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Diversity in the regulation of Islamic Financial Institutions[☆]

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Abstract

More than 200 Islamic Financial Institutions (IFIs) are reported to have total combined assets in excess of US$ 200 billion with an annual growth rate estimated between 10 and 15%. The regulatory regime governing IFIs varies across countries. International organizations have been established to set standards that would strengthen and eventually harmonize prudential regulations as they apply to IFIs. The paper contributes to the discussion on the nature of the prudential standards to be developed. It clarifies risks IFIs are exposed to and the type of regulation that would help to manage them. It considers that the industry is still evolving with an anticipated convergence of the practice of Islamic financial intermediation with its conceptual foundations. Accordingly, the paper contrasts the risks and regulation that would be needed in the case of Islamic financial intermediation operating according to core principles and current practice. Implications for approaches to capital adequacy, licensing requirements and reliance on market discipline are outlined. The paper suggests an organization of the industry that would allow it to develop in compliance with its principles and prudent risk management and to facilitate its regulation.

JEL classification: G28; G32

Keywords: Islamic finance; Regulation; Risk management

☆ The findings, interpretations, and conclusions expressed in this paper are entirely those of the authors. They do not necessarily represent the view of the World Bank, its Executive Directors, or the countries they represent.

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1. Introduction

Islamic finance services are expanding worldwide.[1] More than 200 Islamic Financial Institutions (IFIs) are reported to have total combined assets in excess of US$ 200 billion (General Council for Islamic Banks and Financial Institutions (GCIBAFI), 2005).[2] Some observers expect that Islamic finance may be able to attract 40% of the total savings of the Muslim population worldwide within the next few years (Zaher & Hassan, 2001). To capitalize on the potential of that market, a number of global financial institutions – including Citibank, Hong Kong Shanghai Banking Corporation (HSBC), Goldman Sachs, BNP-Paribas and Union Bank of Switzerland (UBS) – have established *Shariah* compatible services (Sundararajan & Errico, 2002).

The growth of the industry and its potential impact raise public policy issues. International organizations and standard setters, national regulatory authorities, policy makers, and academia are focusing on IFIs' risk management practices, the broad institutional environment in which they operate, and the regulatory framework that governs them. Institutions have been established notably the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the International Islamic Rating Agency (IIRA), the Islamic Financial Services Board (IFSB), and the Liquidity Management Center (LMC).[3]

Less widely understood than conventional finance, Islamic finance generates mixed perceptions on the risks it introduces. Thus, Islamic finance reminds of Merton's (1995) point that "less apparent understanding of the new environment can create a sense of greater risk even if the objective level of risk in the system is unchanged or reduced". Thus Islamic finance viewed as financial innovation is generating concerns on its inherent risks and their possible spillover on the rest of the financial system (Merton, 1995).

These concerns are compounded by features specific to Islamic finance. First, there is the divergence between the theory of Islamic finance, and the way it is practiced.[4] Second, IFIs have to compete with conventional financial intermediaries while they do not have access to similar risk management tools. Third, each IFI's business conduct is idiosyncratic, shaped by its *Shariah* board, local legal tradition and interpretations, and the specific market's competitive pressure. Fourth, in many jurisdictions, IFIs need to comply with conventional finance regulations that may not be adapted to the business. Fifth, different schools of thought on Islamic finance offer different interpretations of permissible financial contracts.[5]

This paper identifies IFIs' risks and considers regulatory approaches that may help deal with them. It starts from the premise that the industry is evolving towards harmonization of core principles and convergence of practice with conceptual foundations. Consequently, the paper dis-

[1] While it is difficult to identify precisely the date of the first formal IFI in recent history, references are often made to Mitghamr Egypt Savings Association in 1963. See Ali (2002) and Archer and Ahmed (2003).

[2] Estimates about the number of IFIs and their growth have differed. A recent Moody's report states that there are 300 IFIs with more than US$ 250 billion growing at 10–15% a year (see Moody's Report, April 2006). The General Council for Islamic Banks and Financial Institutions reports that there is a total of 284 businesses offering Islamic financial services and managing US$ 178.5 billion (General Council for Islamic Banks and Financial Institutions (GCIBAFI), 2005).

[3] AAOIFI, IIRA, and LMC are based in Bahrain whereas IFSB is based in Malaysia. For a description of the role of each institution (see Ali, 2002).

[4] See for instance Moody's (2001), which reports that "A survey of published accounts indicates that most IFIs do not see their on-balance sheet deposits as being profit-and-loss sharing", Special comment, January 2001.

[5] The five schools are: *Hanafi*, *Shafei*, *Hanbali*, *Maliki,* and *Jaafari*. Although there is consensus on all major issues, there are some minor differences pertaining to the operations of different instruments, such as, the binding nature of a *murabaha* contract.