TOWARDS RISK-SHARING REGULATORY FRAMEWORK: A CASE FOR MALAYSIA

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This dissertation studied the efficacy of contemporary Islamic banking regulatory framework in promoting risk-sharing finance. Malaysia is selected as a case study given its strengths as an advanced and comprehensive Islamic financial market. The study found that, risk-transfer philosophy is dominant in the design of the regulatory framework for both the Islamic and conventional financial systems. Harmonizing the regulations of the two markets is necesssary to minimize regulatory arbitrage and ensure that both are governed at the same level of regulatory robustness. An unintended consequence however is the deep entrenched risk-transfer paradigm that permeates into the way Islamic banks operate. Risk transfer runs counter to the spirit of Islam that espouses for the proper exchange of property rights in Mu'amalat transactions. For example the use of credit enhancements (such as Wa'ad and ar-Rahnu) is rampant as devices to transfer the risk that the bank must undertake, back to the customers. In addition, the imposition of Basel capital adequacy requirements on Islamic banking disincentivizes undertaking of equity-based financial transactions. These two elements remain to be part of the permissible banking practices even after the introduction of IFSA. Thus to ensure successful implementation of IFSA, a risk-sharing regulatory framework is proposed to be devised. 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; and

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.

The study also proposes for Islamic banks to re-calibrate their business model based on risk sharing. Empirical investigation of the balance sheet structure proved that Islamic banks operate just like conventional banks - borrow short and lend long. By mimicking conventional banking, Islamic banks are in fact worse off. They would be more vulnerable given the lack of liquidity risk mitigants in the Islamic financial sphere.

They would end up in head-on competition with the conventional banks, but less equipped in size, capacity and market know-how. To ensure the sustainability of Islamic banking, it is therefore imperative for its business model to evolve from risk transfer to risk sharing. Reform is necessary as consumers are becoming more financial and Shari'ah literate, demanding true Islamic financial products and services. As such, Islamic banks are recommended to take on investment intermediation role that emphasize on efficiency, transparency and social justice. The 'skin-in-the-game' feature should be added to enhance the fiduciary duty of banks in managing the investment funds, thereby reducing moral hazard issues on adverse selection and excessive leveraging.

Islamic banks are recommended to issue tradable risk-sharing securities to promote equity ownership of real sector activities by the members of public. The securities are of low denominations to maximize financial inclusion and the returns are determined ex-post based on actual performance of the underlying economic activities. Direct link with economic activities ensures that the financial sector is firmly anchored to the real sector. Since there is no readily available ROR of the real sector, the study computed the Return on Long Term Assets (ROLA) of 424 Shari'ah compliant companies listed in Bursa Malaysia as the proxy for the ROR of risk-sharing securities. The estimated ROLA was 20.98% implying that the ROR of the real sector has the potential of offering the investors and banks at least 3 times more than the return generated from debt-based financing (presently 6 to 7%). The simulation provided an empirical illustration of how risk-sharing model unveils new opportunities for investors and banks to enjoy the upside potential of the real sector. The stress test on the balance sheets also showed that risk- sharing banking is more resilient to shocks than its risk-transfer counterpart. In adverse and extreme scenarios, risk sharing offers a much lesser impact to the profit margin of the banks due to the pass-through mechanism, avoiding the banking system from becoming over reliant on debt-based funding. It also saves the bank in terms of capital allocation on assets that are at risk, which the bank would otherwise have to provide under the present model.