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Global Regulatory Reforms and their impact on the Islamic Banking Industry

Introduction

Research from KPMG (2014) indicates that the overall regulatory pressure index is slightly higher in 2014 than the previous years. The continuing emergence of new regulatory initiatives, such as leverage, structural separation, localised supervision and capital requirement gives new wave to regulatory reforms. In 2011, the global pressure index was 33.7, which then increased to 36.7 in 2013 and up to 37.3 in 2014 (KPMG, 2014). These regulatory reforms have made some impact on global financial sector, which also includes the Islamic banking sector. The aim of some of these regulatory policy reforms is to emphasise on granting protection to customers.

Markets in Financial Instruments Directive (MiFID 2), which was introduced in Europe, comes at a time when there is fundamental changes sweeping the financial services industry. The failure of Lehman Brothers in 2008, and the financial crisis that ensued, has highlighted some of the shortcomings in financial markets that needed to be addressed. Hence, the aim of MiFID 2 is to reduce systemic risk and strengthen financial stability by ensuring maximum transparency in markets and ensure robust levels of protection for investors.

The United States of America introduced the Dodd Frank Act, which was passed by US Congress in 2010, that led to the establishment of the Consumer Financial Protection Bureau (CFPB or Bureau) as an independent agency within the Board of Governors of the Federal Reserve System. The Bureau regulates the offering and provision of the consumer financial products and services under federal consumer financial laws. Among the duties entrusted to the Bureau is to ensure that the federal consumer financial laws are enforced consistently, hence, providing consumers access to markets for financial products, and also ensuring that these markets are fair, transparent and competitive. The Bureau has the authority to administer, enforce, and otherwise implement federal consumer financial laws, which includes the power to create rules, issue orders, and issue guidance when necessary. The Financial Stability Oversight Council (FSOC) has the power to set aside any of the Bureau's regulations if the FSOC decides that such regulation could jeopardize the safety and soundness of the banking system, or the stability of the financial system of the United States of America (Wex Legal Dictionary and Encyclopedia). The Volcker Rule, which was added under the Act, prohibits a banking entity from engaging in proprietary trading, similar to the Glass-Steagall Act. Proprietary trading is defined as "engaging as a principal for the trading account of the banking entity or nonbank financial company supervised by the Board in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule as provided in subsection (b)(2), determine" (U.S. Code). Thus, compliance with the Rule by a banking entity depends on whether the account for which the trade is placed satisfies within the definition of "trading account" or whether the trade involves a "financial instrument".

The Swiss Financial Services Act (FFSA) sets new standards for customer protection in financial services in Switzerland. On 27th June 2014, the Swiss Federal Council launched the consultation on the Federal Financial Services Act (FFSA), expected to come in force in 2017. The Financial Conduct Authority in the United Kingdom, also drafted the "Treating Customers Fairly" (TCF) Program to better serve the need and interest of customers for fair treatment. These, and many other, newly drafted laws focus on strengthening customer's protection. Hence, these rules are drafted to govern the relationship between financial intermediaries and their clients while taking into consideration the complexity and pre-existing knowledge that consumers have when buying financial products. However, would these changes have much effect on the Islamic banking industry?

Impact on Islamic Banking

These changes are relevant to Islamic banking, being that it involves in a lot of transaction where the bank acts as a principal, such as in Commodity murabahah transactions, murabahah transactions, and other Islamic exchange transactions. However, Islamic banking could be categorized as an exception to the Volcker Rule, since the Rule does not apply to certain types of trading activities that do not involve short-term trading; for example trade pursuant to repurchase, reverse repurchase agreements or any trade in which the banking entity lends or borrows securities temporarily under an agreement pursuant to which the lender retains the economic interest in the securities, and has the right to recall the loaned securities. The Volcker Rule applies to the US operations of foreign banks, but the proposed regulations would extend its reach far beyond the shores of the US, hence, applying the Rule to the global activities of foreign banks, even banks with small branches in the US.

Notwithstanding, it appears that the proposed regulations would require trading desks in foreign countries to report detailed information about their activities directly to the US regulators, therefore, completely bypassing their local regulators. Moreover, the Volcker rule by statute exempts trading in obligations of the US government – yet, there is no parallel exemption for trading in foreign sovereign bonds. The failure of such regulatory to provide exemption clauses for certain types of trades has attracted considerable and justifiable concern from foreign governments and their respected central bank authorities, which might also receive similar criticism from Islamic financial institutions. These reforms might be contrary to the established Islamic Finance regulatory framework that is already formed in certain Muslim countries. This paper will on give a brief overlook at three main Muslim countries, namely Malaysia, Indonesia, Nigeria, with an Islamic Finance regulatory framework.

Malaysia Islamic Finance Regulatory Framework

Malaysia has introduced the Islamic Financial Services Act (IFSA) 2013 and the Financial Services Act (FSA) 2013 to cater to both the Islamic and conventional finance industry. Interestingly, IFSA 2013 makes breach of Shariah tantamount to breach of law. IFSA introduces a new scheme of Financial Ombudsman scheme which will be subscribed to by all members. As of to date, there are no terms of reference or standard issued on how the scheme should be operated as part of the alternative dispute resolution (ADR) complement to the court system. The establishment of an Ombudsman scheme or institution is not a new phenomenon. There are currently few ombudsman schemes globally, such as those covering financial services sectors, e.g. the Italian Banking Ombudsman scheme, the German Insurance Ombudsman, the French Ombudsman of the Authority of Financial Markets, the UK Financial Ombudsman Service, the Consumer Complaints Manager of the Malta Financial Services Authority and the Dutch Financial Services Complaints Institute or those handle consumer complaints in general, e.g. the Swedish National Board for Consumer Complaints and the Lithuanian State Consumer Protection Authority.

Indonesia Islamic Finance Regulatory Framework

After numerous debates for an Islamic financial institutional framework, Indonesia introduced Law 21/2008, which was enacted in 2008. Ever since that the Indonesian Islamic Scholars Council (MUI) has been responsible to supervise the aspects of Shariah compliance. MUI is a non-governmental organization that has been mandated by the Indonesian government with the aspect of Islamic religion through the provision of Law No. 21/2008 on Shariah Banking. This new and revised law consist of 13 chapters and 70 sections. Section 1(7) of the Act defines "Shariah bank" as the bank that implements their banking business in accordance with Shariah. However, the full extent to how these global regulatory reforms might affect the Indonesian Islamic banking industry has yet to emerge. As of September 2014, there were

11 full-fledged Islamic banks and 23 Islamic business units in Indonesia with combined assets of 244 trillion rupiah ($20.1 billion), representing a 7.2 percent growth year-on-year (Reuters). Hence, any drastic change in the global market might have an effect on the newly emerging Islamic market.

Nigeria Islamic Finance Regulatory Framework

In Nigeria, The Central Bank of Nigeria Act (CBN) 2007 was enacted by the National Assembly of the Federal Republic of Nigeria. This new Act which came into enforcement on 25th of May 2007 repealed the Central Bank of Nigeria Act 1991. By the power given under section 33(b), the Central Bank issued Guidelines on Shariah governance for non-interest financial institutions in Nigeria. This guideline has given a clear mandate for the establishment of Shariah Advisory Council. Consequently, all non-interest banks and other financial institutions under the purview of the Central Bank of Nigeria (CBN), herein designated as Non-Interest Financial Institutions (NIFIs) in Nigeria are required to establish a Shariah advisory body as part of their governance structure to be known as "Shariah Advisory Committee" (SAC). In recognition of the foregoing, the CBN has developed the following guidelines for the appointment, duties and responsibilities of the Shariah advisory committees of NIFIs. Hence, to effectively play its role, the SAC shall operate as an independent body, with the principles of competence, confidentiality and consistency properly enshrined in its operations. It is expected that an independent SAC will command public confidence, thereby promoting the growth and development of the industry. The objectives of the guidelines are as follows:

i. To set rules, regulations and procedures in the establishment of a Shariah Advisory Committee of a NIFI;

ii.to define the role, scope of duties and responsibilities of the Committee and its members;

iii. to outline the functions relating to Shariah review and audit processes; and

iv.to define the relationship and working arrangement between the Committee and CBN Shariah Council (CSC).

An offence or breach of the rules or guidelines issued by CBN is punishable on conviction by imprisonment not exceeding three years or with a fine not exceeding N10,000,000 (est. USD56,000) or both for every false information. Also the offender could be imprisoned or given a fine not exceeding N2,000,000 (est. USD12,000) for failure to comply with the requirements of the Bank. Both Acts establishes Financial Ombudsman Scheme for handling dispute in conventional as well as Islamic finance.

Conclusion

These global reforms, although meant to better suit the protection of customers under the investor protection law, consumer laws and other banking regulations, however, such changes will affect the way banks operate, including Islamic banks. Being that although these changes are not meant directly toward Islamic banks per se, but the inter-connection between banks globally would require some changes in various banking laws to ensure universality among institutions. The new policies will require banks to reconsider the current practices to ensure that they comply with the proposed requirements. In particular, changes to the way in which banks may provide transparent investment advice, advice investors and report breaches. The main concern in these regulatory changes is the manner in which a bank may conduct business. By prohibiting proprietary trading, which might be possible for conventional banks that generate profit from mere lending based on interest; this will be unrealistic for Islamic banks that function on the basis of mutual trade.