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Legal and Regulatory Issues and Challenges Inhibiting Globalization of Islamic Banking System

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Abstract

Arguably the Islamic finance system has become an accepted phenomenon in the international financial system. The recent unprecedented rapid growth of Islamic financial system is gradually changing the status of the Islamic banking system as an alternative to the conventional counterpart to a mainstream contender. Due to its universal growing acceptance and popularity many countries are embarking on legal and regulatory reforms to sustain the global development of the system. This has generated a lot of issues and challenges for sustainable growth of the financial system. Despite this, a supportive uniform regulatory and legal framework to enhance global integration of the system is yet to be developed. Therefore, considering the critical role of sound and robust legal and regulatory framework in the sustainable development of Islamic banking system, it is imperative to align the regulatory and legal framework in line with the development. The focus of this paper is premised around these issues and the challenges posed to the growth and sustainability of Islamic banking system.

Keywords: Islamic financial system, legal and regulatory framework, Islamic banking system, sustainability and development.

Introduction

There are substantial amount of evidence from numerous studies supporting the fact that Islamic financial system is a phenomenon which had been accepted as an integral part of global financial system. The industry is in the midstream of its integration and phenomenal expansion with a conservative average annual growth rate of about 20.4 percent (KFH, 2013). The global expansion cum the rapid growth can be traced to not only the surge in the demand for *Shar'iah* compliant products from the Middle East as well as other Muslim countries' financiers but also the demand by both Muslims and non-Muslims investors all over the world (Heiko et al, 2008). Owing to the increasing global acceptance, Islamic finance is surprisingly transiting into a new era of growth and development even in this era of post global financial crisis.

The expansion is not only geographical but also encompasses rapid expansion across the spectrum of business and financial activities such as retail banking, capital market investments, and even insurance - *takaful* (Heiko et al, 2008). However, Zeti (2013) noted the increasing demand for *Sharia'ah* compliant financial services and products triggered the entry of large number of institution into Islamic banking and finance field with even some conventional ones eager to have a share of the promising Islamic financial markets. These had in the recent years propelled innovation and development of new Islamic financial products in order to develop Islamic counterparts of the conventional financial products. The drive for innovation had resulted to having more sophisticated Islamic financial products exhibiting more challenging risk profiles. Indeed, sound and robust legal and regulatory frameworks are required to provide enabling environment for the innovation and development of innovative products that are competitive enough to satisfy the increasing demands of the customers. This paper based on the existing

literature examines the major legal and regulatory issues in Islamic banking system and argues the importance of robust legal and regulatory framework to sustainable growth and development of the banking system.

The rest part of this paper is divided into four sections. Section one discusses the issues relating to the legal and regulation of Islamic banking system. Section two highlights the legal and regulatory challenges facing Islamic banking system while section three focuses on how to strengthen legal and regulatory framework of Islamic banking system. Last but not the least, section four concludes the paper.

Regulatory and Legal Issues in Islamic Banking System

To sustain the growth and development of Islamic financial system, the resilience of the industry has to be strengthened through evolving legal and regulatory reforms by the regulators (Zeti, 2013). At this stage recent studies agreed that putting in place an appropriate and effective legal and regulatory framework is particularly important for Islamic financial institutions. The general belief is that instituting appropriate, robust and sound legal and regulatory framework will create an enabling environment for the stakeholders and thereby provides healthy development and growth of the financial system. Karimi (2009) opined that importance of institutionalizing an appropriate robust legal and regulatory framework for Islamic banks and other financial institutions cannot be over emphasized. He argued that availability of an appropriate legal and regulatory framework can immensely enhance the soundness of these institutions and aids the regulators especially Central Banks in regulating and supervising the financial institutions. It can also assist the central bank to be more effective in the execution and management of its credit and monetary policies.

In a nutshell it can be inferred that a robust and sound legal and regulatory framework is required to create an enabling environment that supports the growth of Islamic financial services industry and as well fosters its stability. Achieving this feat Zeti (2013) noted has been presenting a serious and variety of challenges to the regulators on how to go about legal and regulatory reform, most especially on interpretation of the reform to ensure a more inclusive and sustainable growth and development of Islamic banking system.

In addition, the emergency of Islamic banking within conventional banking system has been a great source of worry to the scholars, policy makers and regulators. The major concern has to do with embedding *Shar'iah* compliant Islamic banking activities into the existing conventional financial system's juridical and supervisory frameworks (Heiko et al, 2008). Therefore, to address this issue they adopted what was referred to as two-tier perspective, i.e. the legal aspects of Islamic contracts and the regulatory aspects of Islamic financial transactions.

The bane of contention is whether Islamic financial transactions governed by *Shar'iah* principles is allowed by the existing common law jurisdiction and must Islamic financial institutions' regulation be of the same intensity and kind of prudential oversight as conventional financial institutions. To the first question, with all indications it can be unambiguously confirmed that the legislations in the secular jurisdiction do not make any provision for the accommodation of *Shari'ah* principles governing Islamic financial transactions.

Though studies such as Vogel and Hayes (1998) and Karimi (2009) argued that the flexibility of the legal set up in some jurisdictions of the conventional legal system gives room for the practice of Islamic banking, but Islamic scholars are not comfortable with this argument.

They insist on the fact that *Shari'ah* is unequivocal in its legal provisions on commercial and financial transactions.

Hence, demands by the Islamic scholars for a separate legal framework for Islamic financial system which differs from that of conventional and takes *Shari'ah* requirements into consideration. This was necessitated by the fact that there are some *Shari'ah* compliant investments and financing products that are complex in nature and continuously demands for innovations of Islamic financial products and operation which attract various types and degree of risk profiles quite distinct from the conventional ones (Chapra & Khan, 2000). Therefore, regulation, supervision and oversight of the Islamic banking products and operations need to address this peculiar nature.

Presently, most of the countries that licensed the operation of Islamic banks still subject Islamic banking Institutions under the secular legal and regulatory framework without provision for Islamic financial infrastructure. The only country making frantic efforts towards this direction is Malaysia. The country had just recently introduced a new Islamic Banking Rules and Regulation known as Islamic Financial Services Act 2013.

Moreover, on the second question concerning whether Islamic financial institutions requires the same level of supervision as the conventional institutions, there is a misconception that since Islamic banking is based on Profit and Loss sharing (PLS) it does not requires much supervision as its conventional counterpart. But the fact remains that there are some features of Islamic banking such as moral hazard, prevention of systemic crisis and protecting demand depositors' interest which require similar degree of prudential regulation and supervision as conventional banking system (Hesse et al, 2008). Oversight

However, an important aspect of the required legal and regulatory framework for Islamic financial institutions is that the central bank or any other regulator must ensure that it addresses the unique nature of Islamic financial system as well as other issues involving all financial intermediations (Zeti, 2009). In addition, it has to give room for the dynamic nature of Islamic financial services

Legal and Regulatory Challenges Confronting Islamic Banking System

Although Islamic banking is in its era of growth and is being recognized as important integral part of the global financial system, its major setbacks are the legal and regulatory challenges facing the financial industry as a whole (Cohan & Cohan, 2011). The sought legal and regulatory reform though may present a wide range of challenges, is to ensure a more inclusive and sustainably growth. It is worthy to note that the Islamic financial industry is yet to develop a uniform legal and regulatory framework that is supposed to support and enhance Islamic financial system.

Currently, Islamic countries' existing banking regulations are based on conventional banking model. It's highly disturbing to know that only a few of these countries have enacted specific laws to manage and regulate Islamic banking and finance sector. However, Rodney (2003) reiterates that the legal and regulatory framework is critical to the effectiveness and efficiency of Islamic financial institutions, as sound legal and regulatory framework ensures adequate reporting, risk management controls, adequate customer disclosure, monitoring of capital adequacy as well as mitigation of asymmetric information problems. He emphasized that failure of legal and regulatory framework to adequately ensure all these may lead to financial panic or bank runs which is poses a serious threat to the survival of the banking institutions.

Therefore, Karimi (2009) suggested central banks and other regulatory bodies should put in place special laws that will address the identified most importance challenges facing Islamic banking industry. Some of the challenges identified by Karimi (2009) and Muttalip (2008) and which the legal and regulatory framework should address include the following;

1. Islamic banks Insufficient Legal Protection:

Karimi (2009) is of the opinion that Islamic banking system is currently lacking legal support because there is no existence of company and commercial laws that are adequately suitable for the implementation of Islamic banking and financial contracts. Therefore, regulators as well as Central banks need to review and reform laws that are related to companies, commerce, investments, legal procedures and the courts in such a way that will meet the requirements of Islamic banking institutions (Muttalip, 2008). He frowned at the situation whereby the company laws still refer to interest and bonds with total disregard for participation deeds and profit. In fact the provisions of company and commercial banking laws sparsely defined Islamic banking activities and even prohibit its scope within the conventional limits (Karimi, 2009).

These laws were formulated based on conventional banking systems before the commencement of Islamic banking and finance and no serious attempt had been made to change them, except few cosmetic changes introduced in some aspects in some countries (Iqbal, 2007). He cited example of interest payments' continuous tax deductible while in most jurisdiction dividend payment is not enjoying the same treatment which puts Islamic banks and firms using Islamic modes of finance at a disadvantage. Therefore, Muttalip (2008) call for a total reform of the whole legal framework so as to meet the needs of Islamic financial system by permitting application of profit/loss sharing modes as well as partnership participation..

2. Jurisdiction – Civil or *Shari'ah* Court:

The common practice is subjecting Islamic banks' disputed cases to the same legal system as the conventional counterparts under the adjudication of the same civil court and Judges without considering the different nature of Islamic legal system. This is the situation in all the countries most especially Malaysia and Saudi Arabia considered to be the biggest Islamic finance markets. For instance, the Federal Constitution which is the supreme law in Malaysia guarantees the right of every citizen in Article 121. Although Article 121 (1A) of the constitution does not give civil courts jurisdiction over *Shari'ah* court but List 1 (Federal List) of the constitution allows civil court jurisdiction over mercantile laws under which Islamic banking and finance operate. This implies that jurisdiction of *Shari'ah* courts does not cover issues concerning banking and finance. The situation in Saudi Arabia is quite similar to that of Malaysia. Arbitration of disputes involving Islamic Finance Institution in Saudi Arabia is under the purview of the Banking Dispute Committee, just like their conventional counterparts.

This is contrary to the fact that *Sahri'ah* normally governs all aspects of commercial activities, including banking and financial transactions in Saudi Arabia (Wassem, 2013). Responsible for this lapse is the failure in duty performance by Saudi Arabia Monetary Agency (SAMA), a regulatory Agency established by Royal Decree in 1957 to oversee banking and finance in the kingdom. Failure of SAMA to issue separate regulations to govern Islamic Financial Institutions has resorted to treating Islamic Financial Institutions the same way as the conventional counterparts. This automatically impedes the growth and prospects of Islamic finance in Saudi Arabia and other countries where Islamic banking institutions are subjected to conventional banking framework. Also, absence of Islamic banking legal and regulatory

framework hinders the enforcement agreements in courts because it may require additional efforts and costs

However, to address some of these challenges Arifin (2013) recommended establishment of Islamic Finance Tribunal that would seek to the disputes relating to Islamic Finance issues. He also recommended a separate Legislative framework or one code for Islamic Banking that will be independent of conventional framework.

3. Amendment of existing laws:

It has been proved beyond doubt that Islamic and conventional banking systems and financial products are not the same and should not be regulated by the same legal framework in order to achieve the objectives of Islamic banking and finance (Arifin, 2013 & Agnelio, 2014). However, Karimi (2009) argued that despite the difference, there are some kind of resemblance between Islamic banking and conventional banking. Therefore, he suggested that Islamic banking laws and regulations should be accordingly amended with consideration for the international standards in order to accommodate exponential growth in Islamic banking and new concepts in international banking. Malaysia is a good example in this regard. The country had been following this path through constant amendment of her Islamic laws and regulations, and just recently a new Islamic Financial Services Act 2013 (IFSA 2013) was issued. Towing the path of Malaysia in this respect are countries like Qatar, UAE and Pakistan.

4. Disparity in Concepts and Practice:

In Islam, economic and financial activities are primarily based on trading and equity participation which involve profits/loss sharing, fees and so on. Loan is allowed only if it is

based on *Qardh Al Hasan*. Also, Islamic banks are supposedly designed to act as “pass-through” financial intermediaries whereby the Investors (depositors) bear either the profit or loss on the asset side. Muttalip (2008) believed that Islamic banks transactions are carried out on the basis of certain theoretical concepts and features. But Iqbal (2007) argued that what is being practiced is different from what the theory says. Therefore, one of the challenges confronting Islamic banks is translating these concepts and features into practices as they have to blend their traditional roles as financiers in trading, leasing activities and fee-based services (Muttalip, 2008).

5. Ownership of Underlying Assets:

From *Shari'ah* perspective underlying assets play a critical role in determining the validity of a trading or leasing activity. For instance the status of tangible and intangible assets to be used as underlying assets in Islamic transactions (e.g. receivables, concessionary right, trademarks, financial rights, copyrights, existing assets or equipment for leasing purposes, property to be constructed in the case of *Istisna* and so on and so forth) requires clear confirmation even before offering the facility to the customer (Muttalip, 2008). Islamic laws also stipulate that these underlying assets must be owned by the customer or he/she must be duly authorized and empowered by the owner to transact business with the asset(s). There are some cases in which lawyers and Bankers may find it difficult to ascertain whether the underlying assets are free from encumbrances. Lack of legal and regulatory framework that would properly address this challenge may render many of Islamic banks' transactions null and void.

6. Lender of Last resort: Studies have shown that like the conventional counterparts, Islamic Banks are also prone to liquidity problems but they (Islamic Banks) do not enjoy the same facility in the form of Lender of Last Resort which is available to the conventional banks for

overcoming financial crisis when it suddenly occur as a result of unanticipated financial problems. Where such facility is available to Islamic banks it is based on interest which is unacceptable because of its incompatibility with the *Shari'ah* principles. Islamic prohibits engaging in any financial transaction that involves interest (*usury*). Thus, Islamic banks are rendered financial security disadvantaged and more exposed to liquidity problems than there conventional counterparts.

Strengthening Legal and Regulatory Framework to Enhance Growth and Development of Islamic Banking System

The expansion and innovative development of Islamic banking products due to the exponential growth and global acceptance of Islamic banking system brings about the new legal and regulatory challenges. Lack of a uniform legal and regulatory framework cutting across all the jurisdictions and supportive for Islamic financial system is a potential hindrance to the sustainability of the financial system's continued growth and development. This is pertinent as most of Islamic countries' existing banking regulations are based on western model. Therefore, ensuring sustainable, effective and smooth function of Islamic banking system requires prudential reform for the purpose of strengthening the legal and regulatory framework. This in turn requires the regulatory regime to fashion out a robust and enhanced risk-based regulatory approach that will provide a level playing field for the full-fledged Islamic banks, subsidiaries and Islamic windows of the conventional banks (Yeseen, 2014).

However, according a number of studies on regulation and supervision of Islamic banking system, strengthened legal and regulation infrastructure through enhanced risk-based regulatory and supervisory framework can be achieved by the regulators and supervisors' prompt and pragmatic actions by taking the following steps:

(i) Drafting Harmonized Legislation and Regulation for Islamic Financial System

A consistent legislation and regulation is what takes to provide sustainable development and efficiency of Islamic financial system. Definitely, it will provide the impetus necessary for the sought total acceptance and complete integration of Islamic banking system into the international financial system. However, Ahmad & Mohsin (2014) argued that though this desires that the regulations of Islamic financial system should be aligned with the regulations of conventional counterpart but it should be done without compromising the *Shari'ah* requirements. In other words the Islamic banking regulatory framework should be complementary to that of conventional banking system and be fashioned in such a way that would reflect uniqueness of Islamic banking system and the different associated risks.

(ii) Ensuring proper and adequate supervision to improve compliance and control system.

The focus of the regulatory and supervisory framework should be on ensuring that the banking institutions adequately fulfill their compliance obligations through effective and efficient control system. The compliance obligation either in-terms of conventional or Islamic compliant need not to concentrate on the religious features of the financial products but rather focus on instituting a risk-based regulatory framework (Nafis, 2012). This goes a long way to assist in the ammonization of regulatory infrastructures and prevents a system to claim superiority over the other. Achieving this feat requires an improved and efficient supervisory process which enables detection of risk symptoms as

well as management of the risk that may arise from the group-wide business/financial activities.

(iii) Providing Reliable Islamic Financial Market Infrastructure

Ability of the regulators and supervisors of Islamic financial institutions to incorporate the International prudential standards into the *Shari'ah* structure of Islamic financial in order to develop a harmonized risk-based regulatory framework for the industry strengthens the financial market infrastructure. The harmonization has to be in tandem with the alignment of the international standards espoused by the Basel Committee, International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) with those of Islamic Financial Services Board (IFSB), the Accounting and Auditing Organization for Islamic Financial Institutions (AIOFI) and International Islamic Financial Markets (IIFM). Achieving this will definitely provides an enabling environment which gives room for healthy development, growth and enhanced efficiency of Islamic financial markets.

(iv) Building Customers' Confidence in Islamic Financial System

Developing sound and robust regulatory/supervisory and governance frameworks allows market participants to have adequate information about the performance of the market in particular and the whole industry in general. Enhance corporate governance ensures that the most qualified *Shari'ah* scholars are selected to serve as members of the *Shari'ah* Supervisory Boards of Islamic financial institutions. These boards in turn ensure that the institutions' policies, procedures, *Shar'iah* requirements as well as the regulatory stipulations are followed and implemented to the letter and this enhances public confidence in the Islamic financial services industry

However, Islamic banking system stands to gain a lot if this approach is embarked on and well implemented. Some of the benefits of the approach include the following;

- (i) it strengthens the financial infrastructure,
- (ii) it tends to enhance investors and customers' protection,
- (iii) it promotes regulatory cooperation and
- (iv) it helps in building human capital, just to mention but few

Conclusion

Islamic financial system due to its current expansion, continuous development and growth at both local and international financial arenas especially in countries reputedly known for practicing conventional banking system without any provision for Islamic banking system in their legal and regulatory framework is deep necked in several issues related to its legal and regulatory framework vis-à-vis International banking standards. Lack of globally uniform regulatory framework that is supportive for the international acceptance of Islamic financial system is a major obstacle constituting hindrance to the efficient and smooth functioning of the system as an alternative to the crisis-ridden international financial system.

Arguably, a robust legal and regulatory framework having harmonious relationship with conventional regulatory framework and special consideration for the unique aspects of Islamic financial system is fundamentally required to project and positioning Islamic financial system as being capable of meeting the customers' multifaceted needs and the challenges of the dynamic

global financial markets. In order to develop an internationally accepted regulatory framework some parameters of conventional financial regulatory framework may need to be adjusted and aligned with parameters that recognize uniqueness of Islamic financial system. This development will surely portray Islamic financial regulatory framework as having internationally accepted outlook which will make it the target of the direct investments in need of *Shari'ah* compatible investment.

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