The Regulatory Framework of Islamic banking in Saudi Arabia

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Preface

This material relates mainly to the regulatory framework of Islamic retail banking industry in Saudi Arabia. Other countries may be adopting different models of application and adherence policies toward Shariah banking, possibly for different considerations.

In Saudi Arabia, Islamic banking was the only realistic logical alternative to conventional banking in the Kingdom. Because the entire population is Muslim, it took a relatively short period to spread across the community and adopt widely later on.

PART 1: Background on Islamic Banking in Saudi Arabia

(1.1) Banking and capital market regulators in Saudi Arabia

There are two main regulatory bodies that oversee and supervise banking and financial activities in the Kingdom:

A. The Saudi Arabian Monetary Agency

“SAMA” was established in 1952. Its main role was to act as the central bank for the government. Its duties included –but not limited to- issuing the national currency (Saudi Riyal), supervising commercial banks, managing the country’s foreign exchange reserves, conducting the monetary policy and promoting the growth and soundness of the financial system.
Constitutionally, Shariah supervision was not identified among its responsibilities.

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B. The Capital Markets Authority

In 2003 (fifty years later), the evolving needs of the industry and its development necessitated the establishment of a separate entity focusing on the capital and investment markets, and therefore the Capital Markets Authority was established. The CMA's duties included monitoring publicly traded companies, ensuring transparency, the regulation and development of issuing securities and protecting investors from unfair market practices.
Once again, no Shariah supervisory responsibilities were assigned to the CMA.

(1.2) Factors behind the expansion of Islamic banking in KSA

With the aforementioned background on the regulation of the financial industry in the Kingdom, one question comes to mind: *How did the Islamic Banking trend and then industry proliferate and expand in Saudi Arabia?*

Three main factors were initially behind the Islamic Banking trend in Saudi Arabia:

1. Influence from other Islamic countries

2. Advances in Islamic financial engineering worldwide

3. Growing local demand and sophisticated investors

Later on as Islamic banking became the "norm" to a large segment of consumers, it also became an essential requirement for conducting business in the retail sector of the industry.

(1.3) History of Islamic Banks in the region and in Saudi Arabia

The beginning was in the early 1950s when foreign colonization of most Islamic countries introduced banking institutions to the internal system. However, the "Fuqaha'a" (Shariah scholars) dealt cautiously with banks questioning its Shariah validity. Ever since, an active pursuit of Islamic banking solutions began. In 1963, the pioneering effort, led by Ahmad El

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Najjar in Egypt, took the form of a savings bank based on profit sharing. This experiment lasted until 1967 by which time there were nine such banks in the country. The 1970s witnessed the establishment of a number of Islamic banks in the Middle East, such as Dubai Islamic Bank (l975), Faisal Islamic Bank of Sudan (l977),
and the Bahrain Islamic Bank (l979). However, many people were still uncertain about the legitimacy of Islamic banking, a situation that remained thru the 1980s.
In 1978 Al Rajhi Investment Co. in Saudi Arabia was set up as the 1st purely Islamic financial institution providing foreign exchange and money transfer services to a large segment of foreigners and locals in the country. In the late 1980s, the Islamic banking image appealed to other banks in Saudi Arabia such as the National Commercial Bank (NCB) but due to absence of structural clarity, it remained as an idea only. By the turn of the Millennium, Islamic banking has become an established form of banking in Saudi Arabia whereby two out of the ten local commercial banks are *purely Islamic.* All others offer various Islamic banking solutions to their clients.

(1.4) The evolution of Islamic financial products in Saudi Arabia

In 1985, Al-Rajhi Investment Co. –then still a foreign exchange provider- first introduced Islamic financing through Murabaha operations. Having been based in the Central region of Saudi Arabia, where a heavy Islamic current was forming, Al-Rajhi quickly gained reputation as a leading Islamic financial services provider in Saudi Arabia. In 1987, NCB introduced its first Islamic mutual fund (International Trade Fund) based on Murabaha transactions and further aided by attractive interest rate levels at those times.
In the Mid 1990s, Payroll disbursement began to be transferred to the national workforce bank accounts nationwide, a development that enhanced financing operations and reduced default risk. Meanwhile, NCB developed the first Shariah-compliance equity guidelines, a breakthrough that was later adopted and modified by Index providers abroad. During the period, NCB also launched the 1st Shariah-compliant global equity fund with assets nearing USD 300 million today.

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By 1999, the SARIE (Inter-bank transfer system) was set up further reducing operational risk and facilitating inter-bank transfers, settlement and clearance operations.

The year 2001 witnessed the launch of Tayseer - by NCB– a revolutionary Islamic financing tool that provides direct liquidity to loan takers in a Shariah-compliant mode based on Murabaha.

Today, there are over 75 Shariah-compliant mutual funds offered by eleven local banks.

A large number of bank clients in Saudi Arabia demand Shariah-compliance in every aspect of banking and investments. Others prefer traditional banking and another segment resorts to traditional banking only in the absence of Islamic alternative.

CONCLUSION

Market and Bank regulators in the Kingdom do not undertake Shariah-related duties. Each institution is free to recognize its Shariah criteria, Shariah board and acceptable established practices. All this allows for maximum innovation, peer review and development of Shariah-compliant products.

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Part 2: Modes of Implementation

(2.1) The implementation of Shariah in the retail banking industry

The functions of Shariah compliance and level of adherence is determined differently across banks, mainly depending on the bank's policy and vision and its interest to employ Shariah principles. Shariah compliance currently follows any of these models:

1. Corporate policy dictates the adherence to Shariah principles of banking

A study conducted in the 1980s shows that out of 50 Islamic banks across the Islamic world, 64% do not stipulate such adherence

2. Appointment of a Shariah auditor, consultant or a Shariah committee

3. Full commitment of a Shariah team

4. Shariah committee on a country level

In 1985, the United Arab Emirates adopted this model pursuant to the Federal law (6).

5. Supreme authority on a universal level

The first meeting of the Supreme authority consisting of prominent Islamic "Fuqaha'a" scholars took place in 1979.

A recent survey conducted by IFSB (Islamic Financial Services Board) shows that a majority of IIFS (*Institutions Offering Only Islamic Financial Services*) do have internal Shariah reviews. It also indicates that most IIFS have their internal auditor / reviewer, and some have this function carried out by their Audit committee, Risk Management or Compliance.

In Saudi Arabia, all eleven local banks, have Shariah boards with some principal scholars (Fuqaha') sitting on the Shariah boards of several banks.

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(2.2) Standards and qualifications of financial Shariah scholars and “Fatwa” issuers in KSA

Currently, the selection of Shariah specialists who meet certain bank criteria is conducted through direct appointment or nomination by the management board.

The majority of scholars are academically specialized “Fiqh” (jurisprudence), and only a few in law or economics. About 90% of Shariah board members are graduates of Shariah institutions whereby the command of foreign languages (such as English) and banking experience is not a requirement.

CONCLUSION

The criteria in recognizing a person as a qualified Shariah scholar are still not standardized, and the Experts agree that_Fatwa issuers must possess general economic knowledge and good understanding of finance before issuing their Fatwa’s, due to the significant impact of these Fatwa’s on the industry.

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PART 3: Market Implications

(3.1) Mixed Messages

It is of no doubt, that the solid foundation of Islamic banking has contributed to the development of Islamic banking solutions promoting it widely, thereby enriching the banks' experience and in some cases enhancing profitability.

In Saudi Arabia, Islamic banking has become the sole banking option for a large number of consumers. Abstinence from receiving interest was the most effortless form of Shariah compliance by Saudi consumers, something that contributed to the massive profitability for Saudi banks. And as discussed in Part 1, the diversity of Fatwa and schools of jurisprudence was beneficial to the industry.

However, strong disagreement among some Fatwa issuers and lack of clear explication of their stances has often sent mixed messages to the end users and the investing public.

(3.2) The Stock Market

There are multiple cases of Fatwa disputes, but we shall focus on the most recent case of the Saudi Stock Market. Lately, the Shariah stream has powerfully reached to the Saudi Stock Market when some new Shariah specialists began to issue disparate Fatwa's (ruling) about equity Shariah guidelines and the conformity of listed companies to these guidelines. In many cases, judgments depend on personal interpretation of "Fiqh" (jurisprudence) rules and understanding of banking concepts. As a result, investors became confused and divided without finding a reference and authority to resolve these disputes.

The most famous example was how Fatwa issuers divided the Saudi stocks to three categories: Pure stocks, Combination stocks, and non-Shariah stocks.

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Consequently, investors began investing in the "purest" stock category with little (or no) regard to the company financials and other technical aspects of the market, foregoing the financial principles in hope of spiritual reward.

(3.3) Experts' opinions

Conceptually, the diversity of Fatwa is a positive feature of Islamic finance, however, certain issues must be specifically explained to the industry in order to avoid chaos and confusion.

"The unbiased autonomy of different Shariah boards is vital and important to investors in public companies in order to avoid mistrust and uncertainty. However, a central Shariah supervisory authority is needed to sustain appropriate decision making and ensure the legitimacy of practice, decision unanimity and standardization of measures."

Translated - Dr. Yasin Al-Jefri, Al-Eqtesadiah, 18/04/2006

"What we are asking for is not the termination of Shariah Fatwa (Shariah ruling), but rather its continuity and its validation (legalization). Fatwa issuers must corroborate their Shariah knowledge with economic and financial knowledge for the purposes of auditing their Fatwa prior to issuance. These Fatwa's contribute to causing confusion among investors. And perhaps we've seen the effect of such Fatwa's on the market a few months back."

Translated – Dr. Abdullah M. Bin Mahfouz, Al-Eqtesadiah, 16/04/2006

CONCLUSION

There is no standalone successful model to incorporate Shariah in the banking system.

This may not even be needed. But what is needed is effective dialogue and convergence across Islamic banks, Shariah boards and scholars worldwide.

The endorsement of Shariah boards by one another is also vital to closing a potentially growing gap between the current efforts to interpret Islamic Finance.

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PART 4: Recommendations

I would like to conclude this paper with a few recommendations based on research findings and the opinions of prominent experts in the local banking industry:

Authority
Establish an “authority” in charge of clarifying the Shariah boards’ rulings. Its resolutions must be advisory–not compulsory- with defined responsibilities. Such authority must be treated as a reference body in cases of major conflict.

Shared Fatwa
Banks must be able to adopt and refer to Fatwa’s of any other ascribed Shariah board locally or abroad as it deems appropriate, after its presentation to the “authority”.

Eligibility to issue a Fatwa
To set up standard guidelines and minimum level of academic qualification and economic and Shariah experience.

Education and apprenticeship
Set-up specialized institutes to fulfill the market needs of more specialists. Also recommended is the application of the “apprenticeship” concept with supreme scholars to enrich the experience of new graduates.

Warehousing
Establish a library with extensive databases including all Fatwa’s issued by different boards and specialists on all topics of Islamic finance.

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