Islāmic Banking in Oman: Evolution and the Unique Features

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While taking the initiative to introduce Islāmic banking in 2011, Oman had not to reinvent the wheel as the major work had already been done on Islāmic banking regulations, Islāmic modes of finance including their definition, main rules, essentials and suitability of specific modes for specific products and services. The country was lucky to benefit from the experiences made in Gulf countries, Pakistan and Far East countries in the areas of legal, regulatory and Sharī'ah governance frameworks. When Oman took initiative towards introduction of Islāmic banking, several international standard setting institutions had already done a lot of work and paved the way for smooth functioning of Islāmic banking business and moving forward. Accounting, auditing, governance, risk management and capital adequacy standards, parameters and guidelines for Islāmic banking industry developed by AAOIFI and IFSB also provided ease for launch of the new segment of banking system.

Oman opted for two-pronged strategy i.e. full-fledged Islāmic banks and Islāmic banking windows (of conventional banks) in a parallel banking system. Islāmic banking institutions are currently gearing up to capture market share by allocating more capital and opening more Islāmic banking branches. The market share of Islāmic banking assets is above 5% of total banking sector assets. Islāmic banking sector is operative with eight Islāmic banking institutions: two Islāmic banks and six Islāmic banking windows of conventional banks.

Steps before issuance of the Islāmic Banking Regulatory Framework in 2012:

1) Central Bank of Oman (CBO) had given limited approval to some financial institutions for offering certain Islāmic financing products. Bank Muscat was allowed to offer diminishing *mushārakah*, while

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Tajeer Finance was allowed to offer some sort of *murābaḥah* product only.

2) On 02 May 2011, through a Royal Order, instructions were issued approving the establishment of Islāmic banks and providing the existing banks in the Sultanate with the opportunity to offer facilities for Islāmic banking through the establishment of Islāmic Windows.

3) On June 15 2011, CBO advised the Islāmic banks and Windows regarding their initial preparedness and recommended that they should equip themselves with the requirements of Sharī'ah compliant banking. These include establishment of Sharī'ah Board, independent department at Head Office, arrangement for separate functioning of Islāmic windows, business policies and procedures for risk management and audit control, etc.

4) Central Bank of Oman shared the draft Islāmic Banking Regulatory Framework (IBRF), on 25th January 2012, with the banks for their feedback and inviting their suggestions and comments on the rules, regulations and guidelines specified under the framework.

5) Royal decree was issued empowering the Central Bank to amend the banking law and issue the Islāmic Banking regulatory framework.

6) Banks and other institutions started organizing conferences, seminars and workshops on Islāmic banking and finance for public awareness and for training of their staff.

7) Islāmic Banking Regulatory Framework was finally issued on 18th December 2012 and it was allowed by the Central Bank to undertake Islāmic banking activities in Oman by way of setting up full- fledged Islāmic banks or Islāmic banking windows of conventional banks.

Unique Features of Islāmic Banking Regulatory Framework (IBRF):

A nine-chapter comprehensive Islāmic Banking Regulatory Framework covers almost all areas of the regulatory aspects. It provides licensing rules and guidance applicable to licensees regulated and supervised by the central bank. Title 1 deals with licensing requirements for Islāmic banking including full-fledge Islāmic banks, Islāmic banking windows of conventional banks (domestic and foreign), process of application at various levels, fees to be paid, role and responsibilities of the shareholders and the BoD towards implementation of rules and regulations, especially with respect to Sharī'ah governance framework of the licensee bank. Title 2 provides general obligations and governance. It also provides the basis for the Sharī'ah compliance of Islāmic banking activities. In addition to a schedule containing details of application and license fees to be paid by banks, the essentials of prescribed Islāmic modes of finance to be used to develop Islāmic banking services and products are part of this title. It also includes instructions on compliance and attachments namely: i) Example Report of Sharī'ah Supervisory Board (Para:5.1); ii) Operational Procedures for SSB, iii) Statement of Sources and instructions and guidelines for uses of Charity Fund for charity purposes under the guidance of the SSB; and iv) Sample of Performance Assessment for the SSB. [Its purpose is an objective accountability of the SSB at collective and individual levels. It has to be transparent so that the assessment mechanism is not misused or abused by the Board of Directors or the senior management of the licensee to force their will on the SSB or to compromise its independence.] As a whole, it requires that the Memorandum and Articles of Association of licensee banks should provide for conduct of Islāmic banking business according to Sharī'ah rules and principles.

Chapter four of the IBRF is regarding applicable accounting standards, requirements for appointment and dismissal of external auditors and external audit issues, disclosure and reporting requirements, internal audit function and matters relating to central bank examiners. Four attachments pertaining to minimum disclosure requirements forms and notes, documents /forms to be submitted to CBO and key differences between AAOIFI and IFRS are also given here.

The CBO has adopted the International Convergence of Capital Measurement and Capital Standards, while instructions and guidelines have been given on minimum capital requirements. The credit risk principles in this section are also applicable to credit risks associated with financing made under the profit sharing modes (e.g. *muḍārabah* and *mushārakah*). It provides building blocks for credit risk management, policies in this regard, credit policies and procedures, assessment of credit quality and risk mitigation tools, risk rating, credit risk models and portfolio management. Instructions and guidelines regarding country and transfer risk, exposure limits, financing to non-residents and placements of bank funds abroad and risk classification are also given.

As per guidelines given in chapter seven, IBIs are required to introduce effective risk management systems that address the issues related to rate of return, foreign exchange, equity and commodity price risks and to address such risks in a structured manner by upgrading their risk management policies, practices and procedures and adopting comprehensive Asset-Liability Management (ALM) practices. IBIs have been instructed to develop and maintain an informed policy about an appropriate level of the balances of Profit Equalization Reserve (PER), bearing in mind that its essential function is to provide for mitigation of the displaced commercial risk. With respect to the treatment of PER and Investment Risk Reserve (IRR), the Licensees must adopt fair, diligent and Sharīʻah compliant practices for the benefit of the Investment Account Holders (IAHs). Chapter eight sets out the principles pertaining to appropriate systems and controls to address Licensees' operational risk, which is defined as the risk of losses resulting from inadequate or failed internal processes, systems or external events including legal risk and Sharīʻah compliance risk. In order to manage the Sharīʻah non-compliance risk, it has been emphasized that Licensees shall have in place adequate systems and controls regarding SSB and internal Sharīʻah reviewers, to ensure compliance with Sharīʻah principles. It also provides guidelines on measuring, monitoring and controlling operational risks involved in various Islāmic contracts and instructions for combating money laundering and terrorist financing. Chapter nine categorized into funding and liquidity risks, sets out rules and guidance pertaining to liquidity risks, highlighting the key elements for effective liquidity management within the scope of licensees' exposures.

General Rules and Guidance provide definitions and profiles of liquidity risk, Liquidity Management Framework, Role of the Board of Directors, Role of Senior Management, identification, monitoring and mitigation of risk, and Islāmic contracts for generating liquidity and investing surplus funds and relevant guidelines on interbank *muḍārabah*, interbank *mushārakah*, interbank *wakālah* and (conditional & restricted use of) Commodity *murābaḥah* (that makes it *fiqhī tawarruq* only, not financial or organized *tawarruq*). The last chapter sums up the Banking Law, regulatory and circular provisions of the central bank, not covered in earlier chapters, such as evaluation of KYC, customers' complaints redressal system, confidentiality in banking transactions, reporting requirements, payments system and instructions regarding promotion of banking products and services.

Another unique feature of the IBRF is clarity on the main objectives of the Sharīʻah Governance framework which are:

- *To provide a structure and a system to govern all the business activities of the Licensee in order to ensure Sharī'ah compliance at all times and at all levels.*
- *To enable the Licensee **to be perceived as Sharī'ah compliant by the stakeholders including the general public.***

The most important feature of Islāmic banking in Oman is prohibition of doubtful and debatable products. IBIs in Oman are not allowed to undertake any *tawarruq* /commodity *murābaḥah*, 'sale and buy-back' or any other product of the same nature.

Even though, Oman is a late entrant in Islāmic banking and finance, it has received global attention in view of its strong Regulatory Framework and Sharī'ah Governance prescriptions. Thomson Reuters' Global Islāmic Finance Indicator Report has placed the Sultanate in 3rd position globally with respect to most developed Islāmic Finance Market. However, the need to ensure full compliance of the regulatory requirements was also emphasized in the Report.

Issues and challenges:

1. **Non-availability of experienced human resources in Islāmic Banking and finance:**
   Being new in Islāmic banking, Oman's Islāmic banking sector faces scarcity of well qualified and experienced human resources locally. Islāmic banking institutions in Oman have been attracting experienced Islāmic bankers from other developed markets for key and technical positions. These bankers are well equipped with relevant experience in dealing with similar challenges in other markets, and are guiding the industry in the right direction and are grooming and training Omani workforce. Omani bankers have now started replacing non-Omanis successfully.
2. **Lack of awareness of Islāmic finance among the public:**
   Similar to other countries where Islāmic finance has been introduced, the initial perception is that people are generally 'unconvinced'. They react with skepticism when they find out that the profit rates on deposits and cost for Islāmic products are more or less the same as for conventional finance. However, Islāmic banking institutions and the Central Bank are paying full attention towards human resource development and stakeholders' awareness. Several conferences and

seminars have been held since 2011 and as a result the awareness level here is improving fast.

However, a well-organized government sponsored and patronized nationwide awareness campaign is the need of the hour to be launched by the involvement of print and electronic media, organizing seminars, conferences and awareness programs for various stakeholders including general public, business community and the Sharīʻah scholars who are not associated with Islāmic banking/financial institutions.

3. **Liquidity Management:**
   Liquidity Management in Islāmic banks is a major issue everywhere, not in Oman only. Central bank and industry players need to work in collaboration to overcome this challenge. It is learnt that the central bank is actively working on development of liquidity management tools; Government is also planning to issue marketable *ṣukūk* in near future, which may solve the problem to some extent.

4. **Innovative Products:**
   As Islāmic banking is asset (or service) based banking, an Islāmic banking institution cannot be merely a lending institution. It offers an asset or service to its customers instead of lending on the basis of interest. Islāmic banks need to develop products for financing needs of its retail and corporate customers in accordance with the true nature of Islāmic finance i.e. by providing a service or an asset. For this, Islāmic banks need to work hard and develop innovative products using suitable Islāmic finance modes.

As mentioned earlier, Islāmic banks in Oman are not allowed to offer *tawarruq*, commodity *murābaḥah* or any similar product in any other name; so they need to develop suitable alternate products for their customers using Islāmic finance modes like *ijārah tul-Ashkhāṣ*, *salam*, *istiṣnāʻ* or any other permissible modes to meet needs of their customers.

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