

Islamic Financial Architecture: Key Components and Framework

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Agenda

- Financial Architecture—Introduction
- Components of Islamic Financial Architecture
 - Legal Infrastructure
 - Regulation and Supervision Framework
 - *Shariah* Governance Framework
 - Liquidity Infrastructure
 - Information Infrastructure and Transparency
 - Consumer Protection Architecture
 - Human Capital & Knowledge Development Framework

Introduction

- Financial Architecture first discussed after the Asian financial crisis of late 1990s
- International Financial Architecture (IFA) launched with two key goals
 - Crisis prevention
 - Crisis mitigation and resolution
- Key features and tools used by World Bank/IMF to assess IFA
 - Financial Sector Assessment program (FSAP)—identify the strength and weaknesses of the financial sector
 - Reports of Standards and Codes (ROSC)—assess the compliance of national architectural institutions with 12 international standards

Post-GFC Developments

- After the GFC, the FSAP program was reviewed
- For emerging and developing economies, FSAP had two key components
 - Assessing financial stability
 - Soundness of banks, quality of supervision, financial safety-nets, etc.
 - Assessing financial development
 - Quality of legal framework and financial infrastructure

Pillars of Financial Architecture

WB/IMF identifies three key pillars of the financial architecture

- Pillar I: Macro-prudential surveillance and financial stability analysis
- Pillar II: Sound financial system supervision and regulation
- Pillar III: Financial system infrastructure
 - Legal infrastructure for finance; systemic liquidity infrastructure; transparency and information infrastructure; payments and securities settlement systems; creditors' rights; incentives for strong risk management and good governance; credit reporting systems; etc.

Financial Architecture for Islamic Finance

- Some elements of IFA are neutral and apply to both conventional and Islamic finance
 - Effective market discipline, well-regulated payments and clearing systems, credit reporting systems, etc.
- Certain unique financial architectural features are needed for Islamic finance
 - Legal Infrastructure
 - Regulation and Supervision Framework
 - *Shariah* Governance Framework
 - Liquidity Infrastructure
 - Information Infrastructure and Transparency
 - Consumer Protection Architecture
 - Human Capital & Knowledge Development Framework

1. Legal Infrastructure

- Financial Laws—provide legal basis for Islamic finance
 - Islamic banking, takaful and capital market laws
- Tax laws—to level the playing field
 - Adjust tax laws related to income (profit, withholding), transactions (capital gains and stamp duties), goods & services (value-added tax)
- Dispute Settlement framework
 - Most courts in OIC Member countries use civil law or common law framework
 - Accommodation for disputes related to Islamic finance
- Bankruptcy and Resolution of Islamic banks

2. Regulations and Supervision Framework

- *Shariah* compliance changes the nature of transactions and risks in financial transactions
- Need for regulatory/supervisory framework to deal with different types of risks in Islamic finance
- Regulatory standards—IFSB responsible for developing regulatory guidelines for Islamic banks, *takaful* and capital markets
- Implementation—departments/units in regulatory bodies to deal with Islamic finance

3. *Shariah* Governance Framework

- *Shariah* compliance key to Islamic finance—many customers deal with Islamic finance due to religious convictions
- Need for a robust *Shariah* governance regime—IFSB *Shariah* governance Guidelines provides a framework
- Two levels
 - National level framework (Central *Shariah* Authority, harmonization of *Shariah* interpretations, ensure compliance with *Shariah* principles, etc.)
 - Provide framework to strengthen the *Shariah* governance structures at the organizational level (Terms of reference for SSB at bank level, roles and duties of SSB, etc.)

4. Liquidity Infrastructure

- Arrangements to mitigate liquidity risks key to financial sector operations
- Liquidity requirements has become a key regulatory instrument under Basel III (LCR and NSFR)
- Elements for Liquidity Infrastructure for Islamic Finance
 - *Shariah* compliant liquidity instruments
 - Islamic money markets
 - *Shariah* compliant lender of the last resort facilities

5. Information Infrastructure & Transparency

- Information infrastructure and transparency key for effective market discipline
 - Information on financial institutions to stakeholders (such as investors, depositors, etc.)
 - Information on credit-worthiness of clients
- Accounting and Auditing framework—some accounting requirements of Islamic finance are not covered by international accounting standards
 - AAOIFI standards provide better representation of Islamic financial transactions
- Credit Reporting Systems and Rating Agencies
 - Credit Rating Agencies: provide the credit ratings corporations and securities (sukuk)
 - IIRA conducts *Shariah* rating of Islamic financial institutions

6. Consumer Protection Architecture

- Consumer Protection—has gained importance after GFC (fair treatment of consumers)
- Specific consumer protection issues arise in Islamic finance
 - Rights and obligations of PSIA, *Shariah* compliance
- Financial Literacy—a key instrument of consumer empowerment on the demand side
 - Islamic financial transactions are new and complex--need for financial education and awareness schemes
- Deposit Insurance—to protect depositors in case of bank closures
 - Need for *Shariah* compliant deposit insurance schemes

7. Human Capital & Knowledge Development

- Good quality of human capital with the right knowledge and skills key to development of Islamic financial sector
- Need for
 - Provision of education and training in Islamic finance
 - Research and development to create new knowledge needed for development of *Shariah* based Islamic finance industry
 - Knowledge & Skills on Islamic financial architecture at different levels

QUESTIONS?

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