

# Why Do We Need Regulations in Islamic Finance?

## LAB3073

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# + 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, Philipines, Thailand.
- Common Law: Bangladesh, Msia, Brunei, Hong Kong, Spore, UK
- Shariah: GCC Countries, Iran, Sudan, Pakistan and Yemen

CIVIL LAW

COMMON LAW

CUSTOMARY LAW

MUSLIM LAW

MIXED SYSTEMS



# + 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?

<ul style="list-style-type: none"> <li>Ihlas finance in Turkey</li> </ul>	<ul style="list-style-type: none"> <li>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).</li> </ul>
<ul style="list-style-type: none"> <li>Islamic Bank of South Africa</li> </ul>	<ul style="list-style-type: none"> <li>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: 3 7 - 3 8 ) .</li> </ul>
<ul style="list-style-type: none"> <li>Islamic Investment Companies of Egypt</li> </ul>	<ul style="list-style-type: none"> <li>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 <i>Shari'ah</i> non-compliance activities ( Z u h a i d a , 1 9 9 0 ) .</li> </ul>
<ul style="list-style-type: none"> <li>Dubai Islamic Bank</li> </ul>	<ul style="list-style-type: none"> <li>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.</li> </ul>
<ul style="list-style-type: none"> <li>Bank Islam Malaysia Berhad.</li> </ul>	<ul style="list-style-type: none"> <li>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 ( P a r k e r , 2 0 0 5 ) .</li> </ul>
<ul style="list-style-type: none"> <li>Patni Cooperative Credit Society</li> </ul>	<ul style="list-style-type: none"> <li>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 (Graiss and Pellegrini, 2006).</li> </ul>

## 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**



**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**

**Management Failures**

**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

Regulatory  
Failures

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

- 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

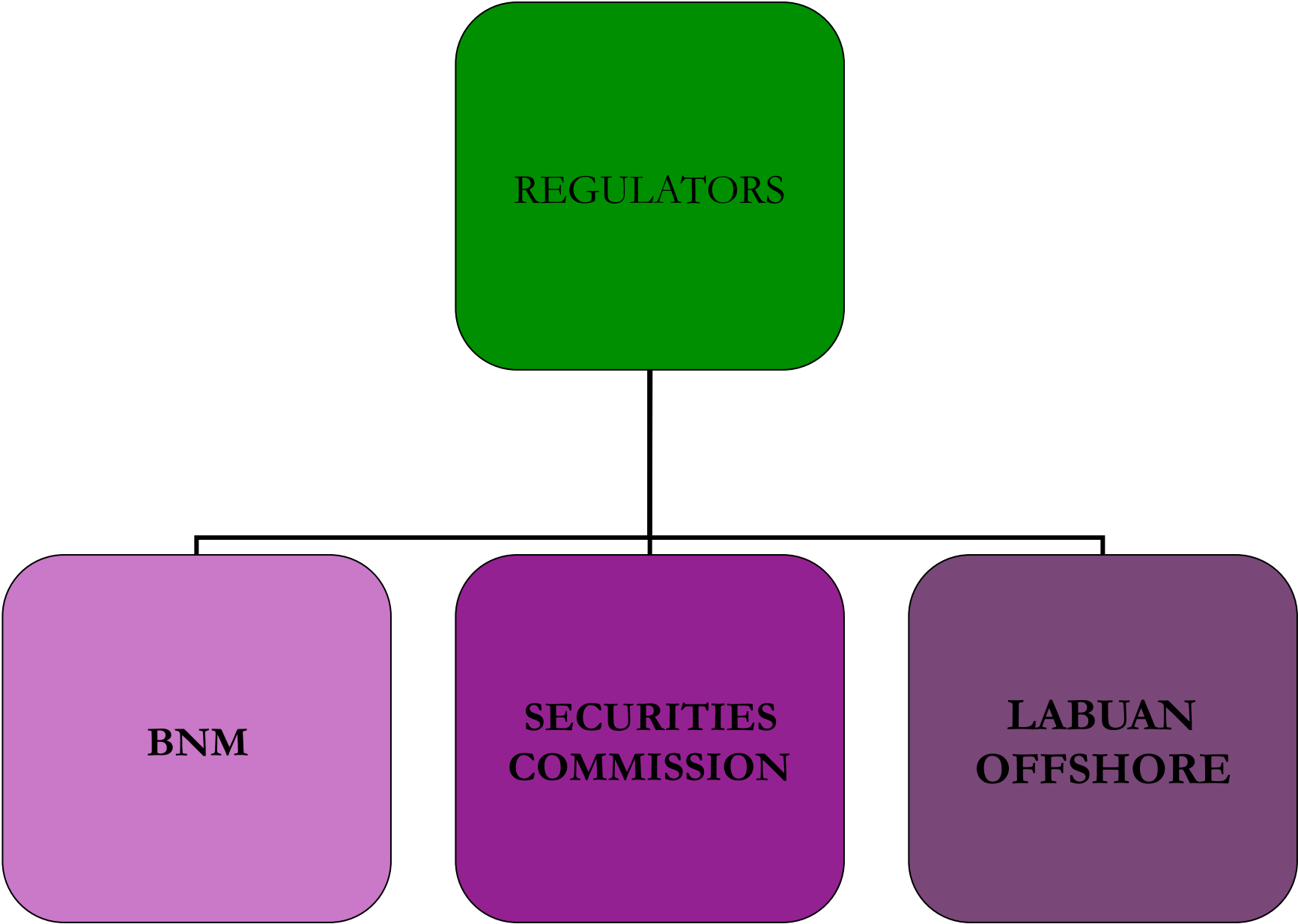
- Banking and finance law: licensing and regulation
- Tax law: incentives
- Business law: real economic activities, trading.
- Property law: to hold properties
- Insolvency law: recovery
- Securities law: capital market
- Employment law: qualified employee
- Dispute resolution framework: court or arbitration.

# + 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

## + 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

<p>Guidelines on Governance</p> <p>Code of Conduct</p> <p>Infrastructure</p> <p>Due Diligence</p> <p>Communication</p> <p>Internal Control</p> <p>Monitoring</p> <p>Enforcement</p>	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 Management	Internal Audit	Compliance Officer	Internal Shari'ah Compliance Unit/ Department

Key Participants	Interest	Functional Roles
<ul style="list-style-type: none"> <li>Regulatory / Supervisory authority</li> </ul>	<ul style="list-style-type: none"> <li>Economic Stability and Compliance with the laws and regulation</li> </ul>	<ul style="list-style-type: none"> <li>Set regulatory framework for sound and proper CG</li> <li>To supervise and monitor the effectiveness of CG and to check compliance with regulation</li> </ul>
<ul style="list-style-type: none"> <li>Shareholders</li> </ul>	<ul style="list-style-type: none"> <li>Wealth maximization; Satisfactory earnings per share; Dividends;</li> </ul>	<ul style="list-style-type: none"> <li>Appoint fit and proper boards, management auditors and <i>Shari'ah</i> board</li> </ul>
<ul style="list-style-type: none"> <li>IAH</li> </ul>	<ul style="list-style-type: none"> <li>Repayment of deposits on the agreed terms; Protection of their interests and Profit</li> </ul>	<ul style="list-style-type: none"> <li>To monitor the investment performance</li> </ul>
<ul style="list-style-type: none"> <li><i>Shari'ah</i> Board</li> </ul>	<ul style="list-style-type: none"> <li>Compliance with <i>Shari'ah</i></li> </ul>	<ul style="list-style-type: none"> <li>To ensure <i>Shari'ah</i> compliance and protect the rights and interest of depositors and other stakeholder.</li> </ul>
<ul style="list-style-type: none"> <li>BOD</li> </ul>	<ul style="list-style-type: none"> <li>Monetary and non-monetary compensation;</li> </ul>	<ul style="list-style-type: none"> <li>To set the IFIs direction and policies</li> </ul>
<ul style="list-style-type: none"> <li>Management</li> </ul>	<ul style="list-style-type: none"> <li>Monetary and non-monetary compensation and commitment to claims of the contract.</li> </ul>	<ul style="list-style-type: none"> <li>To implement policies set by the BOD</li> </ul>