

Building an Effective Islamic Financial System

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Surge in capital from oil rich economies may have spurred the activity in Islamic Finance (IF) but one should not assume that this phenomenon will be the sole catalyst to promote growth in IF industry. The primary driver of IF growth will be the effectiveness with which this industry is consistently, persistently and substantively nurtured, groomed and developed and how successful the industry is in maintaining its robustness, soundness and governance as it grapples with some of the fundamental issues and challenges facing the industry in its evolving and growth phase.

What is comforting and encouraging that Islamic world has collectively launched IF with a fair degree of commitment and fervor backed by adequate capital base. The process has been further supported by the right mix and blend of institutional frameworks that have led to gradual development of internationally accepted architecture for regulatory and accounting frameworks for Islamic industry.

There is further an intensive effort underway to aggressively explore and exploit the virtues and benefits of this discipline. As one unfolds the mysteries of Islamic tenets and ethical spirit in finance, it offers opportunities for financial innovation and flexibility to structure different types of financial products which, among others, would allow for a shift from debt based financial system more to equity and partnership based. What is further amazing is IFs has promising potential to channel wealth by offering alternate avenues for saving and investment, while dealing with the problems of financial exclusion by extending riba free services to devout Muslims.

Critical driver for effective development of IF industry, its growth and sustainability will depend on the ability of the system to offer clients comfort that these financial services do conform to the Shariah injunctions and principles. It is this value addition that will help enhance the outreach and appeal to the larger Muslim population base in particular rural and poor that suffers from financial exclusion.

It is equally critical that the IF emerges as a robust, competitive, efficient and well diversified segment of financial industry to be able to compete with the long

standing conventional industry. To evolve and develop a strong, healthy and competitive system, IF industry has to

- (i) Further explore the depth and breadth of IF systems in order to fully unleash its uniqueness and potential,
- (ii) Develop and implement policies and regulatory frameworks for IF which are complementary to conventional banking system but which are tailored to capture the different types of risks associated with IF,
- (iii) Recognizing that IF offers an opportunity to diversify financial system to more equity based and better risk sharing instruments than offered by conventional system thereby helping the overall financial system to evolve in a more balanced way, and
- (iv) Better understand and appreciate the richness of IF which advocates a different liability and asset approach that once effectively acknowledged and applied will offer wide range of opportunities for financial innovation key to the further development and diversification of overall financial system.

It is the recognition and implementation of the above goals and objectives that will lay the foundation for an effective financial system. I will now dwell on some of the key preconditions which are critical for laying the foundation for an effective IF system.

First, it has to be recognized that depending on their circumstances, regulators have adopted varying approaches to develop IF system. At this stage, it is too early to pre-judge which approach and model will be effective but success would be contingent on how effectively these institutions are nurtured and supervised. In some jurisdictions regulators have allowed dual systems whereby it issues some additional policies and regulations for IFIs over and above the prudential regulatory framework for conventional banks. Within this category there are variations with regard to role of regulator in Shariah compliance. Some countries have declared the entire financial system to be Islamic and in others no distinction is made between Islamic or conventional financial systems, and the decision to establish Islamic bank is with the owners, e.g. Saudi Arabia and UAE. As distinct from these, there is now a wave across developed financial systems, such as U.K and Singapore, to introduce specific legislation and regulations to facilitate IF transactions.

Depending on regulators' adopted policy stance, approaches to issuance of licensing and role of regulator in Shariah compliance varies significantly. For instance, some regulators issue standard form of banking license (e.g. Saudi Arabia) for both Islamic and conventional institutions, while others issue separate Islamic banking licenses (e.g. Malaysia).

When regulators apply the same criteria and due diligence for licensing both IFIs and conventional institutions, they strengthen the competitive forces. **Use of a separate licensing criterion should be applied carefully; because relatively lax criterion for IFIs will lower industry standards and result in a protected non-competitive class of institutions.**

Second, for long term sustainability and confidence of IF sector, it is critical that clients and Islamic banks effectively and fully exploit Islamic financial intermediation potential and process based on Shariah principles. Profit sharing is the cornerstone of Islamic financial intermediation process, be it fund raising or funds used or lent among the depositors, banks and the businesses. Lack of appreciation of this and reluctance of banks to experiment and expose themselves to different types of transactions and risks has delayed proper application of IB and as such prevented the desired level of portfolio diversification that IB theoretically have potential for.¹

On liabilities side, while money deposited as amanah is repayable on demand and is backed by 100% reserve requirement, the money held under investment account holders (IAHs) on profit and loss sharing basis and deployed in riskier businesses is not guaranteed and is not strictly a liability. This, however, is not fully recognized by ordinary customer thereby serving as a limitation to business expansion and also carries unintended consequences for IAHs who may not appreciate the risks they are exposed to.

While IFIs are now recognizing this liability distinction more and more, the problem emerges more on asset side. As businesses have evolved, IFIs have ended up largely depending on less risky trade and commodity financing which typically are of shorter maturity even though the IF allows for financial intermediaries to structure various transactions (including Musharakah, Mudarabaha, and Ijarah etc.) that allow adequate flexibility for portfolio and maturity diversification. However, high dependence on Murabahah and on short term transactions has limited the asset diversification potential of IFI and their portfolio ends up resembling conventional fixed income securities in terms of their risk-return profile. Islamic banks have been thus far less open to adoption of some profit-loss sharing instruments (i.e. musharaka or mudarabah) because of bank's low appetite for risk, the associated costs of monitoring such transaction, lack of transparency in markets within which Islamic banks are operating and the reluctance of the depositors/IAHs to take risks.

Furthermore, in contrast to conventional banks who are obligated to offer fixed return to depositors, irrespective of the actual return on assets, IF inherently and potentially helps in asset: liabilities match in the balance sheet. All profits and losses on asset side are expected to be shared by the participants and there are no guaranteed returns to depositors or investors. Thus far IFIs have not fully exploited

¹ H. V. Greuning and Z. Iqbal (2007). "Banking and Risk Environment." In S. Archer and R. A. A. Karim (edt.). *Islamic Finance – The Regulatory Challenge*. New York: Wiley Finance.

these real distinguishing characteristic and features of IF that assign it distinct edge and advantage relative to conventional banks. Despite the flexibility of the IF system, there is often lack of clarity and lack of differentiation between depositors and investors (i.e. those serving as equity holders or partners in businesses) nor is there full appreciation of the profits and loss sharing arrangements that are typically backed by “pass through” arrangements for the stakeholders. Consequently, the IFIs continue to observe asset-liability mismatches even when there are Islamic products/structures available to address these. Continued partial and adhoc applications of IF-system relative to what it offers theoretically will hinder the effective development of IF system and over the period carries the risks of eroding confidence in the system.

Third, to enhance effectiveness of IF it is important that IFIs recognize that the wide array of Islamic financial products do offer opportunities for asset and risk diversification both for the banks balance sheets and that of financial system at large. Proper application of IF alters inherently the balance sheet risks and has potentially inbuilt risk mitigation. On one hand, it brings to forefront different characteristics and types of risks, while making the risk identifiable and transparent. On the other hand, it provides a better framework for risk sharing and mitigation.

What is critical for effective development of IF that both regulatory and supervisory regime recognizes the risk profile of IF and provides adequate guidance on exposures, risk weights and capital to be assigned so that there is uniform application of these standards by industry. There are several aspects that can be discussed and debated in this area, but I will offer only few perspectives:

The regulatory regime should be open to providing adequate incentives for risk and profit sharing and the IF industry needs to adopt more conformed standards to enhance system predictability and stability, while promoting greater awareness among fund suppliers about the terms and conditions of profit sharing under different contractual arrangements. For instance as illustrated and well articulated in one of the recent papers of V.V. Sundarajan (2007): for an IAH who largely provides funds on a mudarabah basis and the IFI which invests these funds (often commingled with shareholders’ and other funds) in various IF contracts (like salam, murabaha, ijara, istisna, musharaka etc.) the risk is the expected variance in the measure of profit distribution between IAH and bank. IFIs have to recognize that this uncertainty or Mudarabah risk can arise from a variety of factors both systemic as well as bank specific. Risk mitigation for IAH can be achieved through use of profit equalization reserves (PER), investment risk reserves (IRR) and by variation in modarib’s share.²

² PER and IRR together adjusts for excessive volatility in profit payouts to investors by aligning the payouts to market rates on deposits and redistributing investment and profits remaining income over time to cover for losses that may emerge. See V. Sundarajan (2007). “Risk Characteristics of Islamic Products: Implications for Risk Measurement and Supervision.” In S. Archer and R. A. A. Karim (edt.). *Islamic Finance – The Regulatory Challenge*. New York: Wiley Finance.

At the same time regulatory regime, needs to offer perspectives on risk determination and capital assignments for the high exposures IFI's face because of their excessive reliance on Murabah and other trade and sales based transactions backed which are prone to higher degree of volatility and appropriate weights have to be assigned for both associated commodity pricing and counter party risks.

While adopting a suitable risk mitigation technique, comprehensive and transparent disclosure of “..... *risk profile, risk-return matrix, and internal governance is critical. Among others, this requires coordination of supervisory disclosure rules, and accounting standards, and proper differentiations between consumer friendly disclosures to assist IAHs and market-oriented disclosures to inform markets.*”³

In this regard, *IFSB Guiding Principles on Risk Management* has served a good purpose. They provide guidance for different risks to which IF industry is exposed and offers guidance on the methodology for credit risk, market risk, liquidity risk, operational risk, equity investment risk and rate of return risk for different types of financial transactions. We are in the process of adapting these guidelines for Islamic Banking Institutions in Pakistan.

Finally, as the IF industry diversifies, it will face increasingly more diverse range of risks associated with investment banks, mutual insurance (takaful), and investment companies. Islamic banks, however, remain the core of the industry in many countries and offshore financial centers and account for the bulk of financial transactions and their soundness would remain a key concern for systemic stability. In Islamic banking, the management of risks becomes more challenging due to its peculiar risk characteristics in line with the requirement for compliance to Shariah principles. While the Basel II initiatives on the identification of credit, market and operational risks can be assimilated into Islamic banking, the initiatives have to be complemented with consideration of the other dimensions of risks that are inherent in the IF transactions.

Fourth, for effectiveness of IF development, it is desirable that eventually model legislation is developed for IFs to recognize different institutions and products. This will facilitate development of contractual frameworks which has its basis on approved legal framework, which among others will allow for proper enforceability of contract. Strictly speaking even in Muslim-majority jurisdictions, Shariah compliant IFIs/products and services are not explicitly recognized in the relevant laws and statutes. As such, interpretation and recognition of financial products and enforceability of Islamic financial contracts may not be there in the laws and courts which have traditionally adopted either the common law or civil law framework. For example, whereas Islamic banks main activity is trading (Murabahah) and participating in equities (Musharakah and Mudarabah), banking law and regulations in most jurisdictions forbids or allows restricted exposure of such activities.

³ *Ibid.*

To address these issues, some countries have adopted separate Islamic Banking laws (e.g., Kuwait and Malaysia), while in others IF system is recognized under a section of the existing banking law (e.g., Bangladesh and Indonesia). Pakistan has also added provisions in relevant banking laws to support financial institutions involvement in Islamic finance transactions.

Fifth there is need for dispute settlement and conflict resolution mechanism. In line with Islamic Laws and Statues, an effective Dispute Settlement Institutions that recognizes the intricacies of Shariah principles and contractual arrangements would be beneficial. Among others, this will facilitate resolution of disputes associated with cross border contractual arrangements that could involve more than one jurisdiction each offering their own perspective. Notwithstanding, there is further need for harmonizing the Islamic rules related to financial dealings. While the courts can not be expected to change fast, formation of special bench that deals with, among others, Islamic financial transactions could be a solution. Malaysia has build some legal infrastructure institutions for IF industry and has dedicated high court judges to oversee litigations related to IF. To complement the court system, the Kuala Lumpur Regional Centre for Arbitration has been enhanced to deal with disputes on Islamic banking and finance for both domestic and international cases.

Sixth, essential for effectiveness and sustainability of IF industry is need for encouraging this segment to enhance corporate governance and ethical standards in banking. In line with the Shariah rulings, the challenge for IFIs is how to balance the dual objectives of achieving economic gains, while ensuring compliance with Islamic faith. Compliance with Islamic faith goes beyond the elimination of Riba to facilitate equitable distribution of economic resources and non-exploitation of any particular segment of the society. In more concrete terms, IFIs should play a greater role in micro finance, SME lending, rural development, and in funding more socially responsible schemes. IFSB should consider working on social responsibility guidelines for IF institutions, which would aim to foster the larger objectives of equity and non-exploitation

In conclusion, proper and sequenced development of IF would be critical for this industry to emerge as an effective channel for both savers and financier's. Collectively continued efforts are warranted to ensure that we address the issues and challenges raised above so that there is greater national, regional, and global acceptability and fast integration of IF with conventional industry. Besides the concerns and proposals suggested above there is need to strengthen capacity in IF both at regulator and industry level, while promoting financial literacy among public; develop new generation of Shariah scholars and other academic and special industry experts, and use more effectively standard setters and private sector to work together to helping align IF industry with appropriate enhancements with existing international standards to lend more confidence and allow greater international integration. Finally, most critical is the standardization of Shariah

rulings within the same jurisdictions and among various regions which currently offer divergent views and advice given the beliefs of different schools of thoughts on same issues.