ISLAMIC FINANCIAL MARKETS - A COMPLEMENTARY TO THE CONVENTIONAL SYSTEM: AN OVERVIEW OF ISLAMIC FINANCIAL MARKETS OF OMAN

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ABSTRACT

The importance of Islamic method of Financial Services is best known during financial crisis. Not even a single Islamic Bank in the world needed to be bailed out. Islamic Banking is steadily moving into the mainstream of conventional financial system and has remained largely insulated from the global credit crisis. It is expanding not only in the Muslim world, but also in other countries where Muslims are in a minority. The Paper presents the basic concepts and structure of Islamic Financial Markets with a focus on Banking, Securities Markets and Insurance. Further, it covers Institutional Development, Regulatory landscape and Sharia Regulations for Islamic Financial Markets including plan of action for the challenges ahead for Islamic Financial Markets for Internationalization of Islamic Finance. Further, the paper highlights with reference to introduction of Islamic Finance and its regulatory environment in sultanate of Oman.

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INTRODUCTION

Global financial industry noticed that the recent financial crisis did not affect the Islamic Financial markets but it certainly did slow its pace and growth. One possible reason for relative lack of activity in Islamic Finance is the decrease in enthusiasm shown by many western Financial Institutions. (1) However, it is important to acknowledge that the Western Banks have played an important role in the development of Islamic Finance globally as well as in local markets. ABSA¹, a subsidiary of Barclays bank for example, has been instrumental in opening up Islamic Financial Services in South Africa. HSBC Amanah and Standard and Chartered Saadiq offer Islamic Financial Services in number of countries and indeed compete with full –fledged Islamic Banks. (2) Let us look at the figures provided by the BMB- Islamic Global Finance Report 2011 (GIFR)² with reference to global Islamic Financial Services industry. The report stated that the potential global size of the Islamic financial Services industry is at US $4.4 trillion growing at 10% per annum. An observation of the Islamic financial Services data of the various countries during the yester years shows that UK based Banks have shown more interest in Islamic fiancé than US Banks. Increasing number of European Banks, also, is an indication that they are showing interest in this new method. (3)

The importance of Islamic method of Financial Services are best known during the financial crisis. Not even a single Islamic Bank in the world needed to be bailed out. This is, of course was not the case for their conventional counterparts. “The global financial crisis seems to be a blessing in disguise for Islamic Finance” opines, Dato’ Dr.

*The views expressed in this article are those of the Author. And should not be attributed to the University. Errors and omissions, if any, are the sole responsibility of the Author.

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¹ The Absa Group Limited (also known as ABSA or Absa, formerly Amalgamated Banks of South Africa Limited) is the largest consumer bank in South Africa. Source: wikipedia

² GIFR 2011 contains an overview of the Islamic Finance Industry in 55 countries.
Ismail, NikNorzul Thani, (4) chairman of the Malaysian Law firm, Zaid Ibrahim & co. According to him, one of the impacts of the crisis has been an increasingly enormous interest around the world with regards to the soundness and resilience of the Islamic Financial Model. Islamic finance, being a genuinely ethical business is yet to be adopted and accepted by most of the countries. “People often forget that the godfather of modern capitalism, and often called the first economist- Adam Smith- was not an economist, but rather a professor of moral philosophy. Smith had a profound understanding of the ethical foundations or markets and was deeply suspicious of the “merchant class” and their tendency to arrange affairs to suit their private interests at public expense… In short, Smith emphasized the ethical content of economics, something that got eroded over the centuries as economics tried to move from being a value based social science to a value free exact science”. (4)

The focus of this paper is to highlight the developments of Islamic Financial markets in Sultanate of Oman. The paper also covers the significant role played by the banking regulator (Central Bank of Oman) and the Securities Markets Regulator (Capital Market Authority) with reference to regulatory aspects of Islamic Finance.

ISLAMIC FINANCE - DEVELOPMENTS IN SULTANATE OF OMAN

Although Oman is a relatively new entrant to Islamic finance, it has already experienced significant developments for its effective implementation. The Banking regulator, Central bank of Oman (CBO), and Capital Market and Insurance sector regulator Capital Market Authority (CMA) took lead in framing regulations for this ever growing industry. After receiving green signal from the Royal to permit the Islamic financial institutions to operate in the Sultanate and the financial instruments supports the operation of Islamic banking and finance, the CMA with the cooperation of international experts introduced Takaful insurance. The Authority also granted approval for the establishment of three Takaful insurance companies in the Sultanate.

Doubtlessly, it is a very successful start of Islamic banking in the country. Thomson Reuters, in its 2013 Global Islamic Finance Development Report, ranked Oman number one for its attempts to increase awareness and understanding of Islamic banking in the country. Addressing delegates at the Oman Islamic Economic Forum 2013 in Muscat, Central Bank of Oman chief executive president Hamoud bin Sanjor Al Zadjali said “the local banking industry has recently witnessed many developments, including the promulgation of a decree which provided new horizons for Islamic banking inside Oman by giving licenses for specialized Islamic banks and Islamic windows at licensed traditional commercial banks”

The Forum expressed that, Islamic economics is not a new phenomenon; it is simply adapting to the challenges of modernity. Its history is replete with examples of ideas and products, thinkers and policies that have contributed to the creation of societies with an impressive socio-economic structure. From financial practices, product development, education and innovation, the Islamic Economy undoubtedly created a culture of excellence. This culture of excellence continues through Islamic banking and finance, a sector that has been praised for its resilience during the credit crisis. Al Zadjali said it is expected that Islamic banks would provide the suitable financial support for small and medium enterprises and entrepreneurs and help them with innovative Sharia-compatible solutions that meet their needs.

Muscat Securities Market took lead in introducing Shariah Index for the Omani Stocks. The MSM director-general Ahmed bin Saleh Al Marhoon said that the launch of the index came at an important time for the national economy as it coincides with the launch of Islamic Banking. He said that the launch of the index would contribute to attracting a new category of investors who prefer to invest in Shariah-Compatible products. This would contribute to the development and growth of the Islamic Capital Market as it provides non-traditional investment options. Al Salmi, the Executive President of Capital Market Authority said, that “the index identifies the companies whose business transactions and activities are compatible with Sharia. This provides a feeling of convenience by a category of investors who were reluctant to trade at the market and also attract new investments to the market,” he said. He pointed out that the MSM continues offering new Islamic investment tools and that the Islamic index would enhance more public issues.

In the recent Global 2014 study Oman ranked as the number one emerging and untapped market. It provides the way and attract for Sukuk investment and issuance. It is reflective of positive perception and sentiment towards Oman's Islamic finance sectors. Sohail Niazi, chief Islamic banking officer of Masaar Islamic Banking Services stated that, "In the last 12 months, we have introduced 12 corporate, retail and treasury products to serve
the Omani market. For our corporate and small and medium enterprises (SME) clients’, we provide range of Islamic Trade Finance solutions through Sharia-Compliant letters of credit, guarantees, and goods Murabaha financing. We offer real estate, construction, and project finance solutions through diminishing Musharaka and other innovative structures.

To meet the working capital requirements of our corporate customers, we have developed, in collaboration with our consulting partners, a Mudarabah financing product. This product is an Islamic alternative to a conventional overdraft facility, and was voted the best product and won the innovation challenge award during the Global Economic Summit in Dubai. Many products from across the globe competed in this category,” said Niazi. Several Islamic windows and two banks have been established here, the MSM Sharia Index was created to track Sharia-Compliant stocks. The first corporate Sukuk was issued, the Takaful Company was launched.

The Central Bank of Oman organized the Annual Bankers meeting on Monday April 28th 2014, wherein CEOs and GMs of the commercial banks operating in the Sultanate converged to discuss pertinent banking matters and issues of common interest. Addressing at the Annual Bankers meeting on April 28th 2014 H.E. Hamood Sangour Al Zadjali, the Executive President of CBO, expressed satisfaction that year 2013 was yet another successful year for our banking sector with positive growth in deposits, advances and profits. Marking the advent of Islamic banks as an important development in the country, H.E. noted that there are two full-fledged Islamic Banks and six Islamic Windows in the country with a total branch network of 28 Islamic Banking Entities (IBEs) as at the end of the year 2013. H.E. further stated that as at the end of first year of operations, total assets of Islamic Banking sector stood at RO 808 million, deposits at RO 170 million and Islamic financing at RO 425 million. Commenting further, He, further, pointed out that there was a need to create awareness on Islamic banking, its products and services, besides, developing innovative deposit and financing products. He said that nurturing human resources and building human capacities in Islamic banking should be one of the top priorities for the bankers. “Capacity building of Omani staff for offering Shari’-a-compliant financial services is going to be a major challenge in the days ahead. However, for the continuous development of Islamic Industry the OIEF highlighted certain Critical issues to be explored which include:

• Consider how Islamic education needs to adapt to the modern age, and ascertain ways in which collegiate institutions can develop curriculums which create dynamic individuals working from Islamic principles in the commercial world.
• Identify failures in producing a robust human resource pool and look into ways in which to develop employment opportunities and entrepreneurship in the Sultanate and beyond.
• Explore the synthesis of the Halal industry and Islamic finance and what needs to be done to strengthen the relationship between the two sectors.
• Developments in Islamic banking and finance industry in Oman.
• The role of Zakat, Waqf and microfinance in Islamic finance and developing corporate social responsibility, and
• Islamic banking as a tool for economic reform.

Oman's Central Bank took a strict approach to regulating Islamic banking in rules for the sector setting higher standards for the industry than many other countries. The Central Bank's rules cover, besides other areas, banks' liquidity management, the administration of boards of sharia scholars who oversee Islamic financial institutions, and the operation of conventional banks' Islamic windows - and in many cases, the rules appear considerably stricter and more detailed than regulations in other countries.

A major provision is tight restriction of the use of Tawarruq as a money market instrument for banks; this is expected to limit banks' flexibility in managing their funds overnight, and could thus raise their costs. "Commodity Murabaha or Tawarruq, by whatever name called, is not allowed for the licensees in the Sultanate as a general rule".

Interbank transactions which are allowed include Mudaraba, Musharaka and Wakala placements, all common Islamic Finance Structures. The rules state that financial accounting standards from the Accounting and Auditing Organization for Islamic Financial Institutions, a Bahrain-based industry body, will be followed. In the area of vetting and supervising Islamic products, Oman is opting for the decentralized approach which prevails in the Gulf. It will allow each bank to have its own Sharia Board to supervise products, rather than imposing a centralized board for the whole industry.
Salient Features of the Islamic Banking Regulations

• Smaller institutions will be allowed to outsource the sharia board function subject to Central Bank approval.
• Unlike other countries in the region, the central Bank has set out strict requirements for scholars, including criteria for whether they are fit and proper, maximum tenures, and limits on the number of board seats that an individual can hold.
• Each Sharia Board must have a minimum of three scholars; they can only be appointed for three-year terms and serve a maximum of two consecutive terms. Board chairman should preferably serve on a rotation basis, the rules state.
• Scholars must demonstrate an understanding of both legal and financial matters and have a minimum of 10 years' experience, and banks are encouraged to develop local expertise by increasing the membership of Omani's in Sharia Boards.
• The scholars are not allowed to serve in two competing Islamic Financial Institutions within the country, and they can work in a maximum of four non-competing institutions.
• They are also required to attend a minimum of 75 percent of board meetings or risk being disqualified; Sharia Boards must meet at least four times a year, and must disclose the number of meetings in the bank's annual report. Sharia Scholars will face performance assessments, both collectively and individually.
• According to the rules, a single branch cannot operate both an Islamic window and conventional banking services, while the windows must disclose the sources and the uses of their funds.
• Banks that plan to offer sharia-compliant products through Islamic windows include Bank Sohar, Bank Dhofar, Bank Muscat, Ahli Bank and National Bank of Oman (NBO).
• The rules also outline stock market listing requirements, ownership limits, minimum paid-in capital amounts, and a 12 percent minimum capital adequacy ratio for Islamic banks.
• Banks may be allowed on a case-by-case basis to issue Sukuk (Islamic bonds) to raise Tier 1 capital and to issue subordinated Sukuk, while the treatment of Sukuk under bankruptcy and insolvency proceedings is outlined in detail. Islamic collective investment schemes will be regulated by the Capital Market Authority.

ISSUES, CHALLENGES AND PLAN OF ACTION

Financial Markets are dynamic in nature. Every system has its own issues and challenges that need to be addressed from time to time. It is more so when both the systems are operating simultaneously in the same jurisdiction. One of the major issues to be addressed is frequent changes in regulations. For example the regulatory changes concerning the structure of Sukuk warrant careful consideration and might tamper some of the recent enthusiasm for Islamic capital market products. In February 2008, the Sharia Committee of the Accounting and Auditing Organization of Islamic Financial Institutions issued recommendations regarding the role of asset ownership, investment guarantees, and the sharia advisory and approval process in Sukuk origination and trading.

The Sukuk market is also still plagued by illiquidity due to high originator concentration, large diversity in deal structures and regional fragmentation (Hesse et al, 2008). In addition, the lack of sufficient information about securitized assets in many Sukuk and the prevalence of “buy-and-hold” investments inhibit efficient price discovery and information dissemination. Secondly the entry of new foreign players in to the domestic markets will heighten competition which necessitated smaller Islamic Banks to consolidate and cascade down into a need for smoother transactions. Further, it is added that the small Islamic Banks will have to strive harder to enhance their efficiency and productivity so as to remain competitive, profitable and most importantly durable.

Profit adequacy is a requirement even for Islamic Banks too but it is supplemented by auxiliary considerations. In case of higher profits for Islamic Banks it is one way good that it meets higher social
responsibility by paying more Zakat, also be able to offer more attractive profit / loss sharing ratio on investment accounts and financing.

Islamic Banks should be in a position to adopt the model which helps to offer more non-traditional Banking products such as Salam and lstisna (sale by order), Mudaraba (partnership of skill and capital), and Musharaka (joint venture) compared to bay'muajjal and Ijara, which are most commonly used modes of financing currently. These products will prove to be potent for entrepreneurial development, as the products are relatively collateral free.

By carrying an equity flavor and risk sharing values Islamic Banks can play a significant role in developing new entrepreneurial friendly products not readily found in conventional Banking. In the absence of money – lending environment, entrepreneurs should stand for a better chance to flourish and perform even better(2) which leads to, in the long run, growth and development of the micro enterprises.

Most importantly, lack of developed market for money market instruments that are Sharia compliant to address the issue of liquidity risk management, is one of the immediate challenges to be looked into. There is also an immediate need for short-term money market investments and tools for liquidity management, a space that could benefit immensely from the introduction of new instruments. Most of the available Conventional Banking Instruments for liquidity management are interest based and therefore not Sharia compliant. Until new products or solutions are developed, this issue is going to severely hinder development of the Islamic Banking inter-bank money market (2) It is an important challenge and is constrained due to limited availability of tradable Islamic money market instruments in the various countries and having weak systemic liquidity infrastructure. There is a strong need for widespread and developed Sharia-Compliant short-term Islamic money market, and Islamic repo instruments.

Islamic Finance is still hampered by the need for harmonized financial regulation. The Governance issues, especially for Sharia compliance of products and services constitute a major challenge for the Islamic Finance industry. There is still considerable heterogeneity of scholastic opinions about sharia compliance, which undermines the creation of a consistent regulatory framework and corporate governance principles. Given the rising global integration of the Islamic financial services industry, greater supervisory harmonization across national boundaries is essential.

The problems and unnecessary risks rise due to the differences between the nations in framing the regulations and regulatory objectives. The main reason for this state of affairs is lack of machinery for monitoring, surveillance and governing these markets globally. The Significant risks are associated with cross-border Islamic Securities Markets are mainly related to (i) differences among nations and markets in regulations, capital requirements and accounting practices and (ii) financial integrity of market professionals and intermediaries, which are important because they may involve systemic risks to Islamic Financial Institutions that are involved in the markets.

Added to above, Islamic Banks are structured to include a special Sharia Supervision Board made up of Islamic scholars. Analysts say the industry's more general problem -- a shortage of qualified people -- shows up at this level, with some of the top 20 scholars appearing on Sharia Supervisory Boards (SSBs) for dozens of different Institutions. Forbes magazine estimates that there are only 260 such scholars in the world, of whom only a handful having the requisite grip on complex financial instruments to sit on a bank's board. Specialized academic centers

iii Zakat – means Purification of wealth (2.5% of annual savings go to the poor) Zakah is an Arabic word root “zaka” means to grow, to increase, or to be pure in heart. Zakah money is used to pay off debts but these people are not living in luxury, they are living a normal life. For example, someone who has gone bankrupt because of job loss and is overloaded with debt. Zakat account – Takaful companies are required to establish a zakat Fund into which zakat amounts must be deposited. The zakat Fund is required to be segregated from the shareholders' Funds and the participants' Funds:
have been set up to address this, such as the Harvard Law School’s Islamic Finance Project. Conventional Banks which have added new Islamic Services keep Sharia-Compliant products separate from other products.

The Islamic Banks depend upon Profit Sharing Investment Accounts (PSIA) as a major source of funds to Finance their assets, without legal, financial and administrative separation between these asset management activities and the bank’s Commercial Banking activities in many jurisdictions. In addition, contractually the bank shares the profits on their investments (but not losses) with the holders of these accounts, so that the latter face the risk of negative returns, in practice the characteristics of these PSIA vary from being deposit-like products in some Banks and jurisdictions to pure investment products in other Banks and jurisdictions, depending upon the way Banks manage the risk-return characteristics of these accounts. PSIA, in effect, offer a risk-return mix that is linked to a specified pool of Sharia’s Compatible Financial Instruments. Thus, for regulatory purposes, Islamic Banks have to be treated as both Investment Institutions in the Capital Market, as well as Banking Institutions of the Monetary System. (IFSB - October 2006)

The effective management of PSIA by Islamic Banks, and risk management generally in such Banks require that the risk-return preferences of these accounts (and the risk, return and maturity characteristics of other funding and liabilities) be matched by the appropriate asset allocation to back the PSIA (and other funding and liabilities). Such on-balance sheet risk management is needed for Islamic Banks, because of the limited availability of Sharia’s compatible hedging products. This, however, requires a robust Islamic Asset Securitization framework with a well-developed market for Islamic Securities so that assets originated by Banks can be exchanged and traded for suitable assets that match their funding and liability profile. (IFSB - October 2006)

The effective Liquidity Risk Management by Islamic Banks has been constrained by the inadequate development of Islamic Money Markets. It is now increasingly recognized that the development of Islamic Money Markets – markets for Sharia’s Compatible short-term financial instruments suitable for monetary operations of Central Banks and liquidity risk management of Commercial Banks - requires active markets for Islamic Capital Market Instruments as a foundation on which short-term financial instruments can be designed and traded. (IFSB - October 2006) This means that both Banks and Securities Firms will play fundamental role in a new risk intermediation landscape as they become actively involved in the origination, securitization and active management of credit exposures. This shift in risk distribution mechanisms towards capital market and traded products would require closer cooperation between Banking and Securities Regulators in the supervision of Islamic Banks and Securities Firms.

Islamic Banks can borrow funds from the conventional banks based on Sharia Principles. However, it is reverse in case of conventional banks unless these are structured on the basis of Sharia Principle. At the same time Islamic banks cannot lend fund to the conventional banks which is an added disadvantage for the Islamic banks. To overcome this one of the solutions is encouraging conventional banks to adopt Islamic Financial system.

For these reasons, an Islamic Capital Market development program needs to be given emphasis as part of national, regional, and international initiatives toward capital market development. In particular, a Capital Market Development Strategy with an emphasis on asset securitization, including a suitable regulatory and infrastructure support for Islamic asset securitization, is critically needed to foster Islamic Capital Markets. Such a strategy would have two elements on which guidance and standards would need to be developed. Firstly, a suitable regulatory and supervisory framework for Financial Instruments that recognizes the cross-sectoral nature of Islamic Banks, the specific operational and governance arrangements for Islamic Capital Market Institutions and Instruments, and their unique risk characteristics and the another is adaptations in legal, governance, information and liquidity infrastructure (including market microstructure, and clearing and settlement systems) to accommodate the specificities of Islamic Finance.

CONCLUSIONS
In spite of above hiccups, the long-term prospects look promising for Islamic Finance. Financial Institutions in countries such as Bahrain, the United Arab Emirates and Malaysia have realized considerable demand for Sharia-Compliant assets and are gearing up for more Sharia-Compliant Financial Instruments and Structured Finance. In addition, financial innovation, driven by both domestic and foreign Banks, will promote alternatives modes of intermediation and contribute to further development and refinement of Sharia Compliant contracts. The regulatory advantages (for example avoidance of double taxation in case real estate registrations) should be given to Islamic Institutions for effective implementation. In fact, it is possible that in the initial stages of the process, some Islamic transactions will fall into legal voids and may be viewed with reticence by the general public. Therefore, the authorities' should be akin to the British Financial Services Authority’s stated policy of “no obstacles, no special favors” (FSA, 2006) as quoted. As Islamic Finance comes into its own, greater regulatory harmonization will be inevitable. Recent efforts have addressed legal uncertainty imposed by Islamic jurisprudence, discrepancies of national guidelines and under developed uniformity of market practices. The Islamic Financial Services Board has moved ahead with its standardization efforts of the Islamic financial services industry that will foster the soundness and stability of the system. Globally accepted prudential standards have been adopted by the Islamic Financial Services Board that smoothly integrate Islamic Finance with the conventional financial system.

Islamic Securities Markets complement the investment role of the Islamic Banking sector. They are more relevant in Islamic economy because prohibition of interest entails a greater reliance of equity and asset based Finance. Obviously, the institutional arrangements of the Islamic financial system may be different with respect to these markets as compared to their conventional counterpart. The important issue before us is how the Islamic Securities Markets will develop and what direction they will take depends on the realization of similarities as well as the differences in the objectives and the means of the Islamic system and based on that, the introduction of new financial products, their characteristics, diversity and the use, the legal and regulatory support provided to functioning of these markets. The regulators should focus, mainly to put effective and transparent legal and regulatory infrastructure in place and amending as per the need time to time. And it is more so in case of adopting the Islamic Securities Markets.

In conclusion I would like to quote from the welcome address by Dr. Zeti ADr Zeti Akhtar Aziz, iv who stressed that “Islamic finance draws its strength from serving the real economy. An important feature of Islamic finance is that it involves financial transactions that must be accompanied by an underlying economic transaction. And when it is cross border, it will facilitate financial flows that will support international trade and investment flows. It will contribute towards bridging economies and enhancing our economic connectivity with each other”. Further, highlighted three important factors for ensuring sustainability of Islamic finance viz., the wide range of global supply of high-quality Islamic financial products and services that are able to meet the requirements of international businesses, secondly, is having diverse and dynamic intermediaries and market participants that have a global focus including having Islamic banking, Takaful and capital market players that venture beyond domestic boundaries to tap global opportunities and in addition, having the required talent is another imperative in steering the Islamic financial sector towards increased internationalization. Thirdly, effective linkages and connections between global financial markets will be facilitated by business enablers, particularly in the area of legislation, taxation and regulation.

Islamic Finance is an established system decades back and spread to the various countries because of its inherent advantages and ethical satisfaction. However, due to the dynamic financial and changing economic scenarios across the globe, Islamic Financial Markets are still facing challenges, including regulatory changes, illiquidity issues, liquidity risk management concerns, need for harmonized regulation, regulatory disparity amongst supervisors and a potentially non-level playing field which can overcome through regulatory discipline and strong

determination. It is obvious that success depends on continuous efforts to curb the deficiencies in the implementation of the new system from time to time.

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