

Basel II: Implications for Islamic Banking

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1. Introduction

In their “Islamic Banking: Issues in Prudential Regulations and Supervision,”¹ Luca Errico and Mitra Farahbaksh observed that regulatory supervision of Islamic banks by their respective monetary authorities tends to follow/use conventional standards and tools that apply to conventional banks although Islamic banks differ from their conventional counterparts in several ways.² Although they conceded that capital minimum requirement should take into consideration assets composition, i.e., the PLS investments versus non-PLS investment,³ they argued that the capital minimum requirement needed to for risks coverage should be higher in Islamic banks than in conventional banks because their PLS assets are un-collaterized. They further added: “it can reasonably be argued that the minimum capital adequacy ratio for Islamic banks should be somewhat higher than the Basel Committee’s minimum level of 8%.”⁴ They also argued that with regard to the criteria of each of the asset, management and liquidity Islamic banks also need more stringent supervision than conventional banks.⁵ Finally, Errico and Farahbaksh recognized that Islamic banking in practise does not follow their fantasized puritan two-tier or two-window paradigms (although they consider this a deviation which is a value judgement that we do not agree with) and they called for re-evaluating each of their conclusions in regard to CAMEL estimation for Islamic banks.

Furthermore, in a recent book on Risk Management in Islamic Banks, Khan and Ahmad argued that Islamic banks not only face the type of risks that conventional banks face but they are also confronted with “new and unique risks as a result of their unique asset and liability structures.” According to Khan and Ahmad, this new type of risks is an immediate outcome of their compliance with the Sharī‘ah requirement. They added that even in regard to common risks, the nature of conventional risks that Islamic banks face is different from those counterpart risks faced by conventional banks. The obvious implication of this argument is that Islamic banks need variant “risk identification processes” and different risk management approaches and techniques and require different kind of supervision as well.

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¹ Luca Errico and Mitra Farahbaksh (1998).

² Ibid., p 4.

³ Ibid., p 17.

⁴ Ibid., p 18.

⁵ Ibid., pp 20-21.

On the other hand, Basel Agreements, both I and II, are concerned with adequacy of capital that can stand up to the risks a financial institution may be exposed to so that if a certain minimum capital is maintained, the financial institution and the financial industry is protected from instability that may lead to insolvency.

This paper aims to examine the bearings that the Proposed Basel II accord may have on the Islamic banking practises. Keeping in mind that the Basel II proposals focus on risk treatment, their main objectives are centred on the calculation of minimum capital requirement that is necessary to promote stability and solvency in the banking industry. Out of this focused concern the proposals also deal with supervision procedures and supportive requirement that enhance market discipline within individual banking institutions.

This paper shall attempt to reach its objective in three sections. Section One will summarize the main concerns of the Basel II proposals and Section Two will examine the Islamic financing modes and practises that are sensitive to these proposals while Section Three will focus on the expected effects of the Basel II Accord on the Islamic financing modes and the Islamic banks' practises and on the necessary adjustment in the latter to accommodate the ideas floated in the New Basel proposed accord. Unlike both Errico and Farahbaksh who followed a dogmatic approach based on pre-assuming either of two paradigms for Islamic banks and unlike the theoretical approach of Khan and Ahmad, we will proceed in looking at the Islamic banks actual practises and the composition of their assets and liabilities as indicated in their balance sheets and financial reports.

2. Risks Addressed in the Basel II and Adequacy of Capital

The Basel II Proposed Accord, as expressed in its consultative version published for comments in July 2003, aims at establishing measures and criteria that enhance the stability and protect the solvency of the banking industry. It focuses on three pillars: A minimum capital requirement that is adequate to stand up to the risks a bank is exposed to, a supervisory review process that assures capital adequacy and a market discipline that aims to complement the first two pillars by enhancing market assessment of a financial institution and its capital adequacy by piecing together key informational bits a financial statement is made required to disclose. It is obvious that capital adequacy entails the whole story of risks and their assessment; a matter that puts the types of risks and processes of their assessment in the core of the Basel II Accord.

2.1 The First Pillar – Calculation of Minimum Capital Requirement

Risks Identified in Basel II

Although the proposed Basel Accord II is only concerned with risks from the point of view of its treatment of capital adequacy, it is in the interest of this paper

to look at the different kinds of risk an Islamic bank is normally exposed to and their respective effect on its capital adequacy. Understood as uncertainly about the outcome, risks may relate to positions held as components of the bank's assets or liabilities; they may also relate to people, systems and processes with which a bank is involved; and risks may be caused by external or internal factors.

Hence, according to sources/causes of risks, we may have external risks that may be caused by changes in policies and regulations of the banking supervisory authority (regulatory risk) or by macro and external factors that affect the rates of benchmarks, such as LIBOR, that are used in determining the rate of mark up in Islamic banks (call it interest rate risk); we have a risk that relates to the fulfilment of obligations by debtors of the IB (credit risk), There is also a group of risks, together called operational risks, that relate to people/staff of the Islamic bank itself, including error, negligence and fraud, to systems and technology used in the IB, to litigation processes and/or to the processes and procedures adopted in the IB; and finally we have trading book risks that are caused by price change of assets held by the IB at any moment of time, such as financial instruments and commodities.

Among all the different kinds of risks, the New Basel Capital Accord, especially its latest consultative document of April 29, 2003, is mostly devoted to the calculation, supervision and market disciplining of minimum capital requirement to meet the challenges of credit risk, operational risks and trading book risks, the latter result from changes in the market prices of marketable portfolio. Pillar 1 that is devoted to the calculation of minimum capital requirement did not give much attention to certain external risks especially changes in the benchmark on the ground that these kinds of risks are intrinsic to the main role of management and must be taken care of by its daily business decisions and that it is difficult to have consensus on methodologies of calculating their effect on capital adequacy; besides the fact that changes in the benchmark only reflect lost opportunities rather than the actual existing contractual relationships between a financial institution and its debtors. Consequently, the New Basel Accord took the position of leaving these kinds of risk to the discretion of the supervisory authorities and dealt with them only under Pillar 2.

Credit Risk and the Minimum Capital Requirement

Basel II goes on to set the general rules for estimating the credit risk associated with each kind of assets. It classifies a bank's assets on the basis of kind of debtors, collaterals or nature of the assets into 13 kinds as follows:

1. Claims on sovereigns,
2. Claims on non-central government public sector entities,
3. Claims on multilateral development banks,
4. Claims on banks,

5. Claims on securities firms,
6. Claims on corporates
7. Claims included in the regulatory retail portfolios
8. Claims secured by residential property
9. Claims secured by commercial real estate
10. Past due loans
11. Higher-risk categories
12. Other assets
13. Off-balance sheet items

It should be noticed that while the first 7 categories of assets relate risks to the kind of debtors the last 4 looks at risks from the point of view of the nature of the asset itself and categories 8 and 9 focus on the security attached to the asset.

Furthermore, for the purpose of calculating the minimum capital requirement, all risk weights are applied on the assets items after the deduction of provisions, i.e., net of all provisions required by the usual accounting and auditing regulations and sound practises.

Credit Risk Assessment

Essentially, the Basel II proposals accommodate three approaches to estimate the risk associated with each kind of assets: the standardized approach, the internal rating-based approach and the advanced measurement approach. No matter which method is used, the total of credit-risk-weighted assets will be used in the calculation of minimum capital that should be required by the supervisory authority.

The standardized methodology requires individual banks to depend on external credit assessment by approved institutions in determining the risk rating of their assets and for each of the above mentioned 13 kinds of assets, the Accord suggests a given weight corresponding with each such rating. Table 1 below gives an example of these risk weights under simplified assumptions.

Table 1: Simplified Sample of Risk Weights Assigned to Ratings

Rating	Kind of asset	A to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
1 & 2	Claims on sovereigns and PSE	0%	20%	50%	100%	150%	100%
3	Claims on multilateral dev. Banks	0%					
4 & 5	Claims on banks & security firms	20%	50%	100%	100%	150%	100%
6	Claims on corporates	20%	50%	100% ¹		150% ²	100%

For rating BBB+ to BB- .

For rating below BB- .

External credit assessment institutions (ECAI) must be approved by national supervisory authorities on the basis of the following six criteria:

1. Objectivity: an ECAI must have a substantiated historical experience of rigorous and systemic assessment that is responsive to changes in financial conditions.
2. Independence: especially for corporate influence of the financial institutions as well as from political subjectivities that may influence the rating.
3. Transparency: This includes public availability of assessment methodology as well as accessibility of the rating to all domestic and international concerned institutions.
4. Disclosure: rules and approaches of assessment methodology must be disclosed including the definition of each rating, the meaning of default, the qualitative and quantitative criteria applied in assessment, etc.
5. Resources: This includes accessibility to top and middle management of the rated institutions and to internal information on continuous basis.
6. Credibility: It denotes acceptability of a ECAI by indiscriminatory classes of rating users including investors, insurers, business partners.

Risk Assessment of Categories of Interest to Islamic Banks

Of course, Islamic banks have assets distributed into all the 13 categories mentioned above. But since we only give the suggested risk weights of the first six

in the simplified example a quick look at the Basel II treatment of risk weighing in the other categories of assets is worthy of a special attention because of their substantial presence in Islamic banks.

For claims included in the regulatory retail portfolios, the suggested risk weight is 75% provided that these claims are on individuals or small businesses; a result of revolving credits, lines of credit, loans and leases (including instalment loans, auto loans and leases, student and educational loans and personal finance) and small business facilities; sufficiently diversified (e.g., no aggregate exposure to one party can exceed 0.2% of the overall regulatory retail portfolio) and no total exposure to one party can exceed a given amount determined by the supervisory authority.

For claims secured by residential properties and commercial properties, the suggested risk weights are 35% and 100% respectively provided that the regulatory authority is satisfied as to the adequacy of these weights and it can increase them as it deems appropriate.

For past due secured loans for more than 90 days, the suggested risk weights range from 100% to 150% depending on the rate of provision that is deducted from the aggregate amount of such loans. At the same time the supervisors are asked to set strict criteria for collateral and to reduce the risk weights if the quality of collateral and loans permits.

For high risk claims, the suggested risk weights are set at 150% or as high as 350% depending on certain criteria whose application is left to the discretion of the supervisory authority. High risk claims include claims on sovereigns, public sector entities, banks, and securities firms rated below B-, claims on corporates rated below BB-, past due loans, securitization claims that are rated between BB+ and BB-, venture capital and equity investment.

For other assets, the suggested risk weights are set at 00% or higher depending on the nature of asset and the discretion of the supervisor. These other assets include: investments in equity and regulatory capital instruments issued by banks or securities firms.

For off-balance sheet items, the Basel II suggests a set of conversion factors that vary between 20% and 100% according to the nature of the item, the quality of collateral and the term of the commitment.

The Internal Rating-Based Methodology

The internal rating-based approach may be opted by some banks subject to certain qualification requirements. These requirements explained in part H of the Basel II Accord documents. They “are set out in 11 separate sections concerning: (a) composition of minimum requirements, (b) compliance with minimum requirements, (c) rating system design, (d) risk rating system operations, (e) corporate governance and oversight, (f) use of internal ratings, (g) risk quantification, (h) validation of internal estimates, (i) supervisory LGD and EAD

estimates, (j) calculation of capital charges for equity exposures, and (k) disclosure requirements.”⁶ The objective of these requirements is to assure that banks have the “abilities to rank order and quantify risk in a consistent, reliable and valid fashion.”⁷ To be able to rely on an internal rating-based approach, a bank must demonstrate to its supervisor that it has a consistent rating system that is able to quantify the risk weights of its assets in accordance with the best practises and guidelines given in the Accord and from time to time by the supervisory authorities.

The rating system of the bank must set standards for sovereign, corporate and other bank’s exposures that are compatible with the recommendations of the Accord. Each debtor must be assigned a risk grade for debtor’s default that will be applied to all exposure to this specific debtor. In addition a second dimension of risk assessment must reflect transaction specific factors, such as collateral, seniority, product type, etc.

In determining the Minimum capital requirement, risk estimates according to the internal rating-based approach must identify all risk components that include measures of the probability of default, loss given default, the exposure at default, and effective maturity.

Banks are required to categorize their exposures into broad classes of assets with different underlying risk characteristics. These classes of assets are: corporate, sovereign, bank, retail, and equity; and each class will have different sub-classes. For instance, from the point of view of risk estimation, the corporate class is divided into five sub-classes as follows: project finance, object finance, commodities finance, income-producing real estate, and high-volatility commercial real estate.

Once the risk components are identified and calculated for each sub-class of asset as well as for each debtor and type of exposure, risk weight functions may be determined that will be applied to the different sub-classes of assets in calculating the value of risk-weighted assets that will be used in determining the minimum capital requirement that is necessary to meet credit risk exposure of the bank.

Finally, the Advanced Measurement Approach requires banks to use their internal risk measurement system to estimate the credit-risk-weighted assets, using the quantitative and qualitative criteria as suggested in the Proposals and subject to a few strict qualification criteria and the discretion of the supervisory authorities.

⁶ The New Basel Capital Accord, consultative document of April 29, 2003, Part H Section 349.

⁷ *Ibid.*, Section 350.

Minimum Capital required for Credit risk exposure

Once the credit-risk-weighted assets are calculated, the minimum capital requirement for the bank is calculated by adding the total of credit-risk-weighted assets to the product of the capital requirement for operational and market risks,⁸ by 12.5% (i.e. The reciprocal of the minimum capital ratio of 8%) and using the sum as denominator; the numerator should be the regulatory capital (Section 22).

The ratio for total capital must not go below 8% and the tier 2 must be not less than 100% of tier 1. Tier 1 capital consists essentially of paid up shareholders' principal plus disclosed reserves and retained earnings or all forms of permanent capital that is able to absorb losses; good will is deducted from tier 1.⁹ Subject to certain limitations, tier 2 capital includes: undisclosed reserves, asset revaluation reserves, general provisions and general loan-loss reserves, hybrid capital instruments and subordinated debt.¹⁰

Operational Risks and Minimum Capital Requirement

The Committee of Basel II defines operational risks as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events." It is the risk of faulty system, people or procedures regardless of whether the fault is intentional, such as fraud or theft or unintentional such as internet or electricity failure and regardless of whether the loss is caused by outsiders such as changes in regulatory policies or insiders such as inadequate or incompetent internal safety procedures. Operational risk includes legal risk, but excludes strategic and reputational risks.

The Basel II Proposed Accord suggest either of three methods to measure the minimum capital requirement for operational risk exposure and leaves the choice between them to the supervisory authority. These three methods are: the Basic Indicator Approach, the Standardized Approach and the Advanced Measurement Approach. They are considered as three levels of development and advancement and the Committee suggests moving from one to the other as banks become "more sophisticated" in their tools of measuring operational risk. It also recommends that the more a bank is internationally active the more sophisticated it is supposed to be in measuring operational risks.

The Basic Indicator Approach is simple. It takes the moving average gross income over the past three years as a proxy of the size of operational risk exposure and suggests a parameter of 15% to calculate the minimum capital required to stand for this kind of risk. The parameter is derived from industry wide studies

⁸ Market risk is incorporated in trading book risks (see Section 642).

⁹ Press Release of October 27, 1998 and International Convergence of Capital Measurement and Capital Standards of the Basel Committee on Banking Supervision.

¹⁰ Ibid., see also Section 22 of the New Basel Capital Accord, consultative document of April 29, 2003.

relating gross income to capital requirement to face losses due to operational failure. The Standardized Approach is a little more refined. It takes average gross income at the activity level, after dividing a bank's activities into 8 categories, and suggest a parameter for each of them. These parameters, ranging from 12% to 18%, are based on the same estimation of industry wide relations of operational risk of each category to its capital requirement and the proxy of operational risk is the category's moving average gross income. The bank's minimum capital requirement becomes the sum of the eight-category requirements or $\Sigma(GI_{i-8} \times \beta_{i-8})$. An alternative standardized approach can be used if it can be shown that it improves the estimation. This alternative standardized method uses average loans and advances instead of gross income for the two activity categories of commercial and retail banking, it also allow to lump sum the other 6 categories and use a parameter of 18% for their total moving average gross income. Finally, the Advanced Measurement Approach allows using internal measurement methodologies to calculate the minimum capital requirement for operational risk exposure provided the bank satisfies certain qualification criteria that assure the supervisory authority of the existence of efficient and independent operational risk management system and of its ability to fairly estimate operational risk and the capital needed to face it including the expected losses as well as the unexpected losses. In addition, the bank's independent internal management and its systemic framework must be subjected to external periodical evaluation.

Trading Book Risk and Minimum Capital Requirement

The Basel II Proposals define trading book risk as the risk resulting from holding positions in actively managed portfolio of financial instruments and commodities either with trading intent or in order to hedge other elements of the trading book. Such financial instruments/commodities should be freely tradable and externally valued.

These are essentially short term positions intended to make a profit from price changes or to hedge against positions that arose from client serving. The Basel II proposals make very stringent conditions for admitting trading book positions under their risk estimating procedures including that they must be documented, approved by senior management with clearly defined policies and procedures, etc. They also require a clear and prudent policy of evaluation, especially for less liquid positions, that should include a system of cheque and control and depend essentially on "marking to market" in evaluating trading book positions whenever this is possible with a system of valuation adjustment/reserves for price differentials especially if the marking to market method in not feasible.

After all the possible tight conditions imposed to reduce the risk impact of trading book positions on equity, the Basel II Proposals suggest that minimum capital requirement for exposure to trading book risk be estimated using methodologies similar to those used in estimating credit risk, they also offer

parameters for calculating capital requirements that vary depending on the kinds of securities held and their maturities (governments, corporates, etc.).

Risk Mitigation

There is no doubt that risk mitigation must reduce minimum capital requirement that is necessary to match the risk exposure a bank has provided the collateral actually reduces the risk exposure.

Collaterals can be used to mitigate credit risk and certain kinds of operational and trading book risks. Credit-risk collateralized transactions are defined by the Basel II Proposed Accord as transactions that have an actual or potential credit exposure but are “hedged in whole or in part by a collateral posted by the counterparty or by a third party on behalf of the counterparty.” [Section 90]

Collaterals may be financial, property or personal. A financial collateral is allowed to reduce the credit risk exposure and consequently capital requirements, if certain conditions are satisfied (that include having the right to liquidate or take legal possession in a timely manner), by replacing “the risk weighting of the collateral for the risk weighting of the exposure subject to a 20% floor, but if the bank uses the comprehensive approach it may be able to reduce the exposure amount by the value of the collateral [Section 92].

In the simple approach, the risk weighting of the collateral instrument is substituted for the risk weighting of the exposure whereas in the comprehensive approach, banks are required to adjust both the amount of the exposure and the value of the collateral and to account of future fluctuations in the value of each of them [Sections 100-101]. At the discretion of the supervisory authority, banks may use standardized indicators to estimate the value of collaterals or they may be allowed to use their own internal estimates. Additionally, not all collaterals are eligible to use either method in calculating the capital requirement. Certain collateral instruments are recognized in the simple approach; these include: cash on deposit, gold, quality debt securities, etc. In the comprehensive approach the conditions for eligible collaterals are more relaxed because this approach take more caution in its estimation.

In the calculation of capital requirement for mitigated exposures, the Basel Committee suggests to take into consideration the evaluation of the collateral, its maturity and the currency exchange risk it may involve and recommends specific ratios for calculating the risk-weighted collateralized assets. Under the standardized approach, for mitigated credit-risk exposures, these ratios ranges from 0.51% to 612% [Section 122]. Other ratios are suggested for a host of other conditions and cases.

2.2 The Second Pillar – Supervisory Review Process

The stated objective of the supervisory review Basel Accord is two folds: “to ensure that banks have adequate capital to support all the risks in their business and

to encourage banks to develop and use better risk management techniques in monitoring and managing their risks,” [Section 678]. The supervisory authority must always be ready to intervene when there exist situations of increased risks that may threaten the stability of the banking industry. However, the Accord recognizes that the main responsibility of risk management and provision for capital adequacy rests on the banks themselves.

In addition to be sure of the adequacy of a bank’s capital to confront all risks’ exposure the supervisory authority must address the satisfactory fulfilment of the conditions that warrant the use of internal rating and advanced measurement approaches by a bank’s management. Recognizing the relation between risk management effectiveness and the amount of capital needed to face risks exposure, the supervisory authority is supposed to focus on evaluating how well banks are assessing their capital needs relative to their managerial approach towards risks and to intervene when necessary.

The Basel II Committee establishes four basic principles for effective supervisory review: “1) banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels; 2) supervisors should review and evaluate banks’ internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios and supervisors should take appropriate supervisory action if they are not satisfied with the result of this process; 3) supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum; and 4) supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.”

To operationalize each of these principles, the Basel II Committee suggests specific sets of tools. It requires each bank to set up a senior management board that oversees the assessment of capital adequacy, risk management and continuous maintenance of capital level; and to establish a documented strategy of sound capital assessment and a process of comprehensive assessment of risks of all kinds including those risks that are not focused on under the first pillar of the Basel II (such as interest rate risk and liquidity risk) along with clear procedures for monitoring and reporting and for periodical internal control review, [Sections 685 and after].

Additionally, the supervisory authority must establish a satisfactory process to evaluate the ability of banks to assess their own capital needs and continuously maintain capital adequacy. This entails on-site and off-site examinations, inspections and reviews of the banks’ internal processes of capital adequacy and the satisfaction of qualifying criteria to ensure the existence of a sound, tested, and properly documented risk management process; continuous interaction with the

management; analyzing external auditing reports and establishing processes of periodical reporting; and taking appropriate action if they are not satisfied with the results of their inspection [Section 704-714].

To ensure bank's safety and stability, the supervisors must consider setting a bank's specific buffer for the uncertainty that surrounds a given bank's risk exposure and requiring a level of capital that is above the general minimum capital requirement set under the Pillar one discussed in the first part of the Basel II Proposals. Finally, a range of options may be considered by the supervisory authority when it finds that a bank is not responding to the capital adequacy requirement and other supervisory concerns. "These actions may include intensifying the monitoring of the bank; restricting the payment of dividends; requiring the bank to prepare and implement a satisfactory capital adequacy restoration plan; and requiring the bank to raise additional capital immediately." Keeping in mind that a capital increase may not be the ultimate solution to a bank troubles, the supervisors should be able to take necessary action to enhance, or even enforce, a restructuring of a bank's risk management policy and strategy, to reshuffle its risk managerial entities and capabilities and to re consider its capital adequacy assessment.

In addition to the basic principles of supervisory review, the Basel II Committee suggests that the supervision should cover a few areas that, for one reason or another, were not emphasized in under the first pillar that deals with banking capital adequacy. These issues include: interest rate risk in the banking book, certain kinds of operational risks, conducting and assessment the results of stress tests, exacting the definition of default, assessment of the residual risk and credit concentration risk, capital treatment for certain specific securitization exposures, keeping up with market innovations and changes in both the financial arena and the IT arena, etc.

The supervisory review must also focus on overseeing complete transparency in information disclosure by banks and full and clear processes for accountability of a bank's different levels of management.

2.3 The Third Pillar – Market Discipline

Pillar Three aims at creating a banking-industry market environment that induces banks to self-maintaining capital adequacy and self-satisfying the supportive supervisory requirements through the disclosure of relevant information. Supervising authorities normally have the power and ability to enforce the necessary disclosure.

To create a market discipline, relevant information is determined by a materiality test: "information is material if its omission or misstatement could change or influence the assessment or decision of a user relying on that information"[Section 766]. Information disclosed should be such that it enables market participants to assess capital adequacy and risk exposure of a given bank.

Furthermore, since the Basel II accord allows banks to rely on internal methodologies of assessing credit and other risks and calculating minimum capital requirement on the basis of satisfying certain qualifying requirements, information on the fulfilment of these requirements should also be known and disclosed. Consequently, while keeping in mind the proprietary and confidentiality nature of certain information, the appropriate disclosure of quantitative information in the banking industry goes a step farther than the general disclosure required under the accounting standards.

The where, how, how often and the extent of coverage of qualitative information of disclosure is left to the discretion of management under the prevailing authority of supervisors. Qualitative disclosure must cover “general summary of a bank’s risk management objectives and policies, reporting system and definitions.

The qualitative and quantitative disclosure requirements are explained in tables 1 through 13 in Sections 770 – 775 of the committee’s Proposals. They include: the scope of application for consolidated statements; capital structure including the amount of Tier 1 capital, the total amount of Tier 2 and Tier 3 capital and the total eligible capital; determinants of capital adequacy; risk exposure and assessment for each separate risk area (e.g., credit, market, operational, banking book interest rate risk, equity).

3. Islamic Financing Modes and Practises Sensitive to Basel II Proposals

In this Section, I will investigate the Islamic modes of financing and their application in Islamic banks for the purpose of finding out any potential sensitivity to the proposed Basel II Accord. It is important to remember that the Basel II proposals restrict their concern to the effect of risks on capital adequacy rather than discussing risk management because the latter is a matter of management attitudes, strategies and policies that, except to the extent they may lead to unsound capital position vis-à-vis claims on the banks, should not be a subject of concern to the macro monetary management/supervision whose interests are focused on the stability of the system rather than on the solvency of a specific financial intermediary. Even when solvency of a specific bank matters to the supervisory authority, it does only from the point of view of protecting the Macro financial system and the effect on other entities that transact with that specific bank. Finally, important as it is I will not address the issue of disclosure requirements because it is essentially procedural. At the same time, I recognize its importance for market discipline and the need to revise and expand the disclosure standard of the AAOIFI in the light of the Basel II and after surveying the actual variety of practises in Islamic banks.

The supervisory concern of capital adequacy is addressed through the components of claims of and claims on a financial institution. This means that for

both Islamic banks and Islamic financing modes, Basel II proposals will deal with these claims from the point of view of how should they be assessed so that an Islamic bank can stand to all of its liability without creating instability in the macro monetary management, both domestically and internationally.

Consequently in this Section we will take a closer look at the Islamic modes of financing from the point of view of what components they create in the balance sheet and what qualitative effect they may have on weighing the risks that are pertinent to the different components of claims to/on an Islamic bank. This will be done under three titles that respectively deal with debt-creating Islamic modes of financing, non-debt creating modes and the assets structure of Islamic banks as it can actually be derived from samples of a few Islamic banks' financial statements.

3.1 Debt-Creating Islamic Modes of Financing

It is well established that the most commonly used Islamic modes of financing are those that produce debts in money terms on the beneficiaries. These include the sale and the *ijārah* modes.

Sale modes include: *murābahah*, whether it creates one lump sum future maturity debt or a stream of instalments that is very often called instalment sale in many Islamic banks. Claims resulting from *murābahah* financing may be on sovereigns, public sector entities, other banks (though rarely), securities firms, insurance companies (rarely too) retail portfolio, etc. From accounting point of view they are normally assessed at the net value after deducting suitable provision. The AAOIFI's Financial Accounting Standard No. 2 on "*murābahah* and *murābahah* to the purchase orderer" states: "Short-term and long-term *murābahah* receivables shall be recorded at the time of occurrence at their face value. *Murābahah* receivables are measured at the end of the financial period at their cash equivalent value, i.e., the amount of debt due from the customers at the end of the financial period less any provision for doubtful debts."¹¹

These modes also include *istiṣnā'* based financing which is a three party contract (consisting of two parallel *istiṣnā'* contracts whereby the I B is a Mustasna' in the first and Mustasni' in the second) that creates a future debt, or a stream of debts of different maturities, on the beneficiary from the *istiṣnā'* against payments advanced at given intervals to the contractor (the final Mustasana') plus the bank's profit. Here again we find that AAOIFI's standard No. 10 emphasizes that the receivables of financing *istiṣnā'* are treated the same way like other claims in the balance sheet of the bank.¹²

We can add to Sale based modes of financing the *mushārahah* import financing that is exercised by certain Islamic banks as an alternative of *murābahah* because this kind of *mushārahah* is normally supported by a promise to buy the financier

¹¹ AAOIFI (2003a), Section 2/3, Standard No. 2, p. 122.

¹² Ibid, Section 2/2 (b), Standard No. 10, p. 301.

(the Islamic bank) out upon receipt of documents. This *mushārah* in imports documentary credit also creates future claims on the temporary and “procedural only” partner.

Since *salam* sale is also a financing contract, although rarely used in most Islamic banks, I feel that we may refer to it too. The Accounting Standard No. 7 deals with *salam* and Parallel *salam*. What is worth noticing in this standard is that it treats the in-kind debt created by a *salam* contract as cash and values it at the principal advanced by the bank to the customer, i.e., without including the potential profit of the bank. Thus a *salam* financing creates debts expressed in cash form while a parallel *salam* reduces this indebtedness by the amount of the parallel contract.

In Addition to Sale-based financing, *ijārah*-based financing also creates future claims on the lessees. This is apparent in connection with the rental dues for future usufructs. But it should also be clear that financing *ijārah*, as practised in Islamic banks, also creates future claims on the lessee/purchaser.

The Standard No. 8 of AAOIFI deals with *ijārah*. It distinguishes between operational *ijārah* and *ijārah* that ends with ownership transfer. According to this Standard, ownership transfer is effected at the end of the lease period by either giving the leased asset as a gift, selling it to the lessee for a nominal or non-nominal price, selling it during the lease contract for a price that is equal to the face value of the remainder of the rental instalments (which is unrealistic because it does not take into consideration the effect of maturity on value, and if it does it becomes covered under sale for non-nominal price) or gradual sale of consecutive portions along with rental payments [Section 2 of Standard 8].

What is unfortunate is that the AAOIFI standard on *ijārah* did not make any reference in the balance sheet to the treatment of the lessee’s commitment to pay the rentals or instalments in either the operational *ijārah* or the ending-with-ownership *ijārah*. The closest it gets to this commitment is when it suggests that the rental revenues must “be allocated proportionately to the financial periods in the lease term and should appear in the income statement as *ijārah* revenues [Section 3/1/1/2]. Except for a disclosure explanatory note regarding the future maturity rentals [Section 3/5/1/1(b)], it stayed silent on the treatment of deserved but not due for payment, deserved but past-due and paid but not-yet-deserved rentals. This means that such cases are left to the general accounting standards that require recording them as claims on, or advances by, the lessee. This kind of treatment is also implied in the AAOIFI Shari‘ah Standard No. 9 that deals with *ijārah* and ending-with-ownership *ijārah*. This Shari‘ah Standard clearly states that *ijārah* is a binding contract that must have a defined and determined period.¹³ Unfortunately, the full accounting treatment of this “binding” principle is not reflected in the Accounting Standard No. 8. Here again we refer to the general

¹³ AAOIFI (2003b), Sections 4/1/1 and 4/1/2, p. 146.

accounting standards requiring that the lessee's commitment to pay the instalment (that are called rentals in spite of the fact that they contain partial payments of the price of the leased asset), with or without a binding buy out, should be reflected as claims on the lessee subject to the continuous existence, and availability to use, of the leased asset.¹⁴ This is because the commitment to pay rentals is binding and represents a debt on the lessee.¹⁵ On the other hand, each of a binding or unbinding promise to buy the asset at a nominal or non-nominal price, or at the remaining instalments or future gradual purchase must be reflected by a separate off-balance-sheet record subject to end of financial year adjustment.

Additionally, while the AAOIFI Standard made a distinction between a binding promise to take ownership at the end of the period of *ijārah* and a non-binding promise, it did not mention how either kind of promises must be reflected in the accounting records and in the balance sheet of the bank. This leaves it to the general accounting standards once more to suggest an off-balance-sheet record that expresses each kind of commitment while we must keep in mind that most Islamic banks adopt the "binding promise" idea.

For the operational *ijārah*, though it is rarely practised in Islamic banks, the AAOIFI Accounting Standard No. 8 suggests to treat leased assets as investment fixed-assets and to subject them to the amortization procedures like any other assets that are acquired for investment [Section 3/1/1/1].

As for the ending-with-ownership *ijārah* of all its kinds, The Standard's suggestion for its treatment in the balance sheet is also: investment fixed-assets subject to amortization in the balance sheet exactly like the assets of operational lease [Sections 3/2/1/1/5, 3/2/1/2/5, 3/2/1/3/5 and 3/2/1/4/6(a)]. Since I see the relation between the lessor and assets leased on the basis of ending-with-ownership *ijārah* much weaker than the commitment of the lessee to pay rentals/instalments, I think this treatment of leased assets is improper and must be replaced by what I suggested above: Expressing the lessor's ownership in an off balance sheet record because the interest of the I B is actually focused on the financing aspect and the legal formulation of this kind of *ijārah* normally includes very tight commitments,

¹⁴ There is a fine distinction between ending-with-ownership *ijārah* and the conventional financial lease that should be pointed out. In financial lease the commitment of the lessee is binding regardless of what happens to the leased asset since the lessee is the one who deals with insurance, while in the ending-with-ownership *ijārah* the lessor remains responsible for making the asset available to the lessee, therefore the former remains responsible for the asset and its insurance (though its premiums are implicitly or explicitly charged to the lessee); it is the lessor who in principle deals with insurance.

¹⁵ Obviously this representation must be accompanied with closing the account of the ending-with-ownership assets to avoid duplication. I suggest that the letter be transformed into an off balance sheet records that indicates the very thin remaining relationship between the lessor and these assets. This is not what the Accounting Standard No. 8 adopts as will be shown after a few paragraphs.

collaterals, supportive insurance and maintenance agreements that increase the distance between the lessor and the leased assets and practically restrict the authority of the lessor to claims of a future flow on the lessee.

It must be noted that the credit risk associated with all these claims and receivables that result from sale and *ijārah* financing can be mitigated by all kinds of collaterals as they are known and practised in conventional banks. Consequently, the same rules and regulations pertaining to either the categorization of claims according to collaterals or to the recognition of the different kinds credit-risk mitigation/collaterals, as suggested in the Basel II proposals, may apply to Islamic banks on the same footing as conventional banks.

Finally, it goes without saying that these different debt creating Islamic financing modes do not go outside the categories of claims as classified in the proposed Basel II Accord, although the accounting standards of the AAOIFI do not require a categorization similar to that suggested in the Basel II Accord. Furthermore, similar to the Basel Accord, the AAOIFI Accounting Standards require that these claims should be evaluated net of any provision of doubtful debts.

3.2 Non-Debt Creating Islamic Financial Modes

Financing modes of *muḍārabah* and *mushārah* do not create debt because the beneficiaries of these modes of financing do not stand liable for the principal of, or any return on, this financing unless when a loss occurs as a result of negligence or transgression on their part. Consequently, the AAOIFI's Standard No. 1, that is devoted to presentation and disclosure in the financial statements, emphasized that financing that uses either of these two contracts must be expressed as investment in *mushārah* and investment in *muḍārabah* respectively rather than debts on the beneficiaries.¹⁶

Financial Standards No. 3 and 4 deal with the treatment of financing through *muḍārabah* and *mushārah* respectively. In brief, they both reinforce the principle that these are investments rather than liabilities on the beneficiaries and that their disclosure in the periodical financial statements must only reflect the actual stage of each such financing transaction. For instance, if a final or partial settlement is completed before the date of a financial statement, the latter must then reflect the profit/loss and record any remainder balance on the partner as debt until it is actually paid. They also make room for creating special provisions for any unrealized decline in the market value of the assets of *mushārah* and *muḍārabah* financing, for any losses resulting from misconduct of the *Muḍāreb*/partner that

¹⁶ Standard No. 1, AAOIFI, op cit., p. 87 Section 4/1, see also its annexed example on p. 110.

cannot be collected from her/him or for any doubt on the collectibility of principal and profit of already settled *muḍārabah* and *mushārah* financing.¹⁷

3.3 Assets Structure of Islamic Banks

A closer look at a the financial statements of a few Islamic banks, aside from the theoretical proposals of the AAOIFI's Standard 1, provides us with a practicable picture of how the financial statements disclose their different assets in a manner that allows the supervising authority and others to make their judgement about the sufficiency of information to measure capital adequacy and to look into the fulfilment of the Basel II disclosure requirements. We took a sample of 7 Islamic banks that are Kuwait Financing House, Dubai Islamic Bank, Jordan Islamic Bank, Bahrain Islamic Bank, The ABC Islamic Bank, Bahrain, Shamil Bank, Bahrain and Qatar Islamic Bank for the years 2000 and 2001. Recognizing that these banks have different levels of accounting aggregation, we looked at the financial statements along with their attached explanatory notes and found that:

1) All the seven Banks, one way or another, show in their financial statements claims and assets that result from:

- Claims from *murābahah*,
- Investments in *mushārah* and *muḍārabah*,
- Investment in securities and others.
- Investment in real estates,
- Investment in leased assets

2) Six banks showed separately claims from foreign commodities *murābahah*,

3) Some banks also showed separately claims from *istiṣnā'* and *salam*,

4) There is no unified standard of aggregation in assets even in banks that are under the same supervisory authority as our sample has three banks under the Bahrain Monetary Agency, one of them is an off-shore bank.

5) Only one bank went into detailed categorization in its financial statement, it shows details as:

- Claims from foreign *murābahah*,
- Claims on domestic Government,
- Claims on domestic businesses and industries,
- Claims on domestic individuals, and
- Claims on domestic contractors,

¹⁷ Sections 2/3, 2/4 and 2/5 of each of Standards 3 and 4.

To wrap up this sub-section one may fairly conclude that although Islamic banks do not have a unified standard for presenting their financial statements, most of them do not deviate much from the theoretical standard No. 2 of the AAOIFI and they have mostly disclosed sufficient information that enables their respective supervising authority to estimate the credit-weighted value of their assets and to calculate their minimum adequate capital.

We will see in the Third section of this paper that while the itemization of assets in Islamic banks and the estimation of their credit risk and their risk-weighted value may not have any qualitative difference from what is suggested for conventional banks in the proposed Basel II Accord, this similarity does not necessarily mean that the minimum capital requirement should also be calculated in the same way as in conventional banks because, unlike conventional banks that have either claims on the bank or capital on the left side of the balance sheet, the nature of the left side of the balance sheet of Islamic banks include a third entity is neither a liability on the bank nor part of the owners' equity.

4. Potential Effects of the Basel II Accord on the Islamic Financing Modes and the Islamic banks' Practises

The underlying assumption of the Basel II proposals for the calculation of capital adequacy to face potential risks is that the counterpart of the asset side in the statement of financial position (balance sheet) consists of liabilities and equity only. Well, this is not the case in the Islamic banks!

In this section, I will investigate the effect of the composition of the 'credit' side of the statement of financial position on the calculation of minimum capital requirement for an Islamic bank and I will suggest a modified principle for this calculation. This will be done in two sub-sections that respectively deal with The restricted deposits, unrestricted deposits and deposits in current accounts in the Islamic banks and the effect of the presence of restricted and unrestricted on the calculation of capital adequacy.

4.1 Restricted Deposits, Unrestricted Deposits and Deposits in Current Accounts in the Islamic Banks

In discussing the functions of an Islamic bank, the AAOIFI's Statement of Financial Accounting No. 2 emphasizes three sources of funds that an I B uses/invests: personal funds of the bank, unrestricted investment (*muḍārabah*) deposits and restricted investment (*muḍārabah*) deposits [Section 2/2(b)].

Unrestricted investment deposits consist of funds deposited in the I B for the investment purposes whereby the bank is given full freedom, discretion and authority to invest in any way, project and manner it deems appropriate and to mix them with its own funds (equity) and with other funds the bank may have authority on their use (i.e., liabilities including deposits in current accounts).

On the other hand, restricted accounts are received by the bank for investment in specific projects, funds or any other kind of restriction in such a way that the bank must not mingle them with its own funds or within its investment pool. Restricted deposits may be given to the bank on the basis of *muḍārabah* (profit sharing) or on the basis of agency contract whereby the bank is compensated in the form of either a lump sum or a percentage of funds invested regardless of the result of investment.

The treatment of these two categories of deposits is different from liabilities. Financial Accounting Statement No. 2 continues to require that the statement of financial position must not include either of them under the title of ‘liabilities’ because neither of them represents a claim on the bank. It argues that under liabilities only claims that are a binding obligation on the bank must be included [Section 4/1/2]. Since both kinds of deposits are subject to profit and loss and the bank is not under any obligation to give a return or to guarantee the principal, they must be treated in a way that does not mingle them with claims on the bank.

Unrestricted investment deposits may be included within the statement of financial position on the ground that the I B mixes them with its own personal funds and with funds sourced out in the form of pure liability and then uses/invests them at its own discretion; but they must have a separate category under the title of “equity of unrestricted investment account holders” [Section 4/1/3].

On the other hand, the restricted funds must have their own statement of financial position totally independent from that of the I B. In this regard, the AAOIFI’s Financial Accounting Statement No. 2 adds another statement to the set of financial statements an Islamic bank must present periodically [Section 3(b)]. This is reinforced in Section 4/5 that deals with the ‘Statement of Changes in Restricted Investments and their equivalent.’ This statement requires the full disclosure of the balances of these deposits, additions and withdrawals of their holders, profits/losses from operations during the period and share of the I B whether as a percentage of balances invested, a share of net profit or a given lump sum.

The Financial Accounting Standard No. 5 that deals with the “disclosure of bases for profit allocation between the I B owners’ equity and investment accounts holders” highlights the rules of calculating the profits distribution between the bank and the holders of each of these two accounts which is obviously a matter that is not at all mentioned in the Basel II proposals.

Finally, I must add that all the seven Islamic banks that we sampled above abide by the essence of these standards. They show the unrestricted deposits independent from liabilities in their statements of financial positions and have a separate statement for the restricted deposits.

4.2 Does the Presence of Restricted and Unrestricted Deposits Matter for the Calculation of Capital Adequacy?

What is the effect of the presence of unrestricted investment deposits in the 'credit' side of the statement of financial position and of a separate statement for restricted deposits on the objectives of the Basel II proposals? To answer this question we need to look from two angles. First, while the objective of the Basel II is to calculate a minimum capital requirement that can stand up to the risks' exposure, the different kinds of risk have different effects on this minimum capital. We have then to look at the effect of the treatment of these two kinds of investment deposits from the point of view of each of the operational risks, credit risk and trading book risks that are the focal issues of the Basel II proposals. Additionally, we need to explore the potential or expected position of the supervisory authorities in regard to the risks to which both the restricted and the unrestricted investment deposits are exposed to; would instability in these two kinds of deposits have a negative effect on the solvency of a given Bank and/or the banking industry in general? And if not, would the supervisory authority be indifferent to such instability?

4.3 Operational Risks in Islamic Banks

Qualitatively speaking, operational risks are the same in Islamic banks as they exist in conventional banks that operate in the same business environment. Consequently, if operational risks affect all the assets of an Islamic bank, their counterpart on the 'credit' side of the statement of financial position is the total of equity and unrestricted deposits together, not owners' equity alone. This instantly leads to a reconsideration of the structure of the standards for capital requirement in relation to operational risks' exposure.

The reason is that the I B's share holders are not responsible towards the holders of unrestricted deposits for losses that result from normal conduct of business as implied by the *muḍārabah* contract that governs their relation. The responsibility of the I B's Share holders is limited to three cases only: 1) violation of the contract on the part of senior management; 2) neglect of applying normal prudential rules of the banking business; and, 3) intentional fault by senior management. On the other hand, any risk of loss that may result from inadequate or failed internal processes, systems, staff and legal advice or from external events are not covered in the I B's liability to holders of unrestricted deposits unless they can be proven as resulting from any of the above three cases.

In the final analysis, while it can strongly be argued that we need to consider unrestricted deposits as equity when we calculate the minimum equity needed to face operational risk exposure, we have to give certain allowance to the limited liability of the I B towards the holders of these unrestricted deposits. The mishap at the Islamic Bank of Dubai in 1999 may be a typical example of such limited liability that calls for adequacy of share holders' equity to face such risk exposure.

Consequently, while we do not disagree with the Basel II Committee on the use of gross income as a proxy of operational risk exposure and on the use of either the Basic Indicator Approach, the Standardized Approach or the Advanced Management Approach to measure the operational risk exposure, the outcome of this calculation for an Islamic bank must be a total equity requirement, that consists of both owners capital and the equity of the unrestricted-deposits holders). The distribution of this operational-risk exposure equity charge between the two kinds of equities must, then, take into consideration the limited liability of the I B's owners toward these depositors in a way that does not distribute the equity charge proportionately but gives more weight to the I B's owners' equity. Therefore, this can be expressed as a reduction in the parameter, or multiplier, used for I Bs in comparison with that suggested by the Basel II for conventional banks.

It may be prudent to estimate an Islamic banking industry parameter that should be developed specifically for Islamic banks on the same basic rules that are used by the Committee to derive its indicator. Such an indicator may then be used as a coefficient or parameter for calculating the minimum capital requirement that stands for operational risk exposure.

4.4 Credit Risk Exposure in Islamic Banks

Here again, we should consider the equity of the unrestricted deposits holders vis-à-vis credit risk exposure because they share losses resulting from debtors' default on equal footing.

While this statement is generally consistent with the *muḍārabah* agreement and with the AAOIFI financial accounting statement No. 2, certain detailed qualifications should be added. First, it is known that Islamic banks treat funds in current accounts as loans guaranteed to lenders and uses them as being 'funds given with authorization to use' on the assets side. This implies that in weighing the ratio of distributing the risk between share holders equity and unrestricted deposits holders we must add to shareholders equity all the funds the bank uses and guarantees. Second, certain Islamic banks declare that they leave certain percentage of unrestricted deposits idle without being invested. The *muḍārabah* contract implies that this percentage must not be charged any losses that result from debtors' default. Consequently, this percentage must also be excluded when we consider the distribution of credit risk between the two kinds of equities. Third, the past experience of the Islamic banks over three decades indicates that there were events in which the share holders and the senior management felt certain moral responsibility, or at least moral desire, to voluntarily relieve owners of unrestricted deposits from certain losses including losses resulting from debtors' default. Would any supervisory authority like to take a similar position especially that such a behaviour has a tremendous impact on the stability of deposits and on the Islamic banking industry at large? I argue that the supervisory authority has a moral and economic responsibility to impose such kinds of restrictions on the behaviour of the senior management of Islamic banks. This would mean higher weight of share

holders equity in shouldering credit risk distribution. Fourth, the previous point is reinforced by the fact that unrestricted deposits are included within the statement of financial position of the I B since this inclusion make them a part of the financial position because, according to the AAOIFI statement of financial accounting No. 2, the I B is authorize to use them in investment at its own discretion. This discretionary use must impose a counterpart burden on the I B, otherwise the responsibility would not mach liability!

The quantitative effect of these elements should be estimated and incorporated into the parameters used in the calculation of the minimum capital requirement in Islamic bank regardless of which approach a given I B used in estimating the credit risk weighted assets. However, it should be noticed that while the minimum share holders equity requirement for credit risk in Islamic bank must be lower that its counterpart in conventional banks because credit risk is also shouldered by unrestricted deposits owners, the above mentioned elements favour the latter in the distribution of the credit risk burden.

4.5 Trading Book Risk in I Bs

For the first instant, one may tend to argue that trading book risk, as defined in the Basel II Agreements, must be irrelevant to Islamic banks because they do not hold short term securities and do not trade commodities on the exchange market.¹⁸

But when we compare statements of financial positions of Islamic banks with conventional banks we will find a few new items of assets that are normally alien to conventional banks. These ‘strange’ items include: investment in sister companies, investment in real estates intended for trading, long term investment in industries and business (usually in the form of shareholding), investments in real estates, etc. These kinds of investments are not usual nor customary in conventional banks, hence, they are not included under the trading book assets as defined in the Basel Agreements, yet do expose the Islamic banks to substantial amount of risk that is, of course, shared by the owners of unrestricted deposits. While these investment may, sometimes, not carry a risk weight higher than the risk weight of commodity positions, they definitely expose the I Bs to a kind of trading book risk that is much higher than that of short term tradable securities, especially commercial papers, and their like, that are common in the trading books of conventional banks. These kinds of investment are sometimes referred to *de-jure*

¹⁸ This may seem surprising to many including those who believe in the two tier *mudarabah* and those who think that the Islamic banks’ involvement in *murabahah*, international *murabahah* and international *Tawarruq*. The actual fact is that the involvement of the Islamic banks in the organized markets of commodities and short run securities is extremely trivial and momentary as they immediately shift their purchased commodities into debts on the “other party” to the extend that in their statements of financial positions one can’t trace commodities and short term securities assets.

in the banking laws as done by the recently amalgamated act of the central bank and banking system in Kuwait.

Although we may be able to squeeze some of these investments, such as investments in subsidiary companies, under categories 11 and/or 12 with regard to credit risk, it seems that even investments in subsidiaries take in Islamic banks a dimension different from their conventional counterpart. Additionally other kinds of investments have no reference in the Basel II proposals unless we are willing to let them be lump summed under high risk assets and apply the same risk weighing parameter of 150%-350%.

I argue that there is a pressing need to develop risk weighting standards and processes of adequate equity estimation in the Islamic banks that call for stringent equity requirements as well as more elaborate disclosure requirements than those suggested in Basel II Proposals, if we want to avoid the especially bad experience of some Islamic banks in this regards.¹⁹ In our example of 7 I Bs, the total of trading book and quasi-trading book investments represent 5% to 26.3% of their total assets.

The supervisory authority has a duty, similar to that envisioned by the Basel II proposal, to assure capital adequacy in Islamic banks at a level that matches this kind of trading book risk exposure that is several times higher than that the trading book risk encountered in conventional banks without losing the principle of including the owners of unrestricted deposits in shouldering this risk up to a fair limit that reflects the essence of the *muḍārabah* contract and the level of disclosure in the relation between the IB and owners of unrestricted deposits.

5. Conclusion

In a nutshell, this paper argues that:

1. Islamic banks have qualitatively similar credit risk to conventional banks, therefore the processes of the calculation of minimum equity requirement for credit risk exposure should not be different from the methodologies proposed for conventional banks. This means that the I Bs can go along with this part of the Basel II Proposed Accord and the supervisory authorities would be fair in asking them to abide by these proposals.
2. In Islamic banks, equity must be interpreted to include the equity of shareholders and the equity of the owners of unrestricted deposits because the latter carry their share of the risk of losses by virtue of the *muḍārabah* contract.

¹⁹ Specifically the case of Bank al Taqwa that was essentially ruined because of un-prudent placement of funds in these kinds of investment.

3. Elements of fairness must be taken into consideration in distributing the losses as well as in distributing equity charges between the share holders and owners of unrestricted deposits.

4. The portion of operational-risks minimum capital charges to share holders in Islamic banks is apparently lower than their counterpart in the conventional banks. Here again the reason is the *muḍārabah* contract that does not charge the *Muḍāreb* for losses not-resulting from negligence, fraud or violation of contract including violation of normal and customary professional standard practises. This means that while the parameters of operational risk weighing and minimum equity calculation in Islamic banks may be the same as in their conventional counterpart, the capital burden on shareholders should be lower than that in conventional banks.

5. Trading book risks, in their literal sense, rarely exist in Islamic banks but quasi-trading book risks are much higher in I Bs than in the conventional banks. Here again, capital charges should be carried by both shareholders and owners of unrestricted deposits.

6. although the supervisory authorities in countries where there are Islamic banks did not yet fully apply the review procedures suggested in Pillar 2 of the New Basel Accord, the application of these proposals does not pose any theoretical or practical impediment to Islamic banking or to Islamic modes of financing.

7. The same also applies to the disclosure requirements of Pillar 3 since whatever the existing level of disclosure in Islamic bank may be, the additional information and their standardization do not pose any theoretical or practical difficulties more than they do for conventional banks.

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