Why Do We Need Regulations in Islamic Finance?

LAB3073

Zulkifli Hasan, PhD
CONTENTS

- Legal Systems
- Rationale for regulations
- Legal framework
- Regulatory and Supervisory Authorities
- International Standard Setting Agencies
- Corporate Structure and Regulatory Requirements
Diversity in the Legal Arrangements

- Civil Law: Algeria, Djibouti, Egypt, Jordan, Indonesia, Lebanon, Syria, Tunisia, Turkey, Philippines, Thailand.

- Common Law: Bangladesh, Mzia, Brunei, Hong Kong, Spore, UK

- Shariah: GCC Countries, Iran, Sudan, Pakistan and Yemen
Why Islamic finance needs regulation? (1)

- Systemic Considerations:
- Domino theory
- To maintain an efficient payment system and mitigate the risks of disruption of payment.
- Promoting development and ensuring the stability
+ Why? (2)

- Protecting the Interest of Depositors and Investment Account Holders
- CA holders are capital guaranteed.
- IAH: do not enjoy capital guarantee
- Disclosure
- Sufficient security assurance
Why? (3)

- Ensuring compliance with shariah
- Regulatory requirement
- Tainted income has to be cleansed
- Credibility and competence of legal avenues
- Shariah board and corporate governance
Why? (4)

- Supporting the Integration of IFIs in the International Financial System
- Global financial stability
- Economic growth
- International trade and payments
Why? (5)

- Financial systems are prone to instability
- Numerous banks failures
- Islamic finance is under regulated
Why? (6)

- Consumer confidence
- Degree of assurance and lower transaction cost
While regulation is expected to govern and regulate the market effectively as in the case of Malaysia, it is worth emphasizing that over-restrictive regulation can also be counter-productive and may impede the development of Islamic finance industry as a whole.
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<th>Why?</th>
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<td><strong>Ihlas finance in Turkey</strong></td>
<td>- IF was closed in 10/02/2001 due to financial distress and weak corporate governance. Failure of CG and internal checks and balances (Ali, 2007).</td>
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<td><strong>Islamic Bank of South Africa</strong></td>
<td>- The IBSA was closed in November 1997 with debt of between R50-R70 million. Lack of supervision from regulatory authority, bad management, weak risk management and numerous loans to insiders (Okeahalam, 1998: 37-38).</td>
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<td><strong>Islamic Investment Companies of Egypt</strong></td>
<td>- The closure of the IICE in 1988 was due to the weak of corporate governance, irresponsible management, and improper regulatory frameworks as well as engaged in Shari’ah non-compliance activities (Zuhaida, 1990).</td>
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<td><strong>Dubai Islamic Bank</strong></td>
<td>- This refer to the fraud case in DIB involving of USD501 million. Seven individuals have been charged including two Dubai Islamic Bank former executives (Morris, 2009). Weak internal control.</td>
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<td><strong>Bank Islam Malaysia Berhad.</strong></td>
<td>- Losses, totaling RM457 million in 2005 (Parker, 2005). The composition of the board was not appropriate as there were no board members who were familiar with banking sectors as well as no sound and proper credit and debt collection (Parker, 2005).</td>
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<td><strong>Patni Cooperative Credit Society</strong></td>
<td>- Failure to asses risk to compensate the regulatory constraints. The BOD and management failed to asses regulatory risk in which led to numerous problems and difficulties (Grais and Pellegrini, 2006).</td>
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Case Study: Ihlas Finans

- **Accumulation of bad debt** - Politically motivated lending and lending to connected business. Finance the businesses of its parent company, Ihlas Holdings.

- **Lax Regulation** - Law on full guarantee of the bank deposits offered by the State made banking a lucrative business for the corrupt entrepreneurs with political connections who set up banks that siphoned off money.

- **Major proportion of the investment was an illiquid assets and projects as compared to other domestic and foreign commercial banks who could hold very liquid government securities.**

- **Failures in CG and lack of internal checks and balances** - Control failure, Management failure and regulatory failure.
A rubber stamp board of directors, Lax Attitude towards governance, Some members appointed to the board did not have requisite experience, Only one institutional member i.e. IDB as minority shareholder and thus it was easy to manipulate the Board

Board members are ignorant of financial and economic facts and working of the company, board members are not motivated, Some board members had conflict of interest owing to their dual role as board members as well as clients of finance from Ihlas Finans Holdings

The Bank staff lack relevant experience and training

The bank is run on trust without proper systems of internal control
Management Failures

- Not preparing enough for changing regulations, No Crisis Management Plan, Decision making during crisis was ad-hoc and uncoordinated internally
- Connected Lending and Investment Concentration, Executive Selection
  - Hired a senior executive from a previously failed bank
- Allowing Withdrawal from Investment Accounts, Failure to manage liquidity risk
- Indulge in fraudulent practices, some of the mudharabah agency financing was done in the name of fictitious parties while the funds were used for solving internal financial problems
Drastic application of rules

Lax Supervision

Lacuna in supervision of law

Unclear scope of deposit protection law and confusion on who is the authority

Regulatory Failures
Legal Framework

- Body empowers to enact the laws
- The applicable laws
- The relevant regulatory and supervisory authorities
- Persons who are subject to the laws
- adjudication
Effective Legal Framework

- 1. An enabling environment that accommodates and facilitates the development of the industry
- 2. Facilitates and allows access to investors
- 3. Credible and reliable forum for legal disputes.
Components of Legal Framework

- Banking and finance law: licensing and regulation
- Tax law: incentives
- Business law: real economic activities, trading.
- Property law: to hold properties
- Insolvency law: recovery
- Securities law: capital market
- Employment law: qualified employee
- Dispute resolution framework: court or arbitration.
Legal Approaches

- Apply the same existing legal framework as for conventional: UK
- Adapt or amend the existing legal framework mainly through subsidiary legislation or insertion of provision under existing laws: Bahrain
- Totally new and separate legal framework: Msia
IFIs in Malaysia

1. Comply with the Malaysian Law
2. Comply with the Shariah principles
3. Comply with the guidelines and directives
BNM

- BNM-CBA 2009: Stability of monetary, financial and payment system.
  - 1. IBS
  - 2. IIMM
  - 3. ICM
  - 4. IDM
  - 5. IEM
  - 6. Takaful
Rationale:

- To provide the BNM with necessary power to carry out its mandate
- Greater clarity in term of mandates
- Autonomy achievement of mandates
- Financial and monetary stability
1. Acknowledgement; dual system: S27
2. Mandate to NSAC: s 56 and s 57
3. Commitment to promote MIFC: s 68.
International Standard Setting Agencies

- BCBS
- IOSCO
- IAIS
- IFSB
- AAOIFI
- IIFM
- IILM
Corporate Structure

Guidelines on Governance
- Regulation
- Electing BOD/
- Code of Conduct
- Approving Key Policy
- Shari'ah Board
- Investor/ Shareholder Protection
- Shari'ah Compliance Unit/ Department

Due Diligence
- Board Oversight
- Risk Committee
- Audit Committee
- Governance Committee

Internal Control
- Management Oversight
- Risk Management
- Internal Audit
- Compliance Officer

Monitoring

Enforcement
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<th>Key Participants</th>
<th>Interest</th>
<th>Functional Roles</th>
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<td>• Regulatory / Supervisory authority</td>
<td>• Economic Stability and Compliance with the laws and regulation</td>
<td>• Set regulatory framework for sound and proper CG</td>
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<td>• To supervise and monitor the effectiveness of CG and to check compliance with regulation</td>
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<td>• Shareholders</td>
<td>• Wealth maximization; Satisfactory earnings per share; Dividends;</td>
<td>• Appoint fit and proper boards, management auditors and <em>Shari’ah</em> board</td>
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<td>• IAH</td>
<td>• Repayment of deposits on the agreed terms; Protection of their interests and Profit</td>
<td>• To monitor the investment performance</td>
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<td>• <em>Shari’ah</em> Board</td>
<td>• Compliance with <em>Shari’ah</em></td>
<td>• To ensure <em>Shari’ah</em> compliance and protect the rights and interest of depositors and other stakeholder.</td>
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<tr>
<td>• BOD</td>
<td>• Monetary and non-monetary compensation;</td>
<td>• To set the IFIs direction and policies</td>
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<tr>
<td>• Management</td>
<td>• Monetary and non-monetary compensation and commitment to claims of the contract</td>
<td>• To implement policies set by the BOD</td>
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