

REGULATION OF ISLAMIC BANKING INSTITUTIONS IN KUWAIT⁽¹⁾

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Abstract

The Islamic financial system has witnessed a fast pace of growth during the last decade. In the State of Kuwait, the Islamic financial industry has already successfully passed the launching phase towards wider regional and international expansion and it now has its own tangible worldwide presence on the banking and financial map. The Islamic financial system is concentrated in two sectors: the banking sector and the non-banking sector. Both sectors need supervision to ensure that each sector functions within the regulatory guidelines of the nation's judicial and legal framework. This article will focus on the former, the banking sector, but the LLM thesis from which this article is sourced covers both the banking and the non-banking sectors.

(1) This article is based on a chapter in the LLM thesis entitled "Legal Framework for Financial Institutions' Supervision in Kuwait" submitted by Ms Lulwa Mubarak Al Ben Ali, under the supervision of Professor Osama Al Fouli and Professor Abdul Hameed Al Baali. The thesis was submitted, examined and accepted in 2015. The full thesis may be accessed from the Kuwait International Law School's library.

The two main questions addressed in this article are: what are the regulations of Islamic finance in Kuwait and how effective are the supervision authorities over the Islamic finance industry? To answer these questions, the article provides an introduction to the regulatory regime of Islamic banks in Kuwait and an overview of the role of the Central Bank of Kuwait (CBK) in supervising Islamic banks. The author evaluates the CBK's effectiveness, discusses the current challenges facing regulation of Islamic banks and it concludes with a series of findings and recommendations to improve regulatory and supervisory oversight.

Introduction

This article will provide an introduction to the regulatory regime of Islamic banks in Kuwait and an overview of the Central Bank of Kuwait (CBK) including the main features of the CBK. As a result of the huge expansion in oil prices since the early 1970s, and consequently domestic liquidity, the banking sector in Kuwait has experienced a rapid growth in numbers, financial aspects and banking activities. This article will also provide an overview of the banking system in Kuwait and the regulatory regime of Islamic banking institutions. This article also analyzes the role of the CBK in supervising Islamic banks, whilst it also evaluates its effectiveness and it includes several recommendations.

1.1 Central Bank of Kuwait

1.1.1 History

In 1960 the Kuwaiti Currency Board was established by Amiri Decree No. 41 of 1960 and the Kuwaiti Dinar was introduced into circulation on April 1, 1961.¹ During the post-independence period from 1960-1968 four commercial banks were established,

(1) Al-Kandari, Dr Ahmad, *Commercial Banking & Financial Institutions, Kuwait*, Al-Falah Books, 2009, p75.

expanding banking activity. This entailed the establishment of the CBK on June 30, 1968 under CBK Law, to supervise banks and perform other function of central banks. The CBK was established to offer a flexible currency system on behalf of the State of Kuwait. The CBK also acts as a banker and financial advisor to the government, while representatives from both the public and private sectors make up the Board of Directors.

According to Article 13 of the CBK Law, the CBK shall have an independent legal personality called the “Central Bank of Kuwait”. Furthermore, Article 14 of the same law states that the CBK shall have a special budget, which shall be prepared in a commercial pattern. Also, the said Article explains that the CBK shall be considered as a merchant in its relations with other parties, and its operations and accounts shall be conducted and organized in accordance with commercial and banking rules.

In respect of the administrative and financial affairs of the CBK, the Board of Directors shall, with the approval of the Minister of Finance, lay down all rules and regulations including staff and accounting matters, without being limited by the provisions of the Public Tenders and Civil Service Laws. The provisions concerning advance control in Law No. 30 of 1964 establishing the Audit Bureau shall not apply to the operations of the CBK. The functions of the Audit Bureau shall be limited to auditing the accounts and assets of the Bank, and the Bureau shall not, in any manner, interfere in the operations of the Bank or question its policy. The technical officer of the Audit Bureau, assigned to audit the operations of the Bank, shall have adequate technical qualifications and special experience in banking business.

Furthermore, the CBK continued its efforts in supervision and oversight of the local banking and financial sector units under its supervision within CBK’s objective of enhancing the safety of the financial position of those units and consolidating monetary and financial stability in the state. Local banking and financial sector units subject to CBK supervision and registered with it at the end

of 2012, totalled 154 units, encompassing local banks (22 banks, of which five are conventional commercial banks, 11 branches of foreign banks including a branch of an Islamic bank, a specialized bank, and five Islamic banks), investment companies (95 companies, of which 51 operate according to the provisions of Islamic Shari'a), and exchange companies (39 companies). Oversight of investment companies - except for the activity of financing - as well as oversight of Investment Funds, has been transferred from the CBK to the CMA as of September 13, 2011. The CBK exercises its oversight role through off-site monitoring and on-site inspection of these units, verification of the implementation of sound financial and banking practices, and compliance with the oversight policies and applicable instructions.

1.1.2 Objectives of the CBK

Article 15 of the CBK Law specified the goals of the CBK, which are similar to those of central banks in general. The main objective of any central bank is to issue a currency on behalf of the state. The objectives of the CBK are as follows:

1. To exercise the privilege of the issue of currency on behalf of the State. It is worth mentioning that the sixth issue of the Kuwaiti currency was unveiled at a celebration event on May 19, 2014, and was released into circulation on June 29, 2014. The sixth issue of the Kuwaiti Dinar banknotes employs a clear and elegant structure throughout the entire series, using visual representations of nationally significant elements and economic accomplishments that are all grounded on one unified background that is of the Kuwaiti flag. Currently used banknotes will remain valid until an official decision is taken to withdraw them;
2. To endeavor to secure the stability of the Kuwaiti currency and its free convertibility into foreign currencies;

3. To endeavor to direct credit policy in such a manner as to assist the social and economic progress and the growth of national income;
4. To control the banking system in the State of Kuwait;
5. To serve as Banker to the Government;
6. To render financial advice to the Government.

The CBK is, as are central banks everywhere, equipped with different tools and instruments, which enable it to carry out its tasks and achieve its objectives. The CBK has tried to be more active since the mid 1980's, in its role, by issuing Central Bank bills and discounting certain commercial papers⁽¹⁾.

1.1.3 Operations of the CBK

First: Relations with the Government

Articles 30-39 of the CBK Law cover the relationship between the CBK and the Government. The CBK is considered to be the advisor to the Government, therefore, the CBK will offer advice to the Government in order to facilitate the realization of its objectives and functions. Furthermore, the Government will consult the CBK in matters relating to monetary and credit policy. The CBK shall act as banker and fiscal agent for the Government on the following basis⁽²⁾:

- a) Government funds in Kuwaiti Dinars on current accounts shall be held solely with the Bank. No interest shall be paid by the Bank on such funds.
- b) The Bank shall in general carry out, free of charge, banking transactions and services relating to the Government inside and outside the country.

(1) Ibid, p76.

(2) Article 31 of the CBK Law.

- c) The Government may place funds in Kuwaiti Dinars with local banks, after seeking the opinion of the Central Bank and in a manner not conflicting with the monetary policy in force.
- e) The Minister of Finance may entrust the Central Bank with the administration of any other Government funds in accordance with the conditions agreed upon at the time.

The Ministry of Finance shall transfer to the Central Bank such amounts as may be necessary for the implementation of any particular monetary policy, after the Minister of Finance has approved such policy.

As an exception, interest may be paid to these bodies on their deposits, but in this case they shall not be exempt from charges on banking transactions and services. The CBK should enforce the laws and regulations pertaining to exchange control⁽¹⁾.

Furthermore, the CBK should, either directly or through banks and other financial institutions, undertake the operations relating to the sale and management of securities issued or guaranteed by the Government. The CBK may also undertake operations relating to the sale and management of securities issued in Kuwaiti Dinars by any public organization or institution in Kuwait⁽²⁾.

Additionally, the CBK may⁽³⁾:

1. Purchase, sell, discount and rediscount Government treasury bills;
2. Purchase and sell public debt securities issued and offered for sale by the Government.

On the other hand, the CBK may not give any loans to the Government, municipalities or public establishments and bodies except in the following case⁽⁴⁾:

(1) Article 33 of the CBK Law.

(2) Article 34 of the CBK Law.

(3) Article 35 of the CBK Law.

(4) Article 36 of the CBK Law.

- a) The CBK may give temporary advances to the Government to cover deficits in Budget revenues. Such interest, as may be determined by the Board of Directors of the Bank in agreement with the Minister of Finance, shall be paid by the Government on these advances.

The total of such advances may not, at any time, exceed 10 percent of public revenue of the State Budget for the preceding fiscal year. Such advances should be repaid as soon as possible. If they are not repaid by the end of the fiscal year following the one during which they were given, the Bank shall not grant any new advances until those outstanding have been repaid.

For the purpose of financing development projects or strengthening the financial market, the CBK may upon approval of the Minister of Finance⁽¹⁾:

1. Own or sell shares or stocks of any Kuwaiti shareholding company, concessionary company in Kuwait or public establishment;
2. Extend loans to banks, public financial or credit establishments, against collateral of their holdings of such shares or bonds. Provided that the total amounts allocated for the acquisition of the aforementioned shares or bonds, or for lending against the collateral of their holding, does not exceed the value of the reserves of the Bank;
3. Issue negotiable bonds.

It is very important to mention here that the Ministry of Finance (MOF) supervises the CBK, therefore, the Governor of the CBK must keep the MOF continuously informed of the monetary and credit policy pursued or intended to be pursued by the Bank.

(1) Article 37 of the CBK Law.

If the MOF has a different view, he may issue general directives to be followed by the CBK, and such directives shall become binding on the CBK⁽¹⁾.

Second: Relations with Local Banks

Articles 40-42 of the CBK Law cover the relationship between the CBK and local banks. The CBK has a major role in assisting banks to operate in Kuwait. The CBK may⁽²⁾:

1. Open deposit accounts for banks and financial institutions operating in Kuwait, and for public credit institutions.
2. Open deposit accounts for other institutions, upon approval of the Minister of Finance. No interest shall be paid on the accounts referred to in this paragraph and the preceding paragraph except in special cases as may be decided by the Board of Directors of the CBL and approved by the Minister of Finance.
3. Open accounts in Kuwaiti Dinars with banks.
4. Participate with banks in any scheme relating to the insurance of deposits.

Also, the CBK may carry out the following operations with banks only, and not otherwise⁽³⁾:

1. Sell, purchase, discount or rediscount commercial papers, provided that these shall mature within one year from the date of acquisition, discount or rediscount by the Bank.
2. Give loans or advances, in emergency cases, through current account for a period not exceeding six months against such collateral, as the Bank may consider adequate.

(1) Article 38 of the CBK Law.

(2) Article 40 of the CBK Law.

(3) Article 41 of the CBK Law.

On the other hand, the CBK must not⁽¹⁾:

- a) Extend the term of loans given for more than six months.
- b) Accept, for discount or as mortgage, commercial papers signed by any member of the Board of Directors or by anyone of the Bank's officials or employees.

1.1.4 Supervision

The CBK is responsible for the management and implementation of monetary and credit policy in Kuwait. In some countries the central bank through its subsidiaries controls and monitors the banking sector. In other countries, banking supervision is carried out by the government department, such as the UK Treasury, or an independent government agency (for example, the UK's Financial Services Authority)⁽²⁾. It examines the bank's balance sheets, behavior and policies toward consumers. Apart from refinancing, it also provides banks with services such as transfer of funds, bank notes and coins or foreign currency. Thus it is often described as the "bank of banks".

Many countries, such as the United States, monitor and control the banking sector through different agencies and for different purposes, although there is usually significant cooperation between the agencies. For example, money center banks, deposit-taking institutions, and other types of financial institutions may be subject to different (and occasionally overlapping) regulations. Some types of banking regulation may be delegated to other levels of government, such as state or provincial governments⁽³⁾.

1() Article 42 of the CBK Law.

(2) Goodhart, Charles A., *The Central Bank and the Financial System*, United Kingdom, Macmillan Press, 1995, p60.

(3) Kamerschen, David R., *Money and Banking*, Ohio, United States of America, South-Western Publishing Co., 1992, p207.

In Kuwait, the CBK has an independent legal personality, which acts on behalf of the government⁽¹⁾. The CBK has a major role in respect of the supervision as mentioned in Articles 71-75 of the CBK Law. Furthermore, the CBK provides instructions to the banks to realize its credit or monetary policy or to ensure the sound progress of banking business.

According to Article 71bis of the CBK Law, the CBK must apply the 'Kuwaitisation' requirements for non-governmental bodies for certain major jobs and professions within the economic sectors such as banks. However, the Article states that the ratio of the national labor force in relation to the bank's total labor force shall not be lower than fifty percent, or lower than the ratio defined by the Council of Ministers in pursuance of Article 9 of the Law No. 19 for year 2000 to support and encourage the national labor force to work at non-government entities.

In addition, the branches of the foreign banks must apply the 'Kuwaitisation' requirements. They are bound to comply with the ratio within three years from the date of their licensing to operate in Kuwait⁽²⁾.

However, the Board of Directors of the CBK - whenever necessary - draws up rules and regulations to which all banks shall adhere in order to ensure their liquidity and solvency, particularly with regard to the ratios which must be maintained between the following items⁽³⁾:

- a) The CBK's own funds on the one hand and the amount of its liabilities on the other;
- b) The bank's liquid funds on the one hand and the aggregate of its on-call and term liabilities on the other;
- c) The CBK's own funds on the one hand and its liabilities in the form of acceptances and guarantees on the other.

(1) Article 13 of the CBK Law.

(2) Ibid.

(3) Article 72 of the CBK Law.

In the instructions issued and notified by the CBK to the banks, the CBK shall define the meaning of the terms: “bank’s own funds”, “liquid funds”, “liabilities” and other such items.

Article 73 states that the Board of Directors of the CBK may, upon approval of the Minister of Finance:

1. Fix for banks the maximum amount of discount operations, or loans or other banking operations, which they may carry out with effect from a certain date.
2. Fix for banks:
 - a) The minimum amount which customers must pay in cash to cover the opening of documentary credits;
 - b) The maximum amount which may be lent to any single person - whether natural or legal - in proportion to the bank’s own funds;
 - c) The portion of the bank’s funds to be deposited in cash with the Central Bank;
 - d) The portion of the bank’s funds to be invested in the local market;
 - e) The rate of interest which banks shall pay on deposits, and the maximum rates of interest and commission that they may charge their customers.

The CBK deals with exceptional circumstances, in the event that they may threaten the regularity of banking business. The Governor of the CBK may - upon approval of the Minister of Finance - order banks to close temporarily and to stop all their operations. The banks shall then resume their operations by a decision to be issued by the Governor of the CBK and approved by the Minister of Finance⁽¹⁾.

(1) Article 75 of the CBK Law.

1.1.5 The Inspection of the Banks and Institutions Subject To Supervision of the CBK

In this context, 'supervision' means to adopt certain measures before, during or after operations being performed so as to minimize errors or deviation from set goals. In order to translate the supervision policy to reality the CBK must have authority to inspect. However, according to Article 78 of the CBK Law, the CBK can inspect banks and financial companies and institutions that are subject to the CBK supervision in addition to branches, companies and banks that operate abroad and are subsidiaries of Kuwaiti banks. Co-ordination shall be carried out in this regard with the central banks or banking supervision authorities in the concerned countries.

The banking supervision authorities in the other countries shall carry out the inspection of branches of their banks operating in the State of Kuwait. In this regard, co-ordination with the CBK shall precede inspection.

According to this concept, the CBK staff authorized to conduct inspection shall have the right to see the accounts, books, records, instruments and all documents they deem necessary for inspection⁽¹⁾.

Furthermore, they may ask any member of the board of directors, or any official of the bank or institution to submit and present such data and information they deem necessary for the purposes of inspection. Review of books, records and instruments shall be carried out within the premises of the bank or institution inspected.

As a result any such inquiry, the CBK shall make a comprehensive report on the findings of inspection made in any bank or institution⁽²⁾. The report shall incorporate recommendations on

(1) Article 80 of the CBK Law.

(2) Article 78 of the CBK Law.

the measures the CBK deems useful for rectifying any unsound position discovered through inspection.

Furthermore, the CBK is the chief and top governing body that licenses and regulates all banks pertaining to both Islamic and conventional banking organizations. Also the Islamic investment companies that exercise financial activity are under the supervision of the CBK⁽¹⁾. The legal supervision is the responsibility of the supervisory authority of each bank. CBK's responsibility is to ensure the banks' commitment to submit all policies and products to the legal supervisory authority, and confirm banks' adherence with issued decisions and fatwa, through onsite inspections, in addition to the auditor of accounts' role in this regard.

1.2 Structure of the Banking System in Kuwait

The CBK is the competent authority to supervise the banking sector in Kuwait. The Kuwaiti banking sector consists of five Kuwaiti conventional commercial banks, ten branches of conventional foreign banks, one specialized bank, and five Islamic banks including banks that are branches of foreign Islamic banks, as listed below⁽²⁾:

a) Conventional and commercial banks

National Bank of Kuwait, Commercial Bank of Kuwait, Al-Ahli Bank of Kuwait, Gulf Bank, and Burgan Bank.

b) Foreign banks' branches

Bank of Bahrain and Kuwait, Bank BNP Paribas, HSBC Bank Middle East Limited, Abu Dhabi National Bank, Union National Bank, Citibank, Qatar National Bank, Doha Bank, Mashreq Bank and Bank Muscat.

(1) Ministerial decree No 38 of 2011 regarding the organization of CBK supervision over investment companies that exercise financial activity are under the supervision of the CBK.

(2) Banking and Financial System Structure, Chart 5, Published by the CBK, December 2014.

c) Specialized bank

The Industrial Bank of Kuwait

d) Islamic banks

Five banks operating in accordance with the provisions of Islamic Shari'a (Kuwait Finance House, Boubyan Bank, Kuwait International Bank, Al-Ahli United Bank, Warba Bank and Al Rajhi Bank which is a branch of a foreign Islamic bank).

The Islamic banking industry has become increasingly important in the local market following the amendments made on May 25, 2003 to the legislative and regulatory framework of the banking and financial system. Those amendments were made to regulate the activities of Islamic banks in the State of Kuwait and to organize the CBK's supervision and oversight of these institutions. Significantly, Law No. 30 of 2003 included the addition of a special section on Islamic banks to the Third Chapter of the CBK Law⁽¹⁾.

In this context, an operating Islamic bank (Kuwait Finance House established in 1977) was registered during 2004, and a new Islamic bank (Boubyan Bank) was established and commenced operations by the end of 2004. Also, a specialized local bank (Kuwait Real Estate Bank) was converted, in 2007, into an Islamic bank named Kuwait International Bank. In March 2010 a commercial bank (Bank of Kuwait and the Middle-East) converted into an Islamic bank, named Al-Ahli United Bank, and on April 27, 2010 Warba Bank was listed with CBK as Islamic bank.

The supervision of Islamic banks has unique characteristics such as self-censorship, internal supervision and external supervision. Self-censorship means that all employees in the banks must follow Shari'a Law. The internal supervision occurs through the bank's Shari'a Supervisory Board (SSB) and accounting review. The external supervision occurs through the supervisory

(1) Ibid.

authority such as the central bank and external auditing firm as well as the external Shari'a supervision⁽¹⁾. It is worth mentioning that the Kuwaiti banks do not have an external auditing firm to review their transactions, unlike the Islamic Non-Bank Financial Institutions (INBFI) which, according to the Executive bylaw of the CML, must appoint an external auditing firm to review the institutions transactions.

1.3 Regulatory Regime Of Islamic Banking Institutions

The establishment of a regulatory and supervisory environment is a requirement of, and a challenge for, the authorities as they face the dual task of understanding the industry and striking a balance between providing effective supervision and facilitating the industry's legitimate aspirations for further growth and development. The CBK took an interest in the legislative regulation of Islamic financing activities since the early 1990s, following the establishment of a number of investment companies operating in accordance with the provisions of the Islamic Shari'a and supervised by the CBK. The Supervision Sector at the CBK assumes the responsibility of following-up the implementation of the provisions of Chapter Three of the CBK Law, and all relevant regulations and instructions issued by the CBK. Furthermore, the most important law regarding Islamic Finance is Law No. 30 of the year 2003 which added a special section from Article 86 to 100 on Islamic banks to the Third Chapter of the CBK Law. The main purpose thereof is to ensure the soundness and stability of the banking and financial system in order to safeguard depositors, and ensure that banking and financial units abide by relevant laws, resolutions and CBK instructions leading to proper application of monetary and credit policies.

(1) Al-Khthairy Dr. Mohsen A., *Islamic Banks*, Egypt, Etrak for Publishing & Distribution, 2nd edition, 1995, at pp295-310.

1.3.1 The Laws that Govern Islamic Banking Institutions

Law No. 30 of the year 2003 added a special section on Islamic banks to the Third Chapter of the CBK Law.

This law reflects the special nature of banks that operate in accordance with the principles of the Islamic Shari'a in contrast to other banks, particularly in the areas of resource mobilization and uses. The said law provides that the Islamic banks are subject to the rules of the CBK Law in all respects, which are not specifically provided for in Section Ten, but to the extent that they do not conflict with the rules of the Islamic Shari'a.

The most important issues addressed in the rules of Islamic banks as set out in Section Ten from Article 86 to 100, are the following:

1. The general framework for the Islamic banking business⁽¹⁾. The regulation of Islamic banks activities on a sound basis taking into consideration the nature of their activities, and the provision of necessary legal instruments for the oversight of banks.
2. Allowing the Kuwaiti banks registered in the Banks Register to establish subsidiaries for practicing Islamic banking, subject to obtaining the approval of the CBK⁽²⁾.
3. The procedures for establishing and registering Islamic banks and foreign Islamic banks branches⁽³⁾.
4. The minimum paid-up capital for establishing an Islamic bank, and the capital required for a foreign Islamic bank branch⁽⁴⁾.
5. The Shari'a supervision in Islamic banks⁽⁵⁾.

(1) Article 86 of the CBK Law.

(2) Article 87 of the CBK Law.

(3) Articles 88-91 of the CBK Law.

(4) Article 92 of the CBK Law.

(5) Article 93 of the CBK Law.

6. The supervision Rules concerning Islamic Banks⁽¹⁾.

The Law No. 30 of the year 2003 also addresses the following issues:

- a) The reconciliation of the status of the companies existing on the effective date of CBK law and which exercise banking business in accordance with the principles of the Islamic Shari'a, and their registration in the Islamic Banks Register⁽²⁾.
- b) Allowing the banks existing on the effective date of the law to shift to Islamic banking⁽³⁾. The conventional banks are permitted to convert to Islamic banking activities by following the terms and conditions set out by the CBK. Two conventional banks have completely converted to Islamic banking activities as per the CBK's terms and conditions⁽⁴⁾.
- c) Performing Islamic banking activities through institutions of an independent legal and financial entity. Those activities are not permitted through windows or branches at conventional banks, in order to avoid money mixing⁽⁵⁾. As an exception to the provisions of the Commercial Companies Law concerning the establishment of companies, and of the CBK Law, the conventional bank may establish subsidiary companies to conduct activities of Islamic Banks in accordance with Shari'a principles – with the approval of the CBK. Apart from the exception stipulated in the preceding paragraph, the subsidiary company mentioned above, which conducts its activity in accordance with the Islamic Shari'a principles, shall be considered an independent Is-

(1) Articles 97 and 98 of the CBK Law.

(2) Article 3 of the CBK Law.

(3) Article 87 of the CBK Law.

(4) "Islamic Financial Industry facts and challenges Kuwait's experience", Central Bank of Kuwait Islamic Banking and Finance Conference, 2013, p9.

(5) Ibid. In my opinion, in order to develop a Shari'a supervision system it is necessary to avoid money mixing.

Islamic bank in the application of the provisions of this Law. Furthermore, the conventional bank shall not sell or transfer the property of its subsidiary company or any part thereof to any other party⁽¹⁾.

- d) The legal supervision is, basically, the responsibility of the legal/Shari'a supervisory authority of each bank. The CBK's responsibility is to ensure banks' commitment to submit all policies and products to the legal/Shari'a supervisory authority (Shari'a Board), and confirm banks' adherence with issued decisions and fatwa, through onsite inspections, in addition to the auditor of accounts' role in this regard.

Note that the CBK's supervisory role regarding the investment companies is limited to their financing activities since the issuance of the CML on 2010.

Kuwaiti banks follow International Financial Reporting Standards (IFRS) except for International Accounting Standards (IAS) 39. The CBK has replaced this specific requirement for collective provisioning with a minimum general provision. The IFRS 7, and the amendments to IAS 1, were adopted by the banks in 2007, which has improved the quality of their disclosures. The decision of the CBK to adopt Basel II in 2005 has enhanced the level of reporting. The public disclosure of these banks has elevated Kuwait above regional standards. The unaudited quarterly financial statements published by Kuwaiti Banks show a fair degree of detail when compared to regional peers⁽²⁾.

Furthermore, in line with the CBK's endeavours to keep pace with the international standards of banking supervision, the CBK's Board of Directors approved on December 24, 2013 the new regulations of the Basel III reforms package which includes

1 Article 87 of the CBK Law.

2 Singh, Jyoti Prakash, "Kuwait Banking Industry", Standards - An Independent Rating Agency, November 2009, p10.

the structure of regulatory capital and the transitional phase for implementation⁽¹⁾.

In order to improve the Islamic banking system, we must review the regular instructions from the CBK to conventional banks and understand the unique nature of Islamic banks. Hence, the following section will review the CBK's instructions for Islamic banks.

This study aims to review the legal framework of the Islamic banking in order to evaluate the supervision of the Islamic industry. Therefore, we will review the CBK's instructions relating to Islamic banks.

1.3.2 The CBK's Instructions for Islamic Banks

In accordance with Article 97 of the CBK Law, the Board of Directors of the CBK sets the rules and regulations for the supervision of Islamic banks with respect to liquidity, solvency, and business organization, including in particular:

1. A system for liquidity and elements thereof;
2. Capital adequacy standards through specifying the ratio of capital to asset elements;
3. The rules for calculation of the required provisions for asset risks.

Therefore, the CBK issued the following instructions that the Islamic banks must follow while practicing finance activities in Kuwait. These instructions are designed to suit Islamic banks' transactions in order to perform well in the Kuwaiti system, furthermore, they reflect Article 97 of the CBK Law.

1 The Annual Report of the Central Bank of Kuwait for the Fiscal Year 2013/2014.

1.3.2.1 Classification Policy For Islamic Banks

The Investment transactions with and finance extended to customers are meant to be the cash and non-cash investment and finance transactions banks conclude with their customers. Cash investment and finance transactions mean the transactions in which the bank provides to the customer monies for their execution, whether directly (such as musharaka and mudaraba, which are among the formulas of funds investment with customers), or in the form of assets (such as murabaha and lease financing).

On the other hand, non-cash transactions mean those transactions that create contingent liabilities on the part of the bank, including letters of guarantee, documentary letters of credit, acceptances and other types of similar transactions⁽¹⁾.

The general framework of the classification policy in the Islamic Banks is the same as in the conventional banks. However, the difference is that the transactions must be Shari'a-complaint. Therefore, the said regulations for classifying investment transactions with and finance accorded to customers according to Islamic investment and finance formulas allows for the computation of their provisions and the manner of the accounting treatment of income generated therefrom⁽²⁾.

1.3.2.2 Shari'a Supervisory Regime

Shari'a compliance is the most critical aspect of Islamic banking as banking practices cannot be legitimized as Islamic unless they comply with the rules and regulations defined by the Shari'a. One of the main factors that contributes to the safety and soundness of a banking system is its supervisory system.³ The role of the Shari'a Supervisory Board inside each Islamic bank is to

(1) Al-Majedi, Abduqadr Q., *Islamic Banks responsibility for their services and activities*, Egypt, Dar AIFkr AlQanon, 2015, at p29.

(2) CBK Instructions No (2/IBS/148/2003) dated November 13, 2003.

(3) Al-Baali, Dr. Abdul Hameed, *Effective Shari'a supervision in Islamic financial institutions*, Turkish Republic of Cyprus, Faisal Bank, pp199-217.

review the Islamic transactions (such as muarabaha, musharaka and so forth) and determine the Shari'a compliance of these products and the investments. It is also tasked with certifying that nothing relating to any of the operations involves any element that is prohibited by Shari'a⁽¹⁾. The Shari'a Board is obligated to inspect all contracts, agreements, and transactions of the bank with the other parties. The management of the concerned bank must present all the contracts, operations and transactions to the SSB for providing its Shari'a opinion (Fatwa) in that regard. In order to ensure that the SSB is qualified to fulfill the said task, all the members of the SSB shall observe the following regulations:

The Rules and Conditions for the Appointment and Responsibilities of the SSB in Islamic Banks.

The CBK Board of Directors resolved, at its meeting of June 15, 2003 to set-up the following rules and conditions that regulate the appointment and responsibilities of the SSBs in Islamic banks. These rules and conditions are intended to ensure the efficiency required for the members of the SSB in order to discharge their functions in the appropriate manner. The instructions establish the framework for performing those duties, while providing independence for the members of the SSB in expressing their opinions, and defining the role of the external auditor in relation to the bank's compliance with the rules and principles of the Islamic Shari'a⁽²⁾.

Furthermore, the said conditions are as follows:

- a) The board of directors of each bank shall nominate the members of the SSB for the approval of their appointment by the bank shareholders' general meeting. Those members should be Islamic Shari'a scholars of recognized ef-

(1) Lotfy, Ahmad M., *The supervision of Islamic banks: between the reality and theory*, Egypt, Dar Al-Fkr wa Al-Qanon, 2013, p14.

(2) Instructions No. (2/IBS/100/2003) Concerning the Rules and Conditions for the Appointment and Responsibilities of the Shari'a Supervisory Board in Islamic Banks.

iciency and experience, especially in the area of transactions jurisprudence⁽¹⁾.

- b) The number of the SSB members should not be less than three. This board may not have among its members any of the members of the board of directors or the executive management of the bank, nor any shareholder of effective influence, where a shareholder of effective influence shall mean a shareholder who owns 5% or more of the capital of the bank⁽²⁾.
- c) The services of the SSB member shall end with his resignation or by a justified recommendation from the bank board of directors to be approved by the general meeting, or by the resolution of the general meeting⁽³⁾.

The SSB in Islamic banks will be responsible for providing opinion on the bank's compliance with the Shari'a rules in all of its operations. To do so, the SSB shall inspect all contracts, agreements, policies and transactions of the bank with the other parties. This board has the right to unconditionally review all the records and transactions of the bank to ascertain its compliance with the rules of the Islamic Shari'a. The bank management must provide this board with all data and information requested for performing its functions⁽⁴⁾.

In order to improve Shari'a supervision system, the SSB decision must be mandatory,

(1) Ibid.

(2) The Second Instruction was modified by the board of directors of the CBK on June 19, 2003.

(3) Instructions No. (2/IBS/100/2003) Concerning the Rules and Conditions for the Appointment and Responsibilities of the Shari'a Supervisory Board in Islamic Banks.

(4) Ibid.

1.3.2.3 Finance Activities

The Islamic banks carry out financing operations for all terms, using Shari'a contracts, such as Murabaha, Musharaka, and Mudaraba. They conduct financial and direct investment operations whether on their own account or on the account of other parties or in partnership with others⁽¹⁾. This includes the establishment of companies or holding equity participations in existing companies or companies with both Islamic Shari'a principle and control as laid down by the Board of Directors of the CBK, all of which must be in compliance with the CBK Law.

Furthermore, the CBK sets the rules and regulations for the supervision of the Islamic banks with respect to finance activities as follows:

First, based on Articles 71 and 97 of the CBK Law, establishing the credit policy is the responsibility of each individual bank. This should take into account the relevant laws and instructions, the resolutions of the Shari'a Supervisory Board, as well as the established banking rules and conventions, in a manner creating consistency between the various elements of the finance transactions and the return anticipated therefrom, so as to achieve the bank's objectives and future plans. In this context, the CBK issued instructions No. (2/IBS/146/2003) concerning the rationalization and organization of Islamic Banks Finance Policy, which all Islamic banks registered with CBK are required to comply with. The said instructions organize the Investment transactions through regulating 1) finance policy, 2) Shari'a opinion, 3) contract requirements, and 4) investment or finance applications (new, renewal and increase). All these instructions are unique requirements and require conformity to Shari'a.

b) Secondly, the Instructions No (2/IBS/98/2003) dated June 15, 2003 concern rationalization and organization of Islamic banks' finance policy. The said instructions regulate the finance

1 Article 86 of the CBK Law.

transactions extended by the Islamic Banks for financing shares and trading transactions on the Kuwait Stock Exchange (KSE). They regulate the finance transactions by setting the requirements and conditions of each transaction. Also, they require the bank to provide the CBK with monthly data on finance transactions directed to trading shares listed on the KSE.

Third, the rules of Article 69 of the CBK Law refer to the CBK's instructions related to rationalization and organization of the Islamic banks' finance policy and the instructions establish the maximum limit for anyone single customer's liabilities towards an Islamic bank. In this context, the CBK issued the Instructions No. (2/IBS/99/2003) dated June 15, 2003 concerning the rules and regulations Islamic banks have to adhere to in respect of finance transactions extended to the bank's Board Members. These are in line with the international regulatory trends concerning the organization of the banks' finance to the members of their boards of directors. These rules aim at ensuring that the finance extended to members of the board of directors do not involve any exceptional risks which would adversely affect the bank's financial position, and that no preferential privileges are granted to such directors by virtue of their positions.

Fourth, in respect of the rules and regulations concerning the Islamic banks' extension of finance in Kuwaiti Dinar to non-residents, generally speaking the instructions in conventional and Islamic banks are the same. However, the nature of the transaction is different. In the Islamic banks there are investment transactions and in the conventional banks there are credit facilities. Both services provide cash or non-cash to the customers but the nature of the transaction depends on the bank.

On the other hand, the following instructions that were issued from the CBK are the same instructions for both conventional and Islamic banks:

- A) Circular No. (2/IBS/136/2003) dated November 10, 2003 regarding finance transactions for the execution of works and projects outside Kuwait. These are the same instructions that organize conventional banks as per Circular dated May 14, 2003 regarding credit facilities extended to finance the execution of works and projects outside the State of Kuwait.
- B) Instructions concerning the application of a maximum limit of 80 percent for the finance portfolio/deposits ratio. The maximum limit was raised to 85 percent pursuant to circular No. (2/BS/IBS/224/2008) dated October 8, 2008. This instruction is the same instruction as in conventional banks⁽¹⁾.
- C) Instructions No. (2/BS/IBS/211/2007) concerning the amendment of the method of calculating finance portfolio/deposits ratio. This instruction is the same instruction as in conventional banks⁽²⁾.
- D) Circular No. (2/BS/IBS/224/2008) concerning the increase of the ratio of net credit facilities portfolio to deposits from 80 to 85 percent. This instruction is the same instruction as in conventional banks⁽³⁾.
- E) Circular No (2/BS/IBS/227/2008) concerning banks' financial transactions with investment companies. This instruction is the same instruction as in conventional banks⁽⁴⁾.
- F) Circular on the general rules to be followed when banks extend the finance required for rectifying the conditions of local investment companies, under the local investment companies support program. This instruction is the same

(1) Circular No (2/BS/IBS/224/2008) dated October 8, 2008.

(2) Circular No (2/BS/IBS/211/2007) dated October 8, 2007 concerning the amendment of the method of calculating the ratio of credit facilities portfolio balances at 80 percent of the deposit balances.

(3) Circular No (2/BS/IBS/224/2008) dated October 8, 2008 concerning the increase of the ratio of net credit facilities portfolio to deposits from 80 percent to 85 percent.

(4) Circular No (2/BS/IBS/227/2008) dated October 19, 2008 concerning banks' financial transactions with investment companies.

instruction as in conventional banks⁽¹⁾.

- G) Circular No. (2/IBS/231/2008) to all Islamic banks concerning the emphasis of the requirement of reducing the rates of return on finance, in line with the reduction of the discount rate. This instruction is the same instruction as in conventional banks⁽²⁾.
- H) Circular concerning the resolution to grant exemptions on some regulatory ratios within the framework of extending the finance required to rectify the conditions of the local investment companies. This instruction is the same instruction as in conventional banks.
- I) Circular No. (2/BS/IBS/233/2008) directing banks to enhance the collaterals submitted by customers against credit facilities/finance transactions. This instruction is the same instruction as in conventional banks⁽³⁾.
- J) Circular No. (2/BS/IBS/235/2008) requesting local banks to engage external auditors for carrying out a special audit on the banks' derivatives deals activity, and to submit the external auditors' report along with the audited annual financial statements. This instruction is the same instruction as in conventional banks⁽⁴⁾.

(1) Circular on the general rules to be followed when banks extend the finance required for rectifying the conditions of local investment companies, under the local investment companies support program.

(2) Circular No (2/BS/230/2008) dated November 9, 2008 to all conventional banks concerning the emphasis of the requirement of reducing interest rates on loans in line with the reduction of the discount rate.

(3) Circular No (2/BS/IBS /233/2008) dated December 1, 2008 directing banks to enhance the collaterals submitted by customers against credit facilities / finance transactions.

(4) Circular No (2/BS/IBS/235/2008) dated December 15, 2008 requesting local banks to engage external auditors for carrying out a special audit on the banks' derivatives deals activity, and to submit the external auditors' report along with the audited annual financial statements.

- K) Circular No. (2/IBS/236/2008) stressing the requirement to reduce the rates of return on finance, in line with the CBK's resolution to reduce the discount rate with effect from October 8, 2008. This instruction is the same instruction as in conventional banks⁽¹⁾.

1.3.2.4 Direct Investment Regime

The rules of Article 86 of the CBK Law, and the laws issued in amendment thereof, authorize the Islamic banks to practice direct investment activities in accordance with the rules set-up by the CBK's Board of Directors. The rules of Article 98 of the said law authorize the CBK to determine for the Islamic banks the maximum limit of the transactions pertinent to a certain activity. The Islamic banks' investment activity that is meant to be addressed by these instructions is the investment business practiced by the Islamic banks for their own account in non-banking or non-financial areas, such as trade and real estate, which results in the banks' acquisition of moveable and immovable assets, either for the purposes of trading seeking to generate profits from the selling such assets to customers, or for investment in order to achieve periodic returns and/or benefit from capital appreciation. The CBK's Board of Directors resolved at its meeting of October 19, 2003 to issue the following rules and regulations concerning Islamic banks' direct investment, and which represent the minimum rules that must be observed by Islamic banks when practicing direct investment activities:

- a) Instructions No. (2/IBS/142/2003) concerning the rules and regulations for direct investment of Islamic banks.
- b) Circular No. (2/IBS/187/2006) concerning the set of guidelines taken into account while considering Islamic banks'

(1) Circular No (2/BS/236/2008) dated December 15, 2008 stressing the requirement to reduce interest rates on loans, in line with the Central Bank of Kuwait's resolution to reduce the discount rate with effect from 8/10/2008.

applications for exemption from the maximum limits established for direct investment and financial investments.

- c) Circular No. (2/IBS/219/2008) concerning the guidelines to be taken into consideration while studying banks' requests for exemption from the prescribed maximum limits of financial investments.

1.3.2.5 Financial Investment Policy

The Islamic banks' financial investment policy that is meant to be addressed by these instructions is the policy that regulates the business of financial investment in the securities portfolio. This includes financial instruments such as shares, finance, sukuk and other investment instruments issued by other parties and acquired by the bank. These may be for trading purposes, seeking to achieve profits from short-term changes in prices, or for holding them for a longer period to achieve profits from their sale if the appropriate opportunity emerges. Additionally, they may be held up to the date of their maturities, in order to generate regular returns there- from and/or to take advantage of these instruments' capital appreciation, as indicated in the statement of Islamic banks' financial statement as designed by the CBK, based on the rules of Article 98 of Law No (32/1968) and its amendments. These rules authorize the CBK's Board of Directors to set-up for the Islamic banks the maximum limit for an Islamic bank's participation in the companies the bank establishes, or participates in establishing, or acquires shares therein, as well as to establish the rules and regulations that must be observed in this regard. They also set the maximum limit for the bank's participation in any one project. The CBK's Board of Directors resolved, at its meeting of October 19, 2003, to issue the regulations and controls concerning the organization of Islamic banks financial investment policy, which represent the minimum that Islamic banks must comply with in regard to financial investment business.

1.3.2.6 Consumer finance transactions and other personal installment finance transactions

In order for the CBK to be able to oversee banks' activity in this area within the framework of regulating the market for this type of finance, the CBK set rules in respect of granting consumer finance and other personal installment finance. A bank shall observe the following regulations:

- A) Instructions No. (2/IBS/161/2004) concerning the rules and regulations for consumer finance transactions and other personal installment finance accorded by the Islamic banks.
- B) Circular No. (2/IBS/115/2003) dated November 10, 2003 prohibiting Islamic banks' sale of any portion of their consumer finance and other personal installment finance portfolio.
- C) Circular No. (2/IBS/135/2003) dated November 10, 2003 concerning the Credit Information Network Company (Ci-Net) system and the exchange of information on consumer and personal installment finance transactions for which legal actions have been taken.
- D) Circular No. (2/IBS/174/2005) dated January 6, 2005 concerning the cancellation of the maximum limit established for total consumer and other personal installment finance transactions.¹
- E) Circular dated November 2, 2005 regarding the discontinuation of the use of the CBK's database relevant to consumer and other installment loans customers, against whom legal actions have been taken, and the use of the database of those customers operated by Ci-Net, with effect from January 1, 2006.

(1) Circular No (2/IBS/174/2005) concerning the cancellation of the maximum limit established for total consumer and other personal installment finance transactions.

- F) Circular No. (2/IBS/185/2006) dated February 7, 2006 concerning the definition of the maximum limit for consumer finance and other personal installment finance transactions to any one single customer, as well as the determination of the maximum period during which the balloon payment of these loans is to be repaid.
- G) Instructions dated January 14, 2007 concerning insurance charges borne by consumer and installment loans customers.
- H) Circular No. (2/BS/IBS/202/2007) dated February 13, 2007 concerning the procedures local banks and investment companies have to comply with for rectifying existing violations of the rules and regulations for extending consumer finance transactions and other personal installment finance transactions.
- I) Circular No (2/IBS/203/2007) dated March 12, 2007 to all Islamic Shari'a-compliant local banks, concerning amendments to the rules and regulations for extending consumer finance transactions and other personal installment finance transactions.
- J) Circular No. (2/BS/IBS/205/2007) dated April 15, 2007 concerning consumer and installment loans prepayment fees.
- K) Circular dated March 3, 2007 stressing that the certificate required to be submitted must be signed by both external auditing firms, testifying that banks have rectified all the violations that existed in relation to the consumer and installment loans (finance transactions) rules and regulations.
- L) Circular dated October 9, 2007 to banks and investment companies' external auditors, concerning the completion of the data on breaches rectification.
- M) Circular dated November 19, 2007 on assigning both external accounts auditors to audit the consumer loans (finance transactions) and installment loans granted during

the period from January 16, 2007 until December 31, 2007 and to submit to CBK a report on this audit not later than the end of April 2008.

- N) Circular No. (2/IBS/IIS/215/2008) dated March 24, 2008 concerning the amendment of the rules and regulations for granting consumer finance and personal installment finance transactions.
- O) Circular No. (2/BS/IBS/216/2008) March 7, 2008 amending the tables of consumer loans (finance transactions) and other installment housing loans.

1.3.2.7 Instructions Regarding Controls For Finance Concentration

In accordance with Article 98 of the CBK Law, the Board of Directors of the CBK may specify for Islamic Banks all or some of the following:

1. The maximum value of operations pertaining to a specific activity;
2. The maximum limit of a bank's equity holdings in companies that it incorporates, participates in establishment, or owns shares therein; and the rules and regulations thereof, in addition to the maximum limit of a bank's participation in any single project;
3. The maximum limit of a single customer's liability to the bank while granting a relative advantage to subsidiaries of the bank according to the conditions laid down by the CBK;
4. The amount of funds that must be invested in the local market;
5. The portion of deposits with the bank that must be deposited in cash with the CBK;
6. The rules and regulations that must be observed in a bank's relationship with its customers, and between its customers and shareholders.

The general aim of distributing the credit risks over a larger base of customers is to minimize the risks that may be encountered by banks as a result of concentrating finance in a limited number of customers.

Furthermore, a key element of Islamic economics is the equitable distribution of rewards to the different factors of production. Islamic economic systems seek redistributive justice where concentration of wealth in a few hands is countered and the flow of money into the economy is fluent. Islamic transactions are unique, therefore, the rules and instructions regarding the concentration limit is different than the instructions for conventional banks⁽¹⁾.

Therefore, the CBK's Board of Directors decided, at its meeting of November 3, 2003 to issue the following regulations regarding the concentration limit:

- A) Maximum limit for any one single customer's liabilities towards an Islamic bank. This means that the total liabilities of any one single customer to a bank, whether in the form of investment and finance deals, or financial investment instruments issued by the customer, may not exceed 15 percent of such bank's capital base⁽²⁾.
- B) Circular No. (2/IBS/173/2005) concerning the guidelines applied by the CBK in considering banks' applications for exempting any customer from the maximum limit established for finance concentration⁽³⁾.
- C) Circular No. (2/IBS/IIS/251/2009) requesting to provide the CBK with the form detailing finance facilities exempted from the maximum limits for finance concentration (A.M. 28), and the form on compliance with the maximum limits for total large financier concentrations (A.M. 29)⁽⁴⁾.

(1) Instructions No. (2/IBS/147/2003) Concerning the Maximum Limit for Anyone Single Customer's Liabilities Towards an Islamic Bank dated June 22, 2003.

(2) Ibid.

(3) Circular to All Local Banks No. (2/IBS/173/2005) dated January 11, 2005.

(4) Circular No (2/IBS/IIS/251/2009) to all Islamic Banks and all Islamic Investment Companies allowed to lend.

1.3.2.8 Islamic Banks' Center of Risks System

The regulations and instructions regarding the Center of Risks System is the same as in the conventional banks. Furthermore, banks - conventional as well as Islamic - are subject to a wide range of risks in the course of their operations.

In general, banking risk falls into four categories: financial, operational, business, and event risk. However, the CBK issued instructions to banks concerning the said risks in several circulars to cover all categories. The CBK issued instructions regarding periodic data supplied to the CBK with regard to credit facilities granted for economic purposes⁽¹⁾.

The new system issued on June 22, 2003 includes amendments to the existing system approved by the CBK's Board of Directors on March 8, 1995 and amendments thereto. The new amendment was introduced in line with the nature of financing transactions carried out by Islamic banks and investment companies⁽²⁾ operating in accordance with Islamic Shari'a principles. However, the data of the Center of Risks to be supplied to the CBK in accordance with this system covers all customers who are the recipients of credit facilities/financing operations, including central banks, banks and other financial institutions, whether for economic purposes or otherwise (including issued credit cards) where the total value exceeds KD 15,000⁽³⁾.

The rules for the Center of Risks System and regulations issued on its implementation consist of six sections: 1) Statements to be presented by financial institutions⁽⁴⁾ on their customers. In

(1) Circular concerning periodic data on credit facilities extended for economic purposes, March 24, 1996.

(2) Investment companies were under the supervision of the CBK before Capital Market Law No. 7 of 2010.

(3) Circular No (2/BS,IBS,IS,IIS/97/2003) to all local banks including Islamic banks, and all investment companies including those operating according to Islamic Shari'a principles.

(4) According to this Circular and for the purposes of this system, financial institutions shall mean banks, including Islamic banks, and investment companies, including those operating in accordance with Islamic Shari'a principles.

this context, they should identify the data related to financing transactions in conventional and Islamic banks. 2) Deletion and renewal of licenses. 3) Data which may be provided to financial institutions. 4) Enquiries form. 5) Registering and keeping data at the Central Bank. 6) General instructions which includes the precautionary measures, the requirements during exchange data.

In light of the periodic review made by the CBK of the regulatory instructions and controls, it has resolved to increase the minimum for reporting on customers to become KD 15,000 instead of KD 10,000. Furthermore, the credit facilities data reported to the CBK should include the credits extended by the head office, local and foreign branches, whether the customer is a resident or non-resident. Also, the Circular deals with the customers of subsidiaries abroad which must follow the same instructions regarding reporting data as it mentioned in the Circular No. (2/BS, IBS, IS, IIS/214/2008) on Center of Risks System and its Implementation Instructions⁽¹⁾.

Moreover, the CBK issued several circulars to all local banks (conventional and Islamic) and foreign bank branches to ensure that non-resident customers who were granted credit facilities by external subsidiaries, do not have dealings with the units of the Kuwaiti banking system,⁽²⁾ in order to protect the financial system in Kuwait.

However, Islamic banks face a unique mix of risk-sharing arrangements resulting from the contractual design of instruments based on the principles of Shari'a, their liquidity infrastructure, and the overall legal governance. Islamic banks' services are set on different foundations from conventional banks. Islamic banks face two types of risk while conducting their operations: first, risk similar to conventional banks, and second, unique and specific risks that arise due to particular requirements necessary to com-

(1) Circular No (2/BS,IBS,IS,IIS/214/2008) to all Local Banks and Investment Companies on "Center of Risks System and its Implementation Instructions", April 22, 2008.

(2) Circular to all local banks and investment companies, July 3, 2008.

ply with Shari'a principles. Islamic banks are required in all their operations and dealings to fully comply with the following ideals:⁽¹⁾

- Promotion of fairness in transactions and the prevention of any exploitative relationship.
- Sharing of risk and rewards between the different partners in the transaction.
- The prohibition of interest, this means that transactions need to include elements of materiality that lead to tangible economic purpose.
- Fair distribution of risk and rewards among all stakeholders.
- The prohibition of financing activities that contradict the Shari'a rules and principles, which are known as 'haram'.

It is important to understand the unique mix of risk-sharing arrangements in Islamic banks to provide an effective legal supervision and framework for the Islamic financial industry. Therefore, the regulations of the Center of Risks System must be developed according to the Islamic banks' needs and to provide supervisors with enough power to perform their duties effectively.

1.3.2.9 The Liquidity System

In general, the regulations and instructions regarding the Liquidity System are the same as they are for the conventional banks. Furthermore, the CBK issued a circular on October 14, 1997 regarding the rules and regulations No. (2/BS/49/97) concerning the Liquidity System according to the Maturity Ladder Approach⁽²⁾ which requires local banks to maintain 20 percent of

(1) El-Tiby Amr M., *Islamic Banking*, United States of America, John Wiley & Sons, Inc, 2011 at p27.

(2) The 'Maturity Ladder System' is a means of measuring liquidity. The future cash flows of the bank's assets are compared to the future cash flows of the bank's liabilities during specific maturity periods: Instructions No. (2/IBS/149/2003) concerning the liquidity system according to the Maturity Ladder Approach.

their Kuwaiti Dinar customer deposits¹ in the form of balances with the CBK (current account or deposits) in addition to Kuwaiti Treasury² bills and bonds, or any other financial instruments issued by the CBK.³

The said ratio has been reduced to 18 percent, pursuant to circular No. (2/BS/234/2008) issued on December 4, 2008.

Furthermore, Circular No (2/BS/162/2004) issued by decision of the Board of Directors of the CBK on June 8, 2004, amended the instructions issued to all local banks on October 14, 1997 concerning the liquidity system according to the maturity ladder approach.⁴ Also, the Circular concerning the CBK's intervention in the money market to withdraw surplus liquidity through the monetary instruments it deems appropriate.⁵

The Circulars are as follows:

- A) The Instructions No. (2/IBS/149/2003) concerning the liquidity system according to maturity ladder approach, which are the same instructions as regards to conventional banks.
- B) The Circular concerning the CBK's Board of Directors' resolution on May 1, 2005, requiring Islamic banks to maintain 20 percent of their customers' KD deposits (government – private sector) in the form of liquid assets. However, the above ratio has been reduced to 18 percent by virtue of the CBK's Board of Directors' resolution in Circular No (2/IBS/234/2008). The transactions related to the maintenance percentage are different from conventional to Islamic

(1) Kuwaiti Dinar deposits received by local banks from government and semi-government agencies and institutions within the framework of financing the investment companies to rectify their liquidity positions were excluded from total customers KD deposits when calculating the subject ratio, pursuant to circular No. (2/BS/234/2008).

(2) This Paragraph was amended by virtue of the CBK Board's approval on June 6, 2004, as mentioned in circular No (2/BS/162/2004) issued on June 8, 2004.

(3) Circular to the Local Banks No (2/BS/49/1997), October 14, 1997.

(4) Circular to Local Banks No. (2/BS/162/2004), June 8, 2004.

(5) Circular to All Local Banks, August 10, 2005.

banks. Therefore, the Circular deals with international Murabaha transactions, and finance Sukuk issued by the Islamic Development Bank or by the governments of Gulf Cooperation Council (GCC) countries. The percentage shall apply to all banks, each according to the nature of its business and the activities the banks are allowed to practice under the provisions of the law.

- C) The Circular regarding the intervention of the CBK in the money market, with a view to withdrawing surplus liquidity through monetary instruments the CBK deems appropriate.
- D) The Circular No. (2/IBS/234/2008) concerning the CBK's Board of Directors' resolution dated December 2, 2008 on amending the instructions issued with regard to the ratio of customers' KD deposits to be held by banks in the form of liquid assets.

1.3.2.10 The Regulations Regarding the Islamic Banks' Purchase of Their Own Shares

The regulations and instructions regarding the banks purchase of their own shares are the same as for the conventional banks.¹

In accordance with Article 175 of the New Companies Law, the company/bank may purchase its own shares for its own account in the following cases:

1. For the purpose of maintaining the stability of the share price and to the percentage of the total shares of the company/bank determined by the Authority.
2. Capital decrease.

(1) Regulations governing Islamic banks' purchase of their own shares (Treasury Shares), and the ministerial resolutions issued in this respect: Instructions No. (2/IBS/101/2003) Regarding the Islamic Banks Purchase of Their Own Shares dated June 15, 2003.

3. If the company/bank repays a debt in consideration of such shares.
4. Any other cases determined by the Authority.

The shares purchased by the company/bank shall not be counted in the calculation of the total shares of the company/bank in cases where shareholders are required to hold a certain percentage of the capital. In all matters concerning the calculation of the necessary quorum for the validity of the general meeting and the voting on the resolutions of the general meeting, the Authority shall issue a resolution to regulate the company's purchase, use and disposition of its shares.

Pursuant to the last paragraph of Article 175, the CBK issued the following resolutions:

- A) The instructions No (2/BS/75/1999) concerning the rules and regulations that shall be observed by banks and investment companies for obtaining the CBK's approval for enabling them to purchase their own shares. Furthermore, the banks may purchase a maximum of 10 percent of their own shares at market value, provided that the funds utilized to finance such a purchase do not exceed the total reserves balances consisting of net profit distributions, retained profits and issue premium⁽¹⁾.
- B) The Circular No. (2/BS/55/1997) to all local banks for the importance of the obligation to present a quarterly statement of shares purchased and annually report on reasons for their holding of these shares⁽²⁾.
- C) The Circular obligating banks to provide the CBK with statements on their own shares' purchase and sale operations on a quarterly basis⁽³⁾.

(1) Circular to All Local Banks (2/BS/75/1999) dated December 15, 1999.

(2) Circular to All Local Banks (No. 2/BS/55/1997) dated December 22, 1997.

(3) Circular to All Local Banks dated July 1998.

D) The Ministerial Resolutions:

1. No. 10 of the year 1987 concerning the Organization of the Shareholding companies' purchase of their own shares, manner of utilizing the purchased shares, and disposing thereof.
2. No. 11 of the year 1988 concerning amendment of certain provisions of the Ministerial Resolution No. 10 of the year 1987.
3. No. 273 of the year 1999 concerning amendment of certain provisions of the Ministerial Resolution No. 10 of the year 1987, as amended by the Ministerial Resolution No. 11 of the year 1988.

1.3.2.11 Anti-Money Laundering

The regulations and instructions regarding money laundering are the same as for the conventional banks. Money laundering is a financial or a non-financial operation or group of operations aiming to conceal or disguise the illicit origin of money or proceeds from any crime making them appear as money or proceeds derived from a lawful origin. It also means any person who knows that funds are the proceeds of crime and who has done the following voluntarily shall be considered to have committed a money laundering offense⁽¹⁾:

- a) Converts or transfers or substitutes such funds with the purpose of disguising or concealing the illicit origin thereof, or helping a person involved in the commission of the predicate offense evade the legal consequences for his/her acts; or
- b) Disguises or conceals the true nature, source, location, disposition, movement or ownership of such funds, or rights pertaining thereto.

(1) Article 2 of Law No 106 for the year 2013 regarding the Combating of Money Laundering and Financing of Terrorism.

C) Acquires, possesses or uses such funds.

Furthermore, money laundering refers to a financial transaction scheme that aims to conceal the identity, source, and destination of illicitly-obtained money. The money laundering process can be broken down into three stages. First, the illegal activity that garners the money places it in the launderer's hands. Second, the launderer passes the money through a complex scheme of transactions to obscure who initially received the money from the criminal enterprise. Third, the scheme returns the money to the launderer in an obscure and indirect way⁽¹⁾.

Banks must comply with the rules of Law No. 106 of 2013 Regarding the Combating of Money Laundering and Financing of Terrorism ('New Money Laundering Law'). The New Law supersedes the previous Law No. 35 of 2002 ('Old Law') and Law No. 32 of the year 1968 CBK Law, relevant ministerial resolutions and international resolutions regarding the combatting of terrorism-financing transactions, therefore, all banks must comply with the following instructions:

- A) Instructions issued by the CBK concerning money laundering and terrorism-financing transactions.
- B) Circular concerning the establishment of the Kuwait Financial Intelligence Unit headed by the Governor of the CBK.
- C) Circular requiring banks to verify the identity of the persons who make deposit transactions in customers' accounts with banks.
- D) Circular No (2/BS/IBS/165/2004) on commencing the commissioning of the online system for daily transmission of cash transactions data.

(1) Cornell University Law School, Legal Information Institute, 'Money Laundering – an overview', available at http://www.law.cornell.edu/wex/money_laundering, last accessed on November 28, 2014.

- E) Circular dated October 19, 2004 regarding the unification of the form of replying to the Central Bank regarding the freezing of the assets and funds of some entities and individuals.
- F) Circular No (2/BS/IBS/188/2006) regarding the amendment of Item No. 10 of the CBK's Instructions issued to local banks with regard to combating money laundering and terrorism-financing transactions.

1.3.2.12 Capital Adequacy

The CBK issued instructions Circular No. 2/RBA/44/2009 on June 15, 2009 to Islamic banks regarding the application of Basel Capital Adequacy⁽¹⁾ instead of previous instructions. This took effect from the end of June 2009. These instructions take into account the nature of risks regarding Islamic banking in light of the instructions issued by the Islamic Finance Board.⁽²⁾ In December 23, 2013, the CBK's Board of Directors approved the new regulations of the Basel III reforms package, which includes the minimum capital adequacy ratio of 13 percent to be implemented in stages between 2014 and 2016. The ratio of 13 percent of the minimum capital adequacy is based on a quantitative-impact study. The study was carried out by the CBK in collaboration with a consultancy firm that was tasked with drafting the Basel III regulations. One encouraging finding of the study was that it proved Kuwait's ability to meet the Basel III regulations and capital adequacy requirements⁽³⁾.

Furthermore, the review of interim condensed financial information of all Islamic banks, as reported to the Board of Directors

(1) A measure of a bank's capital. It is expressed as a percentage of a bank's risk-weighted credit exposures. It provides instructions regarding risk measurement options.

(2) Kuwait Banking and Financial Market Handbook, United States, International Business Publications, Volume 1, Strategic information and regulation, 2011, p61.

(3) The Annual Report of the Central Bank of Kuwait for the Fiscal Year 2013/2014.

in 2011, refers to the capital adequacy which confirms that Islamic banks must comply with capital adequacy regulations.

The supervisor sets prudent and appropriate capital adequacy requirements for banks that reflect the risks undertaken by, and presented by, a bank in the context of the markets and macro-economic conditions in which it operates. The supervisor defines the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, capital requirements are not less than the applicable Basel standards⁽¹⁾.

1.3.2.13 Instructions Concerning Financial Data Prepared to Stock Exchange Purposes Where a Bank's Shares are Listed and the Bases of Preparing Closing Financial Data of Islamic Banks

The regulations and instructions in this regard are the same as for the conventional banks. In order for the CBK to review the data to be submitted by banks to the KSE, banks are required to provide the Supervision Sector of the CBK with a copy of the subject data, at least one week before the date of submission to the stock exchange. All banks shall observe the following regulations:

1. Instructions concerning the financial data prepared for the KSE.
2. Instructions concerning the unified form for semi-annual financial data.
3. Instructions concerning the preparation of quarterly financial data.
4. Circular No. (2/BS,IBS/IS,IIS/197/2007) concerning the requirement of notifying the CBK in advance in case of listing

(1) Core Principles for Effective Banking Supervision, Bank for International Settlements, 2012, p44.

a bank's shares on any external stock markets.

5. Circular No. (2/IBS/113/2003) regarding preparation of quarterly financial data.
6. Circular No. (2/BS,IBS,IS,IIS/197/2007) concerning the requirement of notifying the CBK in advance in case of listing a bank's shares on any external stock markets.
7. Ministerial resolution No. 18 of the year 1990⁽¹⁾.
8. Instructions No. (2/IBS/122/2003) concerning disclosure of transactions with related parties in the closing financial data.

1.3.2.14 Instructions Concerning External Auditors

In principle, the instructions for the conventional banks are similar to Islamic banks, except that the auditor must be specialized in Islamic transactions. The instructions are as follows:

- A) Guideline criteria for approving the appointment of external Auditors for Islamic Banks.
- B) Instructions concerning the appointment of external auditors and the organization of their functions.

Within the framework of verifying the compliance of the bank management with its responsibilities in relation to implementing the rules and principles of the Islamic Shari'a, the task of the external auditor must include the necessary examinations to ascertain the following⁽²⁾:

- a) All the procedures followed by the bank in launching its new financial products or in modifying its existing products, include the proper steps for ensuring complete compliance with the rules and principles of the Islamic Shari'a, including the review of such procedures by the bank management and the SSB.

(1) Instructions No (2/IBS/122/2003) To All Islamic Banks, November 10, 2003.

(2) Instructions No. (2/IBS/100/2003) Concerning the Rules and Conditions for the Appointment and Responsibilities of the Shari'a Supervisory Board in Islamic Banks.

- b) All the products of the bank have been examined by the SSB who has confirmed that these products are compliant with the rules and principles of the Islamic Shari'a.
- c) In its report, the external auditor must indicate the extent of the bank management's compliance with the Fatwa (Shari'a legal opinion), resolutions and directives of the SSB in the transactions executed.

1.3.2.15 Islamic Banks' Foreign Exchange Transactions

The regulations and instructions in this regard are the same as for the conventional banks.

The instructions are as follows:

- A) Circular No (2/IBS/107/2003) Concerning Islamic Banks Foreign Exchange Transactions.
- B) Circular No (2/BS/IBS/195/2006) concerning the cancellation of the rules and controls applicable to foreign exchange transactions, and allowing banks to resume those activities while complying with certain regulations.

1.3.2.16 Instructions Concerning Internal Control System and Risk Management

The same instructions apply as with the conventional banks, but the instructions must be Shari'a-compliant, as per the following:

- A) General guidelines directory on Islamic banks' internal control systems, and external auditors reports on the evaluation of those systems.
- B) Basel Committee's Operating Guide concerning the risks associated with settlement of foreign exchange transactions.

- C) Circular concerning Basel Committee's guidelines on the principles of managing E-Banking risks.
- D) Circular concerning guidelines on sound practices in managing and monitoring operational risks.
- E) Circular concerning Corporate Governance in financial institutions.
- F) Providing the CBK with the external auditors' report prepared under the name "Management Letter".
- G) Circular concerning Guidelines on the establishment of the compliance function and its role in banks, as issued by the Basel committee on banking supervision in April 2005.
- H) Circular requiring banks to take the necessary actions for enhancing internal control systems, so as to bridge the gaps in some aspects of the internal control systems of some banks, as revealed by the CBK's inspection of those banks.

1.3.2.17 Instructions Regarding Communications with Regulatory Financial or Banking Authorities in Other Countries

The regulations and instructions regarding the necessity of notifying the CBK before proceeding with any communications with regulatory financial or banking authorities in other countries are the same as for the conventional banks. Furthermore, the local bank must notify the CBK of any plans or activities that are intended to be performed abroad in the future and which need discussion or consultation with the regulatory authorities in the hosting countries.

Worth noting is that these plans or activities include the acquisition or increase of a share in companies capital, the establishment of a subsidiary or an affiliate, amendment of a company's capital, the opening of branches, expansion of activities or initiating new activities. The local bank must also advise the CBK of

any transactions it conducted in breach of the laws and regulations prevailing in the host country⁽¹⁾.

1.3.2.18 Investment Placements With Both Local and Foreign Banks and Financial Institutions

The rule of Item Six/1 of the CBK's instructions concerns the maximum limit for the liabilities of any one single customer towards an Islamic bank. The financing obligations granted to banks were exempted from such limits, on condition that the banks exercise care and caution in this regard, in particular when determining the maximum finance concentration limits for each bank separately.

Therefore, banks must provide the CBK with the maximum finance concentration limits policy applied by the bank for the finance facilities granted to local or foreign banks, along with a detailed quarterly statement showing the size of the actual concentrations of local or foreign banks toward the bank concerned⁽²⁾.

1.3.2.19 Instructions Regarding Robbery And Embezzlement Acts

The regulations and instructions in this regard are the same as for the conventional banks. The instructions are as follows:

- A) Instructions to notify the CBK of any embezzlement of the Islamic banks' funds.
- B) Circular concerning the actions to be taken for ensuring the protection of properties and people against the risks of armed robbery.

(1) Circular dated July 11, 1994.

(2) Instructions No (2/IBS/110/2003) Circular to All Islamic Banks, dated November 10, 2003.

1.3.2.20 Instructions Organizing The Management Of Third Parties' Portfolios With Islamic Banks

The regulations and instructions in this regard are the same as for the conventional banks. The instructions are as follows:

A) Instructions No. (2/IBS/181/2005) concerning the regulations governing the management of third parties' portfolios with Islamic banks.

The CBK's Board of Directors agreed, at its meeting on October 2, 2005, to issue revised instructions to local banks and investment companies concerning the regulations organizing the management of third parties' portfolios. The role of the CBK has been limited to monitoring foreign securities portfolios and deals in other investment instruments managed by banks and investment companies on account of third parties⁽¹⁾.

But it has different provisions under item two, No 14 which states that it is prohibited for the managing parties, who manage portfolios on their customers' account, to utilize third parties funds in granting finance of any form to others (third party finance transactions)⁽²⁾. Also, item four of the regulations states that there must be an acknowledgment of the independence of the customers funds' from those of the managing party.

1.3.2.21 Customers Relationships With Islamic Banks

The relationship between the Islamic bank and its customers is based on the principle of participation and sharing in risks, losses, profits. The regulations and instructions regarding the banks' relationship with their customers is the same as for the

(1) Revised Instructions No. (2/IBS/181/2005) Concerning The Regulations Governing Management of The Third Parties Portfolios.

(2) This paragraph was amended pursuant to circular No. (2/IBS/176/2005) issued on February 14, 2005 to all Islamic banks.

conventional banks. The instructions for the Islamic banks include the following:

- A) Circular concerning the criteria regulating banks' relationship with their customers.¹
- B) Instructions concerning the actions to be taken by Islamic banks in relation to fees and commissions.²
- C) Instructions for preserving the confidentiality of customers' information and data.
- D) Circular requiring banks to comply with the procedures established for opening accounts for non-Kuwaiti employees working for non-Government bodies.
- E) Circular No. (2/BS, IBS/193/2006) requiring banks to provide the customer with a copy of the contract he concludes with the bank, as per the CBK's established criteria regulating the relationship between banks and their customers.
- F) Circular No. (2/BS, IBS/209/2007) requesting banks to stop offering cash or in-kind incentives to customers against obtaining facilities or credit cards of all types.
- G) Circular No. (2/BS, IBS/222/2008) requesting all local banks to stop offering cash/in-kind incentives to customers - whether directly or through draws or any other forms - against obtaining facilities or credit cards of all types

1.3.2.22 The Accounting Treatment of Goodwill

Goodwill is referred to as an intangible³ asset. Management is responsible for valuing goodwill every year and to determine

(1) Instructions No (2/IBS/132/2003) "Circular to all Islamic banks" dated November 10, 2003.

(2) Instructions No (2/IBS/134/2003) "Circular to all Islamic banks" dated November 10, 2003.

(3) Something that does not exist physically but that is a cost or a benefit to a business.

if impairment is required. If the fair market value goes below historical cost (what goodwill was purchased for), impairment must be recorded to bring it down to its fair market value. However, an increase in the fair market value would not be accounted for in the financial statements. Therefore, a bank shall observe the following regulations:

- A) Circular No. (2/IBS/112/2003) dated November 10, 2003 regarding the manner of accounting treatment of goodwill resulting from holding the shares of other institutions and companies for the aim of controlling them. Banks must generally amortize the subject goodwill by charge to the operating results of the year in which the goodwill is reported⁽¹⁾.
- B) Circular No. (2/BS/175/2005) dated January 1, 2005 concerning the compliance with the rules of International Financial Reporting Standards when treating goodwill resulting from holding the shares of other institutions and companies. International Financial Reporting Standards, or IFRS, refers to a set of international accounting standards that define how different types of transactions and other accounting events should be reported in financial statements.

1.3.3 A Comparison Between the CBK Instructions Addressed to Islamic and Conventional Banks

Due to the difference between conventional finance and Islamic finance, the CBK has issued several instructions to supervise the Islamic and conventional banks. In order to evaluate the effectiveness of its supervision, it is necessary to assess and compare the main CBK instructions regarding the supervision of Islamic and conventional banks. A comprehensive comparison is set out in the Table entitled “A Comparison of CBK Instructions to Conventional and Islamic Banks” (attached as Appendix 1)⁽²⁾.

(1) Circular No. (2/IBS/112/2003) To All Islamic Banks, November 19, 2003.

(2) This is a reference to Appendix 1 of the thesis, supra n1. It is not attached to this article.

Evaluation and Recommendations

The main objective of this study has been to highlight the fundamental bases of the legal framework of the Islamic financial institutions in Kuwait. The role played by the CBK in the control and regulation of Islamic banking is central to this study. The supervisory framework developed by the CBK concerning Islamic banking in Kuwait takes into consideration international practices for effective supervision of conventional banking with adaptations to suit the Islamic banking business⁽¹⁾.

There are some important features in the Islamic banks' section of the CBK Law, which may be summarized as follows⁽²⁾:

1. Each Islamic bank shall have an independent SSB, comprised of not less than three members appointed by the bank's General Assembly⁽³⁾.
2. In case of a conflict of opinions among members of the SSB concerning a Shari'a rule, the board of directors of the designated bank may transfer the matter to the Fatwa Board in the Ministry of Awqaf and Islamic Affairs. That shall be the final authority on the matter⁽⁴⁾.
3. Open accounts between the CBK and Islamic banks in accordance with Shari'a Law. Such actions shall be performed in accordance with the terms and conditions that are not in contradiction with the Islamic Shari'a principles and are as decided by the CBK⁽⁵⁾.
4. The CBK provides emergency finance to Islamic banks for a period not exceeding six months using instruments and methods that conform with the Islamic Shari'a principles,

(1) The Annual Report of the Central Bank of Kuwait for the Fiscal Year 2013/2014.

(2) Yousif, Mahmood M. Study about Islamic Banks in Kuwait, Cairo University, 2011, pp14-15.

(3) Article 93 of the CBK Law.

(4) Article 93 of the CBK Law.

(5) Article 94 of the CBK Law.

and in accordance with the terms and conditions set by the Board of Directors of the CBK.

5. Allowing the banks existing on the effective date of the law to shift to Islamic banking⁽¹⁾.
6. Allowing the Kuwaiti banks registered in the Banks Register to establish subsidiaries for practicing Islamic banking, subject to obtaining the approval of the CBK⁽²⁾.

Regulation and oversight development is needed to ensure the smooth functioning of Islamic banking. The fact that Islamic banking is an evolving industry raises several issues. There is a need for a clear and robust set of regulatory measurements by the CBK in order to provide enough clarity for Islamic banks to operate. For example, credit concentration ratios for a single customer do not generally differ in conventional and Islamic banks, while capital adequacy ratios have to be adapted to take into account the different asset-liability structures in conventional and Islamic banks.

Furthermore, the CBK must appoint more expertise in Islamic finance to fully understand Islamic banking operations and be able to use suitable instruments for the control of Islamic banks. This is necessary in order to achieve all aims, including control on money and product supply and increasing the real national income⁽³⁾.

One of the main objectives of this article has been to compare between Islamic and conventional banks in respect of the CBK's instructions. In summary, these instructions can be divided into three sections: 1) financial instructions, 2) legal instructions, and 3) administrative instructions. Administrative instructions can apply to both conventional and Islamic banks, but the financial and

(1) Article 87 of the CBK Law.

(2) Article 87 of the CBK Law.

(3) Lotfy, Ahmad M., *The supervision of Islamic banks between the reality and theory*, Egypt, Dar Al-Fkr wa Al-Qanon, 2013 at p22.

legal instructions must develop to meet the specific requirements and needs of Islamic banks. From a legal perspective, Islamic banks suffer from issues related to credit ceilings, reserve ratios and liquidity issues. They also suffer from laws that limit investment internally and externally which do not fit with the nature of these banks and their special nature should be better recognized. From an economic perspective, there are difficulties related to practicing trade activities in respect of owning or renting real estate even though these activities are part of the Islamic banks' role in encouraging the market to invest⁽¹⁾.

Furthermore, Islamic banks have SSBs, which are responsible for providing an opinion on the bank's Shari'a-compliance in all its operations. This stands in contrast to conventional banks that do not have such a board. The management of the bank must comply with the implementation of all fatwa, resolutions and guidelines issued by the SSB in this regard⁽²⁾.

The CBK does not have Shari'a scholars who are experienced in both Shari'a and finance. There is some ambiguity regarding what action should be taken by the CBK if the SSB does not conduct the necessary review or does not follow their fatwa. In addition, the lack of standard practices and the different interpretations of the same issue due to the existence of different Shari'a Boards for each bank creates inconsistencies⁽³⁾. The Shari'a non-compliance risk is defined by the Islamic Financial

(1) Article 99 of CBK Law.

(2) The Governor of the CBK, Dr. Mohammed Al-Hashel, stated at the Shari'a conference on March 15, 2014 that it is necessary to pay more attention to ensure that the SSB follows and implements Shari'a principles or what is known as «Subsequent forensic audit», which is responsible for re-examining the opinion (fatwa) by the SSB to ensure that it is Shari'a-compliant. In some cases, the SSB that is responsible for re-examining the opinion is the same Board that issued the opinion. Therefore, the Governor highlighted the necessity to determine internal protocols that each Board must follow.

(3) El-Tiby, Amar M., *supra* at p184.

Services Board (IFSB) as “the risk that arises from IIFSs⁽¹⁾ failure to comply with the Shari’a rules and principles determined by the Shari’a Board of the IIFS or relevant body, in the jurisdiction in which the IIFS operates”⁽²⁾.

It is difficult for the CBK to set such regulatory measurements based on Shari’a interpretation and ruling, because of this lack of consistency⁽³⁾. As a result, the CBK does not intervene to supervise or examine the compliance of the Islamic banks’ transactions or operations with Islamic principles.

In order to create the most appropriate regulatory environment, the regulator should draw upon the experience of the conventional counterparty. However, the regulator should bear in mind the unique characteristics of Islamic finance. Above all, the Islamic financial industry is faced with a shortage in expertise in Islamic transactions (fih almuamalat), which is the Shari’a commercial jurisprudence.

Therefore, it is submitted that the CBK, with the current tools at its disposal, is not qualified to regulate Islamic banks. It needs to establish a higher board to supervise the SSB to ensure that their opinion (fatwa) is in compliance with Shari’a law. Moreover, it is necessary to establish a specialist legal entity to be responsible for organizing and developing the Shari’a’ Board’s task. Each member of the SSB needs to be independent. This means that each member must be financially independent from the bank. The purpose of such independence is to ensure that there is no influence on any member to issue certain opinions, in other words, to ensure there is no conflict of interest.

(1) IIFS stands for institutions (other than insurance companies), which offer only Islamic financial services. In many scholarly writings, the terms “Islamic banks”, “IIFS” or “Islamic financial institutions” are used interchangeably. The IFSB opts to use IIFS in its publications.

(2) IFSB 2005.

(3) Hanif, Mohammed, “Differences and Similarities in Islamic and Conventional Banking”, *International Journal of Business and Social Science*, Vol. 2, No. 2, 2011, p4.

The Islamic finance industry needs to increase the specialist membership in the field of the Shari'a Board. Therefore, the CBK must provide conditions and requirements that the Shari'a supervisory board must follow in order to issue a Fatwa (legal opinion). In other words, to prevent banks from pressuring members of SSB to issue a Fatwa for the sake of the bank's profits without ensuring that it is Shari'a-compliant⁽¹⁾.

The challenge to Islamic banks is to develop such alternatives while meeting the internationally accepted standards. The financial instructions must take into account that the nature of risk that faces Islamic banking is different because of its unique foundations. In general, banking risk falls into four categories: financial, operational, business, and event risk. Islamic banks face a unique mix of risks and risk-sharing arrangements resulting from the contractual design of the financing instruments, which is based on the principle of Shari'a. The effect and impact of each type of risk differs depending on whether it is applied to conventional or Islamic banks. Islamic banks have higher operational risk exposure than conventional banks. Islamic banks are exposed to two sets of risk: 1) risk that is similar to conventional banks, 2) risk that is concerned with adherence to a certain principle⁽²⁾.

As mentioned earlier,⁽³⁾ the instructions for both conventional and Islamic banks do not generally differ. With regards to the operational risk, the instructions in this regard cannot be the same for both conventional and Islamic banks. The development of an Islamic banking industry in Kuwait requires that the products and services in Islamic banks must be flexible to respond to the changing economic conditions, as well as the need to maintain and manage commodity inventories⁽⁴⁾.

(1) Ibid, p7.

(2) El-Tiby, supra at pp27-45.

(3) See Appendix 1 of the thesis, which is not reproduced here.

(4) Yousif, Mahmood M. supra at p17.

In Islamic banking transactions there is usually a third party due to the asset-bases and contractual nature of the financial instruments used by the Islamic banks. For example, in the Murabaha there are three parties unlike the conventional banks' contractual obligations, which are only between the bank and the customer. Accordingly, the CBK needs more techniques to deal with the unique situation of Islamic banking. Specifically, the CBK needs regulations that govern the relationship with the third party. Also, it needs regulations to govern the subsidiary companies that engage in Islamic transactions and ensure that the transaction is asset-based. For example, capital adequacy rules in Islamic banks should be different from conventional banks.

Moreover, the contractual agreement between Islamic banks and investment account holders is based on the concept of sharing profits and losses, which makes investment account holders a unique class of quasi-liability holders. Although they are not part of the bank's capital, they are expected to absorb all losses on investments made through their funds. The nature of intermediation and liabilities in Islamic banks has a great impact in the determination of adequate capital⁽¹⁾. Therefore, the instructions must correspond to their particular nature to provide for and strengthen the safety and soundness of the financial system by strengthening the capital adequacy measurements. Islamic banks face a unique mix of risks, which are different from conventional banks. Bank supervisors utilizing the traditional standards cannot assess such risks. The need for special guidelines for the regulation and supervision of Islamic banks has long been felt.

As a result of the above, the main difference between conventional and Islamic banks can be summarized as follows:

1. Islamic banks conduct operations based on Profit and Loss Sharing (PLS) and accordingly their activities are free of 'riba'. By contrast, conventional banks operate strictly

(1) Ibid, p166.

on pre-determined interest rates. Interest rates are determined and guaranteed either paid on deposits or changed on loans⁽¹⁾.

2. The relationship between the Islamic bank and its customer is based on the principle of participation and sharing in risks, losses, profits, and rewards.
3. Islamic banks do not offer direct loans, but instead, they finance the needs of clients for funds through methods of participation such as Musharaka in which the Islamic bank buys goods needed by the client and sells them to him on an agreed profit for each payment or on a deferred payment basis. Conventional banks do offer different types of each loan.
4. Unlike conventional banks that hold liability for the funds deposited with them in different types, Islamic banks do not accept the liability and are not responsible (if the bank has not been negligent) for the loss of all or part of the deposited funds. That is because the Islamic bank is only the 'mudarb' (manger of the funds) and it enters into a contract with a depositor of the funds (rab almal) based on sharing the losses or profits.
5. Regarding managing and using funds, in order to calculate returns correctly for both clients and banks Islamic banks do not mix the capital funds (bank funds) with investors' funds (clients' deposits). Conventional banks do mix these types of funds regardless of the source because they pay a certain amount of interest over a certain period of time on money invested⁽²⁾.

(1) Al-Majedi, Abduqadr Q. Islamic Banks responsibility for their services and activities, Egypt, Dar Al-Fkr wa Al-Qanon, 2015 supra at p31.

(2) Al-Kandari, supra at pp149-150.

6. Conventional banks concentrate heavily on attracting funds from various sources, paying a specific rate of interest, and then lending the funds on high fixed rates of interest, thus making profits. By contrast, the main objective of Islamic banks is to participate in the developments and welfare of the society. Socio-economic objectives are carefully studied when financing any project with a client. Banking operations in conventional banks are supervised and controlled only by the regulatory authorities while Islamic banks are watched and controlled by both the regulatory authorities and the religious advisory boards, the latter of which supervise all of the bank's operations to ensure they conform to Islamic principles.

In conclusion, the most important challenge facing the Islamic finance industry today is that only a limited number of countries have issued specific laws governing Islamic banking and finance. The need is therefore pressing for countries that have introduced Islamic banking to issue such laws. The necessary legal and regulatory framework must provide a clear definition of an Islamic financial services institution, along with specifying the licensing requirements, particularly with regard to capitalization, scope of activities, prudential dispositions and relationship with the regulatory authorities. Additionally, this legal and regulatory framework needs to allow for both the dynamic nature of Islamic financial services, and the broad objectives and responsibilities inherent in the supervision and oversight of the banking and financial system as a whole.

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