Regulatory Framework and Institutional Mechanism for Islamic Finance Insurance and Banking: Perspective and Paradigm

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ARTICLE INFORMATION

ABSTRACT

The regulatory framework and institutional mechanism of interest-free banking, finance and insurance for promoting investment depends on Sharia compliant assets, sukuk trading and takaful. The number of Sharia compliant banks, sukuk issues, exchange-traded funds (ETFs) has given rise to law firms supplying services in Islamic finance and advisory services. The enforcement in Islamic finance provides the easiest approach to regulation and governance. Islamic financial markets and market-supporting institutions require minimal effort and asset-based transactions can be easily converted into conventional loans for regulatory and enforcement purposes and regulatory capital, reserve ratio, and risk management. The regulation and governance of Islamic mutual funds, investment banks, venture capital firms, and the like are even more direct, since their operations are virtually identical with conventional counterparts. The two sets of Islamic financial institutions for which corporate governance and corresponding regulation and enforcement standards need to be developed are in the areas of banking and insurance. The need for mutualization in Islamic banking and insurance, allow us to reduce governance and regulatory problems while ensuring riba free economy. The mutuality in Islamic insurance according to jurists sought solutions to the problem of gharar inherent in the risk trading business of insurance through non commutative relationship between insurers and insured in takaful. The paper seeks to appraise the jurisprudential and regulatory framework for the development of Islamic banking by addressing regulation, governance and enforcement dimensions.

Keywords
Sharia compliant assets, exchange-traded funds, sukuk, takaful, riba, gharar, murabaha, ijara, tabarru

1. Introduction

The Sharia compliant assets and Islamic financial services (Iqbal, Zubair et al, 1987) has accelerated sukuk and takaful in Malaysia (Ishaq, Bakarudin bin, 2002), Iran(Yasser,Ali, 2000), Saudi Arabia, Kuwait, Bahrain, (Al Sadah, Anwar Khalifa, 2002) Sudan and Egypt and replicated in Asian countries(Fry, Maxwell J. et al, 1996), such as Bangladesh, Pakistan, (Gieraths, Christine,1990, 171-195), Indonesia, Sri Lanka and India. The impact of Islamic banking is formidable in western countries (Ainley, Michael, 1996, 11-20), and banks like HSBC and Citi have taken massive initiatives. The
spontaneous interest in Islamic finance is attributed to less volatility by the financial crisis and global economic downturn by resilient sukuk market (Buckmaster, Daphne, (ed.), 1996, 146-150). The sukuk continue to attract demand from investors because of downturn of non-performing loans by conventional banks. The number of Sharia compliant banks, Sukuk issues, exchange-traded funds (ETFs) has given rise to law firms supplying services in Islamic finance and advisory services (Ahmad, Ausaf, 1994 369-393). The enforcement in Islamic finance provides the easiest approach to regulation (Chapra, M. U., et al., 2000) and governance (Chapra, M. U. et al., 2002). Islamic financial markets and market-supporting institutions require minimal effort to view all products and operations as compared to their conventional counterparts (Fadil, Farah, 1994). Many asset-based transactions can be easily converted into conventional loans for regulatory and enforcement purposes, and regulatory capital, reserve ratio, and risk management requirements may be easily applied to Islamic transactions and the institutions that implement them (Gafoor, A.L.M., 1995). The only requirement in this regard is to keep track of things like multiple trades and leases in order to report Islamic loan alternatives in the same format used by conventional banks in their reporting to central banks and other regulators (Gafoor, A.L.M., 1996). The regulation and governance of Islamic mutual funds, investment banks, venture capital firms, and the like are even more direct, since their operations are virtually identical with conventional counterparts. The two sets of Islamic financial institutions for which corporate governance and corresponding regulation and enforcement standards need to be developed are in the areas of banking and insurance (Gafoor, A.L.M., 2000). The need for mutualization in Islamic banking and insurance, allow us to reduce governance and regulatory problems while ensuring avoidance of forbidden riba and gharar. The mutuality in Islamic insurance according to jurists sought solutions to the problem of gharar inherent in the risk trading business of insurance through non commutative relationship between insurers and insured in takafuf (Al-Misri, R. Y., 2001; Al-Qarafi, A., 1998; Al-Zarqa’, M., 1994). The paper seeks to appraise the jurisprudential and regulatory framework for the development of Islamic banking by addressing regulation, governance and enforcement dimensions.

2. Juristic Basis of Mutuality

The mutuality in banking and insurance would provide natural solutions to the problems of riba and gharar (Al-Darir, S., 1997) associated with intermediation of credit and risk, respectively (Iqbal, Munawar et al., (Eds), 2002, 95-110). The prohibitions of riba and gharar, and associated conditions imposed by classical jurists on contracts allow transfer of credit and risk without violating prohibitions of prudential regulation and risk management. The secular regulators have put in place regulatory requirements that limit systemic risks posed by joint-stock financial companies; mutuality appears to fill a needed regulatory gap for protecting individuals from their own tendencies to undertake excessive risk that may prove personally ruinous (Gafoor, A.L.M., 1999). The rise of mutual savings banks and mutual insurance companies appears to have occurred in the West precisely to meet the demands of profit motives. It is this similarity of motives and substance that made mutuality a natural idea in the early days of Islamic banking and in the early literature on Islamic insurance (Saleh, Nabil A., 1986). The theoretical results and empirical evidence indicating that mutual financial institutions tend to provide their owners with lower risk and return profiles, and to offer their customers (who are often shareholders as well) better service, compared to joint-stock banking and insurance companies (Abalkhail, Mohammad et al., 2002, 111-137). In other words, mutual financial institutions provide the same financial (credit and risk) intermediation services and products, which are necessary for economic well-being, but do so in a manner that does not increase risks unnecessarily (Usmani, Taqi M., 1999).

This lower risk profile also makes mutual financial institutions more resilient, especially during periods of financial panic, such as during the Great Depression of the early twentieth century. It is interesting in this regard to note that the prohibitions of riba (El-Gamal, M., 2000, 31-44) and gharar (El-Gamal, M., 2001, 29-58) are precisely restrictions on means of trading in risk (the extension of credit exposes the creditor to potential borrower default or bankruptcy, and leverage increases the borrower’s own risk thereof). Thus, the spirit of Islamic jurisprudence allows transfer of credit and risk only if bundled within a financial transaction such as sales, leases, and partnerships (AAOIFI, Accounting, Auditing and Governance Standards for Islamic Financial Institutions 2003-4, Manama: AAOIFI, 2004). Such bundling regulates the riskiness of financial transactions, thus allowing for necessary risk taking to encourage investment and economic growth, while minimizing individual and systemic risks of bankruptcy and wild fluctuations in economic values.
3. Regulatory Alternative and Mechanism

The mutuality in Islamic banking replaces conventional bank savings accounts with investment accounts based on profit and loss sharing continues to be the main distinctive feature of Islamic banks, to which much of the work of Accounting and Auditing Organization for Islamic Financial Institutions, (AAOIFI) in Bahrain (Bahrain Monetary Agency, 2002, 59-70) and Islamic Financial Services Board (IFSB) is devoted Islamic Financial Services Board (IFSB, 2006, 4-6). Of particular concern in this context is the fact that Islamic bank managers answer to shareholders, whose risk preferences (associated with equity investment) are typically quite different from those of investment account depositors (conventionally associated with debt investments that seek low risk and low return). The problem is exacerbated by investment account holders’ lack of control over bank decisions, which exposes them to substantial moral hazard compared to bank shareholders. Investment account holders are also disadvantaged relative to conventional depositors who are deemed creditors of the bank, and thus have first claims to its assets in case of bankruptcy.

A natural sequel to this problem is for Islamic banks to adopt a mutual corporate structure. The mutual corporate form does not eliminate moral hazard entirely, since shareholder/depositors are typically too small individually to control bank operation (El-Gamal, M. (2006). Indeed, the literature on mutual banks often identifies each shareholder's ability to withdraw his deposit from the bank as the only means of punishing its managers – a prospect called "displaced commercial risk" in the literature on Islamic banking. However, by eliminating the separate group of profit-oriented shareholders from the formula, or putting them on par with investment account holders in the corporate structure, managers' incentive for excessive risk taking is largely eliminated, resulting in lower risk taking that reflects depositors' preferences.

The mutuality in Islamic banking can in fact bring to the industry large numbers of depositor/investors as well as managers who are committed to Islamic ideals of social and economic development, as opposed to profit- and fee-oriented Shari’a arbitrageurs. A by-product of identification of Islamic banking with mutualization would be to give indigenous Islamic banks a much-needed comparative advantage vis-à-vis international financial behemoths that have been able to attract the most respected Shari’a advisors and law firms, thus capturing fast-increasing market shares in today’s Islamic finance industry that is built on rent-seeking Shari’a arbitrage. Unfortunately the Islamic banking industry originally envisioned replacing conventional banks with a mutual-fund model of two-tier mudaraba created a curious liability structure with full equity shareholders and quasi-equity investment account holders with little protection against moral hazard (Islamic Financial Services Board (IFSB), 2011).

4. Islamic Financial Management

Islamic banks envisioned equity or quasi-equity instruments (Karim, Rifatt Abdel,2002) on both asset and liability sides by becoming the polar opposite of commercial banking practice (wherein debt instruments dominate both the asset and liability sides) in most countries that do not allow German-style universal banking(Kane, Edward J.,1987). Islamic bankers have discovered at an early stage that the moral hazard problem made equity investment on the assets side of Islamic banking prohibitively risky. Islamic banks have switched the bulk of their assets to debt instruments by adopting a peculiar structure on the liabilities side with some equity holders and some quasi-equity holders (Sundararajan, V. et al. (2008). The four possible combinations of debt and equity on the assets and liabilities sides need to be considered in detail. The first combination, corresponding to conventional commercial bank structure, matches debt-instrument assets with debt-instrument liabilities. This structure has the advantage that all corporate governance and regulatory issues will be handled in the same manner used for conventional banking. On the other hand, we have a model of equity-instrument assets and equity instrument liabilities (two-tier mudaraba), which was envisioned historically as the Islamic alternative to conventional banking. Of course, this equity-based structure is a very meaningful and successful model for mutual funds, private equity, and venture capital, which have gained substantial market shares worldwide (Gafoor, A.L.M. Abdul,199544-77).

This class of models plays an important financial intermediation role, through aggregation of savings on the liabilities side, and diversification of investments, with various levels of risk, on the assets side. It must thus play an important part in any financial system, Islamic or otherwise (Ahmad, Ausaf, 1994, 369-393). One of the basic features that distinguish Islamic banks from conventional banks is that the contractual relationship of Islamic banks with investment account holders does not specify that holders of these account [sic] are entitled to a predetermined return in the form of a percentage of their investment as this is strictly prohibited by Shari’a the contractual relationship is based on the mudaraba contract which stipulates that profit realized from investing the mudaraba fund is shared
between investment account holders – as rab-al-mal (A.L.M. Abdul Gafoor, 2000) – and the Islamic bank – as a mudarib. The basis for considering the mudarib as a trustee with respect to the mudaraba funds is that the mudarib is using another person’s money with his consent and the mudarib and the owner of the funds share the benefits from the use of the funds. In principle, a trustee should not be held liable for losses sustained by the funds (Abdel-Fattah A.A. Khalil et al., 2002, 57–94). Rather, the risks of such losses must be borne by the mudaraba funds.

5. Equity and Accounting Model

The accounting treatments of the equity or profits of investment account holders differ greatly from one Islamic bank to another. This has prompted AAOIFI, as a first step, to promulgate Financial Accounting Standard No. 5 namely Disclosure of Bases for Profit Allocation Between Owners’ Equity and Investment Account Holders in order to provide users of the financial statements of Islamic banks with information on the bases which Islamic banks adopted in allocation profit [sic] between owners’ equity and investment account holders. The AAOIFI has restricted its role in protecting investment account holders to maximizing transparency and uniformity of reporting standards. The only recourse for investment account holders, assuming that the Islamic bank does not engage in negligence or fraudulent activities, is to withdraw their funds from that bank. This gives rise to what AAOIFI research and later analysts called displaced commercial risk (AAOIFI, 2004, 2003–4). That threat of fund withdrawal drives Islamic banks to use their loan-loss reserve accounts to smooth rates of return paid to investment account holders, ensuring their competitiveness against rates paid by other Islamic and conventional financial service providers.

This complex set of competing incentives has made the issue of corporate governance of Islamic banks one of the most difficult (Usmani, Taqi M., 1999).

The publication of a consultation paper on the subject was promised by the Islamic Financial Services Board in 2006 indicated at maintaining the “mutual fund” model, whereby investment account holders continue to lack the protection of board representation as equity holders, or the protection of principal guarantee as depositors. Under the mutual fund model, all that is required of Islamic banks – as de facto collective investment schemes, even if not labeled as such – is to provide consistent and transparent distribution rules for profits and losses between the competing interest groups (equity-holding owners and quasi-equity investment account holders). This solution appears vastly inferior to the solution in mutuality, which aligns the incentives of shareholders and depositors.

A third alternative would be to use debt instruments on the liabilities side, guaranteeing principal and interest for depositors, while investing the funds using equity contracts. This appears to be the model underlying the fatwa issued by Al-Azhar’s Islamic Research Institute wherein the payment of interest on deposits was justified as fixed-profit rates on funds forwarded to banks to “invest in permissible ventures.” This closely approximates the model of universal banking, wherein savers deposit their funds with the bank on a debt basis, usually with an added deposit insurance scheme, while banks can take equity positions in various companies. Under this structure, Boyd, Chang, and Smith (1998) have shown that moral hazard problems between the bank and the deposit insurance company is increased substantially, especially when banks can benefit from diversion of funds ostensibly being invested (a very real threat in the developing Islamic world where similar abuses exist even within a debt-based bank asset structure) (John H. Boyd et al., 2004, 741–767). Thus, the model implicitly envisioned by Al-Azhar’s fatwa – with equity-based bank investments being funded by guaranteed bank deposits – seems to be a very poor candidate for further examination.

This leaves us with the fourth potential combination of debt and equity structures on the asset and liability sides, which is the mutuality structure of thrift institutions such as mutual savings banks and credit unions. Under this model, Islamic banks would – as they do currently – build the bulk of their assets in the form of debt-based instruments, through murabaha, ijara, and various sukuk structures (Thomas, Abdulkader et al., 2008). The financial (loan) officers at those Islamic banks would – as they do currently – rely on the same criteria used by their conventional bank counterparts (prospective debtors’ earnings before interest, taxes and depreciation, credit risk scores, etc.). In the meantime the liabilities side of the bank will consist mainly of shares (after excluding various owed debts, e.g., for leased bank buildings), whereby shareholders and investment account holders will be put on par. The elimination of the substantial short-term conflict of interest between Islamic bank shareholders and investment account holders has been a main focus of Islamic banking literature. The juristic development on this count reduced the corporate governance and regulatory issues for Islamic banks to their well-studied counterparts for mutual thrift institutions such as mutual savings banks and credit unions. Moreover, regulating Islamic finance from a religious point of view should also focus on corporate forms of Islamic financial institutions. In this regard the focus on contract forms only may be
sufficient for regulation of Islamic financial markets, but analysis of corporate forms and incentives must play an important role in regulation of financial institutions.

6. Principles of Takaful and Tabarru

The absence of mutuality is even more surprising in the Islamic insurance industry, known generally by its Arabic name takaful (mutual guaranty). It is interesting that even companies that use the term takaful taawuni (cooperative mutual guaranty or insurance) have not adopted mutuality structures (Mahmood, Ahmed, 2006). This is particularly astonishing given the Classical Ruling 9/2 of the Fiqh Academy of the Organization of Islamic Conference (OIC), which distinguished commercial insurance from what is called cooperative insurance, built on the principles of voluntary contribution (tabarru”) and mutual cooperation (Mahmoud A. El-Gamal, 2006). The contemporary jurists have enumerated three types of insurance, which they called mutual insurance, social insurance, and commercial insurance. The first form was envisioned along the lines of Western mutual insurance companies (where policyholders are themselves the stockholders), the second form encompasses state-sponsored pension and health insurance plans, and the third is the familiar type conducted by profit-oriented joint-stock companies. Mustafa Al-Zarqa, Dr. Ali Juma, and other scholars have also recognized that the mutual insurance version was the least controversial, and unanimously accepted, alternative (Mahmoud A. El-Gamal, 2005).

The contemporary Islamic insurance industry has adopted mutuality notion in takaful structured with stockholder rather than policyholder ownership. Insurance claims are paid by shareholders through the takaful provider on the basis of tabarru (voluntary contribution, as opposed to contractual obligation). This model based on voluntary contribution, replacing commutative contractual obligations with legally binding unilateral promises, raises a host of legal and juristic problems that have not yet been resolved fully. While insurance providers are typically characterized as investment agents of the stockholders, Bank Al-Jazira in Saudi Arabia has pioneered a characterization of insurance provider as pure agent (wakil, rather than mudarib). This can be a step toward eventual mutualization, where the insurance provider can act as a pure agent for shareholders who are themselves the policyholders (Venardos, Angelo M. 2006). This would satisfy the most widely accepted means of eliminating gharar from insurance, by negating the commutative financial nature of the transaction through mutuality. However, there seems to be precious little initiative for mutualization in the Islamic insurance industry today.

Islamic banks have not been allowed to act directly – through agency and guaranty – as financial intermediaries that insure their investment account holders from the credit risk associated with the bank’s own debtors (Venardos, Angelo M. 2006). Saeed sympathized with arguments by Sami Humud, Baqir Al-Sadr, and others, who aimed to find alternatives within the mudaraba context (Mahmoud A. El-Gamal, 2005) to allow the Islamic bank to guarantee investment account holders’ principal. He justified that position based on the view, reported by Ibn Rushd in Bidayat Al-Muqtahid wa Nihayat Al-Muqtasid (Ibn Rushd, 2004) that an entrepreneur (mudarib) who forwards an investor’s funds to another entrepreneur thus guarantees the invested principal for that original investor. However, he noted correctly that most Islamic economists and bankers feared that this approach would remove the most important perceived substantive distinctions between Islamic and conventional banking. In particular, he argued that the Hanafi view that depositors can be entitled to a return based on provision of money, rather than liability for risk, could shatter the foundations of riba theory as it is accepted in Islamic banking (Uzair, Mohammad, 1982, 211-236). Besides, he pointed out correctly, Islamic banks benefited from the provision that investment account holders (as investors) bear the financial risk. Hence, the best Islamic alternative for conventional commercial banking may in fact be adopting mutual banking structures that have been in existence in the west for well over a century, and for which corporate governance and regulatory issues and methods have become well understood (Vogel, Frank et al., 1998). Hence, Western governance and regulatory frameworks for mutual banks may be adapted to this version of Islamic finance with relative ease. In this regard, while there are a number of different secular models of corporate governance in the world, the Anglo-American model is the one of greatest relevance for Islamic finance, since most countries with fast-growing Islamic financial sectors were previously under various types of British control and continue to have strong links with English and U.S. banks and law firms. In this regard, it is important to note that the bulk of academic and practical advances in corporate governance in the Anglo-American world have the objective of aligning manager interests with those of shareholders. This is accomplished through a variety of mechanisms ranging from shareholder representation on the board of directors to external market discipline and manager compensation schemes.
7. Conclusion and Suggestions

There appears to be no secular reason to question the economic merits of mutualization of Islamic banks. On the contrary, there is evidence that mutual banking institutions have played a very important role in the development of the U.S. financial system during the nineteenth century, when they were every bit as competitive as stockholder-owned banks.

7.1 Non-Usurious Institutions: Most of the mutual funds are also structured as nonprofit organizations, which ensure that customers who obtain financing from such mutual organizations have access to credit at lower rates than those generally offered by profit-oriented banks. In this regard, the nonprofit approach to credit extension may bring financial practice closer to the Islamic ideal enshrined in the prohibition of *riba* (Mirakhor, Abbas, 1989, 45–80). Indeed one cannot make a general claim that all for-profit financial intermediaries would engage in usurious lending if they could. However, recent evidence suggests that the profit motive may indeed drive financial providers in the direction of discriminatory and predatory lending practices, especially when it is difficult legally to prove such accusations.

7.2. Mutuality in Insurance: Mutuality in Islamic banking and insurance can play an important role in redefining the “Islamic” brand name of Islamic finance. Many areas of Islamic finance (e.g., in investment banking and fund management) differ only very slightly from conventional financial practice. Differences in those fields exist on substantive grounds (e.g., lower tolerance for debt and leverage, ethical investment bias), which would widen its potential market.

7.3. Development of Legal Expertise: the Government strategy for the development of Islamic finance requires specialist legal expertise from law firms providing legal services in Islamic finance (El-Hawary, Dahlia *et al.*, 2004). The Big Four professional services firms – Price Water House Coopers, KPMG, Ernst & Young and Deloitte - have established an Islamic finance team in London providing specialist services including advice on tax, listings, transactions, regulatory compliance, management, operations and IT systems.

7.4 Education and Training: There is a growing demand for skills as Islamic finance expands and institutions are at the forefront of providing qualifications for the global industry (Siddiqi, Muhammad Nejatullah, 1996). Courses in Islamic finance are offered by the Chartered Institute for Securities and Investment (CISI), Chartered Institute of Management Accountants, Association of International Accountants, Cass Business School and the Institute of Islamic Banking and Insurance. These courses have been key to the development of Islamic finance qualifications in the UK. One new development in January 2010 has been the launch by Aston Business School of an Islamic Finance and Business Centre.

In a separate initiative, the Islamic Finance Council UK has developed a pioneering ‘Scholar Professional Development Programme’ in conjunction with the CISI. The objective of the course is to teach conventional finance to Shariah scholars worldwide. Partners for this programme include the Central Bank of Bahrain and the International Shariah Research Academy for Islamic Finance (ISRA) that is backed by Malaysia’s Central Bank. Beyond Islamic finance, the UK education offering that majors in Islam spans the full range of qualifications starting from 16 year-old school level through vocational and career-based qualifications as well as under graduate and postgraduate degrees.

7.5. Governmental Strategy: the government strategy for development of Islamic finance should be supportive in policies and broaden the market for Islamic products for both Sharia compliant institutions and firms. A key aspect of supportive government policy should be an enabling fiscal and regulatory framework in the Islamic finance. There are a number of initiatives which are intended to be adopted such as removal of double tax and extension of tax relief Islamic mortgages to companies as well as individuals. The reform arrangements should ensure that regulatory treatment of Islamic finance is consistent with its statutory objectives and principles. The issuing Sharia compliant government bonds and Sukuk trading should provide more liquidity in the secondary market and act as a benchmark for companies. The legislative framework for Alternative Finance Investment Bonds (AFIBs) requires further
regulatory clarity of corporate sukur, reduction of legal costs for Islamic investments and removal of obstacles to investment. The juristic and regulatory framework for Islamic finance and banking requires changes in standardization and regulation.

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