

Regulation, Supervision & Governance of Islamic Financial Institutions

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Introduction

- * This presentation is an overview of a regulatory framework applicable to Islamic financial services at national and international levels.
- * It discusses various issues facing regulatory authorities and possible solutions.
- * It explains how differences between conventional financial institutions and Islamic financial institutions (IFIs) impact the regulation and governance of the Islamic Financial industry.

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1. Rationale for the Regulation of Islamic Finance

- * **(1) General Systemic Considerations:**
- * To maintain an efficient payment system & mitigate risks of disruption of payments, Regulation is needed to
 - * Guard against the contagious risk of insolvency threatening the financial system.
 - * Manage the delicate balance between *risk-prone* developmental challenges and financial stability.

1. Rationale for the Regulation of Islamic Finance

- * **(2) Protecting Depositors & Investment Account Holders (IAHs) of IFIS;** which is only possible through:
 - * Promotion of investors' awareness as regards contractual risks/ rights of the IAHs
 - * Adoption of representative governance through transparency/ recourse system
 - * Regulatory approach similar to that of promoting the integrity of fiduciary contracts.
 - * Leveling the playing field ensuring a “no worse off” treatment vis-à-vis conventional finance

1. Rationale for the Regulation of Islamic Finance

- * **(3) Ensuring *Shari'ah* Compliance: how to maintain public confidence in IFIS?**
 - * Depending on different jurisdictions, this point raises problems as regards dispute resolution and credibility.
 - * Establishment of Shari'ah supervisory board have significantly improved credibility of IFIs *worldwide*.

1. Rationale for the Regulation of Islamic Finance

- * **(4) Integration of IFIs within the International Financial System (IFS):**
- * IFIs are believed to have passed the acid test of the current global financial crisis.
- * More is, yet, needed to integrate IFIs into the IFS through:
 - * Greater engagement in international trade
 - * Closer adaptation to international stability policies.

2. Unique Characteristics of the Regulation of Islamic Finance Institutions

- * Regulation of IFIs necessitates recognition of their unique characteristics and requirements:
 - * Shari'ah compliance risk, investment equity risk, displaced commercial risk
 - * Need to address gaps in Basel Standards with respect to the treatment of capital.
 - * Recommendable IFSB standards as they covers cross-border supervision issues.

2. Unique Characteristics of the Regulation of Islamic Finance Institutions

- * Need to set prudent capital adequacy requirements reflecting inherent IF risks.
 - * Equity-like IF investment transactions cannot be regulated as debt-creditor conventional relationships.
 - * IAHs should more appropriately be aligned somehow with shareholders.
 - * This should be reflected in the risk weights assigned to individual asset components of IFIs.
 - * IFIs have to allocate more resources to support the identification, assessment and management of risks

3. Rationale for Capital regulation

- * The objective of capital regulation is to promote financial market stability, fortify banks against shocks and protect investors against consequential losses.
- * Basel III calls on banks to hold top-quality capital (Core Tier-1 capital).

3. Rationale for Capital regulation

- * Basel III:
 - * Core Tier1 Capital consists of equity or retained earnings worth at least 4.5% of assets.
 - * Plus capital conservation buffer of common equity comprising 2.5% of assets (=7.0%)
 - * Counter-cyclical buffer range [0.0, 2.5%]
- * However, this has not been tailored with due consideration to IFIs' peculiarities.

3. Rationale for Capital regulation

- * The IFSB issued Capital Adequacy Standard (IFSB-2), 2005 based on Basel II
 - * This standard incorporates features similar to ‘capital conservation buffer’ and ‘capital cyclical buffer’ of Basel III.
 - * It relates particularly to IRR (investment risk reserve) and PER (profit- equalization reserve) established in IFSB-2
 - * However, the rationale was different !

3. Rationale for Capital regulation

- * IFSB-2 addresses the quantification of Capital Adequacy of IFS against market, credit and operations risks.
- * Such exposures arise from specificities of IFIs' financial contracts which are:
 - * Asset-based (e.g. murabaha)
 - * lease-based (e.g. Ijarah)
 - * Profit Sharing (e.g. mudarabah, musharakah).

4. Regulatory & Supervisory Authorities for Islamic Finance (Malaysian Experience)

- * Central Banks have different mandates in the conduct of monetary policy and the regulation/ supervision of financial institutions; namely:
 - * Price stability (maintain value of money)
 - * Real economic stability (macroeconomic policy)
 - * Financial stability (maintain an efficient payment system)

4. Regulatory & Supervisory Authorities for Islamic Finance (Malaysian Experience)

- * Bank Negara Malaysia (BNM): the CBA Act 1958 has been repealed by CBA 2009 to:
 - * Acknowledge dual financial systems i.e., Islamic/ conventional financial system.
 - * Establish mandatory power of the National Shari'ah Advisory Council (NSAC) as the highest Shari'ah authority in Islamic finance.
 - * Commit to promote and position Malaysia as an international Islamic financial center.

4. Regulatory & Supervisory Authorities for Islamic Finance (Malaysian Experience)

Structure of Malaysian Islamic Financial Industry (MIFI)

- * Comprehensive IF system consisting of :
 - * Islamic banking system (retail services)
 - * Islamic interbank money market (e.g. IIM = Mudarabah Interbank Investment mechanism)
 - * Islamic Capital Market (sourcing of LT funds)
 - * Islamic Debt Market (LT finance for infrastructure / development projects)
 - * Islamic Equity Market (corporate expansion)
 - * Takaful Market (Enhances financial resilience)

4. Regulatory & Supervisory Authorities for Islamic Finance (Malaysian Experience)

Strengthened International Synergies .

- * Malaysia contributed significantly towards the integration of Islamic Finance into the international market through:
 - * Accelerating development of IF markets: this resulted in a wide range of innovative instruments (liquidity/ risk management)
 - * Liberalization policy: this resulted in greater foreign institutional presence, cross-border financial flows and more diversity of players.

4. Regulatory & Supervisory Authorities for Islamic Finance (Malaysian Experience)

Human Resource Development

- * The BNM established International Centre for Education in Islamic Finance (INCEIF) for practitioners and post-graduate studies to ensure the continuous supply of talent in Islamic finance.
- * It invites students from more than 60 countries: UK, Canada, France, Japan and Korea as well as the Middle East etc.

4. Regulatory & Supervisory Authorities for Islamic Finance (Malaysian Experience)

Security Commission (SC)

- * The Malaysian Securities Commission (SC) was established under the Securities Commission Act (SCA) 1993 as self-funding statutory body with mandate to:
 - * Promote and maintain fair, efficient, secure and transparent securities and futures markets
 - * Facilitate the orderly development of an innovative and competitive capital market.

4. Regulatory & Supervisory Authorities for Islamic Finance (Malaysian Experience)

SC joined the International Organization of Securities Commissions (IOSCO).

- * Remained an active member of various committees and task forces of IOSCO.
- * Invited to sit on the drafting committee for IOSCO's Objectives and Principles of Securities Regulation.
- * Invited to sit on the Implementation Task Force which released in October 2008 the Methodology for Assessing the Implementation of the IOSCO Objectives and Principles of Securities Regulation.

5. International Standard-Setting Organizations

- * International standardization bodies do not possess any formal supranational supervisory authority through legal force.
- * Rather, they formulate broad supervisory standards and guidelines that can be properly adapted to suit different national systems.
- * They encourage convergence towards common approaches and common standards without attempting detailed harmonization of member countries' supervisory techniques.

5. International Standard-Setting Organizations

The Basel Committee for Banking Supervision (BCBs)

- * The BCB Objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide.
- * International standards on Capital Adequacy
- * The Core Principles for Effective Banking Supervision
- * The Concordat on Cross-Border Banking Supervision

5. International Standard-Setting Organizations

The International Organization of Securities Commissions (IOSCO)

- * Recognized as the world's most important international co-operative forum for securities regulatory agencies.
 - * Playing key role in setting international standards for securities regulation.
 - * Established Islamic Capital Market Task Force, 2002, chaired by the then chairman of the SC of Malaysia.
 - * The Task force published the Islamic Capital Market Fact Finding Report in 2004.

5. International Standard-Setting Organizations

International Association of Insurance Supervisors (IAIS)

- * Its objectives are to:
 - * Cooperate towards improved supervision of the insurance industry on a domestic as well as international level in order to maintain efficient, fair, safe and stable insurance markets.
 - * Promote the development of well-regulated insurance markets.
 - * Contribute towards global financial stability.

5. International Standard-Setting Organizations

Islamic Financial Services Board (IFSB)

- * Inaugurated on 3 November, 2002 with the objective:
 - * To ensure the soundness and stability of the Islamic financial services industry, broadly defined to include banks, capital markets and insurance.
 - * This involves introducing new, or adapting existing and recommendable international standards consistent with Shari'ah.

5. International Standard-Setting Organizations

- * As of April 2010, the IFSB has 191 members, including 50 regulatory and supervisory authorities
 - * Six multilateral inter-governmental organizations, including the IMF, World Bank, Bank for International Settlements
 - * Islamic Development Bank (IDB), Asian Development Bank; and 135 market players and professional firms from 40 countries.

5. International Standard-Setting Organizations

- * The IFSB largely complements the work of the BCBS and IOSCO.
- * Thus, the IFSB has issued a prudential and governance framework for the Islamic financial services in the form of Standards, Guiding Principles and Technical Notes
- * This covers banking, insurance (takaful) and capital markets for the Islamic financial services industry (see table 5.5).

5. International Standard-Setting Organizations

Other infrastructural institutions

- * **AAOIFI** : Accounting and Auditing Organization for Islamic Financial Institutions
- * **IIFM** : International Islamic Financial Market
- * **IILM** : International Islamic Liquidity Management Corporation

6. Conclusions: Opportunities, Issues & Challenges.

Opportunities:

- * Financial centers such as London, Japan, Hong Kong and Singapore are starting to make aggressive efforts to become Islamic financial hubs.
- * Increasing numbers of advanced economies such as France, Japan and Korea have started initiating amendments to their laws to permit Islamic finance transactions.

6. Conclusions: Opportunities, Issues & Challenges.

Challenges:

- * Lack of a reliable database: How to promote the culture of transparent disclosure.
- * Haphazard Policy Decisions and Lack of a Level Playing-Field: Compliance with multiple supervisory and regulatory regimes would impede the industry's growth,
- * Human Resource developments: need for more capacity building to address the human capital needs of the IF industry