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Legal Aspects of Islamic Finance

LCA4592

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CONTENTS

Diversity in the Legal Arrangements

- Civil Law: Algeria, Djibouti, Egypt, Jordan, Indonesia, Lebanon, Syria, Tunisia, Turkey, Philipines, Thailand.
- Common Law: Bangladesh, Msia, Brunei, Hong Kong, Spore, UK
- Shariah: GCC Countries, Iran, Sudan, Pakistan and Yemen


CIVIL LAW
COMMON LAW
MUSLIM LAW
MIXED SYSTEMS
NORTH AMERICA
SOUTH AMERICA
EUROPE
ASIA
AFRICA
MIDDLE EAST

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

Over-Restrictive Regulation?

- 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 Islamic finance industry as a whole.

Why?

• Ihlas finance in Turkey	• 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).
• Islamic Bank of South Africa	• 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).
• Islamic Investment Companies of Egypt	• 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).
• Dubai Islamic Bank	• 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.
• Bank Islam Malaysia Berhad.	• 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).
• Patni Cooperative Credit Society	• 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).

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

Control Failures

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

Regulatory Failures

Drastic application of rules

Lax Supervision

Lacuna in supervision of law

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

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

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

Components of Legal Framework

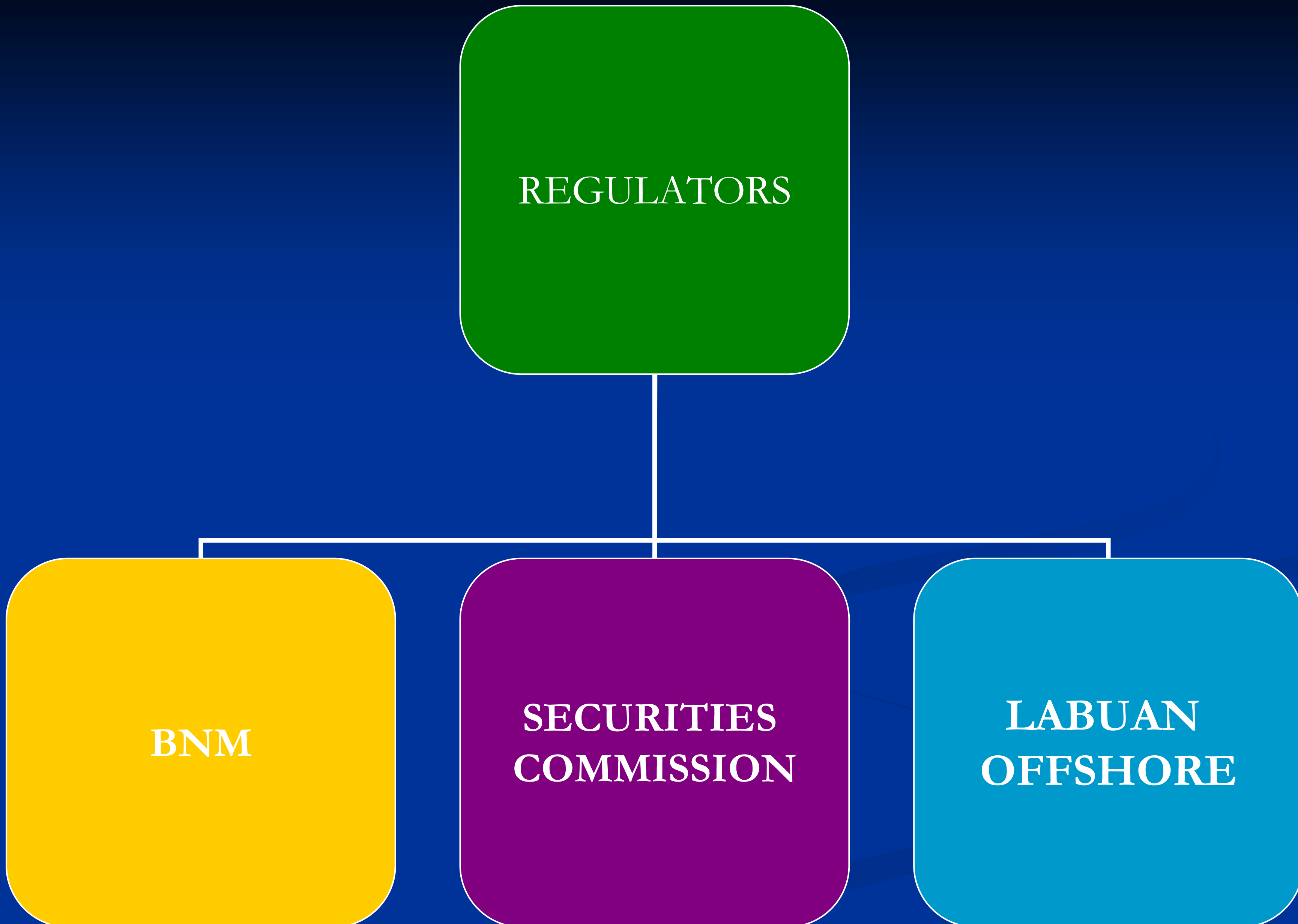
- Banking and finance law: licensing and regulation
- Tax law: incentives
- Business law: real economic activities, trading.
- Property law: to hold properties
- Insolvency law: recovery
- Securities law: capital market
- Employment law: qualified employee
- Dispute resolution framework: court or arbitration.

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

- Comply with the Malaysian Law
- Comply with the Shariah principles
- Comply with the guidelines and directives


REGULATORS
BNM
SECURITIES COMMISSION
LABUAN OFFSHORE

BNM

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

CBA 2009

- 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

CBA 2009

- 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
- Code of Conduct
- Infrastructure
- Due Diligence
- Communication
- Internal Control
- Monitoring
- Enforcement

Regulation		Regulator		
Electing BOD/ Approving Key Policy		Shareholder		
Investor/ Shareholder Protection		BOD		Shari'ah Board
Board Oversight	Risk Committee	Audit Committee	Governance Committee	
Management Oversight	Risk Manageme nt	Internal Audit	Compliance Officer	Internal Shari'ah Compliance Unit/ Department

Stakeholders in IFIs

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

Key Responsibility

Board and Senior Management

- Credit Risk
- Equity Investment Risk
- Market Risk
- Liquidity Risk
- Rate of Return Risk
- Operational Risk

Shari'ah Board

- Shari'ah Non-compliance Risk

Types of Risk	Roles of BOD and Senior Management
Credit Risk	•Strategy for financing and recognize the potential credit exposures. •Carry out due diligence review •Appropriate methodologies for measuring and reporting credit risk exposure •Shariah-compliant credit risk mitigating techniques
Equity Investment Risk	•Strategy for risk characteristics of equity investments •Appropriate valuation methodologies •Establish exit strategies in respect of equity investment activities
Market Risk	•Appropriate framework for market risk management in respect of all assets held
Liquidity Risk	•Appropriate liquidity management framework •Able to assume that liquidity risk commensurate with their ability to have sufficient recourse to Shariah-compliant funds to mitigate such risks
Rate of Return Risk	•Comprehensive risk management and reporting process to assess the potential impacts of market factors affecting rates of returns on assets in comparison with the expected returns for IAH
Operational Risk	•Adequate system and controls to ensure Shariah compliance •Appropriate mechanism to safeguard the interest of all fund providers.

Tutorial

- What are the rationales for having specific regulatory framework for Islamic finance?
- Compare and Contrast the different existing regulatory approaches in Islamic finance.

Thank You

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