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Model Proposal for Islamic Supervisory Boards in Financial Institutions

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Abstract: Islamic finance is a sector with growth potential. Muslims with religious sensitivity have started to bring their savings which used to be idle into the economy through the participatory banking, trusting them operating in compliance with Islamic principles. They prefer participatory banks over the conventional ones because of their religious values. It is critical not to lose the trust of customers in Islamic finance sector. For this reason, existence of Islamic Supervisory Boards (ISB) which make sure that the participatory banks operate in compliance with Sharia rules. In order for these boards to work independently and efficiently, the overall framework and standards must be developed. Moreover, for the ISB decisions to be consistent and supervisions to be accurate, existence of a national board is important in terms of reliability of the sector. The objective of this thesis is to address the functions and roles of the supervisory boards with the examples in the world and provide suggestions towards the general framework of an ISB model appropriate for the participatory banks in Turkey. This model is developed considering the social, economic, and judicial environment of Turkey and similar applications in the world. As a result of the evaluation of surveys and available sources within the methodology used in this study, it is concluded that the ISBs of the participatory banks in the country are not influential enough in the product development and other corporate processes, the reports are not being published so the system is not transparent enough. This in return, supports the validity of the hypothesis provided at the start of the study.
Keywords: Islamic finance, Islamic supervisory board.

INTRODUCTION and THEORETICAL FRAMEWORK

Current global markets are based on an economic model designed around capitalist theory. While the discussions over the socialist and capitalist theories continue, the economic models for which they form a background are subject to criticism by their own people after the collapse of Soviet Union and the mortgage crisis started in USA, one of the most influential country in the world.

In the midst of search efforts for new economic alternatives, interest free finance of which the theory and practical foundations are designed by Islam, has been initially started to be used along with Hammurabi Laws. This financial system now draws attention more than ever as the most important model that can potentially replace the current economic systems.

Islamic approach upholds fundamental freedoms such as private life, property right, and decentralization on the contrary of socialism where human and its need are neglected. On the other hand, this approach stresses the importance of social equality and solidarity against the absolute and unlimited benefit on the contrary of capitalism. Thus, Islamic finance model stands out as an original system which contains unique principles.

In Islamic finance system, compliance of any financial transaction with Sharia rules is the most important prerequisite for that transaction to be Islamic. In other words, in Islamic economy there is no room for a practice violating the Sharia rules. In fact, the biggest criticism against the Islamic model is in regards to these rules being quite radical and limiting. However, introducing a set of rules should be considered fair for a religion stressing that “nine out of ten of one’s sustenance is in trade”.

Islamic finance which exists for centuries has especially started to draw more attention of the financial markets. Two of the most important reasons for this attention are the global financial crisis taking place repeatedly and unfair income distributions among the individuals and countries as a result of current financial system that is based on making money out of money using interest instrument. Moreover, there are millions of people that are not able to bring their assets into the economy due to the unavailability of an Islamic finance system is another factor that requires an Islamic finance model to be made available. Another reason in this context is that the high amounts of income obtained from natural resources in Muslim countries being also tied to the financial system in developed economies causing the financing cost for local investors to be high (Bilir, 2011:11).

Islamic finance provides a more fair mechanism from the revenue and risk perspective in the center of real economy thanks to the profit/loss sharing factor. In this sense, it is expected that Islamic finance receive a high demand and bring a new alternative to the global finance system. Along with the developments in leading countries in Islamic finance such as Malaysia and Saudi Arabia, along with researches and projects conducted in the field in European countries in the center of the western finance system such as UK, Luxembourg, and Ireland, shows that Islamic finance model will find a wide growth potential in many countries regardless of the religious structure of their societies.

Islamic Finance Regulating Organizations

There are four main international organization operating in Islamic finance market.

1. Islamic Law Academy
2. Islamic Development Bank
3. Islamic Financial Services Board
4. Accounting and Auditing Organization for Islamic Financial Institutions

Islamic Law Academy (IFA)

It is widely discussed throughout the Muslim geography whether the Islamic finance instruments comply with Sharia or not. The judgments(fatwa) issued by the scholars in Islamic law are the main sources on this issue. However, these judgments can contradict with each other as well. To be able to solve such issues, in January 1981, Organization of Islamic Cooperation (OIC) composed of 57 member countries, has established the Islamic Law Academy which provides consulting service on Sharia compliance for all matters. The judgments of the Academy under prestigious OIC, are respected by all Muslim societies on a wide range of matters like medical ethics, social cases, and economic issues.

Judgments of the Academy in finance sector provides guidance for the Sharia boards of the leading Islamic finance institutions. Especially, their opinions on various issues such as utilization of credit card, currency exchange transactions, and business contracts are examples for the impact of the Academy on the markets. However, their permit on a financial transaction or product does not mean it is permissible in all cases. On the contrary, in many cases it is expressed that they are permitted in determined conditions. For instance, while leasing is considered compliant with Sharia principles, it is prohibited in cases where the insurance payments of the product are left for the lessee. Similarly, interest payments in credit cards are prohibited while the membership fees for a predetermined credit limit is allowed.

Islamic Development Bank (IDB)

Islamic Development Bank is established in 1973 during the conference of finance ministers with the aim of being an organization helping with the development. The biggest partners are Saudi Arabia and Iran, holding 25% and 10% of the capital, respectively. As the first practice, it has helped the relatively poor Muslim countries with the import of petroleum during 1970s in over-valued petroleum market, using murabaha instrument. In other words, the Bank has bought the petroleum and then sold it to the importing countries with a low profit. Since then, the Bank has involved in various financing operations using instruments such as icarah, murabaha, and sukuk. This way, it has served the Muslim societies in various fields including project financing, poverty alleviation programs, donations, scholarships for poor Muslim students, and research and development sponsorships. In this respect, Islamic Development Bank has evolved into a kind of World Bank for the Muslims.

Islamic Financial Services Board (IFSB)

The Board established in November 2002 in Kuala Lumpur has initiated its activities in March 2003. Due to the fact that Islamic actives and passives have different risk characteristics compared to their conventional substitutes, the Board has been established to determine the required standards in Islamic finance sector in such a way that meets the needs and expectations of the sector objectively. It also provides the related people in Islamic finance sector consisting of banking, capital markets, and insurance fields with consulting services about how to manage the Islamic finance institutions and how to adapt the international regulation requirements into the Islamic finance products. Along with its coordination activities for the purpose of establishing sectorial solutions, the Board also helps with organizing various seminars, conferences, and meetings for the market regulators, policy makers, and sector players. Currently, it has 148 members including International Money Fund, World Bank, and Islamic Development Bank.

Accounting and Auditing Organization for Islamic Finance Institutions (AAOIFI)

AAOIFI has been established in March 1991 with the goal of supporting Islamic finance sector in terms of regulation and auditing standards. The standards that it has developed so far is being used extensively in countries like Qatar, Lebanon, Syria, UAE, and Bahrain where it was established. Moreover, Saudi Arabia, Indonesia, Malaysia, Pakistan, Australia, and South Africa have benefited from their standards often when preparing their own regulations. In this sense, AAOIFI is also being evaluated as an alternative to the International Financial Reporting Standards (IFRS). However, the standards provided by AAOIFI should be considered as a complimentary factor to the ones of IFRS rather than being an alternative to them, due to the fact that they are more like a standards package regulating the Sharia compliant actives and passives of the Islamic finance institutions and the revenues generated from them.

Islamic Finance in the World

According to the surveys conducted, countries with Muslim majorities still have larger market shares in Islamic finance sector than European countries like UK, Ireland, and Luxemburg as expected, although these countries have taken significant steps in the sector. Especially Saudi Arabia, Malaysia, and Iran are the biggest players in the market. On the other hand, let alone being a global player, it is surprising that the sector has not even been able to reach double digit penetration rates in the local markets of developing countries like Turkey and Pakistan where there is great potential for the Islamic finance.
It is important to analyze some numbers about the global market when studying the Islamic finance in the world. Total global Islamic finance assets of 1.66 trillion USD by the end of 2013 was composed of 1.2 trillion USD in banking, 27.8 billion USD in insurance, 279.6 billion USD in exported sukuk certificates, 50.7 billion USD in various funds, and remaining in the other financial instruments (Thomson Reuters, 2014:21). Evaluating the growth data of the sector in 2013, it can be observed that not all the factors of the sector have recorded a growth in spite of the positive picture overall. For instance, banking has shrinked by 5%, while Islamic funds and sukuk certificates have grown by 14% and 11%, respectively.

Islamic Finance in Turkey

The first applications of Islamic finance in Turkey have started to be seen towards the end of 1980s. The first institutions of their kind were established by the approval of Board of Ministers and classified as "Private Finance Institution". Followed by the change in Banking Law that took place in 2005, these institutions were named as "Participatory Banks" and awarded the authority to provide all kinds of banking services in compliance with Islamic finance principles. Although its popularity was already increasing before the recent global financial crisis, Islamic finance has drawn greater attention due to its consistent and durable performance during the crisis, including Turkey. Sectorial depth has also increased with government support during this period. Among the most significant examples of this support, preparing the required legal regulations to audit and regulate the financial system, a public bank (Ziraat Bank) opening participatory branches, and sukuk export figures reaching 1 billion USD since 2012 can be mentioned.

SWOT Analysis for Islamic Finance in Turkey

Conducting a SWOT Analysis of the sector will provide us with important clues in order to better understand the current state of Islamic finance in Turkey.

Strengths:

- High demand potential for the Islamic finance products due to the population structure with young and Muslim density.
- The government supporting Islamic finance and announcing its objective of increasing market share of participatory banking in the sector of banking to be 25% by the year 2023.
- Two major public banks announcing that they will be starting Islamic finance operations.
- Current Islamic finance institutions being able to operate successfully and in a well-balanced manner.

Weaknesses:

- The market share of participatory banking in the whole banking sector being only 5%.
- The fact that banking sector is being controlled by only few major banks.
- In spite of all the changes made so far, the required regulations for the Islamic finance are still not satisfactory.
- Islamic finance term is still not well understood.

Opportunities:

- Potential of increasing awareness of public on Islamic finance upon the entrance of public banks into the sector.
- Middle Eastern capital planning to get involved in Turkish participatory banking industry.
- The government announcing its planning activities for giant projects.
- The image of Turkey towards being a finance center.
- Preparations on new sukuk exports.
- Fast growth in halal food and tourism industries.
- Very low penetration rates in spite of the potential, especially in the takaful sector.

Threats:

- Problems of complimentary banking in complying with Islamic finance principles.
- Widespread impression among the conservative customers who are the potential customers of Islamic finance industry that participatory banking is another way of conventional banking that uses interest.
- Recent fluctuations in the national economy.

- Increasing political risk.
- Lack of information available about the features of Islamic finance.

Future of Islamic Finance in Turkey

Along with plans to change the tax law which is one of the important problems of banking sector, announcement of two public banks to enter the participatory banking sector shows that Islamic finance in Turkey has great growth potential in the future. Following the local financial crisis in 2001 and global crisis in 2008, participatory banking which is more fair compared to the interest based conventional banking, plays an important role in the growth of Islamic finance in Turkey with the support of government support.

It is estimated that the assets in Islamic finance sector will nearly triple during the next five-year period, with the extra help of new sukuk law that was approved by the Parliament in 2013. This way, it is expected that new methods of financing will emerge and economic development will speed up once again. Still, the Turkish sector of Islamic finance is not developed enough compared to countries like Bahrein, Malaysia, and UAE. However, as a result of advances in participatory banking, there is an overall development trend in the sector.

Islamic capital markets which is an important component of Islamic finance system has made significant progress recently. This progress of capital markets consisting Sharia compliant investments, products and services can be attributed to the variety of products and services, infrastructure regulations, and presence of strong regulation institutions (Sadeghi, 2008:15). Along with this fact, it has also drawn the attention of market players following a stable and durable image compared to the instruments of conventional finance system during the last global crisis. By this means, Islamic capital markets has advanced to be the fastest growing segment of the Islamic finance (Ali, 2008:3).

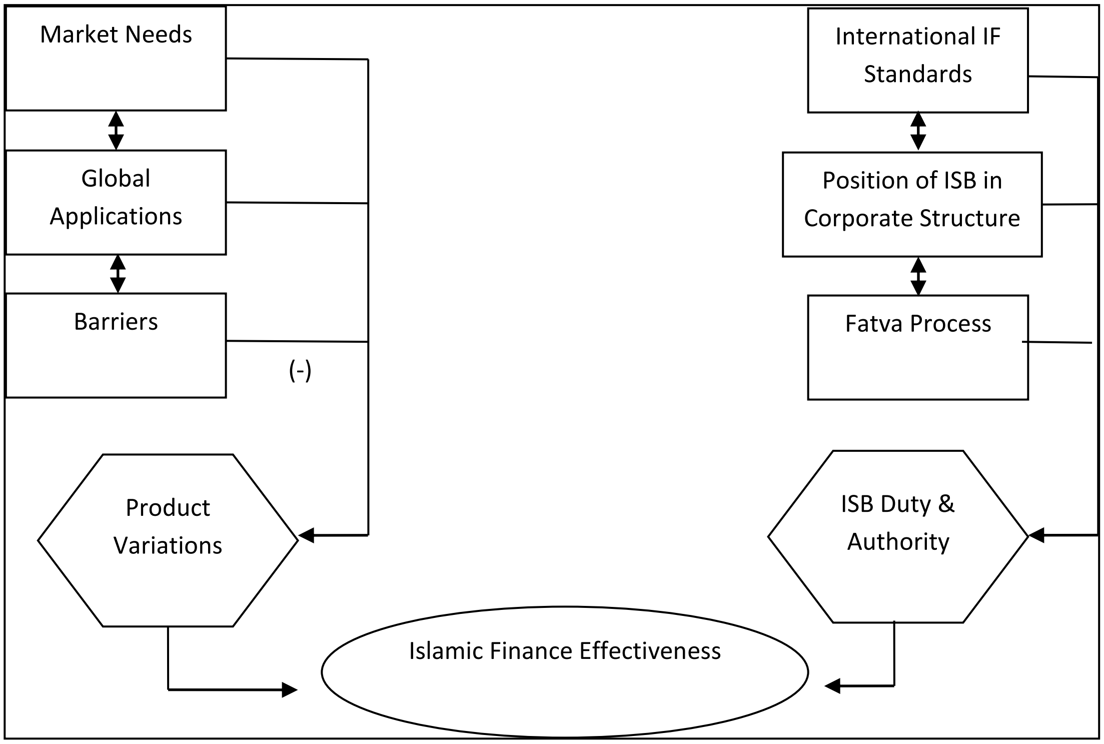
ISLAMIC SUPERVISORY BOARDS

In order to set a basis for the model proposal for Islamic Supervisory Board in Turkey, results of the survey conducted with the related managers of the participatory banks operating in the Turkey are provided in this section. The model proposal developed considering the economic-political, socio-cultural, legal, and religious environment of Turkey is also presented at the end of the section. Within the scope of survey study, upper-level managers of the all four participatory banks currently operating in Turkey are interviewed face-to-face. The questions directed to the managers during the survey involves issues of financial product variety of the banks, the barriers in front of the banks developing Islamic financial products, whether they have Islamic supervisory boards or not, the duties and authorities of such boards if available, their status in the corporate structure, the criteria involved within the selection process of the board members, and the opinions of these managers on the National Islamic Board.

Survey Theoretical Structure:

Hypothesis: Duties and authority of ISBs within the Participatory Banking framework in Turkey being limited in corporate management and not being clear; and they are not being benefited from in product development and supervision processes.

Theoretical Framework:


Market Needs
Global Applications
Barriers
(-)
Product Variations
International IF Standards
Position of ISB in Corporate Structure
Fatva Process
ISB Duty & Authority
Islamic Finance Effectiveness

Relational Matrix:

Product Variation	What is your Islamic Finance product variety?
	Can the variety of financial products meet the demand of the market?
	Is the product variety in parallel with the global applications?
	What are the barriers in front of the progress of product variety?
Islamic Supervisory Board	Is your institution a member of any Bank Association? Do these associations provide the principles and good application standards in management and supervision issues?
	Are you applying the standards of IFSB ve AAOIFI?
	Is an Islamic Supervisory (Advisory) Board available in your institution? How many members serve in the board?
	What are the criteria in establishing an ISB? What are the responsibilities of this board?
	What is the authority of the ISB? Does this board have supervisory or advisory role?
	Do the ISB members attend the board of directors meetings or provide them with sufficient information?
	What is the status of ISB in corporate structure?
	How does the fatva (ruling) issue process function?
	Are the fatvas of the ISB and decisons issued publicly?
	Can the ISB audit the processes of the Bank?
	Will a National Islamic Board be beneficial for the growth of the sector?

Survey Outcomes:

Responses to the survey clearly indicate that the ISBs in current participatory banks in Turkey lack the authority in decision making processes of the institutions and they are not benefited from in the product development process. There is lack of information about the role of such boards even among the upper level managers in the sector. Another problem is the transparency of the institutions. There is a lack of information shared with customers to ensure the Sharia compliance.

Need for ISB:

ISB are defined as an internal mechanism that helps the Islamic financial institutions align their processes in accordance with the Sharia principles (Grassa, 2013). The existence of Sharia board in Islamic banks is defined as the pre-condition of joining the International Association of Islamic Banks (El-Nagar, 1980).

A corporate governance that can contribute to the economy in accordance with the Islamic principles and objectives need to be established. There are big responsibilities for the ISB within this process. The board members need to be involved in all related institutional processes. Such an approach will only result in a positive contribution to the Islamic institutions. In order for

Turkey to have a greater role in global Islamic finance sector, related legal framework and management standards need to be established. Institutional and national supervisory boards also need to operate effectively for the Islamic financial institutions of Turkey to gain the trust of global customers.

Proposed Model:

Proposal 1: The best option is to conduct this supervision with cooperation of auditors of supervisory board and the ones of the interest-free banking institutions. There are difficulties for the institutions with such a dual supervision system, however considering the importance of Sharia compliance, such challenges need to be dealt with. Initially, ISB members and internal auditors can work together in the process. By the time the auditors become sufficient to conduct the audit in terms of the Sharia as well. Whenever the number of experts who can audit both in terms of Sharia and financial principles, it is possible to set the dual approach aside. However, current market conditions are not appropriate at this time.

Proposal 2: The banks need to determine the authority of this board clearly. These boards are named as advisory boards within the examples of other countries but their decisions are binding. There are conflicts in such applications because the institutions have to obey the decisions of so called "advisory" boards. In fact, ISBs exist in order to add value to the institutions and direct them towards the better directions. The participatory banks need to view them like that and prepare them an appropriate environment so that they can work efficiently. The duties and functions need to be defined in accordance with the objective and the market conditions. Accurate information flow and inter-departmental relations need to established for a well-functioning board.

Proposal 3: It is vital that the board members are experts in Islamic law or trade. Of course it is a great advantage that the members have knowledge of economics and finance but the number of experts both in Islamic law and modern sciences is quite insufficient. Considering the conditions in Turkey, average age of experienced and qualified scholars in Islamic law is high, thus it is a challenge and for them to gain expertise in modern finance and economics. In order to save time and take advantage of what is available, teams need to be set up in order to enable such experienced scholars to do their jobs and gain on-site experience. Having at least two of the members experts in Islamic law and a third member knowing the Islamic finance and the market will be effective.

Proposal 4: Preparing the Sharia compliance reports and publishing them both on the websites or journals of the banks and TKBB will result in increasing customer trust towards the institutions. In the case of establishing a national board, such reports can be evaluated by this upper board. Thus, in Turkey case, Sharia compliance report can also be submitted to the authorities along with annual financial reports. While the number of meetings in a year depend on the country or even institution, it varies between four and eight. For a faster adoption of the system, it will be beneficial for the board to meet at least six times a year.

Proposal 5: Establishing a national board is important in order to solve the independence issue. In the case of setting a standard of having boards with three members in each participatory banking institutions, the salaries of these members can be paid from the budget of the national or an authorized board for the sake of independence principle.

Proposal 6: Some participatory banks in Turkey appoint the board members during the general assembly. In some countries, the national board decide to dismiss the members. It will be appropritate to give the participatory banks the option of choosing the ISB members that they want to work with but requiring the approval of national board as well.

Proposal 7: Considering the small number of participatory banks in Turkey, requiring the board members serving in only one board will be effective both in terms of privacy issue and giving the chance to the new experts.

Proposal 8: Establishing a management guide and standards for institutional ISB, and having the members free of pressure will ensure the consistency of the decisions. Board members being local or from the same country can also minimize the problems in consistency issue.

Proposal 9: Developing collaborative problems and experience sharing with senior executive experts in these fields are important in order to solve problems. It will be also beneficial for the current participatory banks to train young experts on-site.

CONCLUSION

Following the results of preliminary research, it is seen that Islamic finance model faces with a growing attention throughout the world. However, analyzing the current status of the conventional finance system, it is apparent that Islamic finance is still away from where it should be quantitatively.

Following factors can be mentioned among the most important barriers in front of the proliferation of Islamic finance instruments: these instruments not being able to react to the market demand fast enough due to the lack of flexibility, delays in providing the new products and services, not having enough awareness in global scale, doubts towards some of the practices due to the controversy among the Islam scholars, and resistance to the change as a result of habitual behavior.

Profit-loss sharing concept of Islamic finance against the current economic system is perceived quite well by the markets. In parallel with better understanding of this concept, competitiveness of Islamic finance institutions continuously increases globally (Warde, 2000:201). Economic model of Islam containing less risky practices and sharing the existing risks among the parties fairly, have great importance for the financial markets in search for solutions to the repeating financial crisis.

Current models of conventional banking such as debt instruments and future/option markets are not able to meet the changing demand of the market players. On the other hand, Islamic finance system offers innovative instruments like sukuk which is based on profit/loss sharing, carries less risk and provides the economy with more benefits. Especially the sukuk export of British Treasury is one of the most important examples in this field.

Islamic finance sector Turkey advances in the leadership of participatory banking. In spite of some negative experiences, participatory banking with 25 years of history in Turkey has managed to reach a fair point. As a result of regulations and warrants put in order by the Banking Regulation and Supervision Agency (BRSA), it has become possible to regain the depositors tired of financial crisis and bring them into the banking system. Participatory banks have benefited from the same trend.

Analyzing the numbers of conventional and participatory banks in the country, it is observed that the participatory banks have competitive ratios in terms of financial durability compared to the conventional ones. On the other hand, average interest rates of the conventional banks are relatively higher than the profit shares offered by conventional banks.

Islamic finance which is a quite strong alternative to the current financial system, is in a growth trend globally. Along with attractive features, this alternative system needs to be further studied extensively so it can turn into an integrated model for the needs of the current state of economies. The proposed research aims to focus on the regulations and supervising activities need to be undertaken to enable the Islamic finance system further grow.

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