

REGULATORY FRAMEWORK FOR ISLAMIC BANKING IN TANZANIA

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ABSTRACT

The growing trend of Islamic banking in East Africa is subsequent to the growth of Islamic banking in the world. Tanzania as one among East African countries is comprehended with the Islamic banking practices in an emerged stance. However, the absence of regulatory framework governing Islamic banking is believed to hinder its development. Moreover, the literature reveals the absence of global standards, regulatory, and supervisory framework dealing with Islamic banking. The paper narratively, analyses the significance of the sharia regulatory framework for Islamic banking by synchronising the authors' view concerning Islamic banking regulations. Henceforth, a ground regulatory framework for Tanzanian context is proposed. Therefore, a confidence among players will be raised with standardised Islamic banking practices.

Key words: Tanzania, regulatory framework, Islamic banking growth.

1. INTRODUCTION

Islamic banking is based on the Islamic laws and sharia. Islamic Sharia forbids the imposition of riba (usury), gharar (uncertainty) and maysir (gambling). Also, any investment or earnings from businesses which is not in line with the Islamic law and principles is affirmed as haram (forbidden).

The emphasis on the necessity of a regulatory framework that ensures strengthened and standardised Islamic transactions and accounting standards that accurate disclose accounting information has been discussed by previous studies [1]. However, majority of the countries are found to lack legal and institutionalised framework in supervising Islamic finance [2-6]. Conversely, the conventional and Islamic finance are practised under a similar framework, which is not suited for some operational adaptations. However, some countries separate regulatory and supervisory framework for Islamic finance [7]. Most of the time, Central Banks play a major role in regulating and supervising Islamic banks, which adopt the same business model as conventional banks with slightly different tools in borrowing and lending. The major concern of Central Banks and other supervisors is capital adequacy of

the banks in preserving their financial stability [8]. The lack of global Islamic sharia principles, obstructs the growth and the advancement of Islamic banking and finance. The divergence is evidenced by the different approaches and remedies in interpreting the sharia due to differences in the domestic legal systems [8]. Despite the basis laid by Islamic Banking, one of the main challenges that have a significant impact is the standardisation of regulations. Regulations for Islamic Banking are scattered which lead to different banks having different sharia components [9]. There is no universally accepted legal, regulatory, and supervisory framework regarding the Islamic banking. Although many organisations have been developed such as ISFB and AAOIFI, but what addressed are recommendations and guidelines rather than mandates for the banks to follow [9]. Intuitively, the situation leads to uncertainty, confusion, and distress among scholars and investors and thus, limits the industry from its potential growth. Doubts are created, hence Islamic banks adopt another bank product's model [10]. Thus, urgent standardisation of Islamic banking

operations is important in order to bridge the operational gap [10].

In general, the paper assesses the importance of a regulatory framework for Islamic banking and finance that may foster the progress of the industry. It tries to track the growth of Islamic banking and the challenges that impede its expansion in Tanzania. Currently, the industry is in its budding stage with a slow rate of expansion. The situation is attributed to the absence of the sharia regulatory framework that enables the separate supervision and regulation of Islamic banks from conventional banks.

2. LITERATURE REVIEW

2.1 Background of Tanzania

The Republic United of Tanzania comprised a population of 51 million people [11]. The country is a merger of two countries in April 1964; Tanganyika and Zanzibar following their independence status achieved in 1961 and 1963 respectively [12]. Tanzania is among the poorest countries based on per capita income of \$920 where 28.2% live below the poverty line [13]. However, robust economy is reached due to gold production and tourism that boost the overall growth rate from 6.9% in 2012 to 7.2% in 2013 [13]. The banking sector

reforms of 2005, lend a hand on private sector growth and investment. The main challenge facing Tanzania is the attainment of the targeted level of fiscal deficit which is at 3.3% of GDP in 2013/14 and 3.8% in 2014/15.

2.2 The Regulatory and Supervisory Framework in Tanzanian Banks

Regulations and supervision are important elements in establishing a sound banking and financial system. This part presents the mechanisms of the regulation and supervision pertaining in Tanzania. The Bank of Tanzania (BoT) is the regulator of the banking sector in Tanzania. The banking sector's regulations are shown in table 1. The supervision and the regulation method employed by BoT are via inspection, which is done for both on-site and off-site [14]. The on-site inspection is achieved by following Capital adequacy, Asset quality, Management quality, Earnings capability and Liquidity (CAMEL) rating system. The off-site inspection is performed by assessing the financial soundness of the institutions by assessing the rigour in order to ensure safety and strength of the institutions [15]. Beside the principal legislations, regulations and

circulars have legal impacts as long as they do not contradict with the Act.

2.3 Islamic Banking in Tanzania

In Tanzania the Islamic banking industry was launched in 2008, driven by the great demand to benefit the community [16]. The significant increase in the introduction of Islamic banking products by different banks influenced the industry dynamics significantly. Five banks; a full-fledged bank and four windows have been established since 2010 to ensemble Islamic banking services. The number of banks that provide Islamic banking services are shown in table 2.

Currently, there is no regulatory framework governing Tanzanian Islamic banking and finance which had been confirmed by the Deputy Governor of Tanzania Central Bank (BoT) [17]. All banks and financial institutions need to follow the existing regulations. The need for the Central Bank of Tanzania (BoT) to create a conducive atmosphere in ensuring positive service delivery for Islamic banks is further emphasised by a sense of certainty in the Tanzania financial scene [18]. Due to this, the Bank of Tanzania makes the prerequisite of five percent non-performing loans as a ceiling for the

banks to perform this banking operation. Henceforth, the BoT engaged World Bank in designing the framework to regulate the operations of Islamic banks in order to comply with international banking principles [19]. Currently Islamic banking is operating in Tanzania without sound sharia law and rely on conventional banking regulations instead.

2.4 Effect of Sharia Regulation to the Growth of Islamic Banking

An important factor that explains the financial development is the flexibility of the laws to resolve the emergence of new socio-economic circumstances [20]. The level of financial sectors' development, efficiency and growth are determined by the adaptation to changing circumstances in legal formalism [21]. Lack of strong legal infrastructure in Muslim countries is an enormous challenge for the development and the growth of Islamic finance [2]. This result in the adoption of common and civil laws from colonisation era and adding few legislative instructions from sharia [21]. Issues related to Sharia finance and compliance limits the IFI to promote their products and services. However, AAOIFI has issued

Sharia standards as part of the solution for IFIs globally to accommodate these issues [3]. To date, the standards set by the AAOIFI and the IFSB are applied only in few countries [22]. Furthermore, the lack of consistency in applications of AAOIFI and IFSB standards is found in countries which practice Islamic banking. This contributes to the risks of undermining transparency of operations and creates a space for regulatory arbitrage [22].

The study by Mohammed Sarea and Mohd Hanefah [3], agreed on the standardisation of Islamic banking regulations to enable high compliance of Islamic accounting standards. Also, Islamic banking is able to play a significant role in attracting global investors to the local market. Musa [4], narrated on the compliance with sharia which is believed to create an ethical side, in line with the Islamic products and services which is a core aspect of Islamic finance. Alam Choudhury and Hussain [23], emphasised on the precept of the sharia in determining the instruments. They highlighted the need of comprehensive network in ensuring that the socio-economic and the political goals are parallel with the financial goals for the purpose of developing Islamic banking and the society.

El-Hawary, et al. [24], pointed on the importance of being accustomed to management skills and sharia issues that are the basis of the Islamic finance performance. Failure in incorporating these issues, may raise specific risks for IFIs. The idea of a strong and robust Islamic legal framework is supported by Yaacob, et al. [10]. The authors suggested on the creation of a framework that can accommodate and facilitate the improvement of the industry in enforcing Islamic financial contracts and clearing legal disputes that arise from Islamic finance transactions. Lack of standardised regulations exposes Islamic banking to a number of addressed risks. Technological risk and institutional risks evidenced in hindering IFIs performance and limit the harmonised financial intermediation. Additionally, IFIs may be exposed to counterpart risks due to the limited effective resolution and legal action to resolve any dispute that arises. Furthermore, the confusion associated with the twofold regulations in countries with a mixture of Islamic and conventional banks, raise regulatory risks to IFIs [25]. The vulnerability of IFIs to liquidity risk is given by the failure in funding the shortage and investing surplus due to constraints in using

conventional money market in borrowing and funding short-term cash [26].

2.5 Implications of Sharia Regulatory Framework: Malaysia as a Focal Point

Malaysia has a unique legislative framework that consists of mixed jurisdictions and legal systems; the common law and Sharia. The common law is functional in the civil court for matter of jurisdiction. Islamic law is practised in sharia courts for matters relating to the family and inheritance [27]. Malaysia is using a strong approach to strengthen her sharia governance framework. Regulators initiate a comprehensive framework for regulatory and non-regulatory aspects. Malaysia's regulatory framework is seen among the advanced and the most comprehensive in the world today. The framework comprises of:

- **Islamic Banking Act 1983** - The IBA provided BNM with the powers to supervise and regulate Islamic banks similar to the scope that it has over conventional banks.
- **Banking and Financial Institutions Act 1989** - The BAFIA is the law for BNM to regulate and supervise conventional banks repealing the Finance

Companies Act 1969 and the Banking Act 1973

- **Central Bank of Malaysia Act 2009** - The Central Bank of Malaysia Act (CBA) was first enacted in 1958 and amended in 2009 to institutionalise the duality of the financial system in Malaysia and the installation of the Sharia Advisory Council (SAC).
- **Islamic Financial Services Act 2013** - This has led to the introduction of IFSA in June 2013, replacing the IBA. Provision for Islamic windows is also incorporated in the Financial Services Act (FSA) which replaced the BAFIA. [28]

3. RESEARCH METHODOLOGY

The paper used a narrative methodology in reviewing the literature. A narrative literature review is valuable when one is attempting to link together many studies on different topics and for the purposes of reinterpretation or interconnection. As such, narrative literature reviewing is a valuable theory-building technique, and it may also serve hypothesis-generating functions [29]. Also, narrative literature review surveys the state of knowledge on a particular topic. The decision for narrative literature review is due to the limited studies concerning the setting of

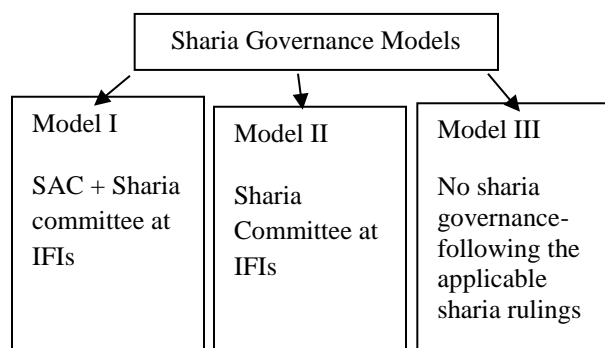
this study. Therefore, the literature reviewed is not only limited from papers in google scholars but also from web pages, newspaper articles and government documents. The study tries to formulate a generalised importance of having a standardised regulatory framework for a country and worldwide. The standardised Islamic law and principles are believed to foster the growth and development of this sector. The study connects the growth of Islamic banking in Tanzania and the conventional regulatory framework used to regulate Islamic banks. The literature connects the theme concerning regulation and supervisory regime and its impact on the growth and development of Islamic banking industry.

4. A PROPOSED SHARIA REGULATORY FRAMEWORK IN TANZANIA ISLAMIC BANKING

In order to enhance the practicability of Islamic banking and finance, the Central bank of Tanzania has to incorporate at least few items concerning Islamic banking regulations rather than governing this industry in a conventional manner. A comprehensive and conducive legal, regulatory framework should be established to support a

comprehensive and complete range of Islamic financial products and services. In order to initiate specific Islamic banking legal and regulatory framework, a conventional regulatory framework should be modified gradually to address the characteristics of Islamic finance. In addition, reference from IFSB should be made for consideration of unique characteristics of Islamic banks [30] Sharia governance models are used as a support to the proposed framework.

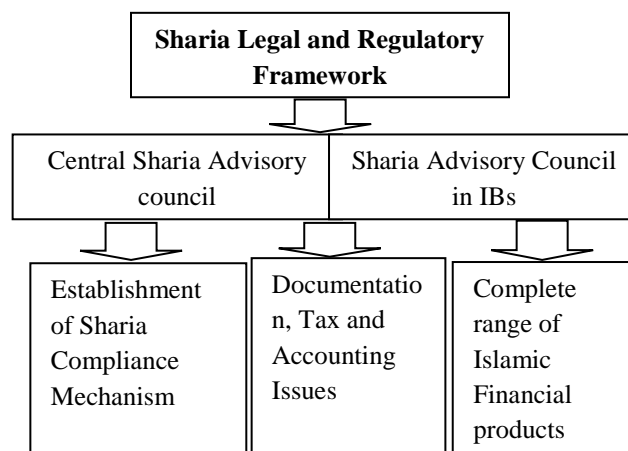
Figure 1: Sharia Governance Models



Model II is a model followed by Islamic banking in Tanzania. Sharia committees provide the check & the balance in ensuring Sharia compliance, advising the IFI on Sharia matters, assisting internal audit of IFIs on the Sharia compliance. From this notion, the following framework is proposed as an initial stage that has to be followed by the establishment of Islamic banking and finance act that will provide a standpoint

of sharia compliance within Islamic banking and institutions.

Figure 2: A proposed Islamic banking framework



5. DISCUSSIONS AND CONCLUSION

The transformation of conventional financial products into Islamic finance products necessitate the specific regulations and supervision in governing Islamic financial institutions. This gap is bridged by improving practices in the following areas: i) designing the appropriate legal framework for Islamic banks and Islamic financial institutions to conform with sharia principles; ii) centralising sharia council/committee, supervision and judgments to ensure equivalence on the practices for Sharia-compliant transactions; iii) setting up Sharia compliance audit framework and audit program [31].

From this standpoint, standardisation and centralisation of fatwas among sharia boards will emphasise the standardisation of operations between Islamic banks. Alternatively, the values and confidence of Islamic financial institutions' governance will increase [31]. Tanzania has to take a step forward in order to ensure that key elements with regards to the regulations of Islamic banking are taken into consideration. To achieve this, the government of Tanzania has to institutionalise regulatory framework for Islamic banking that changes the existing regulatory framework and enables Islamic banking practice in a smoothing living arena. Supervisors need to understand the challenges that Islamic banking and financial products impose on Islamic banks and the implications of the interactions between Islamic and conventional banks. Also, they should pay attention to potential regulatory arbitrage between Islamic banks and conventional banks.

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