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Supervision and regulation: Experts see need for a common approach

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Mohamed Nedal Alchaar has the challenging job of bringing clarity and uniformity to a fragmented but rapidly growing Islamic finance industry.

As head of the Bahrain-based AAOIFI – the Accounting and Auditing Organisation for Islamic Financial Institutions – he is part of a group of officials around the world working on the regulatory front to catch up with the extraordinary expansion of the sector.

For, despite an explosion of interest in Islamic finance and the proliferation of new products, experts are warning of the need for better regulation and more standardisation if the industry is to play a larger role in the global economy.

As McKinsey, the consultancy, says in a report: “The lack of standards inhibits the development of the international Islamic banking markets and results in an industry that is little more than a collection of national strongholds.”

Created 17 years ago but now expanding its operations, AAOIFI works on two levels. First, it has an accounting board that issues rulings on how transactions should be booked in banks’ financial statements. It has also started giving crash courses and issuing professional certifications for accountants working in the sector.

Second, AAOIFI runs a Sharia board of 17 religious scholars whose role is to try to unify the various opinions issued by religious scholars on behalf of individual institutions.

AAOIFI’s Sharia board rules on the Islamic credentials of financial products. Scholars on the board then abide by the AAIOFI rulings in their daily bank jobs.

“We’re always watching the developments taking place and when we feel there’s a legitimate tool being offered in the market, we look at it from a Sharia (or Islamic law) and accounting point of view and issue a standard,” says Mr Alchaar.

The organisation, however, faces serious constraints. Set up by the industry itself, AAOIFI has no power of enforcement. “We’re a source of credibility – not a source of enforcement,” says Mr Alchaar. With a permanent staff of only 15 – and an additional 40 outside consultants – the organisation’s resources are also limited. Only eight countries have adopted AAIOFI accounting standards as mandatory, though many other Islamic financial institutions tend to use them.

Mr Alchaar argues that organisations such as AAIOFI – another is the Malaysia-based Islamic Financial Services Board – are becoming the checks and balances on the industry. But he acknowledges that a lot more needs to be done.

“The industry has to be standardised – otherwise it will be local. For it to be a real viable alternative system it needs harmony. You cannot have a product be one thing in Bahrain and another in Malaysia,” he says.

Although everyone agrees on the need for harmony in accounting and on the merits of more uniform Shariah standards, there is a debate in the industry over whether Islamic institutions should have separate licensing regimes, as is the case in Kuwait, for example.

Some analysts argue that the sector requires clear and specific regulations while others say this would shield Islamic institutions from competition and promote complacency.

A recent report by KMPG, the professional services group, says many financial regulators and supervisors around the world still do not distinguish between the treatment of Islamic and conventional financial products, though Islamic organisations follow a different financial model.

The report also notes that there is little consensus in the industry on how to create reporting and governance standards.

“To begin with there is no common approach on regulatory frameworks, and there is varying interpretation of Sharia-compliant products,” says the report. “The resulting lack of transparency in operations, and the varying degrees of governance, raises questions about how effectively Islamic financial organisations are managing their internal controls.”

Anwar Khalifa Alsada, deputy governor of the Bahrain central bank, says Islamic banks should be separately regulated.

The industry, he says, needs more transparency, particularly for depositors. Unlike conventional banks, deposits in Islamic banks are not guaranteed. That is why, he says, Bahrain now requires Islamic banks to disclose more details about profit allocation between shareholders and depositors.

Mr Alsada and others, however, say regulators have an additional job – that of educating the public about the risks and benefits of Islamic banking. Indeed, analysts say some depositors appear unaware that (at least in some cases) their bank deposits are not guaranteed.

This may not present a problem in today’s booming economic climate, which has seen bank profits soar. But it could prove a shock to depositors during a downturn.

“So far some investors don’t differentiate between Islamic and conventional products – the perception is that there’s no risk on their money. That’s why we’ve taken the lead in educating the public,” says Mr Alsada.

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