

Recent developments in Islamic finance regulation and outlook

Due to the significant regulation of the finance industry, development in the regulatory frameworks governing it is a key factor in the success or failure of the industry. While more liberal regulatory regimes may pose opportunities for short-term growth and high-risk investors, dedicated and effective regulation typically builds trust and fosters long-term progression. This is true to both the conventional industry as well as the Islamic finance industry. Thus, DR NICOLAS BREMER opines that regulatory developments and legal reforms have and continue to play a key part in the development of the Islamic finance industry.



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Over the last year, secondary Islamic finance markets have taken significant steps to develop the Islamic banking sector by adopting specific Islamic finance and banking legislation. In 2015, the Moroccan central bank began to approve on a case-by-case basis Islamic banking activities of conventional banks. However, due to a lack of specific Islamic financing principles and the resulting regulatory ambiguity, the market share of Islamic banking remained insignificant. As a response, the Moroccan central bank – Bank Al Maghrib – sought to formalize the legislative regime for Islamic banking in the country by issuing the regulatory framework for ‘participation banking’. The regulatory framework established by Bank Al Maghrib allows for five Islamic finance models: Murabahah, Musharakah, Ijarah, Mudarabah and Salam.

Similarly, Lebanon has developed a dual approach to banking that provides separate regulatory frameworks for Islamic and conventional banks. However, despite a relatively complex regulatory framework and the recent adjustments to it, Islamic banks still operate in an environment dominated by conventional banking. The most recent regulatory reforms of Banque du Liban – the Lebanese central bank – were aimed at increasing transparency in the Islamic banking sector and providing Islamic banks with the means to better meet their liabilities. In particular, provisions differentiating between restricted and unrestricted investment accounts in the context of a Murabahah or Mudarabah have been repealed.

Furthermore, Indonesia, Pakistan and Bangladesh have managed to expand their share of Shariah compliant banking assets due to ongoing regulatory developments aimed at formalizing their Islamic banking regimes and increasing transparency in the sector.

Finally, with the Bank of Uganda releasing the Financial Institutions (Islamic Banking) Regulations, we have seen further development of the Islamic banking sector in sub-Saharan Africa. The Bank of Uganda has taken a single regulatory approach for both conventional banks and those offering Islamic banking products. Thus, financial institutions engaged in Islamic banking are subject to the same rules and regulations governing capitalization, corporate governance, compliance, liquidity and ownership and control.

As a general investment trend, profit and loss-sharing through recovery and resolution implementation has become more common. While this is a key feature of Islamic finance, the Islamic banking industry has thus far been struggling to profit from this trend. Regulatory reforms aimed at increasing flexibility and transparency in the sector may serve as a means to change this issue and allow Islamic finance to raise its attractiveness. In particular, the industry offers attractive solutions due to its flexibility: transactions can be modeled to generally mirror conventional finance while Islamic finance can offer pure profit and loss-sharing models.

Moreover, further standardization of regulatory regimes and legal documentation may foster further growth of the Islamic finance industry. In 2017, the market saw a substantial increase of Sukuk issuance. Due to a lack of specific regulatory guidance, this spike in Sukuk issuance led to a plurality of legal documentation, which had negative implications for investor trust. Investors



are generally weary of uncertainty they cannot quantify. Therefore, standardization of legal documentation and interpretation of Shariah principles may serve as an effective means to increase the attractiveness of the Islamic finance industry and Shariah compliant investments.

In addition, fintech may have positive implications for the Islamic finance industry. Fintech businesses may, as potential disruptors, pose a threat to some business lines such as money transfers. Still, fintech can also offer new opportunities, facilitate growth and enhance the security of transactions in the Islamic finance industry. Blockchain technology can help banks to conduct their business in a more secure manner and crowdfunding may offer financing opportunities to smaller or more risky ventures that may be regarded as less attractive by banks.

While we have seen positive trends in regulatory reforms, new technologies and demands of a growing industry pose challenges to the Islamic finance industry. Whether the sector will be able to harness new opportunities and continue to grow will, in no small part, depend on how the regulatory authorities are able to shape legal frameworks to address and anticipate the requirements of the market. ☺