

The Current Status of Islamic Bank Regulation in the World

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Abstract

The general consensus on the status of Islamic bank regulation in previous research literature has indicated that there are several improvements that need to be made in order for Islamic bank regulation to become effective. This paper examines a survey administered to Islamic finance stakeholders from 41 countries on the current status of Islamic bank regulation in their respective jurisdictions. We hypothesize that the current status of Islamic bank regulation is considered to be in its development stage and that further improvement and development is required for Islamic banking to foster growth in the Islamic banking industry. The results from this survey bring insight as to what improvements should be undertaken to further develop Islamic bank regulation in OIC member countries.

1. Introduction

The current status of Islamic bank regulation varies by region and by country. The present consensus is that Islamic bank regulation is still in the development stage. Previous studies have examined the status of Islamic bank regulation both domestically and internationally. Our paper looks to contribute to the existing literature by providing additional insight as to what the current status of Islamic bank regulation is in OIC member countries through a survey administered to 192 respondents from 41 different countries. The main topics covered are prudential regulation, Shariah compliance, regulation infrastructure, and transparency standards. Section 1 provides a summary of the recent literature on Islamic bank regulation, Section 2 discusses the survey

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administered in this study, Section 3 discusses the findings from the survey with summary statistics from the survey responses, and Section 4 provides a conclusion derived from the survey results.

2. Literature Review

Existing research literature has examined Islamic bank regulation in several aspects. Several studies have stated that there is an absence of a well-defined and adequate regulatory and supervisory framework that is Shariah compliant. A main contention of existing Islamic finance regulation is that there is not enough cohesion between government regulation and Shariah compliance. This has been examined from a regulatory perspective by Ainley, Mashayekhi, Hicks, Rahman, and Ravalia (2007). Additionally, studies have focused on the presence and effectiveness of Shariah governance in Islamic finance. Hamaza (2013) focuses on Shariah governance and compares two models, the decentralized model used in the Gulf Cooperation Council (GCC) and the centralized model utilized in Malaysia. Hamaza (2013) concludes that the model used in Malaysia is more beneficial to the Islamic finance industry due to its effectiveness and positive impact on the credibility of Islamic banks. Lee (2016) examines securities regulation and Islamic finance in Dubai and determines how securities regulation affects Shariah compliance.

Enhanced prudential standards have been passed in accordance with new regulations as a reaction to financial crises. This has occurred in several countries, including the United States in 2014. Prudential standards in relation to managing Islamic Financial Institutions are discussed in El-Hawary, Grais, and Iqbal (2006). They also suggest that an organization within the Islamic finance industry is needed in order to administer industry regulation. Song and Oosthuizen (2014) conclude that the “growing presence of Islamic banking needs to be accompanied by the development of effective regulation and supervision.”

Risk management and capital adequacy are different for Islamic and conventional financial institutions. Several studies have proposed that regulation for Islamic financial institutions should be created taking this into account. Archer and Karim (2009) state that there are regulatory problems with Islamic banking due to the depositors being required to accept negative returns. This contrasts with jurisdictions where “bank deposits are required by legal definition to be ‘capital certain’.” Ariss and Saredidine (2007) analyze the current guidelines for risk management and capital adequacy in Islamic banking and state that there are specific risks that are inherent to Islamic banking and that regulation needs to be updated in order to cater to these types of risks.

Karim (2012) discusses Unrestricted Profit Sharing Investment Accounts (UPSIA) that are used in Islamic banking and how existing Western regulation does not adequately cover the issues that arise from this type of Islamic financial product. Sarker (1999) states that, “Islamic banks can provide efficient banking services to the nation if they are supported with appropriate banking laws and regulations.”

3. Data and Methodology

Our survey collected responses from academics, scholars, researchers, and industry professionals involved in the Islamic Finance industry throughout the world. This was administered through Qualtrics, a web-based survey platform. The final sample consists of 192 respondents from 41 countries from North America, Europe, Asia, the Middle East, and Africa. The countries included are listed in Appendix B. The questions administered addressed the status of Islamic bank regulations in the respondent’s jurisdiction, current regulatory infrastructure, human capital development, and Shariah governance. A copy of the survey administered can be seen in Appendix B and the survey results are in Appendix A.

4. Findings

Table 1 shows the responses from the questions regarding current regulatory infrastructure in Islamic Banking. The majority of respondents expressed that there is regulatory infrastructure set up in their region. 77.27 percent of the respondents confirmed that there are legal and regulatory infrastructures that work for the establishment and operation of Islamic banks and/or Islamic windows. Islamic windows are separate entities of a conventional bank that offer Islamic financial products and services. 70.73 percent of the respondents disclosed that there are banking regulations in place that are specifically for the operation of Islamic banks. 68.18 percent confirmed that there is legal and regulatory infrastructure in place that advises Shariah compliant financial contracts. 70.73 percent stated that there is regulation in place that governs insolvency and creditor rights for Islamic banking and 61.36 percent stated that there are Deposit Insurance facilities for Shariah compliant deposits. Smaller percentages of the respondents stated that there are existing regulations regarding tax neutrality, Systematically Important Banks, and arbitration and dispute resolution for Islamic finance transactions. These responses suggest that there has been progress made in creating bank regulation that is specifically designed for Islamic banking.

Table 2 contains survey results that focus on Islamic banking operations infrastructure guidelines. 80 percent of the respondents have Islamic banking operations infrastructure

guidelines for risk management and corporate governance; 78 percent for business conduct; 75 percent for capital adequacy, transparency, and Shariah governance; and 70 percent for market discipline and supervisory review. Table 3 shows the responses to questions about existing Islamic banking infrastructure. 75.61 percent of respondents state that there is a monetary and exchange system in place. 72.5 percent state that the information and statistical infrastructure provides Islamic banking statistics. 60 percent state that the information and statistical infrastructure provides macro-prudential indicators for overall banking and specifically for Islamic finance. 58.54 percent of respondents' jurisdictions contain a center for research and development specifically for Islamic banks. 41.03 percent offer award incentives for Islamic banking industry development. This reflects an opportunity to incentivize Islamic banking industry development, which will further build the Islamic banking industry.

Table 4 contains the responses to questions about Islamic banking human capital development, which is present in several of the respondents' regions. The overwhelming majority of respondents confirm that their region has workshop training in Islamic Banking at 91.43 percent while over 90 percent of respondents have held seminars (93.94%) and conferences (91.19%) in Islamic banking. Having a high calibre of human capital is vital for the Islamic banking operations and these results suggest that there is a foundation of training being offered in respondents' regions.

Table 5 reflects the survey results regarding Shariah governance in Islamic Capital Markets. The survey indicates that there is currently a presence of Shariah governance in the majority of the respondents' regions. Half of the respondents have a National Shariah Board, and slightly over half at 57.14 percent state that there is an external Shariah review audit entity present in their country. Over 60 percent of the respondents state that a governance structure is present and required for the Internal Shariah Board, Shariah secretariat, Internal Shariah Compliance Unit, and the Internal Shariah Review Unit. These results do show that there is room for improvement, since 40 percent of the respondents state that these stated governance entities are not present.

Table 6 and Table 7 show the survey responses about regulatory infrastructure. Over 50 percent of the respondents state that there are legal and regulatory infrastructures in place that govern Islamic capital market operations and that advising is available for Islamic capital market products and services with Shariah compliant financial contracts. Additionally, there are regulations present that govern cross-border financial transactions and provide customer protection. Less than half of the respondents state that their region has developed a strategic plan for building an Islamic capital market

sector (43.24 %). Less than 40 percent confirm that there is regulation in place that governs the insolvency of Islamic capital market instruments and creditor rights. 35.14 percent state that tax neutrality is present for Islamic capital market products and services, while 29.73 percent state that dispute resolution mechanisms or means of arbitration are present for resolving issues with Islamic finance transactions. 37.84 percent state that regulations governing Corporate Social Responsibility are in place and 30.56 percent confirm that there are guidelines for Islamic capital market operations for Governance for Islamic Collective Investment Schemes (ICIS). These responses show that these regulatory infrastructures are quite weak and need to be strengthened through regulatory reforms that emphasize governing insolvency, dispute resolution mechanisms or means of arbitration, and tax neutrality.

Table 7 shows that over 50 percent of the respondents report the availability of guidance for issuing Sukuk, the existence of Islamic Finance Supervisory Review, and the presence of business conduct regulation. 48.57 percent respond that there are disclosure requirements for Islamic Capital Market (ICM) instruments. 47.22 percent report that there are Shariah standards for Islamic financial products and services. Under 40 percent state that there are accounting standards for ICM products and services, auditing standards for ICM products and services, infrastructure of Shariah governance present, and external credit assessment institutions that assess ICM products and services. These survey results reflect the weaknesses in Islamic Capital Market regulation. Additional ICM regulation reform is needed to strengthen the regulations in place in order to further grow Islamic capital markets.

5. Conclusion

Our survey results suggest that legal and regulatory infrastructures need to be updated in order to work for the establishment and operation of Islamic banks and/or Islamic windows. Regulation should be put in place that governs insolvency and creditor rights for Islamic banking. Organization award incentives should be added in order to develop the Islamic banking industry. There should be additional Shariah governance for ICM entities for National Shariah Boards and external Shariah auditing. Regulation that governs the insolvency of Islamic capital market instruments and creditor rights must be put in place. Tax neutrality should also be a priority and be present for ICM products and services. Dispute resolution mechanisms or means of arbitration should be implemented to resolve issues with Islamic finance transactions. Regulations that govern Corporate Social Responsibility should also be incorporated. There is a need for guidelines for ICM operations for Governance for Islamic Collective Investment Schemes (ICIS) to be put in

place. Additionally, infrastructure for Shariah governance needs to be further developed. Accounting and auditing standards for ICM products and services, as well as external credit assessment institutions that assess ICM products and services needs to be established.

Our findings reflect that most existing regulations are centered on finance companies and Islamic banks, whereas limited regulation exists for Islamic Capital Markets. There is a considerable amount of regulation for financial institutions in comparison to the other segments of the Islamic finance industry. Respondents report similar capital adequacy and regulations as conventional banks. The most common international standard when developing infrastructure is the Basel committee for banking supervision, but IFSB and AAOIFI are also frequently used. There is a great need for national Shariah boards and national Shariah compliance measures in the majority of the respondents' countries. 73 percent of respondents state that capital adequacy and financial product regulations are less strict in comparison to banks. 56 percent of respondents state that strict laws and overregulation do not suppress the Islamic finance sector.

We conclude that in order to improve current Islamic bank regulation, existing regulations and guidelines need to be updated in order to become compatible with Shariah guidelines. A regulatory agency is needed for monitoring secondary markets and exchanges. Development of a legal infrastructure that fosters growth of the Islamic financial system should be a priority and specific disclosure guidelines for Islamic banks need to be developed to increase transparency. These findings bring insight as to what improvements should be undertaken to further develop Islamic bank and Islamic financial regulation and can be useful for regulators as a reference for creating efficient Islamic financial regulation reform.

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Appendix A: Survey Results

Table 1: Current Regulatory Infrastructure in Islamic Banking

Question	Yes	No	Other	Total Responses	Mean
Are there legal and regulatory infrastructures that work for the establishment and operation of Islamic banks and/or Islamic windows?	34	8	2	44	1.27
Are there banking regulations in place that are specific for the operation of Islamic banks?	29	11	1	41	1.32
Is there legal and regulatory infrastructure in place that advises Shariah compliant financial contracts?	30	13	1	44	1.34
Is there regulation in place that governs insolvency and creditor rights for Islamic banking?	29	8	4	41	1.39
Are there Deposit Insurance facilities that are for Shariah compliant deposits?	27	12	5	44	1.5
Is there tax neutrality for Islamic finance activities?	20	20	3	43	1.6
Is there an arbitration and dispute resolution for Islamic finance transactions?	18	20	3	41	1.63
Is there regulation that protects consumers?	29	11	2	42	1.36
Is there regulation in place that governs cross-border financial transactions?	30	11	2	43	1.35
Is there regulation present for SIBs (Systematically Important Banks)?	16	16	7	39	1.77
Is there regulation present for CSR (Corporate Social Responsibility)?	25	15	3	43	1.49

Table 2: Islamic banking operations Infrastructure Guidelines

Question	Yes	No	Will have in future	Total Responses	Mean
Risk Management	32	6	2	40	1.25
Capital Adequacy	30	7	3	40	1.33
Corporate Governance	32	7	1	40	1.23
Transparency	30	8	2	40	1.3
Market Discipline	28	9	3	40	1.38
Supervisory Review	28	8	4	40	1.4
Business Conduct	31	8	1	40	1.25
Shariah governance	30	7	3	40	1.33

Table 3: Islamic Banking Infrastructure

Question	Yes	No	Other	Total Responses	Mean
Is there a monetary and exchange system in place?	31	5	5	41	1.37
Does the Information and Statistical Infrastructure have periodical Islamic banking statistics?	29	10	1	40	1.3
Does the Information and Statistical Infrastructure have macro-prudential indicators for the overall banking and specifically for Islamic finance?	24	12	4	40	1.5
Is there a Center for Research and Development specifically for Islamic banks?	24	14	3	41	1.49
Does your organization award incentives to build an Islamic banking industry?	16	20	3	39	1.67

Table 4: Islamic Banking Human Capital Development

Question	Yes	No	No, but planning to in the future.	Total Responses	Mean
Is there workshop training?	32	3	0	35	1.09
Are there seminars being held?	31	2	0	33	1.06
Are there conferences being held?	31	2	1	34	1.12
Are there transfers to Islamic financial institutions from international organizations, research centers, market intermediaries, etc.)?	21	12	1	34	1.41
Are Islamic finance scholarships being issued?	22	8	4	34	1.47
Other (Please Specify)	2	0	1	3	1.67

Table 5: Shariah Governance for ICM Entities

Question	Yes, the governance structure is present and required.	Yes, the governance structure is present	No, this governance structure is not present	Total Responses	Mean
National Shariah Board	18	2	16	36	1.94
Internal Shariah Board	25	8	3	36	1.39
Shariah secretariat	22	4	7	33	1.55
Internal Shariah Compliance Unit	23	5	8	36	1.58
Internal Shariah Review Unit	22	4	9	35	1.63
External Shariah Review / Audit	20	2	13	35	1.8

Table 6: ICM Regulatory Infrastructure

Question	Yes	No	Other	Total Responses	Mean
Has your region developed a strategic plan for building an Islamic capital market sector?	16	18	3	37	1.65
Are there legal and regulatory infrastructures in place that govern Islamic capital market operations?	19	16	2	37	1.54
Is there advising available for Islamic capital market products and services with Shariah compliant financial contracts?	22	15	0	37	1.41
Is there regulation in place that governs the insolvency of Islamic capital market instruments and creditor rights?	12	22	3	37	1.76
Is there tax neutrality present for Islamic capital market products and services?	13	21	3	37	1.73
Is there a dispute resolution mechanism or means of arbitration present to resolve issues with Islamic finance transactions?	11	23	3	37	1.78
Are there customer protection regulations in place?	23	13	1	37	1.41
Are there regulations present that govern cross-border financial transaction?	21	11	4	36	1.53
Is there regulations in place that governs Corporate Social Responsibility?	14	19	4	37	1.73
Are there guidelines for Islamic capital market operations for Governance for Islamic Collective Investment Schemes (ICIS)?	11	20	5	36	1.83

Table 7: ICM Regulatory Infrastructure

Question	Yes	No	Other	Total Responses	Mean
Is there guidance for issuing Sukuk?	20	13	3	36	1.53
Is there Shariah governance present?	18	15	3	36	1.58
Are there disclosure requirements for Islamic Capital Market instruments?	17	15	3	35	1.6
Is there an Islamic Finance Supervisory Review?	19	16	1	36	1.5
Is there business conduct regulation present?	24	10	1	35	1.34
Is there an infrastructure of Shariah governance present?	13	20	2	35	1.69
Are there Shariah standards for Islamic financial products and services?	17	19	0	36	1.53
Are there accounting standards for ICM products and services?	14	19	3	36	1.69
Are there auditing standards for ICM products and services?	13	19	4	36	1.75
Are there external credit assessment institutions that assess ICM products and services?	9	22	4	35	1.86

Appendix B**List of survey respondent countries of residence**

New Zealand	Tunisia	Brazil	Qatar	Japan	United Arab Emirates	Egypt
Germany	Tanzania	Czech	Australia	Singapore	Bosnia and Herzegovina	Nigeria
France	South Africa	Algeria	Pakistan	Jordan	Saudi Arabia	India
United Kingdom	Kuwait	Morocco	Ghana	Kazakhstan	Bahrain	China
Turkey	Bangladesh	Iran	Pakistan	Lebanon	Jordan	Malaysia
United States	Iran	Sudan	Sri Lanka	Oman	Indonesia	