Proceedings of the Fifth Harvard University Forum on Islamic Finance: Islamic Finance: Dynamics and Development Cambridge, Massachusetts. Center for Middle Eastern Studies, Harvard University. 2000. pp. 161-163

Regulatory Environment and Strategic Directions in Islamic Finance

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ABSTRACT

The regulatory and compliance environment in Islamic financial institutions benefits from the independent supervision of *shari^c^a* boards and from *shari^c^a*-compliance mechanisms that supplement the normal regulatory and compliance mechanisms found in other financial institutions. This provides a solid basis for products and services on both sides of the balance sheet. Islamic financial institutions function under strict *shari^c^a* principles that uphold moral and ethical values and guard against money laundering and other types of malpractice. The strategic directions of Islamic financial institutions today include full cognizance of regulatory and compliance requirements, technological development (including e-banking and e-commerce), and development of more sophisticated products in the realm of, among other things, project finance, securitization, and Islamic sovereign/treasury securities. The example of Kuwait Finance House (KFH) illustrates how the increasing sophistication of the industry and its participants on one hand, and government involvement in the strategic direction of the industry on the other, bodes well for continuing Islamic banks' track record of regulatory compliance.

I. INTRODUCTION

Islamic financial institutions need to project the edge they have over their conventional counterparts—a dual-compliance mechanism, which has been in place since the very beginning. However, more universally accepted regulations and standardized accountancy procedures are also needed. The time has come for Islamic financial institutions to intensify research and development efforts in product innovations and sophistication.

This paper covers two different but related topics: the regulatory environment, and the strategic direction in Islamic finance.

II. REGULATORY ENVIRONMENT

It is especially important to begin by taking careful account of the regulatory environment in which Islamic finance operates. This is particularly relevant today, since in the immediate aftermath of the September 11 terrorist attacks, a public perception has arisen that Islamic financial institutions are vulnerable to financial malpractice such as money laundering and terrorist funding. On the contrary, Islamic financial institutions can truthfully claim to have an excellent track record in monitoring their financial practices. This is largely due to the inherent design, and the culture of compliance within Islamic financial institutions.

A. Inherent Design and Dual Compliance Culture

The Islamic financial institutions, like their conventional counterparts, are regulated by their respective Government Authorities. In addition to this, the regulatory and compliance environment in Islamic financial institutions benefits from an additional independent supervision from *shari^c^a* supervisory boards and *shari^c^a* compliance mechanisms. The *shari^c^a* principles, which uphold moral and ethical values, bolster the guardianship from any malpractice such as terrorist funding, money laundering and other evils. Due to *shari^c^a* considerations, Islamic investment funds are not employed in certain industries, including such obvious items as breweries or banks, but also arms manufacturing and dealing. This is a common investment guideline subscribed to by all the mainstream *shari^c^a* scholars and Islamic financial institutions all over the world. Such industries, accordingly, are automatically excluded from the universe of acceptable Islamic investments.

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The anti-money laundering fundamental, "Know Your Customers" (KYC), has been in force in the Islamic banking industry since its inception. Not only from the liability side, but also from the assets side of the balance sheet, the Islamic finance is screened through the dual processes of credit and *shari^{c}a* compliance, which direct Islamic financial institutions to know the customers and their operations better.

On the assets side, not only do all the credit criteria have to be satisfied, but the lines of business of the customer need to be acceptable, and the structures and implementation are normally closely linked to the flow of business or tied to particular assets. On the liability side, the *shari^{c}a* guidance pertaining to lines of business applies as well, in addition to any regulatory KYC requirements. Further, *shari^{c}a* rules regarding structuring of liability products especially as regards the sharing of risk and returns, apply.

This provides a solid basis from which stem products and services, on both assets and liability side of the balance sheet, which promise to be of wholesome benefit to the society at large, and where chances of malpractice are systematically minimized.

B. Kuwait Finance House and the Regulatory Environment

The stringency of the regulatory environment in which Islamic finance operates, by necessity of its special restrictions, are exemplified by the Kuwait Finance House.

- Kuwait Finance House complies with the instructions of both the Ministry of Commerce as well as the Central Bank of Kuwait.
- The Board of Directors comprises 10 members, of whom six are nominated by the government, including the chairman, as well as a nominee of Central Bank of Kuwait.
- The Shari^{c}a Supervisory Board of the Kuwait Finance House has met on a weekly basis since its inception in 1978. In addition, the Finance House has Shari^{c}a Compliance Officers for day-to-day supervision and guidance.
- Kuwait Finance House is required to comply with the Accounting Bureau of Kuwait, a government regulated body.
- It is also required to be audited by two independent and reputable external international auditing firms.
- It adheres to the Accounting and Auditing Organization for Financial Institutions, which follows International Accounting Standards.
- It has established an Anti-Money Laundering Compliance program, with the assistance of Citibank, a major international bank.

C. Regulatory Environment for Islamic Financial Institutions: Improvement Potential

The risk profile of Islamic financial institutions differs from their conventional counterparts mainly with respect to profit/loss sharing deposits and assets-backed financing. In this respect, further development of a regulatory framework for Islamic financial institutions by refining and adjusting the required capital adequacy, reserve and liquidity ratios could greatly help the smooth and sustainable growth of the industry.

Due to the unique accounting features of Islamic finance products, the development and application of an appropriate and well-accepted accounting and auditing framework would enhance the transparency and disclosure of Islamic financial Institutions.

III. Strategic Direction

The strategic direction in Islamic finance today can be clearly seen to be fully cognizant of the regulatory and compliance requirements. To operate successfully in a highly competitive environment, efforts are being directed toward technological development including telephone banking, e-banking, and e-commerce and strengthening the industry's institutional and operational capabilities by developing more sophisticated products like project finance, securitization and Islamic sovereign/treasury securities. The increasing sophistication of the industry and its participants on one hand and the start of government involvement in the strategic direction of the industry on the other hand, are good indicators for continuing the excellent track record of compliance.

As competition increases, the industry is forced toward project and corporate finance for higher spreads and these markets are marked by increased tenor—mostly medium- and long-term financing. Institutional investors and Islamic banks can provide more long-term funding if those investments or transactions can be securitized or if their liquidity profile could be made more flexible.

Islamic *sukuk*s (asset-backed bonds) have recently been introduced in the industry. Besides, a global Islamic financial infrastructure, comprising an Islamic Financial Services Board (IFSB); an International Islamic Money Market (IIMM); a Liquidity Management Center (LMC) and an Islamic Credit Rating Agency

(ICRA), is expected to be in operation soon, perhaps by the end of this year, at the initiative of Islamic Development Bank and with the assistance of the International Monetary Fund (IMF). If the infrastructure's operation becomes a success, this can help largely in meeting the concerns and requirements of effective and efficient liquidity management of the Islamic financial institutions.

The use of technology now enables the banks to offer and distribute the products in different ways and through a number of delivery channels such as the use of ATMs, Point Of Sale units, Telephone banking, e-com and Internet banking services. Although e-commerce is still a largely unregulated market place, conscious attention and the dual screening processes of Islamic financial institutions are likely to better position them in avoiding any malpractice or oversights.

A. Kuwait Finance House: Emphasis on Technology

- Kuwait Finance House provides traditional banking services through its Internet services, as well as real estate, consumer finance, commercial trading products and services.
- It provides the latest telephone banking technology services such as SMS, WAP, and tele-banking IVR.

B. Kuwait Finance House: Project Finance

- Kuwait Finance House arranged and co-arranged the Islamic tranche for two large projects in the Gulf region, namely, Equate Petrochemical (Kuwait) and Shuweihat Power and Desalination (UAE). Both received a Euromoney Best Deal of the Year award last year.
- It is also a founder of the Liquidity Management Center in Bahrain, alongside Bahrain Monetary Agency, Islamic Development Bank and other Islamic banks, with the aim of introducing short-term liquid instruments (asset backed securities).

IV. Conclusion

The increased competition and the rapid growth in the Islamic industry forces Islamic financial institutions to adopt and comply with both international standards and *shari^{c}a* requirements. Islamic financial institutions are also required to apply the latest technology in all aspects, and to be more innovative in developing project finance and asset securitization in the long, medium, and short terms. By following the regulatory guidelines and applying these strategic directions, it is certain that Islamic banking will continue its excellent track record.