Islamic Banking: Issues in prudential Regulations and supervision

INTERNATIONAL MONETARY FUND, Monetary and Exchange Affairs Department

Prepared by Luca Errico and Mitra Farahbaksh[1]

Abstract

This paper analyzes the implications of Islamic precepts on banks, structure and activities, focusing on banking supervision issues. It points out and discusses these issues in the context of a paradigm version of Islamic banking, as well as in frameworks that fall betweent the paradigm version and conventional banking. The case of Islamic banks operating in a conventional system is also examined.

SUMMARY

Islamic precepts influence the structure and activitis of banks in several ways, the most important being the prohibition against the payment and receipt of a fixed or predetermined rate of interest, which is replaced by profit-and loss-sharing arrangements whereby the rate of return to financial assets held with banks isnot known and not fixed prior to the undertaking of each transaction. Islamic Bank thus differ from conventional banks, but the issue of what prudential standards should apply to Islamic banks has received

---

1 - We are grateful to Abbas Mirakhor and Nadeem Ul Haque for their advice and encouragement during this project. We also wish to thank William Alexander, Tito Cordells, Peter Hayward, Malcolm Knight, Hassanali Mehran, Ghiath Shabsigh, and Reza Vaez-Zadeh for their helpful comments.

little attention.

This paper argues that effective prudential supervision on banks is just as necessary and desirable in Islamic banking as it is in conventional banking. To help reach this goal, a number of standards and best practices established by the Basle Committee on Banking Supervision are useful and provide a valuable reference. These standards, however, are not always applicable to Islamic banking. An appropriate regulatory framework governing Islamic banks needs to place greater emphasis on the management of operational risks and information disclosure issues than is normally the case in conventional banking. To help develop such a regulatory framework, a CAMEL rating system adapted to an Islamic environment is discussed, along with issues such as legal foundations, information disclosure requirements, and licensing procedures.

Islamic banking in actual practice diverges markedly from its paradigm version and is carried out in a variety of ways that lie somewhere in between the benchmark case and conventional banking. The degree of divergence from the benchmark differs from country to country, the focus of banking supervision should shift accordingly, and each argument discussed in the benchmark case needs to be reebaluated and given the appopriate emphasis in light of the circumstances and specific Islamic banking practices prevailing in a country.

Islamic banking is expanding outside the traditional borders of Muslim economics into westem countries where conventional banking is followed, notably the United Kingdom. This situation is unprecedented. Specific areas in the operation of Islamic banks are likely to be viewed by supervisory authorities in conventional systems as well as potential counterparties as difficult to understand. To mitigate these concerns, effective prudential supervision of Islamic banks in their home countries should be viewed as a key factor in the procese of establishing a fuller international integration of Islamic banking.

1. INTRODUCTION

At the heart of every robust economy is a sound banking system. In its endeavors to help strengthen the economies of its member countries, the Fund is increasing its emphasis on stronger financial system surveillance through improved supervisory efforts. Experience has shown that given the close interrelation between banking system soundness and macroeconomic policy implementation and performance, a key element of financial system surveillance is effective prudential supervision of the banking system.[1]

Forty-eight developing and emerging market countries, representing almost one-third of all Fund-member countries, are increasingly involved, with varying intensity, in Islamic banking.[2] In the Islamic Republic of Iran, Pakistan, and Sudan all banks and financial institutions have adopted Islamic banking principles since the early 1980s; other countries, such as Malaysia, Indonesia, Bangladesh, Jordan, and Egypt operate Islamic banking alongside conventional banking.[3] By some estimates, Islamic banking has been growing at an annual rate of 15 percent over the past five years; the market,s current size is estimated at US$70 billion, and is projected at about US$100 billion by the year 2000.[4] Moreover, Islamic banking is increasingly expanding outside the traditional borders of Muslim countries into western economies, notably the United Kingdom.

Islamic banking differs from conventional banking in several important ways. These include the prohibition of transactions based on a fixed or

---

1 - Banking supervision in this paper refers to the assessment and permanent monitoring of banks, financial performance and position. Banking supervision is carried out throught an effective regulatory framework aimed at reinforcing banks, operating environment, internal governance, and market discipline.

2 - These countries are: Afghanistan, Albania, Azerbaijan, Bahrain, Bangladesh, Benin,Brunei Darussalam, Burkina Faso, Cameroon, Chad, Comoros, Djibouti, Egypt, Gabon, The Gambia, Guinea, Guinea Bissau, Indonesia, Islamic Republic of Iran, Iraq, Jordan, Kuwait, Kyrgyz Republic, Lebanon, Socialist people,s Libyan Arab Jamahiriya, Malaysia, Maldives, Mali, Mauritania, Morocco, Niger, Oman, Pakistan, Qatar, Saudi Arabia, Senegal, Sierra Leone, Somalia, Sudan, SyrianArab Republic, Tunisia, Turkey, Turkmenistan, Uganda, United Arab Emirates, Republic of Yemen, and West Basnk and Gaza (WBG).

3 - In this paper, the term "conventional" defines an interset-based bank or banking system

4 - Iqbal, 1997.

predetermined rate of interest, and the requirement that banks, operations be carried out according to certain procedures through the use of certain financial instruments. However, broadly speaking, in the majority of countries where Islamic banks operate the same regulatory framework applies to both conventional and Islamic banks. This regulatory framework tends to follow standards and Guidelines established by the Basle Committee on Banking Supervision.[1] However, these standards are not always applicable in an Islamic banking framework in the same way as they are in other banking systems. Therefore, a fuller understanding of how Islamic banks operate is key to developing an appropriate and effective regulatory system. Until now the issue of what standards used for conventional banks should apply to Islamic banks has received little attention, even in countries where all banks follow Islamic principles. This paper focuses on those aspects of Islamic banking that need to be recognized and addressed to help make the conduct of banking supervision more effective in an Islamic framework. Greater stress on these issues is likely to strenghthen financial system surveillance in countries where Islamic banking principles are followed.

The lack of uniformity in specific forms of Islamic principles applied in Muslim countries makes it difficult to generalize as to what might be considered Islamic banking in practice. In other words, similar banking procedures and financial instruments may be accepted in one Muslim country and be rejected in another one. Another constraint in the search for a common set of banking practices in Muslim countries is the different degree of public sector involvement in the economy in general and in the financial and banking seciors in particular. The spectrum is rather wide, ranging from full public-sector control of banks in Iran, to more liberal environments, such as Malaysia.

Given that there are many variants of Islamic banking practices, it may be useful to reach an understanding of a paradigm version of Islamic banking and use it as a benchmark against which to measure current practices. By so

1 - The Basle Committee on Banking Supervision has issued a consultative paper,Core principles for Effective Banking Supervision (April 1997). Which provides a comprehensive analysis of best principles and practices.

doing, effective supervisory norms can be developed to address special issues that characterize banks operating according to a paradigm version of Islamic banking. This may prove to be that best course of action because it is always difficult to envisage general prescriptions that are valid for all countries at all points in time.

The paper is organized as follows. Section II provides a basic understanding of the fundamental features of Islamic banking with a view to defining a paradigm version of Islamic banking and characteristics of banks operating according to it. Based on this understanding, Section III discusses how the regulatory framework should be designed to address in an effective manner special issues that characterize banks operating according to a paradigm version of Islamic banking. Section iv discusses how the focus of banking sopervision should shift when Islamic banking practices diverge from the paradigm version, it also examines the case of Islamic banks operating in a conventional system. Section V provides concluding remarks.

II. Review of the fundamental Features of Islamic Banking

To understand Islamic banking is to realize that its banks and their operations are considered to be an integral part of a complete Islamic economic system, which is based upon the codification of injunctions outlined in the Koran and the traditions of the Prophet Mohammed, that is the Islamic Shariah, Key elements of the Islamic economic system include individual rights, property right, contracts, work and wealth, and the role of the State.[1] While preserving their key tenets, the rules established in theShariah have been elaborated upon and refined over time by Islamic scholars and economists in order to adapt them to the evolving economic environment. Hence, this section reviews the fundamental features of Islamic banking as

1 - For a fuller discussion on the theoretical aspects of Islamic banking, see Mirakhor,1988, Khan and Mirakhor, 1986 and 1993, Kazarian, 1993, and Presley, 1994.

they are presented in the literature with a view th defining a[1] paradigm version of Islamic banking and characteristics of banks operating according to it.

These Islamic banks are characterized by the following features:

- **Prohibition against the payment and receipt of a fixed or predetermined rate of interest.** This is replaced by profit and loss sharing (PLS) arrangements where the rate of return on financial assets held in banks is not known and not fixed prior to the undertaking of the transaction. The actual rate of retutn can be determined only expost, on the basis of actual profits accrued from real sector activities that are made possible through the productive use of financial assets.
- **Requirement to operate through Islamic modes of financing.** These modes affect both the assets and liabilities sides of a bank,s balance sheet and can be divided into two groups: the ones that are based on the PLS principle (core modes) and the ones that are not (marginal modes). Table 1 provides a summary description of the main features of both groups.
- **Investment deposits.** Such deposits are not guaranteed in capital value and do not yield any fixed or guaranteed rate of return. In the event banks record losses as a result of bad investment decisions, depositors may lose part or all of their investment deposits. The only contractual agreement between depositors and banks is the proportion (ratio) according to which profits or losses are to be distributed.

Demand deposits. Such deposits are guaranteed in capital value, although no returns are paid on them. The reason to justify the capital value guarantee is the assumption that demand deposits have been placed as Amanat (i.e., for safekeeping). Hence, they belong at any time to depositors.

1 - Section IV discusses how Islamic banking in current practice diverges from the paradigm version and assesses implications for banking supervision.

TYPE	DESCRIPTION	COMMENTS
PLS Modes	**Profit and loss sharing modes**	**At the core of Islamic banking**
Mudaraba	**Trustee finance contract** The bank provides the entire capital needed for financing a project, while the entrepreneur offers his labor and expertise. The profits (or losses) from the project are shared between the bank and the entrepreneur at a certain fixed ratio. Financial losses are borne exclusively by the bank. The liability of the entrepreneur is limited only to his time and efforts. However, if the negligence or mismanagement of the entrepreneur can be proven he may be held responsible for the financial losses incurred. It is usually employed in investment projects with short gestation periods and in trade and commerce.	Three conditions need to be met: 1. The bank should not reduce credit risk by requesting a collateral to this purposs: it bears entirely and exclusively the financial risk. Collateral may be requested to help reduce moral hazard, e.g. to prevent the entrepreneur from running away. 2. The rate of profit has to be determined strictly as a percentage and not as a lump sum. 3. The entrepreneur has the absolute freedom to manage the business.
	It affects both assets and liabilities sides of banks' balance sheet. On the liabilities side, the contract between the bank and depositors is known as *unrestricted Mudaraba* because depositors agree that their funds be used by the bank, at its discretion, to finance an open-ended list of profitable investment and expect to share with the bank the overall profits accruing to the bank's business. On the assets side, the contract between the bank and the agent-entrepreneur is known as *restricted Mudaraba* because the bank agrees to finance a specific project carried out by a specific agent-entrepreneur and to share the relative profits according to a certain percentage.	The bank is entitled to receive from the entreprneur the principal of the loan at the end of the period stipulated in the contract, if an only if a surplus exists. If the enterprise's books show a loss, this will not constitute default on the part of the entrepreneur, except for negligence or mismanagment.
Musharaka	**Equity participation contract** The bank is not the sole provider of funds to finance a project. Two or more partners contribute to the joint capital of an investment. Profits (and losses) are shared strictly in relation to the respective capital contributions. It is usually employed to finance long-term investment projects.	Banks can exercise the voting rights corresponding to their share of the firm's equity capital. Their representatives can sit on the firm's board of directors. All parties invest in varying proportions, and have the right to participate in the management of the enterprise.
Muzar' ah	Traditional counterpart of the Mudaraba contract in farming. The harvest is shared between the bank and the entrepreneur. The bank may provide funds or land.	
Musaqat	Traditional counterpart of the Musharaka contract in orchard keeping. The harvest is shared among the partners based on their respective contributions.	
Direct investment	The same concept as in conventional banking. The bank cannot invest in the production of goods and services which contradict the value pattern of Islam, such as gambling.	Banks can exercise the voting rights corresponding to their share of the firm's equity capital. Their representatives can sit on the firm's board of directors.

Non-PLS Modes	Non Profit and loss sharing modes	They are used in cases where PLS modes cannot be implemented, for example, in cases of small scale borrowers or for consumption loans.
Qard al-Hasanah	**Beneficence loans** These are zero-return loans that the Quran exhorts Muslims to make to "those who need them." Banks are allowed to charge the borrowers a service fee to cover the administrative expenses of handling the loan, provided that the fee is not related to the amount or maturity of the loan.	
Bai' Mua'jja l	**Deferred payment sales** The seller can sell a product on the basis of a deferred payment in instalments or in a lump sum payment. The price of the product is agreed upon between the buyer and the seller at the time of the sale and cannot include any charge for deferring payments.	Contrary to contracts based on the PLS principle, modes such as markup, leasing, and lease purchase have a predetermined and fixed rate of return and are associated with collateral. In fact, banks add a certain percentage to the purchase price and/or additional costs associated with these transactions as a profit margin, and the purchased assets serve as a guarantee. Additionally, banks may require the client to offer a collateral.
Bai' Salam or Bai' Salaf	**Purchase with deferred delivery** The buyer pays the seller the full negotiated price of a product that the seller promises to deliver at a future date. This mode only applies to products whose quality and quantity can be fully specified at the time the contract is made. Usually, it applies to agricultural or manufactured products.	These instruments can be considered to be more closely associated with risk aversion and they do not substantially differ from those used in a conventional banking system, other than in their terminology and in some legal technicalities. They are considered to conform to Islamic principles because the rate of return is meant to be tied to each transaction, rather than to the time dimension. However, some Muslim scholars advocate a stricter utilization of such a modes.
Ijara **Ijara wa iqtina'**	**Leasing** **Lease purchase** A party leases a particular product for a specific sum and a specific period of time. In the case of a lease-purchase, each payment includes a portion that goes toward the final purchase and transfer of ownership of the product.	
Murabaha	**Mark-up** The seller informs the buyer of his cost of acquiring or producing a specified product; then profit margin (or mark-up) is negotiated between the buyer and the seller. The total cost is usually paid in installments.	
Jo' alah	**Service Charge** A party undertakes to pay another party a specified amount of money as a fee for rendering a specified service in accordance to the terms of the contract stipulated between the two parties. This mode usually applies to transactions such as consultations and professional services, fund placements, and trust services.	

Sources: Kazarian, 1993; Iqbal and Mirakhor, 1987.

- **Consistency with one of the following two systems of operation:**[1]

Two-tier Mudaraba (also designated in this paper as Scheme A). In this situation, the assets and liabilities sides of a bank,s balance sheet are fully integrated. On the liabilities side, depositors enter into a Mudaraba contract (a trustee finance contract, see Table 1) with the bank to share the overall profits accruing to the bank,s business. Thus, depositors act as financiers by providing funds, and the bank acts as an entrepreneur by accepting them. On the assets side, the bank, in turn, enters into Mudaraba contracts with agent-entrepreneurs who search for investable funds and who agree to share profits with the bank according to a certain percentage stipulated in the contract. In addition to investment deposits, banks are allowed to accept demand deposits that yield no returns and may be subject to a service charge. These deposits are repayable on demand at par value. However, depositors are also aware that banks will be using demand deposits for financing risk-bearing projects. Under this arrangement, banks may grant short-term interest-free loans (Qard al-Hasanah, see Table 1) to the extent of a part of total current deposits. Finally, it should be noted that, although the concept of reserve requirements is a recognized one in Islamic banking, the two-tier Mudaraba scheme does not mandate specific reserve requirements on both types of deposits.[2]

Two windows (also designed in this paper as Scheme B). Under this arrangement, bank liabilities are divided into two windows: one for demand deposits and the other for investment deposits. The choice of the window is left to depositors. Demand deposits are assumed to be placed

---

1 - These two analytical models of banking in an Islamic framework are considered to be fully consistent with Islamic rules and guidelines. For a fuller discussion, see Khan and Mirakhor, 1993.

2 - Traditionally, banks operating with the two-teir Mudaraba scheme have kept substantial reserves against demand deposits (even if they were not considered as Amanat) and little (sometimes none) on investment deposits.

as Amanat (safekeeping), thus they are considered to belong to depositors at all times. Hence, they cannot be used by the bank as the basis to create money through fractional reserves. Consequently, banks operating according to this arrangement must apply a 100 percent reserve requirement ratio on demand deposits. By contrast, investment deposits are used to finance risk-bearing investment projects with depositors, full awareness. Therefore, these deposits are not guaranteed by the bank and reserve requirement are not applied to them. The bank may charge a sevice fee for its safekeeping services. Interest-free loans may only be granted from funds specifically deposited for that purpose.

Table 2 summarizes the above characteristice and provides a synoptic comparison of Islamic and conventional banking frameworks.

Table 2. Comparison of Banking Frameworks

Characteristics	Paradigm Version of Islamic Banking	Conventional Banking
Nominal value guarantee of: Demand deposits Investment deposits	 Yes No	 Yes Yes
Equity-based system where capital is at risk	Yes	No
Rate of return of deposits	Uncertain, not guaranteed	Certain and guaranteed
Mechanism to regulate final returns of deposits	Depending on banks' performance/ profits from investment	Irrespective of banks' performance/ profits form investment
PLS principle is applied	Yes	No
Use of Islamic modes of financing: PLS and non-PLS modes	Yes	N/A
Use of discretion by banks with regard to collateral	Possible for reducing moral hazard in PLS modes Yes in non-PLS modes	Yes always
Banks' pooling of depositors' funds to provide depositors with professional investment management	Yes	No

There are several points that are worthnoting. First, neither the capital value nor the return on investment deposits is guaranteed by Islamic banks, and these banks basically pool depositors, funds to provide depeoitors with professional investment management. This situation underscores an interesting similarity between the operation of Islamic banks and investment companies.[1] There is, however, a fundamental differnce between the two that needs to be recognized. It lies in the fact that investment companies sell their capital to the public, while Islamic banks accept deposits from the public. This implies that shareholders of an investment company own a proportionate part of the company,s equity capital and are entitled to a number of rights, including receiving a regular flow of information on developments of the company,s business and exerting voting rights correspording to their shares on important matters such as changes in investment policy.[2] Hence, they are in a position to take informed investment decisions, monitor the company,s performance, and influence strategic decisions. By contract, depositors in an Islamic bank are entitled to share the bank,s net profit (or loss)according to the PLS ratio stipulated in their contracts. Investment deposits cannot be withdrawn at any time, but only on maturity and, in the best case, at par value. Moreover, depositors have no voting rights because they do not own any portion of the bank,s equity capital. Hence, they cannot influence the

1 - The term "investment company" defines an entity that pools shareholders, funds to provide shareholders with professional investment management. An investment company sells its capital to the public, invest the proceeds to achieve tis investment objectives, and distribute to its shareholders the net income and net gains realized. Investment companies include open-ended funds, or mutual funds. These have outstanding redeemable securities of which they are the issuers. The unit ownership is represented by units of investment, such as shares of stock or partnership interests to which proportionate shares of net assets can be attributed (see Guide to Audits of Investment Companies, American Institute of Certified public Accountants, 1996).

2 - See the Organization of Investment Companies and the Investment Company Act,1940, Section 13(a), United States Securities and Exchange Commission.

bank,s investment policy (as noted, their relationship with the bank is regulated according to an unrestricled Mudaraba contract, see Table 1). Second, because of the structure of their balance sheets and the use of profit and loss sharing arrangements, banks operating according to a paradigm version of Islamic banking appear to be better poised than conventional banks to absorb external shocks.[1] Indeed, as noted previously, these Islamic banks have the ability to reduce the capital value of investment deposits in the case of a loss. Third, Islamic banks are not expected to reduce credit risk by systematically requiring a collateral or other guarantees as pre-requisite for granting PLS facilities. Fourth, a critical difference between the two permissible systems of operation needs to be recognized. Islamic banks can use all of their deposits (demand and investment)for their financing and investment activities in Scheme A, while only investment deposits can be utilized for such purposes in scheme B. This makes scheme A, where banks, assets and liabilities are fully integrated far riskier than Scheme B, where banks, liabilities are divided into two windows. Indeed, in Scheme A--given the fact that (1)demand deposits are guaranteed in capital value and are redeemable by the depositors on demand; (2) demand deposits can be used to finance risk-bearing investment projects; and (3)there is not a mandated specific reserve requirement on demand and investment deposits-an asset-liability mismatch can occur, leading possibly to negative net worth, or bank insolvency.

III. Banking supervision in an Islamic Framework

prudential supervision is just as necessary in an Islamic banking framework as in conventional banking to reduce risks to the soundness of the banking system and enhance banks, role as active palyers in the development of the economy.[2] This is so for a number of reasons. First it is worth keeping

---

1 - On this point see also Khan and Mirakhor, 1989; and Iqbal, 1997.

2 - In some Islamic countries a significant portion of the banking sector is

in mind that, as argued in section II, even in a paradigm version of Islamic banking, insolvency risks cannot be ruled out, notably in cases where banking operations are carried out according to a two-tier Mudaraba arrangement (Scheme A(, that is, when assets and liabilities sides of a bank,s balance sheet are fully integrated.

Second, risks of economic losses, or losses incurred as a result of poor investment decisions, are equally possible when banks carry out operations according ti either Scheme A or B.Poor investment decisions may derive from a mix of factors, including a volatile operating environment, weak internal governance-notably mismanagement, and limited market disciplince. Economic losses not only would be reflected in the depreciation of the value of depositors, wealth, but also in a decline in banks, profitability. If not corrected in due course, such an economic downturn could jeopardize banks, soundness. This, in turn, would progressively reduce banks, intermediation role and hamper the mobilization of private savings towards investment.

Third, weak banks may detract from the achievment of fundamental macroeconomic objectives, such as the efficiency of the payments system and the effectiveness of monetary policy, particularly if implemented through the use of indirect instruments. Unsound banks may also reduce public confidence in the financial system, thus impeding or delaying necessary structural reforms in this area.

Fourth, a weak banking system is likely to prevent the economy from benefiting from the ongoing globalization process and the liberalization of capital markets, particularly in developing and emerging market countries-such as the ones where Islamic banking principles are

---

state-owned(in the case of Iran, all banks). Prudential supervision of state-owned banks, however, is equally as essential because any deterioration of their financial position would ultimately affect the state budget. Such a deterioration could develop progressively, remaining unnoticed for a long period, because there would be no concern about banks, solvency. When finally discovered, such a deterioration would materialize in the form of a need for recapitalization, at the State,s budget expenses.

followed-where banks are the major (or the sole)players in domestic financial markets.

Therefore, as in conventional banking, an appropriate regulatory framework for an Islamic system should aim at reinforcing banks, operating environment, internal governance, and market discipline. To help develop such a regulatory framework, standards and best practices established by the Basle Committee on Banking Supervision are usful and provide a valuable reference.[1] However, these standards are not always applicable in an Islamic banking framework in the same way as in conventional banking systems.

Islamic banking implies special issues that need to be recognized and addressed to help make the conduct of banking supervision more effective. First, it is most important to recognize the impact of PLS modes of financing on Islamic banks. Specifically the fact that when Islamic banks provide funds through their PLS facilities, there is no recognizable default on the part of the agent-entrepreneur until PLS contracts expire, barring proved negligence or mismanagement on the part of the agent-entrepreneur. In fact, a "default" of PLS contracts means that the investment project failed to deliver what was expected, that is a lower or no profit, or a loss. In this case, the lower profit/loss is shared between or among parties according to the stipulated PLS ratios For example, in the case of a Mudaraba contract, the bank is entitled to receive from the entrepreneur the principal of a loan at the end of the period stipulated in the contract, if and only if, profits have accrued. If, on the contrary, the enterprise,s books showed a loss, the bank would not be able to recover its loan.[2] Moreover, such a situation would not normally constitute default on the part of the entrepreneur, whose liability is limited ot his time

---

1 - See Core principles for Effective Banking Supervision (April 1997).

2 - Of course, in the typical case of a restricted Mudaraba, the bank seeks to stipulatein the Mudaraba contract certain conditions that it considers essential for a successful outcome. However, this is done ex-ante and the contract,s terms and conditions cannot be altered during the life of the contract except-with the mutual consent of the parties.

and efforts. Additionally, banks have no legal means to control the agent-entrepreneur who manages the business. This individual has complete freedom to run the enterprise according to his best judgement. Banks are contractually entitled only to share with the entrepreneur the profits (or losses)stemming from the enterprise according to the contractually agreed PLS ratio.[1] In Musharaka and direct investment contracts, banks have bette opportunities to monitor the business they invest in. Indeed, in these arrangements, all partners may concur to the mangement of the enterprise and banks hold direct voting rights (see Table 1).

The above situation underscores investment risk as the most critical operational risk affecting banks operating according to a paradigm version of Islamic banking because it is inherent in their core activities. those carried out through the PLS modes of financing. Moreover, the assessment and management of investment risk becomes more difficult in an Islamic environment than in conventional banking because of the following factors: (1)in Mudaraba contracts, the bank cannot exert control on the management of the investment project; (2)PLS modes cannot systematically be made dependent on collateral or other guarantees; (3)administration of the PLS modes is more complex compared with conventional financing. Indeed, these modes imply several complex activities that are not normally performed by conventional banks. These activities include the determination of profit and loss sharing ratios on investment projects in various sectors of the economy, and the ongoing auditing of financed projects to ensure that Islamic banks,

1 - By contrast, Khan and Mirakhor, 1993, contend that banks have direct and indirect control over the agent-entrepreneur through both explicit and implicit contracts. This is so becouse banks could refuse further credit or blacklist the agent-entrepreneur and (an important consideration in the Islamic ethos) because the agent-entrepreneur puts at stake his credibility and respectability; therefore a strong deterrent to irresponsible behavior would be put in place. However, it still remains a matter of fact that the bank has no legal means to intervence in the management of the current enterprise while it is being run by the agent-entrepreneur.

share of profits are fairly calculated; and (4) the relatively weak legal framework supporting bank lending operation.

Therefore, in order to safeguard invested funds and realize profits, Islamic banks would need to rely moer than conventional banks on a set of appropriate policies and adequate infrastructure for protfolio diversification, monitoring, and control. They would also need to rely on the existence of an adequate supply of trained banking staff skilled in investment and Islamic banking practices to implement these policies. However, as the experiences of other developing and transition economies indicate, appropriate policies and infrastructure for risk-management and human technical expertise are difficult to establish and require a considerable amount of time to develop.[1] Therefore, the regulatory framework for banking supervision should be designed to help address these issues.

Second, information disclosure is more important in an Islamic environment than it is in a conventional banking system. This is the case because the absence of protection for investment depositors is at the core of Islamic banking, as argued in Section II.[2] Indeed, the more depositors are left unprotected, the more public disclosure of information about banks, policy objectives and operational strategies is necessary to enable creditors and depositors to monitor banks, performance. Further, in an Islamic banking framework, depositors have more incentives to monitor banks, performance than conventional depositors. This is due to the fact that capital value of and returns on investment deposits are not fixed and guaranteed, but, as noted previously, depend on banks, performance in investing depositors, funds.

1 - Khan and Mirakhor, 1989, argue that the shortage of ixpertise in PLS financing in commercial bankis is one of the most important reasons explaining the slow growth of PLS modes of financing in Iran.

2 - It should be noted, however, that, in principle, a deposit insurance arrangement, whereby a third party (excluding the central bank, the government, and the interested deposit bank) agrees, against the payment of a price, to ensure investment depositors is possible in an Islamic banking framework.

Hence, depositors have incentives to monitor Islamic banks not only to seek to protect the capital value of their funds, but also to seek to ensure that the rates of return paid to them reflect a fair application of the PLS principle on banks, net profit. Therefore, by reducing information asymmetries, a clear and concise disclosure of key data and information is likely to allow depositors more flexibility in choosing a specific bank in which they can allocate their funds according to their risk preferences. This is the case in a paradigm version of Islamic banking (where the relationship between banks and depositors is regulated according to an unrestricted Mudaraba contract)because depositors would be able to choos among different banks disclosing different investment objectives and policies. It is even more the case if banking practices diverged from the paradigm version as, for instance, in the Islamic Republic of Iran where banks are allowed to accept depositors, funds for investment in specific types of projects (in this case, a restricted Mudaraba is possible also on the liabilities side).

Additionally, appropriate information disclosure can provide the supervisory authorities with a better understanding of banks, strategies and their relevant risks. This places the supervisors in a better position to exercise effective prudential supervision, hence reducing systemic risks.

Based on the above considerations, an appropriate regulatory framework for banking supervision in an Islamic environment should be designed to ensure that: (A) legal foundations for the supervision of Islamic banks are in place; (B)investment are adequately dealt with, taking into account that financing through the PLS modes adds an element of complexity to the already difficult task of investment banking; and (C)adequate information is disclosed to allow the supervisory authorities to exercise a more effective prudential supervision and to enable the public to make reasonably informed investment decisions . Greater stress on these issues, particularly during the licensing process, is likely to strengthen financial system surveillance in countries where Islamic banking is followed.

A. Legal Foundations

In order to provide the legal foundations for the supervision of Islamic bank, it is necessary that either the general banking laws or specific laws pertaining to Islamic banks define in detail the nature of these banks and their specific operating relationship with the central bank and other conventional banks, if applicable. Such a legal framework should contain provisions relating to licensing, permissible modes of financing, and stats clearly powers to address compliance with laws and regulations, In particular, such provisions should determine which enterprises may call themselves Islamic banks, collect deposits, and carry out banking practices on the basis of Islamic principles. Moreover, laws should state clearly that the central bank (or a separate supervisory authority)has the authority and all necessary powers to supervise Islamic banks and conventional banks, if applicable.[1]

B. Management of Operational Risks

Management of operational risks in Islamic banks cold usefully be addressed through an appropriate CAMEL rating framework. CAMEL rating is a measure of the relative soundness of bank and is calculated on a 1-5 scale, with one being a strong performance. The acronym stands for capital, assets, management, earnings, and liquidity. These are the five critical dimensions of a bank,s operations. They reflect in a systematic fashion a bank,s financial condition, compliance with supervisory regulations, and overall operating soundness.[2] The standard CAMEL rating system would need to be

---

1 - The above approach has been adopted by the authorities of contries where all banks and financial institutions operate according to Islamic principles (i.e., Iran, pakistan, and sudan), as well as a number of countries where Islamic banks operate alongside conventional banks (for example, Jordan, Malaysia, Egypt, and United Arab Emirates).

2 - For more details on the CAMEL rating, see Bulletin 97-1, Comptroller of the currency Office, January 3, 1997 and Notices, Federal Register, Vol. 61,n. 245, December 19, 1996.

appropriately adapted to an Islamic banking environment as discussed below.

B.1 Capital

In a standard CAMEL rating, capital adequacy is evaluated (1 through 5)according to: (1) the Volume of risk assets; (2) the volume of marginal and inferior assets; (3)bank growth experience, plans, and prospects; and (4)the strength of management in relation to all the above factors. In addition, consideration may be given to bank,s capital ratios relative to its peer group.

The bulk of the assets of banks operating according to a paradigm version of Islamic banking is represented by PLS transactions, that is mostly uncollateralized equity financing. These assets are far riskier than the ones represented by non-PLS transactions, which are collateralized commercial or retail financing operations. As noted in section II, PLS transactions are at the core of Islamic banking, while non-PLS modes are at the margin. Hence, the ratio of riskier assets to total assets can be higher in an Islamic bank than it is in a conventional bank. Therefore, a CAMEL rating for capital adequacy in an Islamic environment should place more emphasis on factor (1) than is the case in a standard CAMEL. All the other rating factors can usefully be applied in an Islamic framework without major changes from standard practices. Additionally, an appropriate assessment ot the capital adequacy ration in an Islamic environment should address two issues: the level of this ratio and the risk-weighting methodology for its calculation.

B.1.1. Level the capital adequacy ratio

According to widely accepted international standards defined by the Basle Committee on Banking supervision, banks, risk-weighted capital adequacy ratio should be at least at 8 percent. However, while the Basle Committee,s minimum level of eight percent may be an acceptable floor given the operational environment of banks in OECD countries,[1] it should be

1 - Most major OECD banks have capital ratios on the order of 10-12percent.

somewhat higher in an Islamic environment. This is the case because of specific reasons inherent to the operation of Islamic banking, as well as more general reasons that are de facto part of the high-risk environment in which most Islamic banks operate. The specific reasons are the following: (1) Mudaraba contracts put depositors, funds at risk, but allow a portion of profits to accrue to banks, owners. This creates a potentially strong incentive for risk taking and for operating financial institutions without suitable capital. Hence, to help teduce moral hazard, it would be important for the banker to have substantial amounts of his own capital at risk;(2) as argued above, the ratio of riskier assets to total assets is typically higher in Islamic banks than it is in conventional banks; and (3) as noted previously, the lack of control on investment projects in Mudaraba transactions and, more generally, the absence of collateral and other guarantees in PLS transactions clearly raise the overall riskiness in Islamic banks, operations,[1] Some of the factor contributing to the high-risk environment of most developing and emerging market countries in which Islamic banks (as well as conventional banks) operate are. (1) a relatively weak legal infrastructure supporting bank lending operations; (2)underdeveloped financial markets; (3) a volatile economic environment, contributing to an uncertain financial condition in the enterprises sector; and (4) the less diversified nature of the economy.[2]

1 - By contrast, it may be argued that operations of Islamic banks are less risky than conventional banks for the very reason that part of the risk is transferred to depositors. Also, in an Islamic system, income is accounted on a cash basis and not on accrual basis. This may reduce the danger of accumulation of nonperforming assets. Moreover, the ability of Islamic banks to reduce the capital value of investment deposits in case of a loss, may be argued to be tantamount to an automatic setting aside of provisions against loan losses. However, these arguments seem to be based on the assumption that individuals should not be concerned about the principal value of their deposits and that the integrity of the banking system as such does not need to be protected. This can hardly be the case even in a paradigm version of Islamic banking.

2 - See also Dziobek et al, 1995.

The assessment of an appropriate level of the capital adequacy ratio for Islamic banks should be primarily based on a thorough analysis of the composition of the underlying asset portfolio between PLS and non-PLS transactions. To complete this exercise in a meaningful way, one should have detailed information on current assets valuation and loan-loss provisioning practice in each country where Islamic banking is followed. However, the general lack of uniformity in accounting standards, particularly in relation to income recognition and profit calculation, makes it difficult to compare financial statements of different Islamic banks. This situation remains a serious one despite considerable progress made by the Accounting and Auditing Organization for Islamic Financial Institutions to produce common standards designed to be consistent with and complement International Accounting Standards.[1] Moreover, current information on the adequacy of Islamic banks, provisions, procedures for making such provisions, and data reported to central banks regarding classified loans and corresponding provisions is not easily accessible to researchers. Additionally, differences in the tax treatment of loan loss provisions and banks, profits further. Complicate this exercise, Therefore, while it can be reasonably argued that the minimum capital adequacy ratio for Islamic banks should be somewhat higher than the Basle Committe,s minimum level of 8 percent, it is more difficult to envisage a precise figure which may make sense for and reflect the particular situations of so many countries. Hence, it seems appropriate to conclude that the assessment of an appropriate level of the capital adequacy ratio for Islamic banks should be carried out on a bank-by-bank and country-by-country basis, taking into account all the elements discussed in this section.

---

1 - This underscores the need for greater standardization in Islamic bankingaccounting practices as an important factor for further growth of Islamic banking.