REGULATION AND SUPERVISION OF ISLAMIC BANKS

Abayomi A. Alawode
Manager, Financial Systems Global Practice
World Bank
Background
Growth of Islamic Banking Assets

## Domicile of Islamic Banking Assets (Top-10)

<table>
<thead>
<tr>
<th>Country</th>
<th>Share (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Iran</td>
<td>39.7</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>13.7</td>
</tr>
<tr>
<td>Malaysia</td>
<td>9.8</td>
</tr>
<tr>
<td>UAE</td>
<td>9.1</td>
</tr>
<tr>
<td>Kuwait</td>
<td>9.0</td>
</tr>
<tr>
<td>Qatar</td>
<td>4.1</td>
</tr>
<tr>
<td>Turkey</td>
<td>2.7</td>
</tr>
<tr>
<td>Bahrain</td>
<td>2.3</td>
</tr>
<tr>
<td>Indonesia</td>
<td>1.5</td>
</tr>
<tr>
<td>Egypt</td>
<td>1.1</td>
</tr>
</tbody>
</table>

*Source: Islamic Financial Services Industry: Stability Report 2013*
Features of Islamic Finance

- Prohibition of interest on transactions (riba)
- Prescribed modes of financing: profit- and loss-sharing (PLS) and non-PLS
- Financing linked to real assets, the performance of which determines the return to the investor (materiality)
- Avoidance of transactions involving uncertainty (gharar)
- Prohibition of financing or investment in certain activities (e.g. alcohol, armaments, pork production, gambling)
- Zakat (compulsory religious alms tax)
- Moral values and ethics (good conduct); trust, respect for contracts and property rights
Islamic Modes of Financing: 1

- **Mudaraba**: Trustee finance contract (PLS)
- **Musharaka**: Partnership; equity participation contract (PLS)
- **Murabaha**: Sale with agreed mark-up (non-PLS)
- **Ijara/Ijara wa iqtina**: Leasing (operational and finance) (non-PLS)
- **Istisna**: Work-in-progress financing (non-PLS)
- **Salam**: Purchase with deferred delivery (non-PLS)
- **Qard al hasan**: Interest free loan (non-PLS)
## Islamic Modes of Financing: 2

<table>
<thead>
<tr>
<th>Mode of Financing</th>
<th>Key Features</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Mudaraba</strong> (trust financing)</td>
<td>One party contributes capital while the other contributes effort or expertise; profits shared according to a predetermined ratio; investor not guaranteed a return and bears any financial loss; no fixed annual payment; financier has no control on how venture is managed</td>
</tr>
<tr>
<td><strong>Musharaka</strong> (joint venture, equity financing)</td>
<td>Both parties contribute capital; profits shared by a pre-determined ratio, not necessarily in relation to contributions; losses shared in proportion to capital contributions; both parties share and control how investment is managed; each partner liable for the actions of the other</td>
</tr>
<tr>
<td>Mode of Financing</td>
<td>Key Features</td>
</tr>
<tr>
<td>-----------------------------------</td>
<td>-----------------------------------------------------------------------------</td>
</tr>
<tr>
<td><strong>Murabaha</strong> (Sale with mark-up)</td>
<td>Financing purchase of assets for a profit margin; asset purchased on behalf of client and resold at a pre-determined price; payment could be lump sum or in installments; ownership of asset remains with bank till full payments made</td>
</tr>
<tr>
<td><strong>Ijara/Ijara wa iqtina</strong> (operational and finance leasing)</td>
<td>Bank purchases asset on behalf of client; allows usage of asset for a fixed rental payment; ownership of asset remains with the bank but may gradually transfer to the client who eventually becomes the owner (ijara wa iqtina)</td>
</tr>
<tr>
<td>Mode of Financing</td>
<td>Key Features</td>
</tr>
<tr>
<td>-----------------------------------------</td>
<td>--------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td><strong>Istisna</strong> <em>(work in progress financing)</em></td>
<td>Agreement to sell a non-existent asset to a customer; asset to be manufactured or built according to the buyer’s specifications; to be delivered on a specified future date at a pre-determined selling price; usable for construction or pre-shipment export finance</td>
</tr>
<tr>
<td><strong>Salam</strong> <em>(purchase with deferred delivery)</em></td>
<td>The bank makes full prepayments for future delivery of a specified quantity and quality of goods on a specified date; typically used for commodity finance</td>
</tr>
<tr>
<td><strong>Qard al hasan</strong> <em>(benevolence loan)</em></td>
<td>Zero-return loan to needy and poor people; borrower only obligated to repay the principal</td>
</tr>
</tbody>
</table>

---

*Islamic Modes of Financing: 4*
## Balance Sheet Structure of Islamic Banks

<table>
<thead>
<tr>
<th>LIABILITIES</th>
<th>ASSETS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Demand Deposits (Amana)</td>
<td>PLS Financing</td>
</tr>
<tr>
<td></td>
<td>-- Mudaraba</td>
</tr>
<tr>
<td></td>
<td>-- Musharaka</td>
</tr>
<tr>
<td>Investment Accounts (Mudaraba, Wakala)</td>
<td>Non-PLS (Murabaha, Ijara, Salam)</td>
</tr>
<tr>
<td>-- Restricted and Unrestricted</td>
<td>-- Sales receivables</td>
</tr>
<tr>
<td>Profit equalization reserve</td>
<td>-- Inventories</td>
</tr>
<tr>
<td>Investment risk reserve</td>
<td>-- Leased assets</td>
</tr>
<tr>
<td>Equity</td>
<td>Qard Al Hasan</td>
</tr>
</tbody>
</table>

Risk Profile of Islamic Banks: 1

- Unique risk factors
  - Displaced commercial risk
  - Sharia compliance and other “contractual” risks
  - Rate of return risk
  - Fiduciary risk
  - Equity investment risk
  - Moral hazard and agency risks (*Mudaraba and Musharaka*)

- Risk-sharing with Investment Account Holders (IAHs) in PLS structures
  - IAHs bear credit and market risks; bank bears operational risks
Risk Profile of Islamic Banks: 2

- “Regular’ risks also present but sometimes manifest in different ways
  - Counterparty risk of delivering assets before receiving payment (murabaha)
  - Market risks of movements in underlying benchmark rates (murabaha)
  - Reputational and operational risks of Sharia non-compliance

- Liquidity management particularly difficult for Islamic banks
  - Inter-bank market and lender-of-last-resort facilities are interest based
  - No access to typical money market instruments
  - Shallow secondary market for Sukuk
  - Use of short-term commodity murabaha
Selected Regulatory and Supervisory Issues
Objectives of Regulation and Supervision

- For both conventional and Islamic banks, objectives of regulators/supervisors are similar
  - Protection of depositors and promotion of public confidence in the financial system
  - Reducing systemic risk and fostering financial stability
  - Consumer protection
  - Promoting competition and efficiency
- Ultimately, the goal is to ensure that banks operate in a safe and sound manner and do not pose threats to financial stability
- Possible developmental role of Islamic regulatory regime
Models of Regulating Islamic Banks

- **Fully Islamic**: All banks are fully Islamic and no conventional banks allowed (e.g. Iran and Sudan)

- **Dual Regulation**: Islamic banks operate alongside conventional ones, typically under the same regulator; different sets of regulations for both, allowing consideration of specificities of Islamic finance (e.g. Bahrain, Malaysia, Turkey, UAE)

- **Single Regulation**: Islamic and conventional bank under the same regulator; same regulations for conventional banks applied with modifications where appropriate for Islamic banks (e.g. UK, Germany)
Licensing and entry

- Satisfactory business plan (including strategy and market objectives)
- Prudential requirements (e.g. paid-up capital, liquidity and reserve requirements, internal controls, financial records and reporting, etc)
- Categories of licenses: retail, wholesale, stand-alone, Islamic window
- Permissible activities and product offerings
- Governance arrangements (e.g. role of Sharia Supervisory Board) and approval of key personnel (expertise, fit and proper, etc)
- Risk factors and mitigation arrangements
Capital Adequacy

- IFSB recommends a minimum capital adequacy requirement of 8% of Risk-Weighted Assets (RWA)
  - Risk profiles and exposures based on underlying Sharia contracts (asset-based, lease-based, or equity based)
  - Risk measurements covering credit risk, market risk and operational risk (Pillar 1 of Basel 2)

- No capital charges for IAs, since losses are to be borne by the investor

- However, if the bank practices income smoothing, a percentage of assets financed by IAHs should be included in the RWA (AAOIFI recommends 50% risk-weighting)

- Liability for losses arising from negligence, misconduct or breach of contract captured under charges for operational risk (fiduciary risk)
Corporate and Sharia Governance

- **Two boards**: Board of Directors and Sharia Board

- Sharia Governance System (Single or Multiple arrangements)
  - Well defined criteria in appointing Sharia Board members (clear TOR, competence, fit and proper, confidentiality, etc)
  - Issuance of pronouncements
  - Dissemination of pronouncements to operational staff
  - Sharia compliance audits
  - Annual Sharia compliance review (external)

- Board and management oversight; transparency and disclosure

- Fiduciary responsibilities for Investment Account Holders
Consumer protection and market conduct

- Full disclosure in financial promotions
- Dispute resolution (bank level; supervisory level)
- Sharing of profits (fairness and equity and clear criteria for setting profit equalizing reserves)
- Deposit protection (part of safety net)
- Financial literacy
Transparency, disclosure and market discipline

- Formal disclosure policy desirable
- Financial disclosures (e.g. capital structure/adequacy, structure of deposits and investments)
- Disclosures for demand depositors and Investment Account Holders
- Risk management, risk exposures and risk mitigation
- General governance and Sharia governance disclosures
- Guidelines on financial reporting: annual and quarterly reports
- Accounting and auditing standards (e.g. reporting of restricted investment accounts)
Challenges for Effective Oversight

- Legal foundations of Islamic finance still developing
- Lack of standardization of Islamic finance principles
- Limited adoption of IFSB and AAOIFI Standards
- Safety net arrangements (LOLR and deposit protection)
- Challenges of liquidity risk management
- Off-site surveillance systems (soundness indicators and stress-testing)
- Failure resolution
Looking Forward

- Need to align Islamic finance regulations with global regulatory standards
  - Increased activity of Islamic banks across borders and the need for cross-border supervisory cooperation
  - Increasing integration with global financial system and the probability of risks being transmitted

- Wider adoption of IFSB Standards critical to establishing a solid regulatory and supervisory foundation
  - Translating Standards into Guidance Notes
  - Core Principles for Regulation and Supervision of Islamic Banks
  - Assessment of Standards in FSAPs (experience of conventional standards)
  - Benchmarking implementation progress through case studies of implementation efforts
Thank You