

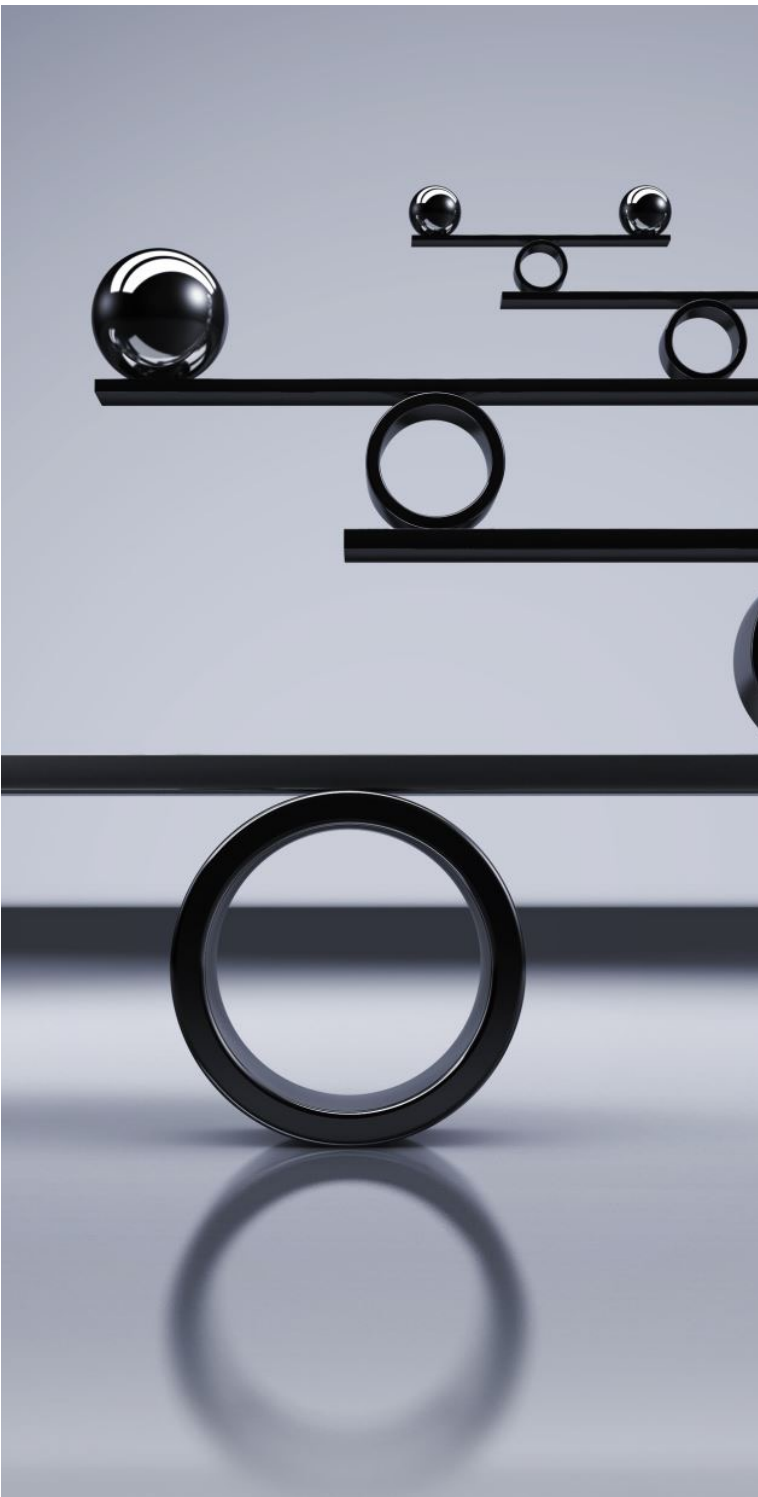


# Why Islamic Finance Needs Regulation?

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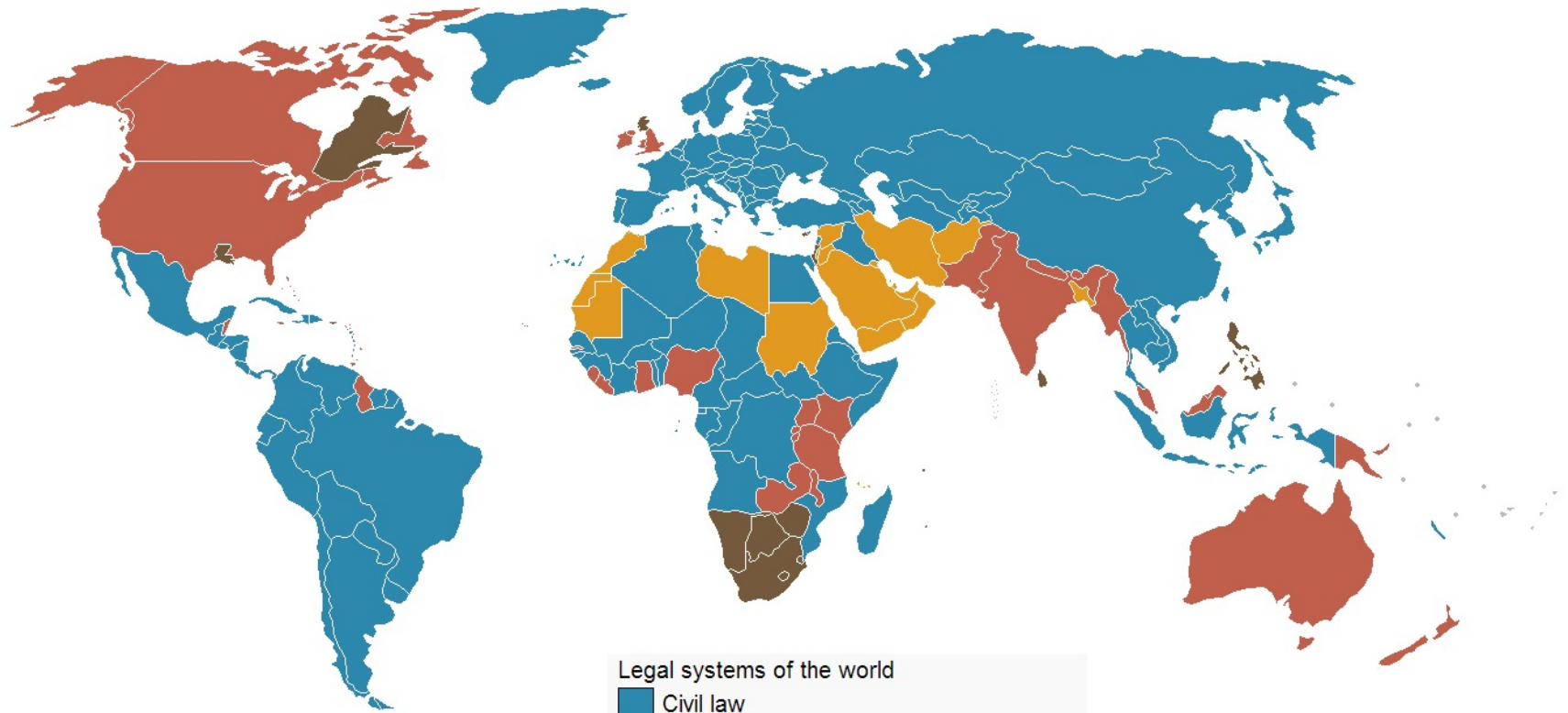
- Legal Systems
- Rationale for regulations
- Legal framework
- Regulatory and Supervisory Authorities
- International Standard Setting Agencies
- Corporate Structure and Regulatory Requirements

## Diversity in the Legal Arrangements

Civil Law: Algeria, Djibouti, Egypt, Jordan, Indonesia, Lebanon, Syria, Tunisia, Turkey, Philippines, Thailand.

Common Law: Bangladesh, Msia, Brunei, Hong Kong, Spore, UK

Shariah: GCC Countries, Iran, Sudan, Pakistan and Yemen



Legal systems of the world

- Civil law
- Common law
- Bi-juridical/mixed (civil and common law)
- Islamic law (Sharia)



WHY ENGLISH  
LAW IS THE  
PREFERRED  
GOVERNING  
LAW FOR  
BUSINESS  
TRANSACTIONS?

Well-known, well-developed and reputable jurisprudence

Independence of the judiciary, the experience and reputation of judges.

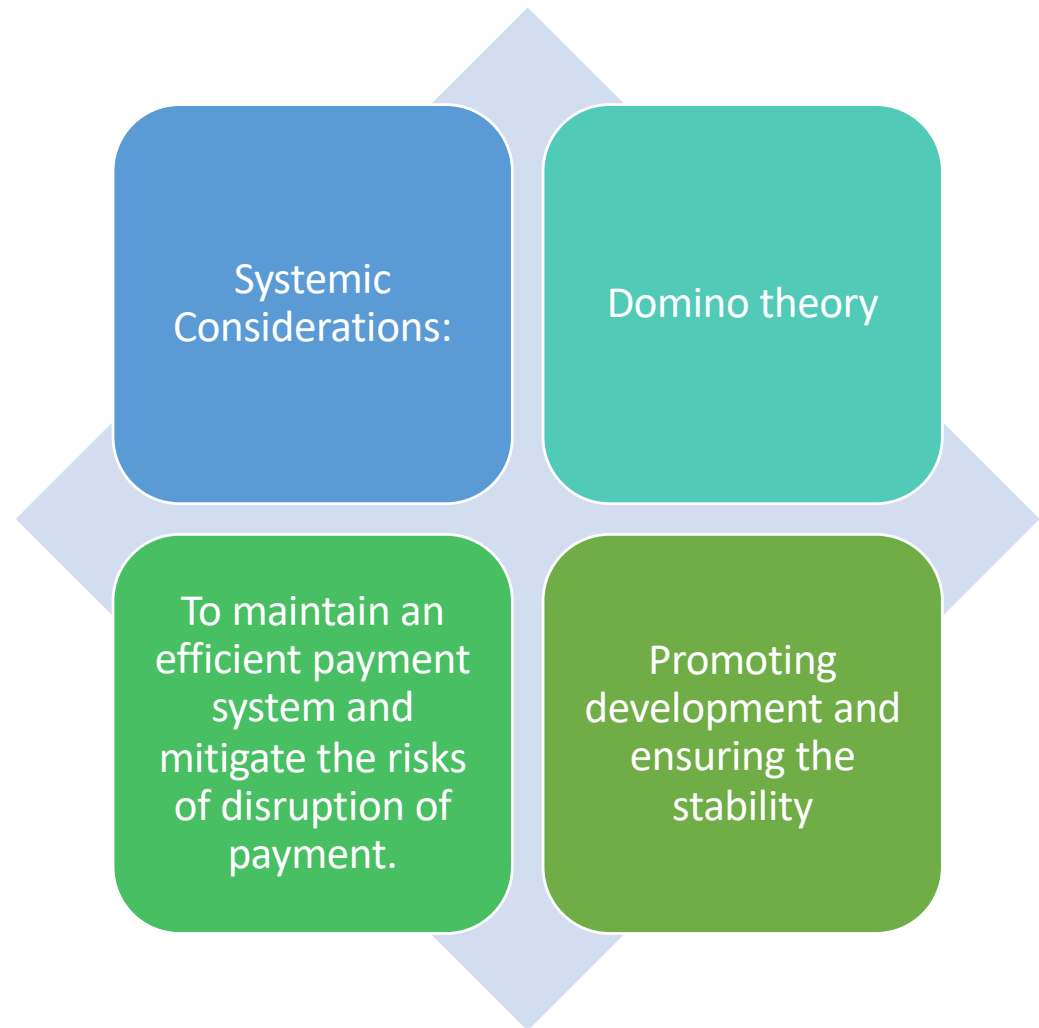
The relative speed and efficiency with which commercial disputes can be resolved through the English courts or ADR mechanisms.


Party Autonomy and Legal Certainty.

Transparent, consistent, stable and predictable.

Providing freedom of contract and a pro-business approach as having an emphasis on the text of the contractual arrangements between parties.

# Why Islamic finance needs regulation? (1)





## Why? (2)



Protecting the Interest of Depositors and Investment Account Holders



CASA 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)



Why? (5)

Financial systems  
are prone to  
instability

Numerous banks  
failures



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?

- **Ihlas finance in Turkey**
  - **Islamic Bank of South Africa**
  - **Islamic Investment Companies of Egypt**
  - **Dubai Islamic Bank**
  - **Bank Islam Malaysia Berhad.**
  - **Patni Cooperative Credit Society**
- **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).**
  - **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: 37-38).**
  - **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 *Shari'ah* non-compliance activities (Zuhaida, 1990).**
  - **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.**
  - **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 (Parker, 2005).**
  - **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 (Grais and Pellegrini, 2006).**

# Case Study: Ihlas Finans

- **1. Accumulation of bad debt- Politically motivated lending and lending to connected business. Finance the businesses of its parent company, Ihlas Holdings.**
- **2. 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.**
- **3. 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.**
- **4. 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: Malaysia

# IFIs in Malaysia

1

1. Comply with the Malaysian Law

2

2. Comply with the Shariah principles

3

3. Comply with the guidelines and directives



# Regulators

BNM

Securities  
Commission

LOFSA

# 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

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





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>