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Forward

The speed at which Islamic Banking has grown and the rate at which it has progressed makes it pertinent to study it systematically so as to ensure its soundness and stability. The increasing presence of this industry in world financial markets has meant that international cooperation is vital in developing and adapting international standards of regulation to various aspects of Islamic financial intermediation. This, in itself is a complex issue given the need to marry such intermediation with the conceptual foundations of the industry.

This paper contributes to the ongoing discussion of the applicability of the international methodology recommended by the Basle Accord to Islamic Banking specifically, that relating to capital adequacy. The author discusses some of the peculiarities of such banking, contrasting the risks and regulations needed under this form of intermediation and explaining the differences with regards to conventional banking. In doing so, the paper outlines implications for approaches to capital adequacy while considering the areas where differences exist between various Islamic supervisory authorities in their risk management practices. In concluding, the author stresses the importance of institutional arrangements in reaching a universally agreed upon approach to prudential aspects and best practices for Islamic Banks. In this connection, the author recognizes the important role that the Islamic Financial Services Board is expected to play.

In writing the paper, the author draws on his extensive experience as a Governor of the Central Bank of Sudan. The first part of his nine years in office, in the early 1990's, coincided with the introduction of Islamic banking in the country. Since then, and during two terms in office, he has overseen the implementation process and contributed to its successful development. The paper takes on an added significance given this practical aspect of the exposure and the specific examples from the Sudanese case which are given whenever relevant.

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I. INTRODUCTION:

Although Islamic banking started as an idea only in the early 1960s, it has grown since then to a full fledged world-wide financial system. According to year 2003 estimates by the General Council for Islamic Banks and Financial Institutions of Bahrain, there are more than 250 financial institutions in over 50 countries involved, with varying degrees of intensity, in the Islamic Financial Industry. The industry which has been growing at an annual rate of about 15%, has a market size that is currently (in 2003) estimated at around U\$300 billion. The growth potential of the industry is enormous, not only because of the huge wealth of Muslim communities, but also because of the interest shown in international financial markets and the large multinational institutions in this form of financial intermediation.

Given the universal recognition of Islamic Banking, it becomes pertinent to address the issue of capital adequacy and the applicability of internationally recognized measures of this important concept to the industry. The purpose of capital adequacy regulations is to limit the probability that adverse outcomes would exceed the banks capacity to bear losses.

Adequacy of capital is a very important subject for both supervisory authorities and banks and is considered to be one of the pillars on which the soundness and stability of the banking system rests. Because capital is viewed by participants as a buffer or cushion for absorbing losses inherent in the normal conduct of business, its adequacy has an important confidence building impact on business transactions. Such confidence is an important factor in the efficient functioning of markets. In particular for banks and other deposit taking institutions, the capital base must be sufficient to protect depositors and counterparts from the institutions' on-and-off balance sheet risks.

Capital adequacy norms as a measure of bank safety and soundness have evolved overtime, from the simple crude leverage ratio to the more complicated risk-based capital ratio. It was only in 1988 that a

universally accepted means of measurement of this important concept came into being and was based on the Basle Accord. In 1988, the Basle Committee on Banking Supervision adopted the Accord setting minimum capital standards for credit risk. The Accord was later amended in 1996 to take into consideration the impact of market risk on capital adequacy and efforts are still being made to incorporate all other risks. The so called “Basle Core Principles for Effective Banking Supervision” issued in 1997 supplement the Accord by providing guidelines for supervisory review of capital adequacy and use of market discipline to motivate deposit taking institutions to enhance their capital adequacy ratios. The Accord (known as Basle (I)) is now being developed into a more risk-sensitive Basle (II).

This paper is meant to address the issue of whether the methodology recommended by Basle Accord can be applied to Islamic banks. While recognizing the crucial importance of capital adequacy for deposit taking institutions, including Islamic banks, and appreciating the significance of the Basle Accord as a guiding indicator, we believe that Islamic banks have specific peculiarities that render the applicability of the Accord to such banks questionable and call for a review of the matter.

II. Islamic Banks and Basle Accord:

There are major conceptual and practical differences between Islamic and conventional banking. The first major difference is that Islamic financing does not deal in interest, rather it is based on a partnership agreement that shares risks as well as returns.

Islamic banks also differ from conventional banks in that their work is not confined to financial intermediation. An Islamic bank is an investor, trader, financial advisor, consultant and a financing house. It is a universal bank, whose objectives are much broader than profit maximization. An Islamic bank is expected to be a socially responsive institution (SRI) with social, cultural and other responsibilities beside profit making.

In addition there exist a variety of Islamic modes of financing. Each

mode of financing has its own characteristics and risks that affect both sides of the bank's balance sheet. These modes take the shape of either trading contracts or profit and loss sharing forms.

These differences highlight the unique characteristics and peculiarities of Islamic banks, which in turn raise serious questions about the applicability of the Basle methodology to Islamic banks.

The entire Basle methodology rests on the notion of risk-weighted assets, which constitutes the denominator of the capital adequacy ratio, while tier capital constitutes its numerator.

Tier capital is comprised mainly of share capital, reserves, retained profit and minority interest with adjustments for any goodwill, and participation in unconsolidated subsidiaries and associates.

The risk-weighted assets are broken down between credit risk and market risk. For the purpose of credit risk, the Basle Committee has recommended risk weighting for each category of asset. Further, the Basle Committee in the amended accord has recommended a methodology for computing the capital charge for market risk.

So what are the issues facing Islamic Banks in applying the risk weighting of assets as recommended by the Basle Committee. This is the question, which the rest of this paper will be addressing. It is clear, that for the purpose of applying the Basle Capital Adequacy methodology to Islamic Banking, it is first necessary to make an appropriate analysis of the liability and asset structure of these banks while taking into consideration their unique and peculiar nature as well as their differences from conventional banks.

III. Investment (Time) Deposits:

One of the major differences between an Islamic bank and a conventional bank is that; the former mobilizes funds on a profit and loss sharing basis while there is no similar concept on the sources (liabilities) side in conventional commercial banking. On the uses (assets) side, the

portfolio of Islamic banks is composed of various finance contracts (modes of financing) many of which are based on profit and loss sharing principle such as Musharaka & Mudaraba. Thus, unlike the situation in conventional banking, the customer – banker relationship in Islamic banking is not a mere debtor/creditor relationship.

On the liability (sources) side for traditional banks, deposit funds mobilized on sight and time deposit basis constitute an ultimate liability, as principles of these funds as well as their fixed (pre-determined) interest rates are contractually guaranteed.

Islamic banks, on the other hand, arrange deposit mobilization on a profit and loss sharing (PLS) basis. Hence, a depositor is not a net creditor to the bank. These funds (deposits) which are referred to as profit sharing investment accounts are reported in the balance sheet if they are received on an unrestricted basis and off-balance sheet if restrictions are placed by the investors on the types or modes of investment. This way holders of investment deposit accounts with Islamic banks are similar to capital holders in that they stand to share different kinds of risk as specified in the contract. Thus, it can be concluded that, in principle, Islamic banks do not face any normal commercial risk for any loss on the assets funded by the investment account holders. In fact, this peculiarity of investment deposits may result in moving them out of the denominator of the Basle Capital Adequacy ratio (i.e. risk weighted Assets) to its numerator (i.e. tier capital).

However, there are risks other than normal commercial ones, which may have implications for an Islamic bank's risk-bearing capital. If the bank's management acts in breach of the investment contract, or is guilty of misconduct or negligence in the management of the investors' funds, then the bank may be legally liable with respect to losses sustained on those funds. The term 'fiduciary risk' may be used to designate this type of risk. This no doubt, has to be taken into consideration when evaluating the capital adequacy of an Islamic bank.

Further, an Islamic bank is liable to find itself under commercial pressure to pay a rate of return to its profit sharing investment account holders, which is sufficient to induce such investors to maintain their funds with the bank. If this 'required rate of return' is higher than that which would be payable under the normal terms of the investment contract, the bank may be under pressure to forgo some of its share of the profits, which would normally have been distributed to shareholders. Failure to do this might result in a volume of withdrawals of funds by investors large enough to jeopardize the bank's commercial position.

Thus part of the commercial risk attached to the returns attributable to the Profit Sharing Investment accounts is, in effect, transferred to the shareholders' funds or the Islamic bank's own capital. This is what has been termed 'displaced commercial risk', which also has implications for the capital adequacy of the bank.

Given these different and additional types of risks faced by Islamic banks the question becomes whether Islamic banks should include the risk assets of profit sharing investment account holders when computing the capital adequacy ratio. The Basle Committee, obviously, did not address this issue. Furthermore, if these deposits are included in the calculation of the capital adequacy ratio, the question arises whether they should not become part of tier capital.

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) addressed this challenge in a commendable achievement. In March 1999, (AAOIFI) issued a statement on the purpose and calculation of the capital adequacy ratio for Islamic banks.

In their statement (AAOIFI) recommended the inclusion of 50% of the risk-weighted assets of the profit sharing investment accounts in the computation of the capital adequacy ratio. Inclusion of 50% of the risk-weighted assets of the profit sharing investment accounts was

recommended to cover the ‘fiduciary risk’ and ‘displaced commercial risk’. This is the first step in the right direction. However, there are still a number of other issues to be addressed, on the uses (assets) side of Islamic banks’ balance sheet.

IV. Risk weighting of assets for Islamic Banks:

The first issue on the asset side is that of assigning risk weighting of assets based on Islamic contracts. Although AAOIFI’s statement on capital adequacy covers the impact of the profit sharing investment accounts, the assets side has not yet been addressed.

The Basle Committee has assigned categories of risk weighting of assets (0, 20, 50, 100%), which are based on the standing of the counterparts. Islamic contracts are based on Shari'a and therefore have certain unique characteristics not present in conventional banking contracts. Islamic modes of finance have the peculiarity that they introduce new features in bank financing e.g. they introduce dealing in kind in the lending process. Labor also becomes an important part of the financing mechanism. Islamic banks are not “provider of funds” but rather co-investors. The types and level of risk involved differ under different modes of finance. Hence, in assigning a risk weighting these unique risk characteristics should be considered, which again for obvious reasons, the Basle Committee has not addressed.

In the absence of a consensus framework for assigning the appropriate risk weighting, the regulatory authorities supervising Islamic banks have interpreted these risk characteristics in different ways. The views in this paper draw on the experience of Sudan giving specific examples where such experience is relevant.

a. Mudaraba:

In this Islamic mode of finance – Mudaraba contracts – one basic juristic rule governing the transaction is that losses are to be borne only by the provider of funds, (the lender) i.e. the banker. The user of funds, i.e. the customer (the borrower) does not bear any portion

of the loss unless the loss was due to misconduct or negligence on his/her part. A second basic rule is that: the user of the fund, i.e. the customer, does not guarantee the principal except in the case of his misconduct or negligence. These two basic rules expose Islamic banks to considerable risk, in particular, in case where inadequate securities are provided or customers of doubted integrity are involved. The risk weight, which should be assigned to this type of finance contract, should reflect the implications of the above-mentioned juristic rules.

Also, the Islamic banker faces an additional risk related to the nature of the commodity which is the subject matter of the Mudaraba contract, a situation which necessitates setting different risk weights for different commodities. Central banks may obviously differ on their treatment of such risk. The experience of Sudan is detailed in the attached supplement.

b. Salam and Parallel Salam:

In a second mode of Islamic finance Salam and Parallel Salam contract, the pattern and nature of risk facing the Islamic banker is quite different from that facing conventional one. The cycle of the Salam contract is composed of three stages:

- * Cash disbursement of the finance to the customer.
- * Delivery of the commodity by the customer to the banker in settlement of the finance, i.e. in kind settlement.
- * Realization of the commodity into cash by the banker.

Each one of the above mentioned stages has its own risk impact on the Islamic banker, a situation which calls again for multiple risk weights instead of a unified risk weight for the whole Salam contract.

Salam contracts are normally used to finance the purchase of agricultural goods and thus may be subject to different interpretations. For example, in Sudan, banks assign credit risk weighting according to the length of the period the goods stay before realization into

cash by the banker ranging from 25%-100% (refer to supplement). Other central Banks may take a completely different view. Some may consider this as a commodity risk and compute a capital charge based on Market risk regulations. Yet, others may simply assign risk weighting based on the standing of the counterpart as per Basle Committee recommendations.

Thus, based on the view taken, the capital charge computed could be quite different for the same type of contract.

Another complication that might arise is when the Islamic Bank also enters into a Salam and Parallel Salam contract. Should the Islamic Bank compute a capital charge on the full amount of commitment against Parallel Salam? If the Salam contract fails; the Parallel Salam contract would have to be honored by the Islamic Bank and therefore could have a substantial loss if the price of the commodity had increased.

Apart from Salam contracts, another asset element in the portfolio of the Islamic bank which deserves special attention when deciding on the risk weight, is the inventory item. This item is composed mainly of agricultural and industrial inputs which are used for in-kind satisfaction of the financial needs of the Islamic banks' customers. While part of this asset is jointly financed by the Islamic bank's own resources and unrestricted investment deposits, the other part is exclusively financed by the bank. Moreover, the fact that the inventory asset is composed of items of different nature and maturities, should be taken into consideration in determining the risk weight of this asset.

c. Ijarah Muntahia bitamleek (hire-purchase):

A fourth example of Islamic financing that requires specific treatment is that of assets acquired for the purpose of leasing out on the basis of Ijarah Muntahia bitamleek (hire – purchase). Under Shari'a law, during the lease period Islamic banks cannot transfer substantial risks and rewards of ownership to the lessee. Therefore, during the term of the lease, these assets must be carried on the balance sheet of the

Islamic bank. This is further evidenced by the fact that if the assets are impaired during the lease period, the Islamic bank is liable to pay to the leaseholder any amount in excess of the fair rental value.

Different treatment of such assets would result in different risk weightings. For example, some central banks may take the view that 100% risk weighting should apply since these assets belong to the Bank and in the event of impairment the bank bears the risk of loss.

Other authorities may apply different risk weightings depending on the maturity or life of the asset. Yet others may consider these to be based on a finance lease and as such not require them to be reported on the balance sheet of the bank. Thus, risk weighting would be assigned on the standing of the counterparty as per the recommendations of the Basle Committee.

d. Murabaha:

Another example of the differences in treatment for risk weighting of assets is that related to Murabaha transactions. Such transactions may be of two types, namely, binding promise or non-binding. In the case of binding promise the assumptions of risk weighting would be relatively simple. A risk weight would be assigned according to the standing of the counterparty. The complexity arises when Murabaha is based on non-binding promise and the bank acquires an asset for sale to its customers. What risk weighting should be assigned? Some central banks may assign a 100% risk weighting. Others may take the view of assigning a risk weighting according to the standing of the eventual counterparty for which the asset would be acquired. In any event, it must be noted that under non-binding promise, the customer may refuse to purchase the asset and the bank may have to sell the asset to a third party, possibly at a loss. Therefore, this market risk has to be taken into consideration

e. Istisn'a and Parallel Istisna'a:

The next example is in the treatment of Istisn'a and Parallel Istisna'a

contracts. Under an Istisna'a contract, the Islamic bank pays a contractor or a manufacturer on the basis of percentage of completion and bills its ultimate customer also on the basis of percentage completed. The amounts paid to the manufacturer or the contractor are accumulated in a Work in Progress or Cost Account. For the purpose of presentation in the Islamic Bank's balance sheet, any amounts billed to the ultimate customer are deducted from this account. The customer account's receivable balance is shown separately on the face of the balance sheet.

However, there may be cases where amounts paid to the contractor or manufacturer may exceed the amounts billed. The Islamic bank would, therefore, have an exposure on the asset being manufactured or constructed. At the same time the Islamic bank would also have an exposure on its ultimate customer or the amounts receivable from him.

What should the credit risk weighting be for these contracts? Different views may again be taken. Some may assign a 100% risk weighting to the net balance in the work in progress account and assign a risk weighting according to the counterparty's standing on the balance in accounts receivable. Others may take the full exposure, i.e. the balance on the work in progress and accounts receivable account and assign a risk weighting according to the standing of the customer for whom the goods are being manufactured.

f. Musharaka:

A further example is on the treatment of Musharaka transactions. Musharaka transactions under Shari'a are normally for partnerships in trading transactions and do not cover participation in the share capital of another entity. Because in conventional banks, trading transactions are not normally allowed, the treatment of such transactions in relation to capital adequacy has not been addressed. Musharaka transactions could be for the acquisition and sale of commodities, real estate or other similar goods. The risk weighting assigned to these assets could

be quite different depending on the type of asset. For example, if the Musharaka is on a commodity, then some Central Banks may assign a risk weighting based on the life of the commodity. Others may subject this to market risk regulations.

Risk weighting where Musharaka is on real estate would be different.

Normally, this exposure would attract a risk weighting of 100% on the capital provided by the Islamic bank for the transaction. Apart from this, and since the basic juristic rule under Musharaka contract is that neither the bank nor the customer can guarantee the other partners' capital, the risk will differ with the parties' capital shares.

The examples discussed above cover the issues concerning the credit risk weighting of assets based on Islamic contracts. There remains another important issue facing Islamic Banks in relation to capital adequacy computation that of market risk.

V. Market Risk:

The issue of market risk is equally important if not more so, for Islamic Banks as for conventional ones. Although both types of banks could be exposed to foreign exchange risk, the various hedging techniques available to conventional banks cannot be used by Islamic ones. Therefore, Islamic Banks should be required to apply capital charge on their foreign exchange exposures based on the market risk methodology recommended by the Basle Committee. Measurement of the foreign exchange risk would involve the calculation of the net open position in each individual currency. The open positions may be either trading positions or simply, exposures caused by the bank's overall assets and liabilities.

Islamic banks may also be involved in taking positions in equities for the purpose of trading and thus would be exposed to equity risk.

The minimum capital requirement for equities would be expressed in terms of two separately calculated charges, one applying to the

'specific risk' of holding a position in an individual entity, and the other applying to the 'general market risk' of holding a position in the market as a whole.

The bank may take the trading position directly or through a fund manager based on Mudaraba contracts. It might be worth considering whether the market risk should be calculated on each position taken by the Mudarib or on a portfolio basis to take account of the diversification impact present in the Mudaraba portfolio. Again central banks may differ in the way they consider such risk. Some may consider equity funds provided on a Mudaraba basis subject to market risk while others may not.

Finally, Islamic banks may have positions in commodities, which could also be subject to market risk. As mentioned earlier some Regulatory authorities may view Salam contracts as being exposed to market fluctuations and therefore require that a capital charge be computed based on market risk methodology recommended by Basle.

Musharaka contracts for purchase and sale of commodities may also be considered as part of market risk.

The computation of commodity risk, as recommended by the Basle methodolgy, may be based on a maturity ladder approach or a simplified approach. For Salam and Parallel Salam contracts some central banks may not allow the simplified approach as the net impact may be 'zero'. However, if a Salam contract fails, the Islamic bank would have to honor the Parallel Salam contract by purchasing the commodity on the open market. Therefore, some central banks may only allow the maturity ladder approach for the purpose of computing capital adequacy ratio.

VI. Conclusion:

This paper discusses some of the peculiarities of Islamic Banking in relation to the setting of minimum capital standards by the regulating

authorities of Islamic Banks. The paper also outlines a number of areas where differences exist between various supervising authorities in their assignment of risk weights to assets. At present a consensus view on the computation of capital adequacy ratio is lacking. Because various supervisors interpret capital adequacy regulations differently, the capital of Islamic banks operating in different countries may not be measured on a level playing field.

By issuing its statement on capital adequacy (AAOIFI) is commended for taking the first step towards a unified approach, but there is need for greater co-operation and commitment by Central Banks and regulatory bodies in narrowing this gap further. There should also be a collective effort, with (AAOIFI) providing the platform, to address other issues relating to prudential aspects and best practices for Islamic banks. A regulatory framework based on a consensus view will further enhance the soundness and stability of Islamic banks. In this connection, the importance of giving serious consideration to the development of institutional arrangements must be stressed. The establishment of the Islamic Financial Services Board (IFSB) is an important move toward achieving this goal and is, no doubt, the first step in the right direction.

Supplement
Application of the Basle Accord
In Sudan

In the early 1990s, the Bank of Sudan imposed the application of the Basle Accord on all the authorised banking units operating in the country. The Bank of Sudan effected certain adjustments to the Accord to cater for the peculiarities of Islamic banking. In what follows, we will shed light on the details of the version of the Accord applied in Sudan.

With respect to the definition of capital which is included in the capital base, capital elements, limits and restrictions, deductions from the capital base, the version which is applied in Sudan conforms to the Basle Accord. Nonetheless we are still debating how to treat investment deposits for the purpose of computing capital adequacy ratio.

With respect to the risk weights by category of on-balance-sheet assets, the version applied in Sudan differs in some respect. It specifies risk weights as per the following table:

Asset	Risk Weight
* Cash in vaults	0%
* Foreign Exchange	0%
* Balances with Bank of Sudan	0%
* Balances with Local Banks	0%
* Balances with Foreign Banks	20%
* Cheques under collection	0%
* Claims on the Central Government Units	0%
* Claims on Local and Other Gov. Corporations	50%
* Finance fully secured by Mortgage on Real Estate	40%
* Finance secured by possessing mortgage	20%
* Finance secured by Joint Warehousing	50%
* Finance secured by Trust Receipts	100%
* Finance secured by Bankers' Guarantee	0%
* Salam kept for more than one year and less than two years	50%
* Salam goods kept for more than two years	100%
Assets	Risk Weight
Goods purchased for commercial purposes:	
a. Agricultural and industrial inputs:	30%
* Kept for less than one year.	
* kept for more than one	100%
	30%
b. <u>Durable goods:</u>	
* Kept for less than one year	
* Kept for more than one year and less than two years	40%
* Kept for more than two years and up to five years	50%
* Kept for more than five years	100%
* Finance against shares of registered companies in Khartoum Stock Exchange	50%
* Purchased Commercial Paper (confirmed L/G)	100%
* Purchased Commercial Paper (Other L/Cs)	100%
* Fixed Assets (net book value)	100%
* Government Securities	0%

Comparing the risk weights which are applied in the Sudanese version with those of the Basle Accord, has been notified that the major variations are in the following areas:

1. Cheques under collection are assigned a zero weight in the Sudanese version, primarily because drawings against uncleared effects is not allowed in the Sudanese banking system. In addition, Bank of Sudan plans in the near future to transfer this item from being an on-balance-sheet item to become an off-balance-sheet item.
2. Goods received in settlement of Salam finance are assigned risk weights within the range 25%-100%. The aim is to motivate the banks to realize such goods in cash as quickly as possible.
3. Durable goods: are assigned risk weights ranging from 30% to 100%. Again the purpose is to motivate quick realization of those goods.
4. Off-balance sheet items: For the Islamic bank this item is composed of letters of guarantee, letters of credit and restricted investment deposits. More specifically, Islamic banks do not deal in derivatives.