

OCCASIONAL PAPER # 3

ISLAMIC DEVELOPMENT BANK
ISLAMIC RESEARCH AND TRAINING INSTITUTE

REGULATION AND SUPERVISION OF ISLAMIC BANKS

M. Umer Chapra and Tariqullah Khan

JEDDAH - SAUDI ARABIA
1421H (2000)

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LIST OF ABBREVIATIONS

AAOIFI	:	Accounting & Auditing Organisation for Islamic Financial Institutions
BCBS	:	Basel Committee for Banking Supervision
BIS	:	Bank for International Settlements
FSB	:	Financial Services Board
GDDS	:	General Data Dissemination System
IAIB	:	International Association of Islamic Banks
IAIS	:	International Association of Insurance Supervisors
IASC	:	International Accounting Standards Committee
IASs	:	International Accounting Standards
ICSs	:	Internal Control Systems
IDB	:	Islamic Development Bank
IFSB	:	Islamic Financial Services Board
IIMM	:	Inter-Bank Islamic Money Market
IIRA	:	International Islamic Rating Agency
IMF	:	International Monetary Fund
IOSCO	:	International Organisation of Securities Commissioners
IRTI	:	Islamic Research and Training Institute
JFFC	:	Joint Forum on Financial Conglomerates
LOFSA	:	Labuan Offshore Financial Services Authority (Malaysia)
OECD	:	Organisation for Economic Co-operation and Development
OIC	:	Organisation of the Islamic Conference
PLS	:	Profit-and-Loss Sharing
SDDS	:	Special Data Dissemination Standards

FOREWORD

The Islamic financial services industry, comprising of commercial and investment banks, insurance (*takaful*) companies, mutual funds and Islamic activities of conventional banks, has registered an accelerated growth over the last two decades and is expected to continue to do so in the future. Since greater market discipline is an inherent feature of this industry, its continued growth should have a positive impact on systemic stability in the global markets. Nevertheless, regulation and supervision of this industry are important policy concerns because of the unique nature of its deposits and modes of finance. It is, therefore, necessary to examine whether the conventional regulatory standards and supervisory oversight are adequate for safeguarding the interests of providers as well as users of funds and ensuring systemic stability, or something else is also needed.

Recognising this need, the Islamic Research and Training Institute (IRTI) has assigned priority to research and training in this area with the objective of meeting the regulatory and supervisory challenges posed by the growth of this industry. Since Islamic banks constitute the most important segment of the industry, the Board of Executive Directors of the Islamic Development Bank assigned to IRTI the task of preparing an Occasional Paper on *Regulation and Supervision of Islamic Banks*. The present paper prepared by M. Umer Chapra and Tariqullah Khan raises the various issues that need the attention of standard setters.

The dynamic nature of international financial markets stresses the need for continued research on the subject on an ongoing basis. It is hoped that the present paper will not only help standard setters, academics, policy makers and, above all, the industry itself, but will also open up avenues for future research. To continue the positive dialogue, IRTI welcomes any observations on the contents of this paper.

Ma'bid Ali al-Jarhi
Director, IRTI

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The first draft of this paper was circulated to a number of scholars and institutions and was revised in the light of their valuable comments. We wish to take this opportunity to thank them all for the invaluable help that they have kindly provided for improving the paper. Among the scholars who deserve special mention are Ma'bid Ali al-Jarhi, Habib Ahmad, Hussein Kamel Fahmy and Osman Babikir, all of them from IRTI. We also gratefully acknowledge the penetrating comments from Professors Anas Zarqa, Muhammad Ali El-Gari and Rafiq al-Misri who possess the rare combination of expertise in both economics and *fiqh*. Members of the IDB Policy Committee were also very generous in giving us their valuable critique during a discussion of the paper in the Bank's Policy Committee meeting.

The paper was also sent to experts associated with the IMF, the BIS, the AAOIFI and to David T. Llewellyn, Professor of International Banking, Loughborough University, UK, and Simon Wolfe, Professor of Banking and Finance, School of Management, University of Southampton, UK, to draw on their vast expertise in international banking regulation and supervision. V. Sundararajan and his colleagues (Michael Taylor, Ghiath Shabsigh and Muhammad Yaqub) at the IMF as well as Professors Llewellyn and Wolfe read the draft carefully and we have benefited immensely from their constructive critique and suggestions. We are also grateful to the Financial Stability Institute (FSI) of the Bank for International Settlements (BIS) for providing an opportunity to Tariqullah Khan to attend the 12th International Banking Supervisory Seminar held in the BIS during 28 April – 6 May 2000. His discussions with the resource persons and the participants in this Seminar proved to be very useful.

The final version of the paper thus reflects the valuable insights of all these scholars and institutions. It does not, however, necessarily reflect their views and, in particular those of the IDB and IRTI. Moreover, none of them has seen the final draft. They are not, therefore, responsible for any errors that may still remain.

Finally, we also wish to record our grateful thanks to Sheikh Muhammad Rashid for the efficient secretarial assistance that he has provided in the preparation of this paper.

M. UMER CHAPRA

TARIQULLAH KHAN

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GLOSSARY OF ARABIC TERMS

Some of these terms have a much wider meaning. It is, however, not possible to encompass this in a glossary. Given below is only the sense in which these terms have been used in this paper.

Bay'	:	Stands for sale and has been used here as a prefix in referring to the different sales-based modes of Islamic finance, like <i>murābahah</i> , <i>ijārah</i> , <i>istisnā'</i> , and <i>salam</i> (q.v.).
Fiqh	:	Refers to the whole corpus of Islamic jurisprudence. In contrast with conventional law, <i>fiqh</i> covers all aspects of life, religious, political, social or economic. In addition to religious observances like prayer, fasting, <i>zakāt</i> and pilgrimage, it also covers family law, inheritance, social and economic rights and obligations, commercial law, criminal law, constitutional law and international relations, including war. The whole corpus of <i>fiqh</i> is based primarily on interpretations of the Qur'an and the <i>Sunnah</i> and secondarily on <i>ijmā'</i> (consensus) and <i>ijtihād</i> (individual judgement). While the Qur'an and the <i>Sunnah</i> are immutable, <i>fiqhi</i> verdicts may change due to changing circumstances.
Fuqahā' (singular, faqīh)	:	Jurists who give opinion on various juristic issues in the light of the Qur'an and the <i>Sunnah</i> and who have thereby led to the development of <i>fiqh</i> .
Gharar	:	Literally means deception, danger, risk and uncertainty, but stands technically in the <i>fiqh</i> for exposing oneself to excessive risk and danger in a business transaction as a result of uncertainty about the price, the quality and the quantity of the counter-value, the date of delivery, and the ability of either the buyer or the seller to fulfill his or her commitment, thereby causing either of the two parties an undue loss.
Ijārah, bay' al-	:	Leasing.

<i>Istisnā', bay' al-</i>	:	Refers to a contract whereby a manufacturer (contractor) agrees to produce (build) and deliver a certain good (or premise) at a given price on a given date in the future. This is an exception to the general <i>Shari'ah</i> ruling which does not allow a person to sell what he does not own and possess. As against <i>salam</i> (q.v.), the price here need not be paid in advance. It may be paid in installments in step with the preferences of the parties or partly at the front end and the balance later on as agreed.
<i>Ji'alah</i>	:	Performing a given task against a prescribed fee in a given period of time.
<i>Khilāfat al-Rāshidah</i>	:	The period of the first four caliphs after the Prophet, ranging from the year 11AH (632 AC) to the year 41AH (661 AC).
<i>Mudārabah</i>	:	An agreement between two or more persons whereby one or more of them provide finance, while the others provide entrepreneurship and management to carry on any business venture whether trade, industry or service, with the objective of earning profits. The profit is shared by them in an agreed proportion. The loss is borne only by the financiers in proportion to their share in total capital. The entrepreneur's loss lies in not getting any reward for his/her services.
<i>Murābahah, bay' al-</i>	:	Sale at a specified profit margin. The term is, however, now used to refer to a sale agreement whereby the seller purchases the goods desired by the buyer and sells them at an agreed marked-up price, the payment being settled within an agreed time frame, either in installments or lump sum. The seller bears the risk for the goods until they have been delivered to the buyer. <i>Murābahah</i> is also referred to as <i>bay' mu'ajjal</i> .
<i>Mushārahah</i>	:	An Islamic financing technique whereby all the partners share in equity as well as management. The profits can be distributed among them in accordance with agreed ratios. However, losses must be shared according to the share in equity.
<i>Qard hasan</i>	:	A loan extended without interest or profit-sharing.

<i>Qur'an</i>	:	The Holly Book of the Muslims, consisting of the revelations made by God to Prophet Muhammad, peace and blessings of God be on him, during his Prophethood of about 23 years. The Qur'an lays down the fundamentals of the Islamic faith, including beliefs and all aspects of the Islamic way of life.
<i>Qurūd hasanah</i>	:	Plural of <i>qard hasan</i> .
<i>Ribā</i>	:	Literally means increase or addition, and refers to the 'premium' that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or an extension in its maturity. It is regarded by a predominant majority of Muslims to be equivalent to interest.
<i>Salam, bay' al-</i>	:	Sale in which payment is made in advance by the buyer and the delivery of goods is deferred by the seller. This is also, like <i>Istisnā'</i> , an exception to the general <i>Sharī'ah</i> ruling that you cannot sell what you do not own and possess.
<i>Sharī'ah</i>	:	Refers to the divine guidance as given by the Qur'an and the <i>Sunnah</i> and embodies all aspects of the Islamic faith, including beliefs and practices.
<i>Sunnah</i>	:	The <i>Sunnah</i> is the most important source of the Islamic faith after the Qur'an and refers essentially to the Prophet's example as indicated by his practice of the faith. The only way to know the <i>Sunnah</i> is through the collection of <i>ahādīth</i> , which consist of reports about the sayings, deeds and reactions of the Prophet, peace and blessings of God be on him.
<i>Zakāt</i>	:	The amount payable by a Muslim on his net worth as a part of his religious obligations, mainly for the benefit of the poor and the needy.

EXECUTIVE SUMMARY

The Islamic financial services industry has expanded substantially over the last three decades. However, further growth of this industry as well as its successful response to the challenges of promoting systemic stability and economic development depend on the adoption of international standards of best practices, the resolution of certain unresolved *fiqhi* issues, and the creation of a proper enabling environment. The paper addresses primarily the crucial question of how to apply the international regulatory standards to Islamic banks, the nature of whose investment deposits, modes of financing, and risk profiles are different from those of conventional banks as a result of the need to comply with the *Shari'ah*.

The paper reviews the standards set by the Basel Committee for Banking Supervision (BCBS). It finds the three pillars of the new Basel framework, namely capital adequacy, supervisory review process, and market discipline to be equally relevant to Islamic banks. It argues that adoption of the new system for risk weighting of assets proposed by the BCBS can help cultivate an effective risk-management culture in Islamic banks through internal ratings and proper control systems. The paper argues that it will be easier for these banks to adopt international standards if separate capital standards are set for demand and investment deposits with the clear objective of protecting demand deposits and transforming investment deposits into mutual funds. This will enhance the endorsement of Islamic banking by international standard setters, thus promoting its worldwide acceptance and enabling it to compete successfully in a globalising environment.

This creates the need to establish an institution that would help set regulatory standards and a framework for supervisory oversight for Islamic financial institutions. There will also be the need to train Islamic bank regulators and supervisors for developing effective internal rating and control systems and risk management culture in these banks. This will, in turn, improve the external rating of these banks and help them not only in utilising their equity capital more efficiently but also in enhancing their growth and stability.

The paper also discusses some of the crucial *fiqhi* issues that need to be resolved to facilitate the effective supervision of Islamic banks and accelerate their development. It also highlights the facilities that need to be provided to help them overcome a number of the difficulties that they are facing.

Part I

INTRODUCTION

The prohibition of interest in Islam, as in some other major religions, and the aspiration of Muslims to make this prohibition a practical reality in their economies, has led to the establishment of a number of Islamic financial institutions around the world. These institutions include Islamic commercial and investment banks, *takāful* (mutual insurance) companies, leasing and *mudārabah* companies, and other non-bank financial institutions.

However, the imperative of ensuring the viability, strength, and continued expansion of these institutions and enhancing their contribution to financial stability and economic development has raised a number of questions. One of these is related to the nature of regulatory standards and supervisory framework that are needed for the purpose. This leads to the related question of whether the existing international standards of best practices are adequate or whether anything more is also needed in view of the relatively different risk perspective of these institutions. The primary objective of this paper is to answer these questions. However, some background material is also provided to put the whole discussion in a proper perspective.

1.1 FINANCIAL INTERMEDIATION IN ISLAMIC HISTORY

From the very early stage in Islamic history, Muslims were able to establish a financial system without interest for mobilising resources to finance productive activities and consumer needs. The system to finance business activities was based largely on the profit-and-loss sharing (PLS) modes of *mudārabah* (passive partnership) and *mushārah* (active partnership). Deferred trading and interest-free loans (*qurūd hasanah*) were also used to finance consumers' as well as business transactions.¹

The system worked quite effectively during the heydays of Islamic civilisation and for centuries thereafter. According to Udovitch, the Islamic modes of financing (*mudārabah* and *mushārah*) were able to mobilise the "entire reservoir of monetary resources of the medieval Islamic world" for financing agriculture, crafts, manufacturing and long-distance trade. They were used not

¹ For a relatively more detailed meaning of the Arabic terms used here and elsewhere in this paper, see the Glossary.

only by Muslims but also by Jews and Christians² to the extent that interest-bearing loans and other overly usurious practices were not in common use.³ According to Goitein, breach of the Jewish, Christian and Islamic law against interest was found in the Geniza documents “only once in the record of a judgement”, even though “an unusually large amount of Geniza documents deal with credit.”⁴ Schatzmiller has also concluded that “financial capital was developed during the early period by a considerable number of owners of monetary funds and precious metals, without the supposed interdiction of *ribā*, usury, hampering it in any way.”⁵

Financiers were known in the early Muslim history as *sarrāfs*.⁶ By the time of the ‘Abbasid caliph al-Muqtadir (295-320AH/908-932AC), they had started performing most of the basic functions of modern banks.⁷ They had their own markets, something akin to the Wall Street in New York and the Lombard street in London, and fulfilled all the banking needs of commerce, industry and agriculture⁸ within the constraints of the then-prevailing technological environment. However, since the *sarrāfs* were not banks in the strictly technical modern sense, Udovitch has preferred to call them “bankers without banks.”⁹

The legal instruments necessary for the extensive use of financing through *mudārabah* and *mushārah* were already available in the earliest Islamic period.¹⁰ These instruments, which constituted an important feature of both trade and industry and provided a framework for investment, are found in a developed form in some of the earliest Islamic legal works.¹¹ Some of the institutions,

² Udovitch, 1970, pp.180 and 261.

³ Udovitch, 1981, p.257; see also p.268.

⁴ Goitein, 1967, pp.255 and 250 respectively. See also Goitein, 1966, pp.271-4.

⁵ Schatzmiller, 1994, p.102.

⁶ These were also called *sayārīfah* (sing., *sayarīfī*) (See the word *sarf* in Ibn Manzūr, *Lisān al-‘Arab*). Another less popular word used for *sarrāfs* was *jahābidhah* (sing., *jahbadh*). The *sarrāfs* were, more widespread because they provided banking facilities to the public sector as well as an extensive private sector. The *jahābidhah* were less prevalent because they served mainly the public sector (cf., Dūrī, 1986, p.898).

⁷ See Fischel, 1992.

⁸ Dūrī, 1986, p.898.

⁹ Udovitch, 1981.

¹⁰ Udovitch, 1970, p.77.

¹¹ Udovitch, 1970, pp.77-8.

practices and concepts already fully developed in the Islamic legal sources of the late eighth century did not appear in the West, according to Udovitch, until several centuries later.¹²

The ability to mobilise the financial resources, along with a combination of several economic and political factors,¹³ provided a great boost to trade which flourished from Morocco and Spain in the West, to India and China in the East, Central Asia in the North, and Africa in the South. The extension of Islamic trade influence is indicated not only by the available historical documents but also by the Muslim coins of the seventh to the eleventh centuries found through excavations in countries like Russia, Finland, Sweden, Norway, the British Isles and Scotland which were on the outskirts of the then-Muslim world.¹⁴ The expansion of trade generated prosperity, which, in turn, “made possible a development of industrial skill which brought the artistic value of the products to an unequalled height.”¹⁵ However, despite the dominant role of the private sector in financial intermediation in the earlier periods, financial institutions had not become highly complex and overextended to pose a threat to systemic stability and to become a public policy concern.

1.2 REBIRTH OF ISLAMIC FINANCE: SYSTEMIC SIGNIFICANCE

Due to a number of historical circumstances, the Muslim world lost its technological and economic vitality.¹⁶ Hence a number of the Islamic institutions, including the Islamic system of financial intermediation, became displaced by Western institutions. However, the independence of Muslim countries has led to the revival of Islam and there is a longing to gradually reinstate most of the lost institutions, the Islamic financial system being one of them.

Two approaches have been adopted by Muslim countries for eliminating interest from their financial systems. Three countries, Pakistan, Iran and Sudan, have opted for the removal of interest from the operations of all their financial institutions simultaneously. In contrast with this, a number of countries, including some non-Muslim ones, have allowed the establishment of Islamic banks

¹² Udovitch, 1970, p.261.

¹³ For a discussion of some of these, see Chapra, 2000, pp.173-85.

¹⁴ Kramers, 1952, p.100; see also pp.101-6.

¹⁵ Udovitch, 1970, p.104.

¹⁶ For a discussion of these, see Chapra, 2000, pp.173-252

alongside of conventional interest-based banks. According to data collected by the International Association of Islamic Banks (IAIB), there were more than 176 financial institutions in the public and private sectors of both these groups of Muslim and non-Muslim countries by 1997 (see Table 1, Section A). They had a capital of \$7.3 billion and reserves of \$3.1 billion. Their assets and deposits amounted to 147.7 billion and \$112.6 billion respectively.

Table 1

**SYSTEMIC SIGNIFICANCE OF ISLAMIC FINANCIAL INSTITUTIONS
(000 US \$)**

A. COMBINED SIZE

Year	No. of Banks	Combined Capital	Combined Assets	Combined Funds under Management	Combined Reserves	Combined Net Profits
1993	100	2,390,259	53,815,280	41,587,332	N/A	N/A
1994	133	4,954,007	154,566,911	70,044,222	2,383,413	809,076
1995	144	6,307,816	166,053,158	77,515,832	2,918,995	1,245,493
1996	166	7,271,003	137,132,491	101,162,943	5,745,765	1,683,648
1997	176	7,333,079	147,685,002	112,589,776	3,075,526	1,218,241

B. SECTORAL FINANCING (Percent of total)

Year	Trading	Agriculture	Industry	Services	Real Estate	Others
1993	30.5	13.3	30.1	11.4	N/A	14.7
1994	26.96	13.32	27.54	14.79	5.44	11.96
1995	29.81	8.53	18.91	13.1	12.1	17.13
1996	31.17	7.5	18.82	13.17	11.67	17.67
1997	32	6	17	12	16	16

C. MODES OF FINANCING (Percent of total)

Year	<i>Murābahah</i>	<i>Mushārakah</i>	<i>Mudārabah</i>	<i>Ijārah</i>	Others
1994	41.54	8.17	12.56	8.70	26.79
1995	45.58	8.72	15.25	9.72	21.06
1996	40.30	7.20	12.70	11.50	28.30
1997	37.00	19.00	6.00	9.00	29.00

Source: International Association of Islamic Banks (1997).

During 1997, these institutions made a net profit of \$1.2 billion. The ratio of their net profit to capital and assets was thus 23.1 and 1.2 % respectively. While most variables have registered a relatively high rate of growth their capital and reserves have not kept pace. They rather declined to 7 % of their assets

(unadjusted for their riskiness) in 1997 from 9.5 % in the previous year. This may perhaps have been partly due to the East Asia crisis which adversely affected nearly all financial institutions around the world.

Of the 176 institutions, 9 were in Europe and America, 47 in the Middle East (including 21 in the GCC countries), 35 in Africa, and 82 in Asia (of which 31 were in South East Asia and 51 in South Asia) (see Table 2). In addition, there were a number of banks which had not yet become members of IAIB. Moreover, the IAIB database does not include the rapidly expanding deposits accepted by a number of conventional banks on the Islamic basis and also the Islamic mutual and index funds marketed by both Islamic and conventional banks.

Table 2

**SYSTEMIC SIGNIFICANCE BY REGION:
SUMMARY OF FINANCIAL HIGHLIGHTS IN '000' US\$**

REGION	NO. OF SHARES	%	CAPITAL		TOTAL ASSETS		DEPOSITS		RESERVES		NET PROFITS	
			Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
South Asia	51	29	884,048	12	39,272,976	26	25,664,913	23	1,077,163	35	249,792	20
Africa	35	20	202,197	3	1,573,846	1	730,025	1	82,087	3	19,750	2
S.E. Asia	31	18	149,837	2	2,332,204	2	1,887,710	2	160,136	5	45,659	4
Middle East	26	15	3,684,136	50	83,136,100	56	69,076,443	61	382,286	12	252,185	20
G.C.C.	21	12	1,787,395	24	20,449,637	14	14,088,581	12	1,353,167	44	603,642	49
Europe/America	9	5	616,795	0	908,922	1	1,139,541	1	20,613	1	66,707	5
Asia	2	1	3,452	0	5,727	0	2,563	0	24	0	282	0
Australia	1	0	5,219	0	5,590	0	N/A	0	50	0	224	0
TOTAL	176	100	7,333,079	100	147,685,002	100	112,589,776	100	3,075,526	100	1,238,241	100

Source: International Association of Islamic Banks (1997).

Islamic banking has thus made substantial progress worldwide even though the niche that it has been able to create for itself in the total volume of international, or even Muslim world, finance is very small. What counts, however, is not the volume, but rather the respectability that the interest-free financial intermediation has attained and the positive evidence that it has provided about the workability and viability of this system. While in the 1950s and 1960s Islamic banking was only an academic dream, of which few people were aware even among educated Muslims, it has now become a practical reality. It has also attracted the attention of Western central banks like the Federal Reserve Board and the Bank of England, international financial institutions like the IMF and the World Bank, and prestigious centres of learning like the Harvard and Rice Universities in the United States and the London School of Economics and Loughborough University in the United Kingdom. It has also received favorable coverage in the Western press. Prospects for the future are expected to be better, particularly if the instability that now prevails in the international financial system continues to accentuate and leads to a realisation that the instability cannot be removed by making cosmetic changes in the system but rather by injecting into the financial system greater market discipline of the type that the Islamic financial system stands for.

1.3 THE CHANGED ENVIRONMENT: SHIFT IN EMPHASIS

There is, however, a substantial difference between the Islamic financial system as it existed in the early and medieval periods and as it exists now. This is to be expected. A dynamic system cannot continue to remain a replica of the past in an entirely different international and domestic milieu. Economies have become more complex and the international financial system has also followed suit in responding to the new challenges that it is facing. The financial system does not consist any longer of just banks. There is a wide variety of institutions which provide financial services and intermediate between the suppliers and users of diverse services. The financial services markets of our times are broadly classified into at least three functionally distinct categories: depository institutions (like commercial banks, finance companies, saving and loan associations, and credit unions), contractual saving institutions (like insurance companies and pensions funds), and investment intermediaries (like mutual funds and fund managers).¹⁷

¹⁷ See Mishkin, 1995, pp.38-40.

The Islamic financial system, which had been in a state of limbo during the long period of Muslim decline, has also been evolving along the same pattern in its attempt to respond successfully to the challenges that it faces. Consequently, the establishment of Islamic commercial banks has been accompanied by the establishment of Islamic investment banks, Islamic *takāful* (co-operative insurance) companies, and Islamic mutual funds. The efficiency and stability of the financial and payments system does not, therefore, depend any longer on the state of only one type of institution or sector. It also relies greatly on the inter-relationship between these institutions and sectors.

Since the three categories of financial institutions have been associated with distinct services, they are traditionally regulated and supervised by separate authorities. However, the interrelationship of the banking sector with the other two sectors as well as the scope of activities of banks vis-à-vis securities firms have attracted wide, and often divergent, academic and policy responses (see Chart-1 for a summary of such diversities). Islamic economists have generally favoured the performance of diversified activities by banks, often loosely included under the rubric of 'universal or multi-purpose banking'.

The evolutionary change has become reflected not only in the variety of institutions but also in the modes of financing. While in the classical period, the equity-based PLS modes of *mudārabah* and *mushārah* were the primary modes used, these constitute only about one-fourth (6.0 % and 19%) of the assets' portfolios of Islamic banks (Table 1, Section C). The remaining three-fourths of their portfolios consist of assets created through other modes of financing, which are also permissible under the *Sharī'ah*. These include shares of joint stock companies (which are essentially a combination of *mudārabah* and *mushārah*), and a number of sales-based modes like *murābahah*, *ijārah*, *salam*, and *istisnā'*.¹⁸ A number of factors point towards the need for this shift in the modes of financing.

- i. The legal framework for banking in many, though not all, Muslim countries is still dominated by the legal and institutional framework for conventional banking which dominates the international financial

¹⁸ Please see the Glossary for a brief explanation of these terms. A substantial volume of literature has become available on the different Islamic modes of finance. Some of this is included in the bibliography.

market and is not necessarily conducive to the adoption of PLS modes.

- ii. The PLS modes are relatively more risky because the rate of return on them may be either positive or negative, depending on the ultimate outcome of the business financed. This implies that there is a possibility of erosion in the principal amount of investment deposits in case of loss. This is not allowed in the conventional banking system where all (demand as well time and fixed) deposits are guaranteed. As a result of the likely effect of this erosion on the depositor, Islamic banks have hesitated to undertake these modes to a substantial extent in the initial phase of their operations. What makes it even more difficult is that they do not have adequate experience in the management of these modes and a number of the auxiliary or shared institutions needed for their successful operation are also not yet available. In contrast with this, the sales-based modes are relatively less risky and easier to manage. They do not involve PLS and the rate of return on them is positive and stipulated in advance. Even the depositors, who have become attuned to the concept of risk-free deposits as a result of their dealings with the conventional system over a long period, may perhaps have found it hard initially to swallow the idea of erosion in their deposits in spite of their desire to avoid interest.
- iii. Islamic banks have to compete with the conventional banking system in which all deposits are fully guaranteed, irrespective of whether they are demand, time or fixed. If the concept of bailing-in banks (making them, and also the depositors as a logical consequence, subject to loan losses), which has now started receiving expression in the Western academic circles¹⁹, becomes a practical reality in conventional banking, then Islamic banks may find it relatively easier to move towards the classical PLS modes.

¹⁹ See, for example, Meltzer (1998), Calomiris (1998) and Yeager (1998). The bailing-in proposal stands so far for making only the bank shareholders suffer the losses. It does not stand for bailing-in the depositors. However, the practical reality is that if a bank's capital turns out to be inadequate to offset the substantial losses suffered by it, and consequently the bank is allowed to fail, the depositors may also suffer substantial losses, if full protection is not provided by deposit insurance, as happened in the case of BCCI.

The predetermined rate of return on the sales-based modes makes them appear like interest-based instruments. They are however not so, as there are significant differences between the two for a number of reasons.

- i. The sales-based modes do not involve direct lending and borrowing. They are rather purchase, sale, or lease transactions involving *real* goods and services. The *Sharī'ah* has imposed a number of conditions for the validity of these transactions to ensure that the seller (financier) also shares a part of the risk and that these modes do not deteriorate into interest-based borrowing and lending transactions. One of these is that the seller (financier) must own and possess the goods being sold. The *Sharī'ah* does not allow a person to sell what he does not own and possess. Once the seller (financier) acquires ownership and possession of the goods for sale on credit, he/she bears the risk. All short sales, therefore, get ruled out automatically. Financing extended through the Islamic modes can thus expand only in step with the rise of the real economy and thereby help curb excessive credit expansion, which is one of the major causes of instability in the international financial markets.
- ii. It is the price of the good or service sold, and not the rate of interest, which is stipulated in the case of sales-based modes of finance. Once the price has been set, it cannot be altered even if there is a delay in payment due to unforeseen circumstances. This helps protect the interest of the buyer in strained circumstances. However, it may also lead to a liquidity problem for the bank if the buyer willfully delays payment.²⁰

However, most scholars agree that even though the sales-based modes are different from interest-based financing and are allowed by the *Sharī'ah*, the socio-economic benefits of the Islamic system of financial intermediation may not be realised fully until the share of PLS modes rises substantially in total financing.²¹ It would hence be desirable for the use of PLS modes to gain momentum.

²⁰ For a discussion of this problem, see Section 3.1 on the "Late Settlement of Financial Obligations".

²¹ For a discussion of the socio-economic benefits of the Islamic system of financial intermediation, see Chapra. (2000). See also Mills and Presley (1999), pp.58-72 and pp.114-120.

1.4 SYSTEMIC CHARACTERISTICS OF THE RE-EMERGING ISLAMIC FINANCIAL SYSTEM

Given the changes that have taken place in Islamic banking and will continue to do so in the future as a result of the evolutionary process through which it is going, it is not possible to pin down a precise definition for Islamic banking. Such a definition is difficult even in the case of conventional banking which, inspite of becoming mature after a long period of development, continues to evolve in response to changing circumstances. Nevertheless, it would help promote a better understanding of Islamic banks if they are tentatively defined within the modern context as depository institutions whose core business is financial intermediation on the basis of a combination of PLS and sales-based modes of financing. Their major characteristics may be said to be as follows:

- i. The liabilities side of Islamic banks' balance sheets generally consists of two types of deposits in addition to shareholders' equity:
 - Investment deposits: These are mobilised on the basis of profit- and-loss sharing (PLS) as well as the different sales-based modes of *murābahah*, *ijārah*, *istisnā'* and *salam* on the assets' side. Even the sales-based modes involve some risk, though not as much as the PLS modes. This participation of investment depositors in the risks of banking is unique to Islamic banking. However, the risks can, and should, be minimised through a proper management of banks in a suitable regulatory and supervisory framework.
 - Demand deposits: These do not participate in profit and loss and, being in the nature of debts owed by banks, their repayment must be fully guaranteed. This is also unique to Islamic banks, particularly if the concept of bailing-in becomes accepted in international banking.

The banks may explore other *fiqh*-compatible modes of resource mobilisation. Such resources are, however, negligible at present.

- ii. They render all the normal banking services which conventional banks are expected to render.

- iii. They also maintain, like the conventional banks, a banking book and a trading book.²²
- iv. The sales-based modes used by them create debt, just like the interest-based credit of the conventional banks. However, unlike the conventional banks, Islamic banks are not yet allowed by the prevailing juristic verdict to trade in debts. Once they have acquired a debt instrument, it stays with them until maturity.
- v. They require collateral for extending finance just like conventional banks. However, they cannot rely on it heavily because of risk-sharing and will, therefore, be under an obligation to carry out a careful evaluation of the risks involved.²³

The upshot of the above description is that Islamic banks have, on the assets side, receivables in accordance with PLS and sales-based modes of financing, which are all subject to varying degrees of risk. On the liabilities side, they have demand as well as investment deposits. While demand deposits do not participate in the risks of banking business and are thus guaranteed, investment deposits do participate in the risks and are not, therefore, guaranteed. Guaranteeing them would be in conflict with the spirit of Islamic finance even though minimisation of risks through their proper management would not only be desirable but also necessary for maintaining the confidence of the depositors in the system. Investment depositors are like shareholders. They are not, however, permanent but rather temporary because they can withdraw their deposits upon maturity and even before that, if the bank has no objection.

Even though demand depositors are not exposed directly to the risks of banking business, they may be exposed indirectly if the losses suffered by banks

²² The banking book consists of all banking activities of the bank, including the taking of various types of deposits, packaging and transforming them into suitable maturities and sizes, and extending them to users of funds, making recoveries, and distributing returns to depositors and shareholders. The trading book consists of the buying and selling of securities, stocks and other financial instruments to facilitate trading with or for customers, to earn profit from the difference between buying and selling prices or to hedge. In general, there could be separate trading books in an institution oriented towards different markets and instruments with different objectives. Normally, demand depositors' funds are not expected to be utilised for financing operations in the trading book except for controlling risks in the banking book by hedging. The distinction between the two books becomes vital for setting regulatory standards and supervisory oversight to ensure systemic stability.

²³ See section 3.1 on the "Late Settlement of Financial Obligations."

on their PLS advances are substantial and the capital and reserves plus investment deposits are not sufficient to cover them. This is unlikely to happen except in extreme circumstances when a substantial proportion of investment deposits has been withdrawn. Such withdrawals may take place due to a number of reasons, including the spread of correct information or rumours about the performance of the bank itself or other banks. Hence it is necessary not only to have a strong capital base for Islamic banks to provide an adequate safety net but also to adopt some effective strategy that would help prevent the risks of investment deposits from being transferred to demand deposits.

The risk to which depositors may be exposed creates a greater need in the Islamic banking system for providing a psychological reassurance to the depositors about the health of the financial system. This demands, firstly, trust in the macroeconomic health of the country's economy and, secondly, confidence in the safety and soundness of the financial system as well as the institutions with which the depositors deal. The former can only be ensured by the pursuit of healthy monetary, fiscal, and exchange rate policies, while the latter can be ensured by the injection of greater market discipline in the banking business. This needs to be further reinforced by prudential regulation and effective supervision, with special stress on capital adequacy, proper risk assessment and management, effective internal controls and external audit, and greater transparency. It is also necessary to improve and streamline corporate governance so that the funds received by firms from banks are more effectively utilised for the ultimate benefit of both the financier and the user.

1.5 GREATER MARKET DISCIPLINE

Greater market discipline, which is one of the strong points of the Islamic financial system, has also been declared by the new Basel framework to be one of the three important pillars necessary for the health and stability of the international financial system. The Islamic system tries to realise this discipline by making the banks participate in the risks of their counter-parties, and the depositors, directly or indirectly, in the risks of banking business. Such a sharing of risks should help motivate depositors to choose carefully the bank in which they place their deposits and to demand greater transparency in the affairs of the bank they choose. It should also induce banks to undertake an in-depth credit analysis of counter-parties as well as the projects proposed for financing, to build closer long-term relations with their counter-parties, and to undertake more effective assessment and management of risks.

The double evaluation of risks by both the counter-party and the bank should help introduce a healthy discipline in the whole banking business and eliminate a range of undesirable lending practices. Although Islamic banks demand collateral to offset moral failure, the adoption of PLS modes will, as indicated earlier, not let them rely too heavily on such collateral. The banks will also have to have adequate capital and sufficient loss-offsetting and other reserves to provide an assurance to their depositors, and particularly demand depositors, that their deposits are safe. The higher the capital and reserves, the greater will be the ability of banks to attract deposits, particularly demand deposits.

It may be expected that maturing of the Islamic financial system will gradually promote greater reliance on equity finance and lesser reliance on debt. An optimum equilibrium between equity and debt may ultimately get established depending on the needs of the economy. This will not only help provide investment opportunities to risk-takers as well as risk-averters, but also take care effectively of all the equity as well as credit needs of both the public and the private sectors for financing productive activity in a modern economy. In addition, the growth of credit in step with the needs of the real economy will help curb excessive credit expansion and speculation and thereby dampen the financial crises, which are now plaguing the world economy.

Part II

PRUDENTIAL REGULATION AND SUPERVISION

The greater market discipline that the Islamic system has the potential of introducing in the financial system cannot, however, eliminate the need for regulation and supervision²⁴. Banks deal with public funds. The deposits they have are far more than their own capital and their leverage is, therefore, much higher than that of non-bank corporations. It is, therefore, necessary to instill confidence in the depositors and to save them from unnecessary and avoidable losses by preventing fraud, mismanagement, over-lending, credit concentration, and exploitation of the banks' powers and resources for the enrichment of a few. It is also necessary to protect the payments system from instability and to promote the efficient operation of the capital market and its institutions for accelerating development. This needs prudential regulations and their enforcement by means of effective supervision. Regulation should not, however, be so tight and comprehensive that it raises compliance costs unbearably and also strangles innovation and creativity. The trade-off between stability and efficiency should not be lost sight of.

However, before we get into a discussion of the kind of regulatory and supervisory framework that is needed for Islamic banks, it is desirable to review the present state of regulatory and supervisory infrastructure that exists around the world as well as in Muslim countries. The existing global regulatory systems may be classified into three general categories: traditional, hybrid, and the emerging unitary system.²⁵ A brief description of these along with an illustrative chart is given below.

2.1 GLOBAL REGULATORY SYSTEMS

The activities of commercial banks, investment banks, insurance companies and mutual funds have been traditionally considered to be distinct

²⁴ For a detailed discussion of why conventional banks should be regulated, see Llewellyn, 2000.

²⁵ There is also the model of narrow banking (Item 6 of the Chart). It is as yet only a theoretical model and hardly any country has adopted it so far. It is designed to have full control on monetary expansion by means of 100% reserve requirement and other restrictions on credit creation. Narrow banks would be responsible for only accepting deposits and cashing cheques, covering their costs by means of a fee for the service. All other banking activities would be performed by special finance companies. Narrow banking has, however, an important relevance for the Islamic financial system. Hence a significantly modified version of it is discussed later in section 2.5.1.2.

from each other. To protect the soundness of each sector and its positive role in enhancing the soundness of the financial system, inter-sector activities are prohibited. Hence each service is also traditionally regulated and supervised by a distinct and specialized authority.

Almost all member countries of the IDB follow this traditional form of supervision at present, and the supervisory authority is the central bank. Most developing countries also follow this pattern and, until recently, the United States was also strictly following this regime in accordance with the requirements of the Glass-Steagall Act (see Chart-1).

As against this traditional system, banks and securities firms undertake cross-sector activities in most European countries within the framework of universal banking, with combined capital adequacy previously, and separate capital adequacy at present. In some European countries banks and insurance companies are allowed to have more interactive business linkages, while in some other countries insurance companies and securities firms enter each others' business domain more frequently. Consequently, banks-securities firms, banks-insurance companies, and insurance companies-securities firms are respectively grouped together under a single regulatory framework.

The sharp increase in the number of financial conglomerates in recent years has led to the crossing of traditional sectoral boundaries. This growth has been the result of a number of factors, some of which are:

- i. Cross-sector mergers and acquisitions between banks and securities firms and between banks and insurance companies;
- ii. Acquisition of fund managers by banks and insurance companies;

- iii. Extension of financial services firms into new areas through internal growth (for example, insurance companies setting up banks and vice versa, insurance companies selling investment products, and banks setting up securities and fund management operations);
- iv. Involvement of non-financial firms in the financial services business through the extension of credit and financial services to their clients; and
- v. Liberalisation of markets coupled with improvement in information technology.²⁶

The combination of securities business and real estate activities with commercial banking activities has remained prevalent in Europe and Japan under the umbrella concept of universal banking. This has differentiated the banking models of these countries from the Glass–Steagall model, which remained the framework of banking in the United States during the period from 1933 to 2000. The new US banking framework (Gramm-Leach-Bliley Act 1999) has made it possible for strong commercial banks to register as financial holding companies and to undertake banking-securities and securities-insurance businesses simultaneously under certain conditions. There is a growing trend of cross-sector mergers in the US. Even in almost all European countries regulators increasingly favour the mix of banking (which already includes securities activities) and insurance businesses, but expect these companies to report their banking and insurance activities separately. In France, this hybrid has already been named as “bancassurance”. This has raised the call for adoption of uniform standards for regulating the activities of financial conglomerates all over the world. As a result, major developments are taking place in the supervisory and regulatory arena, including the following:

- i. At the level of national jurisdictions, some countries have merged their regulatory infrastructure into one institution, like the Financial Services Authority (FSA) of the United Kingdom, and the counterparts in Scandinavia and Japan. Some other countries, like the United States, have taken initiatives to identify a lead regulatory authority to coordinate the activities of other regulators and enhance cooperation among them.²⁷

²⁶ See, Briault (1999) and Dale (2000).

²⁷ For more information, see Zuberbuhler (2000).

- ii. At the international level, a strong cross-sector supervisory co-ordination between the activities of the Basel Committee for Banking Supervision (BCBS), International Organisation of Securities Commissioners (IOSCO), and International Association of Insurance Supervisors (IAIS) has already been initiated within the framework of the Joint Forum on Financial Conglomerates (JFFC).
- iii. Within the new Basel capital adequacy framework (See Section 2.4), the umbrella of consolidated supervision has been extended to cover the full range of activities of the financial conglomerates. With such consolidated supervision that establishes effective safety nets with control on capital leverage, non-prudential connected businesses, and capital arbitrage, and enhances market discipline by proper exposures, cross-sector activities are expected to promote the efficiency of financial markets.

2.2 THE INTERNATIONAL SUPERVISORY FRAMEWORK

If the discipline that Islamic finance has the potential of introducing in the financial market becomes an integral part of the new architecture for the financial system in Muslim countries, the functioning of financial institutions should improve considerably. However, the introduction of this discipline will expose the depositors to risks to which they do not get exposed in the conventional system. Therefore, it is necessary to put in place appropriate safety nets to protect the depositors' interest, safeguard the markets and ensure systemic stability. This cannot be done satisfactorily except through adequate regulatory standards and effective supervision.

This brings into focus the question of whether the supervisory framework laid down by the Basel Committee on Banking Supervision is adequate for Islamic financial institutions.²⁸ If not, then the next question is about the type of legal framework that they need, and the problems involved in creating such a framework. This makes it necessary to quickly review the Basel Committee's

²⁸ BCBS, *Core Principles for Effective Banking Supervision* (1997) sets out 25 basic principles that are required for an effective supervisory system. These Principles are: Principle 1: preconditions for effective banking supervision; Principles 2 to 5: licensing and structure; Principles 6 to 15: prudential regulations and requirements; Principles 16 to 20: methods of ongoing banking supervision; Principle 21: Information requirements; Principle 22: formal powers of supervision; Principles 23 to 25: cross-border banking.

recommended Core Principles of effective banking supervision and then to see what else needs to be done for Islamic banks.

The Core Principles make supervisors concerned with a number of important issues related to improved governance of banks and thereby the health and stability of the financial system. These include licensing and capital adequacy, procedures and practices used by banks for lending and investing, identification of different types of risks and techniques for their effective management, methods for evaluating the quality of banks' assets, creation of loan-loss provisions and other reserves, extent of the permissible exposure to directors and their friends and relatives and single borrowers, and the kind of internal controls and external audit necessary for ensuring fairness and accuracy.

The Basel Committee has also emphasised the proper supervision of banks to ensure that the legal requirements are faithfully met. Such supervision would be more effective if the supervisors have certain qualities. They must be trained to do their job and have a proper understanding of the banking business and the problems that banks encounter. They must also be capable of identifying the risks involved in financial operations and of working out the best ways to anticipate, manage and control them. All this may not be meaningful unless the supervisors have also the legal authority to initiate and enforce corrective measures before it is too late. Hence a great deal of emphasis is being laid on the granting of such authority to supervisors.

2.3 REGULATION OF ISLAMIC BANKS

One may ask whether all these regulatory measures specified by the Basel Committee are also necessary for Islamic financial institutions? The answer has to be positive even though on the face of it one may feel differently. It may be argued that because investment depositors participate in the risk, Islamic banks should not be subjected to regulations any more than normal corporations are. However, there is a significant difference. Firstly, there are systemic considerations. While the failure of a corporation may affect primarily its own shareholders, who are expected to be on the guard, the failure of a bank has implications for the health and stability of the whole payments system as well as the development of the economy. If depositors lose confidence in the system, they will withdraw their deposits, which will not only destabilise the financial system but also jeopardise their availability for financing development. Secondly, there is the interest of demand depositors which needs to be safeguarded. However, investment depositors also need greater safeguards than what

shareholders do in normal non-bank corporations. This is because of the significantly higher leverage in banking business. Such leverage would come from demand deposits. The higher the proportion of demand deposits, the higher would be the leverage. This would necessitate the adoption of certain procedures by banks to prevent arbitrariness in investment decisions, mismanagement and excessive risk exposure, and to manage prudently whatever risks they take. They would also have to build adequate reserves to avoid excessive erosion of investment deposits. Thirdly, it is also necessary to ensure the faithful compliance of banks with the teachings of the *Sharī'ah*. Fourthly, there is the imperative of making Islamic banks accepted in the inter-bank market of the international financial system. This will not happen unless they conform to international regulatory standards.

Hence the difference between the nature of Islamic and conventional banking will not reduce the need for regulations and the related supervision to ensure their effective enforcement. This call for regulation is, however, not something new. It was also made as long ago as March 1981 by the governors of central banks and monetary authorities of the member countries of the Organisation of the Islamic Conference (OIC), in their detailed Report on "Promotion, Regulation and Supervision of Islamic Banks" approved by them in their Fourth Meeting held in Khartoum on 7-8 March 1981.

A number of measures would be needed to ensure the safety of both demand and investment deposits. Among the most important of these measures would have to be better macro-management of the economy combined with efficient micro-management of banks under an umbrella of proper regulation and supervision, and the building of adequate loss-offsetting reserves. These may have to be reinforced, if necessary, by the insurance of at least demand deposits.

Depositors would be able to safeguard their interests more effectively if they are allowed to participate actively in the shareholders' meetings and also to have their representatives on the banks' board of directors. Since it would be difficult for them to elect these representatives directly, particularly if the banks are large and have several branches not only within the country but also abroad, the regulatory authority may have to play an important role in the appointment of representatives on behalf of depositors on the banks' boards of directors. The banks may, however, resent this, even though this is important not only for safeguarding the depositors' interests but also for systemic stability. If such representation is ruled out, then it may be worth considering the establishment of

specialised chartered firms in the private sector to protect the interest of depositors, just like auditors, one of whose job it is to protect the interests of shareholders. If this is also not considered feasible, then the only other way to protect the depositors' interests would be for the regulator to ensure greater transparency so that the depositors know what is going on and are thus able to play a greater role in safeguarding their interest. This cannot be sufficient and has to be further reinforced by effective regulation and supervision.

With respect to conformity with the *Sharī'ah*, it is necessary to ensure that the banks faithfully comply with the conditions laid down by the *Sharī'ah*. Such conformity cannot be ensured until all the outstanding *fiqhi* issues related to finance have been satisfactorily resolved.²⁹ It is also necessary for preparing a widely-agreed legal framework, the absence of which is creating obstacles in the path of developing standardised products for Islamic banking, imposing a penalty on loan defaulters and compensating banks for the loss of income, and managing risks more effectively through the adoption of certain techniques used by conventional banks internationally for this purpose. It is also necessary to specify clearly the specific roles of the *Sharī'ah* board, the central bank, and the chartered auditing firms in ensuring that the banks do not violate the teachings of the *Sharī'ah*.

This indicates the greater importance of regulation and supervision in an Islamic financial system, which is still in its embryonic stage. Without such regulation and supervision, the system may not be able to raise the confidence of the people in its strength and future prospects for development. Any serious failures at this early stage will tend to bring the system into disrepute and do tremendous harm to the movement for Islamisation of the financial system in Muslim countries.

However, as indicated earlier, regulation should not be so strict and cumbersome that it hurts the profitability and development of Islamic banks and makes them incompetent in relation to conventional banks. It has also to be determined what it is that should be stipulated legally and what it is that should be left to the discretion of the supervisors. A proper understanding of what the two can and cannot accomplish will enable the financial system to be more flexible and able to develop within the framework of its own country-specific circumstances. Moreover, regulation should also be accompanied, as discussed

²⁹ These issues have been discussed in Part III of this paper.

later, by a number of measures to help the proper functioning of Islamic banks in a relatively difficult and hostile environment.

2.3.1 Islamic Banking Supervision in Some Member Countries: Salient Features

This brings us to the regulatory and supervisory framework prevailing at present for Islamic banks in the IDB member countries. The available information is summarized in Exhibit-1. Some of the salient features of this framework are presented here thematically:

2.3.1.1 Compliance with International Standards

- Most member countries reviewed here have adopted the international standards, including the Basel Committee's Core Principles and minimum risk-weighted capital requirements and the International Accounting Standards Committee's international accounting standards.
- Some countries are implementing crash programmes to adopt the international standards but report difficulties, particularly in the risk-weighting of assets created by the Islamic modes of finance. A few countries have not revealed the state of their compliance with international standards.
- Compliance with the standards set by the Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI), has not yet fully materialised; only two countries (Bahrain and Sudan) have so far explicitly adopted the standards set by it.
- Since most Islamic banks are small, some countries have announced a program of mandatory merger of Islamic banks and strengthening of their capital to make them viable in an international environment which has become characterised by megabanks.
- Three countries, Iran, Pakistan and Sudan, which have initiated the transformation of their entire economies in accordance with Islamic teachings, have announced major restructuring programmes for their banking sectors. All the three countries have active plans for privatisation of banks. Pakistan and Sudan have announced a mandatory programme for strengthening the capital of banks and of mergers to the extent to which this is necessary for the purpose.

2.3.1.2 Offsite and Onsite Supervision

- Iran, Malaysia, Pakistan and Turkey have put in place both offsite and onsite supervision systems to realise the standard objective of such systems.
- Malaysia follows the CAMELS rating system.³⁰

³⁰ The CAMELS rating system refers to capital adequacy, assets quality, management quality, earnings, liquidity, and systems for internal controls.

EXHIBIT – 1
**SUMMARY OF SALIENT FEATURES OF ISLAMIC BANKING AND
SUPERVISORY SYSTEMS IN SOME IDB MEMBER COUNTRIES**

Country	Salient Features of Islamic Banking Supervisory Systems
Bahrain	Regulated by the Bahrain Monetary Agency (BMA) ♦ BMA regulates both commercial banks and investment banks (securities firms); insurance companies are under separate regulatory authority ♦ Dual banking (Islamic and conventional) banking system; Basel capital requirements and core principles adopted for both groups, ♦ Four Islamic banking groups: a) Islamic commercial banks, b) Islamic investment banks, c) Islamic Offshore banks, and d) Islamic banking windows in conventional banks ♦ Consolidated supervision ♦ International Accounting Standards adopted, ♦ Each Islamic bank must have a <i>Sharī'ah</i> board ♦ Compliance with AAOIFI standards under active consideration ♦ Investment deposits, current accounts and capital allocation for assets must be declared, ♦ Mandatory liquidity management by adopting the standardised maturity buckets of assets ♦ Islamic and conventional mixed system
Gambia	Regulated by the Central Bank of Gambia(CBG) ♦ Islamic banking law exists ♦ Dual system ♦ Separate <i>Sharī'ah</i> board required ♦ Compliance with Basel capital requirements and core principles and International Accounting Standards not clear
Indonesia	Regulated by the Central Bank of Indonesia (Bank Sentral Republik Indonesia – BSR) ♦ Separate regulatory bodies for banks and securities firms ♦ Separate Islamic banking law does not exist; Islamic (<i>Sharī'ah</i>) banking is covered by added section in the banking law (Act No. 10 1998 and Act No. 23 1999) ♦ Separate <i>Sharī'ah</i> board required ♦ Islamic windows allowed ♦ Consolidated supervision ♦ Basel capital requirements and core principles adopted ♦ International Accounting Standards adopted ♦ Major financial transformation in process to strengthen bank capital and solvency ♦ Active <i>Sharī'ah</i> bank development strategy in place by the government
Iran	Regulated by the Central Bank of Iran (Bank Jamhuri Islami Iran) ♦ All banks in the public sector with a plan for minority privatisation ♦ Bank regulation and supervision is strongly effected by monetary as well as fiscal and other government policies ♦ Single (Islamic) banking system under the 1983 Usury Free Banking Law ♦ Modes of finance are defined by this Law ♦ Recent policy orientation towards adopting the Basel capital and supervisory standards and International Accounting Standards ♦ No <i>Sharī'ah</i> board for individual banks ♦ Onsite and offsite supervisory methods and objectives defined and applied ♦ Banks and insurance companies are supervised by different regulatory authorities
Jordan	Regulated by the Central Bank of Jordan (CBJ) ♦ Separate regulatory bodies for banks and securities firms ♦ Islamic banking law exists ♦ Dual system ♦ Separate

	<p><i>Sharī'ah</i> board required ♦ Consolidated supervision ♦ Basel capital requirements and core principles adopted ♦ International Accounting Standards adopted</p>
Kuwait	<p>Supervised by the Central Bank of Kuwait (CBK) ♦ CBK regulates both commercial banks and investment banks (securities firms); insurance companies are under separate regulatory authority ♦ Dual banking system ♦ Two Islamic banking groups: a) Islamic commercial banks, and b) Islamic investment banks. Conventional banks not allowed to have Islamic banking windows. ♦ Consolidated supervision ♦ Basel capital requirements and supervisory standards adopted ♦ International Accounting Standards adopted ♦ Separate Islamic banking law under active consideration ♦ Separate <i>Sharī'ah</i> board for each bank necessary</p>
Malaysia	<p>Regulated by the Central Bank of Malaysia (Bank Negara Malaysia – BNM) ♦ Insurance companies and banks under same regulatory authority; securities firms under separate authority ♦ Private banks ♦ Dual banking system ♦ Islamic windows allowed in conventional banks ♦ Consolidated supervision ♦ Basel capital requirements and core principles adopted ♦ International Accounting Standards adopted ♦ CAMELS rating system adopted ♦ Onsite and offsite supervision well defined with clear objectives ♦ Separate <i>Sharī'ah</i> boards at institutional level in the BNM and Securities Exchange Commission ♦ Islamic money market and liquidity arrangement exists ♦ Ministry of Finance closely associated with the supervision of Islamic banks</p>
Pakistan	<p>Regulated by the Central Bank of Pakistan (State Bank of Pakistan-SBP) ♦ Securities firms, and Insurance Companies are regulated by separate regulatory bodies ♦ Major banks in the Public Sector; bank regulation and supervision effected by government policies ♦ Islamic banking law does not exist ♦ <i>Mudārabah</i> Companies Law exists ♦ <i>Sharī'ah</i> board concept does not exist ♦ Islamic banks are not identified distinctly ♦ Basel capital requirements and supervisory standards adopted ♦ Bank merger is on cards to strengthen capital ♦ Concept of onsite and offsite supervision exists ♦ Major financial transformation is called for by the Supreme Court of Pakistan to introduce Islamic banking and financial system; a Financial Services Transformation Committee has been established by the SBP.</p>
Qatar	<p>Regulated by the Central Bank of Qatar (CBQ) ♦ Dual banking and separate regulatory system ♦ No separate Islamic banking law exists ♦ Islamic banks supervised by special directives of CBQ ♦ Separate <i>Sharī'ah</i> boards for banks required ♦ Standardised transparency requirements for Islamic banks exist</p>
Sudan	<p>Regulated by the Central Bank of Sudan (CBS) ♦ Single (Islamic) system ♦ Islamic banking law in place ♦ Separate <i>Sharī'ah</i> boards for banks required, also the Central Bank has a <i>Sharī'ah</i> Supervisory Board ♦ Substantial public sector control; supervision and regulation is effected by other government policies ♦ Evolution of financial instruments underway ♦ Compliance with the capital</p>

	adequacy and supervisory oversight standards of the Basel Committee not clear ♦ Major bank merger is planned to strengthen bank capital
Turkey	Regulated by the Central Bank of Turkey (Turkey Cumhuriyet Merkez Bankasi – TCMB) ♦ Banks and securities firms regulated by separate bodies ♦ Law about Special Finance Houses covers Islamic banks ♦ Dual system; no Islamic windows allowed ♦ Basel Committee capital adequacy requirements and supervisory standards recently introduced ♦ Major financial transformation underway ♦ Onsite and offsite supervision concepts and methods exist
UAE	Regulated by the Central Bank of UAE ♦ Islamic banking law exists ♦ Dual system ♦ Islamic banking windows allowed ♦ Separate <i>Sharī'ah</i> boards required ♦ Basel Committee capital adequacy requirements and supervisory standards in place ♦ International Accounting Standards in place
Yemen	Regulated by the Central Bank of Yemen (CBY) ♦ Islamic banking law exists ♦ Dual system ♦ Islamic banking windows allowed ♦ Separate <i>Sharī'ah</i> board required ♦ Major policies and standards set by the CBY are equally applicable to all banks ♦ Separate supervisory office for Islamic banks inside the CBY under active consideration ♦ Compliance with the Basel standards not clear

Sources: Compiled from Country Case Studies referred to in the bibliography, Babikir (1999) and Web Sites of respective central banks, also given in the bibliography

2.3.1.3 Supervisory Framework

- Islamic banks are generally supervised within the framework of the prevailing international commercial banking supervisory systems. In some countries special laws have been introduced to facilitate Islamic banking, while in others no such laws have been introduced. Islamic banking operations in the latter group of countries are performed under the guidelines issued by their respective central banks.
- Member countries covered in this review segregate banking functions from securities and insurance businesses, and distinct supervisory authorities are assigned the task accordingly. Malaysia is the only exception, where banks and insurance companies are supervised by a single authority, namely, the central bank (Bank Negara Malaysia). The global trend is also inclined towards the concept of universal banking with emphasis on supervision by a single mega-supervisor.
- Banks in member countries are supervised by central banks. However, the emerging trend in the world is to segregate the monetary policy framework of macroeconomic management from the microeconomic considerations of bank soundness. As a result of this segregation, bank supervision is separated from monetary policy and assigned to a specialised authority. There are many examples of this segregation, the most recent and significant being the separation of supervisory functions from the Bank of England in 1998 and the establishment of the Financial Services Authority to take up the responsibility of a mega-supervisor.
- In cases where different supervisory authorities specialise in supervising different banking and non-banking financial institutions, the need for cooperation and coordination between these authorities increases. The available literature on banking supervision in member countries does not mention other sectors. This could perhaps be an indication of the absence of such coordination between the different supervisory organisations.
- Conventional banks are allowed to open Islamic windows in some member countries, while some other countries do not allow this.

- Only two member countries, Bahrain and Malaysia (Labuan), have offshore banking centers. In terms of compatibility with international banking standards, a study conducted by the Financial Stability Forum puts these centers in the moderately good second category.³¹

2.3.1.4 *Sharī'ah Supervision*

- Most private banks have their own *Sharī'ah* supervisory boards. However, in Malaysia and Sudan the central bank also has a central *Sharī'ah* board.
- The banks in Pakistan and Iran do not have *Sharī'ah* boards as such. However, the Council of Islamic Ideology in Pakistan and the Council of Guardians in Iran are available to provide guidelines. The Federal *Sharī'ah* Court (Pakistan) is empowered to review all laws in the light of the *Sharī'ah*. It has declared interest to be a form of *ribā* and the existing system of mark-up transactions to be interest-based, and hence unlawful.
- It needs to be made clear whether the function of the *Sharī'ah* boards is primarily to clear the Islamicity of the products in which the bank deals or also to ensure that their advice is duly implemented? If the latter is also considered to be their function, then the question is whether it is possible for them to do so without the necessary qualified staff? If not, then the question is about who should perform this task - the central bank, specialised private firms, or chartered auditors, along with their normal job of bank inspection and auditing?

³¹ Financial Stability Forum, *Report of the Working Group on Offshore Financial Centres*, April 2000.

2.3.1.5 Areas of Challenge

- Since investment depositors share in the risks of banks while demand depositors do not, one of the most important challenges of Islamic banking would be to adopt some strategy whereby the risks associated with investment depositors do not get mixed up with, and transferred to, demand depositors.
- If the international standards are adopted, the risk-weighting will require the evolution of a methodology suitable for determining the relative risk of different modes of Islamic finance.
- The PLS modes are relatively more risky in nature. Therefore, the adoption of international standards may tend to create a natural bias towards a greater utilisation of the less risky debt-creating sales-based modes of finance. This may tend to jeopardise the movement of the Islamic financial system to the desired optimal mix of PLS and debt-creating modes.

2.4 CAPITAL ADEQUACY: IMPLICATIONS OF THE EMERGING RISK-WEIGHTING SYSTEMS FOR ISLAMIC BANKS

A sound and efficient financial system cannot be built except on an atmosphere of mutual trust between the providers and the users of funds. The creation of such a relationship of mutual trust is, however, a complex task. This is because, on the one hand, banks receive their funds from depositors and are thus simultaneously users as well as providers of funds and, on the other hand, the return on their equity increases as they use a larger proportion of funds from depositors.

Demand deposits, which constitute a significant part of the Islamic banks' total deposits, are repayable on demand. Although investment deposits do not contractually enjoy this privilege, banks do not generally object to withdrawals before maturity. Since investment deposits are most likely to be withdrawn substantially when the depositors lose confidence in their bank and there is a typical 'bank-run' situation, it is desirable for banks to strengthen their own capital and to build loan-loss reserves. This will inspire confidence of the depositors in the bank and help prevent massive withdrawals. All these considerations underline the special significance of minimum capital requirements to serve as an internal insurance fund. However, it is not possible to address this question without knowing the international standards for this purpose.

2.4.1 Definition of Bank Capital

Before the 1988 Basel Accord,³² there were no standard definitions of bank capital or minimum capital requirements. However, the discussions held under the initiative of the Basel Committee on Banking Supervision (BCBS) of the Bank for International Settlements (BIS) have led to the 1988 Basel Accord, the 1997 Core Principles for Banking Supervision, and other prudential guidelines. The Basel Accord defines capital and sets minimum capital requirements for internationally active banks in the G10 countries. Banking supervisors are the guardians of these standards and are expected to enforce them in their respective jurisdictions.

The Basel capital standards differentiate between Tier-1 or core capital, Tier-2 or supplementary capital, and Tier-3 capital.³³ It is required that tier-1 capital shall not be less than 50% of total (tier-1 plus tier-2) capital and that tier-2 capital shall not exceed 50% of total capital. It is also required that banks must maintain minimum tier-1 capital and total capital of 4% and 8% respectively of total risk-weighted assets. Because of the zero risk-weight of some types of assets, it is required that banks maintain a core capital equivalent to a minimum of at least 3% of their total assets.

These standards have become universally accepted during the last decade. They have been already implemented in more than 90 countries all over the world (including many IDB member countries) in addition to the G10 countries. More countries are in the process of adopting them. Since the implementation of these capital standards has strengthened banks' capital worldwide and improved systemic stability,³⁴ they have become a convenient benchmark for measuring the

³² See, BCBS, *International Convergence of Capital Measurement and Capital Standards* (July 1988). The original Accord caters only for the credit risk of banks. However, subsequent modifications have also incorporated capital requirements for market risks.

³³ Tier-1 (core) capital is defined as a) basic equity + b) disclosed reserves from post-tax bank earnings *minus* goodwill and investment in subsidiaries. Tier-2 (supplementary) capital is defined as a) undisclosed reserves, + b) revaluation reserves + c) general loan loss reserves + d) hybrid debt instruments + e) subordinated term debt of 5 years' maturity (maximum limit: 50% of tier-1 capital). Tier-3 capital is defined in some countries as subordinated debt having a maturity of less than 5 years with a maximum limit of 250% of tier-1 capital.

³⁴ See, BCBS, *Capital Requirements and Bank Behavior: The Impact of the Basel Accord*, (April 1999).

capital and hence the soundness of banks. The BCBS has accordingly become a *de facto* international standard setter.

2.4.2 Emerging Risk-Weighting Systems

The fundamental rationale behind minimum risk-weighted capital requirements is that banks need to maintain more capital against riskier assets and less capital against less risky assets. The better the quality of assets, the sounder the bank is considered to be and the lesser the capital required. The assignment of risk-weights to assets is the most important building block in the establishment of international standards for bank supervision. It is even more so in the case of Islamic banks because of the different nature of their modes of finance.

The 1988 Accord puts the assets of G10 internationally active banks into five risk buckets (0%, 10%, 20%, 50%, and 100%) in terms of credit risk, defined as the probability of default of the counter-party. An asset is considered to be risk-free if the probability of the counter-party's default is zero (such as cash, local currency claims on governments, and claims on OECD countries). Hence there is no need to allocate capital against such assets. Some assets (such as claims on domestic public sector in the G10 countries) face a very low level of default risk, and it is considered safe to keep capital against 10% of such assets. Some other assets (such as claims on multilateral development banks and claims on banks outside OECD countries with a maturity of less than one year) face moderately low default risk and require capital against 20% of such assets. If a loan is for long-term, but its collateral is very good (such as collateralised residential mortgage), it would be enough to keep capital against 50% of such assets. Finally, there are assets (such as loans with a maturity of more than one year and claims outside the OECD countries) which face a high probability of default, capital is required against 100% of such assets.³⁵ This risk-weighting system has become known as the "Standardised Approach".

This standardised approach has, however, recently come under significant review by the academia, bankers, policy makers, and the BCBS itself. Some of the important points in this regard are summarized below:

- i. The standardised risk-weighting system was initially meant for the G-10 and other OECD countries. But it has also been adopted by a

³⁵ For details of assets and risk weights, see, the original Accord document, BCBS, 1988.

large number of non-G10 countries over the last decade. However, since it was designed for the G-10 countries, its application to non-G-10 countries may be problematic because of their different circumstances and needs. It is, hence, considered necessary to make adjustments in it to enable it to fulfil the needs of these countries.

- ii. The risk-weighting system encourages short-term credit movements from the G-10 countries to non-OECD countries. Claims with a maturity of less than one year are considered very safe and assigned a risk-weight of 20 %, while claims of more than one year's maturity are risk-weighted at 100%. Since short-term credit movements have become associated with the recent Southeast Asian financial crisis, there is intuitively a very strong reason to believe that the risk-weighting system may actually have encouraged short-term, at the expense of medium- and long-term, lending, and thereby contributed to financial instability.
- iii. Although the Accord was revolutionary at the time of its adoption, market conditions have changed drastically since then. A number of new risks have arisen by now and new risk management methods have been innovated. These changes need to be taken into account while measuring the real capital adequacy requirement of banks. The 'standardised' nature of the Accord does not provide incentive for credit risk mitigation or risk management. There is, therefore, a need to encourage the development of risk management culture in banks.
- iv. The greatest weakness of the Accord is perhaps the "capital arbitrage" (CA) opportunities that it has created.³⁶ The most important example of CA is securitisation through "cherry picking". Good quality assets are taken away from the balance sheets and sold for raising additional funds without removing the corresponding liabilities from the balance sheets. As a result, additional funds are raised with the same amount of capital, thereby reducing the overall quality of assets and making the bank riskier.

2.4.2.1 The New Framework

³⁶ See, Jones (2000).

Due to the above-mentioned considerations, it is felt that the 1988 Accord has become less than optimal in providing a suitable capital adequacy regime. Hence the BCBS has itself proposed a new capital adequacy framework in its recent consultative paper.³⁷ This new framework is expected to become effective from 2001. It aims at filling a number of gaps in the existing one, making it relevant not only to the G10 countries but also to the realities prevailing in other countries where also it has to be applied. It has been designed to:

- i. better reflect the banks' true risks,
- ii. take into account developments in the market, particularly, the availability of technological innovation and information,
- iii. reflect developments in the area of measurement and control of risk and promote a culture of risk management by providing suitable incentives,
- iv. enhance market discipline by encouraging sound disclosure policies,
- v. promote cross-sector interaction, because the difference between banking, insurance and securities activities of financial institutions is fading as a result of the emergence of financial conglomerates,
- vi. build on the experience accumulated so far, particularly, the core principles of bank supervision, loan accounting, disclosures, and complementary aspects of the new framework,
- vii. promote, wherever possible, non-standardised approaches based on internal ratings and models used by different banks, and
- viii. strengthen market discipline by utilising external assessments of banks for determining asset quality.

The proposed new framework is based on three pillars. The first pillar relates to capital adequacy. While the second and third pillars relate respectively to supervisory framework and market discipline. The most important feature of the proposed framework is a retention of the definition of capital adequacy standards of the present system, with a significant change in the risk-weighting of assets through:

- i. external-credit-assessment-based standardised risk-weighting;
- ii. internal-ratings-based system for the banking book credit risk as well as the trading book market risk; and

³⁷ See, BCBS, *A New Capital Adequacy Framework*, June 1999.

- iii. models-based approach, wherever feasible.

The main differences between these approaches are summarized below in Table 3.

Table 3

DIFFERENCE BETWEEN THE THREE APPROACHES FOR ASSESSMENT OF CAPITAL

	Standard Approach	Internal Ratings			Credit Risk Models
		Approach A	Approach B	Approach C	
Risk-weighting Categories	5 categories	5 categories	Expanded set of categories	Categories not prescribed	Categories not prescribed
Assignment of Instruments to risk-weights	Supervisor	Bank	Bank	Bank	Bank
Portfolio Diversification	No	No	No	No	Yes

Source: Cordewener (2000).

The basic difference between these approaches is the primary role of supervisors in determining capital in the standardised approach and the basic role of banks themselves in the other two approaches. At present, the standardised approach is the dominant official approach, the internal ratings-based approach being officially applicable to market risk- weighting of assets in the trading book only.³⁸ Some internationally active banks have maintained in the past that they already apply the internal ratings-based approach and the models-based approach to their banking books too. Appreciating the positive incentive implications of these two approaches for risk management, international standard setters are now recognising these also for determining capital on the basis of supervisory discretion.

2.4.2.2 External Credit Assessment-Based Risk-Weighting

³⁸ In order to properly assess the risk exposure of banks, the banking book activities must be clearly separated from trading book activities. We need to make some further observations on the contents of the two books for Islamic banks. The banking book comprises of assets and liabilities of banks arising primarily from the mobilisation of deposits by these institutions from savers and the packaging of these into funds of suitable sizes and maturities for extending to users. The trading book of banks is affected by two considerations: portfolio diversification to offset some risks arising on the banking book, and trading in securities to earn additional income. Trading book of conventional banks comprises transactions in interest, foreign exchange, commodity and equity-based instruments, most of these being derivatives. The Islamic banks do not deal in interest-based or derivative instruments. Therefore, the trading book of Islamic banks at the present time is insignificant as compared to conventional banks and can be ignored safely. Therefore, most of our discussion is related to the banking book requirements.

In the proposed standardised approach, risk-weighting of assets is based on external credit assessment of the counter-party.³⁹ The proposed system contains five different categories for risk-weighting of assets as claims on: (i) sovereigns (ii) banks/securities firms, (iii) corporations, (iv) public sector entities, and (v) asset securitisation programmes. The credit assessments of these categories are made by all available means of external credit assessment, such as rating agencies and supervisory reports. The proposed risk-weighting system is given in Table-4 below.

2.4.2.3. Proposed New Risk-Weights

Table 4

EXTERNAL CREDIT ASSESSMENT BASED WEIGHTING SYSTEM

Claim	Assessment					
	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Sovereigns	0%	20%	50%	100%	150%	100%
Banks	Option 1¹	20%	50%	100%	100%	150%
	Option 2²	20%	50% ³	50% ³	100% ³	150%
Corporations	20%	100%	100%	100%	150%	100%

1 Risk-weighting based on risk-weighting of the sovereign in which the bank is incorporated.

2 Risk-weighting based on the assessment of individual banks.

3 Claims on banks of a short original maturity, for example less than six months, would receive weighting that is one category more favourable than the usual risk-weight on the bank's claims.

Source: Taken from BCBS 1999a.

The new Basel approach allows the claims on sovereigns to be weighted at less than 100% provided that such sovereigns subscribe to the Special Data Dissemination Standards (SDDS) of the IMF.⁴⁰

³⁹ The use of external credit assessment is based on the assumption that the rating data are reasonably reliable. For example, Moody's B rated company has an 8.5% default probability in a 1 year period. In a 10-year period this probability increases to 37.5%. Whereas, an Aaa company does not show any default probability during a period of 7-years, in a 10 years time perspective, its probability of default rises just to 1%. Despite a unanimous criticism from the industry on the full reliance of external ratings for supervisory purposes, the Basel Committee argues that there is no better alternative to reliance on external credit assessments for risk-weighting.

⁴⁰ Among the member countries of the IDB, Indonesia, Egypt, Malaysia, and Turkey have so far subscribed to the SDDS. The SDDS was established in 1996 to guide countries that have, or that might seek, access to international capital markets in the dissemination of economic and financial data to the public. The General Data Dissemination System (GDDS) was

An example of application of the above risk-weighting system is the claims on a sovereign who is rated AAA to AA-; no capital allocation would be required for such claims. If the sovereign is rated below B-, the risk-weight will be 50% more than the actual assets, and capital allocation will be required at 150%, i.e., if the assets in this category are worth \$100 million, these assets will be treated as \$150 million for the calculation of capital requirements. In this case the required minimum tier-1 capital will be \$6 million (i.e., 4% of \$150 million) and total capital will be \$12 million (i.e., 8% of \$150 million). Under the existing system, the required minimum tier-1 capital is \$4 million (i.e., 4% of \$100 million) and the total capital is \$8 million (i.e., 8% of \$100 million). This implies that in this rating approach, risk-weighted assets (RWAs) can exceed total assets.⁴¹ Thus the minimum capital requirement for riskier assets will be more than that required in the existing system and, conversely, the capital requirement against sound assets will be less than that in the existing system.

2.4.2.4 Internal Ratings-Based Approach

An internal ratings system refers to a summary indicator of the risk inherent in an individual credit (asset). Ratings typically embody an assessment of the risk of loss due to the failure of a given borrower to pay as promised, based on the consideration of relevant counter-party and facility characteristics. A rating system includes the conceptual methodology, management processes and systems that play a role in the assignment of a rating.⁴²

Internal rating models were first introduced along with the Amendment to the Capital Accord to Incorporate Market Risks (1996) to cover trading book market risks only. The proposed framework extends this approach to the banking book credit risk too. Some banks already use internal ratings, but these rating systems differ from bank to bank. Supervisors will be required to ensure that, before qualifying banks for use of the internal-ratings based approach, the risk management systems in such banks fulfill the requisite minimum standards.⁴³

established in 1997 to guide countries in providing to the public comprehensive, timely, accessible, and reliable economic, financial, and socio-demographic data. See <http://dsbb.imf.org/>

⁴¹ See, the original document of BCBS (*ibid*) for more details.

⁴² BCBS, "Range of Practice in Bank's Internal Ratings System – A Discussion Paper", Basel: January 2000; see also El-Makkawy (2000).

⁴³ Efficient working of the internal ratings-based approach requires at least the following information and systematic procedures: (a) Based on their evaluation of the systems in place supervisors will decide which banks can utilise the internal approach, (b) banks develop a system whereby they keep information on each client with the aim of knowing the clients'

Given the minimum required information and technical skills within banks, an index of the capital requirement for each asset is to be calculated.⁴⁴ This approach has several merits.

- i. It aligns the actual risk exposure of banks with their capital requirements. Less risky banks will need to keep less capital while more risky banks will be required to keep more capital.
- ii. It is expected to encourage and motivate banks to develop a risk management culture and thereby reduce the risks in the banking industry and enhance stability and efficiency.
- iii. It is expected to generate reliable data and information and enhance transparency and market discipline.
- iv. It will use external credit assessment as benchmark, and thus truly integrate internal and external information to generate more reliable data. This is important because external credit assessment may not have the full set of reliable information that an internal-ratings system can have, and internal-rating systems may lack the objectivity of external ratings. This information, used in harmony with incentives for risk management, will be instrumental in controlling moral hazard and capital arbitrage.

The approach also faces a number of limitations. These are:

- i. It is used presently by only some sophisticated banks. The successful application of the system on a larger scale is not possible at present.
- ii. According to the Models Task Force of the BCBS, it will take substantial time and resources to set standards for best practices in this regard and to get the supervisory validation for using the systems in various banks. Hence both banks as well as supervisory

probability of default (PD), (c) Given the PD for each asset, the credit risk of each asset is known separately; (d) the methodology of calculating this PD must be clear and each PD is calculated for a duration of one year; (e) for each asset, a loss given default (LGD) or recovery rate is calculated by the bank and preferably also by the supervisor; (f) for each asset, an exposure at default (EAD) is also calculated by the bank and preferably also by the supervisor; (g) maturity of the credit is known; (h) information on usage given default (UGD) is calculated; and (i) concentration of credit to a borrower as percentage of total assets is also calculated. See, El-Makkawy (2000).

⁴⁴ See, ISDA (2000)

authorities have to invest substantial resources in developing the capacity for the application of the system.

- iii. All banks will have to go through a supervisory review process to qualify for application of the internal ratings system, depending on their systems in place. Thus the second pillar of the proposed framework becomes very important.

In spite of these limitations, it is expected that the internal ratings system will be used more and more in future by banks, either by developing their own systems or using the computerised models available in the credit risk management market.

2.4.2.5 Models-Based Approach

The models-based approach is in fact a refined version of the internal ratings-based approach. While information can be based on qualitative judgement in the internal ratings-based approach, such qualitative judgements can be limited in the models-based approach, because models are based on quantitative data.

The internal ratings-based system can be initiated without using models and with a modest information base. A models-based system, however, requires a substantial amount of good quality data. Depending on the availability of data, internal-ratings-based systems can also use computerised models.⁴⁵ Credit risk models are based on portfolios rather than individual assets, while the internal ratings system treats assets separately.

The advantages of credit risk management models are the same as those of internal rating systems, but the limitations restrict the use of these models at present. Typically, credit risk management models cover spread risk, default risk, downgrade risk, recovery rate risk, and concentration risk. Hence the methodology is based on decomposing risks into smaller and more specific components. This requires more specific information about the quality of assets, which is not available at present in most banks. Due to lack of data, supervisory

⁴⁵ Although this is a new area, several good publications are already available. See, for example, BCBS, "Credit Risk Modeling: Current Practices and Applications" BCBS, April 1999 for a review of such models. Also see, "Credit Risk Models at Major US Banking Institutions: Current state of the Art and Implications for Assessment of Capital Adequacy," US Federal Reserve Board, 1998. For a survey of papers presented to a conference on the theme in London, see, UK, Financial Services Authority, *Financial Services Review*, June 1999.

validation of these models is not easy even in the case of sophisticated banks. For these and related reasons, even though the BCBS appreciates and encourages banks in the extended use of models, it does not intend to require the use of these models in the supervisory process soon, unless some of the limitations are removed by the collaboration of banks, model venders, and supervisors.

2.5 ALTERNATIVES AVAILABLE FOR ISLAMIC BANKS

One of the most important concerns of regulators and supervisors of Islamic banks is how to apply internationally recognised standards to these institutions while, simultaneously, enabling them to operate in conformity with the *Shari'ah*. In view of the special nature of investment deposits and the risks faced by the assets of Islamic banks, application of the international capital adequacy standards to Islamic banks has become a challenging task. Since capital adequacy is now internationally considered to be the core of systemic safety and hence supervisory concerns, the fulfillment of this crucial requirement will help enhance the credibility and growth of Islamic banking worldwide. We briefly discuss this subject in this section with a view to facilitate the application of international standards to Islamic banks while ensuring the banks' compliance with the *Shari'ah*.

2.5.1 Capital Adequacy Alternatives

The capital of Islamic banks is simple, as it does not contain hybrid instruments, subordinated debts, and other new forms of funds. However, while the nature of demand deposits of these banks is not different from that of conventional banks, the nature of investment deposits is significantly different. Accordingly, application of the Basel capital adequacy standards has created a tendency on the part of some Islamic banks to keep their investment deposits off-balance sheet. This tends to weaken their capital. It is, therefore, encouraging to note that the standards established by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI),⁴⁶ require Islamic banks to report these deposits on their balance sheets.⁴⁷ Once investment deposits are shown on the balance sheet, there arises the question of their position with respect to the

⁴⁶ See AAOIFI (1999a).

⁴⁷ Investment accounts are, according to the AAOIFI (1999a), mostly un-restricted (to be kept on balance sheet), but in some cases these can also be restricted (to be kept off balance sheet).

fulfillment of capital adequacy requirements. The AAOIFI requirement that banks show their investment deposits on their balance sheets will strengthen the capital of those banks which kept these deposits off-balance sheet. However, the AAOIFI standards⁴⁸ suggest capital as a common numerator for both demand and investment deposits. This prompts us to first discuss these standards and then suggest for the consideration of standard setters an alternative that requires separate capital numerator for both these deposits.

2.5.1.1 Combined Capital Adequacy for Demand and Investment Deposits

The AAOIFI capital standards suggest a risk-sharing scheme between investment deposits and the bank's capital. Investment deposits share with the bank capital the normal commercial risks of the bank's operations. It is argued that the bank's capital faces two types of risks in the management of investment deposits. These consist of "fiduciary risks" and "displaced commercial risks". Fiduciary risks refer to the probability of the bank being guilty of negligence or misconduct in implementing the deposit (*mudārabah*) contract. The depositors may as a result lose their confidence in the bank and withdraw their deposits. Displaced commercial risk arises from the probability of the bank not being able to catch up with other Islamic or conventional banks in competition. Consequently, a certain proportion of its profits attributable to shareholders may have to be diverted to investment depositors to prevent the withdrawal of these deposits and, in an extreme case, a run on the banks.

The AAOIFI standards, therefore, suggest a scheme for the sharing of risks between investment depositors and shareholders of the bank. Accordingly, 50% of the risks of assets financed by investment deposits should, as a rule of thumb, be assigned to investment depositors for the purpose of capital determination, and the remaining 50% to shareholders. Thus, the AAOIFI capital adequacy ratio = $\text{Total capital} / \text{total average risk-weighted assets financed by bank capital and current accounts} + 50\% \text{ of total average risk-weighted assets financed by investment deposits}$. This means that the risk of assets financed by investment deposits will be assigned a weight of 50% for the purpose of determining capital requirement.

The establishment of capital adequacy standards by the AAOIFI is indeed a pioneering task for which it needs to be complimented. It has helped crystallise the differences between the capital of Islamic and conventional

⁴⁸ See AAOIFI (1999b).

banks. It has also contributed to increased transparency by requiring the banks to keep investment deposits on their balance sheets. Furthermore, it has also highlighted the need to report the assets of current and investment accounts separately, thus enhancing information on exposures. Nevertheless, it may be useful to make the following observations for the consideration of standard setters for Islamic banks.

- i. It is perhaps accounting rather than systemic considerations which have motivated AAOIFI to formulate its capital standards. However, it is indispensable for Islamic banks to adopt the accepted international standards for the recognition of Islamic banking practices in the international markets, where the primary concern is systemic stability. Accordingly, an attempt is being made by most IDB member countries to strengthen the capital base of Islamic banks operating in their respective jurisdictions. This seems to be more desirable because discounting the risks of assets held against investment deposits by 50% may tend to provide an opportunity for capital arbitrage.
- ii. Even though the risk-sharing nature of investment deposits will enhance market discipline and add to the soundness of banks, these deposits do not constitute, as indicated earlier, a permanent base of the banks' equity. These deposits may rise or fall with the level of depositor confidence in the soundness and profitability of the banks. As against this, equity capital is available permanently. Even though investment depositors would absorb the losses to some extent, it is the banks' capital that would provide a strong shock-absorbing capacity. Adequacy of capital is hence important for Islamic banks. It would serve as the foundation on which the strength and soundness of these banks would ultimately depend.
- iii. The proportion of demand deposits in some Islamic banks is much higher than what is generally the case in conventional banks. The banks use these funds without rewarding the depositors. This has prompted some scholars to suggest that Islamic banks should either share the returns with demand depositors or reduce their reliance on these deposits.⁴⁹ Moreover, there has to be someone to absorb the losses and to guaranty the safety of these deposits. Equity capital with adequate loss-offsetting reserves is the most suitable for this purpose.

⁴⁹ See, for example, Kahf (1996).

Deposit insurance, even if it is available, cannot and should not shoulder the whole burden. The greater the capital, the lower will be the burden on investment depositors as well as the resources of deposit insurance.

- iv. The size of the bank also has implications for capital adequacy. Most Islamic banks are relatively very small in size. Since smaller banks cannot diversify their assets portfolios as much as larger banks can do, they need a larger amount of capital relative to their assets to inspire confidence in their viability as well as their ability to maintain their core operations over the longer term. For this reason regulators in several member countries, including Turkey, Pakistan, Sudan, and Indonesia, are requiring banks to either strengthen their capital or merge to ensure greater strength.
- v. Capital requirements also depend on the riskiness of the banks' portfolio of loans and investments. If the more risky PLS modes of *mudārabah* and *mushārah* constitute a greater part of banks' assets, the need for capital may be relatively larger to guarantee the full repayment of demand deposits and also the withdrawal of investment deposits. If, however, the less risky sales-based modes of *murābahah*, *salam*, *ijārah* and *istisnā'* constitute a larger proportion, the need for capital may be relatively less. Even among these sales-based modes, *istisnā'* and *salam* may perhaps be riskier than *murābahah* and *ijārah*. The probability of default also determines the quality of assets and therefore the size of capital, and until a consensus is reached on the imposition of a penalty on the defaulting party, banks may have to be required to hold more capital.
- vi. Adequacy of capital would also be affected by the availability of collateral and legal facility for its hypothecation, shared institutions, and efficient courts for deciding default cases promptly. Countries where the collateral can be easily hypothecated, where shared institutions exist, where there is insurance of demand deposits, and where the legal process is less cumbersome and time-consuming, the need for capital may be relatively less.
- vii. The economic strength of the country concerned as well as its banks and depositors is also a factor in determining capital requirements. For example some Muslim countries are richer and their banks and

depositors are stronger than those in poorer countries. It is obvious that depositors in poorer countries would need more safety nets than those in stronger countries. Since the most effective way of providing a safety net is the banks' own capital, banks in these countries may be required to have larger capital.

- viii. The extent and nature of off-balance sheet items that the banks carry and the risk concentration resulting therefrom are also important in determining the extent of capital requirements.

The riskiness of banks' assets can hence be assessed only on an ongoing and case-by-case basis by the supervisory authorities. It is therefore, prudent to make the Basle Accord as the basis for capital determination and to raise the standard of adequacy by taking into account the above-mentioned considerations, particularly the ratio of demand deposits in total bank resources and the degree of risk involved in different Islamic modes of finance. Since the legal framework may not be able to take into account all the factors on which the riskiness of bank portfolio depends, supervisory authorities will have to play an important role in ensuring the adequacy of capital in relation to the different types of risks that the banks carry. These risks include credit risks (arising from counterparty default), operational risks (arising from the breakdown of internal controls and corporate governance), market risks, and legal risks. It is expected that the existence of greater market discipline in Islamic finance as a result of the risk to which the investment depositors are exposed, would help raise the incentive for prudent management of risks and also for effective internal controls and external audit. This may not, however, be true until the depositors have some say in the management of the bank and there is also sufficient transparency in the affairs of the bank to enable them to play their role effectively.

2.5.1.2 Separate Capital Adequacy for Demand and Investment Deposits

A suggestion worth considering would be to adopt separate capital adequacy standards for demand and investment deposits. Separate capital adequacy standards will serve the objective of preventing the transmission of risks from investment deposits to demand deposits. It will also enhance comparability,⁵⁰ transparency, market discipline, depositor protection and

⁵⁰ Fahmy (1992) suggests the restructuring of the Islamic banking system such that demand deposits will have 100% reserve requirements. Other suggestions of Fahmy are closer to what we have suggested here.

systemic stability. It will also be consistent with the firewall and safety net requirements which are already prevalent in major regulatory and supervisory jurisdictions around the world and are growing in acceptability because of the important role they can play in preventing the transmission of risks from investment deposits to demand deposits.

Demand depositors need a lot more protection as compared to investment account holders. Therefore, the capital as well as statutory reserve requirements must be substantially higher for demand deposits. Since mutual funds are considered to be more transparent, liquid, and efficient in the allocation of returns to risks, there would be merit in gradually transforming investment accounts into mutual funds. In many jurisdictions capital adequacy regimes have played an important role in creating incentives for securitisation by requiring lower capital for trading book activities as compared to banking book activities of banks on the one hand, and depository institutions and non-depository financial institutions on the other. As a result, the size of banking book activities of banks has declined sharply and that of trading book activities has widened.⁵¹ This incentive effect of regulatory capital can be replicated in Islamic banks so that the investment accounts of these banks get gradually transformed into mutual funds. The relatively lower capital adequacy requirement on investment accounts (mutual funds) may provide a strong incentive to Islamic banks to develop mutual funds. This may enhance PLS financing and ensure efficient risk-sharing, market discipline and transparency in the distribution of returns.

Islamic banks can thus have two alternatives with respect to capital adequacy requirements. The first alternative would be to keep demand deposits in the banking book and investment deposits in the trading book with separate capital adequacy requirements for the two books. The second alternative would be to pool investment deposits into a securities subsidiary of the bank with separate capital adequacy requirement.

It is expected that these alternatives will enhance transparency and also eliminate a number of the *fiqhi* objections to the nature and practices of Islamic banks.⁵² Furthermore, these alternatives will also help eliminate the difficulty of treating investment accounts while applying the international capital adequacy

⁵¹ See for example, European Commission (1999), and Dale (1996).

⁵² Some of these are: Giving a share of profits to demand depositors; paying a rate of return that is closely related to LIBOR; relying excessively on sales-based modes; and free entry and exit of depositors.

standards. In addition, segregation of the depository function of Islamic banks from their investment function, will make these banks more credible and acceptable under almost all jurisdictions, thus enhancing the growth of Islamic finance.

2.5.2. Risk-Weighting Alternatives

Most Islamic banks are at present supervised within the framework of the existing standardised approach, namely, the 1988 Basel Accord on capital requirements and the accompanying supervisory framework contained in the 1997 Core Principles. There are strong indications, particularly from Iran, Pakistan and Sudan, that Islamic banks will be required to strengthen their existing capital and to adopt international standards. As discussed above, the part of the existing Accord which relates to the risk-weighting of assets for determination of capital requirements, has been changed and the changes are expected to be implemented starting from the year 2001. Depending on the supervisory assessment of banks' risk management capabilities, these changes would give the banks the option to adopt either a) the external credit assessment-based standardised approach, b) the internal ratings-based approach, or c) the models-based approach. In the first case, supervisors will continue to assess and determine capital requirements for banks, and in the last two approaches, qualified banks will be allowed to assess their own capital requirements subject to the supervisory review process and verification. The ultimate objective is to develop risk management culture in banks by requiring lesser capital for the adoption of appropriate policies by banks.

What would be the best risk-weighting choice for Islamic banks? If Islamic banks aim at being competitive world-wide and gaining acceptance from international standard setters, these banks have no other choice but to choose from these three approaches. The adoption of any one of these approaches will first depend on the capabilities and preferences of banks and the subsequent supervisory review and follow up. The following three considerations make it preferable for Islamic banks to apply the internal ratings-based approach.

- i. The difference in the nature of Islamic modes of finance makes the risks of Islamic banks' assets different from those created by interest-based lending. This makes the risk-weighting system more complex in assessing the quality of assets. This is because assets are not risk-weighted individually in the existing Basle system, but

rather grouped and bucketed according to the different risk categories. The internal ratings-based approach removes this problem by requiring the probability of default (quality) of each asset to be determined individually. Hence the quality of assets created by *murābahah*, *salam*, *istisnā'*, *ijārah*, etc., need to be recorded one by one and case by case instead of being put collectively into the standardised risk categories. Once these assets are recorded according to their probability of default and maturity, it would be possible to develop an index of the assets' risks.⁵³ This index could be used to determine the capital requirement for each asset, to be aggregated afterwards for determining the overall capital requirement.

- ii. The internal ratings-based approach allows each bank to develop its own risk management system and culture. This will make it possible for Islamic banks to develop systems which can meet the peculiar requirements of the Islamic modes of finance.
- iii. The diverse nature of Islamic modes of finance, inadequate development of risk management systems, and requirement for risk-sharing make it incumbent upon Islamic banks to allocate more resources to risk management as compared with their conventional counter-parts. Hence the internal ratings-based approach seems to be most conducive to the development of a risk management culture.

However, choice of the internal ratings-based system depends on supervisory approval. This approval would be based on the existence of required capabilities within the banking institution. Given the small size of most Islamic banks and their inadequate risk management capabilities, we do not expect many of them to be able to initially qualify for this most desirable approach. Therefore, most Islamic banks could initially be supervised within the framework of the external credit assessment-based standardised approach. Moreover, the lack of ratings or external source of credit assessment for the clients of most Islamic banks is also a serious limitation. The new standardised approach handles this limitation by allowing 100% risk-weight to assets for which no external credit assessment is available. It may therefore, be suggested that, even if the Islamic banks have to start with the second-best approach, it would

⁵³ Several studies are available on the index; see for example, ISDA (2000).

be desirable for them to quickly graduate into the first-best approach. As far as the models-based approach is concerned, it is too early at this stage for Islamic banks to fully rely on this approach. However, it would again be in the interest of these institutions to start familiarising themselves with these approaches and building the capability for the application of computer-based models.

2.6 RISK MANAGEMENT

A number of risks are inherent in the banking business. These include credit risks, market risks, liquidity risks and operational risks. Since the rate of return on equity depends on the total volume of assets accumulated, banks have a natural tendency to mix as small an amount of their own equity with as much of the depositors' funds as possible. If assets are far larger than equity, even a small loss on assets may be enough to wipe out the bank's entire equity and cause it to collapse. Moreover, as a result of the contagion effect, the collapse of even a small bank has the potential of becoming a source of serious systemic instability in the payments system.

Banks, therefore, need to be extremely cautious about their exposure to these risks and to develop systems for their identification, control, and management. The development of a risk management culture in banks is hence becoming an integral part of the responsibility of regulators and supervisors. Therefore, the supervisors of Islamic banks also need to become well-versed in the nature of risks and to promote efficient risk management in their institutions.

2.6.1 Credit Risks

Credit risks arise from the volatility in a bank's net cash flow as a result of an unexpected decline in its total cash flow due to default by a counter-party. This can give rise not only to a liquidity crunch but also adversely affect the quality of the banks' assets. Recent developments in credit risk management techniques have enabled banks to identify their expected losses, thereby enabling regulators and supervisors to require them to build adequate loan-loss reserves to ensure the safety of the bank.

In general, the standing of counter-parties, nature of the legal system, quality of collateral, maturity of credit facility, size of banking and trading books, utilisation of credit derivatives, and internal control systems determine the level of credit risks of a bank. Supervisory authorities, therefore, need to be familiar with the following major factors that influence the general nature of credit risks to which Islamic banks are exposed:

- i. A large group of the counter-parties of conventional banks consists of issuers of debt securities, derivative instruments and users of commercial loans. Even though Islamic banks do not deal in these instruments, they are nevertheless exposed to risks involved in both the PLS and the sales-based modes, more so because the counter-parties of these banks are relatively much less sophisticated in their business practices and in maintaining systematic accounting records as compared with those in developed countries.
- ii. The prohibition of interest does not allow Islamic banks to reschedule debts on the basis of a re-negotiated higher mark-up rate. This can provide an incentive to their unscrupulous clients to willfully default, thereby exposing these banks to additional credit risk. Fortunately, such default cases have been limited so far. Moreover, the asset-based nature of Islamic finance serves as a safety mechanism by providing the banks with a marketable collateral that enables them to control their risk exposure. In this respect Islamic finance is similar to collateral-based mortgages, which are less risky compared to commercial loans and are, accordingly, assigned a lower risk-weight of 50% against 100% for the latter.
- iii. One of the determinants of default is the maturity of credit facility. Assets of long-term maturity are assigned a higher risk-weight as compared to those of short-term maturity. Islamic banks are at present primarily involved in extending short-term financing for real goods and services and, therefore, the risks they carry are relatively lower.
- iv. The size of a bank's trading book depends on the volume of its trading in interest-based corporate bonds and government and municipal securities. Except for Bank Islam Malaysia, Islamic banks do not have trading book credit exposures presently, because there are no marketable Islamic debt securities.
- v. Islamic banks do not have access to credit derivatives, which are assumed to be effective instruments for credit risk mitigation. The non-availability of these interest-based derivative instruments for risk management raises the importance of internal controls in Islamic banks.

In addition to these general points to be considered in assessing the credit risks of Islamic banks, there are a number of counter-party risks associated with the use of specific Islamic modes of finance, which need the attention of bank supervisors.

- i. According to some *fuqahā'*, including the OIC *Fiqh* Academy, the *murābahah* contract is binding on only the seller and not the buyer. In contrast with this, some other *fuqahā'* consider it binding on both parties, and most Islamic banks operate on the basis of this latter verdict. However, the OIC *Fiqh* Academy considers the defaulting party fully responsible for compensating the aggrieved party for all the losses incurred.
- ii. There are a number of counter-party risks in the *salam* contract as well. These range from the failure to supply on time, or even at all, to the failure to supply the agreed quality or quantity. Moreover, the counter-party risk in *salam* does not depend only on factors that are in the supplier's own control, but also on factors that are beyond their control, like natural disasters and climatic and other reasons for crop failure. Thus the credit risk involved in *salam* financing is also significant.
- iii. While entering into an *istisnā'* contract, an Islamic bank assumes the role of a builder, constructor, manufacturer and supplier. Since the bank does not specialise in all these areas, it has to rely on sub-contractors. This exposes the bank to a two-way counter-party risk. One of these is the risk of default from the client of the bank. This is the same as that in *murābahah* and also similar to the credit risk faced by conventional banks. In addition, there is the risk of failure of the sub-contractor to fulfil his obligations efficiently and on time.
- iv. Some *fuqahā'* do not allow Islamic banks to undertake *ijārah* ending in ownership. Nevertheless, the *ijārah*, as practiced by most Islamic banks, is much closer to lease finance which is allowed by a number of jurists. This conflict of views can be an important source of risk in the *ijārah* contract, there being no standard basis for litigation.

2.6.2 Market Risks

Market risks consist of interest rate risks, exchange rate risks, and commodity as well as equity price risks. Like conventional banks, Islamic banks are also exposed to these risks.

- i. Interest rate risk is one of the most important market risks faced by conventional financial institutions. Since Islamic banks do not deal in interest-based instruments, it has sometimes been argued that these institutions do not face this risk. However, the fact is that Islamic banks are also indirectly confronted with this risk through the mark-up price of deferred sale and lease-based transactions. Since Islamic banks use LIBOR as benchmark in their financing operations, it is natural for the assets of these banks to be exposed to the risk of changes in the LIBOR rate. A rise in LIBOR will automatically lead to a rise in the mark-up and, in turn, lead to the payment of higher profits to future depositors compared with those received by the banks from the users of long-term funds. The nature of investment deposits on the liabilities side of Islamic banks adds an additional dimension to this risk. Profit rates to be paid to *mudārabah* depositors by the Islamic bank will have to respond to changes in the market rate of mark-up. However, profit rates earned on assets cannot be raised because the price has been fixed on the basis of the mark-up rates of the previous period. In other words, any increase in new earnings has to be shared with depositors, but it cannot be re-adjusted on the assets side by re-pricing the receivables at higher rates. The inevitable implication is that the net *murābahah* income of the Islamic bank is exposed to the mark-up price risk.
- ii. Conventional banks try to manage interest rate, exchange rate, and commodity and equity price risks by using futures, forwards, options and swaps contracts. However, no agreement has yet taken place among the *fuqahā'* on the permissibility of these instruments. It has, therefore, not been possible to design *Sharī'ah* compatible substitutes for the conventional risk management instruments.

2.6.3 Liquidity Risks

Liquidity risks arise when there is an unexpected decline in a bank's net cash flow and the bank is unable to raise resources at a reasonable cost by either selling its assets or borrowing through the issuance of new financial instruments. This may make the bank unable to meet its obligations as they become due, or to fund new opportunities for profitable business. Sound liquidity management is, therefore, crucial for banks if they wish to avoid being engulfed in serious liquidity problems.

The liquidity risk faced by Islamic banks seems to be low at present because of the excess liquidity syndrome that these banks face as a result of the non-availability of adequate *Shari'ah*-compatible investment opportunities. However, there are a number of reasons which may lead to liquidity risks in the future. First, most of them rely largely on current accounts, which are withdrawable on demand. Second, there is a *fiqhi* restriction on the sale of debts, which constitute a major part of their assets. Third, due to the slow development of Islamic financial instruments, Islamic banks are not able to raise funds quickly from the markets. The non-existence of an Islamic inter-bank money market tends to make this problem a little more difficult. Fourth, the Lender of Last Resort (LLR) facility is also not available at present except on the basis of interest. Nevertheless the Islamic banks have so far not faced any liquidity problem. This has been a double-edged weapon because while it has saved the banks from liquidity crises, it has also led to the lack of development of formal liquidity management instruments. These problems are, however, not insurmountable. They can, and will be, resolved with the passage of time with the cooperation of banks, the *fuqahā'* and the central banks.

2.6.4 Operational and Other Risks

Operational risks arising from the breakdown of internal controls and corporate governance can also lead to shortfalls in a bank's net income or cash flow as compared with that expected or targeted, and thus create problems for management. In addition to these risks, the Islamic banks also face substantial *fiqh*-related risks arising from the non-standardised nature of some Islamic banking products. Moreover, an efficient and prompt *Shari'ah* litigation system is not in place, and banks as well as supervisory staff are not well-oriented in the knowledge of *fiqh*. The *Shari'ah* supervisors are also not well-versed in the implications of modern risk management concepts. This has had the effect of depriving Islamic banks of the utilisation of many genuine risk management concepts and systems which may not necessarily be in conflict with the *Shari'ah*. Operational risks also arise from technology, reputation, and compliance with regulatory standards, etc. The exposure of most Islamic banks to all these risk factors may be relatively high but it seems that they have been able to manage these fairly well so far.

2.6.5 Enhancing Risk Management Culture in Islamic Banks

The cultivation of an effective risk management culture is extremely important for the competitiveness and survival of Islamic banks. This cannot,

however, be done without the active collaboration of bank supervisors, senior management of banks, and the *Sharī'ah* scholars. For this purpose supervisors must make a number of reports and actions mandatory on the senior management of Islamic banks. These are:

- Development of internal rating systems and the utilisation of risk management models,
- Market risk and value at risk (VaR) reports,
- Credit risk reports,
- Liquidity risk reports,
- Operational risk reports, and
- Follow-up on internal control systems with a suitable checklist.

2.7 INTERNAL CONTROLS AND EXTERNAL AUDIT

Most research works identify the failure of risk management and internal control systems as the primary causes of financial crises.⁵⁴ As a corollary, it is argued that if proper risk management and internal control systems (ICSs) were in place, most of these crises would perhaps have been averted. The external audit system further strengthens internal controls by supplementing the operational soundness of these systems. Hence these systems working together play an extremely important role in the stability and soundness of financial institutions.

The importance of these systems is even greater in the Islamic financial services industry because of its unique PLS system along with new products and procedures, not well known even to all the practitioners, and the need for *Sharī'ah* compliance. Therefore, supervisory oversight in these institutions should aim at ensuring the existence of effective internal controls and external audit. It should also aim at motivating these institutions to remove on an ongoing basis the deficiencies that they happen to have in these systems.

Internal control systems must ensure the achievement of three distinct and clear objectives. First, they must aim at enhancing the performance of the organisation by utilising its assets and growth potential optimally and also ensuring the participation of all personnel with integrity, sincerity and honesty.

⁵⁴ See, for example, BCBS, *Framework for Internal Controls in Banking Organizations*, 1998.

Second, they must aim at ensuring the preparation, up-dating and availability of all reliable information which is considered to be important for raising the efficiency and competitiveness of the organisation and for serving the interests of its owners and investors. Third, they must ensure full compliance of the organisation with the laws, regulations, standard business ethics, and social values.

The ICSs must be put in place by the organisation's governing board and senior management, and must be practiced and complied with at all levels and by all individuals working for the organisation. It is the responsibility of the internal auditor to ensure that such a comprehensive implementation of the systems is in place.

The effectiveness of ICSs depends on a number of factors. First and foremost, the board and senior management of the organisation must not only appreciate the immense importance of internal control functions but also be committed to the development of a culture of effective ICSs. Second, the ICSs must be committed to the recognition and assessment of all the risks faced by the organisation, such as credit risks, liquidity risks, market risks, operational risks, compliance risks, technology risks, etc., and the management must ensure that the organisation has credible systems in place to control these risks. The ICSs must continuously verify the integrity of risk management systems of the organisation and ensure that periodic risk reports are regularly prepared and followed up carefully with back testing.⁵⁵ Third, the ICSs must ensure that there is no conflict of interest within the various offices of the organisation and that the ICSs do not themselves create hindrances in the smooth operation of these offices. For example, it is the responsibility of the information technology (IT) office to develop for the organisation a credible IT system that is the best available for the control of various risks and for the proper functioning of different offices, approval processes, and delegation of authority. Fourth, the ICSs must ensure that all the required information is not only easily and systematically available about the organisation, including its financial affairs, profitability and operations, but also that it is fully reliable. Similarly the organisation must also maintain external data critical for its own operations. Fifth, the ICSs for Islamic banks must be vigilant so that the operations of the organisation are in conformity

⁵⁵ Back testing refers to the practice of applying the valuation or risk forecasting model based on historical data to help appraise the model's possible usefulness when current and future data are used.

with the *Sharī'ah*. Finally, the ICSs must be dynamic in their review process, self-evaluation, and adoption of policies for overcoming deficiencies on an ongoing basis.

External audit helps in making the ICSs dynamic, effective, and reliable in many ways. First, it provides for a review and verification process for the integrity of the ICSs. Second, it brings in objectivity by being external and relatively independent of the organisation's management. Third, it provides for cross-checking of the critical information provided by the management to outsiders, irrespective of whether they are individuals, organisations, or the market. Fourth, it ensures compliance with international standards, which is most important for comparability and market discipline.

Since ICSs play an extremely important role in the stability and efficiency of a banking organisation, supervisory oversight is indispensable on an ongoing basis to ensure the credibility of such control systems and to remove the existing deficiencies over a reasonable period. ICSs tend to be weaker in organisations which do not have credible governance systems, a phenomenon which appears to be endemic in the banks of many developing countries, and Islamic banks do not seem to be an exception. It is the responsibility of supervisory authorities to set minimum governance standards for Islamic banks so that they are compelled to develop ICSs on professional criteria. It is also the responsibility of supervisory authorities to motivate these institutions to develop credible risk management cultures within their organisations.

2.8 GREATER TRANSPARENCY

Transparency of banks through the provision of correct information about important financial variables and other institutional and administrative factors which have a bearing on the soundness of a bank, is vital for not only protecting the interests of depositors and other concerned parties but also systemic stability. It is, therefore, the core principle of international accounting standards. Its importance increases even further in the risk-sharing nature of Islamic finance, because of the need to enable the shareholders and the depositors to monitor the affairs of the bank and thereby help inject greater discipline. It is necessary, therefore, to enhance transparency and comparability of banks through suitable

disclosures about the quality of capital, accounting standards, risk exposures, and capital adequacy.⁵⁶

2.8.1 Capital Quality

The need for transparency about banks' capital structures arises due to the fact that banks' tier-1 or core capital may be increasingly diluted by tier-2 or supplementary capital (and in some countries also by tier-3 capital). To ensure that this dilution does not erode the core capital, the BCBS makes two recommendations. First, banks should appropriately and timely disclose i) the amount of tier-1 and tier-2 capital with their detailed components; ii) deductions from tier-1 and tier-2 capital; iii) amount of tier-3 capital, if any; and, iv) the total capital base of the bank. Second, banks should appropriately disclose the loss absorbing capacity of capital instruments, including: i) maturity of instruments; ii) level of seniority; iii) dividend deferrals' and iv) status and characteristics of derivative-like instruments, etc.

It is highly relevant to note that the capital of Islamic banks consists so far of only shareholders' equity and is, therefore, primarily core capital which is not diluted in any way. Even if the AAOIFI's recommendation regarding investment deposits is accepted, no complications would be introduced because of the absence of preference shares and subordinated debt. However, if Islamic banks induct new types of capital into their capital structure in the future, they should fully adopt the international exposure and transparency requirements.

2.8.2 Accounting Standards

Effective market discipline also requires an appropriate and standardised accounting framework and disclosure policies with respect to assets, liabilities and income statements of banks. The special accounting requirements of Islamic modes of finance also need to be specified in detail. The way in which profits are calculated and distributed by Islamic banks is also not clear. Therefore a number of papers have urged these banks to adopt uniform and transparent standards.⁵⁷

2.8.3 Risk Exposure

⁵⁶ Market discipline elements and guidelines are elaborated in i) BCBS, *Enhancing Bank Transparency*, 1998; ii) BCBS, *Sound Practices for Loan Accounting and Disclosure*; 1998; BCBS, *Best Practices for Credit Risk Disclosure*, 1999; and (iii) BCBS, *Pillar-III: Market Discipline*, 2000.

⁵⁷ See, for example, Iqbal *et. al.*, 1998.

To strengthen market discipline, banks must release both qualitative and quantitative, information on their risks and risk management policies. Banks can strengthen market discipline only if there is a timely release of information about all risks, including credit risks, liquidity risks, and market risks. This is a highly challenging area for Islamic banks. Two factors need to be given special consideration in determining the risk profile of Islamic banks. One of these reduces the risk while the other raises it. The one that reduces the risk is absence of the use of derivative instruments by them. Their risk exposure is hence not as complicated as that of conventional banks which use derivatives to a very large extent, but make a limited disclosure of this, thus raising concerns about the high level of systemic instability. The factor that raises the risk is the use of modes and mechanisms which are new and risk-sharing. Thus these banks need to adopt conscious policies and mechanisms to decompose their risks, adopt suitable measures to manage them and provide suitable timely disclosures about their risks and the manner in which they deal with them.

2.8.4 Capital Adequacy Measures

Market discipline can also be strengthened if capital ratios and the way these are calculated are transparent and released timely. The implementation of this recommendation of the BCBS is extremely important for Islamic banks. As of now, most Islamic banks do not generally disclose information about their capital adequacy policies and ratios. We therefore recommend that Islamic banks adopt a clear and uniform capital adequacy standard as capital is critically important for averting, or significantly reducing, shocks and for stabilising the banks after a shock. Islamic banks must at least initiate a policy with regard to the standardised approach, the internal ratings-based approach and the models-based approach as outlined earlier in the paper. Given the present infrastructural and technical capabilities of Islamic banks, which are at best very modest by international standards, it is prudent to adopt the standardised approach but, at the same time, initiate work on building capacity to adopt the more sophisticated internal ratings-based and models-based approaches.

The non-exposure of Islamic banks to derivatives makes their case much less complicated, but the non-existence of appropriate methods and mechanisms to deal with credit risks, market risks, liquidity risks and operational risks creates initial difficulties. It is therefore imperative that these banks adopt suitable policies and provide sufficient disclosures in this regard while calculating their capital adequacy ratios. As indicated earlier, many factors affect the capital adequacy of

a bank on an ongoing basis in a dynamic setting. Banks need to systematically plan, prepare and disclose factors which change, or have the potential of changing, the capital adequacy ratios once these are disclosed. These factors may include planned investments, as well as contingencies for unplanned changes in the capital structure of banks.⁵⁸ This recommendation is also equally relevant for Islamic banks.

2.8.5. Facilitating the Supervisory Review Process

All the previous suggestions, if adopted by banks, will facilitate not only market discipline but also the supervisory review process, i.e., the second pillar of the New Framework. There is hardly any information available on the allocation of various components of Islamic bank's funds, investment deposits, current accounts and shareholders' capital. Some studies are very critical of this phenomenon and recommend a compartmentalised allocation of not only these funds, but also the different maturities of investment deposits along with the investment activities of similar maturities. Such strict compartmentalisation may not be feasible, and may even be counter-productive, as it is against the basic principle of bundling and packaging of funds. However, a reasonable record and disclosure of the allocation of these funds can facilitate supervisors in comparing the bank's soundness in its peer group. Thus Islamic banks need to prepare such information and make suitable disclosure of these. In this regard the Bahrain Monetary Agency (BMA) has adopted a conscious policy which can be reviewed and replicated by other supervisory authorities.⁵⁹

2.9 DEPOSIT INSURANCE

The financial crises faced by almost three-fourths of the member countries of the IMF over the last two decades have induced many countries to adopt, or consider, deposit insurance to protect their depositors from losses, and their financial systems from the adverse impact of the resultant loss of confidence in them. In fact even countries which do not have deposit insurance, have rescued the depositors in case of bank failures because of the fear that refusal to do so might lead to the collapse of the financial system.

The problem, however, is that such protection tends to create a moral hazard and induces banks to overextend themselves and to act imprudently. A fine

⁵⁸ For details see, BCBS, *Pillar III – Market Discipline*, 2000.

⁵⁹ See al-Sadah (2000).

line, therefore, needs to be drawn between the need to ensure the confidence of the depositors in the banking system and to discourage laxity on the part of individual banks.

Such a fine line may have to be drawn even in the Islamic system. This may be done by protecting demand deposits, which must be guaranteed and repaid in full. It may not be possible to ensure this without insurance of these deposits. However, even investment depositors cannot be left out of the insurance net totally even though they would be participating in the risks. This is because investment depositors are required to share only in the market risks and not those related to fraud, carelessness, mismanagement, and loan concentration. Investment depositors need to be protected against such risks. Although well-formulated procedures for accounting and loan valuation, combined with prudential regulation and supervision, may help reduce such risks, these may not be enough and the provision of insurance protection against such risks may be unavoidable.

The knowledge that their deposits are protected will give depositors, and in particular small depositors, confidence in the Islamic financial system as a whole and prevent panics. It is particularly important to protect small depositors because large depositors have the resources to monitor the condition of their banks, and giving them full protection would tend to reduce market discipline by providing them an incentive for laxity in paying due attention to the soundness of their banks.

It would be desirable to have an explicit insurance scheme specifying the kind and extent of coverage available to depositors. This would be better for building the depositors' confidence in the financial system. They would be aware of the extent of coverage they have. In the absence of such an explicit coverage, the depositors would tend to assume a full implicit coverage, particularly in the case of large banks, because of the "too big to fail" doctrine. This will be more costly for the central banks because they will have to bail-out all depositors, irrespective of the size of their deposits. In addition, it will introduce a moral hazard and reduce depositor watchfulness of large banks which is necessary for greater market discipline.

2.10 INSTITUTION FOR SUPERVISORY OVERSIGHT

The above discussion points towards the need for clear-cut guidelines for the regulation and supervision of Islamic banks. Since such guidelines can be better prepared by a specialised institution, the conference on Islamic Banking

Supervision organised in Bahrain in February 2000 by the IDB, the IMF, the Bahrain Monetary Agency (BMA) and the AAOIFI recommended the establishment of the Islamic Financial Services Board (IFSB). This recommendation was discussed in a meeting held in conjunction with the IMF and World Bank meetings (Prague, 23 September 2000) by a group of representatives of a number of central banks.⁶⁰ It was decided to establish an interim committee comprising of the central banks of Bahrain, Iran, Malaysia and Sudan along with the IMF, the IDB and the AAOIFI. The committee will work out a detailed proposal for the establishment of the IFSB with the purpose of creating an autonomous body to set standards for the regulation and supervision of Islamic banks. The governors of central banks attending the meeting urged the IDB to play a leading role in the establishment of and operation of the proposed IFSB.

This raises the question of what characteristics should the IFSB have to be able to perform its task effectively. The following characteristics would be desirable. Firstly, it must have a high level of expertise in the international standards set by BCBS, IOSCO and IAIS. Secondly, it must have full knowledge of the unique characteristics of Islamic banking, its strengths and weaknesses, and the challenges that lie ahead in the future. Thirdly, it must have the support of governments and central banks and enjoy a prestige and authority that would enable it to get its recommendations accepted and implemented by the authorities. This is more likely to happen if the organisation has been established by the governments themselves, and has the governors of central banks and/or the ministers of finance on its governing body. Fourthly, it should be able to coordinate the efforts of banks, securities organisations, insurance companies, and other non-bank financial institutions. If it enjoys the support of only Islamic banks, it may not be able to effectively regulate the entire Islamic financial market. Fifthly, it should not be an organisation established by Islamic banks themselves. This would create a conflict of interest and reduce confidence in its overall ability to prepare the needed guidelines for regulation and supervision and to get them implemented. Establishment of the IFSB with the above characteristics should help in the regulation and supervision of Islamic banks in accordance with international standards as well as the *Shari'ah*.

⁶⁰ These central banks were: Bahrain, Egypt, Iran, Jordan, Kuwait, Malaysia, Palestine and Sudan. In addition, the IMF, the IDB and the AAOIFI were also represented.

2.11 ISLAMIC ACCOUNTING STANDARDS

The data presented by financial institutions in their balance sheets, income and cash flow statements and other such statements are indispensable for determining the soundness of these institutions. The information provided in these statements is utilised by shareholders, depositors, investors and regulators. If all these statements are prepared on the basis of uniform standards, it facilitates objective comparison between different financial institutions and enables the market discipline to work more effectively. The standards set by the International Accounting Standards Committee (IASC) are by and large followed by financial institutions around the world. A number of developments during the past few years have increased the significance of such standardised information.⁶¹

The general purpose financial statements of the Islamic financial institutions are by and large based on international accounting standards (IAS), IAS30 of which specifically provides for the format of preparing and presenting financial statements by banks. The AAOIFI, has done a valuable job of adapting the international standards to suit the Islamic financial institutions.⁶²

Such an adaptation is necessary for a number of reasons, including the following. First, interest-based lending has been replaced by the Islamic modes of finance. These modes comprise of diverse contracts, each one having its own accounting requirements. Leasing operations of Islamic banks may be partially covered by IAS 17, but totally new standards are required for *istisnā'*, *salam* and *murābahah*. Second, the accounting standards for Islamic modes of finance need to be uniform across time, regions and institutions. Third, the accounting standards used by Islamic financial institutions are also necessary to fulfil other Islamic requirements, the most important of which relates to *zakāt*. Fourth, the Islamic accounting standards have to facilitate the work of the *Sharī'ah* supervisors. Fifth, transparency is also needed with respect to the liability side of

⁶¹ Some of these developments are indicated below. First, markets and economies have opened up and an interaction between institutions has increased due to the liberalisation policies. It has also brought with it the challenges of the associated risks and uncertainties. Second, development of technology, financial markets and instruments has enhanced the role of information and market discipline. Third, differences between the activities of commercial banks, investments banks and, to some extent, insurance firms has largely faded away, increasing the need for coordination of activities between standard setters, various types of institutions and regulators.

⁶² See, AAOIFI (1999)

Islamic banks. Finally, almost all Islamic banks originate from developing countries. These institutions, therefore, carry the same or similar systemic characteristics as other financial institutions in these countries.

The AAOIFI standards were introduced for the first time in 1993 for Islamic financial institutions. Nevertheless, these have so far not become reflected in their accounts even though the standards setting committees of the AAOIFI had representatives from a number of these institutions themselves, the central banks, and *fiqh* scholars. Given such representation, one would have expected that the practices of Islamic banks would converge to the AAOIFI standards.

It needs to be appreciated that the objectives of accounting standards are different for regulatory and supervisory authorities from those of accountants. For example, the central concern of IAS 39 is to adopt standards for liability reporting *at cost* and for asset reporting *at fair values*. However, according to the BCBS, this standard will increase the volatility of reported earnings and equity, making the measurement of the true risk of a financial institution difficult. To remove such conflicts, accounting standard setters, banks, other market participants, and regulatory authorities must come together to set best accounting standards, which can enhance the risk management objectives of banks. Therefore, the BCBS, IOSCO, IASC and the IAIS are working together to review international accounting standards with the objective of setting principles of best practices.⁶³

The AAOIFI needs to take part in this joint effort and in any future efforts for setting supervisory standards for Islamic financial institutions. The concern for global financial stability has made it necessary to make the IASs more dynamic. The BCBS has, therefore, undertaken a quick review of IAS 30 and a more thorough review of IAS 39.⁶⁴ The finding of the review was that, since IAS 30 has not been updated after 1991, it was necessary to update it to encompass current best practices in terms of disclosure of risk exposures and risk management policies of financial institutions. These standards are hence under full review during 2000.

The debate on the review of IAS 30 and IAS 39 is equally valid for Islamic financial institutions, particularly, for the AAOIFI. IAS 30, which provides for the

⁶³ See BCBS (April 2000).

⁶⁴ IAS 30 deals with disclosures in the financial statements of banks and similar financial institutions.

format of general purpose financial statements, is being reviewed to cover the dynamic requirements of the financial markets, and IAS 39 is a new standard covering financial instruments. The debate on these standards between standard setters, financial institutions, and regulators needs to be followed up by the AAOIFI, Islamic financial institutions, regulators and other relevant institutions. For this purpose, the following may be suggested:

- i. The concern for risk management should be incorporated into the AAOIFI standards
- ii. Islamic banks should keep themselves fully involved, on their own as well as through the platform of the AAOIFI, with the ongoing reviews of IAS 30 and IAS 39.
- iii. The international standard setters should also include Islamic banks as concerned institutions while distributing consultation papers during the review process.
- iv. The relationship between AAOIFI and regulatory and supervisory standard setters for Islamic financial institutions needs to be strengthened for adopting the AAOIFI standards.
- v. Since subscription to the Special Data Dissemination Standards (SDDS) of the IMF has important implications for IDB member countries, the AAOIFI accounting standards must also take note of these standards. The IAS constitutes the basis of the SDDS and, therefore, while adapting IAS, the AAOIFI may also consider the requirements of the SDDS.

2.12 INTERNATIONAL ISLAMIC RATING FACILITY

External rating of businesses and banks is important for the efficient operation of the Islamic financial system. It is needed by depositors to choose the right bank, and by banks to save themselves from losses. It is also important for the proposed standardised approach to determine the capital requirements for financial institutions. Hence, the existence of such a rating system would greatly help enhance market discipline by improving the availability of information to depositors, bankers and central banks.

Existing conventional rating systems are primarily concerned with the financial strength of counter-parties and ignore compliance with the *Sharī'ah*

requirements.⁶⁵ This drawback needs to be overcome in an Islamic system. Consequently, the need for an Islamic rating agency has always been felt. Keeping this need in view, the establishment of an International Islamic Rating Agency (IIRA) is under the active consideration of the IDB and other Islamic financial institutions. A preparatory meeting of the prospective shareholders was held in Bahrain on 16 September 2000 for this purpose. The meeting was attended by 20 institutions. It was agreed to incorporate the IIRA in Bahrain by December 2000 with an authorised capital of US\$ 20 million and an initial paid-up capital of US\$ 2 million. Once such an agency becomes operational, it would be able to add highly useful information to the available rating facilities, thereby helping in the implementation of uniform international supervisory standards for the Islamic financial services industry.

⁶⁵ Cunningham, (1999).

Part III

SOME UNRESOLVED *FIQHI* ISSUES

During the discussion in Part II of this paper, references were made in different places to certain *fiqhi* issues which have an important bearing on regulation and supervisory oversight and which, therefore, need to be resolved. It is now time to put together all these unresolved *fiqhi* issues in one place. It is not our intention to challenge the positions adopted by the *fuqahā'*, particularly those that enjoy a consensus. Our intention is just to highlight the issues because, while the Qur'an and the *Sunnah* are immutable, *fiqhi* verdicts are not necessarily so. They represent interpretations of the Qur'an and the *Sunnah*. These interpretations tend to be affected by the socio-economic and political circumstances prevailing at the time of the *fuqahā'*. These circumstances keep on changing and make it necessary to at least reconsider the verdicts from time to time.

Fiqhi verdicts related to the financial system have remained dormant for more than two centuries, over which period the conventional financial system has made tremendous advances. Revival of the Islamic financial system is, therefore, taking place in an environment which is entirely different from that of the classical *fuqahā'*. Even though a great deal of progress has been made over the last two decades in facing the new challenges, there are still certain crucial issues that remain unresolved. This is but natural because the issues are difficult and require an expertise in both the *fiqh* and the complexities of modern finance, which is not easy to find. However, since, it may not even be possible to prepare an agreed legal framework and capital adequacy standards for Islamic banks until a consensus or near-consensus has been reached on these fundamental *fiqhi* issues, they need the special attention of the *fuqahā'*. This may not necessarily lead to a change in the classical verdicts. There will, nevertheless, be a satisfaction that, in spite of taking into account the changed realities, it was not considered desirable to change the age-old verdicts because of the strong rationale behind them. In that case it would be necessary for the *fuqahā'* and financial experts to join their hands to find practical *Sharī'ah* compatible solutions for the problems faced by Islamic financial institutions. In the absence of such solutions, the risks faced by banks may be higher and the need for capital greater. Capital standards which are significantly higher than those for conventional banks may reduce the profitability of these banks and make them less competitive.

3.1 LATE SETTLEMENT OF FINANCIAL OBLIGATIONS⁶⁶

One of the most important of these issues is the failure of the purchaser of goods and services under the *murābahah* mode of financing to make payment on time even when he is capable of doing so. If this failure were due to strained circumstances, then Islam recommends not just rescheduling but even remission, if necessary. However, if it is due to unscrupulousness, then the question is whether a penalty can be imposed on the defaulter and whether the financier or the bank can be compensated for the damage as well as the loss of income caused by such default? If the late payment does not lead to any penalty, there is a danger that the default may tend to become a widespread phenomenon through the long-run operation of self-reinforcing mechanisms. This may lead to a breakdown of the payments system if the amounts involved are significantly large.

Scholars have expressed a number of opinions on the subject, but so far there is no consensus.⁶⁷ The conservative view allows blacklisting of the defaulter's name and also his imprisonment if the delay is unjustified, but prohibits the imposition of any monetary penalty on the defaulter or the payment of any compensation to the aggrieved party for fear that this may become equivalent to interest. Although blacklisting and imprisonment may serve as deterrents to the unjustified delaying of payments, it does not provide any relief to the aggrieved party, which has suffered damage and loss of income.

The relatively liberal view, therefore, allows the imposition of a financial penalty on the debtor who delays payment without any justification, but allows it to be made available to the aggrieved party as compensation only if the penalty is imposed by a court. However, even in the case of a court decision, there are two different views. One view permits the court to determine compensation for the damage caused by late payment as well as the loss of income suffered by the aggrieved party. The other view allows the court to determine compensation for only the actual damage but not for the loss of income. If the penalty is not determined by a court, then the proceeds must be utilised for charitable objectives only and cannot be made available as compensation to the aggrieved party.

⁶⁶ This section has been adapted from Chapra (2000), pp-301-303.

⁶⁷ For a range of opinions expressed on the subject, see M.A. Zarqa and M.A. El-Gari (1991), pp.25-27 as well as the comments by M. Zaki 'Abd al-Barr, and Habib al-Kaf, on pp.61-4 of this same issue, and by Rabi' al-Rabi on pp. 67-9 of the 1992 issue of the same Journal. See also al-Misri (1997), pp.131-54; al-Zu'ayr (1997), pp.50-7; and Abu Ghuddah and Khoja (1997), pp.55 and 91.

The possibility of imprisonment of the defaulter can serve as a strong deterrent provided that this can take place promptly. It would help minimise default cases. However, if lender and police highhandedness are to be eschewed, imprisonment should take place only on the basis of a court decree issued after a due process of law. This may be difficult because, given the present-day inefficient judicial system of many Muslim countries, court decisions usually take several years and involve substantial litigation costs. It is, therefore, imperative that special banking tribunals be established to promptly penalise the unjustifiably defaulting party and thereby help minimise default cases and, if the *fuqahā'* agree, also compensate the aggrieved party.

If the concept of compensation for loss becomes accepted by the *fuqahā'*, then there would arise the question of how to determine the compensation in a way that reduces subjectivity as well as the possibility of injustice to either the defaulting or the aggrieved party. The answer may lie in developing an index of "loss given a default" (LGD). It should be possible to develop and maintain such an LGD index using internationally recognised standards. The LGD will, for example, provide a schedule of the loss incurred by a bank if \$100 is defaulted in payment for a given number of days. The LGD will capture all costs related to the administration of the default until its settlement, the litigation cost and the loss of income. The ultimate decision will, of course, have to be made by a special banking tribunal in keeping with the LGD schedule with adjustments for individual circumstances.

3.2 THE NATURE OF LIABILITY: LIMITED OR UNLIMITED

There is no specific direct discussion in the *fiqh* literature on the nature of a PLS partners' liability, limited or unlimited, with respect to third parties. This is understandable because the nature of liability gains prominence only when there is leverage. Such leverage was not possible within the framework of the classical modes of *mudārabah* and *mushārahah*. However, the expansion of debt and demand deposits has given rise to leverage and made it possible to raise a large superstructure of PLS and sales-based modes of financing on a relatively small base of equity and investment deposits.

In such a situation it is important for equity holders as well as investment depositors to know the extent of their liability, particularly because the share of demand deposits is proportionately quite large. Limited liability helps confine the degree of investors' risk to the extent of their contribution to total equity or PLS finance. It is, therefore, necessary to clarify the nature of liability through a clear

fiqhi verdict and this should be reinforced by legal reform in Muslim countries to leave no ambiguity. This should not be difficult to do because all that is needed is to formalise the concept of limited liability that already exists in the *fiqh literature*.⁶⁸ What would also help is the adoption of separate capital adequacy requirements for demand and investment deposits, as suggested earlier. This would imply that the larger the proportion of demand deposits in a bank the greater may be the capital requirement and vice versa.

3.3 SOME ISSUES ABOUT LEASING⁶⁹

The *fuqahā'* are unanimously agreed on the need for the lessor to bear at least a part of the risk of lease financing to make the lease contract lawful. Nevertheless, there are differences of opinion among them on the permissibility of different types of lease contracts. Unless these differences are resolved, it may not be possible to prepare a clear and comprehensive legal framework for leasing.

The kind of leasing which the *fuqahā'* have generally discussed in the classical *fiqh* literature, and about the permissibility of which there is no difference of opinion, is what is now called the operating lease. This form of lease distinguishes itself from the other forms in a number of ways. Firstly, the lessor is himself the real owner of the leased asset and, therefore, bears all the risks and costs of ownership. All defects, which prevent the use of the equipment by the lessee, are his responsibility, even though it is possible to make the lessee responsible for the day-to-day maintenance and normal repairs of the leased asset. Secondly, the lease is not for the entire useful life of the leased asset, but rather for a specified short-term period (a month, a quarter, or a year), and ends at the end of the agreed period unless renewed by the mutual consent of both the lessor and the lessee. The entire risk is thus born by the lessor. This has, however, the potential of introducing a moral hazard through the misuse of the leased asset by the lessee.

The financial lease helps take care of the moral hazard problem by making the lease period long enough (usually the entire useful life of the leased asset) to enable the lessor to amortise the cost of the asset with profit. At the end of the lease period the lessee has the option to purchase the asset from the lessor at a price specified in advance or at its market value at that time. The lease

⁶⁸ See Chapra, 1985, p.250.

⁶⁹ This section has also been adapted from Chapra (2000).

is not cancelable before the expiry of the lease period without the consent of both the parties. There is, therefore, little danger of misuse of the asset.

A financial lease has other advantages too. The leased asset serves as security and, in case of default on the part of the lessee, the lessor can take possession of the equipment without court order. It also helps reduce the lessor's tax liability due to the high depreciation allowances generally allowed by tax laws in many countries. The lessor can also sell the equipment during the lease period such that the lease payments accrue to the new buyer. This enables the lessor to get cash when he needs liquidity. This is not possible in the case of a debt because, while the prevailing *fiqhi* position allows the sale of physical assets, it does not allow the sale of financial debt instruments except at their nominal value.

Some of the *fuqahā'* have expressed doubts about the permissibility of financial lease. The rationale they give is that the long-term and non-cancelable nature of the lease contract shifts the entire risk to the lessee, particularly if the 'residual' value of the asset is also fixed in advance. The end result for the lessee may turn out to be worse than the outright purchase of the asset through an interest-bearing loan. A financial lease has thus the potential of becoming more exploitative than outright purchase. Suppose the lease contract is for five years, the lessee would have to continue making lease payments even if he does not need the asset, say, after two years. In the case of a purchase through an interest-bearing loan, the purchaser can sell the asset in the market and repay the loan, thus reducing his loss. This he cannot do in a financial lease. If he is unable to make lease payments, he may lose his stake in the asset even though he has paid a part of the asset price beyond the rental charge he would normally pay in an operating lease.

There are, however, *fuqahā'* who consider financial lease to be permissible if certain conditions are satisfied. Firstly, the lessor must bear the risks of leasing by being the real owner of the leased asset. He cannot lease what he does not own and possess, and should be responsible for all the risks and expenses related to ownership.⁷⁰ Therefore, a lease contract where the lessor acts only as an intermediary between the supplier and the lessee and plays the role of only a financier, with ownership of the asset being nothing more than a

⁷⁰ The *fuqahā'*, however, allow the sub-lease of a leased asset even though the sub-lessor is not the owner of the asset. The sub-lessor then bears the risk, but can pass it on to the original lessor.

legal device to provide security for repayment of the loan and legal protection in case of default, is not allowed. In this case the lessor leases an asset before buying it and taking possession of it, and gets a reward without bearing any risk. Secondly, obligation of the lessee to make lease payments does not start until he has received possession of the leased asset and can continue only as long as it remains usable by him.⁷¹ Thirdly, all manufacturing defects and related problems, should be the lessor's responsibility. The lessee can, however, be made responsible for the proper upkeep and maintenance of the leased asset. Fourthly, the lease contract should be separate from, and independent of, the contract for the purchase of the residual asset. The residual value has to be market-related and cannot be fixed in advance. The purchase contract has, therefore, to be optional and not a condition for the lease contract because the quality of the asset at the end of the lease period as well as its market-related price, two of the essential requirements for a valid contract, are unknown when the lease contract is signed.

Almost all Islamic banks use the financial lease by fulfilling, or at least making an effort to fulfil, the *Sharī'ah* conditions. The residual value remains a problem but the banks have tried to overcome it by setting a small nominal value for the residual asset or transferring it as a gift from the lessor to the lessee. This does not satisfy the *fuqahā'* who are opposed to the financial lease because, according to them, it does not fulfil the *Sharī'ah* requirements. The residual value gets automatically predetermined and becomes built into the lease payments, and thereby leads to injustice. The lessee loses the asset as well as the extra payments made by him in case he dies or is unable to continue lease payments. The alternative suggested by them is that the lessor should sell the asset to the 'lessee' on an installment basis and then get it hypothecated to ensure full payment. However, once the asset is owned by the 'lessee', it is very cumbersome for the bank to get it back from him in a number of Muslim countries even if he is unable to make payments. Moreover, the ownership of the asset enables him to sell the asset and use the money, leaving the bank with nothing to fall back upon.

The *fuqahā'* are agreed that the security lease (also referred to as 'financing' lease) is not acceptable from the point of view of the *Sharī'ah* because it is not a lease contract in the traditional sense. It is just a financing transaction,

⁷¹ This does not mean that the lessee cannot make lease payments in advance of the lease period. However, his liability cannot start until he has received the leased asset.

and nothing more than a disguised security agreement. It involves the effective transfer to the lessee of all the risks and rewards associated with ownership. The security lease has, therefore, been ruled out from the modes of Islamic finance.

3.4 SALE OF DEBTS: SECURITISATION

There is a general agreement among the *fuqahā'* that the sale of debts is not allowed except at their face value. The rationale usually given for this position is that the sale of debts involves *ribā* (interest) as well as *gharar* (excessive uncertainty),⁷² both of which are prohibited by the *Sharī'ah*. Such a position is undoubtedly true with respect to the sale of debts incurred by borrowing money. Since it is normally not possible to sell a debt except at a discount, such a sale would be nothing but a disguised way of receiving and paying interest. It is also argued that, as a result of what is now called asymmetric information, the buyer of the debt may be unaware of the true financial position of the debtor and of his willingness and ability to honour the debt. Consequently there is *gharar* in the transaction. Hence the *fuqahā'* have a strong rationale in not allowing the sale of debts.

The rationale does not, however, apply to debts sold by Islamic banks in modern times for two main reasons. Firstly, the debt is created by the sale of goods and services through the sales-based modes of Islamic finance, particularly *murābahah*. If, say, an airplane or a ship is sold by a bank or a consortium of banks to a government or a corporation, the debt is not incurred by borrowing money. The debt is created by the *murābahah* mode of financing permitted by the *Sharī'ah* and the price, according to the *fuqahā'* themselves, includes the profit on the transaction and not interest. Therefore, when the bank sells such a debt instrument at a discount, what it is relinquishing, or what the buyer is getting, is not interest but rather a share in the profit.

Secondly, in the present day sale of debts by banks, we are not talking of a debt owed by an unknown (*majhūl*) person with an unknown credit rating, such that the buyer of the debt instrument does not know whether the debt will be honoured or not. The debt instruments intended to be sold are generated by the financing provided through the sales-based modes to governments and well-known corporations and firms having a high credit rating. The buyer of the debt instrument can know about the rating as much as the bank. Moreover, the debt is not unsecured. It is rather asset-based and well-secured. Its payment is hence

⁷² For a detailed meaning and explanation of *gharar*, see Saleh (1986), pp.49-52.

almost certain. Therefore, there is no question of any *gharar*. The past ruling of the *fuqahā'* given in entirely different circumstances, does not, therefore, seem to fit the changed realities of modern times.

The *fuqahā'* may, therefore, wish to reconsider their verdict, not because the earlier verdict was wrong, but because circumstances have changed. They should definitely retain the ban on sale of debts in the form of treasury bills, bonds and other such interest-based instruments which involve pure lending and borrowing against interest. However, their ruling with regard to the sale of asset-based debt instruments, which originate in the sale of real goods and services and which transfer a part of the profit, and not interest, from the original financier to the new financier, needs to be reviewed. The development of a general agreement on this important issue would help create a secondary market for such debt instruments and thereby lead to the accelerated development of an Islamic money market.

The absence of such a secondary market for debt instruments creates two major problems for banks and thereby serves as a hindrance to the further development and expansion of Islamic banking. Firstly, the banks are stuck with the debt instrument until its maturity. There are so many uncertainties facing banks in the modern volatile financial system that, even without being guilty of overlending, it is possible for them to get into a tight liquidity situation. This may be the result of an excessive net outflow of funds from the banks for some unexpected reason. It may also be due to the failure of a big client of the bank to settle payment on time because of some unexpected developments. There may be a number of other unforeseen reasons for the liquidity crunch of an individual bank. If the bank cannot sell some of its debts to acquire the badly needed liquidity before the maturity date of those debts, it may not be able to meet its obligations or to fund more profitable opportunities for investment.

Secondly, it is difficult for banks to play effectively their role of financial intermediation, without being able to securitise their receivables. When banks grant a big sales-based credit for an expensive item (say, an airplane, a ship or a building), they would like to package it into small portions and sell these to small financiers. In this way they would be able to provide a large amount of credit without straining their own resources excessively and would simultaneously be able to provide investment opportunities to small investors. If they are unable to play this role effectively, the economy may suffer by the hesitation on the part of banks to finance the purchase of costly items. Companies will have to sign loan

agreements separately with numerous investors to raise a large amount. This would undoubtedly be a cumbersome task. Syndicated loans may not be a substitute for the sale of debts because, in addition to the lead bank, there are generally only a few big lenders participating in such loans. Therefore, while a large purchase may be facilitated for a big borrower, the packaging of the amount into small portions would not be possible and small lenders would not be able to benefit from the investment opportunity.

It may be argued that the problem of financing a big purchase can be solved by an increase in the company's equity in keeping with the spirit of Islamic finance, which aims at promoting greater reliance on equity and lesser reliance on debt. The sale of shares will not only provide resources to the company concerned but also make investment opportunities available to investors. If resort to credit is still necessary, the bank concerned may act as an agent for raising funds against a fee, as is permissible under the Islamic financing mode of *ji'alah* (performing an assigned task against an agreed fee).

Both these sources of funds would undoubtedly be helpful but would not, nevertheless, help the bank raise liquidity when it is badly needed. Ways of acquiring such liquidity need to be found. If this problem is not solved, the bank will be required to have larger capital and higher liquidity ratio, both of which may hurt its profitability. While the creation of a lender of last resort for banks as discussed later in the "Concluding Remarks" of this paper would be helpful, it would be preferable to enable the banks to rely on the sale of their own assets to raise liquidity.

3.5 HEDGING AND FINANCIAL ENGINEERING

Efficient risk management requires the decomposition of total risk into smallest possible components and then designing financial instruments to meet the requirements of the return profile of each micro component of the risk. This process has become known as financial engineering. In a broader sense the financial engineering process aims at designing new financial instruments for their possible utilisation in resource mobilisation and allocation. Designing *Shari'ah* compatible financial instruments is one of the most important challenges confronted by the Islamic financial institutions at present.⁷³

One of the most effective applications of financial engineering has been in the area of hedging. Hedging has become an important instrument for the

⁷³ Iqbal, et. al. (1998), report that, according to a survey conducted by them, there is a consensus among Islamic scholars that financial engineering is the most important challenge faced by the Islamic financial institutions.

management of risks in the present day international economic and financial environment where there is a great deal of instability in exchange rates as well as other market prices. If individuals, businesses and financial institutions do not resort to this instrument for the management of their risks, there is a strong likelihood that they may suffer substantial losses with knock-on effects for the whole economy.

Exchange rate risks do not seem to have been common during the days of the Prophet, may the peace and blessings of God be on him, and the *Khilafah al-Rashidah*. The rates of exchange between gold and silver coins in the then-prevailing bimetallic monetary system were relatively stable at around 10. Such stability did not, however, persist later on. The two metals faced different supply and demand conditions, which destabilised their relative prices. The ratios sometimes moved to as low as 20, 30, and even 50.⁷⁴ This instability enabled bad coins, according to al-Maqrizi (d. 845/1442) and his contemporary al-Asadi (d.854/1450), to drive good coins out of circulation,⁷⁵ a phenomenon which has become known since the 16th century as Gresham's Law instead of al-Maqrizi or al-Asadi Law. Such instability created difficulties for everyone, but there was no solution at that time to protect individuals and economies from its adverse effects.

To solve this problem the world abandoned the bimetallic standard and moved to the gold standard and then to the Dollar exchange standard, both of which helped stabilise exchange rates because of the fixed parities. These two standards, however, created other difficult problems and had to be abandoned in favour of floating exchange rates. The farewell to fixed parities has, however, introduced a great deal of instability in the foreign exchange markets and the risks involved in foreign trade and finance have become unduly intensified. In such an unstable climate, hedging has proved to be a boon. It has made it possible for banks and businessmen to manage the exchange rate and price risks by passing them on to those who are willing to bear them at a certain cost.

To understand the problem, let us assume that a Saudi businessman places an order for Japanese goods worth a million Dollars (Rls. 3.75 million) to be delivered three months from now. If the rate of exchange is 117 Yens per Dollar, and if the exchange rate remains stable, Y117 million will become due at the time of delivery of the goods. Since exchange rates are not stable and, consequently, if the Yen appreciates over these three months by, say, 5 %, the Saudi importer will have to pay Rls. 3.94 million for the goods instead of Rls. 3.75 million. The Saudi businessman will, therefore, incur an unforeseen loss of Rls 190,000.

⁷⁴ Al-Qaradawi, 1969, Vol. 1, p.264; Miles, 1992, p.320.

⁷⁵ Al-Misri, 1990, pp.54 and 66.

One way of protecting himself against such loss would be to purchase now the Yens payable three months later. This will freeze his financial resources unnecessarily and create a liquidity crunch for him. To avoid such liquidity tightness, the alternative solution available in the conventional financial system is to purchase Y117 million in the forward market at the current exchange rate of Y117 per Dollar plus or minus a premium or discount. All that the importer has to do is to pay a small percent of the total amount as deposit for this purpose. Such a transaction is called hedging.

The question that, therefore, arises is whether the mechanism of hedging to protect the importer from exchange rate fluctuations is permissible. The verdict of the *fuqahā'* so far is that hedging is not permissible. This opinion is based on three objections. These are that: hedging involves *gharar* (excessive uncertainty), interest (*ribā*) payment and receipt, and forward sale of currencies. All three of these are prohibited by the *Sharī'ah*.

As far as *gharar* is concerned, the objection is not valid because hedging in fact helps eliminate *gharar* by enabling the importer to buy the needed foreign exchange at the current exchange rate. The bank, which sells forward Yen, also does not get involved in *gharar*, because it purchases the Dollars spot and invests them until the time of delivery. The bank, therefore, earns a return on the Yens that it invests for three months but also loses the return that it would have earned on the Riyals or the Dollars that were used to purchase the Yen. The differential in the two rates of return determines the premium or the discount on the forward transaction.

The other two objections are, however, perfectly valid. Of these two, the objection with regard to interest can be handled by requiring the Islamic banks to invest the Yens or other foreign currencies purchased by them in an Islamically permissible manner to the extent to which it is possible for them to do so.

The third objection is, of course, very serious. The Prophet, may the peace and blessings of God be on him, has clearly prohibited forward transactions in currencies. However, we live in a world where instability in the foreign exchange markets has become an unavoidable reality. It is not possible for businessmen as well as Islamic banks to reduce their exposure to this risk. How are they going to manage it. It is very risky for them to carry unhedged foreign exchange or other assets on their balance sheets, particularly in crisis situations when asset values depreciate steeply. If they do not resort to hedging, they actually get involved in *gharar* more intensively. In addition, one of the important *maqāsid al-Sharī'ah*

(objectives of the *Sharī'ah*), which is the protection of wealth (*hifz al-māl*),⁷⁶ gets compromised unnecessarily.

Institutions, which provide the needed protection through hedging, are well-qualified for this service because of their greater financial resources and better knowledge of market conditions. The fee that they charge can be 'Islamised' by resort to Islamic instruments. The question, therefore, is about whether hedging could be accepted in an unstable exchange rate environment. To curb speculation and misuse of this facility, hedging could be confined only to foreign exchange receivables and payables related to *real* goods and services. Moreover, this facility may be allowed only as long as exchange rates and commodity prices remain volatile. If not, then is it possible for the *fuqahā'* to suggest some other permissible mechanism whereby individuals and businesses may protect themselves against exchange rate and commodity price risks.

⁷⁶ According to al-Ghazali (d.505 AH/1111th AC.): "The objective of the Sharī'ah is to promote the well-being of the people, which lies in safeguarding their faith, their life, their intellect, their posterity, and their wealth. Whatever ensures the safeguard of these five serves public interest and is desirable" (al-Ghazali, 1937, pp. 139-40). The same objectives have been upheld in the same, or a somewhat different, order by a number of other *fuqahā'*. (For a discussion of these *maqāsid*, see Chapra, 2000, pp. 118-123).

Part IV

CONCLUDING REMARKS

The Islamic financial movement has taken off fairly successfully and it is hoped that it will continue to expand and strengthen in the future. Individual Islamic banks seem to have done quite well so far in spite of the difficulties and internal and external shocks that they have experienced. A great deal of experience has been gained and concepts have become clearer. Even though the sales-based modes have received a predominant weight in the portfolios of Islamic banks, notable progress has also been made in the use of equity-based or PLS modes. Public acceptance has also continuously widened and deposits and assets of these institutions have grown rapidly. Nevertheless, there is no room for complacency. It is possible that there may be failures in the future – failures that would tend to weaken the system and adversely affect its reputation and future prospects. It is, therefore, necessary to respond successfully to the challenges that lie ahead.

Among the most important of these challenges are prudential regulation and effective supervision, accompanied by proper internal controls, risk management and external audit, and greater transparency. This will help strengthen the Islamic financial movement, minimise failures, and enable it to fulfil the rationale of socio-economic justice that lies behind the prohibition of interest. Legal reform and supervisory oversight as discussed in this paper are hence not options but rather imperatives and should be undertaken as fast as possible.

However, if attention is given only to legal reform and supervisory oversight, it may not be sufficient to enable the movement to realise its full potential. Islamic finance is still in its initial phase of development and faces a number of difficulties. Therefore, the second, but essentially more important, challenge is to provide it the official support that it needs to solve the problems that lie ahead and to do its job more effectively.

The establishment of shared institutions to perform the various tasks that these banks have to perform themselves at present is one of the most indispensable needs of Islamic banks. The establishment of such institutions will help reduce the overhead costs of Islamic banks and raise their profitability. Most Muslim countries do not have private credit rating agencies to make available to banks information about the credit rating of counter-parties. Without such information, it will not be possible for these banks to move into the relatively more

risky modes of *mudārabah* and *mushārah*. The establishment of such agencies will also greatly help enhance market discipline.

Islamic banks are under an obligation to get clearance about the Islamicity of their products and also a certificate about all their operations being in conformity with the *Sharī'ah*. While it is definitely the responsibility of the *Sharī'ah* boards to perform the former task, it may be difficult for them to do justice to the second task, which demands a review of all the different transactions of the bank to ensure that they are in conformity with what the *Sharī'ah* Board has specified.

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For performing the first task, every Islamic bank is at present under an obligation to have its own *Sharī'ah* board. This is very expensive, particularly for small banks. It would be desirable, at least for smaller banks to have a common *Sharī'ah* board to determine the *Sharī'ah* compatibility of their products. A private company well-versed in both the *Sharī'ah* and modern finance and having adequate research facilities may perhaps be the most suitable for providing the services of a *Sharī'ah* board. Once such a company has been established and is able to build a prestige for itself in terms of integrity and professionalism, its verdicts may tend to command greater respect than those of individual *Sharī'ah* boards, all of whose members may not necessarily be well-known. It will also help avoid the prevailing duplication of effort as well as conflicting verdicts on different issues. However, if difficulties are encountered in the establishment of such a company in the private sector, then the second best alternative would be to house the *Sharī'ah* board in the central bank so that all banks, and in particular the smaller ones, could benefit from its services. The existence of a *Sharī'ah* board in the central bank would have the added advantage of helping develop consensus on *fiqhi* issues, provided that the central bank does not try to impose its own views but rather allows the crystallisation of opinions through a free discussion.

Effective performance of the second task of ensuring conformity with their verdicts by the bank management is of course, as stated earlier, difficult for *Sharī'ah* boards. They do not have the time to do it themselves and do not have the staff to do it on their behalf. There are three alternatives, which may be considered. One of these is for the central bank to itself undertake the *Sharī'ah* audit during the process of its banking inspection so that the conformity with the

⁷⁷ This is because transactions take place in a large number of branches by different managers throughout the country.

Sharī'ah is examined along with that with national banking laws and standard accounting practices. The second, but more preferable, alternative is to establish independent *Sharī'ah* audit firms in the private sector. A third, and even more preferable, alternative is for the existing chartered audit firms to acquire the necessary expertise in the *Sharī'ah* to enable them to undertake the *Sharī'ah* audit along with their accounts audit so as to avoid the proliferation of institutions with which Islamic banks have to deal.

Another indispensable need of Islamic banks is the establishment of *Sharī'ah* courts or special banking tribunals to give verdicts promptly on the different *Sharī'ah* related disputes of banks with their counter-parties, particularly with regard to the late payment of dues. Normal civil court verdicts, as indicated earlier, usually take several years and it is not possible for banks to wait that long for recovering their dues with compensation, if possible, for both damages as well as loss of income.

Islamic banks also badly need some facility akin to the lender-of-last resort available to conventional banks, to overcome a liquidity crisis when it occurs unexpectedly. Such a facility is only available to Islamic banks at present on the basis of interest and is, therefore, unacceptable. It may be worth considering the creation of a common pool at the central bank to provide mutual accommodation to banks. All banks should be required to contribute a certain mutually-agreed percent of their deposits to this common pool, just as they do in the case of statutory reserve requirements. They would then have the right to borrow interest-free from this pool with the condition that the net use of this facility is zero (i.e., drawings do not exceed contributions) over a given period of time.⁷⁸ In a crisis situation the central bank may allow a bank to exceed the limit, with appropriate penalties, warning, and a suitable corrective programme.

Islamic banks also need some official help for the resolution of *fiqhi* differences of opinion. These differences prevent the standardisation of products and also create other difficulties for Islamic banks. There is no Church in Islam to

⁷⁸ Some of the *fuqahā'* may not find this to be acceptable because it may appear to them as a form of reciprocal lending (*qurūd mutabādalāh*) which to them is like deriving benefit from a loan, and hence equivalent to interest. However, it can also be looked at as a form of cooperative insurance, whereby the banks provide themselves with protection in case of need and the central bank does not get any return for its management of the fund. Mutual cooperation of this nature had prevailed in Muslim history between businesses in the form of what was then called *ibdā'* or *bidā' ah*. (See Chapra 1985, pp.75 and 250).

issue ecclesiastical decrees. Differences of opinion can be of minimised only through discussions among the *fuqahā'*. The OIC and Rabitah *fiqh* committees are doing a valuable job in this connection. They hold periodic meetings of the prominent *fuqahā'* to discuss the various *fiqhi* issues. The International Association of Islamic Banks (IAIB) had also established a Unified *Sharī'ah* Commission, comprising of '*ulamā'* from different countries and different schools of thought, to discuss these issues. However, the IAIB has now closed its operation. Its place has, fortunately, been taken over by the Council of Islamic Banks established by the IDB. As a result of all these efforts, substantial progress has already been made. Nevertheless, there are a number of issues where a general agreement has not been reached. The effort, however, continues. The problem is financial constraint. In spite of their international character, the OIC and Rabitah *fiqh* committees are unable to have access to adequate resources for employing full-time professional staff well-versed in the *Sharī'ah* as well as the complexities of modern finance. The availability of such staff is essential on a full-time basis for preparing background papers to provide the *fuqahā'* a proper perspective on the *fiqhi* issues under discussion and thereby enable them to take the right decision. Assistance from the central banks could prove to be valuable in helping expedite the formulation of consensus on different outstanding issues.

It is also necessary to remove the disadvantage of small size of Islamic banks by encouraging and facilitating the merger of a number of such banks so that an optimum size is attained. In the absence of an optimum size, their average overhead costs are high and it is not possible for them to diversify their risks or be able to compete successfully with large conventional banks. However, it may not always be practical to bring about the merger of banks situated far apart and catering to the varying needs of different sectors of the economy. In that case adequacy of capital along with proper risk management, regulation and supervision may be the only alternatives available.

Islamic banks also need help in the field of training. Presently every bank has to arrange its own training programme. The central banks in Muslim countries could help by initiating a programme to train the staff of all banks in Islamic banking, thereby reducing the overhead costs of these banks. Since central banks generally provide training programmes in conventional banking, there is no reason why they should not do so for Islamic banking. The central banks may also make arrangements for the training of businessmen in the maintenance of proper accounts and in having a proper understanding of Islamic banking. A programme

to inform the public about the nature of Islamic banking could also be very useful. With the coming of the regulation and supervision of banks into the forefront, it would also be necessary for the central bank to prepare staff well-versed in these as well as the relevant aspects of the *Sharī'ah*.

The absence of the secondary market for Islamic financial instruments as well as an inter-bank Islamic money market (IIMM) is also among the most difficult obstacles in the development and expansion of Islamic banks. They are under a constraint to maintain liquidity that is higher than what conventional banks normally keep. This has an adverse effect on their profitability and competitiveness. The establishment of IIMM is thus one of the most important building blocks for the Islamic financial services infrastructure. A very welcome development, therefore, is the joint initiative undertaken by the IDB, Labuan Offshore Financial Services Authority (LOFSA) of Malaysia, and the Bahrain Monetary Authority (BMA) to establish the IIMM in the jurisdiction of LOFSA. A memorandum of understanding was signed by the three institutions in Kuala Lumpur, Malaysia, on 21 October 1999 to establish the IIMM. The follow-up meeting of the working group held in Jeddah on 24-25 June 2000 agreed to establish a Liquidity Management Committee (LMC) for the IIMM, to enlarge the scope of IIMM for developing international Islamic capital markets, and to finalise the launching of the IIMM before the end of 2000. The most recent meeting held in Darassalam, Brunei, on 29-30 August 2000 decided to implement the recommendation of the Jeddah meeting by establishing a market management center in the IDB. All these developments have important implications for the Islamic financial system, one of which is the provision of some form of lender-of-last-resort facility to Islamic banks.

It is also necessary to ensure that the prevalent financial and economic regulations in Muslim countries are amended to bring them in conformity with the *Sharī'ah*. All the prevailing disincentives to the promotion of Islamic modes of finance need to be removed, particularly the treatment of interest payments as a deductible expense as compared with dividends, which do not enjoy this privilege.

Islamic banks may not be able to create for themselves a large enough niche in the fields of domestic as well as international finance until all the problems that they face have been removed. This is a challenge before Muslim countries and there is no reason to believe that this challenge cannot be met successfully if there is co-operation between Islamic banks, the regulating authorities, and the *fuqahā'*. The *fuqahā'* responded positively to the challenges

they faced in the earlier centuries of Islam and this led to a substantial development of *fiqh*. We have no doubts that they will again rise to the occasion once they understand the challenges that Islam and the Islamic financial system face in the modern world. Consensus-building may be expedited and substantial economies of scale may also be realised if the regulating authorities and the governments play a greater and more committed role in the development and expansion of the Islamic financial system.

Since all this is time-consuming, we need to bear in mind that full-fledged elimination of interest from Muslim countries will take place only gradually after going through an evolutionary process. There should be no qualms about this because the Prophet's own example clearly demonstrates a preference for gradual implementation. However, the preference for a gradual approach should not be considered as a license for doing nothing or moving at a snail's pace. Islamic banking can make a valuable contribution not only to Muslim countries but also to the international financial system, which is plagued by continuing instability. It deserves all the help that it needs.

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CENTRAL BANKS OF IDB MEMBER COUNTRIES

Bahrain Monetary Authority

<http://www.bma.gov.bh/>

Banque Centrale des Etats de l'Afrique de l'Ouest

<http://www.bceao.int/>

Central Bank of Bosnia and Herzegovina

<http://www.cbbh.gov.ba/>

Central Bank of Egypt

<http://www.cbe.org.eg/>

Bank Sentral Indonesia

<http://www.bi.go.id/>

Central Bank of Jordan:

http://www.cbj.gov.jo/docs/cbj_engl.html

Central Bank of Kuwait

<http://www.cbk.gov.kw/>

Central Bank Lebanon

<http://www.bdl.gov.lb/>

Bank Nagara Malaysia

<http://www.bnm.gov.my/>

Palestinian Monetary Authority

<http://www.palnet.com/inv/pma.htm>

Qatar Monetary Agency

<http://www.qcb.gov.qa/pages/defaulte.htm>

Saudi Arabian Monetary Authority

<http://www.us-saudi-business.org/economy.htm#SAMA>

State Bank of Pakistan

<http://www.sbp.org.pk/>

Central Bank Tunisia

<http://www.bct.gov.tn/>

Central Bank of Turkey

<http://www.tcmb.gov.tr/>

State Central Bank of Turkmenistan

<http://www.infi.net/~embassy/bank.html>

Central Bank of Yemen

RESOURCES

<http://www.cbyemen.com/>

CENTRAL BANKS OF THE WORLD

<http://patriot.net/~bernkopf/>

<http://www.bis.org/>

SELECTED REGULATORY AUTHORITIES OF THE WORLD

Bank of Japan

<http://www.boj.or.jp/en/seisaku/99/seisaku.htm>

Bank of England - Financial Stability Review

<http://www.bankofengland.co.uk/fsr/fsr07.htm>

Bank of England

<http://www.bankofengland.co.uk/>

The Financial Services Authority UK

<http://www.fsa.gov.uk/>

European Central Bank

<http://www.ecb.int/>

Federal Reserve Board

<http://www.federalreserve.gov/publications.htm>

Deutschen Bundesbank

http://www.bundesbank.de/index_e.html

INTERNATIONAL STANDARD SETTERS

AAOIFI

<http://195.65.102.235/index.htm>

Bank for International Settlements (BIS)

Basel Committee for Banking Supervision

Financial Stability Institute (BIS)

<http://www.bis.org/>

IMF - Transparency in Monetary and Financial Policies

<http://www.imf.org/monfintransparency/>

IMF-SDDS

<http://dsbb.imf.org/>

European Commission

<http://europa.eu.int/index-en.htm>

Financial Stability Forum - Compendium of Standards by Subject Area

<http://www.fsforum.org/Standards/Categories.html>

International Organization of Securities Commissions (IOSCO)

<http://www.iosco.org/iosco.html>

International Accounting Standards Committee (IASC)

<http://www.iasc.org.uk/frame/cen0.htm>

International Association of Insurance Supervisors (IAIS)

<http://www.iaisweb.org/>

RATING AGENCIES

Standard & Poor's

<http://www.standardandpoor.com/>

Duff & Phelps Credit Rating Co. (DCR)

<http://www.dcrco.com/>

Moody's Rating Service

<http://www.moodys.com/>

OTHER IMPORTANT LINKS

Institute for International Economics

<http://www.iie.com/>

International Swaps and Derivatives Association

<http://www.isda.org/>

Risk Management

<http://risk.ifci.ch/>

Asian and Global Financial Crisis

<http://www.stern.nyu.edu/~nrubini/asia/AsiaHomepage.html>