in compliance with the *Shari'ah* and take any necessary actions to avoid any non-compliance.

Some *Shari'ah* scholars have suggested that if a bank fails to act in accordance with the *Shari'ah* rules, the transaction should be considered null and void and any income derived from it should not be included in the profits to be distributed to the investors/depositors.

Reputation Risk

Reputation risk or "headline risk" is the risk that the trust of the clients is damaged by irresponsible actions or behavior on the part of the bank. The implications of this are wide-ranging in that the irresponsible behavior of a single institution can taint the reputation of other Islamic banks. Negative publicity can have a significant impact on an institution's market share, profitability and liquidity. The Islamic financial services industry is a relatively young industry and a single failed institution can give a bad name to all others that may not be engaged in any such irresponsible behavior. Close collaboration among financial institutions, the standardization of contracts and practices, self-examination, and the establishment of industry associations can help to mitigate reputation risk, to which all Islamic banks in a given market are exposed.

An IFI enters into a contract with its stakeholders that it will conduct its business according to the spirit of *Shari'ah* and is required to fulfill this obligation to the best of its abilities. In addition, the institution has made an implicit contract to ensure that no violation of *Shari'ah* principles occurs. Anytime it fails to meet these obligations or is guilty of breach of contract, it runs the risk that stakeholders will withdraw their business.

The IFI is subject to higher standards of preserving the property rights of its stakeholders and to ensure that it does not withhold anyone's rights, willingly or unwillingly. To breach this sacred trust would be to risk its reputation.

Risks Associated with *Sukuk*

As the *sukuk* market expands, it is important that the risks associated with it are fully understood. On the surface, a *sukuk* appears to be like a debt-based fixed-income security. This being the case, the common practice is to apply to it the same risk management framework. However, a *sukuk* has distinctive features that can give rise to non-conventional risks, as outlined below.

Although similar in structure, *sukuk* are different from conventional asset-backed securities. By design, a *sukuk* is supposed to be a true asset-based securitization where the risk/return is passed on to the owners. However, the practice is different and it is often structured to minimize direct exposure to the underlying assets. The investors need to understand the structure and the exposures of each structure.

It is critical that investors know who owns the underlying or securitized assets in a particular *sukuk* because, depending on the answer, risks can change. For example, under some conditions, investors may not be able to sell the underlying assets independently or may not be fully protected from the borrower's insolvency. In other circumstances, investors may be exposed to the corporation's creditworthiness (a practice that is considered to be in conflict with the basic principles of risk sharing) or to that of the underlying assets or projects. The *sukuk* market has serious liquidity issues arising from a shortage of supply, which leads investors to buy and hold the contract, rather than trading it in the market. This results in a shallow secondary market where the transaction costs (measured by bid-ask spreads) are much higher. This exposes investors to liquidity risk and impairs their ability to manage their portfolios in an efficient and cost-effective manner.

Investors are also exposed to transparency risk because structuring *sukuk* transactions involves complex legal documentation which can lead to unconventional legal positions and can become a source of ambiguity and future disputes. The lack of clarity can lead to reputational risk for the parties, including the arrangers, issuers and regulators.

Risk Management Framework

The complex nature of risks faced by Islamic banks requires a comprehensive risk management, risk reporting and risk control framework.

Efficient risk management is essential for reducing an organization's overall risk exposure. Adequate resources need to be devoted to identifying and measuring risks and developing appropriate techniques for managing them. The IFSB has formulated a set of principles for sound risk management that should be followed by Islamic banks to mitigate the various risks they are exposed to. There are several areas in which there is room for improvement. These are discussed below.

IFSB PRINCIPLES OF RISK MANAGEMENT

- [Islamic Financial Institution] shall have a sound process for executing all elements of risk management, including risk identification, measurement, mitigation, monitoring, reporting and control. This process requires the implementation of appropriate policies, limits, procedures and effective management information systems (MIS) for internal risk reporting and decision making that are commensurate with the scope, complexity and nature of the activities.

(*Continued*)

- [Islamic Financial Institution] shall ensure an adequate system of controls with appropriate checks and balances are in place. The controls shall (a) comply with the *Shari'ah* rules and principles; (b) comply with applicable regulatory and internal policies and procedures; and (c) take into account the integrity of risk management processes.
- [Islamic Financial Institution] shall ensure the quality and timeliness of risk reporting available to regulatory authorities. In addition to a formal standardized reporting system, [Islamic Financial Institution] shall be prepared to provide additional and voluntary information needed to identify emerging problems possibly giving rise to systemic risk issues. Where appropriate, the information contained in the report shall remain confidential and shall not be used for public disclosure.
- [Islamic Financial Institution] shall make appropriate and timely disclosure of information to Investment Account Holders (IAH) so that the investors are able to assess the potential risks and rewards of their investments and to protect their own interests in their decision-making process. Applicable international financial reporting and auditing standards shall be used for this purpose.

Quantitative Methods of Risk Measurement Risk assessment and measurement is an art as well as a science. The increased complexity of financial instruments calls for more sophisticated risk assessment tools. While work on identifying the sources of risk associated with Islamic banking has made good progress, risk measurement techniques and the models used to quantify risk need to be applied more widely.

Sundararajan (2004) has suggested several quantitative methods for measuring risk. For example, similar to the idea of value at risk (VaR), the risk to investors/depositors can be quantified by a measure of profit at risk (PaR) based on the historical profits and the volatility of returns. The PaR model assumes normal distribution and can be calculated as follows:

$$\text{PaR} = Z\alpha \times \sigma p \times \sqrt{T}$$

where $Z\alpha$ = is the constant that gives the appropriate one-tailed confidence interval with a probability of $1\text{-}\alpha$ for the standard normal distribution (e.g., $Z_{...01} = 2.33$ for 99% confidence interval); T is the holding period or maturity of investment account as a fraction of a month; and σp as the standard deviation of the monthly profit as a percentage of assets.

The PaR measure can have multiple uses. First, it can provide an indication of the level of volatility in the expected profits of investors/depositors. Secondly, it can determine the level of income-smoothing reserves—the Profit Equalization Reserves (PER) maintained by some IFIs to mitigate displaced commercial risk. The correlation between the PER and the asset's return could, therefore, be an indicator of "displaced commercial risk." Thirdly, the PaR model can also be applied to individual business lines within the bank, such as the case of specific portfolios linked to restricted investment deposits to determine the level of risk. The application of quantitative models such as PaR can help management with their decision-making regarding the level of PER and can offer transparency to investors regarding the volatility of profits.

Trade financing and lease-based financial instruments on the assets side of IFIs resemble fixed-income asset-based securities and thus some of the standard risk measurement techniques such as duration, gap analysis, bucketing, DV01, and Value-at-Risk (VaR) can be computed to monitor the level of the risks. Baldwin (2002) provides a discussion on duration and VaR measures for Islamic instruments. The use of such monitoring tools becomes more important for IFIs given the lack of risk-mitigating derivative products and the low liquidity of the assets. Also, there could be issues in the use of parametric VaR for instruments based on *mudarabah* and *musharakah* contracts and therefore alternative measures should be designed.

On the credit risk side, the valuation of collateral needs special attention. Although the use of collateral is recognized as a legitimate risk mitigation tool, in practice, many supervisory authorities tend to underestimate the existence of collateral because the valuation and determination of fair market value is not an easy task, especially in the case of underdeveloped markets. Therefore, advanced models based on simulations and other analytical techniques should be developed to measure the extent of exposure arising from credit risk.

Implementation Challenges Implementation of the risk management framework requires close collaboration between the IFIs, regulators and supervisors. At the institutional level, it is the responsibility of management to establish internal systems that can identify, measure, monitor, and manage various risk exposures. Although the general principles of risk management are common to both conventional and Islamic financial institutions, IFIs face the following specific challenges:

- Establishing supporting institutions and systems such as a lender of last resort, a deposit insurance system, a liquidity management system, secondary markets, and a legal infrastructure favorable to Islamic instruments and for the efficient resolution of disputes.
- Achieving uniformity and harmonization in *Shari'ah* standards across markets and borders. The current practice of maintaining individual *Shari'ah* boards by individual institutions is inefficient and should be replaced by a centralized board within each jurisdiction.
- Developing risk management systems is costly and out of reach for many Islamic financial institutions. Efforts should be made to collaborate with other institutions to develop systems that are customized to the needs of IFIs and which address instrument-specific modeling needs.

- Effective risk management will assist IFIs to integrate with global financial markets. Efforts should be made to enhance transparency in financial reporting and to development accounting and reporting standards across markets.
- Risk management requires highly skilled human resources, which are currently in short supply. Efforts should be made to develop customized research and training programs to spread the knowledge and awareness of the significance of risk management. Such training programs should provide for the certification of successful participants.

The sub-prime financial crisis was also attributed to the failure of risk-management frameworks. Several institutions that had such a framework were surprised when the risk models failed to predict the problems and did not estimate the risks accurately. During the boom periods, financial institutions had become heavily reliant on risk and other quantitative models, but as the financial markets increased in complexity so did the risk models. For example, a well-known and frequently used standard measure for risk, VaR, came under fire after the crisis for its unrealistic assumptions and the way it was applied in the decision-making process. The main lesson of the financial crisis for the risk management profession was that the financial institutions need to develop a culture of mixing quantitative with qualitative or subjective analysis. The use of sophisticated risk measures is still not widespread in the majority of IFIs and they need to develop both proper risk models and an institutional culture that supplements risk measures with qualitative judgments based on experience and knowledge of the markets.

CHAPTER 14

Regulation of Islamic Financial Institutions

INTRODUCTION

Firms in the financial services industry, especially banks and insurance companies, are subject to various forms of regulation. As the industry has advanced, the regulation of it has also become more experienced, complex and dynamic. The nature of regulation of any industry can be understood by asking the questions: Why is regulation required? What needs to be regulated? How should this be done? The rationale for regulation (the "Why?") is the same for IFIs and conventional financial institutions alike, but there are clear differences in the "What?" and "How?" questions.

Diverse views on the need for regulation in conventional finance range from positions of almost total opposition to any regulation, to the justification of broad, intrusive regulation. The arguments for the regulation of conventional financial services include the public good, mitigation of systemic risk, the protection of depositors, and the integrity of fiduciary contracts.

The Public Good

One view of regulation is that it provides a public good that the market cannot supply on its own. The objective of prudential regulation is to mitigate risks taken by the stakeholders (for example, depositors) unable to undertake the necessary due diligence to enable them to assess these risks. Some stakeholders have sufficient investment savvy to develop these assessments on their own and would not, in principle, need in the same degree the support of public regulation, except for transparency and disclosure requirements necessary to conduct their due diligence. Consequently, from the public-good perspective, the design of prudential regulation would call for a clear sense of the type, quality and quantity of the public good to be delivered, as well as the nature of the risk and risk exposure or values at risk involved.

Mitigation of Systemic Risk

Another rationale for regulation, linked to the notion of public good, is that it is a pre-emptive measure to avoid or mitigate any systemic risk that can lead to a contagious collapse of the financial system. Such mitigation can reduce the financial distress and social costs associated with the failures. Banks are particularly vulnerable to such collapses because of the nature of their business; that is, illiquid assets financed by liquid liabilities. Therefore, the objective of prudential regulation is the mitigation of the risk of disruption of the normal business performed by the financial system in payments or the provision of liquidity. Such systemic risks could be the outcome of a spillover from distress in one institution unable to honor its commitments, undermining confidence in the system. It could also be the result of a failure in the payments system itself—either of its material infrastructure or of the mechanisms and instruments to exchange liquidity.

Protection of Public Resources

Another view of financial regulation is that the existence of an explicit or implicit safety net, notably in the form of deposit insurance, creates a contingent government liability. The existence of such a commitment of public resources entails both the right and the duty of the public authority to regulate activities that may endanger these resources. This view is not unrelated to the public-good view, as the existence of deposit insurance is itself a public service. The existence of any safety net or deposit insurance also creates a moral hazard, as it reduces the incentive for depositors to impose market discipline on banks with regard to their risk taking. Regulation is one of the means to check such moral hazard.

Integrity of Fiduciary Contracts

Another perspective on regulation is provided by a focus on the fiduciary nature of the business of finance. The role of regulation is seen here as the provision of sufficient checks and balances to mitigate the risk of the intermediary failing the trust of its stakeholders. These are generally seen as the depositors, but also include small shareholders, which underlines the importance of sound corporate governance.

In the light of this rationale, Chapra and Khan (2000) suggest four reasons for the regulation of IFIs:

i) *Systemic considerations*, particularly the need to maintain an orderly payments system and ensure the development of the economy.

   Maintaining orderly payments is clearly in the nature of a public good which needs to be protected. Whether IFIs operate according to core principles or follow prevailing practices, regulation to mitigate the risks of disruption in payments can be justified.

In contrast, the promotion of economic development may be beyond the role that should be assigned to financial regulation. Expansion and growth is promoted by increased trust in the financial system that regulation can provide. However, its design to explicitly promote development may distort its objectives of ensuring soundness and stability, and pose difficult challenges for regulators in having to choose between promoting economic development and ensuring the stability of the financial system.

(ii) *Protecting the interests of demand depositors.* The protection of demand depositors is envisaged in the two-windows model of an Islamic financial intermediary, which asks for the maintenance of 100-percent reserves against demand deposits.

(iii) *Ensuring compliance with the* Shari'ah. The relationship between civil and religious law varies across national jurisdictions. Where there is a strong separation of the two, it is difficult to justify assigning to public authorities the role of ensuring that financial intermediation activities comply with the *Shari'ah*. This is considered a private religious matter that does not call for public intervention. The issue of truth in disclosure and in advertising, however, remains and gives stakeholders legal redress. This is not, however, a matter of financial regulation, but one of broad institutional infrastructure for business. In jurisdictions where the distinction between civil and religious law is less pronounced, one can well see a public policy choice for assigning to a public regulator the role of ensuring that banking activity complies with the *Shari'ah*.

(iv) *Supporting the integration of IFIs in the international financial system.* Integration would develop from the participation of IFIs in the financing of international trade and international payments. Counterparts would want to be satisfied with the ability and commitment of IFIs to fulfill the contracts they enter into. In this respect, national and international regulation can be grounded in the public good and needs to ensure orderly participation in international payments and the integrity of fiduciary contracts.

DISTINCTIVE FEATURES OF REGULATING IFIs

Having considered the "Why?" of financial regulation, we now turn to the "What?" and the "How?" It has been often argued that the case for introducing regulation to protect the value of deposits of IFIs fully abiding by risk-sharing principles is less compelling than for conventional finance. IFIs are different from conventional banks in several respects, which makes their regulation somewhat different. The areas of difference are as follows.

The Nature of Intermediation

The financial intermediation undertaken by IFIs is based on the principal–agent model and the contractual relationship is based on the profit/loss-sharing principle, which is different to the intermediation relationship between depositors and conventional banks. Given the partnership-based relationship, the two-tier *mudarabah* model of Islamic banking does not require banks to have reserves. It is argued that in the presence of symmetrical risk as well as profit/loss sharing, introducing a guarantee on the downside would run counter to the essence and the core objective of the system. Investment depositors should, however, expect to be informed on the features of the contract they enter into and have recourse to law if it is breached. Therefore, the focus of regulation will shift from protection of investment account holders to ensuring the integrity of the fiduciary contracts.

Depositors vs. Investors

Depositors in the conventional banking system create a debt claim on the financial institution, whereas the depositors in the Islamic banking system are investors and therefore do not create such a claim; rather, they act like pseudo-equity holders. Because of the pass-through nature of intermediation, where all profits and losses are passed through to them, investors theoretically do not have a claim on the capital of the bank except in cases of misconduct or negligence. This pass-through feature has a major impact on the capital requirements of Islamic banks. Requiring a certain minimum level of capital is the cornerstone of the regulation of conventional banks.

Systemic Risk

Islamic banks are not immune from bank runs when depositors/investors lose confidence in the bank and withdraw funds in panic. Large volumes of panic withdrawals by investment account holders could result in financial distress. Archer (2004) argues that unlike conventional banks, which maintain liquid assets on their liabilities, the assets of Islamic banks are illiquid, which makes such risk primarily a liquidity risk. In the event of a liquidity crisis, a conventional investment firm will generally be able to wind down its business in an orderly manner by meeting its obligations through prompt disposal of marketable securities at the market price. In contrast, an Islamic bank's asset portfolio is dominated by less-liquid trade-financed or rental-generating assets, which exacerbate the problem of illiquidity and therefore the systemic risk.

IFIs AS UNIVERSAL BANKS

As mentioned in earlier chapters, financial intermediation performed by IFIs combines commercial and investment banking activities similar to a universal bank in the conventional system. This combination of banking with securities (underwriting) operations demands that a different regulatory framework, including capital-adequacy requirements, be applied to banking and securities operations. Differences in commercial and investment banking activities have led to the adoption of a "banking book/trading book" approach in the EU Capital Adequacy Directive of 1993. The securities activities grouped as "trading book" are subject to a capital-adequacy regime that is separate from the banking business as defined by the "banking book" (Archer 2004). One marked difference in the case of IFIs is that the trading operations are not confined to securities business only, but also include positions in commodities and other non-financial assets (for example, by means of *salam* and *istisna'* contracts). Given the universal-banking nature of Islamic financial intermediation, it is important that well-defined rules and standards are designed to clearly demarcate the boundaries of banking and trading books, with respective allocations of capital, depending upon the nature of business.

Regulators have traditionally governed their jurisdictions through direct rules, mostly on capital, assets, and income allocations. At the same time, regulatory changes often lag behind financial developments and may consequently either constrain the ability of financial institutions to flexibly manage their portfolios, or provide them with opportunities to take unchecked risks, implicitly comforted by the existence of the safety net. In adapting to these developments, the industry is now moving toward letting the regulated institutions assess and manage their risks within a framework agreed on with the regulator. In this context, there is a call for the introduction of mechanisms to let the market impose the necessary discipline on the financial intermediaries. The essence of market discipline is to induce market investors to penalize excessive risk taking by raising the cost of funding and limiting its availability. This can happen directly, with depositors demanding higher returns or withdrawing their deposits. It can also happen indirectly if there is an asset traded in the market whose price reflects the investors' assessments of the risks being taken by the issuing institution.

In light of the discussion on risks and the rationale for regulation, it is clear that capital, transparency, and licensing requirements are primary candidates for regulation. The method of regulation will depend, to varying degrees, on a combination of direct "command and control" rules, market discipline (direct and/or indirect), or organization-specific home-developed risk assessments. The type and method of regulation chosen depends on the adopted rationale for regulation, on the extent to which IFIs follow core principles, and on the assessment of their practices.

For IFIs that follow strict risk sharing principles, there would be minimal regulation required. There would be less emphasis on capital requirements, and more on transparency and disclosure, management screening, and licensing of business lines; that is, regulation equivalent to conventional banking. There would be greater reliance on direct market discipline and less on "command and control" regulation.

The two-tier *mudarabah* or two-windows frameworks use, for the most part, profit/loss-sharing (PLS) accounts on both sides of the balance sheet. They would provide trade finance or facilitation, as well as payments services. They would take demand deposits as part of these services. The PLS intermediation has direct market discipline embedded in it and, hence, should not require significant capital. Some minimal capital may be needed to protect the reputation of the institution, which is its legitimacy as a partner for all its stakeholders. But one could argue that sufficient transparency and disclosure should allow markets to judge this legitimacy and induce the institution of its own volition to maintain the needed level of capital. The case for a capital requirement to protect orderly payments and demand deposits would be stronger. It is not likely to lead to the same level of capital requirement, but suggests the need to consider the appropriateness of bundling the intermediation and payments services in the same balance sheet. Consequently, the regulation of an IFI, compliant with risk sharing principles, would need to put a heavy emphasis on transparency and disclosure as well as licensing requirements, but de-emphasize capital requirements.

In existing IFIs, prevailing intermediation practices point to the need for equivalent emphasis on capital requirements, supervision and licensing, but more emphasis on transparency and disclosure than for conventional banks. Competitive pressure is encouraging the established IFIs to provide sufficient safety and return to depositors in unrestricted investment accounts. They consequently face the risk of "displacing" shareholders in their returns and capital to accommodate these depositors. As a result, they face an intermediation risk similar to that faced by conventional banks and should therefore be subject to similar capital and supervision requirements.

To summarize, keeping in view the rationale for regulation, it is reasonable to propose minimal regulation for IFIs operating fully in accordance with the core principle of risk sharing. However, as prevailing practices of IFIs are not fully compliant with profit/loss-sharing principles, the situation presents risks akin to those in conventional banking. Therefore, a similar regulatory framework can be justified. Such specific regulation for IFIs should be supplemental to the existing regulatory framework and not a whole new separate framework. This is the view notably taken by both the AAOIFI and the IFSB.

CAPITAL ADEQUACY REQUIREMENT FOR IFIs

Capital plays an important role in any business but is critically important for financial institutions such as banks. The role of capital is vital for a banking institution because capital is one of the key determinants and indicators of the safety and soundness of a bank, since an adequate capital base serves as a safety net against losses and absorbs possible losses. A well-capitalized bank can boost the confidence of the depositors and creditors. It is also the ultimate determinant of a bank's lending and investment capacity.

For these reasons, it is argued that the capital of a bank should have three important characteristics: (i) it must be permanent; (ii) it must not impose mandatory fixed charges against earnings; and (iii) it must allow for legal subordination to the rights of depositors and other creditors. The nature of a financial intermediary such as a bank is such that its capital-to-liabilities ratio is lower than other types of businesses. This low ratio is a reflection of the nature of the intermediation business and acceptance of large liabilities in the form of deposits. To encourage prudent management of the risks associated with this unique balance sheet structure, the regulatory authorities require that the banks maintain a certain level of capital, which is considered adequate to meet the risks of the assets. The idea behind such a requirement is that a bank's balance sheet should not be expanded beyond the level determined by the ratio of the level of the capital and the risks of the assets, so that the level of capital determines the maximum level of assets.

In the 1980s, the Basel Committee on Banking Supervision (BCBS), under the auspices of the Bank for International Settlements (BIS), developed a framework to determine capital-adequacy standards for banks with the objectives of promoting soundness and stability in the international banking system. This initiative resulted in the Basel Capital Accord of 1988 (commonly referred to as "Basel I"), which laid the framework for a "regulatory capital" and defined the guidelines to measure the risk exposures of different asset classes. The Basel Accord introduced the concept of assigning risk weights to different asset classes based on the riskiness of the asset and defined the minimum levels of capital and reserves that a bank should maintain in order to meet the risk-weighted exposures.

The determination of capital adequacy is a two-step process. The first step involves the measurement of risk exposures of the assets based on the risk weights. For example, an investment in a government security is assigned a lower risk weight than the lendings to a corporation or private business, which carries a significant credit risk. In the second step, the regulatory capital available to support the risk is measured. This is divided into Tier 1 and Tier 2 capital. The ratio of regulatory capital to the amount of risk-weighted assets is the capital adequacy ratio (CAR). The aim of Basel I was to indicate a minimum recommended level of regulatory capital, with a CAR of eight percent.

The Capital Accord standard has been accepted and adopted by more than 100 countries. Although the initial standard was mainly focused on credit risk, a refined standard in 2004 ("Basel II")[1] included provisions for market and operational risks, but the desired CAR level was unchanged. The notion of a minimum capital requirement should not be confused with the optimal economic capital. The minimum capital is a guideline and requirement by regulatory authorities, but well-capitalized banks tend to carry more than the minimum level and the regulator of a particular country may decide to increase this level based on the level of risk in the system.

With the growth of Islamic banks, the issues of regulation and capital requirements are being raised and addressed. The BCBS framework for capital adequacy provided the impetus for dealing with similar issues for the Islamic banks. Although the need for a minimum capital ratio was recognized, it was argued that the nature of intermediation by Islamic banks is different from that of conventional banks and therefore the same capital requirements may not apply. Two main features of Islamic banks were highlighted: the nature of intermediation and the risk weights of the assets they held.

CAR and the Nature of Intermediation

Unlike depositors of conventional banks, the contractual agreement between the Islamic bank and the investment account holders (IAHs) is based on the concept of sharing profit and loss, which makes IAHs unique in that they are neither depositors nor equity holders. Although IAHs are not part of the bank's capital, they are expected to absorb all losses on the investments made through their funds, unless there is an element of negligence or misconduct on the part of the bank. The nature of intermediation and liabilities has serious implications for the determination of adequate capital for Islamic banks, as follows:

- Deposits taken on the basis of profit/loss-sharing agreements should not be subject to any capital requirements other than to cover liability for negligence and misconduct, and winding-down expenses.
- Investments funded by current accounts carry commercial banking risks and should be subject to adequate risk weights and capital allocation accordingly.
- The existence of restricted investment accounts on the liabilities side constitutes a collection of heterogeneous investment funds resembling a fund-of-funds and therefore such financial institutions should be subject to the same capital requirements as are applicable to a fund manager.
- The presence of displaced commercial risk and the practice of income smoothing have indirect implications for the Islamic bank's capital adequacy, which a regulator may take into account in determining the CAR.
- Islamic banks acting as an intermediary (*mudarib*) can face a moral-hazard issue. Since, as *mudarib*, the bank is not liable for losses but shares the profits with IAHs, it may have an incentive to maximize the investments funded by IAHs and by attracting more IAHs than it has the capacity to handle. This in turn can lead to risky investment decisions where the IAHs have a lower tolerance for risk that they are prepared to accept. Such a misalignment of incentives may lead to an increased displaced commercial risk, which necessitates higher capital requirements.

Determination of Risk Weights

Determining which risk weights to assign to different asset classes depends on the contractual relationship between the bank and the borrower. For conventional banks, a majority of assets are debt-based, whereas for Islamic banks the assets range from trade financing to equity partnerships; this fact changes the nature of risks. In some Islamic instruments there are additional risks that are not present in conventional lending instruments. Therefore, the calculation of risk weights for the assets of Islamic banks differs from that for conventional banks because:

- Assets based on trade are not truly financial assets and carry risks other than credit and market risks.
- There are non-financial assets such as real estate, commodities, and *ijarah*- and *istisna'*-based contracts that have special risk characteristics.
- Islamic banks carry partnership and profit/loss-sharing assets, which have a higher risk profile.
- Islamic banks do not have well-defined risk mitigation and hedging instruments such as derivatives to hedge some of the risks on the assets side, which raises the overall risk level of assets.

In partnership-based contracts such as *mudarabah* and *musharakah*, the bank is exposed to both credit and market risks which need to be analyzed within the credit and market risk methodology of the Basel Accords. When such partnership-based assets are acquired in the form of tangible assets—commodities—and are held for trading, the only exposure is to the market risk because the credit risk is minimized by direct ownership of the assets. However, there is significant risk in the form of the risk of capital impairment when direct investment takes place in partnership-based contracts and the investments are intended to be held to maturity. Treatment of this risk within the Basel framework is not straightforward and therefore requires special attention.

CAR for IFIs: IFSB Methodology

In the early 1990s, the AAOIFI drafted a basic standard on capital adequacy of Islamic financial institutions. In December 2005, the IFSB working group on capital adequacy issued the first draft if its capital-adequacy standards for institutions (other than insurance institutions) that offered only Islamic financial services. This document includes a comprehensive discussion of the nature of risks and the appropriate risk weights to be used for different assets. The standard deals with the minimum capital adequacy requirements for both credit and market risks for seven of the *Shari'ah*-compliant financing and investment instruments: *murabahah* and *mudarabah*; *salam*; *istisna'*; *ijarah*; *musharakah* and diminishing *musharakah*; *mudarabah*; and *sukuk*.

IFSB PRINCIPLES FOR MINIMUM CAPITAL ADEQUACY REQUIREMENTS

- The minimum capital adequacy requirements for IFIs shall be a CAR of not lower than 8 percent for total capital. Tier 2 capital is limited to 100 percent of Tier 1 capital.

(*Continued*)

- In calculating the CAR, the regulatory capital as the numerator shall be calculated in relation to the total risk-weighted assets (RWA) as the denominator. The total of RWA is determined by multiplying the capital requirements for market risk and operational risk by 12.5 (which is the reciprocal of the minimum CAR of 8 percent) to convert into risk-weighted equivalent assets, and adding the resulting figure to the sum of RWA computed for credit risk.
- The *Shari'ah* rules and principles whereby IAHs provide funds to the IFI on the basis of profit-sharing and loss-bearing *mudarabah* contracts, rather than debt-based deposits—that is, lending money to the IFI—would mean that the IAHs would share in the profits of a successful operation, but could also lose all or part of their investments. The liability of the IAHs is exclusively limited to the capital provided and the potential loss of the IIFS is restricted solely to the value or opportunity cost of its work.
- However, if negligence, mismanagement or fraud can be proven, the IFI will be financially liable for the capital of the IAHs. Therefore, credit and market risks of the investment made by the IAHs shall normally be borne by themselves, while the operational risk is borne solely by the IFI.

The IFSB standard requires that an IFI maintain a minimum capital of 8 percent of the total risk weighted assets. The assets financed by IAHs are excluded, considering that the IAHs directly share in profits and losses of those assets and the loss to the bank (as *mudarib*) is limited to the time and resources spent on the investments, except in cases of negligence and misconduct. Therefore, it is argued that the risks on the assets financed on the basis of profit/loss-sharing agreement by investment account holders do not represent risks for the IFI shareholders' capital and thus should not entail a regulatory capital requirement for the IFIs. This implies that assets funded by either an investment account holder—unrestricted or restricted—are to be excluded from the calculation of the capital ratio.

The IFSB standard (see Table 14.1) is defined in two forms: standard and discretionary. In the standard formula, capital is divided by risk-weighted assets excluding the assets financed by IAHs, based on the rationale given earlier. The size of the RWA is determined for the credit risk first and then adjusted to accommodate for the market and operational risks. To determine this adjustment, the capital requirements for market risk and operational risk are multiplied by 12.5, which is the reciprocal ratio (1/0.08) of the minimum CAR of 8 percent. For example, if an asset has a capital charge of 10 for market risk, the RWA will be increased by $10 \times 12.5 = 125$. Similarly, if the capital requirement for operational risk is 5, then the weight would be $5 \times 12.5 = 62.5$.

Determining Risk Weights: An Example

Risk weights are assigned depending on the nature of the asset and the kind of collateral. For example, if an Islamic bank provides *murabahah* financing to a client, and there is no pledged collateral, a risk weight of 100 percent is applied to the value of the asset. On the other hand, if the client pledges collateral with a market value of X, then the asset value is reduced by 75 percent of X before applying the risk weight of 100 percent to the asset. An asset valued at \$500,000 will have a risk weight of \$500,000 if there is no collateral and of \$425,000 if collateral worth \$100,000 is pledged, as follows:

$$\$425{,}000 = (\$500{,}000 - \$100{,}000 \times 75\%) \times 100\%.$$

For a *musharakah* (equity) investment, when there is no third-party guarantee, the credit risk weight of 400 percent is assigned. However, this weight is reduced considerably when there is a third-party bank guarantee and a risk weight of only 20 percent (for AAA-rated bank guarantees) is assigned.[2]

In the Supervisory Discretion formula (see Table 14.2), the formula is modified to make appropriate adjustments to accommodate the existence of

TABLE 14.1 IFSB CAR standard formula

Eligible Capital		
(Total Risk-weighted Assets) PLUS (Operational Risk Capital Requirement)	MINUS	Total Risk-weighted Assets Funded by PSIA

Notes:

- Risk weighting includes weights for market and credit risk.
- PSIA = Profit Sharing Investment Accounts.
- PSIA balances include Profit Equalization Reserves (PER) and Investment Risk Reserve (IRR).

TABLE 14.2 IFSB CAR Supervisory Discretion formula

Eligible Capital	
(Total Risk-weighted Assets) PLUS (Operational Risk Capital Requirement)	(1 – α) × Total Risk-weighted MINUS Assets Funded by PSIA MINUS α × Risk-weighted Assets Funded by PER and IRR

Notes:

- Risk weighting includes weights for market and credit risk.
- PSIA balances include PER and IRR.
- α refers to the proportion of assets funded by PSIAs which is to be determined by the supervisory authorities. The value of α would not normally be expected to exceed 30 percent.

reserves maintained by IFIs to minimize commercial displaced, withdrawal and systemic risks. In markets where IFIs are maintaining PER and IIR, the supervisory authorities are given discretion to adjust the denominator of the CAR formula according to their judgment of the systemic risk and prevailing practices.

This percentage is applied to assets financed by both unrestricted and restricted IAHs. Further adjustment is made for PER and IRR reserves in such a manner that a certain fraction of the risk-weighted assets funded by the reserves is deducted from the denominator. The rationale given for this adjustment is that these reserves have the effect of reducing the displaced commercial risk.

As Basel II takes into account the capital requirements for operational risk, the IFSB's exposure draft also deals with the issue in detail. Difficulties in quantifying the exposures from operational risk make determining how much capital should be allocated for such risks complex. The IFSB recommends that this may be based on either the Basic Indicator Approach or the Standardized Approach.[3] It is further recommended that, given the different structure of their lines of business, at the present stage IFIs may use the Basic Indicator Approach. An example of how CAR may be calculated is shown in Table 14.3.

TABLE 14.3 IFI CAR computation: An example

Liabilities:	
Demand Deposits	\$200M
Unrestricted Investment Account Deposits	\$500M
Restricted Investment Account Deposits	\$250M
PER and IRR	\$50M
Shareholders' Capital	\$20M
Assets:	
Trade Financing (*Murabahah*)	\$550M
Salam/Ijarah/Istisna'	\$250M
Mudarabah and *Musharakah* Investments	\$220M
Total Risk-weighted Assets for credit risk	\$250M
Risk-adjusted Assets Financed by Investment Account Holders	\$100M
Risk-adjusted Assets Financed by PER and IRR	\$10M
Supervisory Authority's discretion (α)	30%
Adjustment for Market and Operational Risk (12.5 × \$5M)	\$62.5M

CAR According to Standard Formula:

$$\frac{\$20}{(\$250\text{M} + 62.5\text{M}) - (\$100\text{M} + \$10\text{M})} = 9.88\%$$

CAR According to Supervisory Discretion Formula:

$$\frac{\$20}{(\$250\text{M} + 62.5\text{M}) - (0.7 \times \$100\text{M} - 0.3 \times \$10\text{M})} = 8.35\%$$

BANK SUPERVISION AND MARKET DISCIPLINE

Basel I was an early attempt to define the framework for ensuring financial stability, but it was a simplistic approach that focused mainly on capital requirements. Increased market volatility and rapid development and the introduction of innovative products into the financial markets, together with a series of financial crises spreading from one continent to another, soon exposed the weakness of Basel I. The financial crisis in East Asian countries in 1997 and that in Eastern Europe in 1998 were evidence of the increased complexity of risks faced by international banks and highlighted the need for improved transparency, governance and supervision of financial institutions.

In light of these factors, in June 2004 the BCBS issued a Revised Framework (Basel II) which, in addition to capital adequacy (Pillar I), deals with the principles of the enhanced supervisory review process (Pillar II) and effective use of market discipline (Pillar III). While the new framework aims to provide a comprehensive approach to measuring banking risks, its fundamental objectives remain the same as those of the 1988 Accord: to promote the safety and soundness of the banking system and to enhance the competitive equality of banks. All three pillars are mutually reinforcing and no one pillar should be viewed as being more important than another.

The message of Basel II is that a robust financial system infrastructure and adequate macro prudential surveillance are the prerequisites for effective supervision and risk management. Several recent studies by the World Bank and the IMF have highlighted the significance of having the appropriate balance of prudential supervision and market discipline in Islamic finance, and the related implications for the organization and financial stability of the industry. These studies stress the importance of disclosure and market discipline in Islamic finance, because the different nature of the risks of IFIs and their limited capacity for risk mitigation expose them more than the conventional financial institutions. This exposure is further enhanced by the inadequacies of its financial infrastructure, manifest in such things as a low level of transparency, the absence of derivative instruments and markets, and a weak insolvency and creditor-rights regime. Weak disclosure and low market discipline also call for active supervision.

While understanding the risks and the allocation of capital under Pillar I is a critical step, the core elements of supervision (Pillar II) and market discipline (Pillar III) are equally or more important. A well-designed capital requirement standard cannot be made effective in the absence of strong and prudent supervision. Therefore, the strengthening of the existing supervisory framework to achieve full compliance with the core principles of Basel is highly desirable for IFIs, particularly in relation to the disclosure requirements on risk exposures and risk management processes.

The disclosure practices of IFIs are highly varied. Although the AAOIFI Financial Accounting Standards provide a sound basis for further developing prudential disclosures, it has been suggested that this should have two key purposes: (i) to develop consumer-friendly disclosures to inform investment account holders on the inherent overall risks that they face, and the related policies about investment risk exposures and mitigation; and (ii) to develop market-oriented disclosures to inform the public at large, particularly other professional counterparties, including regulators (who will require more details, not publicly disclosed) on capital, risk exposures and capital adequacy, along the lines of Pillar III of Basel II. The true risks borne by the investment account holders can be made transparent by enhancing the reporting and disclosure requirements. For example, disclosure of the definition, levels and variations of *mudarabah* profits and profit equalization reserves will help investors in determining the level of their exposure while also providing valuable insights to supervisors.

The following issues pertaining to the implementation of Basel II are worthy of further discussion:

- Risk Reporting: The significance of risk reporting should not be underestimated and it is necessary that IFIs work together and with the supervisory authorities to implement a comprehensive risk reporting framework. The IFBS has recently emphasized the need for just such a process, including appropriate board and senior management supervision to identify, measure, monitor, report and control relevant categories of risks and to ensure the adequacy of reporting to the supervisory authority. Supervisory authorities themselves need to allocate resources to ensure timely implementation of the proposed framework.
- Information Infrastructure: There is a need to establish an information gathering infrastructure to provide reliable information about the creditworthiness of borrowers, the fair value of collateral and independent valuation of assets. This requires a systematic effort of data collection and analysis, the establishment of credit registries that can track the credit history of potential borrowers, and well-functioning rating agencies. There is now increasing recognition that credit registries with appropriate modifications in data content could facilitate systematic credit risk measurement.
- Liquidity Enhancement: IFIs have limited choices for maintaining liquidity, especially in times of stress. The availability of liquidity is critical for risk management and it is essential, therefore, that IFIs allocate resources to introduce liquidity-enhancing financial instruments through securitization and the development of capital markets.
- Fragmentation and Concentration: IFIs are often fragmented, highly concentrated, and are small compared to average conventional banks. As a result, IFIs do not have enough opportunities to gain from the benefits of diversification. Supervisors need to monitor IFIs that have significant exposure to a particular industry or deposit base. Supervisory authorities should also encourage IFIs to seek diversification. Through geographical diversification of the deposit base, an IFI can reduce its

exposure to displacement or withdrawal risks. Diversification on the asset side can reduce the variance in the returns that accrue to the claimholders of the financial intermediary. The geographical spread of products can further help an IFI mitigate its credit risk by selecting borrowers of the best credit quality and avoiding those with weak credit quality. Further diversification benefits can come from economies of scope by extending the line of products and services.

- Investment in Risk Management Infrastructure: Establishing risk-assessment and measurement systems often becomes an expensive proposition, as it requires sophisticated models, software and technologies, and skilled human resources who can understand the nature of the risks and prepare models accordingly. Measurement and control of the operational risk are still evolving. Given the small average size of Islamic financial institutions, establishing such a framework at the organization level may not be possible. IFIs and supervisory authorities should work together to find a reasonable solution to this problem.

REGULATION OF IFIs: LOOKING FORWARD

The legal and regulatory practice governing IFIs varies across countries (as illustrated in Table 14.4). Indonesia, Iran, Lebanon, Malaysia, Pakistan, Sudan, Turkey, the UAE, and Yemen have enacted Islamic banking laws. However, these laws may not always take full account of the unique characteristics of Islamic banking. For example, the Malaysian Islamic Banking Act (1993) refers to banking as a "lending business" and investment accounts are considered to be liabilities. In Iran, IFIs accept customer investments on the basis of the *wikala* agency contract,[4] not the *mudarabah* contract as is the case in other countries. In Saudi Arabia and Egypt, no laws have been enacted to regulate IFIs, which operate under the same laws governing conventional banks.

TABLE 14.4 Diversity in legal, regulatory and supervisory arrangements

Country	Banking System	AAOIFI Standards	Islamic Banking Law	Existence of *Shari'ah* Boards	Supervision
Iran	Islamic	No	Yes	No	No
Jordan	Dual	IAS	Yes	Yes	Consolidated
Kuwait	Dual	IAS	Considered	Yes	Consolidated
Sudan	Islamic	Yes	Yes	Yes	–
Yemen	Dual	No	Yes	Yes	No
Malaysia	Dual	IAS	Yes	Yes	Consolidated

Source: Compiled from Zaher and Hassan (2001), Chapra and Khan (2000), El-Hawary, Grais and Iqbal (2004)

Effective regulation requires readable, reliable signals of the risks that a financial institution faces as a consequence of its own behavior or from events external to it, as well as risks that may affect the financial system through contagion or infrastructure failure. It also requires an ability to process these readable signals and to introduce appropriate corrective actions as needed. In this respect, the role of the broader institutional infrastructure is critical. Of particular importance is the clarity and enforceability of property rights, the quality of the contract law and the feasibility of quick action in cases of breach, the efficiency of judicial recourse and other dispute-resolution mechanisms. The majority of IFIs, however, operate in jurisdictions where these matters leave much to be desired, to the detriment of their performance.

The quality and transparency of accounting and auditing practices play a crucial role. The measurement and comparison of risk exposure should underlie regulation. The efforts towards establishing accounting and auditing standards for IFIs have made a significant contribution in this respect. However, disclosures of accounting results may not be an adequate instrument for risk-assessment purposes because, as a structure, accounting is directed toward value, not risk allocation. This situation gives additional importance to other services, such as the collection and dissemination of financially relevant information and credit rating. In addition, it would call for renewed efforts at enhancing the relevance of accounting and auditing for risk assessment. El-Hawary, Grais and Iqbal (2004) suggest that under the circumstances, regulators dealing with IFIs may want to consider a two-pronged strategy: managing current practices, and a transition toward stable and efficient intermediation. In managing current practices, regulators need to promote the stability of existing IFIs that conduct financial intermediation, reflecting the market pressures they face, their stakeholders' demands and their institutional environment. A long-term perspective for the industry calls for the development of a consensus on a vision on its nature, the role it would play in the development of the communities it serves, and how it would enact that role. A significant intellectual effort, geared towards providing practical ways of achieving consistency between the demands of the market place and the underlying principles, needs to be made. This effort needs to include debates that remain substantive, consultative, and evidence-based. In particular, it is important to be clear on the type of Islamic financial intermediation being considered, with special attention given to the core principles and how practice can develop consistent with them.

The combination of the services offered by IFIs and the prevailing practices they follow compound the difficulties of designing a regulatory framework to govern them. The problem of co-mingled funds from different classes of deposit holders particularly needs to be addressed. IFIs are often criticized for not maintaining proper firewalls between the funds of different investor classes and equity shareholders. This creates difficulties in both regulation and supervision. One approach for better regulation could be to encourage IFIs to structure their operations in clearly defined and separated segments catering to different classes of depositors, depending on their respective investment objectives. For example, one class of depositors may be looking for custodial services only, while others may need to place funds for performing day-to-day transactions and therefore do not exhibit much risk appetite. Similarly, there may be a class of depositors that is less risk-averse and would like the IFI to deploy its savings for a longer term.

A visionary design consistent with the founding principles of Islamic finance could see an IFI structured as a group of fairly independent entities, each designed to optimize the functional demands of its clients. This view is presented by El-Hawary, Grais and Iqbal (2004), who argue that institutions offering Islamic financial services can be viewed as three distinct segments (see Table 14.5), which can then be regulated individually for greater stability and transparency.

Segment A is designed to handle funds for depositors who are highly risk-averse and require a high level of liquidity; who would use the funds for daily transactions; or would prefer to keep savings in safe assets where their capital (principal) is preserved. This segment would invest funds in asset-based securities with fixed-income characteristics and the IFI would intermediate by screening and monitoring such opportunities and making sure that credit and operational risks are contained. The concept is similar to narrow banking and would require a similar approach in its regulation.

Segment B is designed to cater to depositors with the next level of risk appetite who are willing to take some risk in the expectation of a higher return, with capital preservation and liquidity less high on their agenda. The IFI would deploy these funds in medium- to long-term instruments, such as *ijarah* or *istisna'*, or may prefer to invest on a *mudarabah* basis directly with the entrepreneur or through *mudarabah* certificates. If there is a well-developed secondary market for *mudarabah*-based funding, then the form of intermediation taken by the IFI will be very similar to mutual funds where the IFI will manage and invest the depositors' money in different *mudarabah* funds. Since the contractual agreement with the depositors would be similar to the fiduciary responsibility of a mutual fund in a conventional system, the same regulatory principles would apply.

TABLE 14.5 A segmented view of an IFI

Assets	Liabilities
Asset-based/Trade Financing **Minimal Risk**	**Segment (A) Depositors** (Risk-averse Investors)
ijarah, *istisna'*, *mudarabah* **Low–Medium Risk**	**Segment (B) Depositors** (Low Risk Takers)
Partnership/Profit and Loss Sharing *musharakah*, *mudarabah* Venture Capital Private Equity **Medium-High Risk**	**Segment (C) Depositors** (Investors with Risk Appetite)

Source: El-Hawary, Grais and Iqbal (2004)

Segment C is designed for investors who are willing to take additional risk and are prepared to participate in riskier investments, like private equity or venture capital. IFIs could deploy these funds on the basis of *musharakah* or *mudarabah* instruments. With the former, the IFI also gets rights to participate in the governance of the enterprise, which raises another issue for the regulators. The IFI's relationship with *musharakah* enterprises would be of a long-term nature, with active involvement in governance, as opposed to a short-term, transactional relationship.

To summarize, an IFI structured to provide financial intermediation through clearly segmented windows, or even separate institutions, would make the task of the regulators easier. Each entity could then be subject to a regulating principle most suited to its nature. Such a separation could promote greater transparency of the risks faced by depositors, shareholders and regulators. The outlined framework would also bring to bear the market discipline through the risk sharing feature of Islamic financial intermediation, and contribute to the stability of the system. An Islamic financial industry incorporating such segmentation would likely require lighter and more focused regulation.

POST-CRISIS REGULATORY ENVIRONMENT AND IMPACT ON IFIs

There is no doubt that the lessons learnt from the crisis will shape the changes in the regulatory and supervisory framework and practices. The debate on which direction policymakers need to take has already heated up in several international fora, including the Financial Stability Forum (FSF), the IMF, national authorities, and standard-setting bodies who are collaborating to address the deficiencies and enhancements. Working groups at the FSF and G-20 are reviewing a wide spectrum of related issues, including complex and difficult legal and institutional hurdles to improving cross-border cooperation in regulation and the resolution of troubled institutions.[5]

Figure 14.1 is a very good depiction of how financial institutions are being surrounded by different pressure points which came to the surface during the crisis. This gives us an idea of the nature of the issues under consideration for shaping a new financial landscape. The environment within which today's financial institutions are operating is changing and the key drivers for the change include defining capital and its adequacy, liquidity, securitization, rating agencies, compensation, OTC derivatives, and systemically important entities. In this section, we will discuss select key drivers and how each will affect the Islamic financial services industry.

Capital Requirements

The first realization is that the increased complexity in the financial system and growing innovation among financial institutions, without a clear

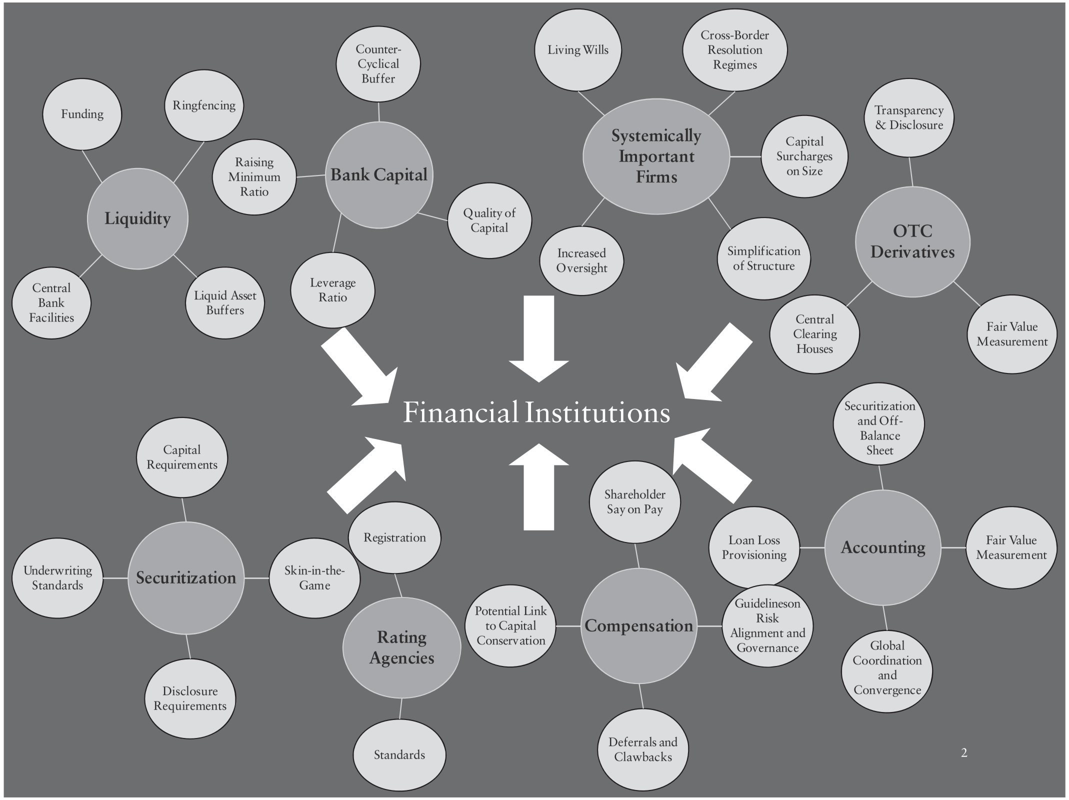

FIGURE 14.1 Key drivers of regulatory change for financial institutions
Source: Portilla (2009)

segregation between commercial and investment-banking activities, cannot be sustained within current capital requirements. Keeping this in mind, Basel III (which came into effect in September 2010) recommends that the financial institutions substantially raise the quality and quantity of capital, with a much greater focus on common equity to absorb losses. Enhanced capital buffers can help protect the banking sector against credit bubbles that can be drawn down during times of stress. Key features of Basel III's new capital requirements include (i) an increase in the minimum levels of Tier 1 capital; (ii) a change in the rules in regard to composition/definition of Tier 1 capital composed of retained earnings and common stock); (iii) a requirement for countercyclical shock-absorbers/buffers (that vary with the economic cycle); (iv) a requirement for a leverage ratio, limiting asset size (both on and off balance sheet); and (v) additional capital charges considered systematically relevant to firms.

Proposed changes in the capital requirements are a step in the right direction. The IFSB has already announced a review of existing capital-adequacy requirements in light of the proposed Basel III requirements. Determining capital requirements for Islamic financial institutions is not straightforward. There are two main issues. First, technically, Islamic financial intermediation is supposed to be on pass-through mode where all profits and losses on the assets side are passed to the liabilities side (to investors/depositors) and therefore the need for capital is minimal. In this mode of intermediation, as with mutual funds, the purpose of capital is to cover negligence and operational risk. However, the reality is that capital requirements have been set for Islamic financial institutions along similar lines to those for conventional banks to maintain the confidence of investors. Following the same tradition, it is expected that the capital requirements will also modified to comply with Basel III, although not strictly necessary. An increased capital requirement can also have an impact on the efficiency and return on equity for Islamic financial institutions.

The second issue concerns the exposure of Islamic financial institutions to real assets that are subject to price volatility as well as to liquidity risk. Several Islamic banks, particularly in the Middle East, have considerable exposure to the real estate sector. Depending on how the assets are valued—book value or market value—the financial health of Islamic banks can deteriorate as result of price volatility. In addition, requirements to adjust capital to economic cycles and the activities of Islamic banks to the real sector will also come into play. Policymakers and authorities can develop sophisticated capital requirements to combat pro-cyclical pressures only after they understand the nature of the risk/return rewards of assets for Islamic financial institutions, which are definitely different from those of their conventional counterparts. Since Basel III will change the capital charge for securitization risks, IFIs dealing with the *sukuk* market can also expect changes. Finally, as discussed below, additional requirements for liquidity in Basel III will put an additional burden on Islamic banks to maintain adequate capital and the levels of minimum capital are expected to increase.

Liquidity

The current financial crisis has been called the "perfect liquidity surprise." Liquidity problems associated with the crisis have forced regulators to get tough on this issue. Basel III incorporates the introduction of minimum liquidity standards and the monitoring of the liquidity coverage ratio (LCR) of financial institutions. The LCR is designed to ensure that the firm has enough liquid assets to cover a short-term crisis based on a predetermined set of cash inflows and outflows established by the BCBS. Such liquidity issues have serious implications for IFIs for several reasons. First, Islamic financial institutions do not have access to short-term liquidity through markets. One of the biggest impediments for IFIs is to develop liquid markets where securities can be traded efficiently at minimal transaction cost. Second, given the heavy concentration of trade or commodity finance, the assets of Islamic banks are illiquid; that is *murabahah*-based assets cannot be traded in the secondary market. Third, whereas conventional banks have access to liquidity provided by a lender of last resort, Islamic banks cannot benefit from such a facility as the lending is interest-based. This means that although an Islamic bank may be in good financial health, it could still face additional capital requirements because of low liquidity which could hamper its growth or efficiency.

Quality of Information

For markets, policymakers and financial authorities, and multilaterals (IMF and World Bank) appropriate coverage and quality of information is becoming increasingly critical for their capacity to assess risks and vulnerabilities. Regulators are looking for better information on a range of activities such as off-balance-sheet risks (involving better consolidated supervision), and the risks of financial inter-linkages. The new regulatory and supervisory environment will be information-focused and financial institutions will be required to enhance the collection and disclosure of information as required by the regulators.[6]

This means that the financial institutions will have to improve, enhance, and upgrade the overall flow and quality of information in their institutions. They will need to be very focused on satisfying the reporting and disclosure requirements for the regulators and supervisors. They should expect to address this issue across all business lines and functional areas, from front to back office. For some institutions, it will require an upgrade of their risk-reporting systems or the development of new risk measures.

The general level of transparency and disclosure in the Islamic financial services industry is low. The impact of the new quality-of-information requirements could come from two directions. At the institutional level, the demand for the flow and quality of information within the institution to be enhanced could entail the automation of manual monitoring processes, the upgrading of information systems, and improving the transparency of data and information for reporting purposes. This could be a challenge, considering that the majority of IFIs are small and do not have surplus funds to invest in the information infrastructure.

Quality of information is also relevant to investors and the regulators but in several countries where Islamic banks operate, general quality of information is considered low. Table 14.6 compares the information-disclosure index in MENA and G-7 countries. Table 14.7 shows the depth of credit information in the region. This index measures the rules and practices affecting the coverage, scope and accessibility of credit information available through either a public credit registry or a private credit bureau. The index shows relatively low levels compared to the developed economies of the G-7. National authorities and regulators need to take concrete steps to enhance information at a systemic level so that all participants in the system can benefit from it. Enhancing the flow and quality of information can be considered as a key driver to which the Islamic financial industry needs to pay attention.

Risk Management Practices

As mentioned earlier, a failure of risk management practices was observed during the financial crisis and, as a result, they have come under close scrutiny,

TABLE 14.6 Extent-of-disclosure index

	2005	2006	2007	2008	2009	2010
Average MENA	5.86	5.86	5.94	6.13	6.44	6.56
Average GCC	6.5	6.5	6.5	6.83	6.83	6.83
Average Non-GCC	5.6	5.6	5.6	5.7	6.2	6.4
Average G7	7.71	7.71	7.71	7.71	7.71	7.71

Source: DoingBusiness, World Bank

TABLE 14.7 Depth-of-credit information index (0–6)

	2005	2006	2007	2008	2009	2010
Average MENA	1.93	2.21	2.69	3.13	3.5	3.69
Average GCC	3	3	3.33	3.83	3.83	3.83
Average Non-GCC	1.5	1.9	2.3	2.7	3.3	3.6
Average G7	5.71	5.57	5.57	5.57	5.57	5.57

Source: DoingBusiness, World Bank

with a review of the risk framework expected. It is expected that policymakers and regulators will be taking a very close look at how banks arrive at their measures of exposure, how they risk-weight their assets, and how they engage in risk mitigation activities. Requirements from the regulators on risk measures and enhanced quality of information will demand that financial institutions are vigilant to such requirements for new products and to comply with the regulatory requirements.

The risk framework in Islamic financial institutions is gradually evolving but is still in its early stages. The emphasis is currently on managing credit risk and the awareness of market and operational risk is not adequate. Some of the financial houses cannot afford extensive enterprise-wide risk management systems, which further exposes them to operational risk from their reliance on manual processes. Some technology vendors are taking their conventional products and offering them, with some modifications, to Islamic banks. However, it is critical that a proper risk framework for Islamic products and financial institutions is developed so that meaningful risk measures such as value-at-risk are developed and proper back-testing and stress-testing of exposures are undertaken to satisfy current and future requirements.

Supervisory Framework

In the standard-setting area, the focus of policy work is on the market-risk rules, systemically important banks, the reliance on external ratings and large exposures. Basel III is the core regulatory response to the financial crisis but, with the regulatory changes, the next critical task is to promote more collaborative supervision at the global level. It is expected that, in addition to the further development of supervisory standards, authorities will be paying more attention to improving supervisory practices and cross-border bank resolution practices. A working group of the Financial Stability Board (FSB) has identified areas of the Core Principles for Effective Banking Supervision that could be expanded or clarified to address topics related to the supervision of systemically important financial institutions. One key challenge for bank supervision would be to assess risks associated with innovations and how such exposure is monitored.

The main challenge for both supervisors and the Islamic financial industry will be to develop and enhance the supervisory framework. In the MENA region for example, where there is large concentration of Islamic financial institutions, supervisory standards, legal institutions governing the resolution of large cross-border financial firms and insolvency issues are under-developed for both conventional and Islamic financial institutions. Unless these impediments are removed, the financial system will be prone to instability. The current practice is to treat Islamic and conventional banks in a similar way when it comes to supervision but this practice is not optimal. Islamic institutions have different contractual agreements and, without understanding the underlying contracts, supervision can overlook areas of potential problems. Although, standards for exposure, governance, and supervision have been issued by the IFSB, these standards have yet to be adopted formally by regulators and national authorities. National supervisory authorities may be very familiar with the supervision framework and methodology of conventional financial institutions, but they need to pay attention to revising supervisory standards and manuals for Islamic institutions in addition to getting serious about implementing IFSB standards. Another dimension of complexity in supervision is introduced by the existence of Islamic windows from conventional banks and the need to maintain a proper firewall to segregate Islamic assets from conventional assets.

As Basel III incorporates macroprudential measures to help address systemic risk and the interconnectedness of financial systems, regulators and supervisors need to enhance supervision of Islamic institutions by forcing these institutions to improve their internal risk systems, their compliance with reporting requirements, the transparency of their disclosures, and the quality of information they put out. Without focusing on these issues, the authorities will not have a meaningful understanding of the risks such institutions pose to the system.

ENDNOTES

1. See Basel Committee On Banking Supervision (BCBS) (2003), Consultative Document-Overview of the New Basel Capital Accord, April, Bank for International Settlements, Basel, Switzerland.
2. For detailed methodology of how to determine risk weights for different assets, consult IFSB standard on capital adequacy at www.ifsb.org.
3. Under the Basic Indicator Approach, a fixed percentage, namely 15 percent, of the annual average gross income, averaged over the previous three years, is set aside. Under the Standardized Approach, this percentage varies according to the line of business, from 12 percent for retail banking, asset management and retail brokerage to 15 percent for commercial banking and agency services, to 18 percent for corporate finance, trading and sales, and payment and settlement.
4. The *wikala* contract operates on the basis of the agent receiving a fixed fee, not a share of profits as in the *mudarabah*.
5. IMF (2009).
6. Ibid.

CHAPTER 15

Corporate Governance

The issue of corporate governance and the search for an optimal governance structure has received considerable attention in the economic literature and in public-policy debates. This increased attention can be attributed to several factors such as:

- The growth of institutional investors—pension funds, insurance companies, mutual funds and highly leveraged institutions—and the role they play in the financial sector, especially in the major industrial economies
- Widely articulated concerns and criticism that the current monitoring and control of publicly held corporations, particularly in the UK and the US, is seriously defective, leading to sub-optimal economic and social development
- A shift away from the traditional "shareholder value-centered" view of corporate governance, towards a structure extended to a wide circle of stakeholders
- The impact of the increased globalization of financial markets, deregulation and the liberalization of the activities of institutional investors.

Although each of these factors provides compelling reasons to examine corporate governance structures, the current financial crisis has unearthed new governance issues, some of which were either ignored, not taken seriously, or were never even discussed earlier. Lapses in corporate governance were cited as one of the reasons why managers and policymakers failed to avoid the financial crisis, which caught everyone by surprise.

The concept of corporate governance is diverse and, over a period of time, the definition of the term has oscillated between two extremes—from a narrow concept of a mechanism for safeguarding investors' interests, to a broad concept advocating the protection of all internal and external stakeholders' rights. This wide spectrum of the concept stems from two divergent views: (i) how the entity of a "firm" should be perceived in an economic system, and (ii) the form of the incentive system to protect the rights and preserve the obligations of the economic agents in the environment in which the firm operates. Whether one views the firm as a bundle of assets and liabilities, a legal entity, an economic or social organization, a nexus of contracts, or as a combination of these elements, will influence the way in which the evolution of the concept of corporate governance is analyzed.

Financial institutions have certain features that necessitate that greater attention be paid to their corporate governance for several reasons. First: As financial intermediation has become increasingly complex, simple governance structures are no longer effective. Financial innovations have introduced complexity and remoteness in governance structure. The resultant multiple layers of intermediaries and legal entities create ambiguity and confusion in implementing effective governance. Second: Financial firms supply and arrange funding for non-financial firms, which may place them in an advantageous position to exert control over the governance of their clients. This is particularly problematic when the financial system is dominated by intermediaries rather than the markets. Third: Financial firms are subject to significant information asymmetries which make it difficult to assess their management performance. Finally, corporate governance has the potential for free-rider problems. Limitations on takeovers, the concentration of ownership, prudential supervision, and investor protection may weaken product-market discipline and lead to the weakening of incentives for the private sector to undertake other governance functions.[1]

AN ISLAMIC PERSPECTIVE: STAKEHOLDER-ORIENTED GOVERNANCE

As explained in Chapter 2, the Islamic economic system is a rules-based incentive system with the ultimate goal of maintaining a just and harmonious social order. Rules impose restrictions on what the members may do without upsetting the social order on whose existence all members count in making their individual choices and actions. Therefore, attachment to and observance of the established rules guides the members of a society in their actions. The rules themselves are composed of those which deal with the individual's body and his state of consciousness, those which govern his relationships with others, and those which constitute the code of conduct necessary for the community as a whole. Rules serve to prevent conflict, reconcile the different purposes of many individuals and facilitate cooperation among them. If as a result of growth, a division of labor, or increasing complexities of markets, either the obligations attached to contracts or property rights are shirked or the rights of the society and the cohesion of the community are undermined, the legitimate authority is justified in intervening to take corrective measures.[2] Compliance with the rules promotes social integration and unity and preserves the intended social order.

The basic agency problem suggests a possible definition of corporate governance as that which constitutes an efficient monitoring structure solving the problems of both adverse selection and moral hazard. A corporate governance structure focused on the investor–manager contract and relationship is often referred to as the "shareholder model." It can be characterized as a model where (i) shareholders ought to have control, (ii) managers have a fiduciary duty to serve shareholders' interests alone, and (iii) the objective of the firm ought to be the maximization of the shareholders' wealth.

This traditional definition of corporate governance, propounded by economists and legal scholars, is based on the agency relationship between the investor and the manager and is concerned with the protection of shareholders' or investors' interests only.

The neo-institutional economists rely on the traditional agency theory to define the firm as a "nexus of contracts" and consider agents and transactions—institutionally, socially, legally, and culturally—as contingent (incomplete) constructs. They argue that the firm's claimants go beyond shareholders and bondholders to include others with whom the firm has any explicit and/or implicit contractual interaction. In this nexus-of-contracts view, each corporate constituency, including employees, customers, suppliers and investors, provides some asset in return for some gain. Contracts are the result of bargaining by these constituencies over the terms of their compensation, as well as the institutional arrangements that protect this compensation from post-contractual expropriation.[3] According to this view, there is nothing unique to corporate governance; it is simply a more complex version of the standard contractual governance.[4] All stakeholders are regarded as contractors with the firm, with their rights determined through bargaining.

Stakeholder theorists reject the three main propositions of the shareholder system and argue that all stakeholders have a right to participate in corporate decisions that affect them, managers have a fiduciary duty to serve the interests of all stakeholders groups, and the objective of the firm is the promotion of all interests and not just those of shareholders. This view is commonly referred to as the "stakeholder model" of corporate governance, where "stakeholders" include customers, suppliers, providers of complementary services and products, distributors, and employees. Therefore, this theory holds that corporations ought to be managed for the benefit of all who have some stake in the firm.[5]

The stakeholder model is largely normative and is still evolving; it is yet to find a sound theoretical foundation in conventional economic literature. In this respect, the distinction between explicit (or formal) and implicit (or relational or self-enforcing) contracts and claims is the key to understanding the basis of the stakeholder model. When it is difficult to write complete state-contingent contracts, people often rely on "unwritten codes of conduct"—that is, on implicit contracts—which implies that in addition to the obligations on explicit contracts, obligations arising out of implicit contracts have to be incorporated into the "nexus of contracts" theory with convincing arguments. This can only be articulated by expanding the scope of analysis to encompass ethics, morals and the social order. Hart (2001) forcefully argues that many economic transactions are sustained by self-enforcing ("implicit") contracts or norms of behavior, such as honesty or trust; concepts which so far have proved difficult to formalize in economic theory.

The second issue is how to draw a line of distinction between a stakeholder and a non-stakeholder. The existence of a stakeholder entity and its rights is easy to recognize, but questions still remain as to who really qualifies as an actual stakeholder. The third issue deals with the stakeholders' right to influence management decision-making or to participate in the governance of the firm. Questions arise as to why stakeholders should be given such a right and why managers should have a fiduciary duty to protect the rights of non-investor or non-owner stakeholders if such stakeholders have protected their rights, through bargaining, within the terms of the contracts. While there appears to be a consensus on identifying the rights of non-owner stakeholders and an implicit agreement to protect these rights, there is still a debate on why such stakeholders should participate in the control and management processes of a firm. So far, discussions of the stakeholder model have not been able to articulate a convincing argument on either theoretical, moral, or legal grounds to recognize an active role for the stakeholders in the management and control of a firm.

In considering the Islamic view of the role of stakeholders, it is noted that two fundamental concepts of the Islamic economic system pertaining to property rights and contracts govern the economic and social behavior of individuals, society and state. These two principles also dictate the objective function of the economic agents, including legal entities such as firms. A firm in the Islamic economic system can be viewed as a nexus of contracts whose objective is to minimize transaction costs with a view to maximizing profits and returns to investors, subject to the condition that these objectives do not violate the property rights of any party, whether it interacts with the firm directly or indirectly. In pursuit of these goals, the firm honors its obligations on explicit and implicit contracts without impinging on the social order. This definition incorporates the stakeholders' role in its view of the firm and supports recognition and protection of their rights.

Property Rights and Governance

The design of the governance system in Islam can be best understood in light of the principles governing the rights of the individual, society, and state; the laws governing property ownership; and the framework of contracts. Islam's recognition and protection of rights is not limited to human beings only, but encompasses all forms of life as well as the environment. Each element of creation has been endowed with certain rights and each is obligated to respect and honor the rights of others. These rights are bundled with the responsibilities for which humans are held accountable.[6] The *Shari'ah* offers a comprehensive framework to identify, recognize, respect and protect the rights of every individual, community, society and the state. Islamic scholars and jurists have defined and codified detailed principles identifying these rights.[7]

The term "right" (*haq*) denotes something that can be justly claimed, or the interests and claims that people may have been granted by the *Shari'ah*. The majority of *Shari'ah* scholars and jurists hold that similar to a physical property, rights are also property (*al mal*) because, like physical property, which has beneficial uses and can be possessed, rights also have beneficial uses and can be possessed.[8] Rules defining property rights in Islam deal with the rights of ownership, acquisition, usage and disposal of the property. Any violation of these rules is considered a transgression and leads to disruption in the social order.

As we saw in earlier chapters, the notion of ownership in Islam is two-tiered: (i) real and absolute, and belongs to Allah (*swt*) alone; and (ii) delegated to man and restricted through time-bound possession.[9] Ownership rights in Islam originate from the concept of stewardship (*khilafah*): as the *Qur'an* and *sunnah* make clear, Allah (*swt*) is the sole owner of property and that man is merely trustee and custodian.[10] This relationship implies that man has the right to use and manage his private property in a manner similar to that of a custodian and trustee. Property is not an end itself, but a means for man to discharge effectively his responsibilities as vicegerent.

The second axiom of property rights in Islam is that this right of possession is a collective right and individuals can only earn a priority in the use of these resources.[11] While a part of these resources is reserved for the exclusive possession of the collectivity, the remaining part is allowed to become the possession of an individual without the collectivity losing its initial right of possession to these resources. However, when individuals apply their creative labor to these resources, they get or acquire a right of priority in the use and enjoyment of the resulting product, but without the prior rights of others being nullified. This proposition becomes a legislative basis for requiring preservation of society's well-being and interests.

Social interest and the collective dimension of human life demand that individual freedom is kept within certain limits and a balance is created in such a way that the individual, the society, and the state each has a claim on property rights in respect of the roles assigned to them. The property rights of these three agents should not conflict with one another, nor should the exercise of those rights by any one of these agents jeopardize the exercise of rights by the others. Ibn Taimiyah (1263–1328) was one of the earliest scholars to recognize and advocate the rights of the society and the state along with private ownership.[12] If, as a result of the growth of the society, division of labor, or increasing complexities of markets, the obligation to share is shirked or the rights of the society and the cohesion of the community are undermined, or a harmonious social order is at stake, intervention by the legitimate authority to take corrective measures is justified.

The second axiom of property rights implies that while the individual's possession of these resources and his share in the outcome is allowed, sanctioned and protected by the *Shari'ah*, it is so only as long as it does not come into conflict with society's interests and well-being. Hence, private initiative and choice are recognized, but such recognition is not allowed to subvert the principle of sharing or to lead to a violation of the rights of the society and the state. However, once individuals have discharged their duties to society and state in conformity with the rules of the *Shari'ah*, their rights to their possessions is held inviolate and no-one has a right to force appropriation (or expropriation) of that person's property to anyone else.[13] Ibn Taimiyah viewed property as a right to utilize an object but a right of varying kinds and degrees. Sometimes the right is an extended one so that the proprietor can sell or give away the object, lend it or make a gift of it, bequeath it or use it for productive purposes; but sometimes the right is incomplete, and therefore the proprietor's rights are limited or restricted.[14] Rules concerning the acquisition, possession, usage and disposal of property should be looked at as regulations rather than restrictions. The basic conditions for maintaining lawful rights to property are that the property should not have been acquired by unlawful means; the acquisition and its continuity should not result in any damage or harm to others; and the acquisition should neither invalidate any valid claim nor establish a non-valid one. Islam does not impose any cap on the amount of property that can be owned, or on the amount of wealth an individual can accumulate, as long as the individual conforms to the obligations set by the *Shari'ah*.

Individuals can obtain rights to property through their own creative labor and/or through the transfer—via exchange, contract, grants or inheritance—of rights from another individual who has gained title to the property or asset through their own labor. Property acquired through non-permissible and unjustifiable means such as gambling, bribery, theft, forgery, coercion, or illegal trading does not qualify as *al-mal* as defined by the *Shari'ah* and is therefore forbidden. Consequently, any property that is considered counterproductive or non-beneficial loses its legitimacy and its associated rights. Hoarding with the intention of creating artificial scarcity and profiteering are considered unacceptable means of building wealth and property. Similarly, property acquired through breach of trust, adulteration, non-compliance with weights and measures, or unethical means does not satisfy the definition of property and therefore its ownership is not considered legitimate.

Concomitant with property rights, the *Shari'ah* imposes responsibilities, among which are obligations not to waste, destroy, squander, or use the property for purposes not permitted by the *Shari'ah*.[15] To do so is to transgress the limits set on an individual's rights and an encroachment on the rights of others. While the right of use and enjoyment of property is affirmed by the *Shari'ah*, the exclusive and absolute right of disposal of property is rejected.[16] The prohibition of waste and squandering (*israf* and *tabdhir*) in all areas applies to property as well. An individual may not make an alteration in his property that may harm even his neighbor. If the property owner proves unable to use the property properly (within the boundaries defined by the *Shari'ah*), he forfeits his ownership rights and the legitimate authority is fully justified in withdrawing the rights of usage of that property.[17] This position is in conformity with both the Islamic conception of justice (*al-adl* and *al-ihsan*) and the rights and responsibilities of the individual and the community.

Islam's concept of property rights differs in many respects from those of conventional economic systems. At one extreme, proponents of the market-based system argue in favor of individual private-property rights as fundamental rights; while at the other extreme, a small minority believes that private property is fundamentally immoral.

In contrast, Islam promotes a balance among the rights of individuals, society and the state. This concept sharply contrasts with the self-centered utility-maximizer economic agent idealized in neoclassical economics in an unbounded, insatiable, quest for acquisition and accumulation. Before the full market society came to prevail in the West, a great deal of the property rights in land and other assets was a right to use and enjoy the asset but not a right to dispose of it. However, it was thought that it was impossible to reconcile this particular right with a full market economy. Hence, of the two earlier kinds of property rights—the right to exclude others and the right not to be excluded by others—the second was all but abandoned and the conception of property rights was narrowed to cover only the right to exclude others. In Islam, however, this right is preserved without in any way diminishing the role of the market as a resource-allocating and an impulse-transmitting mechanism. Islam does not endorse the conventional notion that a person does no harm to members of his group if as a result of his effort he is better off and others are no worse off than they would otherwise be.

Several conclusions can be drawn from this. Firstly, Islam's concept of property rights is different, inasmuch as the individual has a delegated right to the property whose acquisition, usage and disposal are subject to rules including the principle of sharing as dictated by the *Shari'ah*. Secondly, while Islam fully recognizes the individual's private-property rights, these rights are governed by rules designed to protect the rights of society and the state. By virtue of the first and second axioms of property rights, every individual, group, community, society and the state becomes a stakeholder whose rights are granted and preserved by the *Shari'ah* in order to promote social order and economic development. While it is difficult to recognize or justify some rights of others in a formal economic theory in the conventional system without drawing any reference to ethics and morality, such a problem does not exist in Islam, where everyone's rights are recognized and protected by Law (*Shari'ah*). Finally, inclusion (or exclusion) and recognition (or denial) of the rights of stakeholders in the Islamic economic system are based on rules and laws that need no justification on the grounds of morality alone, but are derived from principles aimed at creating justice and balance in the economic and social system.

Whereas the *Shari'ah* guarantees some basic property rights to individuals by virtue of their being members of the society, the rights of a firm or a legal entity such as a corporation are earned and acquired. It is not the firm that acquires property rights, but it is the property acquired in the course of the firm's economic activity that has property rights and claims. Once a property is earned or acquired, it is subject to the same rules of sharing and the same prohibitions as apply to the property of individuals. The firm's property rights also come with the same claims and responsibilities as do those of individuals. This implies that the firm is expected to preserve the property rights of not only the local community or society, but also of those who have participated in the process of acquiring or earning the firm's property. No action of the firm that violates the basic set of property rights of those with whom the firm interacts is acceptable.

The principles of property rights in Islam clearly justify the inclusion of stakeholders into the decision-making and accountability of an economic agent's activities. This inclusion is based on the principles that

- The collectivity (community, society, state) has sharing rights with the property acquired by either individuals or firms
- The exercise of property rights should not lead to any harm or damage to the property of others (including stakeholders)
- The rights of others are considered as property and are therefore subject to rules regarding violation of property rights
- Any property leading to the denial of any valid claim or right is not recognized as *al mal* and therefore is considered unlawful according to the *Shari'ah*.

Contracts and Governance

As we saw from Chapter 2, the significance of contractual obligations in economic and social relations cannot be over-emphasized. The whole fabric of Divine Law is contractual in its conception, content, and application.

A contract in Islam is a time-bound instrument, which stipulates the obligations that each party is expected to fulfill in order to achieve the objective(s) of the contract. Contracts are considered binding and their terms are protected by the *Shari'ah* no less securely than the institution of property. The freedom to enter into contracts and the obligation to remain faithful to their stipulations has been so emphasized in Islam that a characteristic that distinguishes a Muslim is considered to be his faithfulness to the terms of his contracts. In the *Shari'ah*, the concept of justice, faithfulness (*amanah*, whose antonym is *khiyanah*, meaning "betrayal, faithlessness and treachery"), reward and punishment are linked with the fulfillment of obligations incurred under the stipulation of the contract.

The contractual foundation of the *Shari'ah* judges the virtue of justice of individuals not only for their material performance but also by the essential attribute of their forthright intention (*niyya*) with which they enter into every contract. This faithfulness to contractual obligations is central to Islamic belief. So basic is the notion of contracts in Islam that every public office is regarded primarily as a contract or agreement that defines the rights and obligations of the parties.

The emphasis placed on contracts in Islam, by implication, makes the members of society and economic agents aware of the obligations arising from their contractual agreements—verbal or written, explicit or implicit. In the case of explicit contracts, parties to the contract clearly stipulate the expected behavior and duties with respect to the terms of the contract. This contract is to be free of information asymmetry; parties intend to comply with the terms of the contract and are fully aware of their rights and obligations. Importantly, the state ensures enforceability of the contract in case of violations by either party. On the other hand, implicit contracts are not formal contracts with clearly defined terms but are claims and obligations that come with the rights to be part of a society. The principles of sharing and the rights of the collectivity to property are types of implicit contracts to preserve and protect the rights of others and thus establish a wide spectrum of implicit obligations. Honoring these obligations is considered a sacred duty that provides the moral, social and legal foundation for recognizing and enforcing the obligations arising from implicit contracts.

Islam's framework of contracts places equal emphasis on obligations arising from both explicit and implicit contracts. Individuals as well as public and private entities are expected to be aware of this. Therefore, just as it is incumbent upon economic agents to honor explicit contracts, it is obligatory for them to preserve the sanctity of implicit contracts by recognizing and protecting the property rights of stakeholders, community, society and state. Whereas the conventional stakeholders' theory is searching for sound arguments to incorporate implicit contracts in the theory of the firm, in the Islamic economic system rights and obligations of stakeholders are taken for granted.

Islam's framework of property rights and contracts also establishes guidelines regarding who can qualify as a stakeholder and whether such a stakeholder has any right to influence the firm's decision-making and governance. In a broad sense, any group or individuals with whom a firm has any explicit or implicit contractual obligations qualifies as a stakeholder, even though the firm may have formal contracts with them through mutual bargaining. In Islam, a stakeholder is the one whose property rights are *at stake* or *at risk* as a result of the voluntary or involuntary actions of the firm. Where an individual's rights are encroached upon or threatened as a result of the firm's operations, that individual, group, community or society becomes a stakeholder.[18]

THE SIGNIFICANCE OF TRUST

The notion of trust was recognized by Fukuyama (1996) as an important component of social capital and a strong explanatory factor in the economic performance of industrial countries. The last decade has witnessed a growing literature covering the importance of trust to, *inter alia*, the development of the financial system (Calderon *et al.* 2002; Guiso *et al.* 2004). This body of research has demonstrated that since finance (particularly risk-sharing instruments such as equity) was trust-intensive, high-trust societies exhibited more developed and deeper financial systems. In particular, the literature indicated that there is a high correlation between trust and the development of the financial sector. If the level of trust is high, people rely more on risky assets, such as equity, invest a larger share of their wealth in stocks, use more checks, and have access to greater amounts of credit than in low-trust countries. Importantly also, since the second half of the 1990s, a number of researchers, using a variety of techniques, have attempted to demonstrate the impact of trust on economic performance.

The *Qur'an* establishes human beings as the *khalifa* or trustees of God on earth, and life is a test of man's worth in the eyes of God (67:2). The divinely mandated command of faithfulness to the terms and conditions of contracts and abiding by their obligations is underpinned by the equally strong and divinely originated institution of trust.[19] There is a strong interdependence between contract and trust; without the latter, contracts become difficult to enter into and costly to monitor and enforce. Laws and expensive administrative apparatuses are needed to enforce contracts where trust is weak. Perhaps trust is emphasized to make entering into and enforcing contracts less costly. Accordingly, numerous verses in the *Qur'an* proclaim trustworthiness as a sign of true belief. Conversely, untrustworthiness and betrayal of trust are considered a clear sign of unbelief.[20]

Trust is important social capital which plays a vital role in promoting good governance, especially in the case of institutions dealing with financial services, which are given property to manage in "trust." Therefore, preserving high trust should be an integral part of the governance goals of business leaders and the holders of public office.

High Ethical Standards and Codes of Conduct

Islam demands high standards of ethical behavior from everyone in society, but emphasizes these standards for who govern or represent others. Within the framework of economic justice, emphasis is placed on being mindful to give full measure and weight in all business transactions. Taken in conjunction with the principles of property rights, it establishes an important rule of business that full measure and weight is not limited to physical quantities but is equally applicable to measuring intangible rights and obligations. In other words, it is the responsibility of those in charge of others' property—tangible or intangible, financial or non-financial, explicit or implicit—to ensure that all obligations are accounted for with great care and all claims and rights are returned in full to the rightful recipient.

The verses which state "Woe unto those who give short measure, those who, when they are to receive their due from [other] people, demand that it be given in full but when they have to measure or weigh whatever they owe to others, give less than what is due!" (83:1–3) remind individuals against any negligence or cheating in determining what is owed to others. They refer not only to commercial dealings but encompass every aspect of social relations, both practical and moral, and apply to every individual's rights and obligations no less than to his physical possessions.[21]

The importance of fulfilling promises and obligations is emphasized time and again in the *Qur'an* (see, for example, 2:177 and 17:34). The grave consequences of not doing so correctly are also made clear (3:77).

Islam expects excellence in moral values, truthfulness, and virtuous conduct from every member of society, particularly those who are involved in business.[22]

Stakeholder-oriented Governance Structure

In Islam, the behavior expected of a firm is not any different from the behavior of any other member of the society. Since the firm itself does not have a conscience, the behavior of its managers becomes the behavior of the firm and their actions are subject to the same high standards of moral and ethical commitment expected of a Muslim. In other words, the firm's economic and moral behavior is shaped by its managers acting on behalf of the owners and it becomes their fiduciary duty to manage the firm as a trust for all stakeholders and not for the owners alone. Consequently, it is incumbent upon the managers to ensure that the behavior of the firm conforms to the principles and rules of the *Shari'ah*. If there is any deviation, institutional arrangements discourage it. In an ideal situation where all agents are true believers whose behavior corresponds fully to the requirements of the *Shari'ah*, their faithfulness to the terms of contracts and accountability for respecting property rights will lead to the elimination of the problems arising from asymmetric information, moral hazard and adverse selection and thus guarantee optimal governance. In a less-perfect world where commitment to contracts may be influenced by personal interests at the expense of the interests of the collectivity, the design of the structure of governance has to ensure faithfulness to the agent's contractual agreements and the protection of everyone's rights.

The design of a corporate governance system in the Islamic economic system, therefore, entails implementation of a rules-based incentive system in which compliance with the rules ensures an efficient governance system to preserve social justice and order among all members of society. This implies institutions and rules that are designed to compel managers to internalize the welfare of all stakeholders. The rights that are claimed for stakeholders are not ends in themselves—which ought to be recognized in any form of economic organization—but a means of protecting constituency rights.[23] In an Islamic system, the observance of the rules of behavior guarantees the internalization of stakeholder rights (including those of the society at large). No other institutional structure is needed. It is the Islamic government that specifies the appropriate corporate governance structure, "incorporating all stakeholders' rights into fiduciary duties of managers" of the firm on behalf of none—investors or stakeholders. So no other institutional arrangement that would allow individual non-investor stakeholders to negotiate directly with the firm is necessary. Incorporating all stakeholders' rights into the fiduciary duties of managers is counterproductive and leads to sub-optimal results. The important point is that each stakeholder is given the freedom of bargaining to protect their rights and there are systematic institutional arrangements in place to provide protection and to mediate where disputes and disagreements arise.

Institutional arrangements can be part of system-wide infrastructure surrounding the governance structure of the firm. For example, because contracts are invariably incomplete, judicial interpretations can fill in the gaps. It is permissible to regard employment law, consumer law, tort law, as well as judicial rulings and administrative regulations, as part of the contracts that various stakeholders have with the firm. Similarly, the concept of the *Shari'ah* boards, which ensure that the operations and code of conduct of the Islamic bank are in accordance with the rules of the *Shari'ah*, is unique to the Islamic financial system. However, having a board for every firm, as is the case at present, is not efficient, as only one set of rules is needed for all firms for appropriate corporate governance based on the *Shari'ah*. This same idea can be extended to a system-level board consisting of scholars from different disciplines including *Shari'ah*, economics, finance, and commercial law, to ensure that rules are so framed and enforced that economic agents fully comply with their contractual obligations to all the stakeholders.

To summarize, the Islamic economic system fully endorses a stakeholder view of governance based on Islam's principles of the preservation of property rights and the sanctity of contracts. The corporate governance model in an Islamic financial system can be derived from a comprehensive understanding of the principles of Islam.

Quality of Leadership

In Islam, the behavior expected of a firm is no different from that expected of any other member of society. The firm's economic and moral behavior is shaped by its managers acting on behalf of the owners and it becomes their fiduciary duty to manage the firm as a trust. Consequently, it is incumbent upon managers to ensure that the firm's behavior conforms to the principles and the rules of *Shari'ah* and such compliance will ultimately lead to the development of trust, responsibility, and accountability.

Shari'ah governs the behavior of leaders no less stringently than that of individuals. Although each member of society is expected to exhibit high moral values in the observance of contracts and covenants, many scholars are of the view that these requirements apply with even greater force to the actions of leaders. Therefore, a breach of faith on the part of a leader is more heinous in its nature and more serious in its consequences than a similar breach by an ordinary individual.

The current financial crisis has highlighted the role of managers and corporate leaders in shaping the crisis: the lack of transparency, greed, misrepresentation, fraud, and breach of trust displayed by certain financial managers and leaders all contributed to the chaos. Collins (2009) has observed the corporate behavior of leaders and identified the different stages they might go through during the course of a fall—from the hubris of considering success as an entitlement, to the undisciplined pursuit of more (more scale, more growth, more acclaim, more of whatever they see as “success”), to putting a positive spin on ambiguous data and being unable to accept responsibility for setbacks. Such behavior was prevalent across the industry in the lead-up to the current financial crisis.

Leaders who are fully conscious of their responsibilities, limitations, and obligations as expected in Islam would never fall into behavior which would promote arrogance, ignorance, greed, deceitfulness, non-transparency, and delinquency. To assist the development of leaders with higher moral and ethical values, integrity, introspection and humility, the governance infrastructure needs to be strengthened.[24] These principles define the social norms in Islam which determine the behavior expected of individuals and institutions and establish a set of socially approved values. While the values and expectations in any given society may shift or change with the passage of time, Islamic values are inviolable at all times. Therefore, these values set a benchmark against which the behavior of individuals and institutions will be judged.

CORPORATE-GOVERNANCE ISSUES OF IFIs[25]

Corporate governance relates to the manner in which the business of the bank is conducted, including setting corporate objectives, the bank’s risk profile, aligning corporate activities and behavior with the expectation that management will operate in a safe and sound manner, running day-to-day operations within an established risk profile, while protecting the interests of depositors and other stakeholders. It is defined by a set of relationships between the bank’s management, its board, its shareholders, and other stakeholders.

The key elements of sound corporate governance in a bank include:

- A well-articulated corporate strategy against which the overall success and the contribution of individuals can be measured.
- Setting and enforcing a clear assignment of responsibilities, decision-making authority and accountabilities that are appropriate for the bank’s risk profile.
- A strong financial risk management function (independent of business lines), adequate internal control systems (including internal and external audit functions), and a functional process designed to incorporate the necessary checks and balances.
- Adequate corporate values, codes of conduct and other standards of appropriate behavior and effective systems used for ensuring compliance. This includes special monitoring of the bank’s risk exposures

where conflicts of interest are expected to appear (for example, relationships with affiliated parties).
- Financial and managerial incentives for the board, management and employees to act in an appropriate manner. (That is, compensation should be consistent with the bank's objectives, performance and ethical values).

Given the fiduciary nature of the financial industry and the scope of asymmetry in access to information, corporate governance arrangements may matter more for financial businesses than for other firms. In its essence, a financial business organization is a fiduciary trustee that is entrusted with the intangible assets of another party, specifically depositors and other investors. Therefore, it carries a special obligation to act in the best interests of that other party when holding, investing, or otherwise using the principal's property. This is crucial in the context of banking, where informational asymmetries are likely to be higher than in other firms.

The distinct nature of financial intermediation conducted by IFIs raises certain governance issues that require further discussion:

Financial interests of account holders Investors or depositors are among the most important stakeholders and protecting their financial interests is critical. In the case of current accounts, IFIs obtain an explicit or implicit authorization to use the deposit money for whatever purpose permitted by *Shari'ah*, but pay no return or profit to the depositors. Any negligence or misconduct on the part of IFIs can result in financial losses to current account holders. There should be proper procedures to ensure that the IFI's management does not go for risky investments or excessive use of these funds to enhance the performance of overall investments to benefit other unrestricted investment-account holders.

In the case of restricted investment accounts (RIA), the bank acts only as fund manager—agent or non-participating *mudarib*—and is not authorized to mix its own funds with those of the investors without their prior permission. It is in the interests of RIAH that they are provided with all relevant information about the returns and risks. In addition, it is the responsibility of the management of IFIs to ensure that investments funded by RIAH are ring-fenced from the rest of the investments and there is full transparency in the identification and distribution of profits and losses. Similarly, unrestricted investment accounts, which constitute the majority of deposits, pose specific corporate-governance problems. It is a common practice of IFIs to place shareholders' and investment funds in common pools, without any mechanism to separate the two. Consequently, there is the concern that shareholder-controlled management and boards may favor and protect shareholders' investments at the expense of those of investment-account holders.

IAHs as stakeholders Investment account holders (IAHs) are like quasi-equity holders, but without any participation in the governance of the financial institutions. As a result, IAHs do not have any direct means to protect their rights. Since they do not have any participation in the governance mechanism they are at the mercy of public policymakers, regulators and *Shari'ah* boards. A transparent and efficient governance arrangement should be devised to include and protect the rights of IAHs.

IFIs as stakeholders By design, a considerable portion of the IFIs' assets side could include profit/loss-sharing instruments, akin to those of *mudarabah* and *musharakah*. Because of the high degree of asymmetry of information in equity and profit/loss-sharing contracts, there is greater need for close monitoring of such investments by IFIs. Therefore, to minimize the cost of monitoring, there is need for institutional arrangements to facilitate monitoring and governance of such equity-based investments made by IFIs. The absence of such a governance mechanism is one of the reasons why the share of profit/loss-sharing instruments on the assets side of the IFIs is currently small.

Furthermore, the presence of profit/loss-sharing instruments creates a situation where financial institutions themselves become stakeholders in the businesses to whom they provide finance. This is similar to the "insider" system of governance as seen in the German model of banking, where bankers may also be represented on the board of directors or may participate in the management of the business. Although not much attention is paid to this aspect at present, it does impose an additional governance burden on the financial institutions.

Governance of reserves Maintaining reserves to smooth income over a period of time is becoming a common practice. The objective of the profit equalization reserve (PER) is to hedge against future losses or low income by keeping a portion of current profits to pay off investment account holders in the future. While this practice is in alignment with prudent risk management, it raises a governance issue that needs attention. Firstly, limited disclosure of such reserves makes investment account holders uneasy because they have no rights either to influence the use of such reserves or to verify the exposure of overall investments. Someone with long-term investment objectives may welcome this practice, but an investor with a short-term view may feel that he is subsidizing the returns of the long-term investor. Some banks (including the Islamic Bank of Britain) require investment account holders to waive their rights to these reserves.[26]

Islamic financial institutions should standardize the practice and the rights to these reserves should be clearly stated and explained to the depositors. One suggestion is that deduction from the profits belonging to investment account holders should apply only to long-term depositors, who are more likely to be exposed to such risk.

The role of *Shari'ah* boards as stakeholders As we have seen, *Shari'ah* boards take on a major responsibility and serve as stakeholders as they are the protectors of the rights of investors and entrepreneurs who have put their faith and trust in the financial institution to perform specific economic activities.

IFIs have created structures and processes that reassure stakeholders on the conformity of all transactions and ensure compliance. A widely adopted approach is to have internal or independent bodies certify compliance with the *Shari'ah*. Each IFI has in-house religious advisers, collectively known as the *Shari'ah* Supervisory Board (SSB).[27] In principle, the prerogatives of the SSBs lie in five main areas:

(i) The certification of permissible financial instruments through a *fatwa*[28] (*ex ante* audit),
(ii) The verification of compliance with the *fatwa* (*ex post* audit),
(iii) The calculation and payment of *zakat*,
(iv) The disposal of non-compliant earnings, and
(v) Advice on the distribution of income or expenses among the bank's shareholders and investment account holders. SSBs issue a report to certify the conformity of all financial transactions with these principles and this is usually an integral part of the IFI's annual report.

The role of *Shari'ah* boards in sound governance is critical—especially in regard to consistency of application. It is common practice in the current governance structure of IFIs to maintain a *Shari'ah* board or adviser for each institution. However, duplication of effort, and the lack of standardization and of competent *Shari'ah* experts make for inefficient decision-making processes. Instead, a system-wide board of knowledgeable religious scholars, who are also specially trained in Islamic economic and financial principles, would prove more efficient and facilitate an optimal governance structure. Such a board could work closely with regulators and supervisors to make sure that effective monitoring and supervisory controls are devised to protect the rights of all stakeholders in accordance with the spirit of Islam.

The functioning of internal SSBs raises a number of corporate governance issues, the first of which concerns the independence of the SSB from management. Generally, members of SSBs are appointed by the shareholders of the bank, represented by the board of directors. SSBs report to the board. Thus, they are employed by the bank, and their remuneration is proposed by the management and approved by the board. The SSB members' dual relationship with the IFIs as providers of remunerated services and as assessors of the nature of operations may create a conflict of interest. In principle, SSBs are required to submit an unbiased opinion in all matters pertaining to their assignment. However, their employment status generates an economic stake in the bank, which may have a negative impact on their independence.

Intertwined with this there may be issues of confidentiality because *Shari'ah* scholars sit on the SSBs of a number of IFIs. This multiple membership may be seen as a strength as it may enhance independence vis-à-vis a particular IFI. However, as it entails access to proprietary information about different and possibly competing IFIs, it may give rise to another potential conflict of interest. SSB members are required to combine a diverse set of competencies, combining knowledge of Islamic law and commercial and accounting practices. In practice, it would appear that very few scholars are well-versed in both disciplines.

A further issue concerns consistency of judgment across IFIs, over time or across jurisdictions within the same IFI. In essence, the activities of an SSB are in the nature of creating jurisprudence by interpreting legal sources. As such, there may be conflicting opinions on the admissibility of specific financial instruments or transactions. However, the diversity of opinions is seemingly less widespread than would be expected. The Council for Islamic Banks and Financial Institutions (CIBAFI) sampled about 6,000 *fatwa*s, and found that 90 percent were consistent across IFIs. The fact that these had been issued by more than a hundred *Shari'ah* scholars around the world suggests an overall consistency in the interpretation of the sources.[29] Nevertheless, as the industry expands, the number of conflicting rulings on the permissibility of an instrument is also likely to soar if no efforts are made to harmonize the standards. This may undermine the customer's confidence in the industry and have repercussions on the enforceability of contracts.

The last and overarching issue relates to disclosure of all the information relating to *Shari'ah* advisory. An objective of a stable Islamic corporate-governance system is to enhance the soundness of *Shari'ah* governance. The framework is enhanced by arrangements put in place by regulators and the presence of providers of financial-information services external to the firms. In addition, public rating agencies aid prudent disclosure by filtering out permissible investments and IFIs and are designed to create a positive climate for *Shari'ah*-compliant investments. However, private mechanisms for the external governance of *Shari'ah*-compliance are limited. Private rating agencies have not yet developed the necessary skills or found sufficient incentive to monitor compliance.

Concentration of *Shari'ah* scholars There is a dearth of qualified *Shari'ah* scholars in the market. In today's complex financial system, a person qualified to determine the authenticity of financial transactions requires in-depth knowledge of not only Islamic Law but also needs to be well-versed in the disciplines of economics, finance and banking. Reputable scholars are in high demand and as a result they end up committing themselves to multiple *Shari'ah* boards, which raises concerns about their capacity to meet the needs of existing and potential clients. The top 10 scholars currently occupy more than 40 percent of all board positions at international organizations and the top three scholars (Sheikh Nizam Yacoubi, Dr. Abu Guddah, and Dr. Ali Elgari) are, between them, on the boards of more than 200 Islamic funds. Table 15.1 lists the top 10 *Shari'ah* scholars and their affiliation with either international standard-setting institutions or with the private sector. This concentration of *Shari'ah* scholars reinforces the need to deal with the issues of independence, confidentiality and transparency discussed above.

TABLE 15.1 Representation on *Shari'ah* Boards

Name of the scholar	Number of Positions at International Organizations	Number of Corporate Positions
Sheikh Nedham Mohamed Saleh Yacoubi	6	72
Dr. Mohammad Daud Bakar	6	32
Sheikh Dr. Abdul Satar Abdul Karim Abu Ghuddah	5	72
Dr. Ali Mohuddin Al'Qurra Daghi	5	26
Sheikh Abdullah Sulaiman Al Manee'a	4	34
Dr. Hussain Hamid Hassan	3	29
Justice Muhammad Taqi Usmani	3	14
Dr. Mohamed Ali Elgari	3	62
Dr. Ahmad Ali Abdulla	3	3
Sheikh Mohamed Ali Al-Taskheri	3	1

Source: Funds@work (2009)[30]

Lack of standardization Corporate governance practices are still evolving in several jurisdictions where Islamic banking and finance is being practiced and developed. For example, banking laws, rules to appoint board directors, accounting standards, and *Shari'ah* board practices are diverse across Muslim countries. Such heterogeneous environments pose challenges for existing and new business, regulators, and policymakers. This lack of standardization weakens the ability to enforce uniform treatment of laws and lessens the degree of transparency in the financial sector. Table 15.2 shows how diverse are the *Shari'ah*-compliance practices and framework in selected Muslim countries. It is clear from the table that there is lack of harmonization of standards and practices across these countries, which raises problems for the integration of Islamic financial markets with the conventional markets and the rest of international financial markets.

Transparency Transparency refers to the principle of creating an environment where information on existing conditions, decisions, and actions is made accessible, visible, and understandable to all market participants. Disclosure refers more specifically to the process and methodology of providing the information and of making policy decisions known through timely dissemination and openness. Accountability refers to the need for market participants, including the relevant authorities, to justify their actions and policies and accept responsibility for both decisions and results.

TABLE 15.2 *Shari'ah*-compliance: practices and framework

Country	Islamic Banking Law	*Shari'ah* Committee		Fit & Proper Criteria for *Shari'ah* Adviser/ Committee	*Shari'ah* Compliance Inspection	*Shari'ah* Standards	Accounting Standard
		At Central Bank	At Bank Level				
Malaysia	Islamic Banking Law 1983	*Shari'ah* Advisory Council	*Shari'ah* Committee	Approval by Bank Negara Malaysia (BNM)	Governance through *Shari'ah* Committee	All Products approved by SAC. Role of *Shari'ah* Committee defined by BNM	Accounting Standards developed by Malaysian Accounting Standards Board
Bahrain	Regulations for Islamic Banks	*Shari'ah* Supervisory Committee	*Shari'ah* Supervisory Board	N.A	Internal and External *Shari'ah* Audit as per AAOIFI standards	AAOIFI	AAOIFI
Indonesia	Laws for Islamic Banking introduced in 1992 and amended in 1999	National *Shari'ah* Board	*Shari'ah* Supervisory Board	NSB approves appointment of SSB members	Internal and External *Shari'ah* Audit	*Fatwa* on products issued by NSB	AAOIFI

(*Continued*)

TABLE 15.2 *Shari'ah*-compliance: practices and framework *(Continued)*

Country	Islamic Banking Law	*Shari'ah* Committee		Fit & Proper Criteria for *Shari'ah* Adviser/ Committee	*Shari'ah* Compliance Inspection	*Shari'ah* Standards	Accounting Standard
		At Central Bank	At Bank Level				
Iran	Usury-free Banking Act 1983	Council of Guardians	N.A.	N.A.	No	Guidelines provided by Council of Guardians	Not Known
Brunei	Islamic Banking Act Cap.168	*Shari'ah* Financial Supervisory Board (SFSB)	*Shari'ah* Advisory Board	SFSB approves appointment of *Shari'ah* Advisory Board members	No	SFSB Approves Islamic products introduced by Financial Institutions	Not Known
Pakistan	Banking Companies Ordinance, 1962 and Policies for Islamic Banking in 2001 & 2003	*Shari'ah* Board	*Shari'ah* Adviser	Fit & Proper Criteria by State Bank of Pakistan	Manual developed in 2004, now being implemented	Essentials for Islamic modes	AAOIFI standards are being adapted by a committee of Institute of Chartered Accountants of Pakistan

Source: Akhtar (2006)

Islamic financial institutions have made considerable efforts to improve the level of transparency and the quality of information disclosure in the market in the last couple of years. However, there are still several areas that demand attention.

Analysts often have difficulty in collecting useful information regarding Islamic financial institutions. One of the factors contributing to this problem is the lack of uniform reporting standards followed by the financial institutions. For example, a study was recently conducted on the basis of a cursory survey of a sample of nine Islamic banks for which balance sheet data was easily available. It showed that only one bank did not provide sufficient details as to the division of equity and deposits. However, when it came to deposits, only five provided a detailed division of the deposit types that they offered, with the remaining three combining different types of deposits together. Of these three, two made no specific reference to special investment accounts, while the other one made no distinction between demand and saving deposits.[31] The disclosure practices are highly varied, as is the supervisor's authority to impose norms.

The collection and dissemination of relevant information and credit ratings need significant improvement. However, this requires an institutional infrastructure that facilitates the production of accurate financial information, the development of agents who can interpret and disseminate it, as well as arrangements to protect its integrity. Considering that reliable and timely information is critical for the Islamic financial system, the current level of infrastructure is not satisfactory. The existing limited infrastructure reduces the role that information flows may play in promoting competition and market activities that would induce managers to adopt sound corporate governance practices.

A transparent Islamic financial institution would ideally reveal the duties, decision-making, competence and composition of the *Shari'ah* board, as well as publish all *fatwa*s issued by it. This would strengthen stakeholders' confidence in the credibility of the board's assessments. In addition, public disclosure would provide a venue for educating the public and pave the way for a larger role for market discipline with respect to *Shari'ah* compliance. Again, this aspect of transparency is missing from the market. Often, annual reports of the *Shari'ah* boards are not easily available to the public and other relevant information regarding *fatwa*s is not made available.[32]

The application of financial modeling to the measuring of asset/liability risks is very limited. The use of quantitative methods such as VaR and PaR (discussed in an earlier chapter) can enhance financial disclosure, especially in the area of credit and equity risk. Risk exposures can provide information to the investors about their expected profits and losses.