Islamic finance: Regulatory issues in the UAE

MOINUDDIN MALIM highlights the regulatory issues facing the Islamic finance industry and believes that a common platform should be established to regulate Islamic financial institutions globally.

The world discovered very late that Islamic financial institutions (IFIs) were not immune to global financial crises. While Islamic finance was not overtly exposed to the sub-prime crises, derivatives, or multiple securitizations, it has its own issues for which they need to go back to the drawing board.

The issues which have caused concern for IFIs are more pertinent to the way these institutions are organized and how they have or have not adopted the best practices when it comes to asset concentration, risk management, liquidity management, governance, service standards, training, quality, etc.

However, these issues are not widely faced by all IFIs in general but are more obvious where these institutions lack prudent management or clear strategic directives from the board of directors. These issues are further compounded in jurisdictions where the regulators have limited appreciation of the complexities of regulating Islamic entities.

Additionally, one of the key aspects that every regulator needs to understand, following the lead from Malaysia, is that IFIs cannot always be efficiently regulated under the same framework as the one they use for conventional institutions. It is time for the regulators, practitioners, scholars, lawyers, etc. to stop experimenting and adapt a model which is working well, such as the one followed in Malaysia, without sacrificing the sanctity of Shariah standards.

Regulatory issues

When the going was good, not a lot of emphasis was given to developing the core competencies of Islamic banking and finance. Even today, while a lot is done, a core limitation faced by Islamic finance is the ability to provide a full suite of products and services, training Islamic resources, risk management, operational efficiencies, transparency and discipline. The main dilemma faced by IFIs is that in high growth periods, while they exorbitantly lent out their balance sheet, they chose to ignore efficiency ratios, high cost of liquidity, maturity mismatches, asset allocation models, etc.

A prudent regulatory framework would have limited these excesses, which were selectively ignored by most financial institutions.

Additionally, the idea of having too many regulations versus no or limited regulations also does not help. These things only surface in an economic downturn and look very rosy in the up-market. These excesses would have been only avoided with prudent management or regulations. Prudent regulations may not be popular during an up-market, but they are vital to keep entities in compliance. This is especially true in the case of IFIs, which have a tendency to avoid responsibility by claiming to be part of an industry in an infantile stage. It is time to grow up.

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Islamic banking windows

The main competition to the IFIs is from the Islamic windows of conventional banks, whether domestic or international, as they have to adapt their Islamic offering under a standardized platform where each concept, product or service has to go through a series of checks and measures in addition to Shariah, including but not limited to risk, operations, compliance, legal, marketing etc. This makes Islamic windows better equipped to understand and deal with risk; more efficient, better service providers; and more focused on delivery.

Today, banks with Islamic windows in the UAE share 10% of the total Islamic finance industry and this percentage is growing at a faster rate than the actual growth rate of pure IFIs. This ratio is substantially higher in Saudi Arabia and Qatar (where Islamic banking windows are now scheduled to close due to the Central Bank of Qatar's directive).

While there is a common understanding among all regulators on how to regulate, monitor and manage conventional financial institutions, why can't the regulators especially in Muslim countries constitute a common regulatory framework and policy guideline on how an IFI should operate as a fully fledged bank or a window?

The route selected by Malaysia after experimenting with other models is an example every regulator needs to take guidance from. Why is it that every regulator needs to experiment with Islamic finance and why is it that every time it is the customer that has to suffer? Why can't every regulator set up a parallel yet separate regulatory framework similar to Malaysia?

The only justification or rationale one can draw is that perhaps the regulators themselves are not convinced of the legitimacy of the Islamic finance or they are just doing it due to customer or authorities' pressure and/or they do not have the time and appreciation to fully understand Islamic finance

There were times not long ago when the IFIs based out of the UAE and Islamic windows of global banks were leading Islamic debt capital market activities. The UAE was leading in terms of US dollar-denominated Sukuk. The lack of development in regulations has meant that banks have not developed much-needed sophistication and specialization, resulting ultimately in the markets not being encouraged to tap this avenue for raising capital.

Simply put, in the current environment, on one hand borrowers will always be at the mercy of banks to provide

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financing for all of their needs and on the other hand, depositors (especially retail) will always be at the mercy of the banks to invest their free cash flows with them and provide low returns instead of the investors directly investing in any fixed income instrument or alternative channels for investments.

The GCC countries, due to their position as economic power hubs based on rich oil and gas reserves, have never pushed organizing their domestic debt capital markets until recently when Saudi Arabia introduced the Tadawal Exchange where issuers were encouraged to list Sukuk/bonds. However, similar efforts are lacking elsewhere. While the UAE's ADX, DFM and Nasdaq Dubai allow the listing of Sukuk and bonds, one finds the basic regulatory framework lacking the push to encourage more domestic issuers to use this platform to issue domestic commercial paper in the form of a Sukuk or a bond.

A complete overhaul is required of the existing regulations, including the establishment of localized rating agencies to support the market, similar to countries like Malaysia. Unless the UAE develops an active domestic debt capital market, it will never be able reach the sophistication and financial acumen where every investor is able to create their own investment portfolio based on their risk appetite and where every issuer is able to put together an optimal capital structure with diverse sources of funding.

Next step

In the UAE and a few other jurisdictions, the next wave of growth in Islamic finance will come from the Islamic windows of conventional banks as they aggressively push forward to retain their customers from switching to 100% Islamic banks. There is a large segment of the population, whether retail or wholesale banking customers, who have now become more comfortable with Islamic banking products, services and terminology. Additionally, those days are gone where Islamic finance was more costly than conventional finance.

Today, if all remains equal, there are no differences in service standards and delivery platforms between Islamic and conventional banks, with both types of products and services being priced the same. Therefore, the choice of selecting whether to go with Islamic or conventional products and services is truly left to the preference of the customer.

It is also seen in all markets including the UAE that Islamic finance is not just limited to those who are the followers of this faith: rather it has also become acceptable with people of all faiths. It is difficult to ascertain the one single reason, why non-Muslims are also attracted to this industry. However, one of the many reasons is that there is no ambiguity in Islamic documentation, they expect Islamic finance to be more fair and they expect no hidden charges.

"The legal framework available to foreclose on property is far more tedious and cumbersome for Islamic home financing than conventional"

It is important to closely examine how Islamic products and services have emerged based on consumer demand, and how these are regulated, to make sure that development is based on the preference of the customer not on price, service quality or delivery platform.

A closer examination reveals that there are still basic issues unaddressed when we start flipping from page to page in the book of Islamic finance in comparison to conventional finance.

In an attempt to allow an IFI to function while not particularly focusing on the regulatory framework, it has been seen that attempts have been made at times to encourage Islamic finance to comply with the same norms as conventional finance and at times a totally divergent view is taken.

The regulators and authorities need to have clarity of purpose, if they want Islamic finance as part of mainstream finance. Then they need to bring about regulations which bring Islamic finance at par with conventional finance.

A case in point is home financing, which was started in Dubai by two IFIs, namely Amlak and Tamweel, prior to anyone taking a serious commercial interest in this business. This is not a new product from a global perspective, where the industry is highly developed, mature and regulated, and has also witnessed two major downturns due to the sub-prime crisis.

One would argue that as this product was started by Islamic entities, the regulation built around this product should benefit both the financiers and obligors. One could also assume that Islamic finance will have an edge in terms of regulatory framework or at least be at parity with conventional financing products for the same.

However, if one closely examines this product being marketed by both IFIs and conventional financial institutions, we notice the way different authorities and regulators have positioned and created policy frameworks for this product, making Islamic offerings inferior to conventional products, especially if there is any stress or event of default where the financier needs to repossess the property.

The legal framework available to foreclose on property is far more tedious and cumbersome for Islamic home financing propositions than conventional ones. Without going into details, it can take six to nine months longer for an IFI to foreclose in case of a default than for a conventional provider of similar product.

Conclusion

While it is time for IFIs to grow up and show maturity rather than become complacent under the banner of being part of an infantile segment of the financial world, it is also time for the regulators to unite and establish a common platform to regulate IFIs globally.

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