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Islamic Banking Regulation and Supervision: Survey Results and Challenges

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Monetary and Capital Markets Department

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Abstract

The growing presence of Islamic banking needs to be accompanied by the development of effective regulation and supervision. This paper examines the results of the survey conducted by the International Monetary Fund to document international experiences and country practices related to legal and prudential frameworks governing Islamic banking activities. Although a number of countries have made considerable progress in creating legal, regulatory, and supervisory frameworks that accommodate Islamic banking, there are substantial differences. This paper also identifies a number of challenges faced by regulatory and supervisory agencies regarding Islamic banking.

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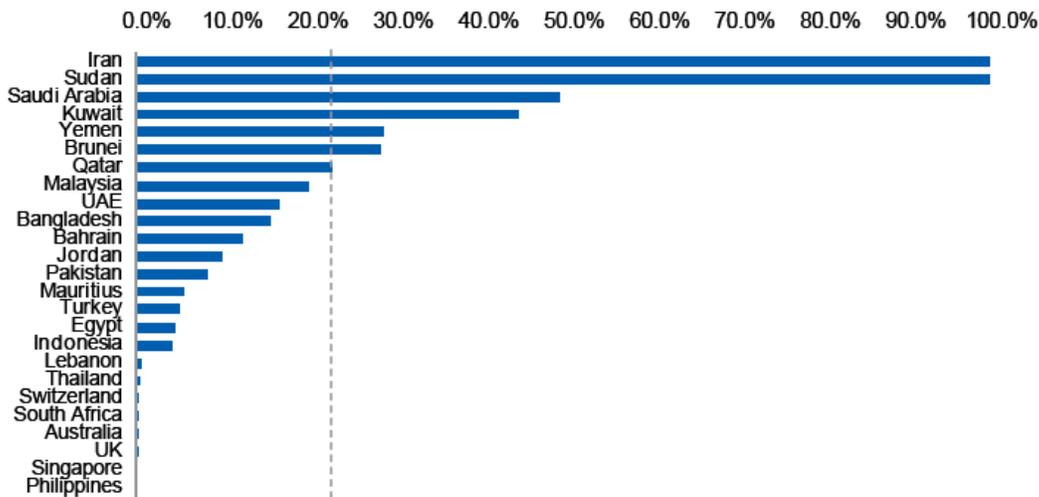
GLOSSARY

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
BCBS	Basel Committee on Banking Supervision
BCPs	Basel Core Principles
CAR	Capital adequacy ratio
CB	Conventional bank
FX	Foreign exchange
GHOS	Group of Governors and Head of Supervision of the Basel Committee
HQLA	High liquidity assets
IAS	International Auditing Standards
IB	Islamic bank
IFRS	International Financial Reporting Standards
IFSB	Islamic Financial Services Board
IRR	Investment risk reserve
LCR	Liquidity coverage ration
NPL	Nonperforming loans
PER	Profit equalization reserve
PSIA	Profit sharing investment account
RIA	Restricted investment account
URIA	Unrestricted investment account

I. INTRODUCTION²

The Islamic banking industry has grown rapidly in recent years and has become an important part of the financial system in many countries (is even systemically important in several countries, Figure 1). Islamic banking is projected to continue to grow faster than conventional banking for the foreseeable future given its low base, low level of penetration, substantial market potential, and the strong demand in many Islamic countries for Shariah-compliant products. In addition, the 2008-09 financial crisis led to renewed interest in Islamic finance in the context of the resilience of Islamic banking in many countries in Asia, Europe, and sub-Saharan Africa.

Figure 1: Islamic Banking Share in Total Assets by Jurisdiction
(June 2013)



Source: Islamic Financial Services Board (2014).

The International Monetary Fund (the Fund) is increasingly encountering Islamic banking related issues in its surveillance work and technical assistance. Given the importance of Islamic banking in a number of countries, the Fund is expected to help identify, assess, monitor, and report systemic issues arising from Islamic banking. To help enhance the capacity of the Fund to service its members in this area, a survey of prudential frameworks governing Islamic banking practices was conducted in 2011. Key results from the survey remain relevant given that regulatory and supervisory frameworks in those countries have not changed much since 2011 although some countries may have regulatory and supervisory improvements. Policy

² This paper is also based on discussions with the authorities of Bahrain, Jordan, Kuwait, Malaysia, Singapore, Turkey, and, the U.K. The MCM/LEG mission visited these countries in October 2010 and January 2011.

implications of the growing importance of Islamic banking are considered in greater detail in López-Mejía and others (2014).

This paper uses the survey results to document current practices on Islamic banking regulation and supervision and identify challenges faced by regulators and supervisors (Box 1). The results indicate that several countries had made progress in creating legal, regulatory and supervisory frameworks, and performing day-to-day supervision, which to varying degrees cater for Islamic banking. However, there are significant differences across countries and many country-specific issues require further improvements. That said, the survey is a good starting point to better understand Islamic banking, and is a useful input to the Fund’s surveillance, policy, and technical assistance on the legal, regulatory, and supervisory frameworks for Islamic banking.

Box 1. Survey on Islamic Banking

The Islamic banking survey questionnaire consisted of several questions under two main headings: i) presence of Islamic banking; and ii) areas of Islamic banking. In turn, under the heading related to the areas of Islamic banking, there were subheadings on general and financial information, legal framework, regulatory and supervisory framework, liquidity management and central banking, and resolution and deposit insurance.

All members of the Fund with a significant Islamic banking presence were canvassed to participate in the survey, and 39 countries responded.¹ Ten of these countries self-excluded themselves, having answered “no” to the following three questions:² (i) Does your legal and regulatory framework explicitly recognize Islamic banking practices, products or institutions? (ii) Is Islamic banking being practiced in your jurisdiction by any stand-alone Islamic bank? and (iii) Is Islamic banking being practiced in your jurisdiction by any conventional bank? Accordingly, in this document references to the “respondent/s” deal with the responses obtained from the 29 none self-excluded respondent countries.

¹ The countries were: Afghanistan, Azerbaijan, Bahrain, Botswana, Burundi, China, Ethiopia, Hong Kong, Indonesia, Iran, Iraq, Jordan, Kazakhstan, Kenya, Kosovo, Kuwait, Lebanon, Luxembourg, Malawi, Malaysia, Maldives, Namibia, Pakistan, Palestine, Qatar, Saudi Arabia, Sierra Leone, South Africa, Sudan, Syria, Tajikistan, Tunisia, Turkey, Tanzania, Uganda, UAE, U.K., Yemen, and Zambia.

² These countries were: Azerbaijan, Burundi, China, Kosovo, Malawi, Namibia, Sierra Leone, Tajikistan, Uganda, and Zambia.

This paper is divided into eight sections. Section II describes legal and institutional developments. Sections III and IV discuss regulatory and supervisory frameworks, respectively. Section V explores risk management issues, and Section VI explains transparency, disclosure, and market discipline issues. Section VII describes deposit protection and bank resolution. Section VIII concludes.

II. LEGAL AND INSTITUTIONAL DEVELOPMENT

A. Islamic Banking: Background and Recent Developments

Islamic banking and Islamic finance are distinct and separate from conventional banking and finance. They are based on compliance with the legal framework referred to as Shariah Law (Box 2). Islamic banks and Islamic banking are largely merchant and investment banking

oriented, as they typically relate to or involve the real economy, especially trade and investment³ (refer to Annex I for a definition of key Shariah compliant contracts).

Box 2. Shariah Law and Islamic Banking

The original and fundamental source for Islamic finance, including Islamic banking, is Shariah Law which plays a varying role in different countries. Whereas in several jurisdictions (e.g., Afghanistan, Bahrain, Iran, Pakistan, Saudi Arabia and Sudan), Shariah Law is the fundamental law of the land (or a key source of the law of the land) in others it does not constitute part of the legal framework.

Various motivations underlie the public policy pertaining to the place and role of Islamic banking within different jurisdictions. In some jurisdictions (e.g., the United Kingdom), Islamic banking is considered to be an acceptable financial innovation whose presence further promotes that jurisdiction's standing as an international financial center. Other jurisdictions such as Kenya, South Africa, and Tanzania accommodate Islamic banking in view of the adherence of a substantial minority of its population to Islam and the demand for Islamic banking from the Muslim community. In jurisdictions where the majority of the population is Muslim, where Shariah Law is the fundamental law, and where Islam is the state religion, Islamic banking is typically present (and sometimes the only form of banking).

Islamic banking has certain inherently attractive requirements and characteristics. Shariah Law imposes a set of ethics that militates against exploitation, and prohibits involvement in activities that are considered morally distasteful, such as drugs, alcohol, prostitution, and games of chance. The use of instruments based on interest is forbidden. Furthermore, pure financing such as derivative transactions and hedging instruments is not permitted, which can benefit financial stability and constrain leverage. Also, real economic activity is promoted through the requirement that only real assets should be financed and a return should be derived from exposure to (proprietary) risk taking, and not merely from financial risk taking. In addition, since an Islamic bank often has ownership of the asset being financed, the Islamic bank is placed in a stronger position vis-à-vis the "collateral." Indeed, this collateral is typically owned by the Islamic bank for the duration of the financing arrangement, until the full amount due and payable has been extinguished.

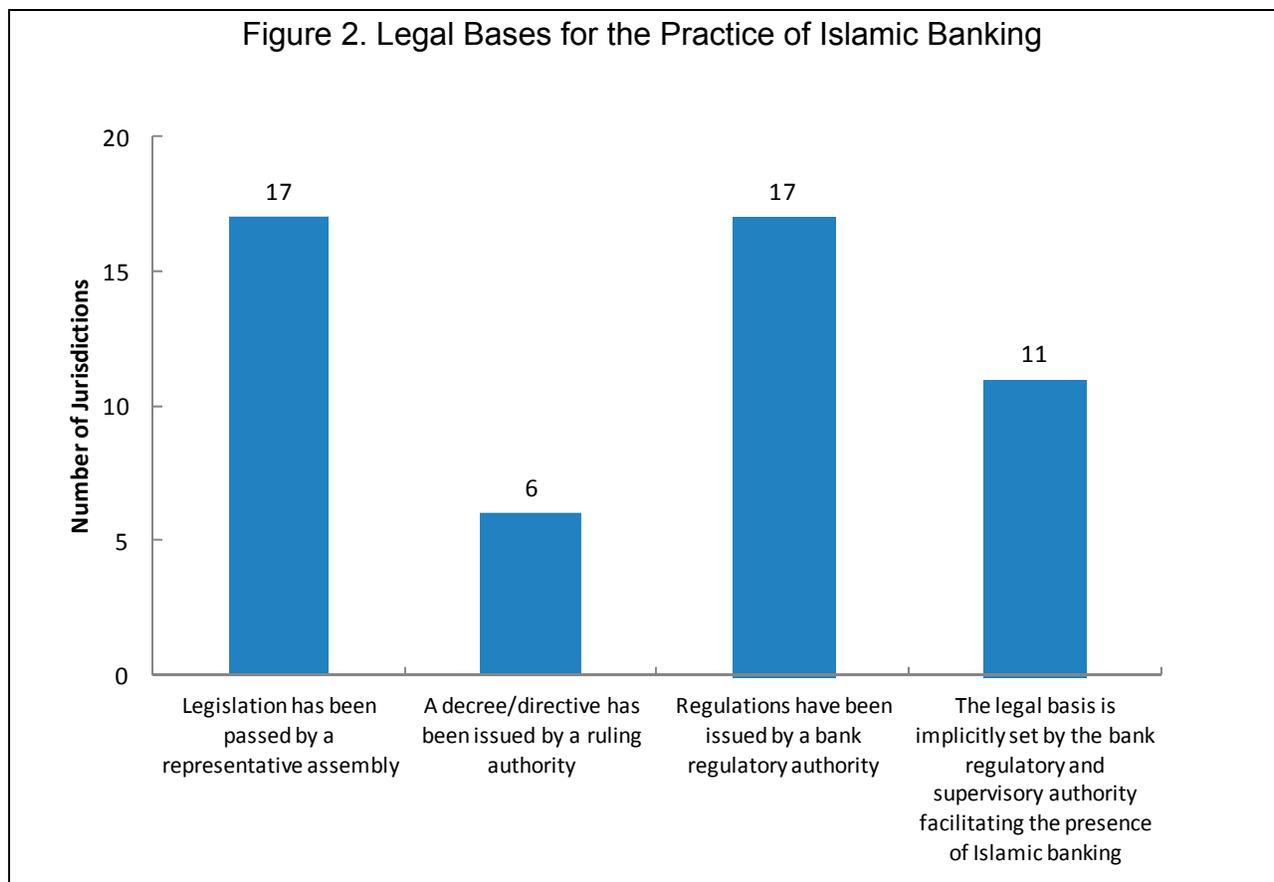
Formalization of Islamic banking is a fairly recent phenomenon. The first formal institutions claiming to provide Islamic banking appeared in the 1960s.⁴ Islamic banking is still in a development phase, given the recent formalization of Islamic banks, Islamic banking and finance, and the stage of development and complexity of conventional banks, banking, and finance. Consequently, there is a wide dispersion of approaches to the formal introduction and regulation of Islamic banks and banking. These range from a custom-made decree for a particular entity wishing to conduct Islamic banking to stand-alone and focused Islamic banking legislation. In addition, the range of approaches varies from those where Islamic banking legislation constitutes a component of the overall banking legislation of a jurisdiction to the

³ Islamic banking can be broadly divided into transactional and intermediation contracts. Transactional contracts govern real transactions, such as trade and the financing of economic activities including mortgage financing. Intermediation contracts facilitate an efficient and transparent execution of transactional contracts (El-Hawary, Grais, and Iqbal, 2004).

⁴ Refer to Verhoef and others (2008), pp. 18–19.

regulation of Islamic banking as financial innovation. Thus, there is yet no internationally generally accepted legal, regulatory, and supervisory framework dealing with Islamic banking, though various initiatives are in varying stages of development.

This wide dispersion of approaches to the introduction and regulation of Islamic banks and banking is illustrated in Figure 2. Legislation has been passed by a representative assembly in 17 jurisdictions (e.g., Indonesia, Iran, Jordan, Kuwait, Malaysia, and Sudan), while a decree/directive has been issued by a ruling authority in six jurisdictions (e.g., Kazakhstan, and Qatar). Regulations have been issued by a bank regulatory authority in 17 jurisdictions (e.g., Afghanistan, Bahrain, Ethiopia), while the legal basis is implicitly set by the bank regulatory and supervisory authority facilitating the presence of Islamic banking in 11 jurisdictions (e.g., Botswana, Kenya, and the U.K.).



Islamic banking is becoming increasingly widespread. Islamic banking is present in all countries where Muslim populations are a majority, and in most countries where Muslims constitute a significant fraction of the overall population. Conventional investors also have demonstrated a growing demand for Islamic banking products, including for diversification purposes. In a few countries only Islamic banking is permitted. In most countries, Islamic banking is conducted alongside conventional banking, which is generally still dominant. However, in these countries Islamic banking is typically growing faster than conventional banking.

Jurisdictions have different approaches to the types of institutions that are permitted to conduct Islamic banking.⁵ In some jurisdictions such as Malaysia and Saudi Arabia, stand-alone Islamic banks and so-called Islamic windows (i.e., divisions of conventional banks) are permitted to conduct Islamic banking.⁶ In other jurisdictions such as Iraq, Kuwait and Jordan, Islamic windows are not permitted. Some jurisdictions (e.g., Baharain, Indonesia, and Malaysia) permit conventional banks to control Islamic banks, whereas in others (e.g., Pakistan and Saudi Arabia) this is not permitted. Different jurisdictions have different approaches to the conversion of a conventional bank to an Islamic bank. Typically, jurisdictions where the Muslim population is a majority do not permit an Islamic bank to be converted into a conventional bank.

B. Survey Results on Legal and Regulatory Frameworks and Scope of Islamic Banking

Islamic banking practices are relatively widespread and given explicit recognition in regulation. (Figures 3-5). Indeed:

- Explicit recognition of Islamic banking: 21 of the 29 respondents (72 percent) indicated that the legal and regulatory framework explicitly recognizes Islamic banking practices, products or institutions;
- Stand-alone Islamic banks: 22 of the 29 respondents (76 percent) indicated that Islamic banking was being conducted by a stand-alone Islamic bank; and
- Islamic banking by conventional banks: 16 of the 29 respondents (55 percent) indicated that Islamic banking was being conducted by a conventional bank.

⁵ Sole (2007) discusses that there are three broad stages through which a country is likely to pass as Islamic banking develops. Errico and Farrahbaksh (1998) and El-Hawary, Grais and Iqbal (2004) discuss that there are certain features of Islamic banks that warrant prudential regulation to a similar degree as conventional banks. Sundararajan and Errico (2002) discuss the regulatory and supervisory challenges related to Islamic banking.

⁶ An Islamic window operation that provides both investment account and financing and investment are called “full windows,” while an institution invests funds in terms of Shariah compliant assets without such funds is called “asset-side only window.”

Figure 3. Explicit Recognition of Islamic Banking

Does your legal and regulatory framework explicitly recognize Islamic banking practices, products or institutions?

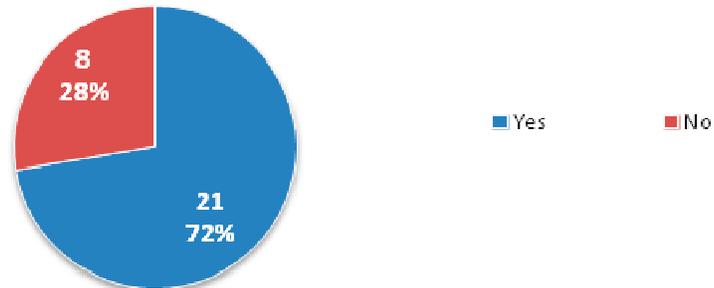


Figure 4. Conduct of Islamic Banking by a Stand-Alone Islamic Bank⁷

Is Islamic banking being conducted in your jurisdiction by any stand-alone Islamic bank?

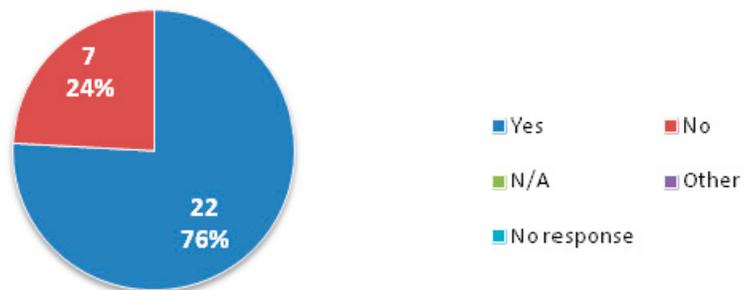
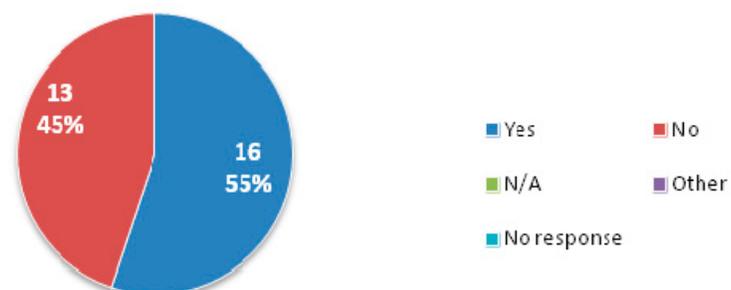


Figure 5. Practice of Islamic Banking by Conventional Banks

Is Islamic banking being practiced in your jurisdiction by any conventional bank?



⁷ There are jurisdictions that have stand alone Islamic banks without legal framework (for example, South Africa).

There is a substantial number of Islamic banks in existence. There were 176 stand-alone Islamic banks operating in 22 of the 29 respondent countries at the time of the survey, and assets totaled US\$871 billion.⁸ Sudan had the highest number of stand-alone Islamic banks at 33 and Iran's total Islamic banking assets amounted to US\$481 billion (52 percent of the total). The total size of Islamic banking assets that belong to the Islamic windows in the 12 respondent countries which indicated that 130 conventional banks had Islamic windows, amounted to US\$109 billion, of which US\$80 billion is attributable to one country (Saudi Arabia).

Respondents indicated advantages and disadvantages of Islamic windows compared to a fully-fledged Islamic bank (Box 3). The advantages cited related to economies of scale and scope, which helped lower the cost of Islamic finance. Disadvantages cited related to the reputation risks and supervisory complexities.

In jurisdictions where Islamic banking and conventional banking are permitted, some authorities advocated a "level playing field" policy such as equal treatment in taxes. This approach reflects a response to complaints that Islamic finance faces disadvantages owing to differences in the tax treatment of Islamic and conventional banking transactions.

III. REGULATORY FRAMEWORK

The effective prudential regulation of banks is as necessary and desirable in Islamic banking as it is in conventional banking.⁹ The risks of Islamic banking are those typical of financial intermediation. Accordingly, the objectives of applying prudential regulation and supervision to Islamic financial activities are the same as the case of conventional banks: namely to pursue and maintain financial stability by ensuring the safety and soundness of banks, thereby preventing problems from having systemic repercussions.

An important objective underlying the regulatory framework for Islamic banking should be to avoid undermining the stability of the financial system. Key elements to achieve this objective include: i) understanding the nature of Islamic banking activities, ii) making appropriate changes to the existing regulatory framework for Islamic banking, and iii) leveling the playing field between Islamic banking and conventional banking. Current trends indicate that specific elements relating to Islamic banking are being increasingly encapsulated into the regulatory framework.

⁸ Total assets with Islamic banks and Islamic banking windows were US\$1.28 trillion at end-June 2013 according to the Islamic Financial Services Industry Stability Report (2014 IFSB).

⁹ Errico and Farahbaksh (1998), p. 11.

Box 3. Islamic Window vs. Fully-Fledged Islamic Bank

Supervisory authorities who allow Islamic windows, noted the following advantages of such structure:

- Islamic banking services/products benefit from the experience and systems that conventional banks (CBs) have. This might improve the quality of services/products and lower their cost, which could enhance intermediation. Windows also facilitate liquidity management, especially in countries where Islamic liquidity instruments are limited. Windows usually have easy access to liquidity support from the conventional part of the bank.
- Windows enhance competition in the market, which could lower the cost of finance for Shariah-compliant products.
- For countries with small demand for Islamic banking services (countries with a small Muslim population), the IB window could be the only feasible way of providing IB services, thus enhancing financial inclusion.

Supervisory authorities who do not allow windows, noted the following risks for such structure:

- The commingling of Islamic windows' assets and liabilities with conventional assets and liabilities could have significant reputational risk, as depositors in windows might suddenly withdraw their money if rumors regarding commingling arise. It also raises issues related to consumer protection.
- The windows could hinder the establishment of effective corporate governance and risk management systems. The management and board of a conventional bank may not be sufficiently attuned to the unique risks inherent in IB activities. As such, their ability to oversee the risk management of the IB window may be compromised. If fit and proper criteria for conventional and Islamic intermediation should exist in CBs' operating windows, it is likely that many CBs will be unable to meet these criteria (for the Islamic banking part). Shariah boards might be unable to verify the complete segregation of assets and liabilities.
- The operation of windows could open the door for regulatory arbitrage or unfair practices. For example, given the profit-and-loss sharing nature of windows' accounts, risky financing could be encouraged to get Islamic financing through windows because, in the case of default, the account holders of windows will bear the losses. Similarly, securities holdings could be shifted between investment portfolios financed by conventional sources of funds and those financed by windows' sources so as to smooth returns.
- Windows could hinder effective financial oversight. Some prudential ratios that might differ for Islamic banking could be difficult to monitor appropriately. Windows could also hinder the preparation of proper financial statements for windows activities, which could hinder effective oversight.
- Resolution of the IB window. The issue of how distressed Islamic banks should be resolved in accordance with Shariah principles is still under deliberation.¹ This issue is further complicated for an Islamic window operating within a conventional bank. If the authorities are faced with a distressed conventional bank (with an Islamic window), they may not be able to carry out an orderly resolution satisfying financial stability objectives and Shariah principles that could potentially modify the treatment of the Islamic banking window.
- Monitoring the impact of using an Islamic monetary instrument (e.g., *Sukuk*) could be difficult in the case of windows. Indeed, CBs' pricing for IB activities will not be strongly linked to a Shariah-compliant liquidity level since CBs can use conventional deposits to finance Islamic banking assets. This could hinder the design of appropriate monetary policies.

¹ See IFSB "Islamic Finance and Global Financial Stability" April 2010.

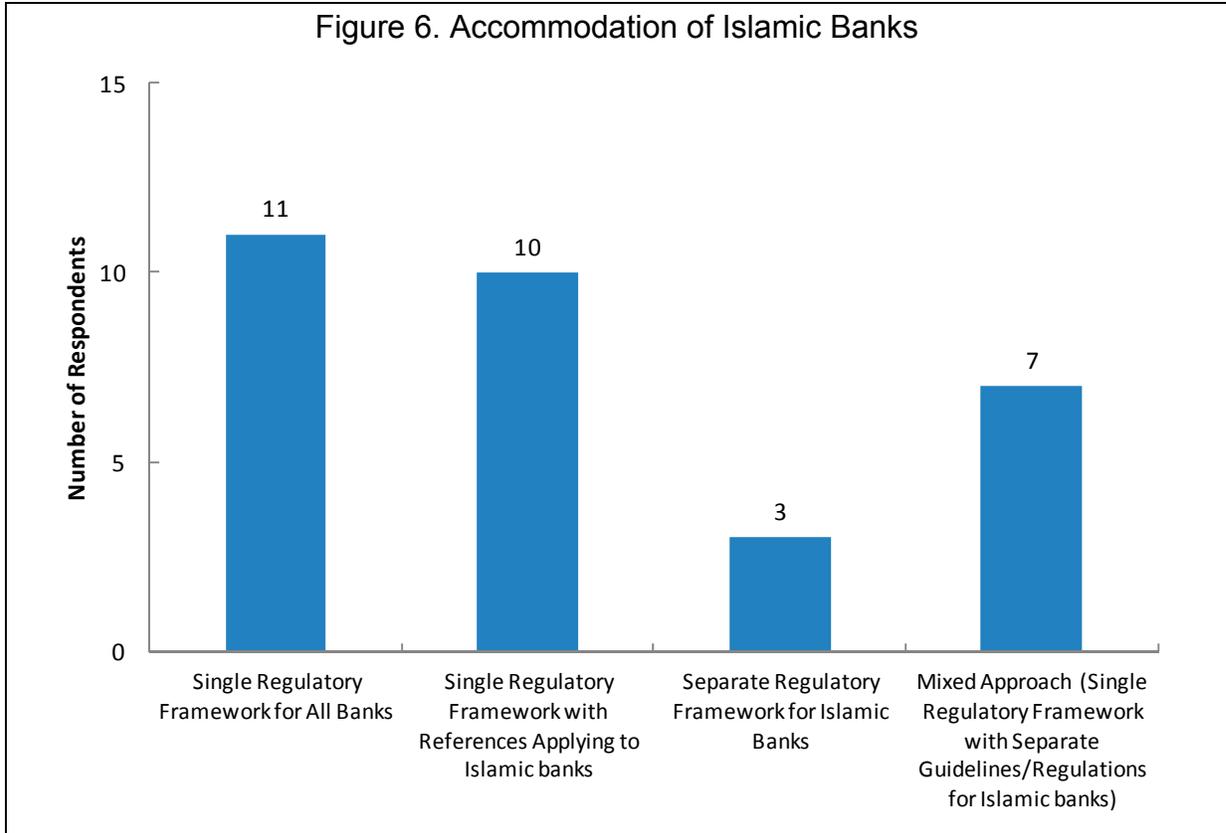
A. Accommodation of Islamic Banking

There are various ways in which jurisdictions incorporate Islamic banking into their regulatory framework. A first approach is where the Basel Committee on Banking Supervision (BCBS) framework for bank regulation and supervision is considered the default regulatory and supervisory framework applicable to all banks (including Islamic banks) and, thus, no distinction is made regarding the regulatory framework between Islamic banks and conventional banks; under a second approach, the regulatory framework consists of a generic BCBS component, applied to all banks with references identifying provisions applying only to Islamic banks. In this case, the BCBS conceptual framework could be complemented by Islamic Financial Services Board (IFSB) prudential standards and guiding principles on Islamic banking, where considered appropriate, to give effect to Shariah law compliance; and under a third approach, the separate regulatory framework accommodates Islamic banking.

A wide range of approaches to regulatory framework for Islamic banking has evolved. In particular: 11 respondents (e.g., Kenya, Saudi Arabia, South Africa, U.A.E., and the U.K.) indicated that a single integrated regulatory framework applied to all banks (with no reference to Islamic banking or Islamic banks); 10 respondents (e.g., Jordan, Kazakhstan, Qatar, and Turkey) noted that a single integrated regulatory framework applied to all banks (with references identifying provisions applying specifically only to Islamic banking and banks); three respondents (Bahrain, Iraq, and Kuwait) pointed out that there were two separate independent regulatory frameworks (i.e., one for Islamic banking and banks, and another for conventional banking and banks); and 7 respondents (e.g., Indonesia, Lebanon, Malaysia, and Syria) indicated the existence of a mixed approach (e.g., a similar regulatory framework is adopted for areas that are applicable to Islamic and conventional banks, but separate guidelines and regulations are issued for areas that are specific to Islamic banking (Figure 6).

The central bank is usually the institution responsible for the supervision of Islamic banks (25 respondents out of 29 indicated that was the case). Three respondents (e.g., Turkey and the U.K.) indicated that an independent authority (outside the Ministry of Finance or the Central Bank) was in charge of regulation supervision.

Shariah compliance plays a role (explicitly or implicitly) in the supervision of Islamic banking. In the U.K., for example, the regulatory framework does not contain any prescriptions on Islamic banking or Shariah compliance. Accordingly, the authorities do not explicitly recommend a Shariah board or the segregation of Islamic banking funds from conventional banking funds within a bank. Nonetheless, the authorities take the issue of Shariah compliance into account, albeit indirectly, when considering issues such as consumer protection, internal controls, governance, and reputational risk.



B. Licensing

Jurisdictions impose different licensing requirements on applicants wishing to establish Islamic banks. Appropriate licensing procedures are as necessary in an Islamic banking framework as in conventional banking. These procedures help supervisory authorities to ensure that new banks are managed in a sound manner. In non Shariah Law jurisdictions, where Islamic and conventional banks are present, licensing requirements do not address specifically and explicitly the issue of Shariah compliance. However, the issue of Shariah compliance does play an important indirect and implicit role in the approval process. Where Shariah Law constitutes (or is part of) the fundamental law of the country, Shariah compliance is a key pre-condition to (and determinant of) whether a proposed request for approval of a Islamic bank would be considered favorably. As part of the licensing process, the supervisory authority should ensure that appropriate corporate governance structures and processes are in place, including on the right of investment account holders to monitor the performance of their investments and the transparency of financial reporting of investment accounts.¹⁰

¹⁰ In some countries like Lebanon, minimum paid-in capital requirements for Islamic banks are different from those for conventional banks.

Different jurisdictions issue different types of licenses to Islamic banks. The survey revealed that in 17 jurisdictions a stand-alone Islamic bank will be issued with an Islamic banking license. In the remainder 12 jurisdictions a single (generic) banking license is issued to a bank, irrespective of whether the bank is an Islamic or a conventional bank (in some of these jurisdictions the authorities are empowered to issue only an Islamic banking license).

Greater uniformity of fit and proper criteria is preferable. Typically, the regulatory framework contains one set of fit and proper criteria applicable to all banks. Accordingly, the regulatory framework does not prescribe a distinct and separate set of fit and proper criteria applicable only to Islamic banks. In regard to fit and proper requirements, it is important for Islamic banking management to be trained and experienced in Islamic banking operations, given the unique features of Islamic banking operations. Especially in the case of a chief financial officer or internal auditor, expertise in Islamic accounting standards, such as Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI), would be useful.

The issue of fit and proper in relation to individuals that play a key role in a bank's Shariah compliance does not yet appear to have received sufficient attention. For example, it is not always clear whether the bank supervisory authority is empowered to make pronouncements on the fitness of individuals responsible for Shariah compliance (e.g., members of the Shariah board, the Shariah accountant, the Shariah internal auditor, the Shariah compliance officer, and the Shariah external auditor).

Few jurisdictions apply fit and proper requirements to Shariah board members and Islamic bank personnel involved in Shariah compliance. Though some jurisdictions impose requirements such as piety, standing in the community and/or recognition as a Shariah scholar, few jurisdictions (if any) impose (secular) fit and proper requirements on candidates for a Shariah board. Twelve respondents noted that a bank's proposal for Shariah scholars to be appointed to its Shariah board was not required to undergo a fit and proper test (10 respondents noted the contrary).

C. Corporate Governance and Sharia Law Compliance

Board of Directors and Shariah Board

Regulatory frameworks typically do not prescribe distinct and separate corporate governance frameworks applicable only to Islamic banks. However, some regulatory frameworks deal with the additional responsibility and authority of the board of directors in relation to Shariah compliance, though, typically, the Shariah board has the ultimate responsibility and authority in advising on Shariah matters.

The survey pointed to a range of frameworks for setting up a Shariah board. Four respondents (Palestine, Sudan, Turkey, and United Arab Emirates¹¹) indicated that the legal framework requires the setting up of a national/central Shariah board; and six respondents (Afghanistan, Malaysia, Pakistan, Palestine, Sudan, and Syria) noted that the legal framework requires setting up a Shariah board for the central bank.

Shariah Board—Central Bank

In some jurisdictions, the central bank has a Shariah board (e.g., Afghanistan, Malaysia, Pakistan, Palestine, Sudan, and Syria). However, Shariah boards of central banks differ in their mandate, scope, governance, and accountability. It appears that the ultimate overall responsibility for a central bank's Shariah compliance lies mostly with its Shariah board of directors, which typically delegates the responsibility for day-to-day Shariah compliance to its senior management. Senior management, in turn, is required to ensure Shariah compliance in line with the guidance of the Shariah board. This implies that the relationship of the central bank's Shariah board vis-à-vis the central bank is advisory.

There are different models on the role of a central bank's Shariah board. In some cases (e.g., Malaysia, and Sudan), the central bank's Shariah board has overall authority over Shariah issues that relate to banking and finance, and it is the final arbiter in disputes on such issues (thus, this central bank's Shariah board has legislative and adjudicative powers). In other jurisdictions (e.g., Afghanistan, Pakistan, and Syria), the central bank's Shariah board does not have legislative or adjudicative powers in relation to Shariah law, though it is required to be consulted on proposed amendments to the legal and regulatory framework which could have Shariah law implications.

¹¹ Whereas law 1985 mentioned that a national Shariah board should be established, it has not been implemented and currently Shariah board operates at the individual bank level only in United Arab Emirates.

Shariah Board—Islamic Bank

A majority of jurisdictions require Islamic banks to have a Shariah board that has legal standing and its actions have legal implications (e.g., Iraq, Kuwait, Malaysia, and Sudan). For the proper functioning of these boards, it would be important to clarify the responsibilities of: i) the board of directors, and those that are under the direction of the board and accountable to the directors, in respect of Shariah law compliance and ii) the supervisory authority in relation to the Shariah compliance of an Islamic bank or an Islamic window. In certain jurisdictions, noncompliance with certain Shariah Law prescriptions can constitute a criminal offence. In most cases it seems that ultimate overall responsibility for an Islamic bank's Shariah compliance lies with the Islamic bank's board of directors, which typically delegates the responsibility for day-to-day Shariah compliance to senior management. Senior management is required to ensure Shariah compliance in line with Shariah board guidance, which implies that the relationship of an Islamic bank's Shariah board vis-à-vis the Islamic bank is advisory.¹²

Supervisory authorities should be aware of the risks when there is no requirement for an Islamic bank to have a Shariah board. In jurisdictions where there are no prescriptions relating to a Shariah board (e.g., Kenya, Tunisia, and Turkey), the supervisory authorities would consider it a possible case of mis-selling Islamic financial products if a purported Islamic bank did not have in place an appropriate function and internal controls to ensure Shariah compliance.

Legal frameworks require the setting up of a Shariah board for an Islamic bank in 17 jurisdictions surveyed. In addition, on the status of the Islamic bank's Shariah board, five respondents indicated that it was a subsidiary organ of the general assembly of shareholders; eight respondents indicated it was a free-standing organ; two respondents mentioned it was a subsidiary organ of the board of directors.¹³

There appears to be heterogeneity regarding the bodies to which the Shariah board reports to. These may include: the board of directors of the bank (eight respondents), the general assembly of the bank (eight respondents), the top management of the Islamic bank (two respondents), the executive committee of the Islamic bank (two respondents), and the bank (one respondent).

¹² Despite being advisory, Shariah board opinions are highly respected.

¹³ Two other respondents noted that none of the above categories applied to the status of the Islamic bank's Shariah board.

Shariah compliance function

The function and role of ensuring Shariah compliance within an Islamic bank is usually conducted by internal auditors or Shariah auditors. In specific jurisdictions where Shariah Law is the default source of all legislation (e.g., Iran, Pakistan, Saudi Arabia, and Sudan), including banking and financial legislation, an Islamic bank's internal auditor has a statutory responsibility to ensure Shariah compliance by the Islamic bank. In other jurisdictions, an Islamic bank is required to have a dedicated Shariah auditor/Shariah compliance officer whose appointment is required to be approved by the bank supervisory authority.

External auditor

The function and role of the external auditor in relation to Shariah compliance depends on legal frameworks. In jurisdictions where Shariah Law is the default source of all legislation, including banking and finance legislation, an Islamic bank's external auditor has a statutory responsibility to assess and verify Shariah compliance by the Islamic bank. However, in jurisdictions where Shariah Law is not the default source of all legislation, the Islamic bank's external auditor has no direct responsibility to assess and verify Shariah compliance by the Islamic bank. The survey revealed that in 20 jurisdictions external auditors of an Islamic bank do not have duties and responsibilities regarding Shariah compliance of an Islamic bank (only five respondents indicated that the external auditors of an Islamic bank have such duties and responsibilities with respect to Shariah compliance).

D. Capital Requirements

The BCBS's regulatory minimum capital adequacy requirement applies in most countries where Islamic banks are present. Accordingly, most jurisdictions strive for compliance with the BCBS capital framework (either Basel I or Basel II and Basel III). The Islamic banking survey revealed that the prescribed minimum overall capital adequacy ratio (CAR) for Islamic banks ranges from 8 percent to 12 percent.

Jurisdictions take different approaches to the application of capital requirements. In certain jurisdictions (e.g., Ethiopia, Kazakhstan, Turkey, United Arab Emirates, and the United Kingdom), the chosen BCBS capital framework applies to all banks, including Islamic banks. In these jurisdictions, the regulatory framework contains a single set of capital adequacy requirements, which are applicable to all banks. Thus, no distinction is made between the capital requirements that apply to Islamic banking/banks and conventional banking/banks. In other jurisdictions (e.g., Bahrain, Jordan, Malaysia, and Sudan), the regulatory capital adequacy requirements contain prescriptions that are often based on IFSB prudential standards and guiding principles on needed adjustments to the BCBS capital framework to cater for certain Islamic banking features.

Accordingly, it may be difficult to compare capital ratios among Islamic banks in different countries. There appears to be little consistency in the adjustments which Islamic banks make to the chosen BCBS capital framework to cater for certain Islamic banking features. For example, certain jurisdictions apply an alpha factor,¹⁴ as proposed by the IFSB, to capture the difference in risk exposure between an Islamic banking risk-sharing product and a conventional banking product (Box 4). In Turkey, for example, the authorities decided on a 70 percent risk weight to be applied to Islamic banking risk-sharing products. These adjustments seem to be based on assumptions on the extent of risk arising from the particular transaction and/or resulting asset, and/or whether there has been an effective transfer of risk to or from a third party.

E. Leverage

Excessive leverage could be a valid concern in the case of an Islamic bank. Indeed, in most cases there are no constraints on the amount of call funds or investment funds, which an Islamic bank may take on deposit. However, there are exceptions. For example, the survey revealed that one jurisdiction (Bahrain) imposes a leverage ratio on Islamic banks, limiting the call funds and unrestricted investment funds placed with an Islamic bank to 20 times the capital of the bank. Moreover, Islamic banks are not permitted to engage in “pure” financing, in the sense that financing does not involve a real asset. This constrains leverage and benefits financial stability.

Box 4. Capital Requirements

While computation of the required capital adequacy ratio in Islamic banking is similar to the relevant BCBS formula, there are variations in the recognition of sources of funds and risk-weighted assets. A major difference between Islamic banks and conventional banks relates to profit sharing investment account (PSIA) loss absorbency. Unlike depositors of conventional banks, PSIA holders are neither depositors nor equity holders. They are quasi-liability holders and are expected to absorb all losses on the investments made with their funds, unless there is evidence of negligence or misconduct on the part of the bank. Given the capacity to pass-through low returns or losses to PSIA holders, this provides Islamic banks with an additional buffer to limit the impact of adverse shocks on their solvency. The higher the share of PSIA as a source of funds and the lower their sensitivity to changes in returns, the better the solvency of IBs compared to conventional banks.¹

The assignment of risk weights to different classes of assets is also different in Islamic banks. This is because in Islamic banks the assets range from trade financing to equity partnership, which may cause the calculation of risk weights to be different from conventional banks. In addition, the presence of income smoothing practices has indirect implications for Islamic banks’ capital adequacy (e.g., in some countries, Islamic banks maintain reserves for income smoothing purposes) and regulators may take this into account when determining the capital adequacy ratio.²

In December 2006, a working group of the IFSB issued the first capital adequacy standard to cater for institutions (other than insurance institutions) offering Islamic financial services. Minimum capital adequacy requirements for credit and market risks are prescribed for each Shariah-compliant financing and investment instrument. As in

¹⁴ Alpha is the ratio of actual risk transferred to shareholders of Islamic banks in relation to PSIAs.

conventional institutions, in the IFSB standard the minimum regulatory capital adequacy requirement for Islamic banks is 8 percent. In May 2008, IFSB issued the guidance note on the recognition of ratings by external credit assessment institutions to facilitate the application of Basel II. In relation to Basel III, IFSB revised its capital adequacy standards in December 2013 to incorporate many elements of Basel III.³

For the calculation of the capital adequacy ratio, the IFSB standard provides two forms: standard and discretionary. In the standard formula, capital is divided by risk-weighted assets excluding the assets financed by investment account holders. The discretion formula is modified to accommodate reserves maintained by Islamic banks to minimize displaced commercial, withdrawal, and systemic risks. In markets where Islamic banks maintain profit equalization reserves (PER) and investment risk reserves (IRR),⁴ the supervisory authorities have discretion to adjust the denominator of the CAR formula. The IFSB Supervisory Discretionary Formula for CAR can be expressed as:

[Eligible Capital] / { [total risk-weighted assets + operational risk] - [RWAs funded by restricted profit sharing investment accounts (credit + market risk) - [(1 - α^) total risk-weighted assets funded by unrestricted profit-sharing investment accounts] - [α^* risk-weighted assets funded by PER and IRR of unrestricted profit sharing investment accounts] }, where α^* is the proportion of assets funded by PSIA and is determined by the supervisory authorities.⁵*

Although the value of α^* normally does not exceed 30 percent, there are wide variations among countries. For example, Malaysia requires 100 percent of general assets financed by investment accounts to be converted into risk weighted assets, Sudan requires 50 percent and Bahrain and Jordan only 30 percent.

The Islamic banking survey revealed a variety of practices regarding the adjustment of the denominator of the CAR formula. Fourteen respondents noted that an Islamic bank is required to hold capital against assets financed by an unrestricted investment account (URIA), whereas 10 respondents expressed that banks were required to hold capital against assets financed by a restricted investment account (RIA). Furthermore, seven respondents indicated that a PER was considered eligible capital for the regulatory CAR, whereas other seven respondents noted that an IRR was considered eligible capital for such purposes.⁶

¹ However, PSIA holders typically have the right to withdraw their funds at short notice to forfeiting their share of profits (but not loss) for the most recent period. Therefore, this could be a source of liquidity risk of an Islamic bank. This has led to Islamic banks practicing the smoothing of investment returns to PSIA, using a combination of PER and IRR (Archer and Karim, 2013, pp.291-2).

² See Van Greuning and Iqbal (2008), pp. 224-228 and Sundararajan and Errico (2002) pp. 9-10.

³ The Basel III capital requirements would not have significant impact on capital adequacy of Islamic banks because the capital structure of Islamic banks is essentially composed of Tier I capital and Tier II capital is rare due to the prohibition of interest payments.

⁴ Survey results show that 11 (Bahrain, Jordan, Kazakhstan, Kuwait, Lebanon, Malaysia, Pakistan, Qatar, Sudan, Syria, and Yemen) out of 19 respondent countries have allowed PER and 7 (Bahrain, Kazakhstan, Lebanon, Palestine, Qatar, Syria and Yemen) allowed IRR. PER is used to reduce the variability of profit payouts on investment deposits to offer returns that are aligned to a market rate of return without the need for the bank to forgo any of its *Mudarib* share. IRR can be used to redistribute over time income which accrues to investment accounts, so as to maintain payouts when periodic loss is incurred. Displaced commercial risk means that the bank may confront commercial pressure to pay returns that exceed the rate that has been earned on its assets financed by investment account holders.

⁵ IFSB issued in March 2011, a guidance note with a methodology to estimate the value of alpha to be used in the supervisory discretion formula.

⁶ IFSB-15 (Revised capital adequacy standards for institutions offering Islamic financial services) made it clear that PER and IRR are not part of the capital of Islamic banks.

IV. SUPERVISION FRAMEWORK

As in conventional banking, prudential supervision is key to help reduce risks to the soundness of the Islamic banking system. The prescriptions on risk management contained in the regulatory framework apply to all banks in the supervisory process. Accordingly, Islamic banks are not subject to a different set of prescriptions on risk management. However, because Islamic banks have special characteristics, the conduct of banking supervision needs to be undertaken in a manner that addresses these characteristics. The IFSB standard on “Risk Management,”¹⁵ which was issued as a guideline for Islamic banking institutions, is a useful starting point. In addition, compliance with the Basel Core Principles (BCPs) is important for the effective supervision of Islamic banks.

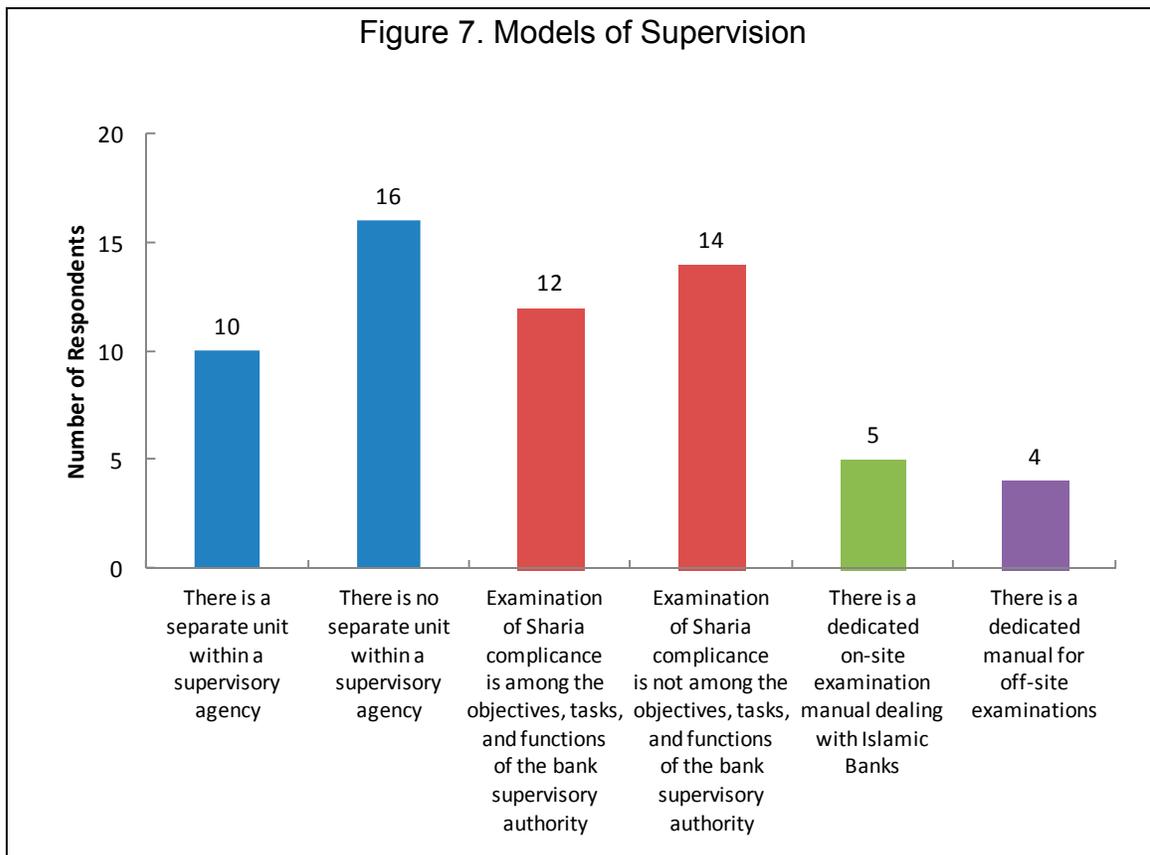
Supervisors need to have an understanding of the challenges that Islamic banking and financial products impose on Islamic banks and the potential implications of the interactions between Islamic and conventional banks. The supervisory authority should also pay attention to the potential for regulatory arbitrage between Islamic banks and conventional banks. The supervisory review process for Islamic banks also culminates in a formalized and structured supervisory strategy, which staff follows when conducting offsite surveillance and onsite examination.

There are two models of supervision of Islamic banks in jurisdictions where Islamic banks and conventional banks are present (Figure 7). In the first model, Islamic and conventional banks are subject to the supervision of a single supervisory authority (e.g., Saudi Arabia, Ethiopia, Kazakhstan, Kenya, Kuwait, Qatar, Tunisia, Turkey, the U.A.E., and the U.K.), whereas in the second model the supervision of Islamic and conventional banks is separated and lies with separate supervisory units within a single supervisory authority (e.g., Bahrain, Indonesia, Jordan, Lebanon, Pakistan, and Syria). In the first model a single supervisory framework applies to all banks (IBs and CBs), while in the second model, separate supervisory frameworks may be applied to IBs by the separate supervisory units, though there is typically substantial correspondence between the different supervisory frameworks.

In jurisdictions where Islamic banks and conventional banks are supervised by a single authority there are typically two types of supervisory frameworks. In the first case, a single supervisory framework applies to all banks and, accordingly, the supervisory authority does not apply a customized supervisory framework to Islamic banks. In the second framework, the supervisory authority applies a separate supervisory framework to Islamic banks (though similar to the one applied to conventional banks). In jurisdictions where the responsibility for supervising Islamic and conventional banks lies in separate units of a particular supervisory authority (or in different supervisory authorities), separate supervisory frameworks may be

¹⁵ Guiding Principles of Risk Management for Institutions (other than insurance institutions) offering only Islamic Financial services (IFSB-1).

applied by the separate supervisory units or authorities (though there is typically substantial correspondence between the different supervisory frameworks).



Some supervisory authorities apply risk-based supervision to Islamic banks. At a general level, supervisory authorities appear to apply the same generic supervisory framework to Islamic banks and conventional banks, as well as the same approaches, systems, methodologies, processes, and procedures. Using a Capital-Assets-Management-Earnings-Liquidity-and Sensitivity (CAMELS) rating framework for Islamic banks is generally appropriate, but it needs to be adapted to the risks associated with Islamic banks. In order to deal with risks proactively, appropriate stress testing framework needs to be developed with improved data focusing on the main characteristic of Islamic banking. At an idiosyncratic level, it appears that, in relation to Islamic banking and Shariah compliance, supervisors apply a compliance approach to Islamic banks. Typically, the higher the penetration of Islam in a society, the more intense is compliance with Shariah Law monitored by supervisory authorities.

Jurisdictions have different approaches to the nature and extent of information which banks are required to submit to the supervisory authorities. At one extreme, in non Shariah jurisdictions, where Islamic banks and conventional banks are present, all banks are subject to the same reporting requirements. At the other extreme, in Shariah Law jurisdictions where

both types of banks are present, Islamic banks may be required to submit additional information that relates to Islamic banking transactions and products, and the Islamic bank's compliance with Shariah Law. Regarding offsite monitoring, 16 out of the 29 countries surveyed have general offsite supervision guidelines or manuals which apply to all banks. Only four countries (Bahrain, Indonesia, Sudan, and Syria) have a different set of dedicated offsite manuals/guidelines designed for Islamic banks (Figure 7).

Jurisdictions also have different approaches to onsite supervision. At one extreme, in non Shariah jurisdictions, all banks are subject to the same onsite supervision policy, framework, approach, manuals, methodologies, systems, processes and procedures. However, in those jurisdictions, the supervisory authority would take into account whether there is a discrepancy in an Islamic bank between the facts on the ground and public representations related to Islamic banking/Shariah compliance. If the supervisory authority finds a discrepancy, it would consider its implications in relation to misselling, consumer protection, governance and internal controls (and could influence the supervisory authority's conclusion on the bank's "systems and controls" and reputational risk management).

Onsite supervision of Shariah compliance can be performed at varying degrees of intensity and to various ends. In a non Shariah law jurisdiction, the onsite examiners sometimes verify that the underlying transactions are real transactions that involve real assets (as opposed to financing transactions which do not involve real assets). In these jurisdictions there is also greater focus on operational risk.¹⁶ In Shariah Law jurisdictions, where only Islamic banks are permitted, up to 80 percent of the resources reportedly devoted by the supervisory authority to ensuring Shariah compliance (and onsite examiners are well trained and well versed in Shariah Law). According to the survey, five countries out of the 29 countries surveyed have separate onsite examination guidelines or manuals for Islamic banks.¹⁷ In Malaysia, supplementary onsite examination manuals for Islamic banks are used on top of those for conventional banks, and dedicated supervisors for Islamic banks conduct onsite examinations in the areas of credit, market and operational risks (Figure 7).

Prescriptions contained in the regulatory framework on contingency planning for crisis management are normally applicable to all banks. Consequently, Islamic banks are required also to perform stress testing, scenario analysis, and simulation exercises as part of their contingency planning for crisis management. However, such contingency planning for crisis management takes into account the idiosyncratic features of Islamic banks/banking.

¹⁶ For example, in the case of commodity *Murabaha* transactions on the London Metal Exchange, supervisors would confirm the sequence of transactions and whether different counterparties are involved.

¹⁷ Bahrain, Indonesia, Pakistan, Sudan, and Yemen.

Typically, the prescriptions contained in the regulatory framework on consolidated supervision and cross-border supervision is applicable to all banks. Currently, a minority of Islamic banks/banking groups have a presence in multiple jurisdictions. These institutions raise new issues, such as whether there should be a separate Shariah board for each separate jurisdiction and how to deal with conflicting *fatwas*.

V. RISK MANAGEMENT

A. General

Risk management applies equally to Islamic banking and conventional banking. Risk management is a generic framework which requires the application of generic processes and methodologies. The BCBS conceptual regulatory framework embraces sound risk management. It is generally expected that an Islamic bank should conduct sound risk management by ensuring it has the appropriate capabilities, systems, procedures, and governance. Accordingly, the risk management prescriptions contained in the legal and regulatory framework, typically apply to all banks in a jurisdiction.

At the specific level, the risk profile of a typical Islamic bank may differ from that of a conventional bank. These differences arise from Shariah Law prescriptions, and include factors such as the construction and legal form of the transaction(s), the assets and liabilities arising from the transaction(s), the risks undertaken, and the party absorbing the risk. Accordingly, an Islamic bank is required to take account of the specific Islamic banking factors which may impact its risk profile. For example, an Islamic bank typically tends to take on more concentration and operational risk, which could be taken into account and counteracted by implementing Basel II, Pillar 2.¹⁸

B. Credit Risk

The risk profile of some Islamic banking credit risk related products may differ from the risk profile of similar products in conventional banking. For example, Islamic banks often take ownership of real assets being financed. Accordingly, physical collateral plays a less important role in Islamic banking than in conventional banking. In *Murabaha* transactions, Islamic banks are exposed to credit risks when the bank delivers the goods to the client but does not receive prompt payment from the client. In a *Mudaraba* contract, where the Islamic bank enters into the contract as “principal” with an external “agent,” the bank is exposed to an enhanced credit risk on the amounts advanced to the agent. The bank is not in a position to

¹⁸ In the survey, 13 respondents indicated that their regulatory framework imposes a requirement on Islamic banks to apply a risk management approach to the management of the risks involved in Islamic banking (12 respondents indicated this was not the case).

know or decide how the activities of the agent can be monitored accurately, especially if losses are claimed.

Credit risk management for Islamic banks is complicated further in the case of a default by the counterparty. Islamic banks are prohibited from charging any accrued interest or imposing any penalty, except in the case of deliberate delay. During this delay, the bank's capital is tied up in a nonproductive asset and the bank is not in a position to earn income from it. Part of this risk could be mitigated through better collateralization and in the pricing of contracts. For example, the bank might ask the client to post additional collateral before entering into murabaha transactions. In addition to collateral, personal and institutional guarantees are also accepted to minimize credit risks.¹⁹

The recognition of nonperforming loans (NPLs) is largely the same as in conventional banks.²⁰ Supervisors are encouraged to recognize NPLs more proactively based on expected loss methods and forward looking criteria. However, in the case of investment account transactions, NPL recognition is based on a profit/loss scheme between the bank and investors. In the case of *Musharaka*, NPL recognition is only possible at the end of the project. During the project period, banks follow closely the performance of the project with their clients. Disclosure of NPL recognition criteria needs to be reinforced for a better comparability of NPLs in Islamic banking.

Concentration risk poses particular challenges for Islamic banks as some have lumpy assets. For example, Islamic banks typically structure their financing of fixed property by purchasing a property and, consequently, may end up with a substantial concentration of fixed property on their balance sheets. Real estate risk concentrations are common among Islamic banks. Hedging, including risk transfer through securitization is mostly limited. Therefore, the supervisory authorities need to provide more detailed and specific guidance on the definition and classification of permitted real estate activities. They should be more proactive in supervising the real estate portfolio of Islamic banks from the perspective of financial stability. Typically, conventional banks are constrained regarding investment in real assets, such as real estate property.²¹

¹⁹ Van Greuning and Iqbal (2008), pp. 120-27.

²⁰ Refer to Archer and Karim (2013) pp. 59-62 for the detailed discussions on loss given default (LGD) related to Islamic banking products.

²¹ On related party issues, the prescriptions in the regulatory framework normally apply to all banks on an undifferentiated basis.

C. Market Risk²²

The risk profile of some Islamic banking market risk related products may differ from the risk profile of similar products in conventional banking. Due to the unique nature of Islamic banks' way of doing business, speculative transactions connected to future events are prohibited. While Islamic banks therefore are not exposed to speculative market risks, this does not limit their exposure to other market risks.²³ For example, market risk is heightened because multiple counterparties are typically involved in Islamic banking transactions. Indeed, for liquidity management purposes, Islamic banks often use commodity *Murabaha* transactions which entail multiple counterparties and market risk in the form of commodity price risks and foreign exchange risk. Islamic banks are further exposed to market risk due to volatility in the value of tradable, marketable, or leasable assets and various forms of *Sukuk* they invested. The prudential measures used for conventional banks, such as position limits and stop loss provisions, are also used by Islamic banks to manage market risks effectively.

D. Operational Risk²⁴

The operational risk profile of a typical Islamic bank differs from that of a typical conventional bank. As in the case of market risk, operational risk is heightened because multiple counterparties are involved in Islamic banking transactions. For example, given that the buyer and seller of a product and the funder of the transaction may be involved in an Islamic banking transaction, operational risk may be higher than in conventional banks because the likelihood of payment to the wrong party is higher and the documentation is more complex.²⁵

Operational risks are likely to be significant in Islamic banks due to their specific contractual features and general legal environment.²⁶ Specific aspects of Islamic banking could raise the following operational risks: i) cancellation risk in the nonbinding *Murabaha* (partnership) and *Istisnah* (manufacturing) contracts; ii) failure of the internal control system to detect and manage potential problems in the operational processes; iii) the need to maintain and manage

²² Market risk is the risk that a bank may experience loss due to unfavorable movements in market prices. Market risk arises as a result of price movements, such as in the case of yields or benchmark rates (rate of return risk), foreign exchange rates (FX risk), and equity and commodity prices (price risk). These movements could have a potential impact on the financial value of an asset over the life of the contract. The risks relate to the current and future market value of specific assets.

²³ Refer to Archer and Karim (2013) pp. 109-10.

²⁴ Operational risk is defined as the risk of loss resulting from the inadequacy or failure of internal processes, as related to people and systems, or from external risks.

²⁵ Implementation of Pillar 2 of Basel II would help tackle operational risk.

²⁶ Refer to Archer and Karim (2013) pp. 138-40.

commodity inventories in illiquid markets; and iv) failure to comply with Shariah requirements.²⁷

E. Profit Rate Risk

Islamic banking substitutes the conventional concepts of interest, interest rate, and interest rate risk for profit, profit rate, and profit rate risk (Box 5). Thus, many of the techniques used to analyze interest rate risk are used to analyze profit rate risk as well.

The definition of profit rate risk is aligned with that of rate of return risk. The rate of return risk is generally associated with overall balance sheet exposures where mismatches arise between assets and balances from fund providers. It also stems from uncertainty in the returns earned by Islamic banks on their assets. It arises when an increase in benchmark rates results in expectations of higher rates of return on investment accounts. An increase in benchmark rates may result in investment account holders' having expectations of higher rates of return. However, the actual rate cannot be exactly determined until the end of the investment period.

F. Equity Investment Risk

The equity investment risk is the risk arising from entering into a partnership for the purpose of undertaking or participating in a particular financing. Islamic banks are exposed to equity investment risk in profit and loss sharing investments. Typical examples of equity investments of Islamic banks are holdings of shares in the stock markets, private equity investment, equity participation in specific projects and syndicated investment.²⁸

G. Sharia Risk

Shariah risk (i.e., the risk of noncompliance with Shariah Law) has several dimensions. Shariah noncompliance has implications in several areas including religion, Shariah Law, Shariah governance, internal control and internal audit, consumer protection, legal risk, and reputation risk.²⁹

²⁷ Van Greuning and Iqbal (2008), pp. 174-76.

²⁸ Van Greuning and Iqbal (2008) p.160.

²⁹ As a residual risk, Shariah compliance risk should be considered under Basel II, Pillar 2.

Box 5. Profit Sharing Ratios

In a jurisdiction where Islamic and conventional banks are present, there is a proliferation of participation ratios on URIAs and RIAs since these are negotiated between the Islamic bank and its customers. Factors such as the size of the amount to be invested and the duration of the investment play a key role in determining participation ratios and there appears to be a strong correlation between deposit rates at conventional banks and participation ratios at Islamic banks. In Turkey, the supervisory authority prescribed the investment participation ratio as 75 percent (for the investor) and 25 percent (for the Islamic bank), which implies that the investor's minimum profit share is 75 percent, while the Islamic bank's maximum profit share is 25 percent.

Given the competitive landscape, an Islamic bank needs to react speedily to market developments, such as changes in interest rates. While in the past Islamic banks paid a premium on deposits relative to conventional banks in view of the public perception that Islamic banks were more risky, this premium has been diminishing. In Turkey Islamic banks are required to keep the supervisory authority informed at all times of the participation ratios and are not permitted to change these ratios more regularly than weekly. There is usually symmetry between the profit sharing ratios and the loss sharing ratios. However, the loss-sharing ratio of a bank may not be less than 50 percent (i.e. the loss-sharing ratio of a customer may not be more than 50 percent). The profit sharing rate on fixed deposits is 75 percent to 25 percent, whereas on term deposits it is 80 percent to 20 percent according to one Turkish bank.

There is no internationally accepted sequence of steps and definitions used by Islamic banks in computing rates of return on Islamic banking products. All income generated by an Islamic bank as a result of lending, investments and bank's investment management and investment performance fees, accrues to the (shareholders of the) Islamic bank. During the 2008-09 global crisis, some Islamic banks decided to forego investment management fees to the benefit of the investors in the Islamic banks' URIA and RIA products.

Distinguishing "smoothing" of the Islamic bank's own revenues from "smoothing" of amounts which belong to investors in the Islamic bank's URIA and RIA accounts is important. Under IFRS, profit smoothing is not being permissible, while investment income smoothing by an investment manager on behalf of the investors is permissible if there is a legal contractual basis. In relation to governance, there are no internationally accepted standards on URIA/RIA investment income smoothing, though by default such smoothing is performed by Islamic banks in certain jurisdictions.

Jurisdictions approach the issue of Shariah compliance risk from different angles. In jurisdictions which do not have Shariah Law as the basis of its legal system, the bank supervisory authority typically does not involve itself directly in the issue of Shariah compliance from a religious perspective but just from a secular perspective. Typically these authorities do not consider that they need to have the capacity to determine compliance with Shariah Law.³⁰ In jurisdictions where Shariah Law is the fundamental source of law, the supervisory authority often has a responsibility to ensure compliance with Shariah Law and, thus, provides supervisory staff with the necessary training.

³⁰ That said, if a bank professes to be selling Shariah-compliant products it is required to be Shariah compliant.

H. Liquidity Risk

Liquidity risk management poses particular challenges to Islamic banks. It is a challenge for Islamic banks to maintain an appropriate level of liquid resources for liquidity management purposes and simultaneously optimize the return on such liquid resources by finding an appropriate investment for their surplus of liquid resources. Islamic banks are usually forced to maintain higher liquidity than conventional banks in view of the dearth of investment opportunities with a short-term tenure that offer the prospect of a return. For practical purposes, there is no Shariah-compliant interbank market, and Islamic banking compatible liquid assets are very scarce. Islamic banks are substantially less exposed to wholesale funding and interbank markets than conventional banks.

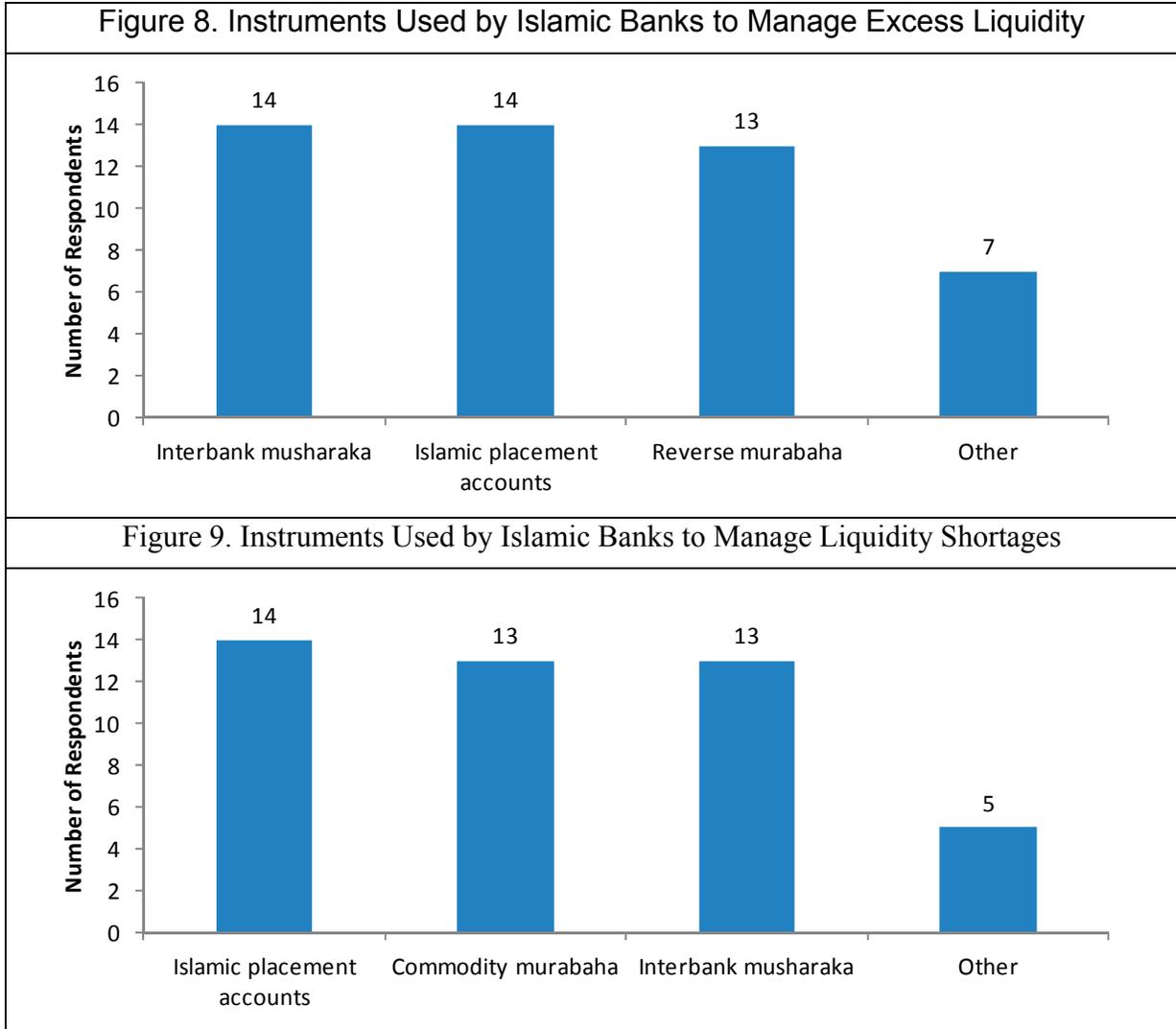
An Islamic bank with surplus funds does not normally place them in the interbank market. After all, most Islamic banks also have excess liquidity and few of them have a liquidity shortfall. Furthermore, Islamic banks avoid dealing with conventional banks out of concern of becoming contaminated by practices which are not Shariah compliant.

When managing liquidity surpluses many Islamic banks often make use of commodity *Murabaha* transactions.³¹ These transactions involve the spot purchase and sale of a commodity, such as precious metals, and deferred payment (in US\$). There are three parties involved in the transaction: the spot seller, the spot buyer, and the deferred buyer. The price of financing the transaction is at a rate closely corresponding to the three month treasury bill (T-Bill) rate. This transaction is operationally efficient, as only two pages need to be signed. Typically, such transactions are expensive for an Islamic bank, though still commercially viable in the absence of Shariah-compliant alternatives, and are often inadequately diversified.

There are several channels of interaction between Islamic and conventional banks, and several instruments to manage excess liquidity and liquidity shortages (Figures 8 and 9). The channels of interaction include interbank markets, guarantees, loans and deposits, and syndicated loans. Instruments used to manage excess liquidity include interbank *Musharaka* (14 respondents) and Islamic placement accounts (14 respondents). Major instruments used to manage liquidity shortages are Islamic placement accounts (14 respondents) and commodity *Murabaha* and interbank *Musharaka* (13, respectively).

Islamic banks typically display excessive maturity mismatches. This is because only short maturity funding is usually available while demand is for risk assets with a longer term maturity (and there is a lack of liquidity risk hedging tools). This is another reason for Islamic banks maintaining substantial surplus liquid resources, which do not generate return.

³¹ An international commodity *Murabaha* is considered part of the liquid assets of an Islamic bank.



A key challenge for Islamic banks is the presence of liquidity facilities with the monetary authority. Typically, in jurisdictions where Islamic banks are present and central banks have liquidity facilities, all banks have access to such facilities. Few central banks in jurisdictions where Shariah Law is not part of the fundamental law of the country appear to make provision for specific Shariah-compliant liquidity facilities for Islamic banks.³² In jurisdictions where Shariah Law is part of or the fundamental law of the country, the central bank normally has Shariah-compliant liquidity arrangements in place. For example, the

³² As a matter of principle, if interest is charged on the borrowing, Islamic banks are not permitted to borrow from the central bank and are not permitted to receive interest generated on the statutory reserve requirement held with a central bank. However, Shariah Law recognizes the concept of necessity. Thus, under exceptional circumstances (e.g., the survival of an Islamic bank) an Islamic bank may temporarily disregard Shariah Law and enter into a borrowing arrangement that requires the Islamic bank to pay interest.

survey indicated that in one jurisdiction (Jordan) the central bank has a liquidity facility for Islamic banks, by which funding can be provided to Islamic banks by means of a contractual construct similar to a repo (using Shariah-compliant securities, such as *Sukuk*, as collateral).³³

Islamic banks also are subject to central banks' reserve requirements. The Islamic banking survey revealed that in 23 jurisdictions Islamic banks are usually required to keep a reserve balance on deposit with the central bank and these respondents noted that there was no difference between the reserve requirements applied to Islamic and conventional banks.

The liquidity profiles of Islamic banking products differ. In the case of demand deposit accounts, an Islamic bank is exposed to liquidity risk in view of the terms attached to such deposits. Though investment account holders are locked into an investment, such an investment may be repaid by the Islamic bank prior to maturity at the discretion of the Islamic bank. In the case of RIAs, an Islamic bank (acting as an agent) does not expose itself to liquidity risk as the transaction (and the associated assets and liabilities) are off the balance sheet of the bank. However, when the bank makes a proprietary investment using its own funds the bank exposes itself to the liquidity risk of an illiquid investment.

VI. TRANSPARENCY, DISCLOSURE AND MARKET DISCIPLINE

Currently, a wide range of accounting standards is applied to Islamic banks. In jurisdictions where Shariah Law is not the law of the land, IFRS or the national accounting standards apply. This is also the case in some jurisdictions where Shariah Law is the law of the land, though in certain jurisdictions Islamic banks are required to apply also AAOIFI standards. AAOIFI accounting standards are mandatory in eight countries.³⁴ AAOIFI has a program of certification of auditors, accountants, Shariah scholars, and Shariah trainers.³⁵

Jurisdictions have different approaches to the nature and extent of information which banks are required to disclose to the general public (Figure 10). In most jurisdictions, in pursuit of

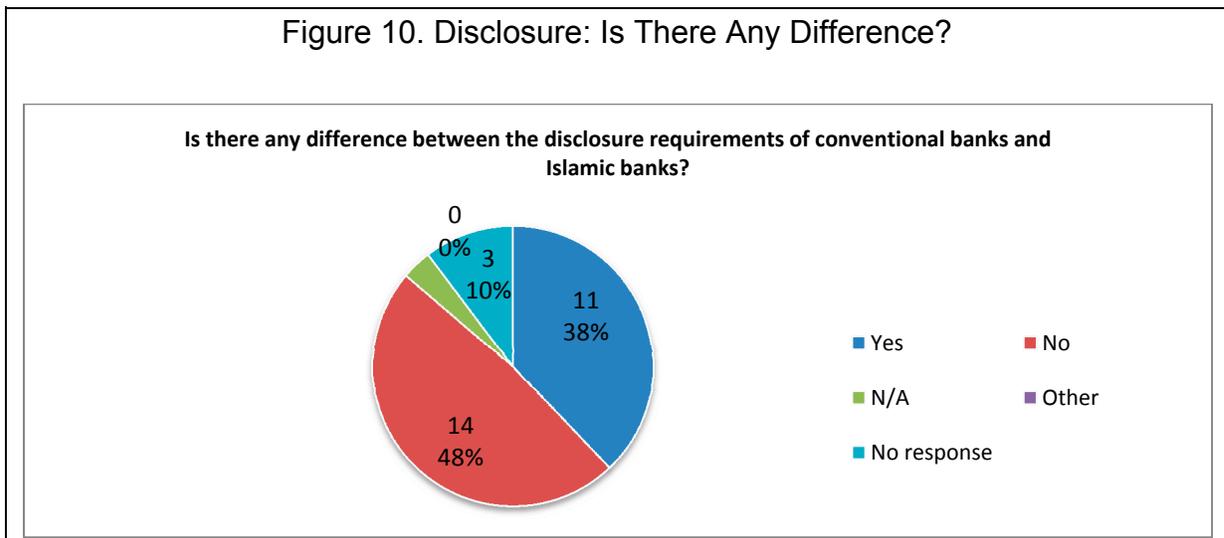
³³ In Islamic banking, it is not permissible to have a sale and repo between two parties. Thus the central bank is introduced as a trusted third party between two Islamic banks, whereby the central bank is expected to return (though it is not contractually bound to do so) the underlying securities upon the maturity of the transaction. However, this is a costly transaction for the borrowing Islamic bank, as the central bank charges a fee (for example, 2.25 percent p.a.) and the lending Islamic bank also charges a fee.

³⁴ According to the survey, these countries are Bahrain, Botswana, Iraq, Jordan, Qatar, Sudan, Syria, and Yemen.

³⁵ One of the main goals of AAOIFI is to design and disseminate accounting and auditing standards that complement the IFRS and can be applied internationally by all institutions offering Islamic banking and financial services and products. However, AAOIFI is not mandatory in many countries, thereby raising problems in the context of cross border banking supervision. For example, because banks have global operations, consolidated financial statements are prepared separately with IFRS and AAOIFI. In some locations, financial statements as per local accounting standards are also prepared.

enabling market discipline and consumer protection through transparency and disclosure, certain minimum generic information is required to be disclosed by all banks. In the case of Islamic banks, additional disclosure may be mandated relating to the Islamic dimensions, such as the bank's compliance with Shariah Law, *ex post* (and, in a certain jurisdiction, even *ex ante*) profit rates on particular Islamic banking products, and the *Fatwas* issued by the Shariah board.³⁶ In jurisdictions that have Islamic and conventional banks (and Shariah Law is not a fundamental source of the law of the land), all banks are subject to the same disclosure requirements (e.g., Saudi Arabia, Turkey, U.A.E., and the U.K.),³⁷ whereas in other jurisdictions an Islamic bank is not permitted to publish its financial statements until and unless the Shariah board has signed off on the Shariah compliance of the financial statements (e.g., Kuwait, Lebanon, Malaysia, Pakistan, Qatar, and Sudan).

Figure 10. Disclosure: Is There Any Difference?



Reporting practices regarding Shariah compliance also vary. Most respondents indicated that an Islamic bank was required to publish a statement by the bank's Shariah compliance officer regarding the Islamic bank's state of Shariah compliance (14 respondents), though a significant number noted that there was no disclosure requirement on Shariah compliance (eight respondents).³⁸

³⁶ *Fatwas* are rulings issued by authoritative Islamic scholars on diverse issues.

³⁷ However, the authorities expect an Islamic bank to make appropriate, relevant, and reliable disclosure on all material aspects of its business, including its Shariah compliance.

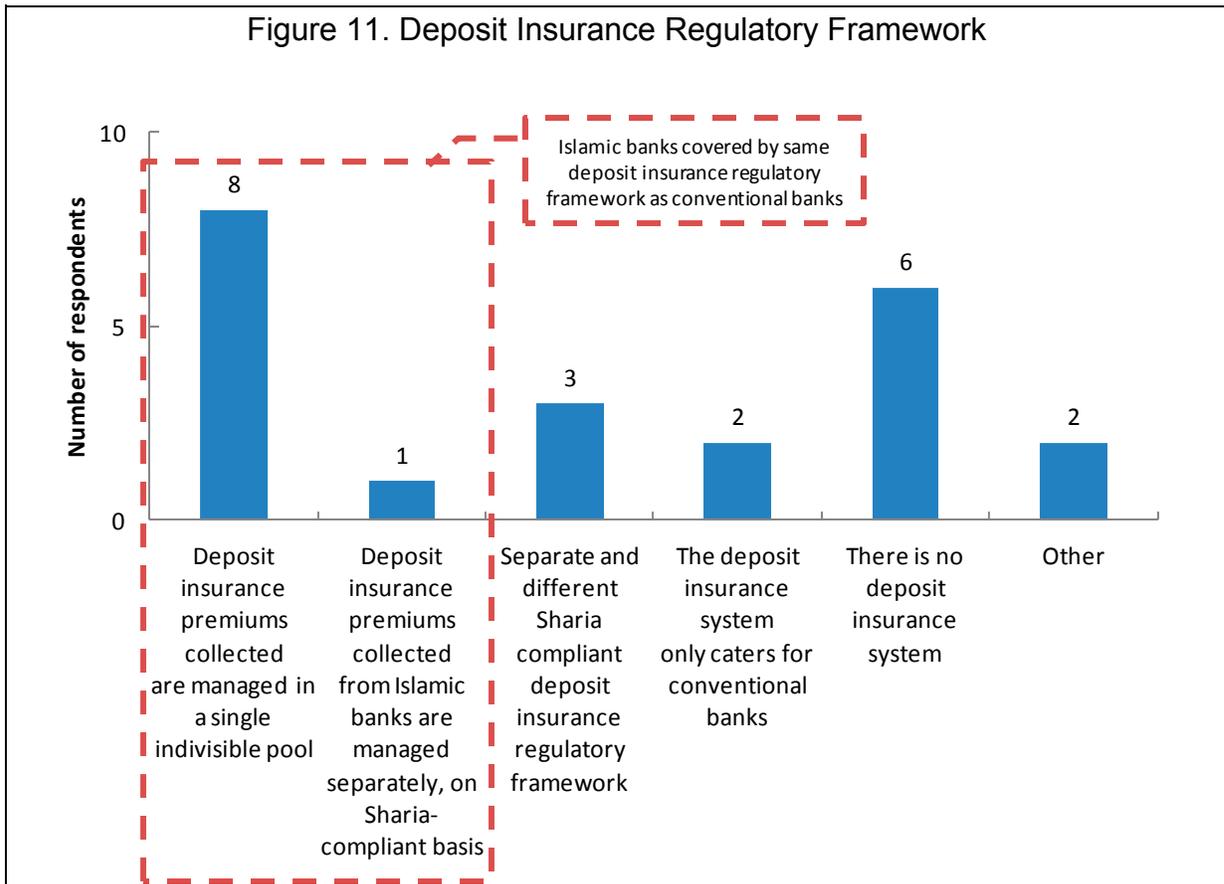
³⁸ Five respondents indicated that "other" practices were followed and two respondents mentioned that an Islamic bank was required to publish a certification by an independent body confirming that it has performed a Shariah audit regarding the Islamic bank's state of Shariah compliance.

VII. DEPOSIT PROTECTION AND BANK RESOLUTION

A. Deposit Protection

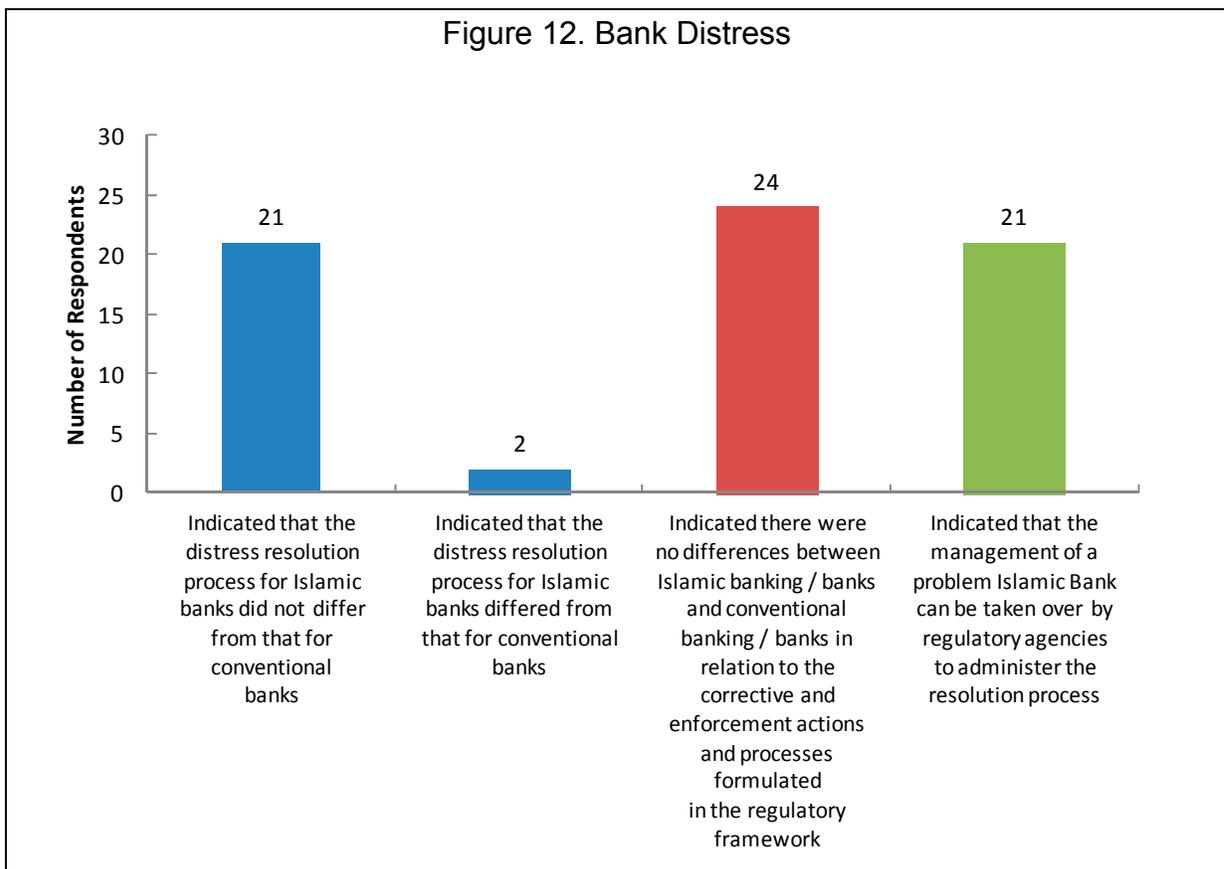
In Islamic banking, it is widely recognized that demand deposits involve an investment that is to be redeemed in par. In other words, an Islamic bank is contractually committed to return the full amount placed on deposit by the client. Consequently, demand/call deposits typically are considered deposits for purposes of deposit guarantee/insurance schemes.

However, there is significant heterogeneity among jurisdictions regarding the protection of deposits and investments with Islamic banks by the safety nets (Figure 11). The range of protection varies from no coverage of deposits and investments to full protection (with partial protection in some jurisdictions). In some cases there is a single deposit protection scheme which applies to all banks (Bahrain, Indonesia, Kenya, Lebanon, Luxemburg, Tunisia, Turkey, the U.K., and Yemen) and in others there are separate deposit protection schemes for Islamic (Iraq, Malaysia, Sudan) and conventional banks (Jordan, Kazakhstan). Where there is a separate deposit protection scheme for Islamic bank depositors (and investors), such a scheme typically invests funds arising from ex ante contributions in Shariah-compliant investments only.



B. Bank Distress

Few countries have comprehensively addressed the issue of bank resolution in the context of Islamic banking (Figure 12). Moreover, practices differ across countries. According to the survey, in most cases the distress resolution process for Islamic banks does not differ from that for conventional banks (Jordan and Yemen are exceptions). On the corrective and enforcement actions and processes framework, in most cases there are no differences between Islamic and conventional banks (Afghanistan is an exception). In relation to the takeover of a problem bank by regulatory agency, in most cases management of a problem bank can be taken over by regulatory agency to administer resolution process (Palestine is an exception).



C. Liquidation

Given the fairly recent formalization of Islamic banks, the issue of liquidating an Islamic bank is still relatively novel.³⁹ According to the survey, 23 respondents indicated that there is:

³⁹ Five respondents to the Islamic Banking survey indicated that a total of nine Islamic banks have been liquidated, five of which were in a particular jurisdiction.

i) a separate and distinct legal and regulatory framework relating to liquidation which applies exclusively to Islamic banks, only two respondents (Sudan, and Syria); ii) an integrated legal and regulatory framework relating to liquidation which applies to both Islamic banks and conventional banks, 10 respondents (e.g., Bahrain, Kenya, Pakistan, Qatar, and Turkey); iii) an integrated legal and regulatory framework relating to liquidation which applies to both Islamic banks and conventional banks only, but it has certain specific features which apply exclusively to Islamic banks, five respondents (Afghanistan, Jordan, Kazakhstan, Qatar, and Yemen) and; iv) the legal and regulatory framework relating to liquidation applies to all legal entities, such as companies, including banks, six respondents (Indonesia, Iran, Kuwait, Lebanon, Saudi Arabia, and Tunisia).

VIII. CONCLUSION

Effective legal and regulatory framework and supervisory oversight needs to take into account the difference between the risk profile of a typical Islamic bank and conventional banks. The differences arise from Shariah Law prescriptions, which include factors such as the prescribed legal form and construction of the transactions, the assets and liabilities arising from the transaction, the risks that are undertaken, and the party absorbing the risk.

Accordingly, an Islamic bank is required to take account of the specific Islamic banking factors that may impact on its risk profile. Effective legal and regulatory framework and supervisory oversight is needed to strengthen early detection of risks in Islamic banking. In addition, both centralized and integrated risk management framework are needed to manage different risks. The disclosure regime with a focus on risk profiles, risk-return mix and internal governance needs to become more comprehensive and transparent.⁴⁰

In order to reduce reputation and legal risk, there would seem to be a need to enhance the transparency about the role and composition of Shariah board. In jurisdictions that do not have Shariah Law as the basis of its legal system, the bank supervisory authority typically addresses Shariah compliance from a secular perspective. Typically, these authorities do not consider that they need to have or build any capacity or capabilities that will enable them to make any determination relating to Shariah Law compliance. On the other hand, in jurisdictions where Shariah Law is the default source of all legislation, the supervisory authorities have a responsibility to ensure compliance with Shariah Law.

The survey results presented in this paper indicate a wide dispersion of approaches to the legal, regulatory, and supervisory frameworks to accommodate Islamic banking. The BCBS conceptual framework for regulation and supervision appears to constitute the default regulatory framework in most countries where Islamic banks are present (though in some of them IFSB's pronouncements complement the BCBS framework with respect to Islamic

⁴⁰ Archer and Karim (2013) pp.70.

banks). However, in other jurisdictions Islamic banks are required to make specific adjustments to accommodate prescribed requirements pertaining to Islamic banking. The regulatory framework should provide the legal foundation for the supervisor of Islamic banks in the context of ensuring adequate risk management, disclosure framework, consumer protection and bank resolution. Regulatory reforms in different jurisdictions need to be harmonized given the rising volume of cross-border Islamic financial transactions.

Prudential supervision in an Islamic framework is key to help reduce risks to the stability in the financial system, though it needs to address the specific characteristics of Islamic banks. In this regard, regulatory authorities where Islamic banks are present should adopt IFSB standards as far as possible to avoid regulatory arbitrage. Transparency should be enhanced by the effective enforcement of AAOIFI's financial reporting standards. In addition, the prudential framework of Islamic banking needs to remain in line with the global financial environment. Risk-based supervision framework needs to be reinforced and stress testing needs to be appropriately conducted to proactively identify risks with improved data.

There is also room to improve the consistency of capital regulations that are applied to Islamic banks. BCBS's capital adequacy requirements are applied in most countries where Islamic banks are present. However, in some countries, regulatory capital adequacy requirements contain prescriptions that are based on IFSB which contains some adjustments that caters for a certain Islamic banking features. These adjustments pose significant challenges for comparability of CARs in different countries. In this regard, harmonization of treatment in alpha and risk weight of assets should be considered. While alpha caters for the ratio of actual risk transferred to shareholders of Islamic banks, the computation of alpha is not consistent across countries, which is important given the high sensitivity of the CAR to changes in alpha. This underscores the need for supervisory authorities to follow the IFSB guidance when determining alpha, which asks supervisory authorities to take into account risks at both the institutional and national levels, and to establish and transparently disclose robust models for this process.

Liquidity risk management poses particular challenges to Islamic banks. Islamic banks are usually forced to maintain higher liquidity than conventional banks, in view of the dearth of investment opportunities with a short-term tenor that offer the prospect of a return. For all practical purposes, there is little Shariah-compliant interbank market, and Islamic banking compatible liquid assets are very scarce.⁴¹ In relation to Basel III liquidity requirements, Islamic banks are likely to be impacted because there is lack of eligible liquidity instruments. Supervisory authorities where Islamic banking are present should ensure to monitor banks'

⁴¹ In relation to Basel III liquidity coverage ratio (LCR), the Group of Governors and Head of Supervision of the Basel Committee (GHOS) in January 2013 recognized that "Supervisors have the discretion to define Shariah compliant financial products (such as *Sukuk*) as alternative high quality liquid assets (HQLA) to meet the LCR requirement." (Refer to Archer and Karim 2013, pp. 27).

effective liquidity risk management in the context of ascertaining liquid assets, longer term funding, using liquidity hedging instrument and interbank market that are Shariah compliant.

The lack of liquidity facilities with the monetary authority is also a challenge for Islamic banks. In jurisdictions with Islamic banks and where central banks make liquidity facilities available to banks, all banks have access to such facilities. However, few central banks in jurisdictions where Shariah Law is not part of the fundamental law of the country make specific provision for Shariah-compliant liquidity facilities for Islamic banks. Consequently, such facilities in these jurisdictions are not much use to Islamic banks. Central banks where Islamic banks are operating should consider catering specifically for Islamic banks in the context of lender of last resort or emergency lending arrangements by providing Shariah compliant arrangements in place and available for Islamic banks.

The protection of deposits with Islamic banks has little uniformity among jurisdictions. Deposit protection schemes range from single schemes applied to all banks to separate schemes where Islamic and conventional banks are covered separately. Where there is a separate deposit protection scheme for Islamic depositors (investors), such a scheme typically invests its funds from *ex ante* contributions only in Shariah compliant investment. Harmonization of protection of deposits and investments with Islamic banks is important to help ensure enhanced financial stability.

Few countries have comprehensively addressed the issue of bank resolution in the context of Islamic banking. In non Shariah Law jurisdictions with Islamic and conventional banks, the regulatory framework contains a single safety net and bank distress resolution framework, which is applicable to all banks. In Shariah law jurisdictions where both types of banks are present, enforcement actions relating to Islamic banks are driven by Shariah Law considerations. The supervisory authorities where Islamic banks are present should be equipped with effective insolvency and bank resolution framework and enhance cross border and consolidated supervision for Islamic banking to ensure financial stability. Bank resolution regimes should support timely and effective resolution mechanism. Resolvability of large and complex Islamic financial institutions should also be ascertained.

A number of additional challenges remain to be addressed by the international regulatory community. These include: i) developing more robust infrastructure such as a credit registry and frameworks on accounting, disclosure, and credit ratings;⁴² ii) managing concentration risk more effectively; iii) addressing the non uniformity of Shariah interpretation and standardization of contractual terms per contract type; and iv) paying more attention on risk and vulnerabilities of cross-border Islamic financial activities and enhancing consolidated supervision to ensure financial stability.

⁴² IFSB has issued guiding principles and guidance notes on the issues related to disclosure and ratings by external credit assessment institutions in connection with capital adequacy standards.

Annex 1. Definition of Key Shariah-Compliant Contracts^{43,44}

Sources of Funds (Deposits and Investment Accounts)

Profit Sharing Investment Account (PSIA) is a contract by which an investor/depositor opens an investment fund with an IB on the basis of *Mudharabah*. The IB could have restricted or full discretionary power in making investment decisions. The IB acts as an entrepreneur while the PSIA holder acts as a capital provider. Both parties agree on a ratio of profit sharing, which must be disclosed and agreed upon at the time of opening the account. Profits generated by the IB are shared with the PSIA holder in accordance with the terms of the *Mudharabah* agreement while losses are borne solely by the PSIA holder, unless they are due to IB's misconduct, negligence or breach of the contract terms. Usually the IB's money (bank capital) is invested in the same income-producing assets or economic activities. Hence, low income (losses) affect the IB through low (negative) return on shareholders' invested capital and low (zero) income from managing PSIA accounts. This source of revenue is the main one for the IB, and it is used to cover operational expenses.

A *Wadiah* (deposit) is a contract between the depositor and the IB (custodian) for safekeeping. The depositor grants the IB permission to utilize the funds for whatever purpose permitted by Shariah. The bank in return guarantees the value of the deposit and allows the depositor easy access for withdrawals whenever needed.

Uses of Funds (Financing and Investment)

A *Murabahah* (Cost-plus financing) contract refers to an agreement whereby the IB sells to a customer, at acquisition cost plus an agreed profit margin, a specified kind of asset that is already in its possession (such as a manufactured good). Following delivery of the asset, a credit risk in respect of the amount receivable from the customer arises. From the perspective of modern finance, a *Murabahah* facility is similar to an asset-backed risky loan.

A *Salam* (Purchase with deferred delivery) contract refers to an agreement to purchase, at a predetermined price, a specified kind of commodity (physical product) which is to be delivered on a specified future date in a specified quantity and quality (such as an agricultural or a manufactured product). As the buyer, the IB makes full payment of the purchase price upon execution of the Salam contract. To mitigate price risk, in certain cases, the IB enters into a back-to-back contract, namely Parallel *Salam*, to sell a commodity with the same specification as the purchased commodity under a Salam contract to a party other than the original seller.

⁴³ This follows closely the IFSB definition of contracts and it is largely based on Hasan, M. and J. Dridi (2010).

⁴⁴ In the case of lease-to-buy contracts, the asset backing the lease is strictly non collateral as it remains the property of the lessor. It may be described as quasi-collateral (see the IFSB capital adequacy standard).

An *Ijarah* (Lease) contract refers to an agreement whereby the IB leases to a customer an asset (such as a ship, aircraft, or telecom equipment) for an agreed period against specified installments of lease rental. The contract commences with an agreement to lease that is binding on the part of the potential lessee and requires the IB to purchase or lease an asset prior to entering into the contract. An *Ijarah* contract could offer the lessee the option to purchase the asset either at the end of the lease period by means of a gift or a token consideration, or by installments of a specified amount during the lease period.

A *Musharakah* (Equity financing) contract is an agreement whereby the IB and a customer contribute capital to an enterprise, whether existing or new, or to the ownership of real estate or a moveable asset, either on a permanent basis or on a diminishing basis where the customer progressively buys out the share of the IB (“diminishing *Musharakah*”).⁴⁵ Profits generated by the enterprise or the asset/real estate are shared in accordance with the terms of the *Musharakah* agreement, while losses are shared in proportion to the respective contribution to capital.

A *Mudharabah* (Participation or trust financing). It is a contract that refers to an agreement whereby the IB contributes capital to an enterprise or activity which is to be managed by the customer/investor. Profits generated by that enterprise or activity are shared in accordance with the terms of the *Mudharabah* agreement, while losses are to be borne solely by the IB unless they are due to the customer/investor’s misconduct, negligence, or breach of the contract terms.

⁴⁵ Diminishing Musharakah is a means of providing financing on a profit and loss sharing basis.

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