Theorizing the Conundrum of Emerging Islamic Financial Regulation: Manifestation from Pakistan

Pir Qasim Shah[*], Zohra Jabeen[†], Shafiullah Jan[‡]

Abstract

The current frameworks of regulatory discipline being used by the financial regulatory bodies in Pakistan, confront challenges in regulating Islamic financial institutions. This paper synthesizes these problems and theorizes regulatory interventions. This qualitative study is operationalized by collecting primary data through 20 face-to-face in-depth narrative interviews of senior leadership working in financial regulatory bodies and through regulatory reports. Contribution to the indigenous literature was maneuvered through computer assisted qualitative content analysis tools. The study finds that multifaceted regulatory challenges prevail in the Pakistani financial market, due to stern supervisory interventions. The regulators and financial market stakeholders offer some incentives to supplement progression and expansion of the sector. However, extortionate internal and external compliance expectations increase regulatory costs for the novice financial institutions. The study interprets first-hand input of regulatory bodies by providing a holistic picture of financial regulation in the emerging field of Islamic finance for a developing economy where such eruditions are scarce.

Keywords: financial regulation, regulatory compliance, market discipline, central banking, Islamic finance, financial intermediation

Introduction

Regulation means *"a principle or condition that customarily governs behavior" and "an authoritative rule"*. Similarly, it has been referred as *"the state of being governed or controlled".* The English word regulation is believed to be derived from Latin word *"regulatus'* which means *"adjust by rule, control"* or *"to control by rule".* These meanings have been internalized throughout the study. (Hornby, 1995). Regulation is frequently reflected as the antonym of 'free market' but in actual it is not. (Woll, 2015). Muslims believe in free market economy and are against the mal practices, which gives birth to regulating the market.

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Islamic financial regulation got into limelight when this alternative system of banking and finance demonstrated strong resilience during the financial crises of 2008-09.

Islamic financial regulation in Pakistan underwent several regimes. The political, social, technological, environmental, and legal challenges played its due role in its evolution. Muslims living in the South Asian region had a movement for having a separate homeland way before the movement for having an Islamic financial system in place. The present-day outcomes of having such a system are believed to be the fruits of independence movement of 1857 which resulted in having an independent country in late 1940s. (Siddiqi, 2000) (El-gamal, 2013). However, due to several challenges the financial system could not evolve, the way it was supposedly believed by the Muslims. Nevertheless, this discourse doesn’t focus on it.

In the late 1980s after three decades of political instability, Islamic finance rejuvenated and resulted in having financial market based on the ethos of Islam. Briefly, examples include historic judgement against Riba (Usmani, 1999; Usmani, 2000), evolution of Islamic finance (Husain, 2006), research and development in Islamic finance e.g. guide to Islamic finance (Usmani & Zeenat, 2002), Knowledge Attitude & Practices (KAP) a study (SBP, 2010) to name a few. Development of the KMI index, establishment of Centers of Islamic finance and so on. The Islamic finance industry evolved ever since and developed by leaps and bounds in scale, technological disruption, advocacy, outreach, inclusivity, integration, and collaboration. Several studies can be found on these as cited in the coming sections. However, regulation in the field of Islamic finance is the least studies phenomenon and therefore the paper contributes most of the current paper towards it. Muslims believe that regulation should contain its purpose, the objectives of regulation, criterion for regulation and tools for regulation which encompasses legal, institutional, supervisory and operational frameworks. (Kahf, 2007) (Ahmed, 2006) (Shah et al., 2019). This framework of regulation seems logical. However, often practices of regulatory bodies deviate from these rudimentary standards.

Theory is an important aspect of research endeavors. Islamic financial regulation may be analyzed through for instance ‘systems theory’ that assists the rationalization of institutional regulatory composition of governance, supervision of Islamic finance operations. Likewise, roles of the regulatory bodies and the regulated industries, in the market, can be understood greatly through the ‘agency theory’ or ‘principle-agent theory’ that also helps in studying different emplacements of regulators. Likewise, network theories assist in studying the geographical spread of regulatory functions. Furthermore, the function, role, and service of IFIs, can be explored using the concepts and constructs of contemporary intermediation theories. However, after an in-depth study of the said theories it was reached to a conclusion that 'economic theory of regulation' prima facie best suits the need of the current study, as it aims is to address the constructs of regulation and helps in comprehending the principles of regulation. It matches the purpose of regulating financial market notwithstanding the intent of Islamic regulatory perspective. Despite the differences of alternative banking, the regulatory constructs in economic theory of regulation and its later development, best inform on the available constructs of regulation. (Shah et al., 2019)

Theory of Economic Regulation

Economic theory of regulation belongs to overall theory of regulation that stems from the theory of governance. (Woll, 2015). It can be viewed into various broad categories. Governance means "the act of governing, exercising authority" and "the persons, committees, departments etc. who make up a body for the purpose of administering something". Likewise, corporate governance means "patterns of rules (i.e., systems, institutions, and norms etc.) by which corporations are directed and controlled". Similarly, as mentioned earlier regulation means "an authoritative rule", "a principle or condition that customarily governs behavior", "the state of being controlled or governed", "the act of controlling or directing according to rule". The study uses these definitions above in the context of Islamic financial regulation, to avoid any confusions and since different disciplines and fields of study describe them in their own language. (Woll, 2015)

Regulatory theory takes various directions in diverse facets. It is believed that regulatory bodies are well informed about their actions and outcomes of these actions therefore they are in a better position to address the interests and needs of public due to their authority and control over law-enforcement. (Joskow & Noll, 1981). However, the opponents of this view suggest that there are other possible reasons for regulatory intervention such as influential interest groups and powerful social groups who try to pressurize their chosen political leaders towards favorable regulations to reap high profits in the industries of their interest. Moreover, regulatory bodies lack information on the cost-benefit of their regulatory decisions and since the most part of an economy works towards satisfying their own personal interests, therefore there is less scope that regulations may promote public interest at large. (Rasmusen & Zupan, 1991) (Rothschild & Stiglitz, 1976) (Miller, 1994) and (Peltzman, 2017). In both the cases, the former one is termed as public interest theory and the latter one is known as private interest theory. However, (Hertog, 2010) is of the view that with the passage of time the discussion from the fundamentals of regulation moved towards social welfare and the overall lens of public & private interest theories shifted towards theories of political actions. Another major distinction made between the general theories of regulation is the economic description of regulation that analyzes the properties and effects of regulation commonly and the types of regulation in terms of optimality and efficiency.

Designing country specific regulation, demands understanding & assessment of maturities & structures of financial markets. If regulators bring home and then institutionalize 'successful eco-systems of other nations' without investigating it against its own environment, then the process adaptation may become cumbersome. (Husain, 2006) (ADB & IFSB, 2015)

Purpose Statement

The purpose of this study is to explore regulatory discipline in Islamic financial market with special emphasis on conduct regulation, by taking cases of relevant financial regulatory bodies/entities. Islamic finance regulation is defined as the set of regulatory directives applicable to Islamic financial institutions in Pakistan and regulatory discipline is considered as an outcome of regulation.

Significance of the Study

Paucity of programs on regulation as a discipline in the field of banking and finance and scarcity of research on Islamic financial regulation in Pakistan, creates unprecedented challenges and motivates relevant researchers to fill the industry – academia gaps. Likewise, pragmatic financial regulations without rigorous exploration of its elements, creates inconsistencies between the regulators and the regulated. The study is important for relevant academicians, regulators researchers and bankers as it aims to explore the phenomenon of Islamic financial regulations in an indigenous perspective with an attempt to develop theoretical framework for Islamic financial regulation, that would help internalize the domestic model of regulation.

Literature Review

Theory of Islamic financial regulation covers various aspects of regulation namely market imperfection, asset safety, monitoring, market failure, monetary policy, Hisbah and aggregate liquidity etc. (Kahf, 2007) (Al-Jarhi, 2016 & Al-Jarhi 2004). However, due to the developing size and scope of the Islamic financial institutions the feasibility of a gargantuan organization taking care of all these activities becomes cumbersome.

Hence, there can be multiple layers and regulatory entities as is evident in many Muslim countries. Contrarily, the otherwise of it may also be possible subject to the effective regulatory management.

Generally, the overall literature of economic regulation is scarce in Asian academia due to lack of research and has various other limitations. A diligent, thoughtful, and comprehensive survey of literature through different sources of inquiry results in a fistful of studies that are also directly or indirectly linked with the regulatory perspective in Islamic finance. However, there are mainly two views of authors who do talk about the scarcity of empirical or theoretical support in the body of economic and financial regulation. First group opines that "No theory aims to explain the optimality of financial regulation and intermediation". Theories discuss regulatory capital, liquidity issues, financial crises and bank runs etc. However, no theory elaborates the substance of regulation. Theoretical or pragmatic efforts to intervene the operations of banking companies by apparently ameliorating them works by taking into consideration the ex-post-facto or retrospective element of regulation, which doesn't consider the "time-inconsistency-problem." (Krug & Lew, 2014). The second hypothetical limitation also demonstrates the impracticality of theoretical literature i.e., the theories that help in explaining the regulation works for a very small time and becomes part and parcel of our reality. (Krug & Lew, 2014) However, it doesn't work in the long run. The reality changes faster than the theoretical development. Additionally, the authors also question the regulatory theories development process. The regulatory theories aim to elaborate a phenomenon by elucidation of the reality but without referring to the very empiric of the reality itself. Furthermore, the problem enhances further, when the regulations are designed for problems; without considering "the costs of externalities" between the perfect collaboration of producers and consumers. (Valliant, 2014).

Conversely, the second group of authors namely (Allen & Gale, 2000) looks at regulation as "empiricism based on historical exigencies and trial and error method."

Historical evolution of regulatory bodies and the upgradation in their core functions over time and space has no formal support of theory. Moreover, policies are made without theoretical reasoning and is usually an empirical exercise. Problem with the regulation is that practice for instance, Basel regulatory standards are developed & implemented with or without any theoretical support. The authors don't comment on the practical value of regulation but are of the view that regulatory developments have outstripped and outperformed theory. Consequently, there is no theory of optimal regulation.

Methodologically, the current available studies are often conducted by using quantitative tools and techniques that takes into account the ex-post-facto view of regulation which means studying it in a retrospective manner see for instance (Bitar, 2012) (Rossignolo et al., 2013) (Hamdaoui, 2016) (Khan et al., 2015) (Shah, 2015) and (Ambrosius, 2017). Whereas this research wanted to see the contemporary manifestation in financial regulation, to conceptualize and contribute towards current frameworks so the study aimed at regulation in a qualitative manner by taking the regulators as case study itself. Out contribution may or may not relate to the current body of knowledge as the study aimed at taking ex-ante input from the practitioners interpretively for novice & evolving field of Islamic finance.

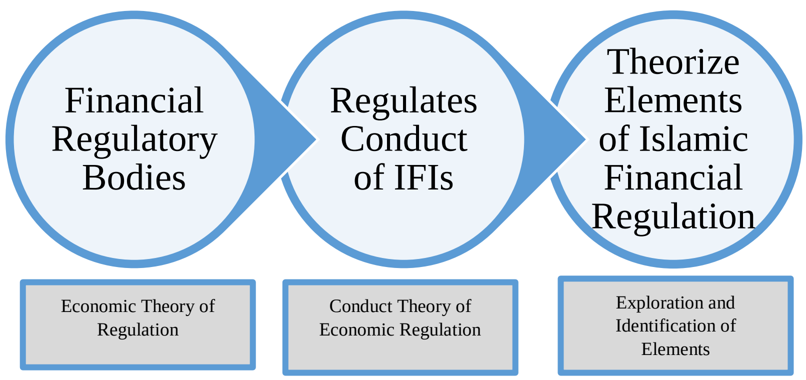
Regulatory Discipline

However, it has been observed that regulation at times focus on one segment of market discipline that creates a window of opportunity for financial market agents to undertake turbulent activities. Therefore, instead of having specific rules covering some areas of financial institutions there should be an overall market discipline (Scott, 2005) whereas markets of many countries dealing in Islamic finance have weak market discipline (Archer & Rifaat, 2013) possibly due to lack of understanding amongst stakeholders, the distinctive agency roles & fiduciary roles. (Hall et al., 2000). Market discipline is very important for the financial sector that even the Basel Committee on Banking Supervision (BCBS) has included it as a full-fledged pillar in its Basel III regulations. The main goal of its inclusion is to ensure that banks publish disclosures about their risks, risk management & capital. (Ainley et al., 2007). But (Chapra. and Khan, 2000) are of the view that it is equally important to understand that financial instability can't be removed from the system by only making cosmic changes but rather with the help of increased market discipline on which Islamic financial system is based.

A critique made by (Al-Jarhi, 2004) & (Al-Jarhi, 2016) is that, 'economic theory of regulations fundamentally answers the questions of need for regulations and the approach towards regulation due to two reasons 1-maket failure & 2-government failure". Fact of the matter is that the underlying nature of a conventional bank is based on the traditional functions of money lending on interest and providing other services to its clients mostly dealing in the domain of intermediation. Whereas (Shah et al., 2019) that Islamic banks deal with a totally different model of business whose nature is asset based contracts with a partnering relationship. The same prevailing on a macro-scale demands distinctive regulations.

The different nature of Islamic finance contracts used by Islamic banks such as Musharakah, Mudarabah, Ijara, Salam, Istisna and Wakalah etc. demands a tailor-made regulation specifically for these contracts. If the same conventional regulation is applied to Islamic banks they will not be given a level playing field and the true potential of Islamic finance would not be achieved. (Husain, 2006). The Jahrian model of regulation revolves around six financial regulatory domains namely Regulating Market Imperfection, Maintaining Asset Safety, Monitoring Incentives, Controlling Market Failure, Ensuring Adequate Monetary Policy & Regulating Aggregate Liquidity. (Shah et al., 2019)

Theoretical Framework



Source: (Abdullah, 2012) (Ainley et al., 2007) (Al-Ghoraira, 2010) (Al-Jarhi, 2004) (Al-Jarhi, 2016) (Alwosabi, 2002) (Ariss, 2010)) (Chapra and Khan, 2000) (El-Gamal, 2005) (Kahf, 2007) (Khan & Shah, 2015) (Archer & Karim, 2007) (Shah et al., 2019)

The study identifies ingenious regulatory bodies and explores the contemporary regulations being practiced in the Country. The study then identifies and theorizes the constructs as an outcome of the study. The next section briefly describes the methods of the study.

Methodology

Approach and Research Philosophy

The study as the name suggest - was conducted – using an epistemologically interpretivist approach (Guba & Lincoln, 1994) by taking the financial regulatory body as a unit of analysis and senior officers of regulatory bodies as unit of observation for the case study (Neuman, 2021) (Yin, 2014). Ontologically the study believes in subjectivism. (Yazan, 2015). The study collects primary data through interviews. (Creswell, 2015) Pilot interviews were conducted using techniques of (Yin, 1981) and (Yin, 2014). As a result, the questions were be fine-tuned with the objectives of the case study. Research ethics, interview guides and overcoming the challenges of interview were also considered during the study. (Cooper, 2012)

Case Study Design and Selection Procedure

Opinions of participants from regulatory bodies were chosen through purposive convenience sampling, together with the field notes and documents, are effective data collection methods that gives first-hand information about the phenomenon in the field setting where the activity, process, policy takes place, and the institution operates. A total of 20 interviews were conducted with the leadership of financial regulatory bodies. (Creswell, 2015) Sample size and technique is inspired by (Neuman, 2021). The study also considered secondary sources of data such as relevant research papers accessible, to enhance the understanding about the phenomenon. (Neuman, 2021) (Creswell, 2015)

Validity Reliability and Generalizability

(Neuman, 2021) is of the view that social scientists use data to connect different ideas and or concepts. Furthermore, he argues that in qualitative studies, the data can possibly be images or objects, symbols, sounds, written or spoken words, actions, maps and videos p.214. Therefore, the nature of validity, reliability and generalizability also depends on various elements. (Creswell, 2015) puts the validity and generalizability into perspective of case studies by saying that "case studies are conducted not to generalize but to 'particularize' by studying each case in-depth and show how it is different and unique than others. This brings new knowledge on the subject matter but it happens after a thoughtful understanding of the case". (Yazan, 2015) suggests purposive/judgmental sampling that enables the researchers to select such cases that answers the research questions & serves the purpose of the cases. Hence, the study also uses purposive sampling.

Data Management and Analysis

The process of making sense out of data is called data analysis. There are different techniques to analyze qualitative data. (Yin, 2014) suggests that data can be analyzed by qualitative & quantitative methods such as testing, examining, tabulating, categorizing etc. (Yazan, 2015) suggests that qualitative researchers should collect and analyze data simultaneously by using own reflection & experience.

Data has been managed and analyzed using Atlasti a qualitative computer software application. It allows the researcher to save, type, code, tabulate & link qualitative data. (Yin, 2014) suggests a step-by-step method to analyze qualitative data i.e. first the researcher comprehends the data, then integrates it & identifies key themes/patterns, develops theories and in the end the researcher draws conclusions. (Creswell, 2015) The study used similar data analyses and management techniques for the study. The study followed and internalized elements of research ethics namely confidentiality, autonomy, beneficence, justice, risks, anonymity, conflict of interest, trustworthiness and authenticity during the study, as outlined by (Neuman, 2021) therefore, the names of the participants have been coded appropriately after obtaining their informed consents. The study brings novelty by sharing the first-hand experience of regulators, to add to the existing body of regulatory knowledge for a novice field of Islamic finance.

Research Findings and Discussion

The following sections outlines the findings of the study and themes generated based on data collected. Wherever applicable the quotations are mentioned with confidentiality of participants.

Intervention

Regulatory Intervention

Since, the participants in the case study were from the financial regulatory bodies therefore, several codes and quotes (mentioned hereunder) relate to regulatory intervention. However, to save space often quotations have been shortened and to avoid confidentiality issues, the names of interviewees have been codified.

Strict Rules for Adherence

Figure 1 Strict rules for adherence (Source: Authors' Contribution)

Regulatory bodies' works under several regimes and each regime has its own repercussions on the financial market. In the beginning of the current evolutionary framework, the expectations were very strict with several interventions from the regulators. The model mostly followed rule-based regulation.

> *[This regime had strict rules for adherence and demanded a lot of intervention on multiple levels. (Case 1 REG 1 P 1 - 1:3 (3:3))]*

Unvarying Regulatory Policies

Figure 2 Unvarying Regulatory Policies (Source: Authors' Contribution)

Irrespective of the nature and size of financial institutions, they've to comply with the regulatory requirements, else there are penalties. The requirements for the industry are strict. The study finds that this may be due the nature and risks involved in the industry to avoid excessive risk taking.

> *[Additionally, we have strict requirements so no matter the size or type of a financial institutions ……. there is requirement that these entities have to meet, period. (Case 2 REG 2 P 1 - 2:39 16:16)]*

Regulatory Capture

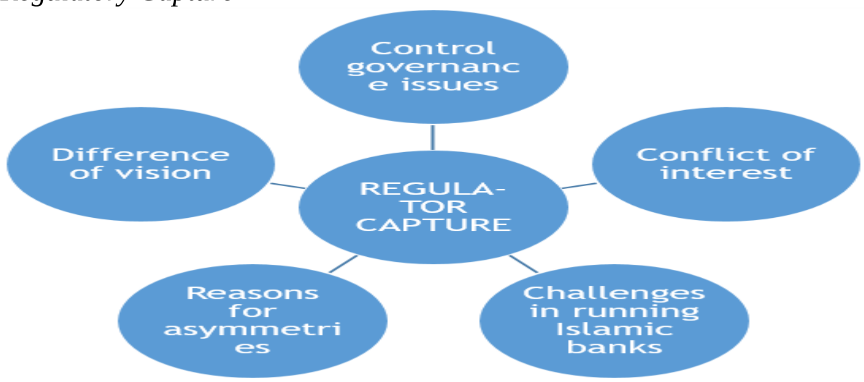


Figure 3 Regulatory Capture (Source: Authors' Contribution)

Often the regulatory body is captured by the so-called bigshots in the industry. Therefore, the regulator should always be impartial, independent and autonomous in its actions. On the other side, doing collaborations is important with the industry participants but regulators should not be dependent on them and do its own research and spadework, before making a policy.

> *[What I am saying is that regulator should make its decisions on its own, yes after due consultations and taking opinions from the market. This happens everywhere, through consultancy and sharing of exposure drafts etc. But after the best practices, if someone A B or C said that we should do this and that. The regulator starts listening to them. Case 2 REG 2 P 2 - 3:9 (2:2)]*

Destructive Policies

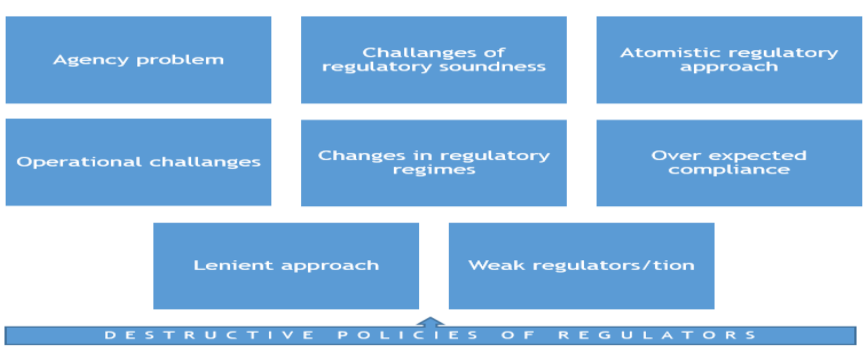


Figure 4 Destructive Policies of Regulators (Source: Authors' Contribution)

The regulators are doing more wrong then good, inadvertently. But the problem is that they themselves can't see it. Therefore, studies for instance proactive regulatory impact analysis should be done through simulations before launching new policies and ex-post evaluative studies should be conducted to do gap analysis and note down lesson learned. Similarly, the frequency of these activities should be shortened.

> *[……… Once, there were small leasing companies. These companies used to lease small products and support the Small and Medium Enterprises (SMEs) sector of the Country. Now imagine a CEO is sitting in a bank with 600 million in deposits only. Of course, his complete balance sheet would be greater than that lets just take the deposits for now. When you have a plan for leasing SME sector goods, the CEOs start thinking that is it worth it? However, those small leasing companies were developing the small businesses ……… Regulators raised the capital requirement of leasing companies and that's it. The industry was killed. How many leasing companies are left now? So, that's how the regulators often intervene unnecessarily. The SME sector can't complete the hectic documentary evidence and paperwork requirements. So, maintaining healthy rivalry and keeping feasible competition isn't an easy task. One wrong regulation and you are done. I think there is need to revisit these types of regulations. You see after 2007-08 SME in the financial sector didn't receive much attention. We all need to understand that not every job can be taken over the banking industry. Case 1 REG 1 P 3 - 5:15 (14:14)]*

Scale – Scope Enigma

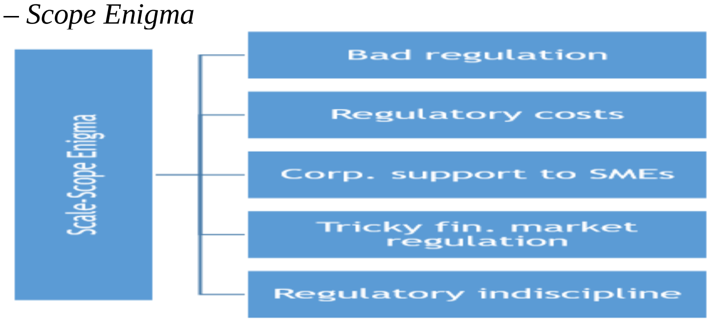


Figure 5 Scale Scope Enigma (Source: Authors' Contribution)

Scaling up industry based on the best practice of one country may not bear same fruits elsewhere. There are inherent systemic challenges that needs to be accounted for, before taking any action to scale up any industry. Financial inclusion isn't happening because polices are made in silos and without consideration of stakeholders. Mergers and acquisitions in the financial industry, effected many and reduced number of participants. Therefore, scale should not be achieved by hitting the scope of an industry. An example of this type of enigma is raising minimum capital requirements or minimum branch network, which are not easy targets and effects the overall industry.

> *[… Another example, there were small vendors who would make customized scotch tapes/cellulose tapes with printed logos in them. It's not like producing the tape but adding small value by printing custom logos and company names in it. A very small business, who's machine doesn't cost much, it's a small unit. These types of many small businesses were being financed by the small leasing companies lately. Now we've ruined the industry and it's all because of the bad regulations. Case 1 REG 1 P 3 - 5:16 (15:15)]*

Documentation Requirements and the Informal Sector

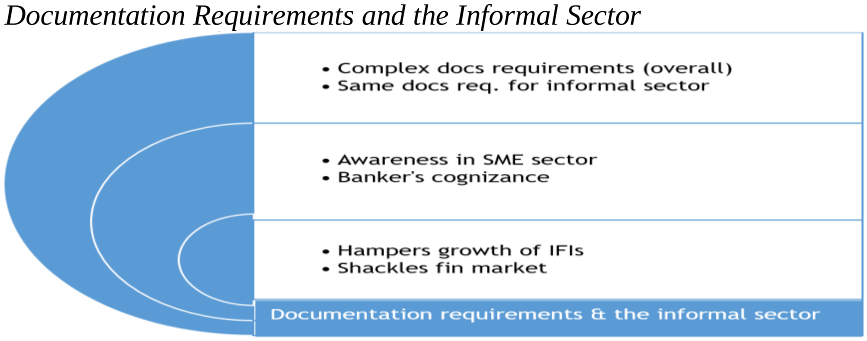


Figure 6 Documentation Requirements and the Informal Sector (Source: Authors' Contribution)

The informal sector of the country may not have documents at par with conglomerate corporations but will have rudimentary papers that could show the businesses' legal status. However, due to the enormous requirements of documentation in state level disclosures, KYC, AML and other FATF related financial disclosures. It has become impossible for the informal sector to function.

> *[There is a need to bring efficiency on every level. We need to think and ask ourselves this work was previously done effectively, what happened now? Why isn't it being done now? These informal sectors don't have that much financial statements, books, bank accounts, etc. to show to the bankers. When they can't fulfill the regulatory documentation requirements, we can't help them. That's why there is a need to revisit several aspects of financial regulations and market. Case 1 REG 1 P 3 - 5:17 (16:16)]*

Regulatory Expectations from Islamic Financial Institutions (Ifis)

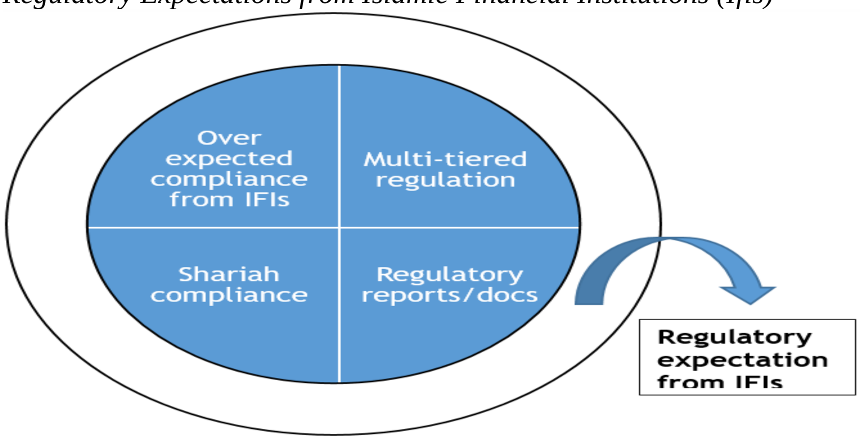


Figure 7 Regulatory expectations from Islamic Financial Institutions (IFIs) (Source: Authors' Contribution)

Islamic financial institutions shouldn't incur extra costs, just because they are Shariah compliant which adds more administrative costs. The tremendous amount of regulatory documentation requires hours and hours of officers of Islamic banks and add more costs then benefits. The documentation process of Islamic financial institutions should undergo a critical normalization and standardization process so that the additional expectation requirements could be minimized.

> *[……… expectations are very high, this is a big task to conduct business in line with the injunctions of Shariah. Therefore, there is a long way to go. The industry needs a lot of courage and hard work. Only those stakeholders will stick around who are sincere with the cause of Islamic finance and complete their expectations. Case 1 REG 1 P 4 - 6:12 (13:13)]*

Political Intervention

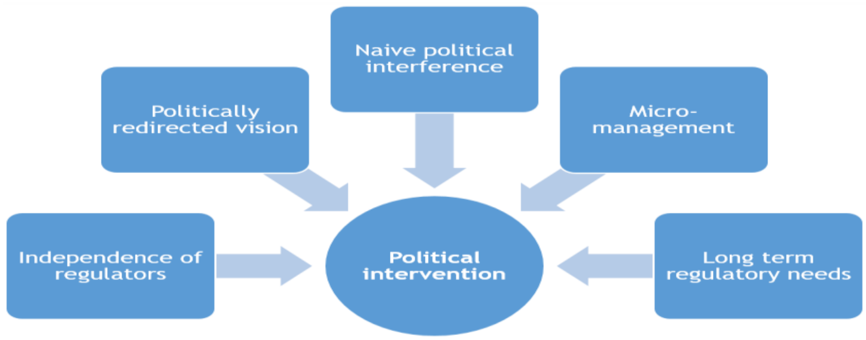


Figure 8 Political intervention (Source: Authors' Contribution)

Every political party has its own vision and charter to which is are embraced by its members, irrespective of the fact whether they are in government or opposition. Problem lies when the policies of one regime are intervened by another with a different course of action. The ultimate sufferer in this whole process is the customers who must bear the costs in addition to the regulatory body and the financial institutions. The worst part is the narrowness of vision, e.g., a politician with agrarian mindset and background, giving benefits only to the agriculture sector and totally butchering the industrial sector, ceteris paribus and vice versa. This creates the mess that can't be easily made-up for. Therefore, regulatory bodies, though play the role of an interventionist per se, but should be left totally independent without recourse to politicians. Otherwise, the long-term growth of economy is affected with every change in political regime.

> [I feel the politicians are the biggest reason behind it but it's my opinion. With every new government the priorities are re-directed towards a different perspective. I think micro-management should not be done and the regulatory bodies should be left free so that they can work on their own vision, for a long – term. *Case 2 REG 2 P 4 - 10:2 (2:2)]*

Incentives

Non-Regulatory Incentives

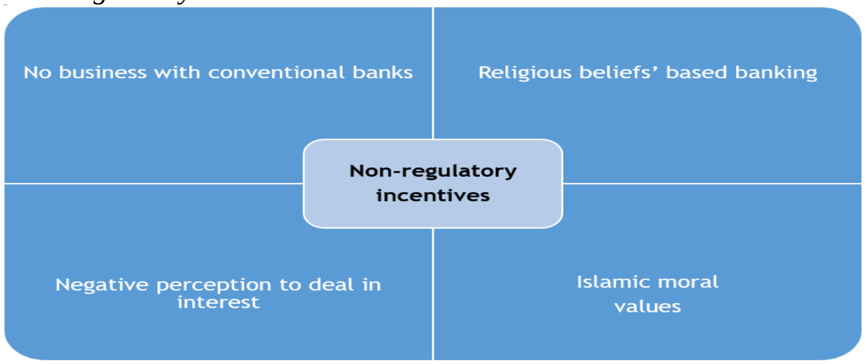


Figure 9 Non-regulatory Incentives (Source: Authors' Contribution)

Beliefs play a major role in the financial decision making. The biggest incentives that the interviewees quotes were the connection of Islamic finance with the faith sentiments of Muslim customers. These financial institutions tend to enjoy this exclusive incentive.

> […side-by-side it was observed, after a detailed survey by the central bank, that customer's perception about banking is also based on their religious beliefs and social value systems. Often religious customers consider it a sin to deal with interest. Case 1 REG 1 P 1 - 1:11 (4:4)]

Technological Disruption

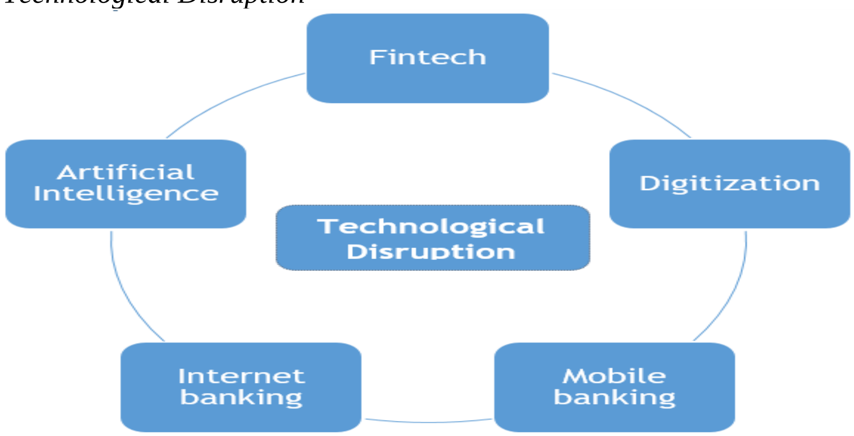


Figure 10 Technological disruption (Source: Authors' Contribution)

Another aspect in the market is the current technological surge on all levels. This disruption helps Islamic bankers to capitalize market through variety of financial solutions such as cashless and contactless payment methods on different platforms such as mobile banking and internet banking. These financial options matured during the pandemic era.

> [… In the world of technological disruption, rivalry has transformed into collaboration not completely but to some extent. Today, the finance industry has transformed into inclusivity through fintech, mobile and internet banking applications around the globe. Case 2 REG 2 P 1 - 2:42 (18:18)]

> [Overall, the picture has transformed and now companies are focusing on digitation and customer focus through artificial intelligence. 2 REG 2 P 1 - 2:48 (18:18)]

Collaboration

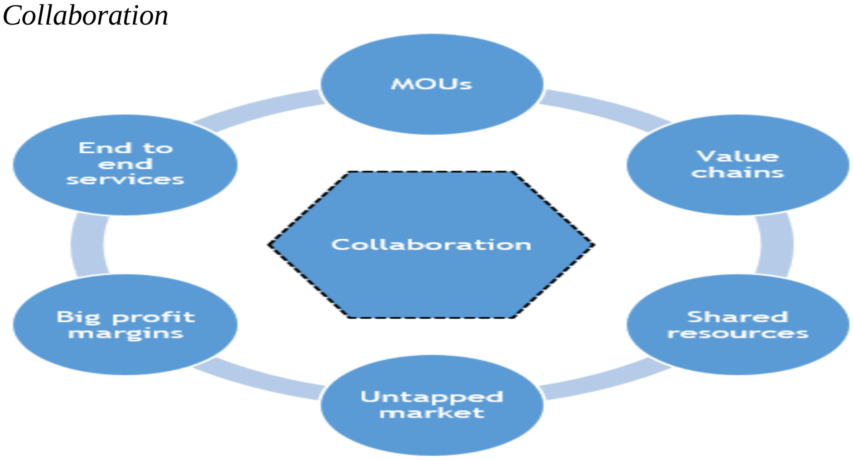


Figure 11 Collaboration (Source: Authors' Contribution)

The traditional financial intermediation has become irrelevant to a larger extent. These days the bankers are vertically and horizontally integrating their value chains through broad spectrum collaboration, both on the demand and the supply side of financial intermediation.

> [Stakeholders can collaborate on variety of terms e.g., signing MOUs with humanitarian organizations, manufacturing organizations and other value chains in their respective domains. Case 2 REG 2 P 1 - 2:46 (18:18)]

> [Yes, I agree that collaboration can work in some areas better such as sharing of technological resources and may not work in other domains such as future growth and long-term strategic objectives. Case 2 REG 2 P 1 - 2:47 (18:18)]
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> [So, I think there is great potential, and the market is not fully tapped. There are greater margins, and everyone can take the share they deserve. Case 2 REG 2 P 1 - 2:55 (21:21)]
>
> [… The more customer centric the financial institutions are the more market share they'll get. Banking and non-banking financial institutions are collaborating with retailers and other value chains to provide end-to-end services to their customers. Case 2 REG 2 P 1 - 2:57 (21:21)]

Regulatory Incentives

The following section throws light on the regulatory incentives available in the Islamic financial market.

Flexible Regulation

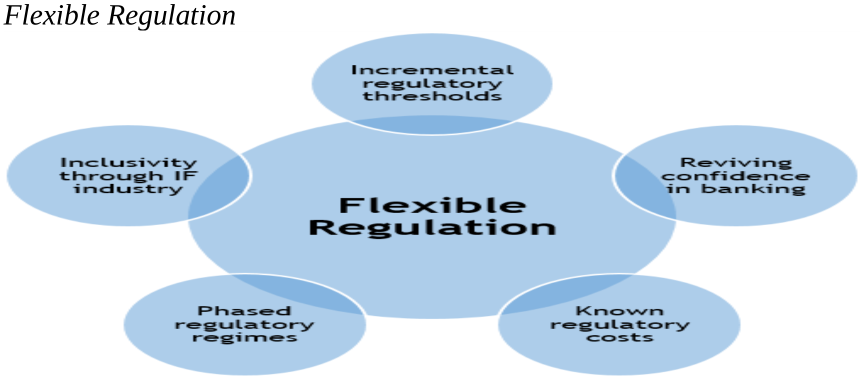

Figure 12 Flexible Regulation (Source: Authors' Contribution)

The regulators are trying its best to help the industry get matured by providing regulatory incentives to IFIs, micro-finance and other types of institutions, through phased regulatory regimes; from extremely stringent to relatively lenient regulations. The regulators want to develop the industry and is aware of challenges faced by aforesaid financial institutions, due to regulatory interventions.

> [… we opted for thresholds like Basel regulations, for the overall financial institutions which means that the regulation was there but with certain thresholds for example instead of individually looking at each and every element of debt financing we gave the banks limits that if your current ratio is X you can give y amount of debt and so on… This regime encompassed these flexible regulation as it's a tricky area and gave a change to the banking industry to self-evaluate themselves. Case 1 REG 1 P 1 - 1:5 (3:3), 1:12 (4:4)]
>
> [I believe that this flexibility allowed the banks to grow and set objectives relative to the thresholds given in our regulatory documents such as circulars, letters, and policy documents. Case 1 REG 1 P 1 - 1:7 (3:3)]
>
> [Hence, to gain the confidence of faith based Muslim customers and enhance the financial inclusion ratio, the regulatory bodies started thinking towards creating an Islamic solution for the customers so that they could be added in the financial net and inclusion ratio could be enhanced. Case 1 REG 1 P 1 - 1:18 (6:6)]

Enhancing Financial Inclusion

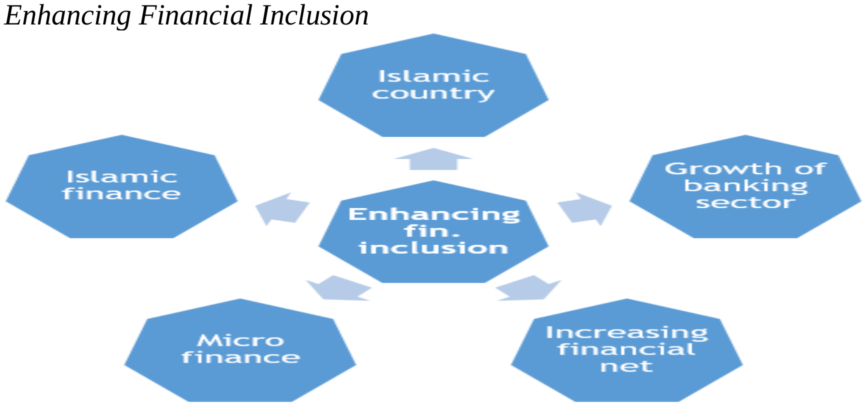

Figure 13 Enhancing Financial Inclusion (Source: Authors' Contribution)

The biggest challenges since inception of Islamic finance and even before that was to enhance the financial inclusions, in the countries where faith based Muslim bankable customers were excluded from the financial net.

Therefore, the central banks keep the Islamic banks and micro finance institutions motivated to achieve the desired inclusion ratios, increase the level of financial nets and inclusivity.

> [Islamic banks are created with a lot of care, as regulators want to enhance the financial inclusion and especially in Muslim world, we can't achieve 100% inclusion without Islamic finance. Two sectors can help us in this regard, one is Micro Finance and the other one is Islamic Finance. We are really counting on these two. Case 1 REG 1 P 1 - 1:17 (5:5)]

Standardization

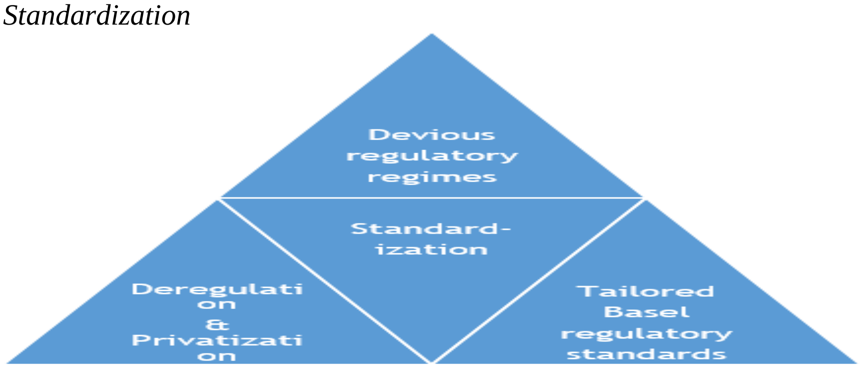

Figure 14 Standardization (Source: Authors' Contribution)

The regulatory regime encompassed different models of regulation in the past two decades. It did not stick to one form of regulation due to political interventions as well. However, the regulation generally evolved towards standardization during this time, to structure it with indigenous needs.

> [So, after the deregulation and having a flexible regulatory regime where the entities were privatized and so on, a third major shift in the regulatory process came with the advent of financial crises in 2008-09 onwards and that was Basel regulatory standards. We as regulator tailored these regulations to best suit the needs of Islamic banks and help them flourish and gain maturity. Case 1 REG 1 P 1 - 1:22 (6:6)]

> [Conventional banks are present from the last thousand or fifteen hundred years in the market. But Islamic banking re-emerged recently. Case 1 REG 1 P 1 - 1:23 (6:6)]

Special Incentives for Ifis

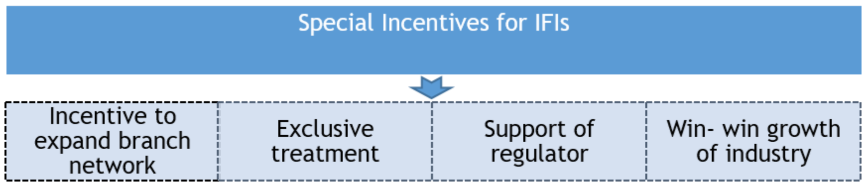

Figure 15 Special Incentives for IFIs (Source: Authors' Contribution)

Islamic banks get several benefits form the regulator, owing to the growth and development strategy of regulator. The support helps the market to have special incentives for IFIs. This has resulted in increasing the size of market.

> [There are a lot of incentives available to Islamic banks. Mainly, the incentives allow the industry to grow and flourish, for instance Islamic banks are given incentives to expand their branch network. The conventional expectations are not applied on the Islamic banks. Like, if a conventional bank has x amounts of net assets or y amount of equity condition, they are subject to a different set of regulation to enhance its network. Similarly, if their CAMELS rating is poor, they are barred from further extensions. Whereas this is not the case with Islamic banks, even the conventional banks are appreciated and supported to open Islamic banking windows, branches, and subsidiaries etc. You can understand how hard it is to convince a large-scale conventional bank to open such banking entities that are costly to operate, risky to manage and subject to additional Shari'ah compliance requirements. Even if it's not in the vision of conventional banks, even if it's not the model of conventional bank to go for Islamic financial solutions, they support the regulatory bodies in opening Islamic banks to enhance the overall picture of financial inclusion. Case 1 REG 1 P 1 - 1:28 (8:8)]

Compliance

Internal Compliance

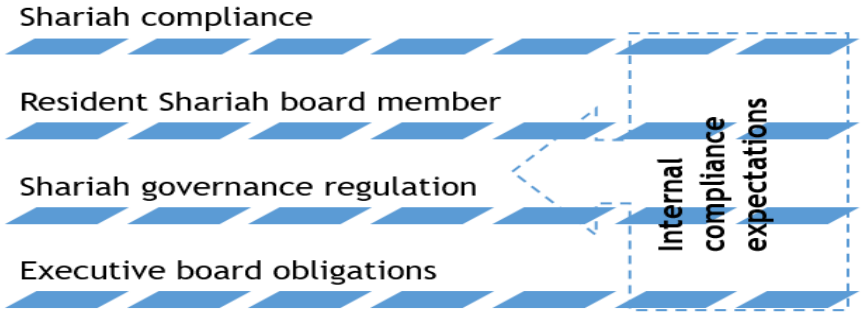

Figure 16 Internal Compliance (Source: Authors' Contribution)

Compliance can be broadly categorized in internal and external compliance. Internal compliance deals with the compliance applicable on IFIs processes and procedures. It covers elements of Shariah compliance, governance requirements and board's expectations. This three-tiered expectation makes it challenging to manage.

> [The compliance expectation from Islamic banks can be viewed in three different tiers, for instance, the first one is of course their Shari'ah compliance expectations for that we do have a central Shari'ah board …… along with a resident Shari'ah board member who is there to check the pre-transaction documentation, risk assessments, Shariah compliance etc. I would mention here that the documentation requirement of Islamic banks makes it complex and costly as well. This is one of the compliance expectations. Case 1 REG 1 P 1 - 1:33 (13:13)]

> [The second expectations …… is the Shari'ah governance expectations. Initially, it was found that one Shari'ah expert was working in multiple places that also included organizations abroad in different countries. This not only created confusions but also created operational challenges. Then regulatory bodies developed its own Shari'ah governance framework that is tailored to the indigenous needs but keeping the international best practices in view. So, now every Islamic bank is expected to meet the Shari'ah governance regulation as well. Case 1 REG 1 P 1 - 1:34 (14:14)]

> [Finally, there are expectations of the executive board and Shari'ah board from each other. This executive board level compliance is the 3rd tier of compliance that an Islamic bank must internally deal with. Case 1 REG 1 P 1 - 1:60 (23:23)]

External Compliance

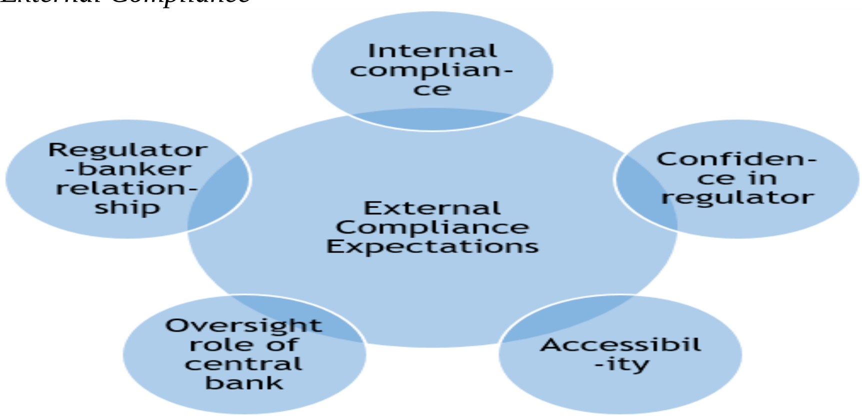

Figure 17 External Compliance (Source: Authors' Contribution)

IFIs are expected to meet the regulatory compliance by external agencies. Therefore, it is essential to have good rapport between the regulatory agencies and the IFIs to be able to better comprehend each other's expectations. Accessibility, location advantage and free flow of communication enables both parties to perform well.

Similarly, the banks need to have faith in the regulatory body that it would help them out beyond just being the lender of the last resort facilitator.

> [I'd also like to add that cities where both the regulators and head offices of commercial banks are located, believe me, it becomes very easy for us to talk to them about our regulatory concerns. We can even call them or visit them three times, if needed be. The central banks have maintained direct linkage with the financial market. They also know what's going on in the sector. Whether the market is in discipline or not? The interaction b/w the regulator and the regulated is quite often and I think it's very fruitful. So, for us to do compliance becomes very easy here. Case 1 REG 1 P 3 - 5:3 (3:3)]

Exorbitant Normative Compliance

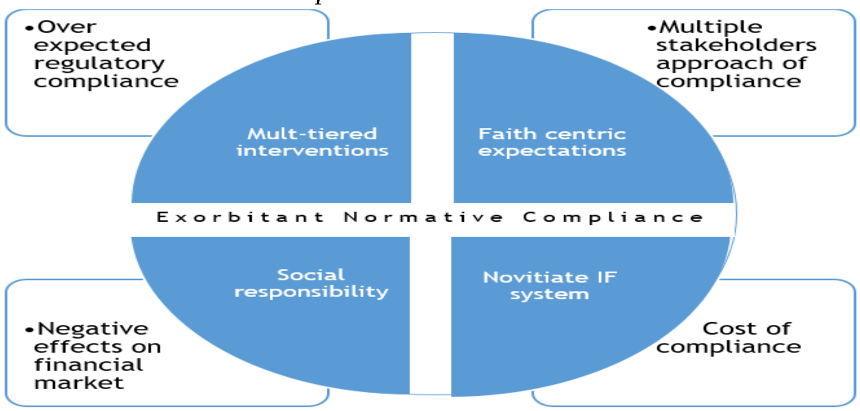

Figure 18 Exorbitant Normative Compliance (Source: Authors' Contribution)

Another aspect of external compliance is the complexity of Islamic financial regulation. Since, the system is new for the masses therefore, it often becomes cumbersome to understand the requirements of compliance. It also increases the cost of regulatory compliance.

> […on the journey of Islamic finance, the bus of stakeholders is already full, now there is only place for those who are willing to hang around and travel in the bus. This industry demands a lot of expectations on every level including social responsibility… Case 1 REG 1 P 4 - 6:12 (13:13)]

> [However, I would mention here again that we need to keep in mind that over regulation and over expected compliance, makes the financial market suffer and suffocate.…. Certain types of regulation increase the cost of regulation. Case 2 REG 2 P 1 - 2:29 (14:14)]

Post Empirical Paradigm Model: Intervention, Incentives and Compliance (Iic)

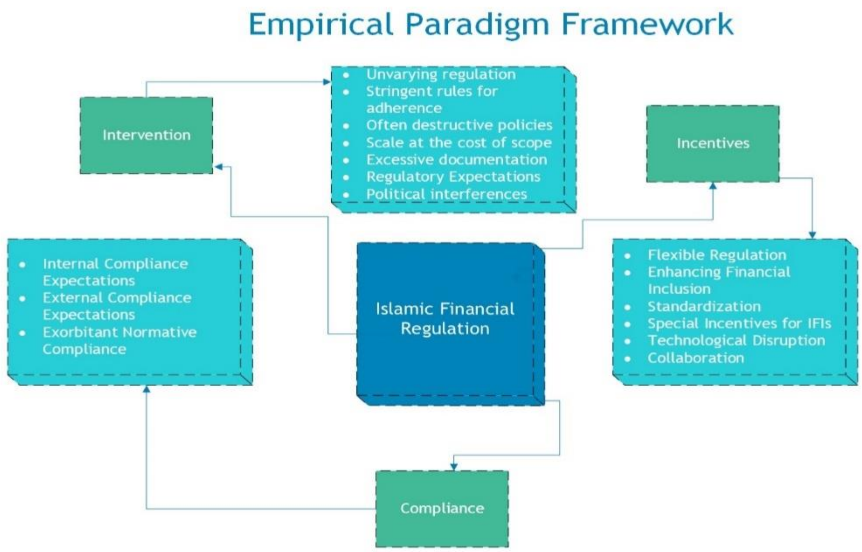

Figure 19 Post Empirical Paradigm Model: Intervention, Incentives and Compliance (IIC) (Source: Authors' Contribution)

The study confirms and adds to the findings of (Al-jarhi, 2020; Al-Jarhi, 2016; and Al-Jarhi, 2004) (Al-Ghoraira, 2010; Shah et al., 2019).

Conclusion

The study finds that Islamic financial regulation in Pakistan is operationalized through Intervention, Incentives and Compliance (IIC) in the financial market. This triad for an infant industry is based on several interventions, operations that are risky to manage and costly to comply with. However, the overall goal of having a financially included society enables both the regulators and the regulated to act towards inclusion. Despite challenges in supervision, incentivization and compliance of IFIs, the growth of this sector has forced the stakeholders to treat this alternative banking model as an investment option, to meet the needs of faith sensitive Muslim customers. (Al-jarhi, 2020) (Hassan et. al. 2018) (Shah et al., 2019).

The post empirical framework helps internalize the contemporary Islamic financial regulatory practices on which the indigenous literature is scarce, this contribution serves as a bases for future development of regulation in the country. Though due to several distinctions the industry still has a long way to go, and the global growth of Islamic finance is promising, its resilience during financial crises of 2008-09 has forced the global leaders in banking think about how to capitalize on this model of banking? Lastly, the growing population of Muslim countries also pushes the industry to think about its customers' need. All stakeholders must think win-win about mutual successes and only then the actual fruits of financial markets would be visible.

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