IMF acknowledges Islamic banking's prolific growth

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THE International Monetary Fund (IMF), especially under its current managing director, Christine Lagarde, has been a proactive supporter of Islamic banking, and, together with the World Bank, has declared it a priority for its operations in countries with Islamic banking.

In a recent report titled "Ensuring Financial Stability in Countries with Islamic Banking", IMF economists have thrown down the gauntlet to its board with a plan of action that, if approved, would have game-changing implications for the regulation and development of the industry, thus further promoting its stability and soundness.

The report acknowledges the significant progress achieved in developing prudential standards for Islamic banking, but concludes that the current framework governing the global industry "contains many gaps that need to be closed through the development of a more comprehensive enabling environment that ensures the financial stability and sound development" of the industry.

Prudential standards for conventional banks generally apply to Islamic banks, but gaps exist, reflecting the specific features of Islamic banking and their associated risks. Prudential standards for Islamic banking have been developed to complement international standards, including, inter alia, on capital adequacy, "Core Principles of Islamic Finance Regulation for Banking (CPIFR)" and the supervisory process.

Particular attention needs to be paid to developing resolution, financial safety nets, such as deposit protection insurance and a lender of last resort, and (short-term) liquidity management frameworks for Islamic banks. Similarly, the emergence of complex hybrid Islamic financial institutions and products, according to IMF, is a regulatory challenge, with potential implications for financial stability.

The industry has seen prolific growth over the last three decades in size, complexity of products and services, and in demographic reach. Innovation usually drives financial regulation. But, this sheer growth has posed a challenge to regulators, especially in emerging markets, given their limited resources, lack of technical expertise and knowledge of Islamic banking principles, qualified personnel, and for socio-political reasons where the phenomenon is not a financial policy priority, but was introduced for financial inclusion reasons.

The outstanding exception is Malaysia, which the IMF, World Bank and the Basel Committee for Banking Supervision concur, has the most advanced and comprehensive legal, regulatory, supervisory and syariah governance frameworks in place in the world, supported by a proactive government public policy supporting the development of Islamic banking side-by-side a conventional one to give Malaysian consumers a choice not only on product preferences, but also on their faith traditions.

In the context of the global financial system, Islamic banking's estimated size of US$2.6 trillion (RM11.5 trillion) of assets under management accounts for a mere 1.9 per cent of total market share of global banking assets, which is miniscule by international standards, but which points to a huge potential for expansion, especially as the world is in search of alternative financial intermediation solutions to the capitalist system in the aftermath of the pernicious global financial crisis of 2008, the effects of which are still impacting the global economy and financial system.

Islamic banking is now offered in more than 60 countries on all continents, and, according to IMF, has become systemically important in 14 jurisdictions. This means it accounts for 15 per cent or more of the market share of the total banking sector. In some countries, this figure is 40 per cent, while in others, such as Malaysia, it is about 26 per cent. Putrajaya has the ambition of reaching a market size target of 30 per cent by 2020. The number of jurisdictions in which Islamic banking is becoming systemically important is set to increase to 20 in the immediate future as Organisation of Islamic Cooperation (OIC) countries seek new ways to raise funds for development and infrastructure spending.

The regulatory, prudential and supervisory regimes for Islamic banking in most OIC countries are a "work in progress". The specificities of Islamic banking, especially the nature of deposits and the difficulty in their insurability, collateral and the extra tier of syariah compliance, have given rise to risks that the IMF says are unique to the phenomenon.

Some industry experts disagree with IMF on the nature of deposits and capital adequacy requirements under the Basle III framework. They want a different consideration, especially in the reporting treatment of deposits and capital and their risk characteristics.

The Kuala Lumpur-based Islamic Financial Services Board (IFSB) has the mandate to set prudential and supervisory standards for the global industry. Since its inception, IFSB has issued 26 Standards, Guiding Principles and Technical Notes for the Islamic financial services industry. While IFSB's work has been highly commended, IMF notes that "further strengthening of the implementation and the consistent applications of these standards are needed, particularly, in jurisdictions where Islamic banking has become systemically important".

IMF surveillance of member countries includes the Article IV Consultations and the Financial Sector Action Plan, which assesses the strength and effectiveness of regulation and supervision of the banking, capital market and insurance sectors in a member country. Core Principles for various financial sectors have become a standard tool to guide regulators and supervisors in developing their regulatory regimes and practices. IFSB's CPIFR was specifically designed for the regulation and supervision of the Islamic financial services industry.

The IMF report proposes that the board formally recognise CPIFR as the international standard for the supervision and regulation of Islamic banks so that these standards can be formally used and assessed under the various IMF and World Bank surveillance and technical assistance programmes.

This is important in that it would give the first independent assessment of the supervision and regulation of Islamic banks. Malaysia, three years ago, was the first and only country that invited IMF to assess the supervision of its Islamic banking sector, albeit then under the core principles for conventional banks.

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