PART One

The Nature of Risks in Islamic Banking
1. INTRODUCTION

The documents of the Basel Committee for Banking Supervision (BCBS)—International Convergence of Capital Measurement and Capital Standards: A Revised Framework (generally known as Basel II) and the recently introduced new major set of reforms to Basel II, which are aimed at addressing global capital regulatory framework in light of the prevailing global crisis (and are generally known as Basel III)—present a real challenge to banking regulators and supervisors. This challenge is, of course, first and foremost in respect of the application of both documents to conventional banks. Basel II was issued in June 2004 (with some revisions in November 2005) to supersede the original 1988 Capital Accord (Basel I), while Basel III was issued in December 2010, with a revised version in June 2011.

The main innovations introduced in Basel II were, first, a significantly more comprehensive and sophisticated approach to measuring credit risk and, second, a capital requirement for operational risk. With respect to market risk, Basel II did not supersede the 1996 Amendment of Basel I, which had introduced a capital treatment for this category of risk not specifically covered in the original Capital Accord. The two approaches to market risk under Basel II, the Standardised Approach and the Internal Models Approach, are continued under Basel III.1 However, while the scope of regulation has been extended under Basel III to liquidity risk, and the
regulatory capital requirements have been increased, and there have been some significant alterations and additions to Basel II regulatory environment, the Three Pillars of Regulation established under Basel II remain and indeed are enhanced under Basel III.

Basel I was a document of modest length that made no great technical demands on the reader. However, the years since 1988 have seen a very significant evolution in banking and finance, including the effects of the globalisation of financial markets and developments such as the abundance of derivatives and securitisations using structured finance. These developments have significant implications for risk and capital adequacy. Hence, Basel II, which (with its appendices) runs to over 250 pages, is a fairly daunting document that makes some nontrivial demands on the reader, both technical and conceptual.

On the other hand, the development of Basel III was mainly prompted by the recent financial crises, which started to take shape in 2007. Basel III emphasises not only the importance of the absolute amount of a bank’s equity position, but most importantly the quality of capital held by these banks, two important issues that were not adequately addressed in Basel II.

The standards issued by the Islamic Financial Services Board (IFSB) have highlighted the fact that neither Basel II nor Basel III was (understandably) written with its application to Islamic banking in mind. However, the rapid development of Islamic banking since the early 1990s, and the fact that international financial authorities such as the World Bank, the International Monetary Fund (IMF), and the BCBS understood the consequent desirability of building bridges between Islamic (Shari‘ah-compliant) financial institutions and the conventional (Shari‘ah–non-compliant) financial sector, inevitably raised the issues of how and to what extent Basel II principles and techniques and those of Basel III are applicable to the regulation and supervision of Islamic banks, and of the regulatory and supervisory problems to be overcome in this context. These issues constitute the concern of this book.

2. THE STRUCTURE OF BASEL II AND BASEL III: SUPERVISORY IMPLICATIONS

The structure of Basel II is based on three “Pillars.” As mentioned above, these were retained and enhanced under Basel III. Pillar 1 deals with the new approach to credit risk, which replaces that of Basel I, and with operational risk; Pillar 2 addresses the supervisory review process from the standpoint of the responsibility of the supervisor to promote the overall safety of the banking system, and establishes a set of common guidelines for supervisory review, while also stressing the primary responsibility of individual banks
and the critical role of dialogue between supervisors and banks; and Pillar 3 lays down a minimum number of public reporting standards on risk and risk management intended to enhance the ability of market participants to be aware of a bank’s risk profile and the adequacy of its capital in relation to this, thus involving the market in the capital adequacy regime. Building on the three pillars of the Basel II framework, Basel III supplemented the risk-based approach by introducing new regulatory requirements (notably concerning liquidity risk and the quantity and risk absorbency of capital) to promote a more resilient banking sector.

Basel II and Basel III thus present all banking supervisors with a major challenge, both in enforcing Pillar 1 together with the disclosure requirements of Pillar 3, and in implementing Pillar 2. The adoption of Basel II was not intended to be a requirement outside of the G10 countries represented on the BCBS, and then only for banks that are internationally active. However, as Basel I had been adopted in more than 100 countries, the supervisors in these and other countries may be expected to adopt both Basel II and Basel III progressively over the next few years. The G10 was broadened to include additional members and renamed G20. Following the financial crisis that began in 2007, the G20 gave more powers to the Financial Stability Board (formerly the Financial Stability Forum), which, inter alia, include oversight over the implementation of Basel III. The membership of the Financial Stability Board includes, among other standard-setting bodies, the BCBS.

For supervisors in countries where Islamic banks are located, there is the further challenge of applying Basel II and Basel III to those institutions. This added challenge results from the specificities of the Islamic (Shari’ah-compliant) modes of finance employed by Islamic banks. These raise issues of capital adequacy, risk management, market discipline, and corporate governance that differ significantly from those that arise in conventional (Shari’ah–non-compliant) financial institutions. The issues concern the types of assets to which Islamic financing gives rise, the related risks and the availability of risk mitigants, and the types of non-interest-bearing savings and investment products offered by Islamic banks for funds mobilisation in place of conventional deposit and savings accounts. The fact that these non-interest-bearing savings and investment products have characteristics similar to those of collective investment schemes, not normally the concern of banking supervisors or regulators, constitutes a further regulatory challenge.

3. THE ISLAMIC FINANCIAL SERVICES BOARD

The Islamic Financial Services Board (IFSB) was launched in 2002 by a consortium of central banks and the Islamic Development Bank (and with
the support of the IMF) with the mandate to provide prudential standards and guidelines for international application by banking supervisors overseeing Islamic banks.

In December 2005, the IFSB issued two prudential standards for Islamic banks that are designed to help supervisors of such banks meet the challenge of implementing Basel II, one on capital adequacy and one setting out guiding principles of risk management. A third standard on corporate governance was issued in 2007. The mandate of the IFSB was extended in December 2005 to the domains of insurance and securities market supervisors and regulators.

The main challenge for the IFSB is to develop a framework that is common and applicable to all jurisdictions. However, unlike the Basel Committee, which can rely on regulatory frameworks and best practices developed by other leading regulators and banks as a background to its global framework, this process could not be readily applied by the IFSB. This is because the IFSB does not have the privilege of borrowing ideas from a large number of countries that have developed robust regulatory frameworks specifically for Islamic banks. Hence, the onus is on the IFSB to develop most of the thinking to set internationally accepted common prudential standards for Islamic financial institutions. This involves identifying the risks in the different types of Islamic finance and activities, understanding the substance as well as the form of the contracts that govern the transactions, dealing with issues that have not been addressed in other international standards, safeguarding the interests of other stakeholders who in principle share asset risks with the shareholders, and adapting Shari’ah rules that would be acceptable to the majority of its members.

In addition, whereas after the financial crises the Financial Stability Board has been given more powers to enhance the implementation of Basel III, the IFSB, according to its Articles of Agreement, can only recommend its standards to be adopted.

4. CONTENTS OF THIS BOOK

Since this book deals with a large range of regulatory issues arising from the application of Basel II and Basel III to Islamic banks, authors who have been chosen are specialists drawn from a variety of relevant backgrounds: banking and capital markets supervisors; the legal and accounting professions; banks and financial institutions; and academia. The book is organised into four main parts, reflecting different aspects of the regulatory challenge, and a concluding chapter, as outlined below.
Part One: The Nature of Risks in Islamic Banking

Part One consists of 12 chapters, this overview of the book being the first. In Chapter 2, Brandon Davies examines banking and the risk environment. He looks at the regulatory developments that have recently taken place following the financial crisis that started in 2007. The risk characteristics of Islamic products, and the complexities of some of these, such as the phenomenon of displaced commercial risk, are rigorously examined in Chapter 3 by Venkataraman Sundararajan. Chapter 4, by Sami Al-Suwailem, highlights the benefits that can in principle be derived from Islamic finance in light of the recent financial crisis, especially in enhancing global financial stability. The chapter points out how Islamic finance provides a framework for balancing the relationship between risk and returns, which, as Sami reminds us, requires careful and proper implementation to be practically relevant.

Chapter 5, written by the two editors of this book, Simon Archer and Rifaat Ahmed Abdel Karim, examines issues of capital structure and risk in Islamic banks and takaful insurance firms. Simon and Rifaat point out that the capital structures of both Islamic banks and takaful undertakings present complexities not found in the case of conventional financial institutions. With respect to the former, Archer and Karim show how capital structure and risk are linked, from a regulatory perspective, via risk weightings and capital requirements set out by the IFSB based on the Basel II and III Accords and the Standardised Approach to risk weighting. They highlight specific risks in contracts used by Islamic banks and the implications in these contracts for the capital requirements, and in some cases the capital structure, of these banks. With regard to takaful firms, Archer and Karim show how the regulatory capital of a takaful undertaking needs to meet the solvency requirements of the insurance operations, and how the takaful operator needs capital to cover its own business risks, especially the risk of its management fees being insufficient to cover its operating expenses and the “underwriting management risk” potentially arising from failure in its fiduciary duties in managing the underwriting of the Policyholders’ Risk Fund.

The next several chapters focus on specific types of risk facing Islamic banks. In Chapter 6, John Lee Hin Hock examines credit and market risks inherent in asset-side products. He shows how Islamic financing assets possess risk characteristics not found in conventional loans, including combinations of credit and market risks. In Chapter 7, Simon Archer and Abdullah Haron analyse consequential or operational risks. For Islamic banks, as they point out, operational risks include those that may arise from errors in drawing up contracts or in executing transactions that result in non-compliance with the Shari’ah, which may have serious financial consequences. Chapter 8, by Samir Safa, sheds light on information technology...
risk, a type of operational risk to which Islamic banks are particularly exposed. Samir claims that the lack of systems that genuinely comply with Shari’ah standards and principles (i.e., systems that are built with the primary purpose of supporting the Islamic finance operating model), seems to have forced the majority of the Islamic financial institutions to adopt conventional banking operational systems that were available in the market. This has greatly contributed, Samir argues, to amplifying the elements of information technology risk that Islamic banks face.

Chapter 9, by Yusuf Talal DeLorenzo and Michael J. T. McMillen, and Chapter 10, by Andrew White and Chen Mee King, deal with a complex and daunting set of risks arising from Shari’ah and legal compliance requirements and their interactions, which result inter alia in legal impediments to the development of Islamic securitisations. Chapter 9 also provides a historical outline, from a legal perspective, of the emergence of modern Islamic banking and finance.

In Chapter 11, Mohamad Akram Laldin addresses another type of operational risk, Shari’ah–non-compliance risk, which is unique to Islamic financial institutions (IFIs). Shari’ah must be the substance of, and provide guidance for, the day-to-day operations and activities of these institutions. The Shari’ah compliance of an Islamic financial institution, the author argues, is crucial to ensuring the confidence of IFI shareholders as well as that of the public in the authenticity of that institution, which in turn, will affect the profitability of the IFIs’ business in the future through its ability to attract and retain funds from the public. A serious lapse in Shari’ah compliance could lead to withdrawals of funds and other loss of business that could plunge the IFIs into crisis. For that reason, Shari’ah–non-compliance risk is arguably a higher priority category of risk for IFIs than other identified risks. In December 2009, the IFSB issued the Guiding Principles on Shari’ah Governance Systems, which delineates a system of internal control over Shari’ah compliance, comprising a continuous internal audit process and an annual review.

Finally, Peter Casey in Chapter 12 considers the implications of these risks in the wake of the financial crisis for a financial sector regulator. In particular, Peter examines the supervisor’s role in Shari’ah matters. He argues that in the case of a firm that claims to be Islamic, the regulator should focus on requiring that the IFI have a sound internal system to ensure Shari’ah compliance, on which the regulator may rely while avoiding the role (for which it is not equipped) of judging the Shari’ah compliance of the IFI. In such a system, the regulator may impose Shari’ah governance requirements on the firm. Implicit in this system is that the supervisor will apply an approach similar to those it would apply in other (nonreligious) control areas, with the aim of achieving compliance with religiously based requirements.
Part Two: Capital Adequacy

Part Two contains four chapters. Chapter 13, by John Board and Hatim El-Tahir, examines the need for bank capital in order to absorb the economic risks of banking. Their chapter touches on two inter-linked developments in capital regulation: first, the globalisation of financial regulation and the impact of the global regulatory framework proposed in Basel III, which aims at promoting a more resilient banking sector worldwide; second, the development and limitations of new forms of capital instruments (contingently convertible or subordinated) introduced by some major financial institutions, including notably systemically important financial institutions (SIFIs) on a global scale. Chapter 14, by editors Simon Archer and Rifaat Karim, highlights an important set of issues concerning the measurement of risk for capital adequacy purposes that results from the use by Islamic banks of profit-sharing and loss-bearing investment accounts in lieu of conventional bank deposit and savings products. In Chapter 15, Sandeep Srivastava and Anand Balasubramanian deal with the measurement of operational risk for capital adequacy purposes under Basel II and Basel III. With respect to Islamic banks, Sandeep and Anand point out that Islamic banks are subject to different types of operational risks, for example, risk of Shari‘ab-non-compliance, fiduciary risk, and risks arising out of the complex documentation involved in Islamic products. However, Sandeep and Anand claim that these unique risks of Islamic banks do not necessarily mean that these banks require different methodologies for measuring operational risk. Finally, in Chapter 16, Richard Thomas examines liquidity risk, an issue that Basel III addresses in depth, in Islamic banks. He highlights the liquidity management challenges, which Islamic banks face in light of the shortage of adequate high quality Shari‘ab-compliant financial instruments. This challenge has been further complicated by the Basel III requirement for the “high quality liquid assets” that banks should hold to manage their liquidity risk. Accordingly, Richard argues that the handicaps which Islamic banks face in managing liquidity risk should be addressed by national authorities (so as to provide Shari‘ab-compliant substitutes for the conventional interbank markets and lender-of-last-resort facilities), as well as by the global regulators and notably the BCBS in terms of what may count as “high quality liquid assets.”

Part Three: Securitisation and Capital Markets

Part Three consists of three chapters. Chapter 17, by Baljeet Kaur Grewal, deals with the developing phenomenon of securitisations in Islamic finance, or sukuk. She provides a market overview of the issuance of sukuk in various jurisdictions, as well as their potential. Baljeet argues that although conventional bonds and
sukuk share a similar process, structure, and end result, there are a few key Shari’ah principles, which must be adhered to, that differentiate the two types of securities. She gives examples of the common sukuk structures that have been used in the market. In Chapter 18, Prasanna Seshachellam considers the opportunities and challenges in the Islamic capital and money markets, and particularly the need to create a Shari’ah-compliant asset base and financial infrastructure for the creation of liquid Shari’ah-compliant assets. Prasanna also discusses the primary developments required to improve Islamic capital markets in general and those that are specifically required to improve the ability of Islamic capital markets to provide liquidity, which include, *inter alia*: (a) a robust and wide suite of credible Shari’ah-compliant products; (b) a stronger market infrastructure; and (c) measures (i) to attract a wider set of investors, (ii) to reduce uncertainty regarding market practices and instruments, and (iii) to achieve a robust and reliable regulatory framework. In Chapter 19, Nik Ramlah Mahmoud discusses the regulation of Islamic capital markets, pointing out that the regulation of the Islamic capital markets poses several unique challenges as compared to the regulation of Islamic banking and *takaful*. Nik Ramlah argues that the fundamental challenge in regulating Islamic capital markets is whether or not the objectives and requirements of Shari’ah are compatible with the underlying principles of general securities regulation. She discusses various approaches that are adopted (mainly in Malaysia) in the regulation of ICM.

**Part Four: Corporate Governance and Human Resources**

This part contains four chapters. The first, Chapter 20 by Carol Padgett, considers some of the common features of corporate governance regulations affecting companies across the globe, as well as banks as a special case. She considers the guidance published by the Basel Committee on Banking Supervision on corporate governance in banks, where she focuses on recent changes in that guidance as it affects risk management, remuneration practices, and transparency in banking structures. Carol also highlights how the recent banking crisis exposed shortcomings in each of these areas. Chapter 21, by the editors, examines specific corporate governance issues in Islamic banks, notably those raised by the requirement for compliance with the Shari’ah, and those resulting from the use by Islamic banks of profit-sharing and loss-bearing savings and investment products in place of conventional deposit and savings accounts. In Chapter 22, Daud Abdullah (David Vicary) considers the transparency and market discipline implications for Islamic banks of Basel II Pillar 3, as well as the developments that have been introduced in Basel III, indicating the potential
key role of the regulator in promoting or “bootstrapping” a virtuous circle of transparency. He also incorporates in his discussions the IFSB guidance on disclosures to promote transparency and market discipline for Islamic banks.\textsuperscript{6} In Chapter 23, Volker Nienhaus examines the human resource management implications of the conceptual and technical challenges facing the Islamic banking sector, including the need to recruit, train, motivate, and retain highly competent personnel in an environment rendered highly competitive by rapid growth and the presence of the major international banks.

\textbf{Part Five: Conclusion}

In the fifth and final section, Chapter 24, the editors present some overall conclusions.

\textbf{NOTES}

1. For more details on Basel III, see in this volume Chapter 2 by Brandon Davies and Chapter 13 by John Board and Hatim Al-Tahir.
2. The article in \textit{The International Journal of Bank Marketing} by Karim (1996), one of the editors of this book, was the first publication to highlight the fact that Basel 1 (the Basel Accord) could not be applied to Islamic banks without taking into consideration the specificities of these banks. This prompted the issuance of a document by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) (1999), which was mainly drafted by Simon Archer and Rifaat Ahmed Abdel Karim, the co-editors of this book.
3. In part, this was due to a series of conferences organised by Rifaat Ahmed Abdel Karim, co-editor of this volume, then Secretary-General of AAOIFI, notably the Conference on Regulation of Islamic Banking held in February 2000.
4. The essential differences between conventional and Islamic financial intermediation are explained by Venkataraman Sundararajan in Chapter 3 of this volume.
5. The IFSB standards on the supervisory review process (Pillar 2) and transparency and market discipline (Pillar 3) were issued in 2006.

\textbf{REFERENCES}
