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The Role of Islamic Leading Organizations for the Promotion of Islamic Finance in Western Countries

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Abstract

The majority of the literature related to Islamic finance in the Western world is country related. They only examine the role of Islamic finance in a respective country according to its Muslim population. I would like to gather all these studies and give a comprehensive overview of opportunities and challenges, such as assets and liabilities driven, securitization and spread, that Islamic financial institutions face in the world and identify the role of leading Islamic Organizations, such as Accounting and Auditing Organization for Islamic Financial Institutions, Islamic Financial Services Board, Islamic International Rating Agency, International Islamic Financial Market, International Islamic Liquidity Management Corporation and Shariah Boards for the promotion of Islamic finance in western countries. This study also investigated what regulatory measures required to Western world, in order for Islamic finance to thrive and prosper in the Western world not only for Muslim but also for non-Muslim consumers. Furthermore, all those institutional changes, which make the financial transactions prohibited, have to be taken into consideration by major Islamic banking and financial organizations, for the promotion of Islamic finance attractive to non-Muslim consumers and compatible with the conventional financial system in the Western world?

Keywords: **Islamic organizations; Western world; Non-Muslim consumers; Regulatory measures**

INTRODUCTION

In the beginning the industry, focused all its attention on retail, which was followed by commercial banking activities. The next step, capital market activities, which took a bit longer time to be developed but it began to boom in a very short time and this boom attracted more and more actors into this business, especially western countries in the mid-1990s. As the Islamic finance industry attracted gradually in different countries of the world with reliability and annual growth rate of (15 to 20%) and the public interest grew all over the world. However, the central banks and regulatory authorities in these countries began to call for regulations and supervision of the Islamic finance industry.

Another additional incentive that followed the boom in IFIs was the difference in products availability by these institutions. IFIs in the beginning of 1970s began increasingly to consult experts in Islamic law in order to be sure if their product were adherent to Shariah [1]. However, there was need for a standard setting so the products at least could be same contents, if not the same name. However, it is observed from open market that United Kingdom is the only country from western countries, which got most benefits from Islamic finance. One of the main reasons, which have been explained by many researchers, is the large Muslim population in this country. While countries like USA, Germany, France and Spain all have relatively large Muslim population butIslamic banking is just at the introduction stage in these countries. One problem there is non-compatibility of Islamic banking with the established financial order of these countries. The other is the limited effort of these countries to encourage the introduction of Islamic finance.

All these problems led to the establishment of Shariah boards within the IFIs. But this was not enough because the inconsistencies in interpretations of different Shariah boards in IFIs led to the fact that some transactions were Shariah compliant in the rules of one board and not compliant with Shariah in the rules of other board. Therefore, international standard setting organs such as Accounting and Auditing Organization for

Islamic Financial Institutions (AAOIFI), Islamic Financial Services Board (IFSB), Islamic International Rating Agency (IIRA), and International Islamic Financial Market (IIFM) were found to facilitate by issuing international standards and guidelines, the homogeneous interpretation of Islamic jurisprudence and dealing with corporate governance issues. Recently the International Islamic Liquidity Management (IILM) has been established to assist institutions offering Islamic financial services in addressing their liquidity management issues in an efficient and effective manner. Suharto [2] argues that there are two sides of impact in the globalization, such as the good and the bad. The good aspect is that the economy becomes more accessible, and it promises increasing welfare for the people as trades between nations become possible. Damanhuri [3] also argues that the positive side of the globalization of economy is that it is promising and offers wider opportunities for even the poorest to seek their economic blessing. The negative side is that it may abandon a country that is located in the periphery capitalism world.

Meanwhile others argue that standardizing international financial reporting is not needed, as it benefits only certain users [4] and it also neglects the country's social, cultural, and institutional setting, as well as the role of influence by the politic and economic institutions [5-7]. In other words, accounting is no longer considered as a neutral device that merely captures and reports the facts of economic activity [8]. From these literatures, it is expected that the standardization process of financial reporting in Islamic nations will be influenced by the active role of those steering the direction of the economy, especially those who believe that the neoliberal economic model is the way forward for the country.

The analysis focuses on how the adoption of IFRS has proceeded and who are the main actors involved in supervising the standardization of IIFIs financial reporting, as well as how the IIFIs positioned themselves against this ongoing process. Notably, IFRS remains the only international standard that is globally recognized and offers a consistent and comparable accounting framework. It is accepted in more than 120 jurisdictions and yet has no single uniform financial reporting standard adopted by IFIs. More and more IFIs in other parts of the world have adopted or plan to adopt IFRS [9] (see study conducted by ACCA[1]).

LITERATURE REVIEW

Islamic finance is a nascent industry compared to the conventional financial industry;

[1] ACCA based in the UK conducted a study in 2009 taking several countries with remarkable performance of Islamic banks in the world as proxies such as Bahrain, Indonesia, Kuwait, Malaysia, Pakistan, Qatar, Saudi Arabia, UAE and the UK. The report reveals that countries in this study, which adopt IFRS in their financial reports, are currently facing problems of inconsistencies due to unique transactions in Islamic banking that are not properly treated. ACCA suggests solutions on how the IFIs should deal with IFRS i.e. adopting IFRS with additional standards specifically to disclose Islamic financial transactions or setting up an Islamic accounting standard based on IFRS but would include specific recognition, measurement, presentation and other disclosure requirements.

therefore there are numerous challenges and opportunities connected to its future development. This study is focused only on the challenges and prospects that are important for the establishment and future growth of Islamic finance in the western world through Islamic leading organizations. As Islamic financial industry tries to achieve a stronger foothold in the western world both with the capital and money markets, the focus of this study is on Islamic finance industry as a whole and not on a particular market. However, it should be noted that there are vast numbers and types of products provided by Islamic financial institutions in the Muslim countries, as in the conventional system. But due to the size and limit of this study, the researcher focused only on those products which have the direct interest of investors and have potential for growth in the western world in near future. As Ball [10] states a new investigation often start with qualitative studies exploring new phenomena. Although Islamic finance is not a new phenomenon in itself, the aim of this study which looks for a new perspective on this matter have not been studied thoroughly yet, which makes the chosen research approach the most appropriate. “Islamic insurance, or Takaful, differs from commercial insurance in that it is a cooperative form of insurance, though the actual business operations may be left to commercial firms, who act as managers, or agents, with the policy holders as their principal [11].

Paying Zakat is an obligatory duty for every adult Muslim, whose wealth exceeds a certain threshold [12]. IFSB [13] defines as an agreement to sell to a customer a non-existent asset, which is to be manufactured or built according to the buyer’s specifications and is to be delivered on a specified future date at a predetermined selling price. The concept of Islamic finance has existed since the emergence of Islam. However, it was not as developed and systematic as today before late 1970s. The main idea of Islamic finance is perhaps best described by Iqbal [1].

According to Iqbal et al. [14] the governance model in the Islamic economic system is a stakeholder-oriented model whereby governance structure and process at both the system and the firm levels protect the rights of all stakeholders who are exposed to any risk as a result of the firm’s activities. But Islamic economists and scholars are divided into three groups concerned with which corporate governance approach is best for the future growth of IFIs. The first group is proponents of the European model arguing that the essence of the Islamic corporate governance necessarily has a wide commission, with obligations extending beyond shareholders and embracing financiers, employees, and customers as European approach does [15].

OPPORTUNITIES AND CHALLENGES OF IFIS

Therefore, both AAOIFI and IFSB, together with other national regulatory institutions, pursue and work on common regulatory policies to upgrade IFIs’ corporate governance regime to international standards. They have issued several regulatory guidelines and codes of corporate governance [16,17]. Therefore, it is of high importance that Shariah boards assist these regulatory and standard setting organizations in establishing and maintaining a good governance practice among IFIs. A study conducted by Vinnicombe

[18] in Bahrain showed high levels of compliance with AAOIFI standards in some areas and relatively low levels in other areas by IFIs. The relatively low levels of compliance are related to the Mudarabah and Zakat which are part of the agency problem of IFIs.

Khan et al. [19] state that operational risk in IFIs is relatively higher and more serious than credit risk and market risk. They believe it is because of new nature of Islamic banking and a lot of the issues related to the operations are not instituted. These issues include the legal risk involved in contracts, the understanding of the modes of financing by employees, producing computer programs and legal documents for different instruments, etc. Furthermore, they argue that; “Operational risk in this respect particularly arises as the banks may not have enough qualified professionals (capacity and capability) to conduct the Islamic financial operations. Given the different nature of business, the computer software available in the market for conventional banks may not be appropriate for Islamic banks. This gives rise to system risks of developing and using informational technologies in Islamic banks.”

IFIs must set up a sound internal training system that professionally trains employees in identifying and dealing with operational risks. Effective management of operational risk in IFIs in the western countries needs extremely skilled employees, with both conventional and Islamic banking background. These employees must be trained in administrating and conducting Islamic financial operations professionally, especially the profit and loss modes identified by IMF as one of the most important issues in dealing with operational risk. The assessment of this risk is a difficult task and unique for IFIs. After the global financial crisis international regulatory authorities have focused much on the enhancement of the operational risk management practices. The Basel Committee on Banking Supervision has lately specified, in its regulatory standard, requirements that safeguard financial institutions against operational risk. To fulfill the requirements of the Shariah as well as the Basel III, it is necessary to create a large pool of highly qualified professionals and experts with in-depth knowledge of not only the Shariah and its objectives, but also dual financial systems [20,21]. Hassan et al. [22] argue that financial services regulators and central banks cannot take on the responsibilities for Shariah compliance, but they should ensure proper procedures for ensuring compliance are in place.

IFIs suffer from application of such rules and regulations well fitted to CFIs and require tailor made regulation for their unique products. Organizations like AAOIFI and IFSB are developing a range of prudential and regulatory standards to solve this problem, in cooperation with leading western countries like Luxembourg and UK. Islamic finance enjoys the support of the Luxembourg Government, which set up a special Task Force in 2008 to identify obstacles for the development of Islamic finance and how to remove them[2]. The Central Bank of Luxembourg is the only member of the IFSB from European Union (EU) and the central bank of Luxembourg is a founder member of the newly established IILM. There are currently 22 banks in the UK, in which 5 are stand-alone

[2] http://www.lff.lu/products-services/islamic-finance/ accessed on 3/9-2011

Shariah-compliant banks, who are offering Islamic finance products, exceeding that of any other Western country[3]. As Parker [23] states; “The irony is that the UK has more enabling legislation to facilitate Islamic financial products and institutions than most Islamic countries”.

ISLAMIC LEADING ORGANIZATIONS

Shariah boards

It should be stressed that Shariah board is not a standard setting body in itself, but assist other regulatory and standard setting organizations in establishing and maintaining a good governance practice among IFIs. Shariah board is a committee of Islamic scholars whose job is to verify if the new products presented by IFIs comply with Shariah. These scholars’ functions are similar to members of boards in conventional corporations, i.e. they are not employed by IFIs but receive honoraria, and they have the right to be members of Shariah boards in different IFIs simultaneously. Although the numbers of such scholars are growing, they still lag behind the growth of the industry need. The first ever Shariah board was established by Egypt’s Faisal Islamic Bank in 1976 and soon other IFIs followed this example. Today Shariah boards of IFIs are required by law in majority of Islamic countries, and even if it is not required by law, Shariah boards have become an important part of IFIs. However, lately Shariah boards have been criticized by many economists for being a part of corporate governance or agency theory problems in IFIs because of conflict of interests. To tackle these kinds of problems Malaysia as the first country in the world has regulated scholars to be member of the Shariah board of maximum three IFIs simultaneously.

AAOIFI standards have defined Shariah boards’ duty as directing, reviewing and supervising the activities of the IFIs in order to ensure that they are in compliance with Shariah principles. AAOIFI standards have also made it mandatory for all IFIs to elect their Shariah board members through the shareholders annual general meeting upon the recommendation of the board of directors, taking into consideration local legislation and regulations. Furthermore it states that these members should not be chosen among directors and majority shareholders of the IFIs [24].

AAOIFI

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is an Islamic international autonomous non-profit making corporate body that prepares accounting, auditing, governance, ethics and Shariah standards for Islamic financial institutions. It was established in accordance with the Agreement of Association which was signed by Islamic financial institutions on 26 February 1990 in Algiers [25]. The AAOIFI has a two-tiered organizational structure in order to separate the standard-setting function from financing the organization, so that the standard setters are not

[3] http://arabnews.com/economy/islamicfinance/article448955.ece?service=print accessed on 5/9-2011

subject to a conflict of interest. Shahzad et al. [26] explain that IFIs are not obliged to adapt AAOIFIs standards and guidelines. However, regulatory and supervisory authorities around the world are increasingly relying upon them and align their standards according to it. For example many Shariah boards consist of at least three scholars who have a comprehensive financial expertise and education in legal questions according to AAOIFI standards. The AAOIFI provides guidelines for IFIs, if they face difficulties in interpretations, or understanding of issues related to new financial products. So far the AAOIFI has issued 25 standards in accounting, 5 in auditing, 7 in corporate governance and 2 codes of ethics [27]. The AAOIFI is focusing on the auditing and accounting side, where processes and transactions need to be handled differently from conventional banking practice.

IFSB

To ensure the sound and stable development of the Islamic financial industry, it needs to be supported by a strong regulatory and supervisory framework. To fulfill this requirement, the Islamic Financial Services Board (IFSB) was established in 2002. The IFSB is an international body hosted by Malaysia. It has the important mandate of developing the prudential standards in accordance with the unique features of the Islamic financial institution [25]. IFSB was established under the sponsorship of the International Monetary Fund and in close cooperation with IMF and Basel Committee on Banking Supervision, which has become one of the most influential international organizations that promote Islamic finance and its standards. IFSB tries to adapt the existing standards and guidelines of the mentioned organizations and adjusts them in accordance with the Shariah principles to IFIs. The IFSB's focus is very much on the standardization of procedures and the way Shariah rulings are interpreted across the industry. Since its establishment the IFSB has issued 17 standards, guiding principles and technical notes in the areas of risk management, corporate governance, transparency and market discipline, and etc. IFSB is closely cooperating with the Basel Committee on Banking Supervision, International Organization for Securities Commissions and the International Association of Insurance Supervisors [28].

IIRA

The Islamic International Rating Agency (IIRA) started operations in July 2005 to facilitate development of the regional and national financial markets by delineating relative investment or credit risk, providing an assessment of the risk profile of entities and instruments. This should be an integral part of the decision process employed by institutional investors[4]. IIRA assists the Islamic financial services industry to gain recognition locally and internationally as strong and capable financial institutions, adhering to greater standards of disclosure and transparency. Its mission is to support

[4] http://www.iirating.com/about_profile.asp accessed on 12/6-2011

the development of the regional capital market and to improve its functioning. IIRA has become an alternative to the international rating agencies and it aims to become a reference on which investors and financiers can rely to achieve "Quality" in terms of compliance with the related Shariah rules and principles for Islamic financial services. IIRA is a profit making body and it works like its conventional counterparts, charging a set fee per piece of work.

IIFM

International Islamic Financial Market (IIFM) is the global standardization body for the Islamic Capital & Money Market segment of the IFIs. Its primary focus lies in the standardization of Islamic financial products, documentation and related processes[5].

The Agreement to establish the IIFM was signed in November 2001 by the Governors of the Central banks /Monetary Agencies Malaysia, Bahrain, Indonesia, Sudan, and the President of the Islamic Development Bank. It began its operation in 2002. Its main objectives are:

1. To spur the establishment and development of an international financial market based on Shariah rules and principles
2. Addressing the issue of liquidity management in IFIs
3. Developing an active secondary market, and
4. Creating the environment that will encourage both Islamic and non-Islamic financial institutions to actively participate in a secondary market and the information of new traceable instructions.

IIFM will also act as the focal point for the harmonization of Shariah interpretations in the global financial market and enhance the cooperative framework among IFIs globally. In September 2006 the IIFM signed a Memorandum of Understanding with the International Swaps and Derivatives Association (ISDA), with an eye to developing a master agreement for documenting privately negotiated Shariah-compliant derivatives transactions. In March 2010 the ISDA/IIFM Tahawwut master agreement was launched. It is a completely new framework document though the structure of the document is similar to the conventional ISDA Master Agreement. However, the key mechanisms and provisioning such as early termination events, closeout and netting are developed based on the Islamic Shari'ah principles[6].

IILM

The International Islamic Liquidity Management Corporation (IILM) is a collaborative effort by 11 central banks or monetary agencies from countries such as Malaysia, Indonesia, Iran, Luxembourg and the United Arab Emirates, as well as two multilateral

[5] http://www.iifm.net/default.asp?action=article&id=126 accessed on 15/6-2011
[6] http://www.isda.org/media/press/2010/press030110.html accessed on 15/6-2011

organizations to assist institutions offering Islamic financial services in addressing their liquidity management. The IILM has been established to assist institutions offering Islamic financial services in addressing their liquidity management issues in an efficient and effective manner. This institution addresses one of the fundamental problems of Islamic financial institutions: the provision of adequate liquidity in times of stress. The IILM is expected to issue high quality, triple A-rated liquid, tradable and low risk Shariah-compliant financial instruments at both the national level and across borders, to enhance the soundness and stability of the Islamic financial markets. The instruments of the IILM will be utilized in liquidity management as eligible collateral for interbank transactions and central bank financing, or through trading of IILM instruments (either within the same country or cross border) in the secondary market. As the IILM is intended to facilitate cross-border liquidity management, its instruments shall be denominated in major reserve currencies such as the US dollar and the euro. This is to ensure access to a large pool of global investors and broaden the range of its holders, thereby enhancing the prospects for active secondary market. If the assets can be traded through the IILM, then much fewer of these assets will be held by the institutions.

CONCLUSION

As Islamic financial industry tries to achieve a stronger foothold in the western world both with the capital and money markets, the focus of this study is on Islamic finance industry as a whole and not on a particular market. The analysis focuses on how the adoption of IFRS has proceeded and who are the main actors involved in supervising the standardization of IIFIs financial reporting, as well as how the IIFIs positioned themselves against this ongoing process. There are currently 22 banks in the UK, in which 5 are stand-alone Shariah-compliant banks, who are offering Islamic finance products, exceeding that of any other Western country. Therefore, both AAOIFI and IFSB, together with other national regulatory institutions, pursue and work on common regulatory policies to upgrade IFIs' corporate governance regime to international standards. They both stress the need for more specific governance practices for IFIs and working on guiding principles intended to help IFIs establish and improve their corporate governance frameworks and assist regulators in assessing such frameworks. Almost all of these regulatory guidelines however have a non-prescriptive approach.

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