Prudential Arrangements for Stability and Development of Islamic Finance

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Prudential regulations, supervisory mechanisms, monitoring and enforcement arrangements are as important to Islamic finance industry as they are to the rest of the financial industry. The only distinction is that the institutional arrangements governing Islamic finance are to be derived from the specific nature and characteristics of Islamic financial institutions, Islamic financial markets, Islamic financial instruments, Islamic banking laws and the Islamic financial infrastructure.

This paper based on a cross country comparison of seven countries which account for most of the Islamic finance activities in the national jurisdictions attempts to highlight the question of adequacy of these institutional arrangements and flag some unresolved issues that need to be addressed by the regulators and industry participants together.

Islamic financial system is by and large equity based. However, trade-based and leasing operations are also allowed that have the characteristics of credit .An Islamic bank is a deposit taking institution whose scope of activities includes all currently known banking activities excluding borrowing and lending on the basis of interest. On the liabilities side it mobilizes funds on the basis of an agency contract. Demand deposits are treated interest free loans from the clients to the bank which are guaranteed. Islamic banks also play the role of investment manager for the owners of the time deposits usually called investment accounts. On the assets side, it advances funds on a profit and loss sharing or a debt creating basis in accordance with the principles of Shariah. In addition, equity holding and commodity and asset trading constitute an integral part of Islamic finance operations. By establishing Murabahah and Leasing funds the banks provide quasi-fixed return out of projects or rentals earned by the respective Funds. Investor accounts are managed on Mudarabah or Wakalah bases. Banks may establish Close/Open ended mutual funds. One category of funds is based on the concept of Murabah that yields a return to the depositors which though not known in advance, varies

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Commented [HH/RFC@I2]: Matching with submitted assignments to HEC, though only 8% and with multiple other sources using parts of this same highlighted para in an extremely narrow range. The other category is based on the concept of equity participation. This fund offers a higher rate of return than the Murabaha based fund but the return is volatile and carries a certain amount of risk.

Islamic financial markets represent a large variety that include: (a) Equity/Stock markets (b) Securities markets-Corporate, Government and Municipal (c) Commodities futures (d) Money markets for placement of funds on Mudarabah basis and (e) Foreign exchange market.

Islamic financial instruments are different in so far as they should represent real assets. A part of these assets can be in the form of debts created by Islamic modes but the debt element should not be predominant. Thus there are two types of financial instruments:-

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a. Fixed profit yielding debt securities or debt instruments carrying fixed return payable in future that can be issued
b. Equity instruments that have a claim to share in the net income and the assets of a business.

Besides equity instruments in the form of shares of any company, Islamic financial system has other redeemable participating instruments representing ownership in the assets and hence entitled to participate in the profit/loss resulting from the operations on the assets. These types of instruments can be based on (a) Profit/loss sharing (Mudarabah/Musharakah) like Participation Term Certificates (PTCs) and (b) Rent sharing in the form of Diminishing Musharakah or otherwise.

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In Islamic finance there is no counterpart to fixed income bonds and securities available in the conventional market. The Securities market permissible in Islamic finance can have Mudarabah Certificates, Musharakah Certificates and rent sharing and leasing based securities. Mudarabah and Musharakah Certificates can also be issued by securitizing a combination of Murabaha and leasing based financing operations.

A number of instruments have been introduced in Bahrain and Malaysia. They have set up an Islamic liquidity Management Centre (LMC) with a whole range of instruments such as 5-year Islamic leasing securities, leasing bonds, 3 months Islamic Government bonds, 3 years Islamic bonds, Islamic Government Bonds.

Having outlined these distinctive characteristics we now review the legal, regulatory, supervisory, monitoring arrangements that are in place in these seven countries. We will also examine the disclosure and transparency standards prevalent and the financial safety nets available for the depositors in the Islamic banks.

Legal Framework:-

Several distinct approaches are being followed in various jurisdictions to promote Islamic banking. One of these approaches is to set up and license Islamic banks under a distinct and separate legislative framework and the other is to modify the existing legal and licensing framework to bring in the Islamic financial services industry within its purview.

Pakistan, Malaysia and GCC Countries have opted to allow dual or parallel banking systems whereby Islamic banking coexists with the conventional banks under a common legal framework. Countries following this approach have allowed Islamic banks to operate under the following modes:-

i. Full fledged Islamic banks
ii. Islamic banking subsidiaries of Conventional banks, and
iii. Islamic banking branches or windows of Conventional banks with separate accounts.

Islamic banking institutions in Malaysia are licensed under the Islamic Banking Act (IBA) 1983. Bank Indonesia made certain amendments in the prevalent banking in order to make the Sharia principles operative in practice. The first amendment came into force in November, 2005 followed by a number of amendments.

In Pakistan, the Banking Companies Ordinance 1962 that governs the whole banking system was amended in November, 2002 and a new clause was inserted that permitted "the carrying on of banking business strictly in conformity with the injunctions of Islam as laid down in the Holy Quran and Sunnah."

Kuwait also added a special section on Islamic banks to the Law no. 32 of 1962 in May, 2003 for the purpose of organizing Islamic banks' activities on sound basis that take into account the special nature of Islamic banking.

The two counties where the whole banking system has been transformed into Islamic banking are Iran and Sudan. The Bank of Sudan Act passed in 2002 specifically stipulates that the Bank will abide by Islamic Shariah principles in the performance of its duties and objects, and in the exercise of its functions and supervision of the banking systems. In Iran, the law for Usury (Interest) Free Banking enacted in 1984 mandates compliance of the entire banking system with Islamic Law. The implementation of this law and Islamic banking as an integral part of economic system started in 1986 and countries to shape the structure of Iranian economy. It may thus be seen that in these ten countries there is no room for Conventional banks to operate.

The legal arrangements described above do suggest a more flexible and pragmatic case by case approach adopted by the authorities considering the particular circumstances of each country. As long as these arrangements provide adequate protection and facilitation, level playing field and satisfactory dispute resolution and contract enforcement mechanisms for the Islamic banks and do not create any unnecessary impediments this multi – faceted approach is to be welcomed and encouraged. Those who insist on 'One – size fits all' in name of uniformity, standardization and symmetry in my view are sadly mistaken as it will stifle legal innovation and creativity.

Regulatory, Supervisory and Monitoring Framework:-

The key objectives of any regulatory system for financial institutions are (a) Protecting the interests of the depositors (b) Ensuring the soundness of the financial system and (c) making monetary policy effective. These objectives remain valid in case of Islamic banks too with the additional stipulation that the regulator has to ensure Shariah compliance. The question then arises whether for regulating Islamic banks do we require a specialized and separate framework or do we modify and amend the existing regulatory framework applicable to conventional banks to make the room for Islamic banks. While it has already been conceded that there are some additional safeguards that have to be incorporated in the prudential regulations to reflect the peculiar nature of relationship between banks and clients both on deposit and asset sides it is not obvious if there are any compelling reasons in favor of either of these two approaches.

An important consideration would be that the standard CAMELS assessment methodology should be adjusted in any case to reflect particular characteristics of the Islamic banks. The PLS mode of financing and uncollateralized equity financing provided by Islamic banks place their portfolios at higher risk compared to conventional banks. Thus the risk weighting as well as Capital adequacy ratios need to be reworked out. It is gratifying to note that the AAOFI has taken the initiative in this respect and issued a statement on Capital adequacy that focuses on Investment accounts of Islamic banks and on displaced commercial risk. I believe that the IFSB has also finalized the standard on Capital adequacy. The other issue has to do with the liquidity. The underdeveloped nature of Islamic liquidity management facilities and limited access to the lender-of-the-last-resort facilities do impinge upon the adequacy of liquidity in an Islamic banking environment. What can be done to provide relief to the Islamic banks on this count?

Luca Errico and Mitra Farahbaksh in IMF Working Paper 1998/30 have argued that Islamic banking is essentially an equity based system where capital is always at risk and providers of capital and labor are put on an equal footing. Islamic modes of financing, do however, include non-PLS- modes such as mark-up lease, lease purchase that are similar to conventional lending. Thus the Islamic banks operate to varying degrees in a hybrid way.

The above analysis, if true, raises the important question in regard to the countries where there is a separation between banking sector regulator and investment companies or asset management regulator. Which of the two agencies is most suited to regulate and supervise the Islamic banks? This question is not pertinent in case s where there is a unified single regulator for the whole financial services industry.

Our survey of the seven countries shows that the differences in the legal framework drive the regulatory regimes in the various countries. The predominant agency that regulates and supervises the banking industry has also been entrusted the responsibilities for regulating, supervising and monitoring Islamic banks. Annex table presents the cross country comparative results.

Bahrain Monetary Agency (BMA) law is the first and only Central Bank in the world to formulate and issue prudential regulations for Islamic banks. The Prudential Information and Regulatory framework for the Islamic banks (PIRI) not only provides the regulatory framework but also monitoring tools for the Central Banks. The regulatory framework is mainly enforced through assessments carried out under CAMELS. BMA has issued a comprehensive rule book on Islamic banking in January, 2005 explaining in detail the requirements for setting up a bank governed by Islamic banking and enlisting all the rules for licensing, regulating, supervising and reporting of Islamic financial institutions engaged in full Commercial banking, investment banking, off shore banking, trust – backed banking activities or precious metals and commodities trading.

In Malaysia the law itself is quite inclusive as it contains explicit provisions on the licensing, financial requirements and duties, ownership, control, management, business restrictions, etc. for Islamic banks.

The Bank Indonesia has amended its regulations concerning capital adequacy ratio for Commercial banks based on Sharia principles and conversion of business of conventional commercial banks to Islamic banks.

The State Bank of Pakistan issued a detailed policy framework for Islamic banks in January, 2003 outlining the eligibility criteria, licensing requirements and other operational guidelines for establishment of Islamic banks, subsidiaries and stand-alone branches. Work is in progress to issue separate Prudential Regulations specific to the Islamic banks on the same line as the one in Bahrain.

The above survey of regulatory and supervisory arrangements of Islamic banks shows that except for Bahrain not much progress has been made in other countries in specifying separate Prudential regulations for Islamic banks. It also shows that some key elements are missing or underdeveloped in case of Islamic banks that make the task of separate regulations more difficult. The absence of standardized contracts, uniform and appropriate accounting and auditing systems, adequately trained and skilled supervisory and enforcement staff, and the credit rating agencies are some of the issues that need to be resolved before separate regulations are issued and enforced. Whether other countries will be forced to issue such regulations or allow financial innovation and experimentation to take place before codifying them under a set of regulations is a moot question that needs to be further explored.

Global monitoring of Islamic financial services industry is far from satisfactory at this stage. The annual summits of the kind we are attending today, conferences and seminars on Islamic finance provide useful vehicles for ad hoc measures but there is a need for more systematic monitoring. Some elements are coming together. Dow Jones Index is one such elements for monitoring Islamic Funds. An Islamic Credit Rating Agency has also started functioning but only recently. In a paper delivered at a seminar on Islamic Finance organized by the World Bank last month in collaboration with the IFSB I had proposed that the World Bank and IMF which have strong capacity for designing, developing and disseminating analytically useful data bases should help the industry by systematically gathering and publishing data on Islamic financial institutions and markets at periodic intervals. This would not only force the providers of data to standardize, upgrade the quality but also permit cross country comparative studies and monitoring of financial soundness of the Islamic financial system .

Public Disclosure and Transparency of information:-

In Islamic modes of financing the capital value and returns on investment deposits depend on banks' profits. This implies that information disclosure and transparency are more important for an Islamic banking system than in a conventional banking system. Information disclosure should reduce information asymmetries between bank managers and depositors and thus the moral hazard. Islamic banks should also publish their ex-ante their investment strategies, objectives and risk-reward thresholds in addition to ex-post audited financial statements. The depositors would then be in better position to make the choices based on their risk preferences among the different banks.

As the Islamic financial services industry is still in its nascent phase, the volumes raised by this industry are miniscule in relation to the total transactions that take place in global financial markets, the systemic risk is negligible. It may also be argued that the nature of Islamic banking products is not yet fully understood and therefore it will take some time to meet the universal standards of public disclosure and transparency. But as pointed out earlier the imperatives of greater transparency are more pressing in the case of Islamic banking as it is intrinsically based on risk sharing. Fund provider and the entrepreneur share the business risk. Transparency of operations must be ensured to avoid losses from moral hazard.

Bahrain has set out rules and guidelines that Islamic banks should adhere to enhance corporate and financial transparency through better public disclosure. These rules incorporate the international best practice in financial disclosures including the recommendations of Basel committee on Banking Supervision and International organization of Securities Commissions. In Bahrain, semi-annual and unaudited quarterly financial statements are also published in addition to rate charges and Deposit protection. The main public disclosure requirements in most countries are that like other banks Islamic banks have to publish their audited annual financial statements in conformity with the provisions of Companies law or Banking Companies Law.

Malaysia has been pursuing an active program of raising consumer awareness and education. The program is directed at addressing the issue of asymmetry of information through the publication and dissemination of information on retail banking products and services to the consumer. Quick and easy reference guides and checklists enable consumers to compare retail banking products and encourage them to take more informed decisions in managing their finances.

In Pakistan the disclosure requirements are at par with those laid down for the Conventional banks. Islamic banks are obliged by law to publish their annual accounts in newspapers and on their websites. Moreover, banks are obligated to disclose correct information on their profit rates on deposits and financing schemes.

Except for the above mentioned three countries we could not gather much evidence about the disclosure and transparency requirements of other countries. In case such requirements are indeed in place it would be advisable for the regulatory and supervisory authorities to disseminate them widely and make them known to as large a segment of population as possible. In a new industry it is all the more necessary that to infuse confidence and win the customers over public disclosure should be heightened.

Financial safety nets for Islamic finance:-

The literature on the financial safety nets in banking industry as such is highly contentious and unsettled. There is one particular school of thought that vehemently highlights the moral hazard effects of a Depositor Insurance or Protection Scheme. Others believe that a selective, low threshold eligibility scheme is necessary to provide some comfort to the small depositors and to maintain their confidence in the banking. The policy makers and practitioners have shown their preference for the latter by setting up Deposit Protection schemes in as many as 95 countries of the world. The unique risks facing the Islamic banking system i.e. risk of loss in ijarah and trading, risks of commodity price fluctuations, risks like that of venture capitalists in case of Musharakah and Mudarabah make the moral hazard issue even more accentuated.

Bahrain Monetary Authority has set out rules and regulations for establishing a Deposit Protection Scheme for compensating eligible depositors when the banks are unable or likely to be unable to satisfy claims against them. A body called the Deposit

Protection Board would be established to operate and administer the compensation scheme.

In 2005, Bank Negara Malaysia set up the Malaysia Deposit Insurance Corporation which commenced its operations in September, 2005. Eligible deposits up to the limit of RM 60,000/- per depositor per member institution are covered under the MDIC. A separate coverage of the same amount is provided for Islamic deposits accounts held under joint ownership and trust accounts, sole proprietorships and partnerships. It is envisaged that the level of coverage will provide full protection for up to 95 percent depositors.

In Sudan, A Deposits Guarantee Fund has been established for protecting depositors, securing the stability and soundness of banks and build confidence in them. But the operational details or the performance of this Scheme are not available for further analysis.

As Iran has state ownership of the banking system the Central Bank implicitly protects the depositors against possible default or bankruptcy by periodically covering bank losses in the annual budgets of the Government.

Like Iran Pakistan's banking system was owned largely by the Government and all the deposits in the public sector banks were guaranteed by the Government. Large infusions were made to recoup the losses of these banks and recapitalize them. The share of public sector banks has now dwindled to about 20 percent and most banks are now owned and managed by the private sector. The State Bank of Pakistan has formulated a Deposit Insurance Scheme which is currently under consideration of the Government.

CONCLUSION

The legal, regulatory , supervisory and monitoring arrangements for Islamic banking are still in a state of evolution and while preliminary actions have been taken at national jurisdictions the AAOFI, IFSB, and other supporting institutions have to play a more proactive and consultative role in formulating standards, norms and guidelines, securing consensus among the stakeholders and disseminating them for adoption. This will obviate the capacity constraints faced by the national authorities and also result in an implicit harmonization across countries.

Annexure

Islamic Finance Legal Regulatory and Supervision Arrangements

A Cross Country Comparison

	Legal Authority	**Regulatory, Supervisory and Monitoring Arrangements**	**Shariah Boards**
Bahrain	BMA Law	• BMA – Islamic banks, under Dual System of banking; Mutual Funds, Investment Advisory Services	Each Islamic bank must have a Shariah Board
Indonesia	Act No.10, 1998 and Act No.23, 1999 and other amended form time to time.	• BoI – Central Bank • OJK – Regulation, Supervision of banks, insurance companies, pension funds.	Separate Shariah board required
Iran	Law for usury (Interest) Free Banking 1983	• BMJII – Single banking system based on Shariah principle. • Separate regulator for Insurance	No Shariah Board.
Kuwait	Law No. 30 of 2003 amended Law No.32 of 1968	• CBK – Islamic banks under Dual Investment system of banking	Separate Shariah board for each bank

		• Separate regulator for Insurance Companies	
Malaysia	Islamic Banking Act (IBA) 1983	• BNM – Islamic banks, Leasing companies, Takaful companies, investment banks; MOF closely associated with Supervision of Islamic banks. • SEC – Securities markets, Investment Banks.	Separate Shariah boards at institutional level in the BNM and SEC.
Pakistan	Banking Companies Ordinance (BCO) 1962 amended in	• SBP – Islamic banks • SECP – Takafuls, Securities markets, Investment Banks, Modarabas, Leasing Companies	At the SBP level At each Islamic banking institution.
Sudan	Bank of Sudan Act (BSA) 2002	• Bank of Sudan – Single banking system based on Shariah principles	Central Bank has a Shariah Supervisory Board separate Shariah Boards for banks