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Islamic Banks - Basel II and Islamic Financial Services Board Standards

Introduction

To the uninitiated Islamic finance, which is inextricably bound to religious doctrines, often evokes a sense of mysticism and curiosity, as, by and large, modern conventional finance has been a product of the western hemisphere developed relatively independently from the influence of religious faith.

Yet the last decade has seen a remarkable blossoming of this field of finance. More than 240 financial institutions in more than 48 countries, including global giants such as Citibank and HSBC, practise some form of Islamic finance. Islamic banking assets worldwide are estimated at over USD200 billion with an average annual growth rate of 15% in recent years.

Furthermore, in August 2004, the United Kingdom's Financial Services Authority (FSA) granted approval for the first Islamic Bank, the Islamic Bank of Britain, to operate in the traditionally Anglican UK. Whilst Islamic banks have long been established in predominantly Muslim countries, the issuance of a banking licence by the FSA marks a bellwether of sorts for the inclusion of Islamic banking into the mainstream of financial markets.

Islamic finance today is therefore an area of topical interest for financial market practitioners. Given the networked and global environment we find ourselves in today, the implications of Islamic finance on the global financial community and the implication of Basel standards on Islamic financial institutions need to be considered thoroughly.

Hence, this article seeks firstly to provide some background on the concepts and features of the Islamic financial system, and secondly to examine the capital adequacy and risk management issues relating to Islamic financial institutions, and how these issues relate to Basel standards.

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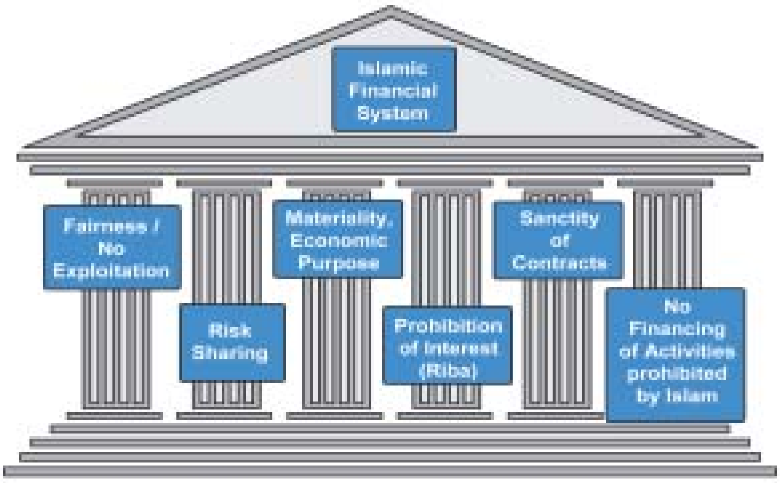
Foundations of the Islamic Financial System

The fundamental tenet of Islamic finance is that of fairness, a similar concept to the English common law doctrine of equity. This motivating factor has been extended into the following principles: (i) requirements that seek to promote fairness in transactions and prevention of exploitation of any one party over another, (ii) sharing of risks and rewards between principals to a transaction, (iii) transactions that carry elements of materiality leading to a tangible economic purpose, (iv) upholding the sanctity of contracts, and (v) prohibition of financing of activities that are outlawed by Islam, such as transactions involving alcohol and gambling, as summarised in Diagram 1.

Diagram 1



Hence, Islamic financial institutions in its most basic level are often structured towards fee-based revenue for services rendered and on profit and risk sharing structures. In essence therefore, Islamic financial institutions are closer in spirit to asset management companies rather than conventional banking institutions.

Some of the common Islamic finance concepts used include the following:

- Murabaha, which is a form of cost-plus or mark-up financing where an asset is acquired by the institution and sold on to the customer, with the institution deriving a profit based on the difference between the sales price and the original cost of the asset.
- Bai' Al-Ajal, which basically allows the payment of instalments by a customer towards an asset, with the title to this asset being transferred from the institution to the customer once payment has been received in full.
- Ijara, which is a contract of leasing where the institution acquires an asset from a supplier and leases it to a customer.
- Musharaka, which is an equity participation scheme in the form of a joint-venture, characterised by clearly defined roles and profit distribution agreements between the principal parties to the transaction.
- Mudharaba, where the institution acts as a fund manager for the investors (depositors). The institution engages in investment or trading activities and pays the investors a pre-determined share of profits.

These and other Islamic finance concepts are often used in combination in order to derive a desired product structure that has similar product features to a conventional financing product.

However, the impact of Islamic financing products on the balance sheet of an institution is very different from that of conventional financing products. The prima facie appearance of conventionality belies the structurally different asset and liability profile of the bank's balance sheet.

Risk Differentials in Islamic Financial Institutions

Understanding the risks faced by Islamic financial institutions requires us to understand the balance sheet of an Islamic financial institution. Diagram 2 provides a conceptual balance sheet for an Islamic financial institution.

Diagram 2

Assets	Liabilities
Asset backed transactions Trade finance / collateralized transactions	**Demand deposits** Amana
Syndication Mudharaba / Musharaka	**Investment Accounts** Mudharaba
Fee based Services Ju'uala Qardh Hasan	**Special Investment Accounts** Mudharaba / Musharaka
	Equity
Off balance sheet	
Restricted investments	**Direct investors**

While the risk profiles of Islamic financial institutions are generally similar to those of conventional financial institutions, especially regarding credit risk, Islamic financial institutions face some unique risks Islamic financial institutions on their most basic level are often structured towards fee-based revenue for services rendered and on profit and risk sharing structures. This includes their "depositing taking" activities, which are referred to as Investment Account Holders (IAHs) rather than depositors. Therefore, their key unique risks include:

- Displaced commercial risk - this risk arises when Islamic financial institutions are under pressure to pay a return that exceeds the rate that has been earned on assets financed by their IAHs, when the return on assets is under performing as compared with competitors' rates. In such a scenario, the Islamic financial institution may decide to waive its rights to the profits, or a part of the profits, in order to retain its fund providers and dissuade them from withdrawing their funds;

- Rate of Return Risk - this risk is associated with overall balance sheet exposures where mismatches arise between the assets and liabilities of Islamic financial institutions. Revenue and expenses are generally accounted for on an accrual basis when deriving the exposure and the Islamic financial institutions are exposed to the expectation of IAH when allocating their profits;

- Market risk - this risk is associated with exposures to price volatility of the underlying "real" assets inherent in some financing modes, which are in the form of trading and real investment;

- Fiduciary risk - this risk arises from a breach of the investment contract for management of IAHs' funds; and

- Shariah compliance risk - this risk arises from non-compliance with Shariah principles in conducting the Islamic financial institutions' business.

Capital Adequacy and Risk Management Considerations for Islamic Financial Institutions

In view of the unique risks faced by Islamic financial institutions, the applicability of Basel standards, which are designed primarily for conventional financial institutions, on these institutions may not be all that appropriate. In the past, the supervisory authorities of these institutions have generally applied the Basel standards on these institutions. Supervisory authorities of these institutions may independently vary these standards to capture the unique risks faced by Islamic financial institutions in their own jurisdiction. As a result, there is often no consistency in capital adequacy and risk management standards across Islamic financial institutions in various jurisdictions.

With the tremendous growth and increasing internationalisation of the Islamic financial system, the supervisory authorities in countries that have an active Islamic financial system realise that there is a need for more consistency in standards. With this in mind, these supervisory authorities established the Islamic Financial Services Board (IFSB).

The IFSB acts as an international standard setting body of the regulatory and supervisory agencies that have a vested interest in ensuring the soundness and stability of the Islamic financial services industry. The establishment of the IFSB was the culmination of an extensive two-year consultative process initiated by a group of governors and senior officials of central banks and monetary authorities of various countries, together with the support from the Islamic Development Bank, the International Monetary Fund as well as the Accounting and Auditing Organisation for Islamic Financial Institutions.

The IFSB has begun the development of two specific prudential standards for Islamic financial institutions, namely, the Capital Adequacy Standards and the Risk Management Standards. These two standards are expected to be issued by early 2005.

The main objective of the Capital Adequacy Standards is to address the specific structure and contents of the Shariah compliant products and services offered by Islamic financial institutions not specifically addressed by the Basel Committee. This particularly includes Islamic financial instruments that are asset-based such as Murabaha, and Ijara. . Such instruments are exposed to price risk in respect of the non-financial asset as well as credit risk in respect of the amount due from the counterparty.

For profit-sharing instruments, i.e., Musharaka and Mudaraba, the exposure is like an equity position not held for trading, and as such is similar to an equity position in the banking book. Hence it is dealt with under credit risk capital requirements, except in the case of investments (normally short-term) in assets for trading purposes, which are dealt with under market risk capital requirements.

Likewise, the Risk Management Standards are developed as a supplement to the risk management standards already established by the Basel Committee. Their purpose is to address the unique risks that Islamic financial institutions face (as discussed above).

Conclusion

The last decade has seen tremendous growth of the Islamic financial system. More than 240 financial institutions in more than 48 countries now practise some form of Islamic finance now. Moreover, Islamic banking assets worldwide are estimated at over USD200 billion with average annual growth rates of 15% in recent years.

Due to this significant growth, Islamic financing is no longer just a fringe financial system, but a mainstream financial system. As a result, there is a need for greater consistency in practices and standards among financial institutions operating within this system. This has led to the establishment of IFSB, which serves as an international standard setting body for the Islamic financial system. Two standards, namely, Capital Adequacy and Risk Management, are in the process of being established and are due for release in the early part of 2005. These two standards are meant to complement the Basel standards to address to risk specificities of Islamic financial institutions.

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