

بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

Towards Fostering Financial Stability of Islamic Financial Industry

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Introduction

Sound macro economic policies are essential for maintaining financial stability. However, recent experience, such as the Asian crisis, highlights the fact that macro economic stability, while necessary is not sufficient for financial stability, which also require sound financial sector policies. The former can only be insured by the pursue of sound monetary, fiscal, and exchange rate policies, while the latter can be insured by reinforcing the market discipline of the system by prudential regulation and effective supervision, with special stress on capital adequacy, proper risk management, effective internal controls and external audit, greater disclosure and transparency, deposit insurance, and improved corporate governance.

Islamic banking

There are 250 financial institutions practicing some form of Islamic finance around the world, and the industry has been growing steadily. Banking is the most developed part among Islamic financial institutions with regard to experience and practice. The banking industry is growing by 10-15% annually, and made substantial progress worldwide. Thus, proving the workability and viability of the free-interest banking industry.

Given the emerging nature of the industry, its need to adapt to the needs of the markets it serves, and to the competitive pressure from conventional finance.

Islamic banking system has many characteristics that distinguish it from the conventional banking system: The receipt and payments of interest is strictly prohibited in Islam. Islamic banks can operate only on the basis of profit and loss sharing arrangement or other modes of financing permissible under shariah. Islamic banks deal in both commercial and investment banking which is closer in nature to what is

recently known as “ universal banking”. They have wider scope of objectives, namely developmental and social role. Furthermore, the emergence of Islamic banks introduced the ethical values to the banking industry. Moreover, an interesting result emerged from the analytical model developed by Khan (1986) is that an Islamic bank may be better suited to adjust to shocks that can lead to banking crises than conventional bank. Similar conclusion derived by Iqbal and Mirakhor (1991). Nevertheless, Islamic banking faces significant challenges regarding their soundness and stability. To reduce risks and foster the stability of Islamic banking , market discipline of the system should be reinforced by appropriate prudential regulations and effective supervisions.

Prudential Regulations and Supervisions in Islamic Banking

Prudential supervision is necessary to insure the soundness of the Islamic banking system and enhance banks’ developmental role, five reasons presented by Errico and Mitra (1998) for the regulation of Islamic banks:

- I. Possibility of economic losses or losses incurred as a result of poor investment decisions. Economic losses would be reflected in the depreciation on depositors’ wealth and in a decline in banks’ profitability. Such losses could jeopardize banks’ soundness if not corrected.
- II. Weak banks may detract from the achievement of fundamental macroeconomic objectives, such as the efficiency of the payments system and the effectiveness of monetary policy, particularly if implemented through the use of indirect instrument.
- III. Unsound banks may also reduce public confidence in the financial system.
- IV. A weak banking system is likely to prevent the economy from benefiting from the ongoing globalization process and liberalization of capital markets, particularly in countries where banks are the major players in domestic financial markets.
- V. Compliance to Islamic Banking principles should be insured by proper supervision.

While in principle the central bank can continue to play the same role in regulating banking and financial transactions when dealing with Islamic banks. In practice problems have arisen where Islamic banks operate side-by side with conventional banks, these problems are extremely important for the efficient functioning of Islamic banking such as:

- The adoption of international standards for Islamic banks.

- The adoption of reserve requirement ratio for Islamic banks.
- The appropriate monetary policy tools for Islamic banks.
- The use of Lender of last resort facility by Islamic banks.

Unified international best practices and prudential standards for supervision and regulation for Islamic banking should be developed, through introducing new or adapting existing, international standards consistent with shariah principles, to address the unique characteristics of Islamic banking and to ensure:

- Legal framework for function and supervision of Islamic banks. Banking laws or other laws pertaining to banking sector should define the specific nature of Islamic banks and their relations with the central bank.
- adequate risk management for Islamic banks
- adequate disclosure of information in Islamic banks
- adequate corporate governance in Islamic banks

The stress on these issues is likely to strengthen Islamic-banking supervision, hence, The soundness of Islamic banks. Recently, a number of institutions have been established to become focal point in the regulatory issues, in particular the accounting and Auditing Organization for Islamic Financial institutions (AAOIFI), the Islamic Financial Services Board (IFSB), the International Islamic Financial Market (IIFM), and the International Islamic Rating Agency (IIRA).

Risk Management in Islamic Banking

Banking failures very often are precipitated from the failure to have in place the appropriate risk management- the failure to understand the risks and to institute the proper system to manage the risks.

Developing a risk management strategy in Islamic industry is a challenging task and requires a thorough understanding of Shariah and the principles of Islamic economics and finance relevant to the Islamic concepts of risk, freedom of contract and property rights. Since, Islamic banks are exposed to a risk matrix that is different from that facing conventional bank.

With the undergoing challenge in the financial market, the ability to remain viable will hinge on the ability to effectively manage the changing risk dimensions inherent in the business of Islamic banking. Thus, it is important to institute a strong risk management culture in Islamic banking.

Developing a Successful risk Management Strategy in Islamic banking

To develop a successful risk management strategy in Islamic banking, a number of requirements need to be addressed:

- ◆ Islamic banks have to hold diversified and balanced portfolios. Currently Islamic banks are concentrated on short-term trade financing, the optimal portfolio will be a well-diversified portfolio of short and long-term nature for both trade and equity financing.
- ◆ Islamic banks need to develop specialized investment banks that can offer product to share and transfer risks among market participants, and to create liquidity through securitization, and to construct financing tools for project finance.
- ◆ There is a need to explore the applicability of the concept of Takaful (insurance) to insure business, commercial and financial losses. This will provide new aspects for investments, and help in mitigating risks for Islamic banks.
- ◆ There is a need to develop financial engineering to design innovative Islamic financial instruments and processes. Financial engineering expands the opportunity for risk sharing, lowering transactions costs and reducing asymmetric information and agency cost. Application of financial engineering is the key to the rapid development of secondary market and of liquidity enhancing products to implement effective risk management.
- ◆ There is a need to enforce Islamic rules regarding contracts and property rights in capital markets, to reduce uncertainty and increase public confidence in capital markets, and in financial intermediaries.
- ◆ There is a need for an appropriate adaptation for standard CAMEL rating system to Islamic banks. Additionally, there is a need for accepted risk weighting methodology that can be used to assess the capital adequacy of Islamic banks. Important progress has been made in this area by AAOIFI.
- ◆ There is a need for credit rating information on Islamic banks, which are globally comparable. The set up of the (IIRA) is a step forward.
- ◆ There is a need for standardization of accounting methods and procedures. In this regard, AAOIFI need to work hard to generalized application of its standards by all Islamic banks.
- ◆ There is a need for adopting appropriate technology and market database to assess risk management.
- ◆ There is a need to invest on research and training, to develop risk management expertise.
- ◆ There is a need for appropriate licencing process to ensure that new Islamic banks are sound and stable.

- ◆ There is a need for co-operation between Islamic banks and institutions to set up infrastructure for risk management.

There are two lessons for risk management from the market turbulence of the recent past. First, risk management should promote a conservative approach to risk (covering significant risks and interactions among them). Second, in risk management as in other areas, complex, formal models can complement but cannot fully substitute for human judgement and experience. (World Economic Outlook 1998).

Disclosure in Islamic Banking

Disclosure is important in facilitating market discipline and to support the mechanism that will reduce risk in financial institutions and markets in order to promote safety and soundness. In this regard the use of enhanced disclosure by banks is an important feature in the proposed new capital adequacy framework of the Basel Committee for Effective Bank Supervision.

The principles of financial transparency and disclosure are deeply rooted in Islamic jurisprudence. The information asymmetry in financial contract is covered under the rule of “gharar”. “Gharar” could arise if the outcome of a certain financial contract is not defined or unknown or because of significant information asymmetry that benefits one party of contract to the losses of the other party . The avoidance of “gharar” promotes transparency.

Information disclosure is more important in an Islamic system than it is in conventional banking system. The Islamic banking system is basically a profit/loss sharing system. Thus, In an Islamic system depositors have more incentive to monitor banks’ performance than conventional depositors, due to the fact that capital value of and returns on investment deposits are not fixed and guaranteed, but depend on bank’ performance in investing depositors’ funds. Hence, depositors need to monitor Islamic banks to protect the capital value of their funds and to ensure a fair share of profit.

Islamic banks are obliged to be transparent by making adequate disclosure to their investment account holder, not only with regard to their own financial conditions but also in respect of the management of their money. This is the area, going beyond disclosure , where topics such as participation of stakeholders in the corporate governance of Islamic banks and developing effective control and accountability mechanisms to enhance fiduciary relationships in Islamic banks become relevant. Appropriate disclosure of key data and information will enable different depositors to choose among different banks disclosing different

investment objectives and policies, in addition appropriate information disclosure can provide the supervisory authorities with a better understanding of banks' strategies and their relevant risks. Which enhance effective prudential supervision.

The Basel committee identified six broad categories for financial disclosure by banks which are equally relevant to Islamic banks. These categories are: financial performance; financial position(including capital,solvency,and liquidity); risk management strategies and practices; risk exposures(including credit risk, market risk, liquidity risk, and operational, legal and other risks); accounting policies; and basic business, management and corporate governance information. The scope of information on the above categories would depend on the nature of Islamic bank's operations and accounting standards. Without appropriate and uniform accounting and disclosure standards, transparency becomes difficult to achieve.

Enhancing Corporate Governance in Islamic Banking

Sound corporate governance according to Basel principles includes:

- Corporate values, code of conduct.
- Corporate strategy
- Assignment of responsibilities.
- Strong internal control systems
- Monitoring of risk exposures
- Financial and managerial incentives
- Appropriate information flows.

Adequate internal control in Islamic banking serves two goals:

- 1- Reduce mis-management risk.
- 2- Reduce moral hazards.

There are two areas in Islamic banks governance structures which require particular attention from transparency point of view:

- a) The role of Shariah boards. Variations in Shariah boards interpretations across Islamic banks will reduce the transparency of their operations.
- b) The role of depositors in assuring performance. Depositors in investment accounts , like shareholders, have a direct stake in the bank's financial performance. Bank governance structure allows the shareholders to safeguard their interests through management control and monitoring mechanisms. Such options, however are not available for investment account depositors.

In this regard important progress has been made by AAOIFI appropriate accounting and disclosure standards. These norms address disclosure in financial reporting, and while these are prerequisites to transparency more work is needed to promote effective supervision.

Other Challenges

Islamic banks will be faced with tremendous competitiveness as a result of globalization and technological innovations. With the merger of banks and financial industries and universal banking, globalization puts the Islamic banking face to face with the international banking giants. The most important challenge facing Islamic banks under globalization of financial services is how to keep their unique identity. Islamic banks should merge together, integrate, increase their capital and efficiency performance on the level of attracting more resource and mobilizing more investment projects. Merger and expansion of Islamic banks is related to the expansion of the Islamic financial market itself. To increase the potential of Islamic financial industry other necessary component of an Islamic financial system should be developed, such as:

- Sizable and organized Islamic financial center.
- Liquid and deep secondary market for Islamic product.
- Islamic monetary control and public debt financing instrument.

As Islamic banking is practiced worldwide, development of common standards and practices became a challenge. An institution that represents all countries committed to Islamic banking can play a leading role to overcome these challenges through mutual consultations and co-operations. No doubt the establishment of the Islamic Financial Services Board (IFSB) would play an important role to foster the development of regulatory and prudential norms for Islamic financial institutions. Hence, fostering the stability of the Islamic financial industry.

Fostering Financial Stability of the Sudanese Islamic Banking

Macro economic reform

The Sudanese government had launched in 1999 a medium-term program of economic stabilization and structural reforms aiming at maintaining a high rate of economic growth, reducing the rate of inflation, narrowing the external current account deficit, building up foreign exchange reserves and improving relations with the international financial community. The macro economic policy mix to achieve these objectives included structural reforms in the fiscal, monetary, banking, trade and foreign exchange areas. Financial sector reform constitute an important part of the medium-term program.

Monetary policy reforms

Monetary policy reforms have focused on three broad areas. First, the BOS has phased out nearly all administrative restrictions on bank credit and its sectoral allocation, exchange rates have been unified and interbank and interbank transactions in foreign exchange have been allowed. As a result, the markets for credit and foreign exchange have been made substantially more competitive. Second, the BOS has introduced a monetary programming framework linking its inflation objectives to the growth in money and credit and to reserve money within a consistent macroeconomic framework. Third, the BOS has created an environment to move towards a marketbased monetary policy and for that purpose designed and introduced two new and innovative Islamic financial instruments, a Central bank musharaka certificate (CMC), which is an equity-based instrument that is issued against the public sector ownership in commercial banks, and Government musharaka certificate (GMC). which is an equity-based instrument that is issued against the public sector ownership of income-yielding assets. Both instruments have achieved wide market acceptability and are now important indirect instruments of monetary policy. Anew financial instruments was introduced in 2003 which is the Government Investment Securities(GIC).

Bank Restructuring and Bank supervision

To improve the health and efficiency of the Islamic banking system the BOS announced a banking sector reform strategy in may 2000. Key elements of this strategy include strengthening the capital base of banking institutions through new capital subscriptions and consolidation of existing institutions, recovering bad debts, and

enhancing banking supervision.

Banking supervision

Bank of Sudan Strategy for effective supervision is based on the following objectives:

- To secure efficient and capable manangement carrying prudent, moral and ethical qualifications.
- To install and build up a capable and sound systems of internal control, effective risk management, adequate transparency and enhanced corporate governance.
- To introduce and develop banking technology in the whole banking industry.

- To ensure the implementation of the international standards consistent with Shariah principles.
- To improve the quality of financial reporting by banks.
- To strengthen the training programmes for bank supervisors.

The supervision and control function is performed through off-site surveillance and on site inspection . As the main objective of on-site inspection is to evaluate the safety and soundness of a bank, as indicated by aspects such as asset quality, management quality and risk management system. The on-site inspections has been reoriented towards assessing the soundness of banks and risk management rather than focusing on compliance checks, and a new manual has been developed for on-site examinations to cater for the risk-based approach to supervision. Efforts has been exerted to apply the CAMEL rating system. And an enforcement unit was established to ensure the implementations of BOS directives.

Measures implemented for effective supervision

Since 1998, the BOS has introduced a number of new prudential regulations aiming at improving bank soundness. These regulations include:

- a) The adoption of the uniform accounting principles which were issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), all banking reports should be prepared according to these principles.
- b) The adoption of the financial disclosure principles which apply both Basel and AAOIFI standards.
- c) The issuing of a circular to enhance corporate governance in banks based on Basel principles. The circular refers to the representation of “ depositors of investment accounts”, in the board of directors and general assembly of the bank to secure corporate governance and transparency for them. Depositors of investment accounts like shareholders, have a direct stake in the Islamic bank’s financial performance.
- d) The issuing of directives to combat money laundering through the financial sector.
- e) Drafting of guidelines concerning customer rating and risk management.
- f) Setting of new regulations governing establishment of new banks and foreign banks.

The BOS also revised the weighted assets risk scales for some Islamic modes of finance, such as salam and purchasing of goods by banks for commercial purposes, and issued guidelines for Murabaha transactions. Guidelines for other Islamic modes of finance are under issuing.

Legal frame work

To strengthen the authority of the central bank to conduct its functions Bank of Sudan Act has been revised. The new Act gave the central bank more independence.

The Banking Regulation Act has been amended to secure the effective supervision and regulation of Bank of Sudan over the banking system. Other legislations related to banking practice has also been under revision such as the Bankruptcy Act and Sale of mortgaged property Act.

To ensure further the safety and soundness of the banking system a Deposit Insurance Fund has been established.

The program of the financial sector reform is a continuous process aiming at ensuring the safety and stability of the Sudanese Islamic financial system.

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