A Cross Sectoral Approach to the Supervision of Islamic Financial Services – Challenges and Opportunities

We begin our discussion of the Islamic Financial Services Industry (IFSI) by examining the context and the emerging trends in which this industry will be operating in the future. We also assume that the IFSI will become an integral part of the international financial system, its reach and coverage will extend both to the countries where the majority of Muslims are residing but also to other parts of the globe and that even in the majority Muslim countries the IFSI will coexist with the Conventional finance. Under these sets of assumptions let us first look at the international context.

The industry, though still dominated by banking, has branched off into securities, asset management, insurance activities and some mergers and acquisitions have helped in consolidation. This trend is on the rise not on decline as can be seen from the present bid for ABN – Amro Bank by Barclays Bank and the Royal Bank of Scotland. Financial Institutions (FIs) transfer – within and across borders – a range of risks that had previously been held on their balance sheets and risk management capacities in general have been strengthened within institutions. It is, however, unclear where the ultimate risk resides across institutions.

Merges and acquisitions activity in the financial system has risen sharply since 2000 with cross border M&A increasing from < 1% to 40% of the total value of financial Sector M&A activity between 1997-2006.

These trends therefore have implications for the IFSI. Due to limitations of time I won't get into this discussion but revert to the topic assigned to me but always keeping these global trends and context in mind.

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The options for a regulatory and supervisory framework for all sectors of IFSI should be examined but before doing so there are certain prior and fundamental issues about the Islamic finance that have to be addressed. The resolution of these issues has implications for the nature and scope of this framework. At least five burning issue come to my mind.

1. What is the appropriate form of legal entity for an Islamic Financial Institution? The Islamic principles of property rights, sanctity of contracts and incentive to enforce Shariah have to be incorporated in the legal entity model for Islamic Finance. Companies Law, Banking Companies Laws and other statutes available under English legal system do not fulfill these principles. Shareholder or owner-centered governance system dominates the English Commercial Law. Inclusion of other stakeholders – the individuals, the firm, community and the state in the governance structure did not figure in. There is no need to undermine the rights of shareholders to maximize profits but the legal arrangements should also allow the rights of stakeholders in legal arrangements in Civil Code jurisdictions.

   The existing commercial laws and codes that are applicable in most Muslim countries are not entirely compatible with the Islamic principles. When the courts take up a dispute they examine it according to the procedures and laws prevailing in the country. As the legal foundations themselves are weak the regulatory framework cannot be robust.
2. Are the Shariah Boards part of the governance structure of the banks for protection of depositors, borrowers and investors' rights with an additional filter of compliance with the Shariah principles? The clients of Islamic banks have chosen to put their deposits and investment account holders their investment because of their faith. The framework o governance should incorporate these stakeholders as there is no such parallel in the conventional banking."

3. What is the extent of the case law and what are the established judicial precedents on a range of issues such as true sale, collateral security, bankruptcy, insolvency, foreclosure applicable in case of Islamic finance. Either some of these issues have not yet been challenged in the courts of law or if they have been a critical mass of legal opinion under different circumstances, different jurisdictions and different Shariah interpretations has not yet emerged even in the common-law based legal systems. There is therefore absence of legal certainty about Islamic finance in contrast to the conventional finance. The regulatory agencies do not know how to handle this uncertainty.
4. Shariah reports are not available to the public or they are full of inconsistencies across sectors and across jurisdictions. This situation is antithetical to one of the principles of good governance i.e disclosure. How can this problem inconsistency in disclosure or

less than full disclosure be handled to maintain the integrity of the corporate governance structure of Islamic financial system?

5. Islamic bank is a hybrid of the commercial and investment types of bank just like conventional universal banks but there are no firewalls to separate legally, financially and operationally – their investment and commercial banking services. Co-mingling of funds leads to difficult in identifying the sources of funds invested at the time of distribution of profits and losses. Although the regulators have succeeded in separation of funds of conventional and Islamic banking windows and subsidiary the further separation between investment and commercial banking operations requires scrutiny.

What are the possible options for cross – sectoral regulation and supervision of IFSI? First, we have to distinguish between those regulating in a wholly Islamic jurisdiction and those regulating both Islamic finance and conventional finance. As the former category contains a very few cells the thrust of the discussion would be focused on the latter category.

The question then arises: do we opt for a single unified, integrated regulatory regime where the securities, banking, asset management, takaful, all are under the jurisdiction of a single regulator or have multiple regulators specialized in a different component of the IFSI and set up a coordinating and information exchange mechanism among these regulators.

In a certain way the unification of Islamic financial industry under a single regulatory agency may address some of the current concerns such as the difference in the liabilities structure of Islamic banking and the Mutual Fund, in Modaraba and venture capital, investment banking and Commercial Banking that are difficult to handle. It may also smooth out the links in the value chain of Islamic finance from Securities markets at one end to non-banking financial institutions on the other hand. This approach may also help in identifying, measuring and determining the distribution of risks throughout the financial system. For example, the banks may off load their assets from their balance sheets through securitization, disperse the risk, diversify and prospectively lower the cost of funding. A unified single regulator would be in a better position to assess whether such a transfer of risks from individual banks to other institutions under IFSI would promote financial stability or give rise to new systemic risks. The question of where the ultimate risk resides in the complex web of transactions under financial engineering and financial innovations can also be better handled under a single integrated regulator.

Such an arrangement will minimize regulatory arbitrage and provide a level playing field both within the IFSI and in relation to the Conventional finance. Separate regulatory agencies for banking and capital markets have faced problems of coordination particularly in the matters of prompt corrective action and the lender of last resort. The costs to individual financial institutions of reporting to multiple regulatory agencies separately may also create some competitive disadvantages.

But for a single regulator to function effectively the challenges for accepting and successfully fulfilling these obligations are enormous:

a) Anchoring of the Islamic financial institutions in a country across sectors have to be firmly anchored within appropriate commercial and contract laws. The present add-ons to the existing laws do not work.

b) A supportive and mutual reinforcing judicial infrastructure that strengthens the legal basis of decision making by the regulators is needed across sectors in jurisdictions.

c) The quality and number of Shariah scholars well versed in the intricacies and complexities of all product offerings under commercial banking, investment banking, sukuk, short term liquidity management, securitization takaful etc. have to be upgraded.

d) The capacity and the manpower of the regulatory agencies to set, monitor, develop and enforce the prudential limits and at the same time facilitate market based financial innovations so that Islamic financial industry remains competitive with the conventional finance have to be expanded.

e) A strong data base, monitoring tools and real time management information system is to be available at the disposal of the single regulator for tracking and then enforcing actions.

f) Uniform reporting standards for all regulatees in a manner that can enable identification, measurement and classification of risks in a consistent manner across sectors are to be prescribed.

6) Reliable, relevant and timely information about basic transaction data is critical for Islamic financial system as it takes partnership positions. The cost of acquiring this plethora of detailed transaction by transaction information may prove to be quite detrimental to IFSI operators in a competitive market environment.

7) Risk mitigants in Islamic finance may be different although they may face common risks – market risk, credit risk, operational risk. On the other hand the characteristics of Islamic finance such as asset backed products, ethical consideration bring the IFIs

closer to customer and obviate the need for higher capital allocation to mitigate risks relative to conventional finance.

8) The smoothing of returns to the customers in practice in Islamic Finance Institutions (IFI) (according to the principle of Mudarabah) creates uncertainty for a regulator as the treatment of Displaced Commercial risk is far from clear. The IFSB standards should come to the rescue but it has not been tested for reality check.
9) Shariah non compliance undermines customer confidence in the Islamic financial institution. Adequate systems and controls that ensure compliance, monitor, and control and take action against a firm for deviation from Shariah principles have not yet been fully tested under adverse conditions and the volume of transactions under the Islamic mode of financing has not reached a high level yet.
10) Would Integrated Regulatory Framework of Systems and Controls, conduct of business, disclosure and prudential requirements be the same across conventional and Islamic finance? Whether there will be duplication and separation even for common areas of regulation that may lead to increase in the costs of regulation and may not make Islamic products markets competitive.
11) Regulator must have the capacity to identify, understand the specific Islamic contracts as well as the risks unique to Islamic firms involved and also ensure that the customers are also familiar with the Islamic products and the associated risks. Additional controls have to be put in place for fiduciary responsibility of the Mudarib and fit and proper criteria developed for the Mudarabah. Islamic products are more complex but less well – tested in the market.

Conclusion

The evolution of a single, unified regulatory for Islamic financial services industry needs to be encouraged as it will help meet some other the current difficulties faced by the regulators. But it is also quite clear that the number of pre-conditions have to be met, the gaps and weaknesses have to be addressed, continuous monitoring, research and corrective action have to be taken and the capacity of the regulators themselves have to be enhanced.