Capital of Alternative Financial institutions and Basel II: Credit Cooperatives and Islamic Banks

Introduction

Not all banks and bank-like financial institutions conform to the model for which rules on capital requirements are generally designed. Thus the balance sheet which underlies the rules of the Basel Capital Accord of 1988 and now of Basel II is that of a conventional financial institution whose liabilities consist of deposits, standard forms of debt, equity, and hybrid financial instruments with both debt and equity characteristics. However, financial systems often also include institutions that are based on alternative concepts as to their rationale with consequences for their operations and risk management and for the items on their balance sheets. Regulatory regimes accordingly include features designed to cover such institutions with implications for the definition and application of requirements as to the adequacy of their capital.

For example, the regulations for banking of the EU cover credit institutions set up as cooperatives for which the distinction between depositors and shareholders differs from that of a conventional bank, the remuneration of shareholders reflecting different risks.[1] For Islamic banks the payment of interest is forbidden, and the holders of their liabilities share in banking risks in accordance with different principles and rules from those applying to conventional financial institutions.

Historically the regulation of non-profit institutions such as credit cooperatives has typically had a focus distinct from that of conventional banks and investment firms, and its implementation is not always entrusted to the same supervisory bodies. Prudential regulation has focussed more on safety for individual depositors or shareholders and not on the implications for systemic risk of the failure of such institutions. The reasons for this difference lie in factors such as the frequently relatively small size of the alternative financial sector and its links, if any, to arrangements for payments and settlement, which are considered an important vehicle for the wider transmission of shocks throughout the financial system. Recently, however, there have moves in the EU to bring cooperative credit institutions[2] inside or closer to the ambit of the regulatory regime of conventional financial institutions, including the rules for capital adequacy. Various reasons seem to be behind this. These include the belief that a standardised set of minimum rules should apply through the region's single financial market to facilitate cross-border supervisory cooperation and to minimise regulatory arbitrage among rules applying to different national jurisdictions.

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[1] An example in the EU of a cooperative financial institution is the British building society. These are non-profit savings banks with origins in the 18th century and the self-help movement of skilled workers during the Industrial Revolution that specialise in the provision of mortgages for owner-occupied houses. As mutual organisations they have no owners distinct from those holding their shares. Their liabilities include deposits and shares, of which by far the largest are the latter. Shares have little in common with those of conventional capitalist enterprises. Shareholders are classified as members of the building society, whereas depositors are merely its creditors. Since depositors have prior access to the society's funds in the event of its liquidation, they receive a lower rate of interest on their funds than shareholders. In the event of the conversion of a building society from cooperative status through transfer to a commercial company its shareholders are financial beneficiaries. The surpluses of building societies are retained as reserves, which are maintained at levels considered prudent in the light of experience regarding losses. Regulation and supervision of building societies was historically the responsibility of the Registrar of Friendly Societies until 1986 when this was transferred to the Building Societies Commission. Under the new unified system of regulation now in force the Financial Services Authority has assumed this responsibility. Regulation of building societies is based on a system of returns and reports covering balance-sheet data, management and internal controls.

[2] "Credit institutions" are defined as undertakings whose business is to receive deposits or other repayable funds from the public and to grant credits for their own account.

Basel II has also been accompanied by re-examination of the legal and regulatory frameworks for Islamic banking, in particular of those parts related to the incidence and management of banking risks and the role played by capital. This re-examination seems to be driven by factors such as the wish to enhance international perceptions of such banks and the enhanced interest in the management of financial risk generated by Basel II. In non-Islamic countries, including several in the EU, where Islamic banks serving Islamic communities coexist with non-Islamic financial institutions, there is pressure for the regulation applying to the former to be as compatible as possible with that for conventional banks in the interest of achieving an acceptable level of conformity within overall regimes. The location in many cases of entities providing financial services according Islamic rules – in Islamic as well as non-Islamic countries – within larger banks subject to regulation and supervision along conventional lines has probably also contributed to pressure for regulatory convergence. Moreover the increased integration of financial markets inevitably leaves Islamic banks exposed to some extent to changes in credit and market risks that are the same as for non-Islamic banks and have their origins in cyclical movements and financial instability with cross-border or economy-wide effects.

The EU regime for cooperative credit institutions

The recitals (31) - (34) of the EU's directive on the taking up and pursuit of the business of credit institutions set out the key objectives of its regime for "own funds," a term intended to comprise not only capital but also other items serving the same function for the institutions covered by the directive.[3]

> "Common basic standards for the own funds of credit institutions are a key factor in the creation of an internal banking market since own funds serve to ensure the continuity of credit institutions and to protect savings. Such harmonization strengthens the supervision of credit institutions and contributes to father co-ordination in the banking sector."
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> "Such standards must apply to all credit institutions authorized in the Community."
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> "The own funds of credit institutions can serve to absorb losses which are not matched by a sufficient volume of profits. The own funds also serve as an important yardstick for the competent authorities, in particular for the assessment of the solvency of credit institutions and for other prudential purposes."
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> "Credit institutions, in an internal banking market, engage in direct competition with each other, and the definitions and standards pertaining to own funds must therefore be equivalent. To that end, the criteria for determining the composition of own funds must not be left solely to Member States. The adoption of common basic standards will be in the best interests of the Community in that it will prevent distortions of competition and will strengthen the Community banking system."

Under Article 36.1 of the directive for credit institutions set up as co-operative societies own funds consist of members' commitments which "shall comprise those societies' uncalled capital; together with the legal commitments of the members of those co-operative societies to make additional non-refundable payments should the credit institution incur a loss, in which case it must be possible to demand those payments without delay." Moreover "The joint and several

[3] See European Parliament and Council Directive 2000/12/EC of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions (published in *Official Journal* L126, 26 May 2000), which consolidates and amends several earlier directives including Council Directive 89/299/EEC on the own funds of credit institutions of 17 April 1989.

commitments of borrowers in the case of credit institutions organised as funds shall be treated in the same way as the preceding items." This language is necessarily general since it must cover a wide variety of countries' legal and institutional arrangements: "All such items may be included in own funds in so far as they are counted as the own funds of institutions of this category under national law."

The specification of the resources capable of serving, like capital, as a buffer against losses for non-profit financial institutions in this extension of EU rules is of interest in itself. But it also illustrates problems that can arise when such institutions are brought within a single set of regulatory rules originally designed to assure the solvency of conventional financial institutions. To the extent that these resources consist of accounting items classified as sources of capital for conventional institutions (and specified as such, for example, in the Basel Capital Accord of 1988 and Basel II), they do not present problems going beyond the possible need to set rules for the contributions to non-profit institutions' own funds made by the various categories of such resources which reflect risks different from those of conventional institutions.[4] But the directive also refers to callable capital and to contingent obligations connected to the cooperative credit institutions' mutual character. These are difficult to measure for the purposes of supervisory solvency ratios as well as more generally as part of the institutions' accounting. Thus under International Accounting Standard (IAS) 37 these items would be classified as contingent liabilities since they correspond to "a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise."[5] Contingent liabilities are not recognised in the balance sheet or income statement. They are disclosed, and under disclosure is included estimation of their financial effect where this is practicable. But no general guidelines as to measurement for this purpose are provided.

Islamic banking[6]

Islamic banking is based on a set of precepts, many of which differ radically from those underlying its conventional non-Islamic counterpart. These precepts include the following.

- The return on the use of money as such (without any other consideration), *riba*, and thus interest, is not permitted.
- Contracts linked to the occurrence or non-occurrence of uncertain future events are not allowable. Such contracts include those for hedging and other derivatives.
- Transactions for purely speculative purposes are not permitted. Trading or investment transactions that may lead to losses as well as profits are not included in this prohibition.

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[4] As a concrete illustration of rules for the capital of a non-profit cooperative financial institutions in the United States those of the National Credit Union Administration (NCUA) for credit unions include the allowance for loan losses, the regular reserve, the investment valuation reserve, other reserves, accumulated unrealised gains on "available-for-sale" investments, earnings not distributed as dividends, and the year's net income after deduction of amounts to cover problem loans, any excess of book over fair value of investments, and other identified losses. See NCUA, Letters No. 161 and 167 to Credit Unions, December 1994 and May 1995.

[5] See International Accounting Standards Board, *International Financial Reporting Standards 2003* (London: IASCF Publications Department, 2003).

[6] This brief account of Islamic banking is based heavily on Bahrain Monetary Agency, *Islamic Banking and Finance in the Kingdom of Bahrain* (Bahrain: Arabian Printing Press, 2002); "Bahrain, a Center of Islamic Finance in the Gulf", interview with Waleed Abdulla Rashdan, Executive Director of Banking Operations at the Bahrain Central Bank, *Finance and the Common Good*, Autumn 2003; and D.El-Hawary, W.Grais and Z.Iqbal, "Regulating Islamic Financial Institutions: the nature of the regulated", *World Bank Policy Research Working Paper 3227*, March 2004.

- Transactions involving certain activities or commodities are prohibited. These include pork, pornography, conventional financial services, arms and munitions with certain exceptions, cinema, tobacco, gambling and alcoholic liquor.
- The asset side of the balance sheet should consist of positions only related to permitted activities. There is greater emphasis than in conventional banking on the closeness of the link between banks' assets and their backing in real economic activities – sometimes denoted by the need for a financial transaction to have a "material finality."

This set of precepts is not comprehensive, others sometimes mentioned under this heading, for example, including the principle that a financial transaction should not lead to exploitation to any of the parties to it. Unsurprisingly the application of the precepts is not uniform. This reflects variations in the interpretation given to Islamic concepts both by banks' Supervisory Sharia Boards and in legal and regulatory systems. Not all Islamic countries have Islamic banking laws. Such laws are in place in Indonesia, Iran, Malaysia, Pakistan, Sudan, Turkey, United Arab Emirates and Yemen but not in Egypt and Saudi Arabia. The regulatory framework in Saudi Arabia makes no distinction between conventional and Islamic banks but the latter are supposed to follow Sharia. However, the regulatory authority, the Saudi Arabian Monetary Agency, has not assumed obligations regarding compliance with Sharia.

Islamic precepts have implications for both the assets and liabilities of banks. On the liabilities side they do not permit the use of interest to mobilise funds. There are various available contractual relationships for account holders, which include non-interest-bearing deposits and, much more importantly in quantitative terms, profit-sharing investment accounts (PSIA), i.e. partnerships between capital and work (*mudaraba)* under which the bank manages the funds of customers in return for receiving a share of profits from activities financed. Under a strict interpretation of Islamic precepts holders of PSIA also agree to bear losses from the investment of their funds. In practice, owing to competitive pressures on Islamic banks to match the terms on deposits in non-Islamic banks, the returns on PSIA are "smoothed" by drawing on income that might otherwise have been attributed to their shareholders, with the result that such banks are able to offer investors accounts that closely resemble deposit or savings accounts in conventional banks.

Islamic banks face risks which belong mostly to the same categories as those of conventional banking but with differences in relative importance which reflect partly differences in the banks' rules and thus in their operations and the nature of their exposures. Regulation of banks operating in accordance with Islamic precepts, like that of non-Islamic banks, is generally designed to ensure that their balance sheets and management meet certain standards. For example, in Bahrain, a major centre for Islamic banking, regulation is based on the items covered by the acronym, CAMEL – Capital Adequacy (C), Asset Quality (A), Management of Investment Accounts (M), Earnings Quality and Profit and Loss (E), and Liquidity Management (L).[7]

Under capital adequacy one initiative has been to develop a conceptual framework which is appropriate for the risks of Islamic banks but also parallels in important respects that of the 1988 Basel Capital Accord and Basel II. Capital adequacy regulations for non-Islamic banks are based on the assessment of credit and market risk in relation to the capital, which consists of shareholders' equity and other items such as retained earnings, certain categories of reserves, and hybrid instruments combining debt and equity, and which serves as a buffer against losses under both risk headings. As mentioned above, Islamic precepts by contrast involve risk sharing between the banks and holders of their liabilities, a close link between banking transactions and real assets,

[7] The same acronym serves as a profile for bank supervision in other countries. For example, supervision of banks in the United States includes rating on a scale of 1 (best) to 5 (worst) for each of the headings of CAMEL.

and avoidance of speculative activities, all of which are capable of affecting the level of banking risks incurred and their incidence between different parties. The bank is also exposed to the risk of losses due to mismanagement and negligence (fiduciary risks), which may lead to legal liability, and to the risk of transfers from shareholders' funds for the purpose of the "smoothing" of investors' returns mentioned above (displaced commercial risk).

A major result of this initiative is the 1999 *Statement on the Purpose and Calculation of the Capital Adequacy Ratio for Islamic Banks* of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).[8] This document proposes a method of calculating a capital adequacy ratio (CAR) for Islamic banks. The numerator of the ratio consists of items classified as capital under the 1988 Basel Capital Accord and Basel II with the exception of instruments included which have debt as well as equity characteristics (and not including PSIA accounts themselves which are not considered to serve the buffer function of capital). The denominator consists of risk-weighted assets as follows: assets financed by the bank's own capital and non-PSIA liabilities plus 50 per cent of assets financed by PSIA (to cover the fiduciary and displaced commercial risks of such assets).

Other approaches to the capital requirements and risk management of Islamic banks that put less emphasis than the AAOIFI initiative on features of an Islamic analogue to the 1988 Basel Capital Accord and Basel II have also been proposed by regulators, credit rating agencies, and other commentators.

- One approach would be to treat Islamic banks for regulatory purposes as mutual funds, whose obligation is to repay not the original sum invested but that remaining after taking account of gains or losses at the time of redemption. However, some commentators have observed that this would fall foul of account holders' own perceptions as to their deposits and investments. Mutual funds complying with Islamic precepts are already available to Muslims and are the recipients of substantial sums. But there are also large sums held in PSIA, which suggest that people distinguish between the two categories of account.[9] However, some commentators would accept regulatory treatment similar to that of mutual funds under the segmentation proposal of the second approach (see below) for entities within Islamic banks whose operations are similar to that of such funds.
- A second approach would be to structure liabilities and assets in entities designed to satisfy the differing objectives and risk appetites of account holders. In the entity intended for account holders with high risk aversion and a high requirement for liquidity their funds would be backed by asset-backed securities with low risk and easy marketability (i.e. in an entity similar to the "narrow bank"[10] of the theory of conventional banking); and funds of other account holders willing to incur greater risks would be similarly placed in entities with assets chosen appropriately in the light of their investment objectives.[11] Thus next to the entities for the most risk-averse would be entities similar to mutual funds for investors with risk appetites similar to those of investors in conventional versions of such funds. Regulation of these entities would follow lines similar to that of its conventional counterpart. A third kind of entity would be directed at the requirements of investors willing to take longer-term, riskier positions similar to investments in private equity and venture capital, which would require another type of regulation. This approach would

[8] AAOIFI, *Statement on the Purpose and Calculation of the Capital Adequacy Ratio for Islamic Banks* (March 1999).
[9] See A.Cunningham, "Islamic banks – in for a pound, in for a penny", *The Banker,* February 2000.
[10] A "narrow bank" is one whose deposits would be backed by assets with low risk and high liquidity such as various categories of government debt. The difference in comparison with an Islamic counterpart is that the assets of the latter could not include debt, though they would require similar levels of risk and liquidity.
[11] An approach along these lines is developed in El-Hawary, Grais and Iqbal, *op. cit.* at note 6, pp. 36-38.

appear to have the advantage over the first approach of accommodating all the different items amongst an Islamic bank's liabilities including non-interest-bearing deposits.

- A third approach, which has some support amongst regulators in the United Kingdom, would involve a structuring of liabilities according to a system of subordination of the rights of different categories of account holder.[12] This would be accompanied on the asset side by an appropriate classification of risks and eventual rules on capital adequacy, which take into account the actual risk experience of banks following Islamic precepts.

The global value of total assets managed according to Islamic principles is still relatively small. Approximate estimates place it at about $250 billion. This total can be compared with one of more than $3 trillion for the outstanding domestic credit advanced by United Kingdom banks and of about $10 trillion for United States banks.[13] However, such assets are growing at a pace well above 10 per cent annually which, if sustained, will eventually lead to amounts that are a significant proportion of global GDP.

More importantly from the standpoint of this workshop Islamic banking is of interest as a form of alternative financial institution based on precepts which not only pose practical regulatory problems but also serve as a mirror which can be held up to conventional banking and thus highlight some its implicit or less frequently examined assumptions and principles, including those with an ethical dimension. Among the Islamic principles particularly striking in the light of the excesses of the speculative financial boom recently experienced in advanced economies is the emphasis on trust and mutuality. One of the papers used for the writing of this note draws attention the way in which the contractual foundation of the Sharia judges a man's justice not only according to his material performance but also the intention with which he enters into a contract. The quality of this intention consists of its sincerity, truthfulness and the associated insistence on rigorous and loyal fulfilment of the contract's aims and elements. This faithfulness to contractual obligations is so central to Islamic beliefs that "when the Prophet was asked 'who is the believer?' He replied that 'a believer is a person in whom the people can trust their person and their possessions'."[14]

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[12] See H.Davies, "Regulatory issues facing Islamic financial institutions", and M.Foot, "The future of Islamic banking in Britain", contribution to the Islamic Financial Services Board (IFSB) London Summit, 19 May 2004.
[13] See W. Grais, "Perspectives for the Islamic finance industry", Remarks at the IFSB London Summit, 19 May 2004.
[14] El-Hawary, Grais and Iqbal, *op. cit.* at note 6, p.6.