# THE LEGAL AND REGULATORY ASPECT OF LIBERALIZATION IN CORPORATE FINANCE. DESIGNING STRICTER REGULATION IS DESIRABLE TO PREVENT FINANCIAL DOWNTURN, WHICH RESULTS IN ECONOMIC RECESSION. ISLAMIC FINANCE PROSPECTIVE.

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The purpose of this report is to examine the legal and regulatory aspect of liberalization in corporate finance and to discuss whether designing stricter regulation is desirable to prevent financial crises that brins to economic recession in line with Islamic Finance industry. The report will begin by defining liberalization in corporate finance, followed by a discussion of the legal and regulatory framework governing corporate finance. The report will then examine the impact of liberalization on financial crises, how it influenced Islamic financing sector, and finally, it will evaluate the arguments for and against designing stricter regulations.

**Keywords:** Stricter Liberalization, Financial crisis, Islamic Finance Regulations.

## INTRODUCTION

Liberalization in corporate finance

In current financial market liberalization takes important place, if one outside of financial world would question what is liberalization oxford dictionary defines this concept as freeing legal, political or religious system[1]. The same approach can be applied to define financial liberalization, this concept of international liberalization was introduced by developed countries after the collapse of Bretton Woods system[2]. According to the theory by giving more decision-making power to the central banks, freeing their interest rate, terms of external flows of capital in various forms[3]; permitting financial innovation and letting the market to determine the price and how the credits should be allocated, would promote economic development[4]. However,

[1] Oxford Dictionary, <https://www.oxfordlearnersdictionaries.com/us/definition/english/liberalization?q=liberalization> ,Accessed March 6, 2023.

[2] Buerhan Saiti, 'The diversification benefits from Islamic investment during the financial turmoil: The case for the US-based equity investors'[2014] Borsa Istanbul Review <https://reader.elsevier.com/reader/sd/pii/S2214845014000313?token=B6CE79CA12B41D6C4C21B398940BCC4E27C6F42890119B41289904551CB61DB3E2BC8EA93653EA02368D3B7BC27070DE&originRegion=eu-west-1&originCreation=20230303052359 > Accessed March 6, 2023.

[3] Jayati Ghosh, 'The Economic and Social Effects of Financial Liberalization: A Primer for Developing Countries' [2005] DESA Working Paper No. 4 < https://www.un.org/esa/desa/papers/2005/wp4_2005.pdf > Accessed March 6, 2023.

[4] Philip Arestis and others, 'Financial Liberalization: The Experience of Developing Countries' [1999] 25(4) Eastern Economic Journal <https://www.jstor.org/stable/pdf/40325950.pdf?refreqid=excelsior%3A25db26ea60b2a6f985fd12f764f18906&ab_seg

from the practice of developed countries, it can be said that mismanagement of financial liberalization and globalization can serve as a main path to trigger crises and bubbles[1]; creation of unchecked or not existing money; lack of moral/ethnical values[2]. One of the main risks associated with liberalization is the potential for excessive risk-taking by financial institutions, which leads to those problems, after results in economic recession[3]. The main aim of regulation is to protect investors as well as costumers for financial products and to prevent occurrence of financial downturns by providing stability and resilience to the all participants of financial sector[4]. The importance of stability was shown in case of financial crisis of 2007-8, where financial institutions, mainly banks failed to meet those requirements of protection and stability of whole market through proper regulations, despite the common believe 'too big to fail'[5]. While Islamic Financing and Economics' fundamental features is socio-economic and distributive justice based on Shariah Law, the principles of risk-sharing and asset-based financing may help to promote financial stability[6]. Moreover, it emphasizes a comprehensive system of ethics and moral values[7]. Overall, designing and implementing stricter regulation is necessary to prevent economic downturns; however, it must be designed in precise way to avoid unintended consequences.

**Legal and Regulatory Aspects of Liberalization in Corporate Finance**

Corporate finance regulation frameworks primarily address a range of issues such as: disclosure requirements, accounting standards, corporate governance, investor protection, and risk management[8]. These regulations focuses to promote transparency, accountability, and responsible behavior in the financial markets. However, they may be in complex form, costly, and subject to political influence, which can create loopholes and opportunities for non-compliance.

Financial services regulation mainly can be followed in two manners: principles-based or rules based. Principles-based regulation entails shifting away from detailed, prescriptive standards (rules) and toward high-level, broadly stated rules or Principles

ments=&origin=&initiator=&acceptTC=1 > Accessed March 6, 2023.

[1] Frederic S. Mishkin, *The Economics of Money, Banking, and Financial Markets (12th edn, Pearson Education 2019)*

[2] Muhammad Ayub, *Understanding Islamic Finance*, (John Wiley & Sons 2007)

[3] Jayati Ghosh, Above n 3

[4] Asian Development Bank, "Islamic Finance for Asia: Development, Prospects, and Inclusive Growth" [] <https://www.adb.org/sites/default/files/publication/226066/islamic-finance-asia.pdf> Accessed March 10, 2023

[5] Julie Young, "Too Big to Fail: Definition, History, and Reforms" <https://www.investopedia.com/terms/t/too-big-to-fail.asp> Accessed March 13, 2023

[6] Alfred Kammer and others, "Islamic Finance: Opportunities, Challenges, and Policy Options" [2015] INTERNATIONAL MONETARY FUND <https://www.imf.org/external/pubs/ft/sdn/2015/sdn1505.pdf> Accessed March 10, 2023

[7] Muhammad Ayub, Above n 6

[8] OECD, "Overview of the legal/regulatory framework with respect to the duties and responsibilities of boards in company groups" (2020) Duties and Responsibilities of Boards in Company Groups, accessed 18 March, 2023 <https://doi.org/10.1787/859ec8fe-en> Accessed March 10, 2023

to establish the standards by which regulated firms must conduct business[1]. For instance, United Kingdom has similar approach, under which broad behavioral standards expected of services suppliers, allowing the market to determine the best manner in which regulatory objectives can be satisfied. While it decreases the expense and burden of regulation, it necessitates proactive oversight and enforcement flexibility. The flexibility to respond quickly to changes in the financial marketplace is one of the benefits of principles-based regulation. Furthermore, principles are supported by comprehensive and prescriptive rules. The advantages of a rules-based approach, such as that used in the United States, include legal predictability by ensuring that regulatory discretion is limited by specific rules. Rules-based or prescriptive regulation addresses specific situations or problems and may result in regulatory arbitrage and a box-ticking compliance culture. Prescriptive standards, according to the UK Financial, are unable to address changing market circumstances and practices at all times, resulting in delays, inability to prevent misconduct, and becoming a burden for the regulator and industry.

**The Need for Stricter Regulations to Prevent Financial Crisis**:

The global financial crisis of 2008 highlighted the need for stricter regulations in corporate finance to prevent systemic risk and promote financial stability. The crisis was triggered by excessive risk-taking, complex financial instruments, and inadequate regulation, which led to the collapse of major financial institutions and a global economic recession[2]. Therefore, designing stricter regulations is desirable to prevent financial crises that can have devastating consequences for the economy and society[3].

Stricter regulations one of the available options to reduce systemic risk by imposing limits on leverage, requiring higher capital ratios, and promoting transparency and accountability in the financial markets. They can also promote responsible behavior by financial institutions, improve risk management practices, and enhance investor protection. However, stricter regulations may also have unintended consequences, such as reduced competitiveness and innovation, increased compliance

[1] Julia Black, “Making a success of Principles-based regulation” [2007] Law and Financial Markets Review < https://www.lse.ac.uk/law/people/academic-staff/julia-black/Documents/black5.pdf> Accessed March 13, 2023

[2] Philip Arestis, above n 4

[3] Micheal P. Dooley and others, ‘Financial Liberalization in Developing countries’ Finance & Development, September [1987] <https://www.google.com/search?q=Micheal+P.+Dooley+and+others%2C+%E2%80%98Financial+Liberalization+in+Developing+countries%E2%80%99&oq=Micheal+P.+Dooley+and+others%2C+%E2%80%98Financial+Liberalization+in+Developing+countries%E2%80%99&aqs=chrome..69i57.314j0j7&sourceid=chrome&ie=UTF-8#:~:text=Donald%20J.%20Mathieson.-,Financial%20Liberalization%20in%20Developing%20Countries%20%2D%20IMF%20eLibrary,https%3A//www.elibrary.imf.org%20%E2%80%BA%20article%2DA009%2Den,-PDF> accessed March 9, 2023

costs[1] and there is a risk that overly burdensome regulation can stifle innovation and growth in the financial sector.

How far Islamic Financial Market was influenced by Financial Crisis

The financial crisis of 2008 had some impact on the Islamic financial market, although it was not as severe as in the conventional financial market[2]. Here are some of the ways in which the crisis affected Islamic finance:

Reduced demand for Islamic financial products: The crisis led to a general decline in global economic activity, which reduced the demand for Islamic financial products. Many investors became more cautious and conservative in their investment decisions, leading to a decrease in the growth of the Islamic financial market[3].

Exposure to toxic assets: Some Islamic financial institutions had exposure to toxic assets, such as mortgage-backed securities, which caused losses in their portfolios. However, the overall exposure of the Islamic financial market to such assets was much lower than that of the conventional financial market, which helped to mitigate the impact of the crisis[4].

Increased regulatory scrutiny: The crisis led to increased regulatory scrutiny of financial markets, including the Islamic financial market. This led to a greater focus on risk management and transparency in Islamic finance, which helped to strengthen the industry and increase investor confidence.

Expansion of Islamic finance in response to the crisis: The crisis led to a growing interest in ethical and responsible finance, which helped to increase the demand for Islamic financial products. Many investors saw Islamic finance as a more stable and ethical alternative to conventional finance, which helped to fuel the growth of the industry.

Overall, the financial crisis of 2008 had some impact on the Islamic financial market, but the industry was able to weather the storm relatively well. The crisis highlighted the importance of ethical and responsible finance, which helped to increase the demand for Islamic financial products and strengthen the industry[5].

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[1] Noel Sacasa, “Preventing Future Crises” [2008] 45(4) Finance and Development <https://www.imf.org/external/pubs/ft/fandd/2008/12/sacasa.htm> Accessed March 13,2023

[2] Ghassan, Hassan B, “Financial Stability of Conventional and Islamic Banks: A Survey” [2017] MPRA <https://mpra.ub.uni-muenchen.de/82372/1/MPRA_paper_82372.pdf> Accessed March 13, 2023

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[4] Ghassan, Hassan B, above n 17

[5] M. Kabir Hassan, “The Global Financial Crisis and Islamic Finance” <https://www.sesric.org/imgs/news/image/585-paper-1.pdf> accessed March 17, 2023

**A Case of Islamic Finance:**

In the context of Islamic finance, the challenges of designing and implementing stricter regulation are even greater. Islamic finance is based on principles that are different from those of conventional finance, and the lack of a comprehensive regulatory framework for Islamic finance has been a concern for regulators and market participants. The principles of Islamic finance are based on ethical and moral principles, which make it an attractive alternative to conventional finance. Islamic finance is becoming increasingly popular in the global financial system, with an estimated market size of $2 trillion in 2021[1]. Islamic finance has several features that differentiate it from traditional finance, such as profit and loss sharing (mudarabah), asset-backed financing (ijara), and risk-sharing (takaful)[2]. In the interests of certainty, interest (riba), gambling (maisir), and uncertainty (gharar) must be avoided in practice of all those Islamic financial instruments. Those three prohibitions are main constitutional elements of Islamic Financial law[3].

Islamic Finance has untraditional approach as well as regulatory framework which is based on Shariah principles, which require ethical and socially responsible behavior in the financial markets[4]. Moreover, this system promotes transparency, accountability, and risk management, which are essential for financial stability. However, Islamic financial market also faces several problems, such as the lack standardized regulatory framework, as the teachings of four different Islamic school of thoughts differ in giving decisions concerning permitted ways of using Islamic banking tools; another issue is associated shortage of qualified Shariah scholars, and limited financial infrastructure[5]. The Financial Stability Board (FSB) published a report concerning the regulation and supervision of Islamic finance in 2015. This report recognized the rapid increase in demand towards Islamic finance and the need for greater harmonization of regulatory standards across different jurisdictions. The report recommended that regulators should adopt a proportionate approach to regulation and supervision of Islamic finance, taking into account the specific risks and characteristics of Islamic finance.

Macro-level evidence of distributive justice and development in the modern world through implementation of Islamic Finance regulatory standards are experienced in many countries. One example is the trickle-down theory (TDT) applied in Malaysia

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[1] Mehmet Asutay and others, 'Islamic Finance in Europe' in Mohyedine Hajjar (eds) (Springer Nature Switzerland AG 2019)

[2] Zamir Iqbal, 'Islamic Financial Systems' [1997] 34(2) Finance and development < https://www.imf.org/external/pubs/ft/fandd/1997/06/pdf/iqbal.pdf > Accessed March 9, 2023

[3] M Kabir Hassan and others, 'Introduction to Islamic Finance and Banking' (Pearson 2013)

[4] M Kabir Hassan, above n 21

[5] Julie Young, Above n 9

from 1957 to 1970 which tragically failed[1], resulting in the country's race riots on May 13, 1969. After the Malaysian governmental body implemented a policy based on Islam's core value of justice and fairness, which has contributed significantly to the country's miraculous achievement during last decades. Even if the government was incapable to implement all Shariah principles in concise way, it implemented a pragmatic policy (New Economic Policy) with the dual aims of eradicating poverty and restructuring society to ensure justice and fairness[2].

In other hand, Uzbekistan is an example of limited practice and infostructure of Islamic finance. Uzbekistan has escalating high demand in Islamic Finance as main population are Muslims with increasing interest in halal banking[3]. Currently only several companies work under Shariah law, these are mainly only Iman invest and Appex Takafful. In 2003 Uzbekistan become member of Islamic Development Bank, but since, despite number of trainings[4] in local banks to open Islamic Banking windows, currently we do not have even one which is actually operating. Of course, there is many other ongoing projects but the general infostructure can be further developed by implementing legal instruments supporting it.

**Advantages of Islamic Financing**

The strict regulations in Islamic financing are intended to prevent exploitation, promote transparency, and ensure fairness in financial transactions towards both. They require financial institutions to engage in ethical and responsible lending practices, to disclose all relevant information to their customers, and to share profits and losses with their customers in a fair and equitable manner. These aspects of mutual risk sharing ensure financial market stability.

Stability

One of the most important aspects in financial market is stability. The proper definition for financial stability might sound like Garry J. Schinasi stated:

"A financial system is in a range of stability whenever it is capable of facilitating (rather than impeding) the performance of an economy, and of dissipating financial imbalances that arise endogenously or as a result of significant adverse and unanticipated events"[5]

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[1] Hashim Sabo Bello and others, "Islamic economy as an alternative solution to managing economic crisis: Some fashionable case studies of Iran, Malaysia Saudi Arabia" [2018] 2(3) Financial Markets, Institutions and Risks < https://core.ac.uk/download/pdf/324216758.pdf > Accessed March 13, 2023

[2] Muhammad Ayub, above n 6

[3] Muzaffar Mirzaev, 'Islamic Banking potential in Uzbekistan' [2018] RB Asia <https://www.rbasia.uz/post/2019/01/01/islamic-banking-potential-in-uzbekistan > Accessed March 9, 2023

[4] ISDB, 'Training Programs for 4 Uzbek Banks on Establishing Islamic Windows' [2022] <https://isdbinstitute.org/training-programs-for-4-uzbek-banks-on-establishing-islamic-windows/ > Accessed March 20, 2023

[5] Garry J. Schinasi," Defining Financial Stability" [2004] IMF working paper <https://www.imf.org/external/pubs/ft/wp/2004/wp04187.pdf> accessed March 16, 2023

The claim is advanced that an interest-based financial system is vulnerable to inflation because money creation is unrelated to productive investment, whereas inflation is allegedly minimized in the Islamic banking system because the money supply is proportional to and correlated with economic activities. According to Islamic economists, techniques like mudarabah and musharakah are used to finance production rather than consumption, and thus do not contribute to inflation. Additionally, investors may be obligated to absorb any losses that arise from loans. For these reasons it results in less leverage, and greater incentive to exercise strong risk management. The risk-sharing features of these financial instruments help to ensure the soundness of individual financial institutions and discourage the forms of lending booms and real estate bubbles that preceded the global financial crisis[1].

Interest

The first major difference between conventional and Islamic financing is the application the principle of interest-based lending, while in first case banks mainly profit from it, Islamic financing and banking prohibits charging or paying of interest (riba). To be precise, conventional banks gain profit on the difference among the interest it pays to depositors, moreover, on the interest it charges borrowers. In Islamic banking, lending is based on a profit or loses of the investment with the borrower[2]. Moreover, many western economists like Fisher, Simons and Friedman believe that current interest-based financial is fundamentally unstable[3]. Currently practiced schemes under interest through leveraging mechanisms and debt are the main cause of instability, and equity financing, from Islamic Financing, may help the system to improve its immunity to financial shocks. In an Islamic finance framework, financial institutions will only be liable for losses that are proportional to their share of the invested capital. Furthermore, the lack of debt and leveraging (despite hedge funds and securitization) limits financial failure to client investors and does not put other market players at risk[4].

Risk

Under Islamic Banking borrower as well as the bank share the risk of the investment. In conventional banking risk is only under borrowers' shoulder[5]. Under

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[1] Mohamed Norat and others, "The Promise of Islamic Finance: Further Inclusion with Stability" [2015] < https://www.imf.org/en/Blogs/Articles/2015/04/06/the-promise-of-islamic-finance-further-inclusion-with-stability#:~:text=Islamic%20finance%20has%20an%20important,to%20exercise%20strong%20risk%20management.> Accesssed March 15, 2023

[2] Faud Al-Omar, Above n 23

[3] [3] Ghassan, Hassan B, "Financial Stability of Conventional and Islamic Banks: A Survey" [2017] MPRA <https://mpra.ub.uni-muenchen.de/82372/1/MPRA_paper_82372.pdf> Accessed March 13, 2023

[4] Ghassan, Hassan B, "Financial Stability of Conventional and Islamic Banks: A Survey" [2017] MPRA <https://mpra.ub.uni-muenchen.de/82372/1/MPRA_paper_82372.pdf> Accessed March 13, 2023

[5] Muhammad Ayub, Above n 6

the first approach both bank and borrower have a stake in the success of the project, which evolves an alignment of incentives between them[1]. For instance, in the case of Investment Dar Company v Blom Development Bank SAL [2009] EWHC 3545, the UK High Court held that a bank's failure to disclose information about the risks associated with an investment in a Shariah-compliant investment fund amounted to a breach of duty. The case highlighted the importance of transparency and disclosure in Islamic finance, and the need for clear and comprehensive regulatory standards.

By summarizing arguments stated above, the key benefits of Islamic financing regulations include:

1. Ethical and responsible lending practices: Islamic financing regulations require financial institutions to lend money in an ethical and responsible manner. This helps to prevent exploitation and ensures that borrowers are treated fairly.

2. Transparency: Islamic financing regulations require financial institutions to disclose all relevant information to their customers. This helps to ensure that customers are fully informed about the terms and conditions of their financial transactions.

3. Profit and loss sharing: Islamic financing regulations require financial institutions to share profits and losses with their customers in a fair and equitable manner. This helps to align the interests of financial institutions with those of their customers and promotes a more cooperative and collaborative approach to lending.

4. Focus on real economic activity: Islamic financing regulations discourage speculation and encourage investment in real economic activity. This helps to promote sustainable economic growth and development.

Overall, the strict regulations in Islamic financing help to ensure that financial transactions are conducted in a manner that is consistent with Shariah law and that promotes ethical and responsible lending practices, transparency, and fairness.

## CONCLUSION

In conclusion, the liberalization of corporate finance has both benefits and risks, with the potential for financial crises and economic recession due to excessive risk-taking by financial institutions. Designing and implementing stricter regulation is necessary to prevent financial crises, to stabilize financial market and to protect investors and users of financial instruments, but it must be carefully designed to avoid unintended consequences. The challenges of designing and implementing stricter regulation in Islamic finance are even greater, but they must be addressed to ensure the stability and growth of the Islamic finance industry. The principles of Islamic finance provide an attractive alternative to conventional finance, with the potential to promote financial stability, ethical and responsible behavior, and sustainable economic growth

[1] M Kabir Hassan, above n 21

and development. This paper aimed to evaluate and highlight the importance of proportionality, transparency, and disclosure in regulatory decision-making and the need for clear and comprehensive regulatory standards in Islamic finance, in order to achieve actability of the market.

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