# Trends in Islamic-Finance Regulation

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## Executive Summary

Islamic financial services comply with Islamic principles on interest, non-Islamic investments, and speculation. This paper provides a general overview of this market and its regulatory environment. Key findings include:

- Growth in Islamic financial services presents significant growth opportunities for U.S. financial service companies and providers of banking technology.
- At the end of 2006 global Islamic financial services exceeded $530 billion and are growing faster than assets in conventional finance.
- The Islamic finance market extends beyond its largest markets in the Middle East and Southeast Asia.
- Islamic banking regulators have prudential and developmental roles. Depository insurance and interbank funding are two significant challenges facing Islamic finance regulators.
- International qualifications and standards could harmonize the application and development of Islamic financial services.

## Introduction

### *Differences from Conventional Finance*

Islamic financial services are financial services that comply with Islamic principles on interest, the sources and uses of funds, and its restrictions on speculation. Traditionally, rather than charging interest, Islamic financial institutions will typically share some of their borrowers' risks and profits. A bank's profit from these 'loans' depends on the overall success of the loans in generating additional revenue or profits for the borrowers.

Islamic finance also avoids investing in ventures that may have components that are not in line with the values of Islam (alcohol, gambling, drugs and tobacco) and speculation (e.g., reliance on the occurrence of events that may or may not take place).

Although Islamic financial principles may differ from those of conventional banks, in practice Islamic financial products look a lot like conventional mortgages, leases, and business loans.

The relatively recent resurgence of Islamic finance has complicated measuring the size of this market. However, according to the International Financial Services London (IFSL), the global market for Islamic financial services, as measured by *Sharia* compliant assets, is estimated to have reached $531bn at the end of 2006. This represents over a 10 percent a year growth rate in the last decade.[1]

The Banker's recent survey of the largest Islamic financial institutions (IFIs) demonstrates the size and the difficulty of defining this sector. The 500 largest IFIs have over $500 billion in total assets. Total Islamic-compliant assets are likely significantly greater.[2]

Still, total assets for IFIs are relatively small compared with the $74.2 trillion in assets of conventional banks that make up the Banker's

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[1] Islamic commercial banks, investment banks, bond, and insurance account for 75, 13, 9 and 3 percent of total assets, respectively.

[2] Only 45 percent of the institutions claiming to provide some type of Sharia-based financial services reported figures on their Islamic operations.

list of the world's 1000 largest banks.[3] The Islamic finance market, however, is in the early stages of growth and innovation.

## *Where are the Islamic Finance Markets?*

Islamic finance markets are concentrated in the Middle East and South Asia but spreading rapidly to other developing and developed markets. The Gulf Cooperation Council (GCC) states (Saudi Arabia, Kuwait, the United Arab Emirates, Bahrain, Oman, and Qatar) account for almost 36 percent of the total market of $500 billion as measured by the Banker.[4] The non-GCC Middle East and North Africa (MENA) region (35 percent of the total), is dominated by Iran, with Lebanon and Egypt acting at significantly lower levels. Asia represents 24 percent of the total and is dominated by Malaysia, Pakistan and Indonesia.[5]

Despite its growth, Islamic financial services are not available for most Muslims. This unmet demand creates a significant growth opportunity for banks to expand into predominantly Muslim countries.[6] Saudi Arabia, with $69 billion in Islamic-compliant assets, and Malaysia, with $65 billion, have larger overall banking sectors than Iran. Iran's Islamic finance market, however, with $155 billion, is more than twice as large as its nearest competitor, but is closed to U.S. financial institutions.[7]

The Islamic finance market is not confined to developing countries. The United Kingdom, with $10.4 billion in *Sharia*-compliant Assets (SCA) is the 10th largest country in the Banker's ranking.[8] The United Kingdom is actively promoting London as a major center for Islamic finance.[9] France, with a large Islamic immigrant community, is also developing its Islamic finance sector. The United States has a proportionately smaller Muslim community, but due to its overall size is also a potentially large market.

## *Technology, the Unbanked, and Transnational Commerce*

The growth of *Sharia*-compliant lending extends beyond the financial sector to influence the adaptation of new technologies and access to the financial sector by the unbanked.

Banking technology companies are rapidly developing products to meet the growing demand of *Sharia* compatible products. Banks are working with software companies to adapt their products to provide the documentation and audit capability the banks' *Sharia* boards require, or to introduce *Sharia*-compliant products to the market.[10] Technology companies can take advantage of opportunities in this sector if their products encourage more efficient operations, attract and engage customers toward a bank's brand, and meet the specific needs of Islamic commercial ventures.[11]

*Sharia*-compliant banking technology could also contribute to reducing the number of the unbanked within Muslim countries and com-

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[3] Of the 500 institutions listed, only 318 reported assets and only 221 reported *Sharia* assets, representing 63.6% and 44.3% respectively of the overall listing. Stephen Timewell and Joe Divanna. "Top 500 Islamic Financial Institutions - How Fast Is The Islamic Finance Industry Growing? *The Banker* (Nov., 2005).

[4] In the GCC, Kuwait, with $37.7 billion in *Sharia* compliant assets (SCAs), is ahead of the UAE with $35.4 billion and Bahrain with $26.3 billion. The UAE has more SCAs than Bahrain, but Bahrain has 54 institutions in the Banker's Top 500 listing compared with 40 in the UAE. Kuwait has 48 institutions in the listing while the leading GCC state, Saudi Arabia, has 45; "Top 500 Islamic Financial Institutions - Iran Dominates in the World of *Sharia* Compliance" *The Banker* (Nov. 2007).

[5] Ibid.

[6] Joe Divanna. "Top 500 Islamic Financial Institutions - From Emergence to Innovation" *The Banker* (Nov. 2007).

[7] Timewell and Divanna, "Top 500 Islamic Financial Institutions - How Fast."

[8] *The Banker*, "Top 500 Islamic Financial Institutions - Iran Dominates."

[9] Timewell and Divanna, "Top 500 Islamic Financial Institutions - How Fast."

[10] Divanna, "Top 500 Islamic Financial Institutions."

[11] Ibid.

munities. Mobile phones and intelligent ATMs could provide access to financial services for many of the unbanked Muslims.[12]

### *Islamic Finance Hubs*

Financial centers and regulators have responded unevenly to these trends. Banks have reacted to the growth in the Islamic finance market by adding new services and offices. Yet, many Muslim majority countries have not yet enacted legislation to authorize Islamic banks. Others, such as Malaysia, Bahrain, and some Gulf states have made significant efforts to regulate Islamic banks separately from conventional banks. The UK, however, is an example of a country that has decided to treat Islamic financial systems in the existing regulatory framework. Many central banks from the Middle East and Southeast have followed suit.[13]

Despite their different regulatory structures, the UK, Malaysia and Bahrain provide examples of best practice. In 2006, for example, the UK issued standards on capital adequacy and risk management and its high courts have significantly accommodated the growth in this market. These reforms have made Islamic financial services including mortgages and bonds (*sukuks)* more competitive with their conventional equivalents.[14] Ultimately, banks and regulators could look toward international standards to harmonize and advance their regulatory frameworks.

## Regulating Islamic Banking

### *The Role of Banking Regulators in Islamic Finance*

Regulation supports the development of a vibrant financial system by ensuring the stability of the entire financial system and the proper conduct of individual institutions. These objectives are similar for both the conventional and Islamic finance sectors. The Islamic finance sector, an emerging sector with significant opportunities, is also influenced by targeted efforts by regulators to develop this sector domestically and internationally.[15]

### Prudential Supervision

Prudential supervision includes countervailing the potential moral hazard problems inherent to financial services. The most important type of moral hazard risk for regulators occurs when there is an unequal distribution of gains and losses between individuals and institution. These risks affect both conventional and Islamic finance institutions. Left unregulated and unsupervised, both types of banks can pass on some of their investment or lending risk to depositors. Regulators can reduce the occurrence of moral hazard through regular and comprehensive supervision. When moral hazard does occur, depository insurance programs can lessen its impact on depositors and prevent its spread to other institutions.

Islamic banks comply with *Sharia* law by structuring their deposits as risk-sharing agreements, rather than as interest-bearing accounts. In Islamic banking, moral hazard is the result of the substantial information asymmetries in information concerning a bank's investment risks.[16] Regulators for IFIs, however, have traditionally been more concerned with fulfilling the *Sharia* requirements for risk-sharing between depositors and investors than reducing moral hazard. Regulators could reduce depositor risk in these institutions by requiring disclosure on the nature of depositor risks and providing recourse in case of breach.[17]

[12] Ibid.
[13] Mufti Barkatulla. "Islamic Report - *Sharia* Raises Its Profile - Islamic *Sharia* Law Is Emerging As An Alternative Means Of Dispute Resolution For Business And Commerce In The Secular World" *The Banker* (Apr. 2008).
[14] IFSL, "Islamic Banking 2008."

[15] Juan Solé, "Introducing Islamic Banks into Conventional Banking Systems" *IMF Working Paper WP/07/175* (July 2007).
[16] Ibid.
[17] Dahlia El-Hawary, Wafik Grais, and Zamir Iqbal. "Diversity in the Regulation of Islamic Financial Institu-

## Sharia Compliance

*Sharia* compliance requires IFIs to meet lending and investment standards not required by conventional banks. It is this convergence of Islamic principals and finance that attracts Muslims to IFIs. There are private and public models to ensure that financial services labeled 'Islamic' or '*Sharia*-compliant' comply with these principals. [18] In some countries, private banks maintain their own *Sharia* advisers to ensure *Sharia* compatibility. In others, consultative boards at the supervisory level increase the predictability and conformity of *Sharia*-board decisions.[19] A regulator's adaptation will depend on the relationship between civil and religious law in the country. Countries that maintain a greater separation between civil and religious law might find it more difficult to assign a government role to adjudicate what are essentially religious questions. According to some scholars, countries with less separation might more easily enter into or consolidate the supervisorial role of *Sharia* compliance. Consumers in both types of countries would still have recourse when IFIs fail to comply with promised services.[20]

## Industry Development

Regulators' influence can extend beyond ensuring financial stability by fostering an environment receptive to *Sharia*-compliant products. Regulators foster development without providing regulatory advantage for IFIs by anticipating regulatory challenges and assuring public support. A regulatory environment that maintains a level playing field yet acknowledges distinctions between conventional and Islamic finance will encourage the creation and demand for *Sharia*-compliant products.[21] For example, the UK's policy of "no obstacles, no special favors" has encouraged the introduction of *Sharia*-compliant mortgages. These mortgages must meet the same degree of supervision as conventional mortgages, yet still meet the principles of Islamic finance.[22]

International transactions are also an important component of Islamic financial services. Counterparts that deal with international financial institutions require confidence in their international transactions. Regulatory participation in this market can ensure this confidence and support.[23]

Licensing Islamic banks and services, however, increases the supervisory burden, especially for conventional banking regulators that are unfamiliar with Islamic finance. Regulators can ease the supervisorial transition to Islamic finance by temporarily restricting the number of Islamic licenses it grants.[24,25]

## *Banking Structure*

The regulatory environment influences the variety of structural forms of institutions that offer Islamic financial services. These restrictions range from allowing conventional banks to open an Islamic window within an existing subsidiary or branch, to only permitting *Sharia*-compliant products. According to the Banker, 72 percent of the largest 500 IFI operate within fully Islamic financial systems. Twenty-eight percent operate with Islamic windows.[26]

### Islamic Finance Window

An Islamic finance window is a window within a conventional bank where customers can

tions." *The Quarterly Review of Economics and Finance 46*, (2007): 778-800.
[18] Solé, "Introducing Islamic Banks."
[19] Ibid.
[20] El-Hawary, Grais, and Iqbal, "Diversity in the Regulation."
[21] Solé, "Introducing Islamic Banks."
[22] Ibid.
[23] El-Hawary, Grais, and Iqbal, "Diversity in the Regulation."
[24] This is not without precedent. In developing the Kuwaiti market, the Central Bank of Kuwait limited the number of Islamic banks to three.
[25] Solé, "Introducing Islamic Banks."
[26] Timewell and Divanna, "Top 500 Islamic Financial Institutions - How Fast."

access Islamic-finance products. Islamic windows are more prevalent in Southeast Asia and the developed countries than in the Middle East, where Islamic subsidiaries are more common. In many cases this may be a more cost efficient way for an existing bank to enter the Islamic market. Often these initial products include deposits and Islamic trade-finance products for small and medium enterprises (SMEs).[27]

### Islamic Subsidiaries

Conventional banks with considerable customer bases might decide to establish an Islamic subsidiary. This could allow a bank to offer a wider range of *Sharia*-compliant banking products.[28]

### Full Islamization

A fully Islamic banking system only permits *Sharia*-compliant financial services. Governments in countries with large Muslim populations, such as Iran and Sudan may find it expedient to abolish interest-based financial services.[29] In other Muslim countries *Sharia*-compliant institutions have existed in a variety of forms. In Malaysia and Bahrain this mix has created a highly competitive banking sector that offers a larger variety of more complex and cost-efficient products.[30]

## *Implementing Islamic Banking*

### Maintaining the Integrity of *Sharia* Accounts

Banks offering *Sharia* compliant products need to separate the conventional and Islamic accounts to avoid mixing conventional and *Sharia* compliant funds. This will often require that banks maintain separate capital funds, capital funds, and reporting systems.[31] Islamic subsidiaries and banks operating in fully Islamic countries are not affected.

### Dispute Resolution

Islamic banks, like conventional banks, rely on dispute resolution systems. For Islamic banks these usually begin with *Sharia* boards. *Sharia* boards consist of *Sharia* scholars familiar with the intersection of Muslim social and legal practices. Board members play an important role in validating a bank's Islamic financial services for the Muslim community.

Regulators in many countries are also establishing institutions to deal with *Sharia*-finance disputes. Malaysia's high court, for example, assigns Islamic finance matters to special courts to legitimize outcomes and make them more predictable and efficient. In addition, Malaysia's central bank reviews the assimilation of *Sharia* principles with common law.[32]

Dispute resolution becomes more complicated upon crossing international borders. Should common or civil law, *Sharia*, or some combination of the two govern international contracts? In many cases large multinational companies have chosen common or civil law to resolve their Islamic finance contracts.[33] In other cases, the development of international standards offers a solution.

### International Accounting and Management Standards

Standards provide essential guidelines and a frame of reference for performance. Often, they become mandatory after adoption into a country's legal system.[34]

In 1990 the Accounting and Auditing Organization for Islamic Financial Institutions

[27] Solé, "Introducing Islamic Banks."
[28] Ibid.
[29] Ibid.
[30] Ibid.
[31] Ibid.
[32] Barkatulla, "Islamic Report – *Sharia*."
[33] Barkatulla, "Islamic Report – *Sharia*."
[34] Ibid.

(AAOIFI) was created. Its main goals included the design and dissemination of accounting and auditing standards for Islamic institutions.[35] These standards are based on the best practices of *Sharia* supervisory panels and boards.[36] The AAOIFI plays a critical rule in harmonizing the frequently different standards applied at the national and local levels. Universal acceptance of new products is important to convince many Muslim and non-Muslims to participate in the *Sharia*-compliant market.

In 2002, central banks from several Islamic countries created the Islamic Financial Services Board (IFSB) in Kuala Lumpur. The IFSB is the AAOIFI equivalent for the development of capital adequacy, risk management, corporate governance, transparency, disclosure, and supervision standards.[37]

The inclusion of many financial regulatory institutions within the AAOIFI and the IFSB promote transparency, soundness, and stability standards for IFIS. These standards, however, have yet to fill the transparency gap between *Sharia* and conventional banks. There are still gaps in the reporting of *Sharia* activities on balance and income statements.[38]

### Deposit *Takaful*

In conventional finance systems, deposit insurance assures public confidence amidst the potential for significant moral hazard problems. Depository insurance (*takaful*) could also play a significant role for Islamic-finance systems. The creation of a sound deposit *takaful* (DT) system could encourage public participation and confidence that in many countries is frequently in short supply. The International Association of Deposit Insurers (IADI) includes the following important principles for depository insurance: the coverage of the deposit *takaful*, the limit and scope of DT account coverage, the funding of DT coverage, the investment of DT funds, and the resolution process for failed banks.[39]

*Sharia* law, however, does not typically acknowledge *takaful* as commonly practiced in the West. Most Islamic banks are not presently covered by a DT plan. Many of these banks, however, are eligible for coverage within their general deposit insurance programs. In contrast, Turkey created a *Sharia*-compatible DT in 2003 and Malaysia is planning on introducing a plan in 2008.[40]

### Islamic Interbank Money Market

Temporary maturity mismatches between shorter term liabilities and longer term assets often require banks to seek short-term loans from other banks. These loans are called interbank loans and are part of the interbank money market. They play an important role in reducing liquidity risks and bank failures. Like other loans, however, they involve interest, which is not permitted in Islamic finance. Until recently, Islamic banks in conventional systems met their liquidity requirements with higher cash reserves. *Sharia* compliant interbank options are now available, however.[41]

## Regulating Islamic Banking in the United States

Although difficult to measure, the Muslim population in the United States is probably between 1.8 and 4.5 million people.[42] This section explores the important regulatory barriers that affect the creation of an Islamic banking market in the United States.

[35] Solé, "Introducing Islamic Banks."
[36] Barkatulla, "Islamic Report – *Sharia*."
[37] El-Hawary, Grais, and Iqbal, "Diversity in the Regulation."
[38] Divanna, "Top 500 Islamic Financial Institutions."
[39] Solé, "Introducing Islamic Banks."
[40] Ibid.
[41] Ibid.
[42] Michael Taylor. "Islamic Banking – the Feasibility of Establishing an Islamic Bank in the United States." *American Business Law Journal* (winter, 2003).

The United States has a dual banking system. A bank in the United States is statutorily defined by both state and federal regulators.[43] The deposit gathering aspect of banking further distinguishes banks from other financial institutions.[44]

The dual state-federal chartering system defines the banking activities of commercial banks, savings associations, and credit unions.[45] In practice, these distinctions have somewhat dissipated with the blending of customers, financial services, and federal preemption.[46]

### *How do Commercial Banks, Savings Banks and Credit Unions Differ?*

**Commercial Banks:** Commercial banks – chartered under federal and state law – are permitted to offer a wide range of banking services including demand, savings and time deposits, investments, and loans.[47] Statutes, judicial findings, and regulatory rulings shape new financial service activity. Commercial banks with an interest in providing Islamic financial services need to seek a determination as to the acceptance of these practices. Currently, commercial banks are prohibited from entering into partnerships or joint ventures and the ownership of real estate and common stock.[48] These limitations complicate the ability of commercial banks to engage in many types of Islamic financial services supported by asset buy-backs and risk sharing.

**Savings Banks:** The Office of Thrift Supervision charters these banks and has traditionally limited them to noncommercial deposit and lending. These activities have broadened somewhat but housing finance remains a key component of savings banks' activities. Savings banks may be organized as either mutual or stock entities and are required to serve a "community purpose."[49] To meet the community purpose requirement, savings associations are allowed to invest in real estate by establishing a service corporation subsidiary. These subsidiaries can invest in real estate for prompt development or subdivision, to hold for rental or resale, for maintenance and management, and for real estate brokerage, among other activities.[50]

**Credit Unions:** Credit unions' activities are also directed toward their communities that have traditionally been limited to specific employers, associations, or neighborhoods. Recently these limitations have been relaxed, but credit unions still rely on the pooled savings of their members to support their lending activities. Credit unions are regulated and chartered by the National Credit Union Administration.[51]

## Conclusion

The Islamic finance sector offers significant opportunities for U.S. bank and bank technology companies. To remain competitive, U.S. banks must adapt their products and strategies to accompany important regulatory and market trends. This paper has highlighted some of these trends for the growing Islamic finance sector and their importance for U.S. financial institutions.

[43] Only the federal (Office of the Comptroller of the Currency) and state banking regulators can authorize these charters.
[44] Patricia McCoy, *Banking Law Manual Second Edition: Federal Regulation of Financial Holding Companies, Banks and Thrifts Banking Law Manual*. (U.S.: Mathew Bender, 2000).
[45] Ibid.
[46] Ibid.
[47] Michael Malloy, *Banking Law and Regulation (*Boston: Little, Brown, 2001).
[48] Milton Schroeder, *The Law and Regulation of Financial Institutions* (Boston, MA: Warren Gorham and Lamont, 1995).

[49] Malloy, *Banking Law and Regulation*.
[50] Taylor. "Islamic Banking – the Feasibility."
[51] Ibid.