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Islamic Finance

Islamic Finance and Economic Development

Risk Management, Regulation, and Corporate Governance

AMR MOHAMED EL TIBY
WAFIK M.GRAIS

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To my mother
To the soul of my father
To my dearest children, Mohamed, Nada, and Khaled
To my dearest friend Maha Eltiby

—Amr El Tiby

To my late parents, who taught me love, tolerance, and perseverance. Their extraordinary humanism is for me a constant lesson that I will always cherish.

To my wife, who remained kind and patient through the whole process. Her support, dedication, and tolerance are continuous reminders to me of the meaning of love.
I am greatly indebted to her.

To my children, who had to bear with my absences. Their presence and support are a constant light and give warmth to my life.

—Wafik Grais

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Preface

Islamic finance is introducing challenges to the global financial landscape. Islamic financial assets, despite the turbulence across all global financial markets, have grown from around US$55 billion in the late 1980s to around US$1.2 trillion in 2011.[1] They represent 0.5 percent of global financial assets. Deutsche Bank's *Global Islamic Banking Report* (November 2011) anticipates a 24 percent compounded annual growth rate (CAGR) in Islamic assets over the coming three years.

Islamic finance is built on different foundations from conventional finance. An institution offering Islamic financial services (IIFS) adheres to *Shari'a*-inspired principles and rules, which take precedence over profit taking. The building blocks of Islamic finance are: (1) promotion of fairness in transactions and the prevention of an exploitative relationship and of fraud; (2) sharing of risks and rewards between all parties involved in financial and commercial transactions; (3) a tangible economic purpose for each transaction, sometimes referred to as the principle of materiality; (4) the prohibition of interest; and (5) the prohibition of engaging in activities prohibited by *Shari'a* laws.

These characteristics, particularly the asset-backed nature of Islamic financial assets and risk-sharing arrangements, have played a major role in mitigating the impact of the 2008 global financial crisis on Islamic finance. These features ensure a tighter link between the growth of economic and financial transactions than would be permitted with conventional finance, and contribute to a clearer identification of where risks lie.[2] They can be expected to limit the scope for leverage. Kenneth Rogoff, a leading Harvard University economist, suggests that Islamic finance demonstrates the advantages of more equity and risk sharing over the bias in favor of debt instruments in conventional finance.[3]

[1] See, for example, M. Mohieldin et al. (2011).
[2] One could surmise that these features would entail a closer link between monetary and real economic expansion than in conventional finance, entailing possibly an easier control of the general price level.
[3] Rogoff states: "In the ideal world, equity lending and direct investment would play a much bigger role." He further asserts: "With a better balance between debt and equity, risk-sharing would be greatly enhanced and financial crises sharply muted." (Umer Chabbra, "International Financial Stability: The Role of Islamic Finance," Institute of Policy Studies, Islamabad, vol. 4, no. 2). www.ips.org.pk/islamic-thoughts/1006-international-financial-stability-the-role-of-islamic-finance.pdf.

Banks, conventional as well as Islamic, are subject to a wide range of risks. In general, banking risk can be categorized into four groups: financial, operational, business, and event risks. However, Islamic financial institutions face a mix of risks that are distinct from the ones faced by conventional banks. The requirement of materiality, risk sharing in earnings-bearing deposits, liquidity management, and operational risks stemming from *Shari'a* compliance highlight the distinctions. The relationship with investment account holders or depositors shapes the nature of a large portion of an IIFS's liabilities and the risks it faces. Also, the systemic liquidity infrastructure bears on the IIFS's ability to place excess liquidity or access liquidity when needed, affecting its liquidity risks. Furthermore, the risk to earnings performance of conducting non-*Shari'a*-compliant activity is specific to IIFSs.

The recent global financial crisis has highlighted the need for effective risk management and the need for international regulatory standards to foster it. The observation is equally valid for Islamic finance. Accordingly, it is crucial to understand the risk characteristics associated with Islamic finance operations to set an effective risk management framework that is sound and prudent, and to develop relevant international regulatory standards. The financial crisis has also highlighted the importance of sound corporate governance that safeguards the interests of all stakeholders, mitigates risks, and fosters growth. In this context, it is crucial to focus on the corporate governance challenges of IIFSs and establish a *Shari'a* governance framework.

This book's messages are:

- Islamic finance is an opportunity to seize to promote development, most notably in communities where conventional finance leads to the financial exclusion of large groups of society.
- Islamic finance has developed beyond infancy, and significant strides have been made in its development.
- Islamic finance faces risks that can result in specific distress, whether idiosyncratic or resulting from spillovers.
- Appropriate regulation can mitigate the mix of risks faced by Islamic finance and increase its resilience.
- Sound systemic *Shari'a* governance can strengthen the industry's stability and vibrancy as well as improve its performance.

The book contributes (1) a highlighting of the relationship of Islamic finance and economic development, (2) a blueprint for a regulatory approach to Islamic finance that promotes stability and vibrancy, and (3) an approach to the development of a systemic *Shari'a* corporate governance framework for Islamic finance.

The book contains four parts: Part One provides a primer to Islamic finance and highlights of its history. This part contributes an analysis of recent developments and a survey of the landscape of Islamic finance. Part Two is about risk, contagion, and distress; it provides a picture of how global financial crises could affect Islamic finance.

Part Three considers the regulatory framework for Islamic banking. It discusses the opportunities and challenges for regulators, policy makers, and bankers. It provides an approach that can enable the mainstreaming of Islamic finance while keeping it true to its principles.

Part Four is dedicated to the governance issue in Islamic finance. It discusses the financial fiduciary governance and the *Shari'a* fiduciary governance. It then presents an approach to the development of a systemic *Shari'a* governance framework for Islamic finance activities.

Part One: Emergence of Modern Islamic Finance

Chapter 1: History and Core Principles of Islamic Finance This chapter provides a brief history of Islamic finance, presenting only the highlights of that history relevant to the industry's development. It does not go into the details of that history that are extensively covered in other writings. The chapter includes a primer of the foundations and modes of operation of Islamic finance.

Chapter 2: Islamic Finance: Opportunity for Egypt's Development Egypt was an early mover in modern Islamic finance. The country offers ample opportunities for the development of Islamic finance, as well as for the contribution of the latter to Egypt's development. Islamic finance could rapidly grow beyond its current size of less than 5 percent of the country's financial assets. Islamic financial intermediation can contribute to deepening Egypt's financial system, increase the diversification of the services it offers, and improve financial inclusiveness. It can offer opportunities for financing development, whether at the state, corporate, small/medium enterprise, or consumer level. At the same time, Egypt's developmental needs and its population's values offer promising prospects for Islamic finance. However, the introduction and development of Islamic finance raise challenges to market participants, policy makers, regulators, and supervisors, as well as standard setters. These challenges need to be addressed. Dealing with them in a professional and systematic manner is the best way to ensure the success of Islamic financial services (IFS) and the opportunity the industry provides for the country's development.

Part Two: Managing Systemic Risks[4]

Chapter 3: Risks, Spillovers, and Distress This chapter identifies risks faced by Islamic financial services (IFS) and spillover and contagion channels across conventional and Islamic banks as well as within the latter group. It then looks at cases of Islamic bank distress where the risks and channels of transmission were at play. The focus is on systemic crises and not on idiosyncratic distress in a single institution offering Islamic financial services (IIFS) without risk of contamination of other financial services. Particular attention is given to the systemic crisis experienced by Turkey's special finance houses (SFHs) at the beginning of the 2000s decade triggered by the collapse of Ihlas Finance House in Turkey.

Chapter 4: Coping with Crises: Policies, Institutions, and Markets Chapter 4 focuses on policies, institutions, and mechanisms to promote financial stability and deal with crises. It deals first with the role of liquidity provision in periods of financial stress. It then turns to mechanisms of liquidity management consistent with Islamic finance and the setups developed in Bahrain and Malaysia. The chapter finally focuses on mechanisms to solve distress episodes when they occur. It concludes by summarizing the vulnerability of Islamic finance to a systemic crisis and provides recommendations for an increased robustness and resilience of IFS.

Part Three: Regulatory Challenges

Chapter 5: The Dilemma of Tailor-Made versus Mainstream Regulation Islamic finance offers opportunities for expanding investments, raising growth performance, and reducing poverty. It does so by offering new financial services, an everyday event in the realm of finance, whose fate is ultimately decided by market developments. In this permanent evolution, market participants, regulators, and the broader institutional environment face continuous challenges. Market participants' challenges lie in their ability to identify opportunities for profit and to pursue them while complying with *Shari'a* and managing risks. The regulators' challenge resides in their ability to provide a systemic governance framework that promotes financial stability while not stifling market vibrancy. Finally, at the broader institutional level, the institutional infrastructure needs to enable the expansion of investments by incorporating features that mitigate investors' risks.

[4]This part draws on Grais and Rajhi (2009). The authors would like to thank Wassim Rajhi for his valuable contribution.

Chapter 6: Toward an Enabling Framework This chapter focuses on the regulators' challenges to provide a regulatory framework that enables market vibrancy, *Shari'a* compliance, market stability, and a level playing field with conventional finance. It considers an approach to avoid the "niche industry" solution as well as one that would lead to tinkering with *Shari'a* principles. It considers the rationale for regulating Islamic finance, and highlights the inconsistency of Islamic finance with general banking rules. The chapter offers an approach that would allow Islamic finance to develop without being hamstrung by the need to fit within the prevailing banking regulatory framework.

Part Four: Corporate Governance[5]

Chapter 7: Financial Fiduciary Governance This chapter focuses on the corporate governance (CG) arrangements of institutions offering Islamic financial services (IIFSs) aimed at protecting stakeholders' financial interests. Many IIFS CG issues are common with those of their conventional counterparts, whereas others are distinctive. In particular, IIFSs offer unrestricted investment accounts that share risk features with common stocks held by shareholders but without a voting right. The chapter first reviews internal and external arrangements put in place by IIFSs to protect stakeholders' financial interests. It discusses shortcomings, notably in terms of potential conflict of interest between shareholders and holders of unrestricted investment accounts. It then suggests a CG framework that combines internal and external arrangements to provide safeguards to unrestricted investment account holders without overburdening an IIFS's financial performance. The chapter uses a review of 13 IIFSs and regulatory information from countries where IIFSs have developed the most.

Chapter 8: Corporate Governance and *Shari'a* Compliance The structures and processes established within an institution offering Islamic financial services (IIFS) for monitoring and evaluating *Shari'a* compliance rely essentially on arrangements internal to the firm. By being incorporated into the institutional structure, a *Shari'a* supervisory board (SSB) has the advantage of being close to the market. Competent, independent, and empowered to approve new *Shari'a*-conforming instruments, an SSB can enable innovation likely

[5] Chapters 7 and 8 draw on Grais and Pellegrini (2006). The authors would like to thank Matteo Pellegrini for his valuable contribution to these chapters.