
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.¹ 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 transaction 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.² 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

1 - 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.

2 - 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.

mortgage, ono-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 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.¹ if Musharaka and

1- 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).

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 similar carried out in conventional banks.¹ 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 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).

1 - However, it should be noted that this issue is currently under several countries consideration in several countries following Islamic banking

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.

B.3 Management

In 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 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 lossmaking 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.¹ It should also be kept in mind that Islamic banks have obligations only towards demand deposit holders, while conventional bank have obligation only 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.² Indeed, to help reduce the possibility of

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

2 - Reserve requirements can also be viewed as monetary instruments, means to

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.¹ 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.² These issues should be considered when calculating an appropriate level of the RR ratio.

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

facilitate interbank settlements, and as a form of taxation.

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

2 - 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.

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.¹

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

1 - 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.

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 not regularly requested from conventional banks; By contrast, because such information disclosure addresses the specific risk characteristic 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 or the means of financing them, predictable or foreseeable shortages or price increase of materials needed for the projects, and the like.
- **Types of securities**¹ 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

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

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.¹

- **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 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

1 - 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.

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. III-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 sections hould 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 aslo 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.¹ 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.² 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.

1 - Shariah Boards are composed of Islamic scholars and jurists. They ensure that Islamic banks, operations conform to Islamic precepts. All banking facilities should receive their clearance before being offered to the public.

2 - 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.

al. have noted, with the exception of the European Union, there are no international agreements on licensing standards.¹ 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.
- **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

1 - For a fuller discussion, see Lindgren, Garcia, and Saal, 1996.

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.¹ 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

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

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.¹
- **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.

1 - 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	Less likely	More likely
2) Insolvency risks	Less Likely	More likely

Relative importance of:

Assessment and management of operational risks:	Higher	Lower
(1) Reliance on appropriate procedure and adequate infrastructure:	Higher	Lower
(2) Reliance on human technical expertise.		
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.¹ 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 as 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 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 breadth, 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 are as 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

1 - In this paper, the term "western" defines countries where conventional banking is followed

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 passage 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.¹ (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 levels of overall liquidity than conventional banks;² 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

1 - Useful conversations on this topic with Michael Ainley of the Bank of England are gratefully acknowledged.

2 - This could affect Islamic banks, profitability compared with conventional banks.

satisfactory operational understanding with the home country authorities on how and on what basis Islamic banks are supervised in their respective countries vis-a-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 precept, 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.

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