Islamic Finance: Emerging Challenges of Supervision

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I. Background

Diversification and structural transformation in financial sector has been accompanied by increasing integration among different segments of the financial sector. The traditional boundaries between banks and non-bank financial institutions are eroding and we are witnessing the growth of universal banking and/or mergers among different segments of sectors.

This trend has its benefits but has associated risks as well. Supervisors face a dual challenge. On one hand, supervisors are promoting financial diversification and consolidation to achieve market development and innovation. On the other hand, supervisors have to position themselves to recognize the new dimensions and types of risks and encourage appropriate risk mitigation. These considerations have triggered world wide debate on how to effectively supervise different segments of financial sector in conglomerate and universal structure.

So far these debates had been concentrated around conventional banking but now it is widely gripping the world of Islamic Finance (IF). Stronger inter-dependencies among different segments of IF are emerging largely because Islamic Financial Institutions (IFIs), in principle, have features and inherent characteristics and more compulsion, than conventional banking, to conform to universal banking or to evolve inter-linkages among different market segments.

II. Factors Driving Cross-sector Linkages and Interdependencies

First and foremost, IFIs' depositors/borrowers desire to conduct financial transactions that are Shariah compliant. It can be assumed that a person preferring to bank with an Islamic bank will also seek to use other faith-based financial services such as Takaful and Islamic mutual funds. This faith-driven feature in itself forces and incentivizes IFIs to offer, along side bank-based services (i.e. deposit and loans), a wide range of financial services. As a result, Islamic banks end up undertaking non-core banking activities such as fund management, capital market operations, securitization, leasing, and housing finance. This has enhanced the degree of integration between various segments of IF. For example: Islamic banks are likely to be strongly integrated with the Shariah capital markets since on credit portfolio side, Islamic banks do not have the same investment avenues as those available to their conventional counterparts. The outcome is that Islamic banks either end up taking large exposure in the capital markets directly or acquire subsidiaries which primarily engage in such businesses.

Second differentiating aspect is the nature of contractual arrangements that drive deposits mobilized by conventional banks as compared to Islamic banks. Conventional bank deposits are interest based contracts with guaranteed interest return whereas Islamic banks raise deposit on a profit and loss sharing basis in either a Mudaraba or Musharaka structure. Mudaraba/Musharaka contracts transform the Islamic banks' deposits into essentially a fund management product (although currently most regulators recognize these as equivalent to conventional deposit contracts) and this impacts the corresponding asset portfolio. There is a need therefore that Islamic banks acquire assets on a PLS basis as well and eventually move beyond fixed return products, like Murabaha and Ijara. This pushes an Islamic bank towards universal banking since in order to manage the portfolio profitability; it needs to invest across sectors in businesses based on Shariah principles, like equity and Sukuks in the capital market and trade contracts like commodity Murabaha, Musharaka, Ijara and Takaful.

Thirdly, further development of Islamic banking itself depends on concurrent development of Islamic capital market. For instance, development of Islamic debt market is key to the provision of adequate liquidity support while providing additional investment avenues. Likewise, Takaful development is critical to provide insurance coverage to Islamic banking products, like auto and consumer financing, while strengthening secondary capital and Islamic bond markets by being a major buyer of Islamic instruments. It is the confluence of these factors that have induced regulators to encourage and IFs to promote rapid and deeper financial inter-linkages and integration.

III. Supervisory Challenges posed by Cross-sector Developments

It is some of these above considerations that have augmented strategic alliances and linkages of various types among IFIs, both within country and cross borders. As such, IFIs are evolving either as part of a global financial concern or as a domestic bank acquiring or establishing subsidiaries and/or the two arms, i.e. Islamic and conventional banks coexist. Moreover, as the conventional parts of financial institutions move towards cross-sector integration, their Islamic counterparts (either as specialized window or as independent entities) will also follow eventually.

While it has by now been well established that there are significant benefits of enhanced integration and inter-linkages or conglomeration in IF, such as the economies of scale, operational synergies and effective use of scarce human resource, there are definitely certain risks.[1] In this area, I would like to offer few basic observations.

Firstly, it is inevitable that enhanced exposure of Islamic banks into capital markets exposes them to the volatility in associated businesses. Likewise, conglomeration, whether through universal banking or through parent subsidiary model,[2] exposes them to a variety of

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1 Financial Sector Regulation: *Issues and Gaps,* IMF 2004.

2 Universal Banks: First structure is of universal bank, in which all financial operations are conducted within a single corporate entity. The second model is the parent-subsidiary or operating subsidiary model, in which operations are conducted in and regulated as subsidiaries of another financial institution, usually (but not necessarily) a bank. Finally, in a holding company model activities are conducted in legally distinct entities, each with separate management and capital but all owned by a single financial or sometimes (unregulated) non-financial institution.

issues such as contagion risk, regulatory arbitrage, high group exposures, conflict of interest etc. These risks apply equally to both Islamic and conventional modes of finance. However, Islamic banks have thus far not erected firewalls, like conventional banks, to separate legally, financially and managerially their investment and commercial banking activities. Obviously these risks pose a challenge to the supervisors and necessitate that appropriate changes be made in the supervisory regime.

Secondly, Shariah compliance issues necessitate taking a more aligned view across IF businesses as user of Islamic products may be oblivious of ideological differences as well as varying perceptions and interpretation of the Shariah advisors or boards and/or by regulators. Since institutions being supervised by one regulatory authority may be offering products of institutions being supervised by a different regulatory body, this could introduce complications and the challenge of ensuring uniform Shariah compliance across financial institutions and products.

Thirdly, traditionally different segments have been regulated by their specialized supervisory authorities. These authorities have adopted risk management principles and supervisory stances which are strictly in line with the risk profile of supervised sectors in isolation. With sector integration, supervisors have to coordinate closely in policy formulation and regulation as well as on-site supervision. They have to coordinate creation of necessary firewalls, remove moral hazards and govern the degree of cross segment exposure. This may even call for institutional restructuring through merging various supervisory bodies into a single entity or for closer coordination between supervisors through creation of a third coordinating body.

IV. Sector Inter-linkages of Pakistan's Islamic Finance System

In Pakistan, besides offering trade loans, like Murabaha, Islamic banks are offering equity and quasi equity products, such as Musharaka and diminishing Musharaka, and investment banking activities such as loan syndication, structured finance, etc. The six full fledged Islamic banks with a network of 108 branches and another 58 stand alone Islamic branches of 13 conventional banks have registered phenomenal growth and as of April 2007, the Islamic banking sector constituted 3.3% of total banking assets.[3] In view of the equity based nature of Islamic banking and lack of Shariah compliant financial instruments, central bank has allowed Islamic banks a relatively higher exposure (35% direct and 10% future of their equity) in capital markets compared to conventional banks (20% direct and 10% future). In addition, the State Bank of Pakistan (SBP) has relaxed statutory reserve requirement (SLR) for Islamic banks at 8% versus industry norm of 18%.

Furthermore, Islamic banks are allowed to nurture parent-subsidiary/affiliate model whereby Islamic banks are by and large setting up asset management companies, brokerage firms and, now, Takaful businesses. Thus far the supervision of IFIs is bifurcated, with Islamic banks being regulated by SBP and non-bank IFIs, namely, Modarabas, Islamic mutual funds, Takaful companies and securities operations under the regulatory oversight of Securities and Exchange Commission of Pakistan (SECP).

Sector specific supervisory approach is also characterized by varying regulatory requirements vis-à-vis operational matters, governance framework and Shariah compliance across the range of IFIs. The differences extend to minimum capital requirements ranging

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[3] See Annex A for details on product wise share and bank.

from Rs6 billion for Islamic banks (by the year 2009), Rs500 million for family Takaful operators (by the year 2011), Rs300 million for general Takaful operators (by the year 2011) and Rs30 million for Islamic fund managers to Rs2.5 million for Modaraba management companies. The low capital base of financial institutions, engaged in the business of Takaful or fund management, poses a significant risk to the solvency of financial conglomerates that characterize the Islamic financial markets. In terms of financial reporting, Takaful companies are not required to circulate quarterly accounts among shareholders whereas all other Islamic financial institutions are required to do so in terms of the legal and regulatory framework.

The segregated supervisory approach has resulted in carving of legal framework specific to each sector for both conventional banks and IFIs[4] but eventually there is a need for addressing the idiosyncratic nature of IF industry, products and market players. Moreover, with regard to IF, both the regulators are following different approaches towards Shariah compliance in the institutions regulated by them. SBP requires Islamic banks to appoint Shariah advisors according to a prescribed fit and proper criteria and a Shariah Board has been constituted at the level of SBP to deal with issues relating to Shariah interpretation and compliance among Islamic banks. SECP's approach varies across different segments of IF. A Religious Board, constituted by the government, is responsible for approving the prospectus of each Modaraba containing the types of business to be conducted, management, etc. While the Religious Board has a significant role, there is no requirement for Modarabas or their management companies to appoint Shariah advisers at individual fund level. Islamic mutual funds and Takaful operators, on the other hand, are required to appoint Shariah Council/Boards but no explicit fit and proper criteria has been laid down by SECP in this regard. SECP is also authorized to appoint a Central Shariah Board under the Takaful Rules, 2005, which has not been established as yet.

The greatest challenge resulting from different Shariah compliance practices followed by Islamic banks, Modarabas, Takaful companies, etc. is the reputational risk faced by IFIs and misperceptions in the minds of public about Shariah compliance. This issue, therefore, needs to be addressed through coordination amongst the supervisors.

Another issue arises from overlapping supervisory jurisdiction. The Banking Company Ordinance allows banks to act as Modaraba management companies for floatation of Modarabas. In terms of Modaraba Companies Ordinance, Modarabas can be formed to conduct any type of business, which is permitted under Shariah, be it trading, manufacturing, airline, financing, leasing, services, etc. and these are regulated by SECP. Due to overlapping regulatory jurisdictions, banks are floating modarabas through separate subsidiaries,[5] resulting in higher administrative, set up and regulatory costs. For sometime (from 1991-1997), these Modarabas were under the regulatory control of SBP, but the powers relating to licensing, winding up, etc. were retained by SECP; consequently the regulatory authority has been reverted to SECP. Again, this highlights the need for cross sector regulation of IFIs.

Eventually there is a need to develop mechanisms for oversight of financial sector in an integrated manner. Besides coordination and cooperation among regulators, there is a

4 Fund management, as used here, refers to management of Islamic mutual funds and Modarabas.

5 A number of banks have formed subsidiaries and floated modarabas like NBP, HBL, ABL, Habib Metropolitan Bank, etc. No Islamic bank has yet floated a Modaraba.

need for consolidated supervision framework for financial institutions, guidelines for consolidated public financial statements and application of regulatory prudential limits on group wide basis and coordination to examine the intra group linkages with industrial and commercial entities. While conventional and Islamic financial industry would have to adopt similar approaches to integrated supervision, it has to be recognized that the latter is a relatively nascent industry and hence the targets should be modified to match the ground realities.

V. Conclusion

IFSB's ten year roadmap has highlighted the cross sector nature of IFIs and the resultant need for supervision to evolve accordingly. It is in recognition of these factors that IFSB has sought to broaden its membership to securities and insurance supervisory authorities as Full Members of IFSB. IFSB's efforts for developing Islamic regulations as well as accounting, auditing and governance standards will facilitate adoption of unified principles for the development, operation and regulation of Islamic financial services.