IMF Working Paper

WP/98/30

INTERNATIONAL MONETARY FUND

Monetary and Exchange Affairs Department

Islamic Banking: Issues in Prudential Regulations and Supervision

Prepared by Luca Errico and Mitra Farahbaksh[1]

Authorized for distribution by William E. Alexander and Charles Enoch

March 1998

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 between the paradigm version and conventional banking. The case of Islamic banks operating in a conventional system is also examined.

JEL Classification Numbers: E58; G18; P51

Keywords: Islamic Banking, Prudential Regulations, Banking Supervision

Authors' E-Mail Address: lerrico@imf.org; mfarahbaksh@imf.org

[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 Cordella, Peter Hayward, Malcolm Knight, Hassanali Mehran, Ghiath Shabsigh, and Reza Vaez-Zadeh for their helpful comments.

Contents **Page**

SUMMARY

Islamic precepts influence the structure and activities 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 is not known and not fixed prior to the undertaking of each transaction. Islamic banks thus differ from conventional banks, but the issue of what prudential standards should apply to Islamic banks has received 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 reevaluated and given the appropriate 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 economies into western 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 process of establishing a fuller international integration of Islamic banking.

I. 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.[2]

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.[3] 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.[4] 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.[5] 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 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

---

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

[3] These countries are: Afghanistan, Albania, Algeria, 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, Syrian Arab Republic, Tunisia, Turkey, Turkmenistan, Uganda, United Arab Emirates, Republic of Yemen, and West Bank and Gaza (WBG).

[4] In this paper, the term "conventional" defines an interest-based bank or banking system.

[5] Iqbal, 1997.

guidelines established by the Basle Committee on Banking Supervision.[6] 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 strengthen 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 sectors 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 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 the 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 supervision 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.

---

[6] 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.

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 rights, contracts, work and wealth, and the role of the State.[7] While preserving their key tenets, the rules established in the *Shariah* 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 they are presented in the literature with a view to defining a paradigm version of Islamic banking and characteristics of banks operating according to it.[8] 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 return can be determined only ex-post, 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.

---

[7] 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.

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

- **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.

Table 1. Islamic Modes of Financing

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. 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.	Three conditions need to be met: 1. The bank should not reduce credit risk by requesting a collateral to this purpose: 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. The bank is entitled to receive from the entrepreneur 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 mismanagement.
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.

Table 1. Islamic Modes of Financing (concluded)

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. 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.
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.	
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:** [9]

  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.[10]

  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 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 service fee for its safekeeping services. Interest-free loans may only be granted from funds specifically deposited for that purpose.

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

---

[9] 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.

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

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 on deposits	Uncertain, not guaranteed	Certain and guaranteed
Mechanism to regulate final returns on deposits	Depending on banks' performance /profits from investment	Irrespective of banks' performance /profits from 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 [11] 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 worth noting. First, neither the capital value of nor the return on investment deposits is guaranteed by Islamic banks, and these banks basically pool depositors' funds to provide depositors with professional investment management. This situation underscores an interesting similarity between the operation of Islamic banks and investment companies.[12] There is, however, a fundamental difference between the two that

[11] Another school of thought maintains that such form of discretion by banks should not be possible. This approach would further strengthen the paper's arguments and conclusions.

[12] 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 its 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.)

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 corresponding to their shares on important matters, such as changes in investment policy.[13] Hence, they are in a position to take informed investment decisions, monitor the company's performance, and influence strategic decisions. By contrast, 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 bank's investment policy (as noted, their relationship with the bank is regulated according to an *unrestricted 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.[14] 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 a 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 players in the development of the economy. [15] This is so for a number of

---

[13] See *The Organization of Investment Companies and The Investment Company Act*, 1940, Section 13(a), United States Securities and Exchange Commission.

[14] On this point see also Khan and Mirakhor, 1989; and Iqbal, 1997.

[15] In some Islamic countries a significant portion of the banking sector is state-owned (in the case of Iran, all banks). Prudential supervision of state-owned banks, however, is equally as

reasons. First it is worth keeping 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 to 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 discipline. 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 achievement 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 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 useful and provide a valuable reference.[16] However, these standards are not always applicable in an Islamic banking framework in the same way as in conventional banking systems.

---

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.

[16] See *Core Principles for Effective Banking Supervision* (April 1997).

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. [17] Moreover, such a situation would not normally constitute default on the part of the entrepreneur, whose liability is limited to his time 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.[18] In Musharaka and direct investment contracts, banks have better opportunities to monitor the business they invest in. Indeed, in these arrangements, all partners may concur to the management 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

---

[17] Of course, in the typical case of a *restricted Mudaraba,* the bank seeks to stipulate in 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.

[18] 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 because 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 intervene in the management of the current enterprise while it is being run by the agent-entrepreneur.

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' 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 more than conventional banks on a set of appropriate policies and adequate infrastructure for portfolio 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.[19] 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.[20] 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. 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 choose 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

---

[19] Khan and Mirakhor, 1989, argue that the shortage of expertise in PLS financing in commercial banks is one of the most important reasons explaining the slow growth of PLS modes of financing in Iran.

[20] 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.

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 and other risks 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 banks, 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 state 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.[21]

B. Management of Operational Risks

Management of operational risks in Islamic banks could usefully be addressed through an appropriate CAMEL rating framework. CAMEL rating is a measure of the relative soundness of a 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

---

[21] The above approach has been adopted by the authorities of countries 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).

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.[22] The standard CAMEL rating system would need to be 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 a 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 of the capital adequacy ratio 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 of 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,[23] it should be 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

[22] 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.

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

and for operating financial institutions without suitable capital. Hence, to help reduce 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.[24] Some of the factors 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.[25]

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 practices 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.[26] 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

---

[24] 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.

[25] See also Dziobek et al., 1995.

[26] This underscores the need for greater standardization in Islamic banking accounting practices as an important factor for further growth of Islamic banking.

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.

B.1.2 Risk-weighting methodology

Conventional banks' assets side includes three broad categories of assets—current facilities to customers, net investments, and mortgage loans, that present, *inter alia*, a credit risk.[27] The Basle Committee's reference risk weights are 100 percent for current facilities to customers, 100 percent for net investments, and 50 percent for mortgage loans on residential properties. The lower risk weight assigned to mortgage loans is explained by the fact that loans fully secured by mortgage on occupied residential properties have a very low record of loss in most OECD countries.

As noted in Section II, Islamic banks' assets side includes all transactions carried out under the permissible Islamic modes of financing. On the basis of the economic functions that these models are expected to fulfil (see Table 1), it is possible to reconcile them with the three conventional broad categories of assets mentioned above, while recognizing that this exercise inevitably involves some approximation. For example, Islamic banks may have on their balance sheet transactions that are the result of a mix of different permissible Islamic modes of financing. Hence, it may become somewhat difficult to reconcile such transactions in a single conventional category. Moreover, very different Islamic modes, such as Mudaraba and non-PLS modes that are not secured by a mortgage (e.g., installment finance) fulfil the same economic functions of *current facilities to customers*.[28] Nevertheless, and keeping in mind the above caveats, Mudaraba contracts may be considered as *current facilities to customers;* Musharaka and direct investment as *net investments.* Depending on the specificities of each transaction—notably, the existence or not of a mortgage, non-PLS modes may be considered as *mortgage loans*, i.e., the least risky transaction, or *current facilities to customers.*

As noted previously, Islamic modes of financing also involve different degrees of riskiness. In particular, PLS modes are far riskier than non-PLS modes. Among the PLS

---

[27] Other types of risk also should be considered, for example, investment risk, exchange rate risk, and concentration risk. The Basle Committee methodology, however, focuses on credit risk, while discretion has been left to national supervisory authorities to build in certain other types of risk.

[28] Of course, Mudaraba and non-PLS modes are and remain very different transactions even if they may be viewed within the same broad category of current facilities to customers.

modes, Mudaraba transactions appear to be riskier than Musharaka or direct investment transactions because banks do not hold any "tangible" assets (i.e., shares representing a portion of equity capital of enterprises banks have invested in) to secure the funds loaned out. Additionally, as noted, Islamic banks have a lower degree of control (often no control at all) on the management of the enterprise they finance through a Mudaraba contract. By contrast, credit risk related to financing through non-PLS modes is lessened by the possibility of collateralization, including mortgage.

Therefore, an appropriate risk-weighting structure for an Islamic system should have the Mudaraba contract carrying the highest risk weight, followed by the two other main PLS modes, namely Musharaka and direct investment. The lowest risk weight should be assigned to non-PLS modes fully secured by a mortgage. All other non-PLS modes should be assigned a risk weight somewhere in-between the lowest one in the system and the one assigned to Musharaka and direct investment.

There appear to be no strong reason why Musharaka and direct investment should not carry the same risk weight assigned by the Basle Committee to the comparable assets category of *net investments,* i.e., 100 percent. This is the case because arguments for advocating a risk weight lower or higher than 100 percent seem to balance each other.[29] If Musharaka and direct investment transactions are assigned a risk-weight of 100 percent, then the appropriate risk weight on Mudaraba transactions should be ***at least*** 100 percent to reflect their somewhat higher riskiness. Non-PLS transactions fully secured by mortgage may well carry the same risk weight assigned by the Basle Committee to the comparable assets category of *mortgage loans*, i.e., 50 percent. By implication, all other non-PLS modes should carry a risk weight somewhere in-between 50 percent and 100 percent, to be determined on a case-by-case basis. However, it is more practical to minimize the number of risk weights that are used in the evaluation of Islamic banks' portfolios. Hence, assuming a conservative approach, all non-PLS transactions that are not fully secured by mortgage can be assigned a risk weight of 100 percent, in line with the Basle Committee's reference risk weight for the comparable assets category of *current facilities to customers*.

B.1.3 Off-balance sheet commitments

On the basis of available information, it appears that off-balance sheet activities, such as issuance of letters of credits, endorsements, and guarantees, do not substantially differ from

[29] Assignment of a risk weight lower than 100 percent can be argued on the grounds that Islamic banks cannot rely on collateral when they extend their PLS facilities, including Musharaka and direct investment. This can enhance Islamic banks' risk taking capabilities (for example, see Iqbal, 1997). By contrast, a risk weight higher than 100 percent may be warranted because of the factors that make the management of investment risk more difficult in Islamic banking than in conventional banking (see above).

similar activities carried out in conventional banks.[30] Accordingly, the Basle Committee methodology is applicable in this case. This means that all categories of off-balance sheet commitments must be converted to credit risk equivalents by multiplying the nominal principal amounts by a credit conversion factor; the resulting amounts are then weighted according to the nature of the counterpart. Hence, depending on the specific cases, off-balance sheet commitments should carry a credit risk conversion factor ranging from 100 percent (general guarantees, bank acceptance guarantees and stand-by letters of credit) to zero (short-term commitments that can be unconditionally canceled at any time).

B.2 Assets

In a standard CAMEL rating, asset quality is rated (1 through 5) according to: (1) the level, distribution, and severity of classified assets; (2) the level and composition of nonaccrual and reduced rate assets; (3) the adequacy of valuation reserves; and (4) the demonstrated ability to administer and collect problem credits.

With regard to factors (1) and (2), it should be recognized that, in an Islamic environment, assets represented by Mudaraba transactions cannot be classified until the relative contracts expire. Until that moment, there is no recognizable default with the exception of the proved negligence or mismanagement on the part of the agent-entrepreneur. As noted previously, "default" of PLS contracts mean that the investment project failed to deliver what was expected, that is a lower or no profit, or a loss. Nevertheless, PLS assets that deliver lower or no profit should be considered as reduced rate assets until the expiration of the relative contracts.

The ability of Islamic banks to reduce the capital value of investment deposits in case of a loss should *not* be viewed as tantamount to an automatic setting aside of provisions against loan losses. Indeed, this situation can hardly be compared with sound loan loss provisioning practices aimed at preserving the solvency and the viability of an Islamic bank as an ongoing operation. Additionally, it introduces strong incentives for moral hazard that could result in systemic risks. Hence, to help prevent the corrosive effect of problem assets on the level of capital, adequacy of valuation reserves should also remain a key factor in an Islamic environment.

With regard to factor (4), the ability of an Islamic bank to administer and collect problem credits should be evaluated in those cases where PLS contracts default before expiration because of negligence or mismanagement on the part of the entrepreneur as well as in all cases of defaulted non-PLS transactions.

---

[30] However, it should be noted that this issue is currently under consideration in several countries following Islamic banking.

B.3 Management

In a standard CAMEL rating, management is evaluated (1 through 5) according to: (1) technical competence, leadership, and administrative ability; (2) compliance with banking regulations and statutes; (3) ability to plan and respond to changing circumstances; (4) adequacy of and compliance with internal policies; (5) depth and succession; (6) tendencies toward self-dealing; and (7) demonstrated willingness to serve the legitimate needs of the community. All these factors are applicable in an Islamic banking environment too. Of course, in this case, the management's specific competence in Islamic banking practices and procedures should be key in such an evaluation (see also Section III.C).

B.4 Earnings

In a standard CAMEL rating, earnings are rated (1 through 5) according to: (1) the ability to cover losses and provide for adequate capital; (2) earnings trends; (3) peer group comparisons; and (4) quality and composition of net income. Earnings rated 1 are sufficient to make full provision for the absorption of losses and the accretion of capital when due consideration is given to asset quality and bank growth. Banks so rated typically have earnings well above peer group averages. Banks whose earnings are rated 5 are typically experiencing losses.

The above criteria are generally applicable to Islamic banks. Nevertheless, it should be kept in mind that, in Islamic banking, economic losses would first result in a depreciation of the value of the depositors' wealth, and then in a decline in the Islamic bank's profitability, particularly when that bank has also used its own resources (for example, through a Musharaka arrangement) to finance the loss-making investment projects.

B.5 Liquidity

In a standard CAMEL rating, liquidity is rated (1 through 5) according to: volatility of deposits; reliance on interest-sensitive funds; technical competence relative to structure of liabilities; availability of assets readily convertible into cash; and access to interbank markets or other sources of cash, including lender-of-last resort (LOLR) facilities at the central bank.

Contrary to conventional banks, Islamic banks cannot obtain funds through LOLR facilities, including Lombard and discount windows, as well as overdraft or other credit facilities operated by the central bank. This is due to the fact that all of the above facilities require the payment of an interest rate. Additionally, while, in principle, appropriately designed short-term financial instruments, interbank and money markets are possible in an Islamic banking framework, in practice they are rather underdeveloped or even non-existent. As a result, Islamic banks may face more difficulties than conventional banks in securing short-term funds if need be. However, some countries have found ways to provide Islamic banks with access to short-term funds. For example, in Malaysia the authorities established an interbank investment facility whereby Islamic banks can obtain short-term funds from one another based on profit and loss sharing arrangements. Also, in Iran, since all banks are state-owned, the authorities view these banks as "part of the family" and extend short-term loans under a LOLR facility. Loans extended under this facility are exempt from payment of interest.[31] It should also be kept in mind that Islamic banks have obligations only towards demand deposit holders, while conventional banks have obligations towards all depositors. Therefore, the above criteria for liquidity rating need to be evaluated in light of these circumstances. As in the case of conventional banks, adequacy of liquidity should be assessed on a bank-by-bank basis.

In an Islamic environment, **reserve requirements** (RR) can be viewed as a particular case of liquidity ratios.[32] Indeed, to help reduce the possibility of asset-liability mismatch when Islamic banks operate according to a two-tier Mudaraba arrangement (Scheme A), the RR ratio applied on demand deposits could be set at a level that would help banks meet unexpected demand deposit withdrawals. In principle, a RR ratio on demand deposits of 100 percent would rule out the problem, as is the case in the two windows arrangement (Scheme B). This, however, would excessively limit Islamic banks' ability to engage in maturity transformation, which is at the core of every bank's activity, and add an element of complexity to the transaction and payments functions that demand deposits are meant to perform. Therefore, a preferred alternative solution—especially if the ratio of demand deposits to total deposits is relatively low—is to mandate specific RR on all deposits held in banks operating according to a two-tier Mudaraba arrangement.[33] However, if applied to total deposits, RR may represent an excessive burden for the banking system given the fact that, in an Islamic framework, RR may not be remunerated.[34] These issues should be considered when calculating an appropriate level of the RR ratio.

---

[31] The issue of how to design short-term financial instruments compatible with Islamic precepts is beyond the scope of this paper.

[32] Reserve requirements can also be viewed as monetary instruments, means to facilitate interbank settlements, and as a form of taxation.

[33] As noted in Section II, the two-tier Mudaraba arrangement (Scheme A) does not mandate specific reserves requirement on both demand and investment deposits.

[34] However, Mudaraba or Musharaka contracts between the central bank and the commercial banks could be designed whereby banks could share in the profits accrued from the central bank's use of RR.

C. Information Disclosure

As argued before, information disclosure is more important in an Islamic banking environment than in conventional banking. Particularly in an Islamic environment, information disclosure should be designed to reduce information asymmetries—due to the *unrestricted Mudaraba* contract between an Islamic bank and its depositors—and incentives for moral hazard due to the fact that capital value of and returns on investment deposits are not guaranteed. Moreover, information disclosure would introduce an element of flexibility in the system, and provide both the supervisory authorities and the public with a better understanding of banks' strategies and relevant risks. Additionally, information requirements should be designed to assist supervisory authorities in addressing Islamic banks' special risk characteristics. In this regard, two areas need particular attention on the part of bank supervisors: (1) the appropriateness of policies and adequacy of infrastructure for portfolio management; and (2) the adequacy of human technical expertise to implement these policies. Hence, supervisory authorities should envisage a list of appropriate data and information that Islamic banks are to be required to provide. Such information should be provided to the supervisory authorities first, and, subsequently, to the public. The authorities should decide on whether information provided to the public can be less comprehensive and detailed than the information provided to the supervisory authorities. Supervisory authorities should also ensure that information provided by Islamic banks is adequate, relevant, and presented in an unmisleading way so that the public faith is protected. Finally, they should authorize the public disclosure of such information.[35]

Given the operational similarities between Islamic banks and investment companies underscored in Section II, it may prove useful to consider information disclosure requirements established for investment companies in conventional systems (for example by the United States Securities and Exchange Commission), and adapt them to the specific needs of an Islamic banking environment as delineated above. In this vein, information disclosure requirements for Islamic banks could usefully include *at least* the following interrelated areas: investment objectives and policies, including concentration; types of securities; risk factors; internal controls; and performance data. Additionally, the authorities should require the disclosure of professional qualifications and experience of management and senior staff. While these disclosure requirements are also appropriate in a conventional system, they are

---

[35] A simple and effective way of disclosing relevant data and information is the publication and distribution of **prospectuses**, in addition to the usual banks' financial statements and annual reports. In case this proves to be too expensive or complex to handle, because of the large numbers of depositors involved, prospectuses may be published on widely circulated newspapers, and/or placed in all branches and made available for free consultation. Appropriate control over the content of prospectuses would need to be exerted by supervisory authorities. However, this activity should not extend to guarantee or endorse the content of prospectuses.

not regularly requested from conventional banks. By contrast, because such information disclosure addresses the specific risk characteristics of Islamic banks, it should be considered as a necessary component of an appropriate regulatory framework governing Islamic banks (see also Section III.D). The content of the proposed disclosure requirements is briefly reviewed below.

- ***Investment objectives and policies, including concentration***. This section should provide the supervisory authorities with sufficient information to assess the appropriateness of policies with regard to portfolio diversification (see also next point). It should provide an accurate description of the investment objectives and policies, including with respect to concentration—investment of more than 25 percent of total assets may define concentration in any one industry. In addition, any economic, business, or political developments or changes which can affect that industry or group of industries should be briefly discussed. Such disclosure may include proposed national or regional legislation involving the financing of the projects; pending civil and/or religious courts decisions relating to the validity of the projects or the means of financing them; predictable or foreseeable shortages or price increases of materials needed for the projects, and the like.

- ***Types of securities*** [36] As noted in Section II, Islamic banks operating according to a two-tier Mudaraba arrangement run the risk of an asset-liability mismatch in case of unexpected withdrawal of demand deposits for which no adequate reserves have been posted (a possible solution to this problem has been discussed above). This section should provide the supervisory authorities with an indication of an Islamic bank's degree of exposure to any type of securities or other assets, particularly those for which there is no established market, that is illiquid assets. An excessive exposure to illiquid assets should prompt the supervisory authorities to action, which may include establishing a limit on aggregate holdings of illiquid assets. This section should also illustrate the "filtration" process which has been followed by the Islamic bank to select securities to invest in.[37]

- ***Disclosure and monitoring of risk factors***. This section should provide information on the main risk factors associated with the investment portfolio. It should also describe the internal procedures, organization, and infrastructure for the monitoring

[36] For Islamic banks the term "securities" defines any note, stock, certificate of interest or participation in any profit-sharing arrangement.

[37] The "filtration" process ensures that the operation, and capital structure of each business an Islamic bank invests in is compatible with Islamic law, hence excluding companies engaged in prohibited activities—that is the production of goods and services which contradict the value pattern of Islam, such as gambling—and those whose capital structure relies heavily on debt financing.

and handling of risk factors. Because of the virtually open-ended list of activities that an Islamic bank can engage in, and the virtually open-ended list of ways to provide funds through the use of combinations of the permissible Islamic modes of financing, each Islamic bank should be allowed some degree of freedom in engineering how best to monitor and handle the risks inherent to its specific activities. However, in any case, supervisory authorities should satisfy themselves about the adequacy of such procedures and infrastructure.

- ***Internal controls***. An Islamic bank performs internally several complex activities that are not normally performed by conventional banks, including the determination of profit and loss sharing ratios on the projects it finances and the ongoing auditing of these projects to ensure that its shares of profit are being fairly calculated. These specific activities highlight internal controls as key to ensuring that all phases of the investment process are monitored, comply with the Islamic bank's investment policies, and are properly accounted for. Adequate internal controls are also crucial to the depositors' interests because, as noted, an Islamic bank's net profits are, in turn, shared with its (investment) depositors. Hence, particularly in an Islamic environment, adequate internal controls serve two goals: (a) reduce mismanagement risk (typically the most important factor of weak internal governance); and (b) reduce moral hazard. Therefore, supervisory authorities should satisfy themselves about the adequacy of arrangements for internal controls.

- ***Performance data***. Particularly in an Islamic environment, expected return on investment deposits is key to the depositors' choice of a particular credit institution. As noted in Section II, an Islamic bank can only indicate the expected rate of return on investment deposits. The actual rate depends on the Islamic bank's ability to finance successful investment projects, thus accruing profits to be shared with its investment depositors. Ill-conceived, unsound institutions might seek to attract depositors by promising unrealistic rates of return, thus crowding-out serious and well-managed institutions. Hence, it becomes a key supervisory issue to reduce the moral hazard inherent in this situation. To help reach this goal, this section should provide a brief explanation on how an Islamic institution calculates its historical performance in order to advertize this data. This should be done in a concise description of the essential features of the data and how it has been computed. A statement should also be included that advertized yields are based on historical earnings and *are not intended to indicate future performance*.

- ***Management and senior staff*** This section should provide information on the education and professional background of an Islamic bank's management, including the Board of Directors, and senior staff (at least at the level of director of department). Particular attention should be paid to the assessment of staff's competence and skills in Islamic banking. This section should also clarify the role of the *Shariah Boards*, particularly whether their role should be limited to approving financial products and services or should extend to the approval of individual credit decisions.[38] Supervisory authorities should satisfy themselves about the "fit" and "proper" requirements for management and senior staff to ensure that credit and investment decisions are taken by experienced bankers.

It is worth noting that the growing emergence of institutional investors, such as Islamic funds, will more than likely make the market enforced discipline mechanism inherent in the process of information disclosure more effective and binding on banks' strategies and risk-taking decisions.[39] As it has already happened in conventional systems, it can be reasonably expected that institutional investors in an Islamic environment are to play a crucial role in collecting, interpreting, and evaluating the flow of information disclosed by Islamic banks. These investors will act as Islamic banks' major private monitors while such skills are being developed by smaller private depositors and other investors. Such a development will more than likely help facilitate banking supervision in an Islamic framework.

D. Licensing Procedures

As with conventional banking, an appropriate licensing process is just as necessary in an Islamic banking framework to enable supervisory authorities to ensure that new banks are sound and stable. To establish an effective entry policy in the banking industry is key to protect the public faith and the banking system from unfair and dangerous competition from undercapitalized, ill-conceived banks or those that are operated by unqualified or less reputable owners and managers. Accordingly, new banks must meet certain requirements to enable them to operate successfully. As Lindgren et. al. have noted, with the exception of the European Union, there are no international agreements on licensing standards. [40] However, there are some basic elements of an appropriate licensing process that are usefully applicable also in an Islamic banking framework. These elements should be seen as an integral part of an appropriate regulatory framework for banking supervision in an Islamic environment.

- **Transparency**. Laws, regulations, criteria, and requirements for a banking license should be published and applied in an even-handed way. Applicants should be notified about the decisions made on license applications.

---

[38] *Shariah Boards* are composed of Islamic scholars and jurisprudents. They ensure that Islamic banks' operations conform to Islamic precepts. All banking facilities should receive their clearance before being offered to the public.

[39] Iqbal (1997) reports that Islamic funds are already in operation. Their current market size is estimated at about US$ 1 billion. These funds invest mainly in equity, commodity, and leasing and issue tradable certificates backed up by their investments in shares, metals, and leases, respectively.

[40] For a fuller discussion, see Lindgren, Garcia, and Saal, 1996.

- **Set the ground rules**. Requirements for a license should set rules for corporate governance; establish "suitability" standards for owners; establish "fit-and-proper" specifications for boards of directors and managers; determine whether commercial and industrial firms can own banks; define the organizational structure of the bank, including internal controls, internal and external audit functions, and any provisions necessary to prevent conflict of interests. Additionally, such requirements should ensure the transparency of the corporate structure of the bank.

- **Capital requirements**. Minimum levels and composition of initial capital should be set forth.

- **Specify activities**. The scope of a bank's activities should be indicated, that is whether and to what extent the bank is allowed to take equity positions in nonfinancial enterprises, engage in securities, underwriting, licensing, factoring, and other activities.

- **Business plan**. The license application should include a feasibility study and a business plan detailing the bank's strategy to attain profitability and maintaining it over the initial period of operation.

Additionally, an appropriate licensing process in an Islamic framework should ensure that due consideration be given to the specific aspects of Islamic banking discussed in the previous parts of this section concerning legal foundations, capital, assets, management, earnings, liquidity, and information disclosure.

IV. Current Practices and Future Developments in Islamic Banking

Islamic banking in current practices diverges in several important ways from the paradigm version delineated in Section II. These differences can be summarized in four main points:

- ***All deposits, including investment ones, are always explicitly or implicitly guaranteed.*** In some cases, the capital value guarantee is formally written in laws and regulations; in other cases, it is based on implicit understandings among the authorities, banks, and the public.

- ***The PLS principle is never strictly applied***. There are various degrees of noncompliance with respect to the PLS principle in current banking practices. In some cases, the expected rate of return on investment deposits is guaranteed by the bank. [41]

[41] In one case, indications are that the central bank would stand ready to subsidize the difference between the indicative, ex-ante rate of return announced by banks to depositors and

Moreover, this rate of return is de-linked from banks' profits. As a result, the expected rate of return for each type of deposits is the same for all banks, irrespective of banks' different levels of profitability. In other cases, the PLS principle is partially implemented through complex formulas aimed at maintaining the link between returns to financial assets and profits originating from banks' investment of deposited funds. However, central banks discourage large variations in the rates of return that banks are allowed to offer to customers in order to avoid destabilizing shifts in deposits. This is done through the imposition of ranges (differentiated by sectors of the economy and nature of borrowers) within which banks and customers are allowed to bargain and agree on the terms of specific transactions.

- ***Financing is mostly carried out through non-PLS modes.*** On average, Islamic banks operate through the less-risky, shorter-term non-PLS modes, notably: mark-up, leasing, and lease-purchase transactions typically related to trade financing. The most recent available aggregate data indicate that, in 1996, non-PLS modes accounted for 75.2 percent (72.8 percent in 1995) of total utilized lines of credit made available by the Islamic Development Bank to the forty-eight member countries to promote Islamic banking.[42]

- ***Discretion with regard to collateral.*** Islamic banks are allowed to use a degree of discretion in deciding if collateral is needed before granting their facilities, including the PLS modes of financing.

As a result of the above practices, the element of uncertainty needed to legitimize the bargain for possible profits has been substantially reduced and, in some cases, eliminated. Moreover, PLS modes of financing have been made similar to non-PLS modes through the reduction of their risk element. Therefore, it can be concluded that, for all practical purposes, Islamic banking is currently carried out in a **hybrid way** that is somewhere in between the paradigm version and conventional banking. The degree of divergence from the paradigm version is specific to each country where Islamic banking principles are followed and need to be assessed on a case-by-case basis.

The more current Islamic banking practices diverge from the paradigm version, the more Islamic banks lose their distinctive features and tend to resemble conventional banks. Hence, supervisory standards and best practices developed by the Basle Committee on Banking Supervision become increasingly applicable to Islamic banks and should be implemented accordingly. Therefore, each argument discussed in Section III needs to be re-evaluated and given the appropriate emphasis in light of the circumstances and the specificities of Islamic banking practices prevailing in any one country at any one point in time.

---

the realized, ex-post rate if the latter were lower than the former.

[42] Islamic Development Bank, Annual Report 1995/96.

By way of illustration, Table 3 indicates how the shift from the paradigm version to current practices should affect the focus of banking supervision in an Islamic framework.

Table 3. Islamic Banking in Practice: Shift in the Focus of Banking Supervision

Issue	**Paradigm Version of Islamic Banking**	**Islamic Banking in Practice 1/**
Robustness to absorb external shocks.	Higher	Lower
1) Liquidity risks 2) Insolvency risks	Less likely Less Likely	More likely More likely
Relative importance of:		
Assessment and management of operational risks:		
(1) Reliance on appropriate procedure and adequate infrastructure;	Higher	Lower
(2) Reliance on human technical expertise.	Higher	Lower
Prudential standards	Relevant; to be assessed on a bank-by-bank and country-by-country basis	Crucial
Information disclosure requirements	Higher	Lower

1/ Depending on the degree of divergence from the theoretical model. At the end of the spectrum, Islamic banking may coincide with conventional banking, except for the terminology.

Islamic banking is expanding outside the traditional borders of Muslim economies into western countries, notably the United Kingdom.[43] This situation is unprecedented both for western supervisors and for authorities (and banks) of countries where Islamic banking principles are followed, at least to some extent. It underscores a number of supervisory issues that can be summarized as follows.

First it should be kept in mind that western supervisors have responsibilities, under the law, to apply current principles in an even-handed way to all banks operating in their countries to ensure that all banking facilities, whether Islamic or not, are in accordance with national

[43] In this paper, the term "western" defines countries where conventional banking is followed.

supervisory and regulatory frameworks aimed at protecting the interests of depositors. In particular, western supervisors must be satisfied that an applicant institution, whether Islamic or not, has adequate capital, adequate liquidity, and adequate control over large exposures. This means, from an operating point of view, that the applicant institution must have adequate risk management procedures, a realistic business plan, and adequate systems for internal control and that its management must be adequate in breath, depth, and experience to run the business in a competent manner. Moreover, western supervisors will need to be satisfied that the applicant institution is subject to *effective consolidated supervision*, most notably that the home country takes prime responsibility for supervising the applicant bank as a whole.

There may well be some areas in the operation of Islamic banking which might be viewed by western supervisors (as well as potential counterparties) as difficult to understand. These areas include the following:

- ***Uncertainties in classifying Islamic funds in western legal terms***. The problem is to understand to what extent and how funds are placed in an Islamic institution as "capital certain," thus falling into the definition of a bank deposit and/or to what extent they are participating in a collective investment scheme, thus falling under the definition of an equity investment (for example, in the United Kingdom, in the former case, the Banking Act would apply; otherwise, the Financial Services Act). Section II may contribute to shed some light on this issue.

- ***Lack of uniformity in accounting and auditing practices***. This problem has already been pointed out when discussing capital adequacy. To reduce it, current efforts made by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) to produce new accounting standards should be enhanced. To help assuage western concerns, the work of the AAOIFI should be increasingly publicized and discussed in international fora attended also by western supervisors, representatives of the Accounting and Auditing professions, and interested potential counterparties.

The United Kingdom appears to have been chosen as the preferred western market in the development plans of institutions operating according to Islamic precepts. Thus far, no formal request for a banking license has been presented to the U.K. supervisory authorities by a bank operating according to a paradigm version of Islamic banking. If it were, the U.K. supervisory authorities would tend to adopt the following approach:[44] (1) set the capital adequacy ratio on the basis of an assessment of the portfolio of risks of each individual Islamic bank, subject to the minimum Basle Committee standards; (2) require that Islamic banks, whose earnings portfolios are viewed as tending towards the longer-term and the illiquid, hold higher

---

[44] Useful conversations on this topic with Michael Ainley of the Bank of England are gratefully acknowledged.

levels of overall liquidity than conventional banks; [45] and (3) expect that credit decisions be taken by experienced bankers. In addition, supervisory authorities in the United Kingdom would consider as a fundamental pre-requisite for the granting of a banking license the establishment of a satisfactory operational understanding with the home country authorities on how and on what basis Islamic banks are supervised in their respective countries vis-à-vis standards laid down by the Basle Committee.

V. Concluding Remarks

In this paper it has been argued that prudential supervision on banks is just as necessary in an Islamic system as in conventional systems. It has also been argued that Islamic banks have special characteristics that should be recognized and addressed to help make the conduct of banking supervision more effective. An appropriate regulatory framework governing Islamic banks needs to place greater emphasis on the management of operational risks and information disclosure issues than it is normally the case in conventional banking. To help develop such a regulatory framework, a CAMEL rating system adapted to an Islamic environment has been proposed and discussed. Other building blocks, such as legal foundations, information disclosure requirements, and licensing procedures adapted to an Islamic environment have also been discussed.

A better understanding of the fundamental features of Islamic banking as they are presented in the theoretical literature has been the starting point of the discussion. Based on this understanding, it has been shown how Islamic banking in its current practices diverges from the paradigm version and how the focus of banking supervision should shift accordingly. Moreover, it has been stressed that Islamic banking is no longer an interesting experiment, but a growing reality which is expanding outside the traditional borders of Muslim countries into western economies where conventional banking is followed. This unprecedented situation underscores a number of supervisory issues that have also been discussed.

The main message of the paper is that, in order to establish a closer integration with other banking systems, supervisory authorities of countries where Islamic banking is followed should acknowledge the need to set up a regulatory framework that, while consistent with Islamic precepts, would, at the same time, be pragmatic and flexible enough to meet internationally accepted prudential and supervisory requirements. In this process, the establishment and implementation of effective prudential supervision on Islamic banks in their home countries appears to be a key factor. On their part, supervisory authorities in conventional systems ought to approach Islamic banking with an open mind realizing the potential gains that this already sizable and growing market could bring to the global economy in general and to selected counterparties in particular. Some issues underscored here are still to be dealt with; others need further analytical work. Hopefully, the discussion developed in this paper can help generate action on this much needed agenda.

---

[45] This could affect Islamic banks' profitability compared with conventional banks.

REFERENCES

Cordella, Tito and Eduardo Levy Yeyati, 1997, *Public Disclosure and Bank Failures*, IMF Working Paper No. 96/97 (Washington: International Monetary Fund).

Dziobek, Claudia, O. Frecaut, and M. Nieto, 1995, *Non-G-10 Countries and the Basle Capital Rules: How Tough a Challenge is to Join the Basle Club*, IMF Paper on Policy Analysis and Assessment No. 5/95 (Washington: International Monetary Fund).

Iqbal, Zamir, 1997, "Islamic Financial Systems," *Finance & Development*, Vol 34 (June), pp. 42–45.

Iqbal, Zubair and Abbas Mirakhor, 1987, *Islamic Banking*, IMF Occasional Paper No. 49, (Washington: International Monetary Fund).

Islamic Development Bank, *Annual Report 1995/96*.

Kazarian, Elias, 1993, "Islamic Versus Traditional Banking: Financial Innovations in Egypt," Westview Press.

Khan, Mohsin and Abbas Mirakhor, 1986, "The Framework and Practice of Islamic Banking," *Finance & Development*, Vol. 6 (March), pp. 32–36.

______, 1989, "Islamic Banking: Experiences in the Islamic Republic of Iran and Pakistan," IMF Working Paper No. 89/12 (Washington: International Monetary Fund).

______, 1993, "Monetary Management in an Islamic Economy," *Journal of Islamic Banking & Finance*, Vol. 10 (July–September), pp. 42–63.

Lindgren, C.-J., G. Garcia, and M. Saal, 1996, *Bank Soundness and Macroeconomic Policy* (Washington: International Monetary Fund).

Mirakhor, Abbas, 1988, "The Progress of Islamic Banking: the Case of Iran and Pakistan," in *Islamic Law and Finance*.

Presley, John and John Sessions, 1994 "Islamic Economics: The Emergence of a New Paradigm," *The Economic Journal*, Vol. No.104, (May), pp. 584–96.

United States Securities and Exchange Commission, 1996, *Investment Company Registration Package*, (June).