise of Islamic Finance and particularly the sukuk market
- Development of mortgages, insurance and credit cards
- Launch of new financial centers (Bahrain Financial Harbour, King Abdullah Financial District and a new financial center being constructed in Jordan)
- Financial education a key ingredient for further development of financial products

Challenges to financial sector development – Corporate Governance

- Corporate governance standards are required to attract local and institutional investors to regional capital markets
- Excess liquidity in the region reinforces the need for improved bank governance to ensure the efficient use of resources and stability of the financial sector
- The banking system can develop a cascading effect to advance corporate governance in the non-bank corporate sector
- The oversight institutions in the MENA acknowledge link between:
 - investment climate
 - capital market development
 - sound risk management practices and
 - the **need for good corporate governance**

Solving the Equity Gap: MENA-OECD Enterprise Financing Network

- **The MENA-OECD Enterprise Financing Network** aims to improve the regulatory conditions for financing entrepreneurship using the MENA-OECD Investment Programme as a forum for exchange of good practice between MENA and OECD business and government representatives
- The Network **aims to foster entrepreneurship** in the region by:
 - Creating a platform to connect entrepreneurs, financiers and government regulators
 - Providing avenues for private sector participants to effectively input into key investment policy reforms relevant to financing of entrepreneurship
- The Network was launched in Manama in 2006 and a meeting hosted by the Dubai International Financial Center was held in 2007

Dubai Declaration adopted at the last EFN Meeting calls for:

- Survey of framework conditions relating to the operation of private equity and venture capital in MENA countries
- The development of a blueprint for successful enterprise funds drawing on best practices of MENA and OECD member countries
- The establishment of a MENA Institute for entrepreneurial finance and to provide training/advice
- The Enterprise Financing Network is open for membership and sponsorship of activities

The MENA-OECD Investment Programme Focus on Financial Sector Development

- A programme by the Region and for the Region
- Aimed to generate growth and employment

Through a better policy environment for private sector development

- Composed of regional Working Groups & Task Forces
- Providing support for financial sector reform programmes in MENA countries

- **Task Force on Capital Markets (headed by the Qatar Financial Centre Regulatory Agency)**
- **Task Force on Corporate Governance of Banks (operated jointly with the Hawkamah Institute on Corporate Governance)**
- **Enterprise Finance Network (located at the MENA Investment Centre, Bahrain)**

Key Role of Islamic Financial Institutions

- **Providing risk capital for productive investment**
- **Helping develop the corporate bond market**
- **Increasing competition and efficiency in the financial sector through diversification of products and actors**

Does Islamic Banking Risk Differ from Conventional Banking Risk?

- Increasing integration of Islamic financial services into global financial markets
- Increasing need for particular attention to sound risk management of Islamic financial institutions, under the current circumstances
- Particular areas Islamic and conventional banking have in common include risk management, corporate governance and capital adequacy
- Critical to identify who bears the risk in Islamic banking and how investment account holders (bearing an investment risk) are protected

Basel II and Risk Management of Islamic Banks

Basel II improves the understanding of risk and is a prerequisite for more effective risk management based on:

- More accurate criteria for assessing capital adequacy (Pillar I)
- Enhanced financial disclosure (Pillar II)
- Supervisory review process (Pillar III)

Basel II and Risk Management of Islamic Banks (Contd.)

IFSB prudential standards and guidelines help to ensure financial sector stability and institution building:

- IFSB capital adequacy standard draws to a large extent on the Basel II capital adequacy standard (Pillar I)
- IFSB guiding principles on issues as covered in Pillars II and III
- IFSB guiding principles on corporate governance reflect OECD & Basel standards

IFSB standards are important reference points for supervisors of Islamic financial institutions

There are numerous types of risks, but some are of particular importance for Islamic banks: *Liquidity – still developing money market; legal risk (enforcement of claims); equity risk; operational risk*

Need for appropriate measurement of risks specific for Islamic banks (especially adjustments on capital adequacy calculations to reflect risk associated with investment accounts)

Importance of appropriate stress testing:

- *Comprehensive: tests covering market, credit & liquidity risks*
- *Considering the effects of prolonged market tensions & illiquidity*
- *Reflecting the nature of the portfolios of Islamic institutions*
- *Factoring the time needed to manage or hedge risks*

Promoting transparency and financial discipline through better market disclosure: *Especially on complex Islamic financial products, their valuation and the respective measurement of inherent risks; Qualitative disclosure, explaining approach to risk management; improved disclosure to stakeholders of the profit and risk sharing implications of shariah based investment; availability of financial data, especially historic data, is a challenge for Islamic banks*

Role of Supervisors

- Particular emphasis on the internal audit function: to achieve comprehensive and effective reviews of bank risk management and internal controls
- Treat the disclosure of transparent and market relevant information as a priority in their monitoring and enforcement efforts
- Special supervisory attention to ensure that risk management practices in place effectively protect investment account holders

Role of Supervisors (Contd.)

- Guidance on sound corporate governance and risk management of Islamic banks
- Focus not only on the evaluation of banks' risk management policies and procedures, but also of their implementation
- Evaluation of the expertise and integrity of directors and management
- Draw attention of boards of directors and managers to problems detected
- Apply sanctions where sound corporate governance & risk management mechanisms are lacking

A New Proposal

Create a MENA Task Force on Islamic Finance

- To enhance contribution to equity and venture capital finance
- To discuss development of corporate bond markets
- To discuss risk management and legal issues

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