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REGULATORY FRAMEWORK FOR ISLAMIC FINANCE:
MALAYSIA'S INITIATIVE

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ABSTRACT

The role of regulation extends beyond ensuring stability and confidence in the financial system, as it is also a behavioral shaper of market players. The laws, standards and guidelines issued are instrumental in creating an incentive structure for market players to behave in certain ways. If well designed, these tools will induce appropriate behavior that is consistent with the social objective of systemic stability and equitable economic prosperity. In the case of Malaysia, the structure of the present regulatory and supervisory framework for Islamic banking serves a predominantly risk-transfer financial system, by virtue of its existence in a dual financial system. An advantage of adopting this approach is the attainment of international recognition for Malaysia's Islamic financial system as being governed by a sound regulatory and supervisory regime. This uniform approach, however, subjects the Islamic financial system to the fragility of the conventional system. Since the flaws of the conventional regulatory and supervisory regime have been proven, there is no guarantee that Islamic finance would be able to withstand the vagaries of future crises. Using incentive audit approach, this paper attempts to examine the efficacy of the evolving Malaysian regulatory and supervisory framework for Islamic banking, in preserving financial stability as well as supporting the growth of the financial system and real economy. The findings suggest that the present framework unintentionally misalign incentives and discourages Islamic banks from fully embracing risk sharing as the underlying principle for their financial instruments. The findings of this paper call for re-configuration of the regulatory/supervisory framework to better promote risk sharing.

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1. INTRODUCTION

The Islamic financial system in Malaysia has been regarded as one of the most comprehensive systems in the world. A financial system is deemed comprehensive when it has at the very minimum a fully functioning legal infrastructure, a robust regulatory/supervisory framework, enabling tax incentives, an effective dispute resolution infrastructure, diverse market players, efficient payment systems and sound ancillary services. Of these components, Malaysia's regulatory and supervisory framework for Islamic finance stands out as one of the best models currently available in the Islamic financial sphere.

The main concern however is the fact that the present laws and regulations, product design and development of the Islamic finance around the world tend to replicate those in the conventional system. The conventional framework which is based on risk transfer[2] has been criticized by many renowned scholars for its misaligned incentives (Haneef and Mirakhor, 2014; Admati and Hellwig, 2013; Sheng, 2009; Demirgüç-Kunt, 2009; Goodhart, 1998; Demirgüç-Kunt and Detragiache, 1997). Hence, continuing the tradition of mirroring the conventional regulatory framework would arguably be counter-productive to the growth trajectory of Islamic banking. On whether these regulations contribute to profitability, many have raised doubt. A recent IMF study on whether Basel compliance improves bank performance found that "the adoption of international capital standards and the Basel Core Principles for Effective Bank Supervision (BCP)… has no association with bank efficiency." (Ayadi et al, 2015).

Unlike conventional banking which predominantly operates on risk-transfer mode, the cornerstone of Islamic finance should be risk sharing[3]. This conundrum if left

[2] Risk transfer is defined as the shifting of risk from one party to another. Examples include the use of credit enhancements such as *Wa'ad*, collateral and guarantees as conditional requirements imposed on counterparties as part of the financial contracts. The main objective of these credit enhancements is to effectively shift the risks of one party to the counterparty with or without the knowledge of the latter. The rationale for the origination of credit enhancements is believed to have been motivated by the need to achieve the same effect of conventional products.

[3] Risk sharing is permissible and highly encouraged in Islam. Unlike risk transfer, risk sharing requires the contracting parties to mutually share the risk and the reward of a contract and that all parties do not violate the Islamic property rights principles. Property rights would be violated when the claim on a property is attained without commensurate work such as in the case of dishonesty, theft, bribery, interest and gambling.

unaddresed would inhibit Islamic finance from achieving its true potential. Optimally, Islamic finance proposes a financial intermediation that is more resilient and stable, contributing significantly to financial inclusion, poverty alleviation, and economic development and growth.[4]

Malaysia has in 2013 introduced a new Act (IFSA) with the intention to reconfigure the Islamic financial system from risk-transfer to risk-sharing[5] based. While this can be considered a significant paradigm shift, the question that arises is how effective the present regulatory and supervisory framework is in supporting this noble initiative. Multitude of studies have focused on the aspects of *Shari'ah*, market performance and product development, however very few studied the regulatory dimension of Islamic finance. In recognizing this scarcity, this paper attempts to contribute towards increasing the knowledge building blocks on the regulatory and supervisory aspects of Islamic banking. Malaysia's model is selected as the case study in view of its sophistication vis-à-vis other Islamic financial centers.

To this end, this paper attempts to evaluate the effectiveness of Malaysia's regulatory and supervisory framework in steering the development path of its Islamic financial system towards risk-sharing based. The focus is an in-depth analysis of the macroprudential regulation and policies issued to Islamic banking institutions in Malaysia during 1983-2014. In particular, the incentive structure of the Islamic Banking Act 1983 (IBA), Banking and Financial Institutions Act 1989 (BAFIA), Central Bank Act 2009 (CBA), Islamic Financial Services Act 2013 (IFSA) and relevant policy guidelines are closely examined to identify any perverse incentives incompatible with risk sharing. The rest of the paper proceeds with Section 2 on methodology, Section 3 on the evaluation of the regulatory and supervisory framework, and Section 4 concludes with policy implications.

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[4] Mirakhor, 2012, Shariah Compliant Macroeconomic Policy, 2nd ISRA Colloquium
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2. METHODOLOGY

The incentive audit approach was first introduced by Chai and Johnston (2000) in a study entitled "an incentive approach to identifying system vulnerabilities". It is qualitative in nature and focuses on the factors that influence economic behavior rather than a statistical based assessment. The method was subsequently used by Cihak et al (2013) who argued that misaligned incentives had played a major role in the 2007 global financial crisis (GFC). Regulatory and supervisory failures, problems with incentives of rating agencies, accounting practices and transparency were among the incentive breakdowns identified. This approach is useful in regulatory policy design/review as it offers a systematic way of identifying the intended and unintended incentives arising from the structures and policies set out by the regulator.

Using the same methodology, this study aspires to analyze the incentive structure of the Islamic banking regulations in Malaysia and their impact on the practices of Islamic banking. This is the first known attempt. The approach comprises a three-step analysis. Firstly, it starts with the 'high-level' assessment at broad country level comprising both Islamic and conventional financial systems. Next, it focuses just on the 'key elements' of regulatory environment surrounding Islamic banking. These two exercises use secondary data. The third step is the 'specific area-level' assessment using primary data. This entails a detailed analysis of the regulation and policy documents in order to gain insights on the underlying incentives therein.

3. ASSESSMENT OF REGULATION AND POLICIES

3.1 FINANCIAL INDUSTRY LEVEL

In order to evaluate the overall soundness of the regulatory system at the country level, the study refers to a secondary source - the "IMF Financial Stability Assessment Program (FSAP) 2013 Report: Malaysia" jointly prepared by the IMF and World Bank. The report focuses on three areas (i) soundness of a country's financial system, (ii) quality of supervision, and (iii) ability of supervisors, policymakers and financial safety nets to withstand and respond to crisis.[6]

[6] The assessment on Malaysia was conducted in April 2012 and the report was published in 2013. It provides a credible assessment as it is benchmarked against the Basel Core Principles for Effective Supervision (BCP). The assessment was considered rigorous as it was based on several sources: (i) self-assessment prepared by BNM; (ii) interview with BNM staff; (iii) review of laws, regulations and

Overall, the assessment on the financial industry level was positive. Malaysia has "a very well developed risk-focused regulatory and supervisory regime, consisting of a hands-on and comprehensive program of onsite supervision and extensive off-site macro and micro-surveillance that is well integrated with its on-site supervision". BNM supervisors were aptly facilitated by "a well-articulated set of risk management and internal control expectations, specified higher than international minimum capital requirements, a comprehensive liquidity risk framework, and effective coordination and information sharing with foreign supervisory authorities". A gap however was noted on the supervision and regulation of financial holding companies (FHC) i.e. absence of consolidated capital ratios, consolidated liquidity framework, and consolidated stress-testing for FHCs. This observation highlighted the heightened awareness of systemic risk created by 'too-big-too-fail' financial entities during the GFC.

On the soundness of the financial system, Malaysia has a well-developed infrastructure. This includes an effective legal framework based on a common law legal system, functioning alternative mechanisms[7] capable of resolving disputes and debts, financial reporting standards which comply with IFRS[8], internationally compliant payment systems[9], and reliable credit information services. On crisis management, the Central Bank of Malaysia Act 2009 (CBA) empowers BNM with

other documentation on the supervisory framework and the structure and development of Malaysia's financial industry; and (iv) meeting with individual banks, the banking association and an external auditor.

[7] Alternative dispute resolution mechanisms in Malaysia are the Kuala Lumpur Regional Centre of Arbitration (KLRCA) governed by the Arbitration Act 1952; Financial Mediation Bureau (FMB) whose decisions are binding on the financial institution but not on the customer; Corporate Debt Restructuring Committee (CDRC) providing negotiation platform for corporate borrowers and creditors; and Credit Counsel and Debt Management Agency providing consultancy to private individuals on personal debt management.

[8] Banks as public interest entities are subject to financial reporting standards set by the Malaysia Accounting Standards Board (MASB). Its standards comply with the IFRS both in content and implementation schedules. The accounts of the banks are required to be audited annually by approved auditors for which the reports and procedures are governed by the National Auditing Standards which comply with the International Standards on Auditing.

[9] Payment systems in Malaysia include a real time gross settlement system for interbank funds transfer known as RENTAS, a securities settlement system and a scriptless securities depository for all unlisted debt instruments.

adequate powers to avert or reduce risk to financial stability.[10] In managing liquidity shocks, BNM has the necessary tools to effectively contain institutional or market liquidity shocks from threatening systemic stability. Deposit insurance system is place since 2005 where the fee structure applies a differential premium system based on risk profiles and financial parameters of the member institutions.

Based on the above, it can be inferred that at the financial industry level, the regulatory and supervisory framework in Malaysia is at par with the internationally accepted banking framework.

3.2 ISLAMIC BANKING SECTORAL LEVEL

This section drills down specifically on the regulatory environment that governs Islamic banking practices in Malaysia, leveraging on the IMF FSAP evaluation on the regulatory/supervisory environment of Islamic banking. In the absence of a review tool, the IMF adopted the 2007 IFSB-5 standard[11], a risk-based approach to evaluate the supervisory review on Islamic financial institutions. It is worth noting that this standard follows closely the Basel II Pillar 2 on Supervisory Review.[12]

Being an active member of IFSB, Malaysia fully adopts IFSB-5 standard and hence a positive review by the IMF FSAP. The report (p.13) concluded that "regulatory framework for Islamic banks in Malaysia encompasses standards which are equally applicable to commercial or investment banks and standards which are modified or distinct to cater for risks specific to Islamic banking business". On the supervisory framework, the BNM supervisory approach on Islamic banking was regarded as state-of-the-art, having adopted the risk-based supervisory framework, the same one used for commercial banks but with an added *Shari'ah* compliance dimension. This is justifiable since Malaysia operates a dual financial system where each component is

[10] These include powers to reduce systemic risks that emanate from regulated or non-regulated entities, as well as to address institutional or market liquidity shocks.

[11] IFSB-5 "Guidance on key elements in the supervisory review process of institutions offering Islamic financial services (IIFS) [excluding Islamic insurance (Takaful) institutions and Islamic mutual funds]. It was superseded by IFSB-16 since March 2014 taking into account enhancements on Pillar 2 of Basel II by BCBS.

[12] The key elements of IFSB-5 are necessary conditions for effective supervision, regulatory capital requirements, risk management and corporate governance, related party transactions, transparency and market discipline as well as consolidated and home-host supervision.

appropriately equipped with full-fledged supporting mechanisms (legal and accounting systems, audit and payment system and public safety net).

What is perhaps lacking in the FSAP report is an assessment on the conduciveness of the regulatory environment in promoting risk sharing, which should be the capstone of Islamic finance. A justification would perhaps be because the IFSB-5 as the reference standard for Islamic banking regulators does not discuss risk-sharing banking nor does it provide a corresponding regulatory framework. An implication of this void has been that the macroprudential regulation and policies for Islamic banking tend to be biased towards risk transfer. The most probable cause of this void is perhaps the lack of study on the application of risk sharing in banking environment.

Having said that, in a setting where Islamic finance is operating in risk-transfer mode, Malaysia's regulatory framework can be regarded as one of the most advanced and comprehensive frameworks in the world today. However, a shortcoming of risk-transfer based regulatory framework is that it may not necessarily be able to shield the Islamic banking system from the vagaries of any financial disaster, particularly when its size has grown bigger in proportion to the conventional system. More importantly, as Islamic banking in Malaysia is transiting into risk-sharing system following the enforcement of IFSA, misaligned incentives in the rules and regulations need to be taken seriously. Without the appropriate regulatory reform, the growth trajectory of Islamic banking may not reach its full potential. To this end, the study closely examined the key legislations and macroprudential policy documents issued to Islamic banks.

3.3 REGULATORY POLICIES LEVEL

a) Islamic Banking Act 1983

The IBA provided BNM with the powers to supervise and regulate Islamic banks similar to the scope that it has over conventional banks. Back then in the absence of an Islamic banking regulatory model, the IBA content was kept brief focusing mainly on governance and micro-prudential aspects of a firm operating banking services. There were 60 clauses contained in a 51-page document, compared to IFSA that has 291 clauses in a 276-page document. Because of its brevity, some criticized the IBA

as being too broad and too vague. A case in point is Section 2 of IBA, which defines "Islamic banking business" as "banking business whose aims and operations do not involve any element, which is not approved by the Religion of Islam". Others argue that its broad scope gives ample room for Islamic banks to seek unique business models such as risk-sharing, socially responsible, or investment-based banking that would enable them to differentiate their products and services from those of traditional banks. In retrospect, the Act would have the potential to push Islamic banks to venture into risk-sharing practices at a much earlier stage. However, inadequate skills and understanding of the risk-sharing concept prevented the full potential of universal banking offered by IBA from being realized.

One key contribution of the IBA is the codification of *Shari'ah* governance. The Act required Islamic banks to establish the *Shari'ah* Supervisory Council (SSC) as the authority to ensure compliance of *Shari'ah*. The first of such installation was in Bank Islam Malaysia Berhad, which was then the only Islamic bank in the country. This requirement is considered groundbreaking as it sets the path to clearly define the structure, role and responsibilities of *Shari'ah* governance. When the number of Islamic banking institutions grew, the function of the SSC was transferred to BNM with its stature elevated to be the sole source of *Shari'ah* interpretation for all Islamic financial institutions, including *Takaful* operators. This move ensured uniformity in interpretation and avoided the need to coordinate and reconcile differing views by various *Shari'ah* supervisory councils. The name was subsequently changed to the *Shari'ah* Advisory Council (SAC).

In terms of incentive structure, the IBA contains three misaligned incentives applicable to Islamic banking operating in a fractional reserve system.

Table 1: Perverse incentives in the IBA 1983

Clause	Remarks
1. S14 maintenance of capital funds 2. S15 maintenance of reserve funds 3. S16 percentage of liquid assets	These policies are adopted from best regulatory/supervisory practices, imposed to address the risk of unexpected events such as unpredictable deposit withdrawals or unpaid credits inherent in fractional reserve system (risk-transfer system). The maturity gap funding widely practiced in

	typical banking business model contributes to the likelihood of such risks to occur. Based on this paradigm, creating such buffers is deemed necessary.

Source: IBA 1983

b) Banking and Financial Institutions Act 1989

The BAFIA was the law for BNM to regulate and supervise conventional banks repealing the Finance Companies Act 1969 and the Banking Act 1973. Its relevance to Islamic banking is in Section 124 of the Act, which provides the legal provision for conventional banks to carry out Islamic banking business, through Islamic windows. To streamline Islamic banking practices between banks licensed by IBA and BAFIA, the conventional banks are also required to establish a *Shari'ah* Committee whose role is to advise the management on *Shari'ah* rulings pertaining Islamic banking business. In terms of financial requirements, IBA and BAFIA required banks to maintain capital funds, reserve funds and liquid assets. These exemplify the perverse incentives emanating from risk-transfer biased regulatory regime.

In terms of clarity, some argued that BAFIA provided better guidance than IBA. A specific example is the broad definition of Islamic banking business as defined by the IBA as any banking business that does not contravene Islam, whereas BAFIA provided a clear-cut definition on what a bank can do. The "banking business" under BAFIA is defined as the business of (1) receiving deposits on current account, deposit account, savings account or other similar account, and (2) paying or collecting cheques drawn by or paid by customers and provision of finance. As a result, all Islamic banks adopted BAFIA's definition as their scope of business and thereby limiting their business model to financial intermediation in a narrow sense i.e. taking deposits and lending. In retrospect, this was perhaps the starting point where the regulatory framework inherently creates a disincentive for risk sharing to develop in the Malaysian Islamic banking. Furthermore, the prudential requirements set out in both IBA and BAFIA encouraged risk transfer instead of risk sharing. The implication of these polices will be further explained in the evaluation of the policy documents.

The main contribution of BAFIA to the development of Islamic banking was to establish the world's first legislation that enabled Islamic windows to operate within the conventional system. Such initiative represented another major milestone, as at the time, the more common approach by other countries was to grant Islamic banks certain exemptions from the conventional banking laws as to avoid the legal impediments. Until year 2013, IBA and BAFIA ensured that the operations of the Islamic banking system in Malaysia had the force of law. Similar to IBA, three misaligned incentives were found in the BAFIA due to Islamic banks operating in the dual system with both systems operating on risk-transfer mode.

Table 2: Perverse incentives in the BAFIA 1989

Clause	Remarks
1. S36 maintenance of reserve funds 2. S37 maintenance of capital funds 3. S38 maintenance of liquid assets	These regulatory requirements are appropriate for conventional banking licensed under BAFIA. However since Islamic window is operating within a conventional set up, the unintended implication of these policies is that they create the incentive for the Islamic window to adopt the business model of the parent bank. This misaligned incentive structure unintentionally results in hindering the development of risk-sharing practices in banking).

Source: BAFIA 1989

c) Central Bank Act of Malaysia 2009

The Central Bank of Malaysia Act (CBA) was first enacted in 1958 and amended in 2009 to institutionalize the duality of the financial system in Malaysia (Section 27) and the installation of the *Shari'ah* Advisory Council (SAC) (Sections 51 to 58). The amended law is another major breakthrough, as Malaysia thus far is the only country that has successfully placed Islamic finance as part of the mandated roles of the central bank. The amendments also gave permanency of the Islamic financial agenda within the country's overall legal framework, and clarity on the apex position of the SAC as the sole authority ascertaining *Shari'ah* matters for Islamic finance in the judicial system. Section 60 empowers BNM to promote Malaysia as an international

Islamic financial center. This empowers BNM through the MIFC (Malaysia as an International Islamic Financial Center) to steer the future growth of Islamic finance in the country and abroad. Section 59 and Section 73 respectively empowers BNM to issue standards on *Shari'ah* matters relating to Islamic financial business and to put in place arrangements or measures to uphold *Shari'ah* compliance.

There were two misaligned incentives in the CBA. Section 26(2)(e) of the CBA empowers BNM to trade currencies and precious metals which arguably may be in conflict with *Shari'ah* that prohibits trading of currencies and precious metals. Another instance is Section 76(a) of the CBA which prohibits BNM to engage in trade. Such prohibition could limit BNM's potential to implement an effective Islamic monetary policy should the whole Islamic financial system operate under a full-fledged risk-sharing model. From a holistic perspective, this limitation may impede IFSA's aspiration in transforming Islamic banking from a mere financial intermediation to real sector linked investment intermediation platform.

Table 3: Perverse incentives in the CBA 2009

Clause	Remarks
1. S26(2)(e) for the purpose of conducting monetary operations, the Bank may undertake such other transactions involving currencies, … precious metals….	S26(2)(e) contradicts with *Shari'ah* which prohibits trading of currencies and precious metals hence does not augur well with risk-sharing banking.
2. S76(a) – BNM may not engage in trade	S76(a) is expected to limit BNM's capacity to implement Islamic monetary policy if the whole Islamic financial system is to operate on full risk-sharing model.)

Source: CBA 2009

d) Islamic Financial Services Act 2013 (IFSA)

Thirty years after Islamic banking began operations in Malaysia the regulatory framework underwent a major review to keep abreast with the changing market environment. This has led to the introduction of IFSA in June 2013, replacing the IBA. Provision for Islamic windows is also incorporated in the Financial Services Act (FSA) which replaced the BAFIA. In terms of content, IFSA and FSA are

intentionally made very similar.[13] The only difference is that IFSA dedicates an additional section on *Shari'ah* requirements. Both Acts represent BNM's efforts to modernize the laws that govern the conduct and supervision of financial institutions in Malaysia. The unique feature of IFSA vis-à-vis FSA is the requirement for Islamic banks to segregate the moneys placed by customers into either (1) Islamic deposits or (2) Investment account. The former treats the placement as risk-free hence its principal is guaranteed and the latter treats the placement as risk-sharing where the placement is no longer protected/ guaranteed. Such policy is the first of its kind in the world hence rendering IFSA as a groundbreaking regulatory reform in the Islamic financial sphere. Mirakhor (2014) regards it as a significant first step to operationalize the principles of risk sharing in Islamic finance.

An important implication of this policy is the changed incentive structure for Islamic banks to evolve from financial intermediation to investment intermediation, and for risk sharing to gain prominence as the new banking mode. The micro-prudential regulation will focus on balance sheet management where the assets and liabilities will be allocated effectively through dollar for dollar asset/liability match, maturity match, equitable risk and reward distribution. The macro-prudential will emphasize on the efficiency of Islamic banks in channeling the available financial resources to the productive sectors. In such a scenario, fractional reserve and deposit guarantees will no longer be applicable as all assets and liabilities are perfectly matched, rendering the system to become inherently less fragile.

IFSA provides the platform for Islamic banks to evolve its traditional role of financial intermediation (based on risk-transfer paradigm) to investment intermediation (based on risk-sharing paradigm). Sections 2(1), 3(a) and 3(b) of IFSA provide explicit definition of Islamic banking business. Definition of Islamic banking business as per Section 2(1), means the business of:

(a) accepting Islamic deposits on current account, deposit account, savings account or other similar accounts, with or without the business of paying or collecting cheques drawn by or paid in by customers; or

[13] The new Acts amalgamated six separate laws - the IBA 1983, *Takaful* Act 1984, BAFIA 1989, Insurance Act 1996, Payment Systems Act (PSA) 2003 and the Exchange Control Act (ECA) 1953.

(b) accepting money under an investment account;

(c) provision of finance; and

(d) such other business as prescribed under Section 3(a) and (b).

Section 3(a) says "… any business or activity as an addition to the definition of –

(i) Islamic banking business;

(ii) International Islamic banking business;

(iii) Islamic financial intermediation activities;

(iv) Islamic factoring business; or

(v) Islamic leasing business.

Section 3(b) says "any business, service or activity in relation to a financial service as an Islamic financial advisory business for the purposes of the definition of "Islamic financial advisory business" under Section 2(1)".

Notwithstanding this, there are misaligned incentives that are in conflict with risk-sharing paradigm, particularly the prudential regulations such as the standard on the regulation and supervision of financial group, capital adequacy, liquidity framework, limit on exposures to single counterparties and the internal capital adequacy assessments. This is due to the fact that IFSA adopts the international standards issued by BCBS that favor debt over equity-based instruments. As such, the adoption of international standards tends to create a natural bias even for Islamic banking to choose debt as the mode of finance. This inadvertently would undermine the aspiration to move towards risk sharing. This issue has not been addressed in IFSA.

IFSA though in spirit promotes risk sharing, is tainted with perverse incentives of risk-transfer system. Prudential requirements in IFSA mimic those in FSA. Section 57(2) requires Islamic banks to comply with (a) Capital adequacy, (b) Liquidity, (c) Corporate governance, (d) Risk management and (f) Maintenance of reserve funds of fractional reserve system. It is noted however that as long as Islamic banks are operating in risk transfer mode, these policies are deemed necessary to safeguard the stability of the system.

e) Policy guidelines on Prudential

Each year for the period under the review, at least half of the policy documents issued relate to the prudential aspect. The focus on prudential implies BNM's primary

concern over prudence and risk management. Prudential policies are mostly benchmarked against international standards including those of BCBS, IFSB, IFRS, etc. The study noted 10 potentially perverse incentives to risk sharing in the following policies that are currently enforced:

Table 4: Perverse incentives in Prudential Policies

	Policy Title	Date Enforced	Remarks
1	Statutory Reserve Requirement	2011 - updated	Negative (Fractional reserve mode)
2	Liquidity framework-I (for Islamic banking institutions)	2012 - updated	Negative (Fractional reserve mode)
3	Prudential standards on securitization transactions	2009 - updated	Negative (Collaterals as credit enhancements, credit ratings criterion)
4	Guidelines on accepted bill-i	2003 - updated	Negative (Debt based instruments - *Murabahah* and *Bay' al-Dayn*)
5	Guidance notes on sell and buy back agreement	2013 - updated	Negative (Repo equivalent as short-term liquidity instruments)
6	Best practices for credit risk management	2001	Negative (Risk transfer culture, collateral & guarantee policy)
7	Guidelines on investment banks	2005	Negative (Capital & liquidity requirements, Fractional reserve mode)
8	Prudential standards on securitization transactions for Islamic banks	2013	Negative (Credit enhancements & SPV as risk transfer tool)
9	Capital funds for Islamic banks	2013	Negative (Risk transfer mode)
10	Reference rate framework	2014	Negative (Link to SRR & the computation of conventional cost of fund)

Source: BNM Website, BNM Guidelines and Circular Listing

f) Policy guidelines on Capital Adequacy

The most active policy issuance is on capital adequacy, totaling six. The policies closely follow the developments of the standards issued by the BCBS and IFSB, which are principally premised on risk-transfer mindsets. The following policies may contain two perverse incentives against risk sharing.

Table 5: Perverse incentives in Capital Adequacy Policies

	Policy Title	Date Enforced	Remarks
1	Capital adequacy framework for Islamic banks (CAFIB): Disclosure requirements (Pillar 3)	2010 – updated	Negative (Favors debt-based financial contracts)
2	Capital adequacy framework for Islamic banks (CAFIB): Risk-Weighted Assets	2013 – new	Negative (Favors debt-based financial contracts)

Source: BNM Website, BNM Guidelines and Circular Listing

The above review of the policy guidelines indicated the presence of 12 misaligned incentives. Among them are (1) the requirements for reserves and capital adequacy evidencing the prevailing fractional reserve banking policies being applied to the Islamic banking system; (2) the deposit guarantee scheme provided by the PIDM; (3) the safety net features that give rise to moral hazards; and (4) the use of credit enhancements (undertakings and collaterals). These observations evidence the strong influence of the risk-transfer regime in impacting the behaviors of Islamic banks. In this context, it can be said that the present regulatory regime for Islamic banking could impede the growth of risk-sharing financing in the following manner.

(i) Implication of Statutory Reserve Requirement (SRR)

The conventional banking system is premised on a fractional reserve system. It is based on debt financing and by structure the system incentivizes the banks to create money and leverage. As such, the embedded risk of such a system is that money and debt creation, as well as leveraging could be excessive. The SRR, also known as the legal cash reserve requirement is a standard technique of credit control. By raising and lowering the SRR, central banks can reduce and increase the credit creating capacity of the banking industry. SRR however operates in a fractional reserve system whose philosophy contradicts

with the 100% reserve system. The 100% reserve system inherently eliminates the power of commercial banks to create money. Under this system, central banks have full control over money expansion.

Some Muslim economists have proposed to do away with the system of fractional reserve system with a 100% reserve requirement for Islamic banking system. They argue that the fractional reserve system leads to the creation of money by private banks, which in turn introduces instability into the system and/or amplifies inflation or recession. Furthermore, the fractional reserve system is said to be unjust in that it gives the power of credit creation to commercial banks when the power should belong to the society as a whole, represented by the central bank[14]. As such SRR does not augur well with the aspiration to promote risk sharing amongst Islamic banks. In fact, in a 100% reserve system, SRR is no longer relevant.

(ii) Implication of Capital Adequacy Requirement (CAR)

The capital adequacy framework for Islamic banks adopted in 2012 by BNM emits a negative impact on Islamic banks if they were to adopt *Mudharabah* and *Musharakah*-based products. The banks will have to put aside more capital on risk- sharing transactions vis-à-vis the conventional, hence a disincentive to risk sharing. The implication of this policy is evidenced in the limited use of these types of contract.

(iii)Implication of Implicit Subsidies

Deposit insurance, classification of 'too-big-to-fail' and other safeguards are implicit government subsidies. They reduce funding costs to banks, create moral hazard, and encourage mispricing and excessive assumption of risk by banks. These in turn threaten liquidity and solvency of financial institutions.

(iv)Implication of Credit Enhancements

[14] INCEIF, CIFP module on Islamic finance regulation and governance: intervention by the regulatory authority p.322

These misaligned incentives effectively discourage Islamic banks to assume risk, which contradicts with the risk-reward principle of Islamic finance. The unintended consequences of these policies could hamper the initiative to reform the Islamic banking practices from risk-transfer based to risk-sharing.

4. CONCLUSION

Risk sharing should be the cornerstone of Islamic finance (Iqbal & Mirakhor, 2011). Through IFSA, Malaysia has taken a bold move in calibrating its regulatory framework as the first step to incentivize Islamic banks to embrace risk sharing. However as the regulatory framework for Islamic banking is designed based on the conventional framework, an important question that comes to mind is how effective is the regulatory framework in supporting the development of risk sharing. This study attempts to respond to this concern.

An evaluation of the governing regulatory framework (IFSA, its preceding Acts and present regulatory policies) revealed that there were 21 occurrences of misaligned incentives that could potentially subvert the reform initiative. Out of 21, 14 or 67% of the perverse incentives pertain to the prudential regulations adopted from the conventional regulatory and supervisory framework. This exemplifies the strong influence of risk-transfer paradigm in the architectural design of the Islamic banking regulations. The unintended consequence of these mirrored regulation and policies is the natural biasness of the regulator and Islamic banks to favor risk-transfer banking over risk-sharing. Such policies at best are minimally necessary in risk-sharing system as it has in-built mechanisms to absorb shocks. To Islamic banking industry, they represent additional regulatory burden and costs to the banks, customers and regulators. In contrast, the corresponding regulatory framework of risk-sharing banking would place less emphasis on capital requirements, but greater emphasis on the aspects of transparency and disclosure, risk management and investment strategies. In this scenario, greater reliance is on market discipline and less on the command and control type of regulation.

It is noted however that these policies are somewhat inevitable so long as the Islamic banking industry operates in risk-transfer mode. The paper also acknowledged the

influencing factors that contributed to this policy dilemma. One, similar to many other parts of the world, risk transfer has been the dominant banking philosophy even for Islamic banks. Two, as Malaysia operates a dual financial system, the regulatory framework for Islamic banking is by design very similar to the conventional framework as to avoid regulatory arbitrage between the two sectors. Three, banking regulations in Malaysia are heavily influenced by the world's best practices and financial standards of the international standard setting bodies. Four, at the time of writing, there is virtually an absence of regulatory framework that caters to risk-sharing banking. Since the present set-up where Islamic banks are operating is dominated by interest-based banking, the existing framework for Islamic banking in Malaysia is considered robust and comprehensive.

While the market transition is on-going, more explicit incentive structure that promotes risk sharing is necessary. To ensure a successful transformation, a few policy issues pertaining the regulatory and supervisory framework need to be addressed. Amongst others:

a) Regulation and supervision to be structured such that there is a constant monitoring of banks' balance sheets. Islamic banks would be required to re-structure the balance sheet where the assets and liabilities are one-to-one matched in terms of maturity, value and risk; and that the assets are tagged to the real economy;
b) The new framework should clearly emphasize risk sharing as its governing foundation. Biases against equity finance should be removed. Policies to create a level playing field for equities to compete fairly with debt-based instruments should be developed via removal of all legal, administrative, economic, financial and regulatory biases that favor debt and place equity holding at a disadvantage;
c) To ensure a smooth transformation of the industry to a full risk-sharing banking system, a blueprint for the regulatory reform in Malaysia should be designed and be phased out in the next 10 years. In the meantime, the risk- transfer and risk-sharing based banking and regulations can co-exist during the transition period;
d) Investing in human capital to produce competent, well-educated and highly skilled regulators. They should be well-rounded specialists who are experts in both Islamic and Western economics, finance and law. Policymakers for Islamic finance must ensure all aspects of micro-prudential (on individual banks), macro-

prudential and monetary policy (on national financial system and economies) and global financial architecture (on global financial and economic system) are in congruence with the risk-sharing paradigm;

e) Establishing low-cost and efficient secondary markets for trading of risk-sharing securities. Transaction costs of market participation should be kept minimal. A market-based incentive structure to minimize speculative behavior should also be established;

f) Effective working collaborations amongst the regulators, standard setting bodies (BCBS, IFSB, AAOIFI, IASB, IOSCO) and multilateral agencies (IMF, WB, IDB, IILM) to champion the international regulatory reform for Islamic finance and promote global widespread risk-sharing practices;

g) Creating positive incentives for high ethical and moral practices in the regulations and guidelines. The financial architecture should align with the vision for the Islamic banking industry. Detailed policies to address misaligned incentives and strengthen risk-sharing environment should designed; and

h) Creating platforms to incubate new ideas such as risk-sharing banking, crowd funding finance, *waqf* fund for applied research and innovations. Effective working collaboration amongst the regulators, researchers and industry.

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