



# Essential Elements for Effective Supervision of Islamic Banking Institutions

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# Objectives of Presentation

**To highlight fundamental differences and issues in Islamic Banking Supervision**

**To share Malaysian experiences and approaches**

**To highlight potential/opportunities and challenges moving forward**



# Starting Point: How Different are Operations of Islamic Banks?

	Islamic Banks	Conventional Banks
Source of Funds	Investment from Investment Account Holders (IAH) <i>Relationship: Investor – Entrepreneur</i>	Deposits from customers <i>Relationship: Creditor - Debtor</i>
Use of Funds	Equity investment and profit-sharing venture (Musharakah and Mudharabah) <i>Relationship: Investor – Entrepreneur</i>	Loan to Borrower <i>Relationship: Creditor - Debtor</i>
	Financing and Trading of assets <i>Relationship: seller – purchaser</i>	

## Level of funding from IAH is the most significant differentiating factor

- Investors-entrepreneur relationship changes the way Islamic banks operate:
  - Investors (IAH) bear fully investment risk (while the bank is only exposed to negligence risk). IAH could therefore determine investments/assets profile of banks
  - Islamic banks have greater fiduciary duty to protect IAH's investment

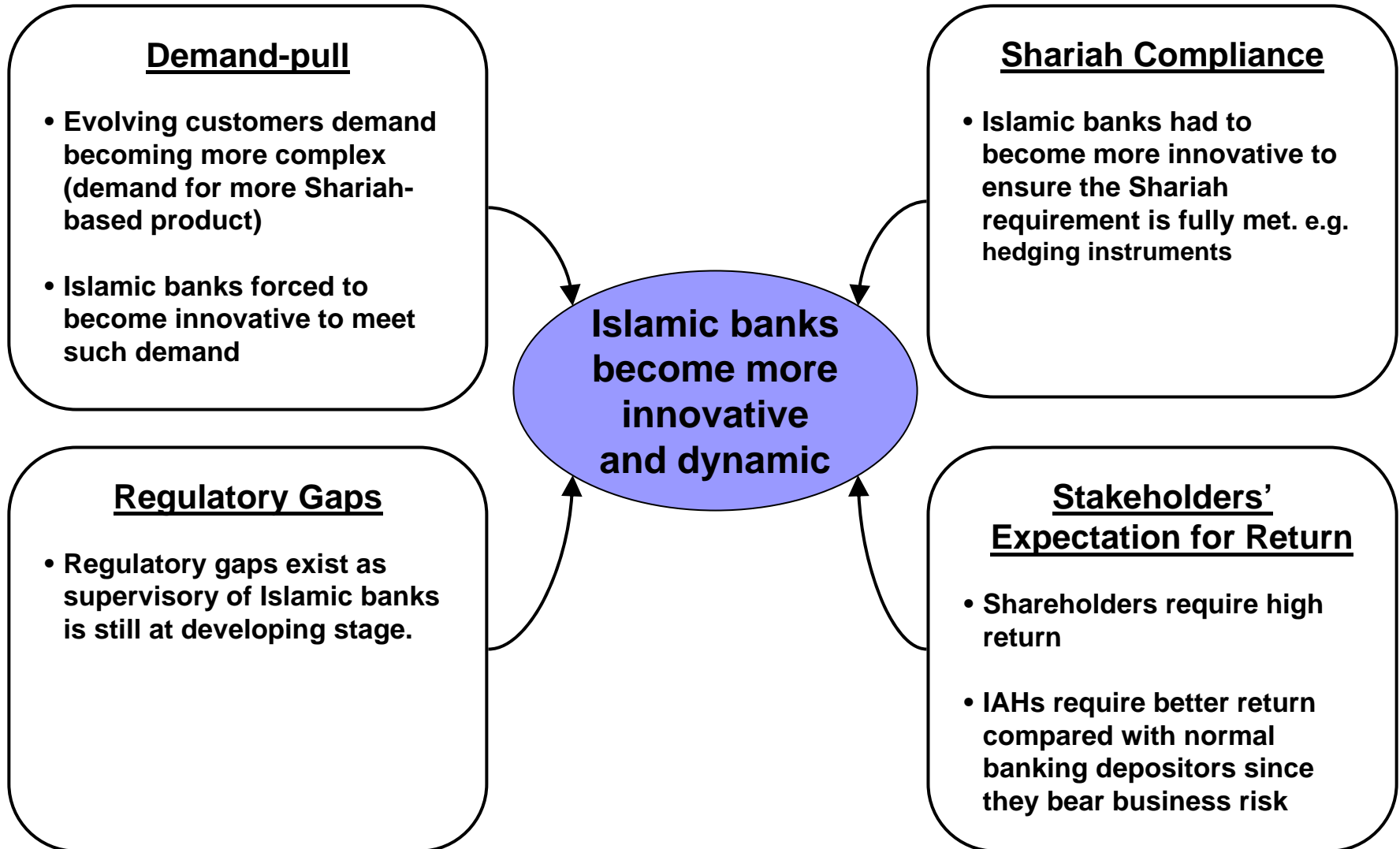


# Islamic banking has become part of global development

- **Cross border** presence of Islamic Financial Conglomerates e.g. Kuwait Finance House, Al-Rajhi Banking Investment Corporation, Lariba American Finance House
- Increasing **complex risk** profile of Islamic banks e.g. greater profit-sharing investment risk, risk of trading of physical assets, fiduciary risk in managing customers investment and encroaching into new territories.



# Islamic financial institutions becoming more innovative & dynamic due to several factors...





# Rapid development of Islamic banking business also contributed to diversity in industry structure

Various jurisdictions have their own Islamic banking model to meet local requirement

## Single Islamic Banking System

- Full transformation of economic system in accordance with Shariah led to existence of single banking system

## Dual Banking System

- Islamic banking system co-exists with conventional system

## Conventional Banks with Islamic Windows

- Islamic products offered by conventional banks via “windows”
- Lack of support infrastructure (e.g. Islamic money market and capital market) may constraint product offering



**In view of rapid evolution  
and dynamism of Islamic  
banking, how can we  
ensure effectiveness of  
our supervisory  
approach?**



# With presence of global Islamic bank, supervisory issues require cross border initiatives

In principle, cross border supervisory issues **similar** to those faced in conventional banking. Specific challenges is in the detailed **application** of Islamic banking model e.g. how to address different Shariah interpretation

## Ingredients for effective cross border supervision of Islamic banking

1. Understanding of supervisory philosophy and objective with regards to Islamic banking system within different jurisdiction
2. Common understanding among supervisors especially on specific risks emanating from Islamic banking operations
3. Clarity of responsibilities of home and host supervisory authorities - Harmonisation of Shariah view? **UNITY IN DIVERSITY**
4. Easy access to relevant information

HOST

HOME



# Effective Cross-border Supervision :

## Ingredient 1 – Understanding of Supervisory Philosophy and Objective within Different Jurisdictions

### What is the challenge?

**“How to ensure Islamic banks which operate across multiple jurisdiction adhere to common PRINCIPLES of strong governance and risk management?”**

- **Pre-requisite:** Supervisors must acknowledge and understand different supervisory objectives and philosophies with respect to Islamic banking
- **The fact:** There are a wide spectrum of supervisory philosophies ranging from well-structured development of markets and regulation to full market driven approach

**Supervisory dialogues may need to be increased**

**Establishing more robust discussion platform** for international Islamic banking community to promote **exchange of information and ideas** on issues relating to Shariah opinion interpretation, supervisory approaches, changes in business models and capacity building efforts



# Effective Cross-border Supervision :

## Ingredient 2 – Common Understanding of Specific Risks of Islamic Banks

Supervisors across different jurisdictions must have same understanding and appreciation on unique risks being emitted by Islamic banking industry

– **need for common risk language**

Significant progress have been made



- Islamic Financial Services Board (IFSB) - provides minimum guidance for effective regulation and supervision of Islamic financial industry to be followed across globe
- So far, there are FIVE standards being issued and/or in process of issuance

- **Guiding Principles for Risk Management – December 2005**
- **Capital Adequacy Standard – December 2005**
- **Guiding Principles on Corporate Governance – December 2006**
- **Disclosure to Promote Transparency and Market Discipline – draft**
- **Guidance on Key Elements in The Supervisory Review Process - draft**



# Effective Cross-border Supervision :

## Ingredient 3 – Clear Responsibility of Home-host Authorities

Islamic banks supervisors should agree on specific responsibilities with regard to supervision of Islamic financial conglomerates with cross-border presence

- Unlike conventional, supervisory approach for Islamic banking still lagging behind in cross-border cooperation
  - Responsibility of host and home supervisors not clearly established
  - Legal framework may not be ready to facilitate such cooperation
- Should we adopt concept of “*apply more stringent requirement*” especially on Shariah differences?

WHAT NEEDS TO BE DONE?

### Responsibility of Home-host Supervisors

- Close collaboration is essential to ensure holistic and effective supervisory approach
- Information sharing necessary for greater cooperation



# Effective Cross-border Supervision :

## Ingredient 4 – Easy Access to Relevant Information

As relationship between IAH and Islamic banks is that of investors and entrepreneur (rather than creditor-debtor), fiduciary duty of Islamic banks are greater and hence disclosure requirement is enhanced

### Challenges in improving level of disclosure across globe

- Willingness to share more information on more frequent basis among Islamic banking supervisors
- Capability of home-host supervisors to select relevant information to be shared cross-border without compromising data sensitivity and confidentiality

**Supervisors need to assess Islamic banks' capability to meet disclosure requirements**

### Cross-border Information Sharing

Supervisors must strike balance between three factors:

- Islamic banks' need to protect their proprietary information;
- IAH's need to obtain relevant information to make informed investment decision; and
- Resulting regulatory cost



# Rapid developments in Islamic banking also require supervisors to be aware of challenges at industry level

## Managing Different Supervisory Boundaries

- Universal banking concept allows Islamic banks to encroach into business activities other than traditional banking
- What principles should be adopted by supervisors in enforcing their own specific requirements
- Collaborative efforts should focus on areas of supervisory concern (risk)

## Standalone Islamic Banks or Islamic Windows?

- Whatever regulatory / supervisory philosophy being adopted, supervisors must understand challenges arising from different Islamic banking structures
- Formulation of supervisory approach must consider specific challenges

**Dynamism of individual industry poses different sets of issues**

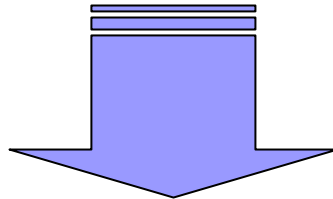
## How Would Role of Market Discipline Influence Supervisory Approach?

- IAH responsible for their own investment → requires high degree of market discipline & strong governance on part of banks
- Supervisors initial challenge would be to gauge level of market maturity – supervisory approach adopted should commensurate with level of market readiness
- Prudential rules may need to be tailored accordingly



# Crossing supervisory boundaries – requiring greater collaboration between different supervisory authorities...

- **Regular dialogue** and MoU between different supervisors required to ensure clear responsibility of various authorities – minimise overlapping / gaps in supervisory functions
- Consolidated supervision framework must be **robust and holistic**, taking into account wide spectrum of business opportunity available to Islamic banks



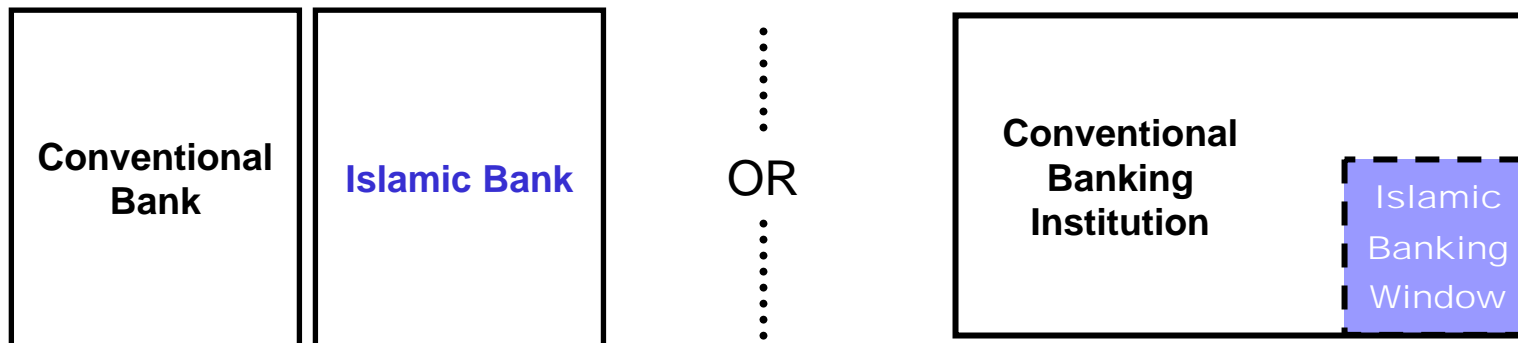
## Potential Areas of Concern

- What if there are business areas without refined regulatory and supervisory framework eg property development?
- Do Islamic bank supervisors have sufficient capacity and capability to look into specific business and risk not in traditional banking business?



# Malaysia has considered possibility of regulatory arbitrage that may arise from co-existence of Islamic windows alongside standalone Islamic banks

## Islamic banking: alternative structures in Malaysia...



### Capital arbitrage opportunity for windows

- Difference in treatment of Basel 2 (base for windows) vs. CAS (base for standalone)
- Single customer limit based on entire bank's position rather than true strength of windows

**Existence of windows stems from market needs. As long as there is demand in industry for Islamic windows, supervisors must keep pace with emerging issues from such structure.**



# ...How does Malaysia address issue of capital arbitrage with respect to Islamic banking windows?

## Supervisory guidance to ensure level playing field between Islamic banks and Islamic windows:

- **Capital requirement for Islamic windows streamlined with that for standalone Islamic banks:**
  - Windows is part of conventional banks and hence should adhere to Basel 2. However, to ensure level playing field between Islamic banks and Islamic windows, regulatory requirement for Islamic windows was crafted in line with CAS (as opposed to Basel 2).  
Examples:
    - allowance for windows to recognise physical assets as Credit Risk Mitigants even under standardised approach (allowed by CAS but not by Basel 2)
    - allowance for windows to adopt supervisory slotting method in calculation of capital charge for Musharakah and Mudharabah exposure even under standardised approach
- **Separate deposit insurance and specified liquidation processes.**
- **Single customer limit of windows now based on Islamic Banking Capital Fund and not on bank's capital**
- Provide level-playing field to both Islamic banks and Islamic windows
  - Minimise risk to Islamic depositors from any loss from potential defaults of large exposures



# If heavy reliance on market discipline is required, Islamic banking market must be prepared for such approach

## Pre-conditions for effective market discipline:

- Market must understand and fully appreciate nature and risk of Islamic banks
- All parties (players, customers, investors, other supervisors, rating agency) are on same wavelength to ensure consistent understanding of market signals and react accordingly.

**UNTIL AND UNLESS CRITERIA ARE MET, SUPERVISORS CANNOT PUT FULL RELIANCE ON MARKET DISCIPLINE TO REGULATE ISLAMIC BANKING INDUSTRY**

**EFFECTIVE MARKET DISCIPLINE**

**Strong Governance Structure**

- Islamic bank's fiduciary duty towards IAH is significant and therefore there is high supervisory expectation with regards to this fiduciary responsibility
- There must also be supervisory expectation on role of Shariah Supervisory Board for Islamic banks especially in ensuring banks' operations are Shariah compliant

ISSUES



# Specificities of operation of Islamic Banking requires in-depth appreciation of business model and financial statements

	<b>Assets</b>	<b>Liabilities</b>	
Conventional do not have this	<b>Inventory</b> Real estates/Automobiles	<b>Demand Deposits</b> Wadiah	Currents and Savings accounts in Conventional
Loans in Conventional	<b>Asset-backed Transactions</b> Murabahah/Ijarah/Istisna'/Salam	<b>Investment Accounts</b> Mudharabah	Fixed deposit accounts in Conventional
Investments in Conventional	<b>Profit Sharing Transactions</b> Mudharabah/Musharakah	<b>Special Investment Accounts</b> Mudharabah	structured deposit accounts in Conventional
	<b>Fee based services</b> Al-Kafalah/Wakalah	<b>Equity</b>	

- **Would supervisors be capable of assessing beyond figures in financial statements and be more proactive?**
- **Would supervisors be able to engage senior management on risk related issues (e.g. risk appetite framework)?**



# Assessing quality of risk management for Islamic banks

In principle, assessment of Islamic banks' risk profile and quality of risk management system should be same as that of conventional...

...however, supervisors must be mindful of :

- risks which are unique to islamic banks i.e. asset price risk, rate of return risk, displaced commercial risk (DCR) and equity investment risk
- The transformation of risk concept
- Shariah compliance
- Element of income smoothing mechanism in managing DCR

## ***How is income smoothing mechanism employed as risk mitigant?***

- ***Profit Equalisation Reserves (PER) and Investment Risk Reserve (IRR) are utilised to ensure rate stability – avoid volatility on return to IAH which can lead to lack of competitiveness during economic downturn***
- ***However, Malaysia choose PER over IRR approach to minimise moral hazard as PER requires bank to contribute to reserves as oppose to IRR which contains only investors' contribution***



# Assessing quality of risk management for Islamic banks – Malaysian approach

Risk-based Supervisory Framework modified to fit need for risk assessment of Islamic banks taking into account uniqueness of Islamic banking

## Risk Based Supervisory Framework (RBSF)

*Modification done to fit Islamic banking model*

### Identification of Significant Activities

- Includes activities carried out in addition to traditional banking business e.g. real estate development and auto trading

### Identification of Significant Risk

- Acknowledging unique risks emanating from Islamic banking business e.g. asset price risk, rate of return risk, displaced commercial risk and equity investment risk





# Assessing quality of risk management for Islamic banks

## Challenges

### Risk transformation:

- Do supervisors have ability to unbundle risks involved? (especially if they doubt that banks have done it effectively)
- Do Islamic banks have capability to capture this risk transformation?

**To ensure that capital charge reflects the risk transformation**

### Unique risks still posing great challenges to supervisors :

- What is appropriate supervisory approach?
- Do we have competencies and expertise to supervise these risks effectively?

Illiquidity of Islamic hedging instruments

### Going Forward...

- What is institution aspiration – Business structure: activity based (retail, corporate) vs. contracts based
- Supervisor should change their perspective according to focus of institution



# Supervisory function: Ensure adequate capital for Islamic banks

## Main Principle

Capital must be commensurate with overall level of risk i.e. including unique Islamic banking risks

- **How is capital framework modified to reflect nature of Islamic bank where risks (except operational risk) are absorbed by IAH?**
- **How to quantify such impact? (Robust stress test and scenario planning may be good supplementary tools for Islamic banks and supervisors)**

Islamic banking risks goes beyond traditional banking risks hence supervisors must apply discretion accordingly for those non-standard risk e.g. DCR and yet be consistent in their judgments

## Malaysian Experience:

- Capital Adequacy Standards for full fledged Islamic banks and Capital framework for Islamic Windows have been streamlined
- Standardised approach to be adopted for computation of credit and market risk capital charge whilst for operational risk there will be two options i.e. Basic Indicator approach or Standardised approach
- **What is capital charge on a Murabahah contract for financing a residential real estate?**



# Examples of capital charge on a *murabahah* contract for financing a residential real estate

Stage of contract	Risk	Capital charge
Bank purchases a real estate (e.g. a residential house) for reselling at mark up	Market risk (Asset price risk )	15%
Customer approaches bank and buys house with a deferred settlement	Credit risk	35% RW (if FTV <80%) or 50% RW ( if FTV is between 80 to 90%) or 75% RW (if FTV>90%)

Asset price risk is treated like commodity under Basel 2, hence attract capital charge of 15%



In essence, to ensure Islamic banking supervision is effective, following elements should be considered...

### **Consolidated Supervision**

- Cross-border issues such as different Shariah interpretation to be delicately handled for global Islamic banks
- Understand industry in which Islamic banking exists
- Collaborative effort needed, considering:
  - Universal concept of Islamic banking
  - To resolve emerging system-wide issues

### **Corporate Governance**

- Role of Shariah Supervisory Board (SSB) in governance
- Processes and controls to protect Investment Account Holder (IAH)
- Transparency in financial reporting in respect to investment accounts

### **Market Discipline**

- Market force will reinforce fiduciary duties especially on IAH
- Therefore, greater disclosure is required to promote market discipline

### **Risk management**

- Supervisors must acknowledge unique risks in Islamic banking e.g. Shariah risk, asset price risk, rate of return risk, displaced commercial risk & equity investment risk
- Supervisors must appreciate risk transformation element in Islamic banking operation

### **Capital Requirement**

- Capital must be adequate to cushion for all risk including risks unique to Islamic banking as identified through proper risk management process



# At end of the day, supervisors must be mindful of supervisory challenges lying ahead...

## Re-visiting the issues

- **How ready are Islamic banking' supervisors to implement effective cross-border supervisory collaboration?**
  - **Is responsibility of home-host supervisors clearly identified?**
  - **Is there any formal platform for discussion?**
  - **How much information is supervisors prepared to share?**
- **Are supervisors prepared to face challenge from dynamic of Islamic banking system?**
  - **More collaboration is required across different authorities**
  - **Do we have necessary skill-sets and capabilities to deal with uniqueness of Islamic banks?**
  - **Are we comfortable enough to let market discipline drive system, bearing in mind different level of understanding among industry players, customers and other related parties e.g. rating agency**

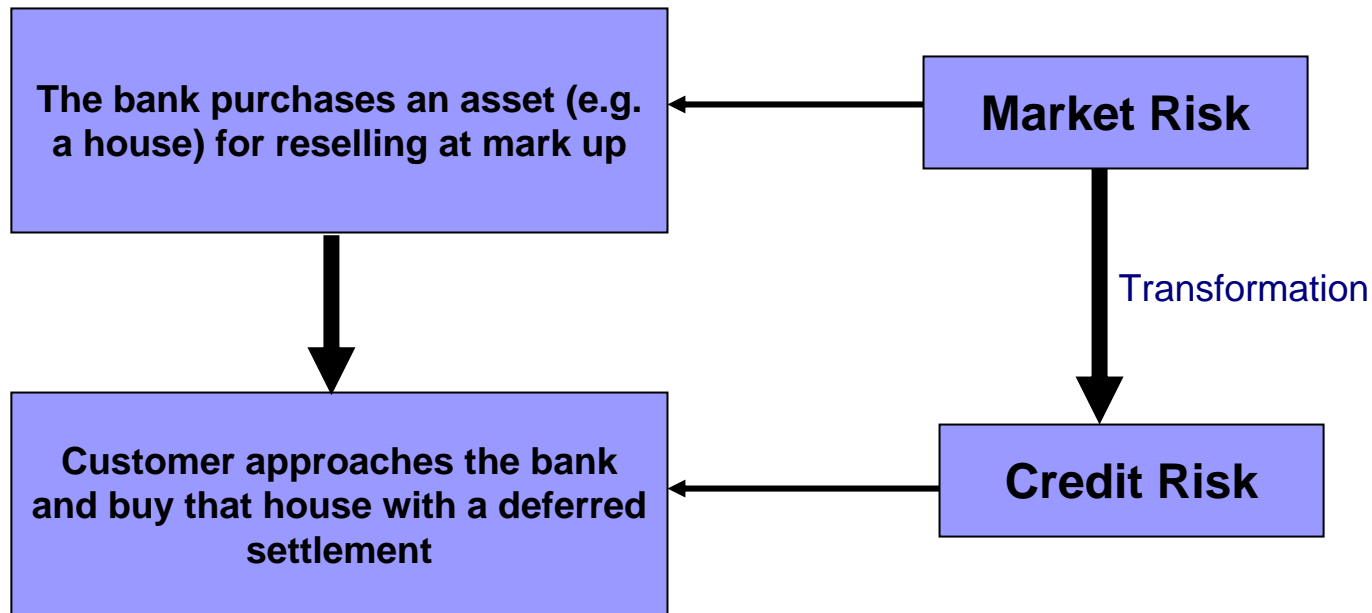


# Q & A



# Transformation of risk and asset price risk in Islamic banking

Non-binding murabahah structure:





# Rate of Return risk

Assets	Liabilities
<b>Asset-backed Transactions</b> Long Term Murabahah (deferred settlement)	<b>Investment Accounts</b> Mudharabah
<b>Asset-backed Transactions</b> Long Term Ijarah with fixed rental	

**Long Term fixed Return on  
Assets**

**Long Term Fixed Returns to  
investor**

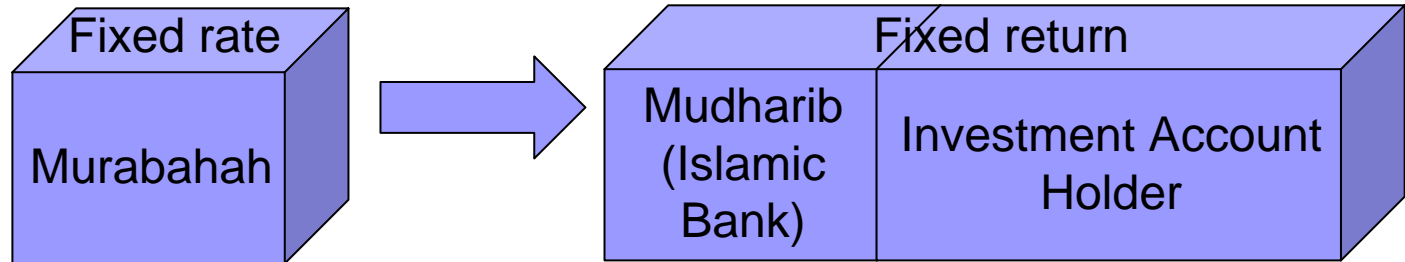
**Long Term Ijarah with fixed rental and Long Term Murabahah (deferred settlement) are susceptible to market rate hike as investor will benchmark the market rate and thus demand for higher return**

*Source: Islamic Financial Group, Ernst & Young, Bahrain*



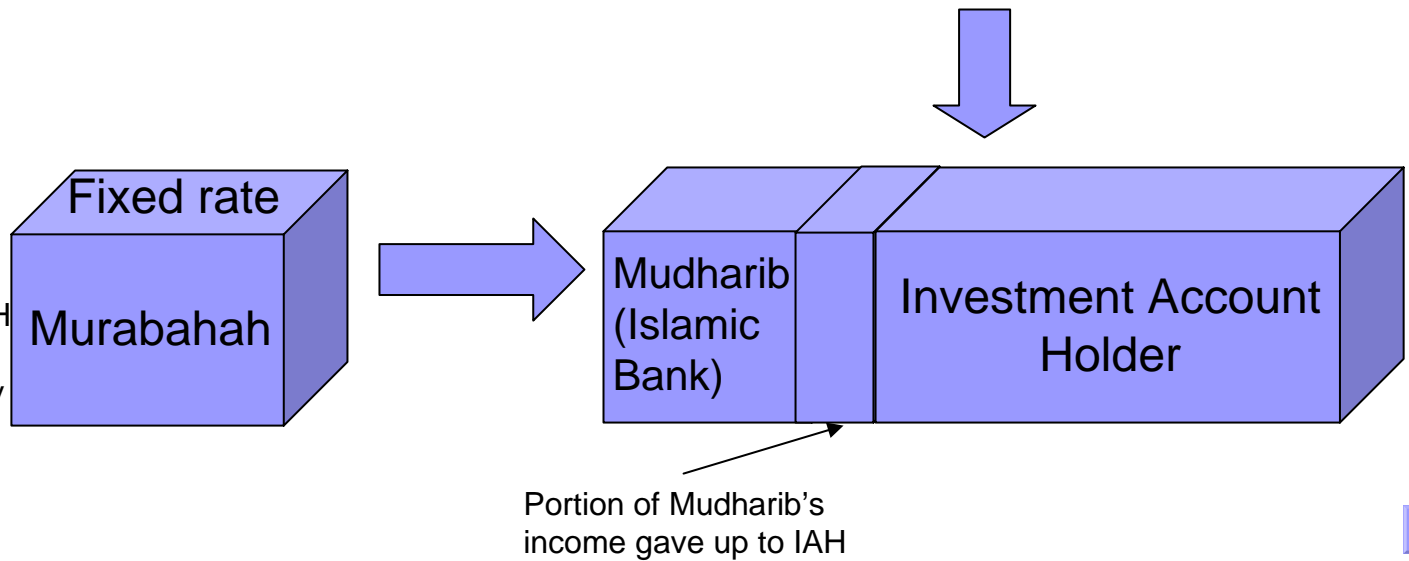


# Displaced Commercial Risk



Sudden rise in market rate may lead to IAH having higher expectation of their rate of return especially in dual banking market

Mudharib must give up some portion of its return in order to pay a competitive rate to its IAH and prevent them from leaving the bank (liquidity risk)

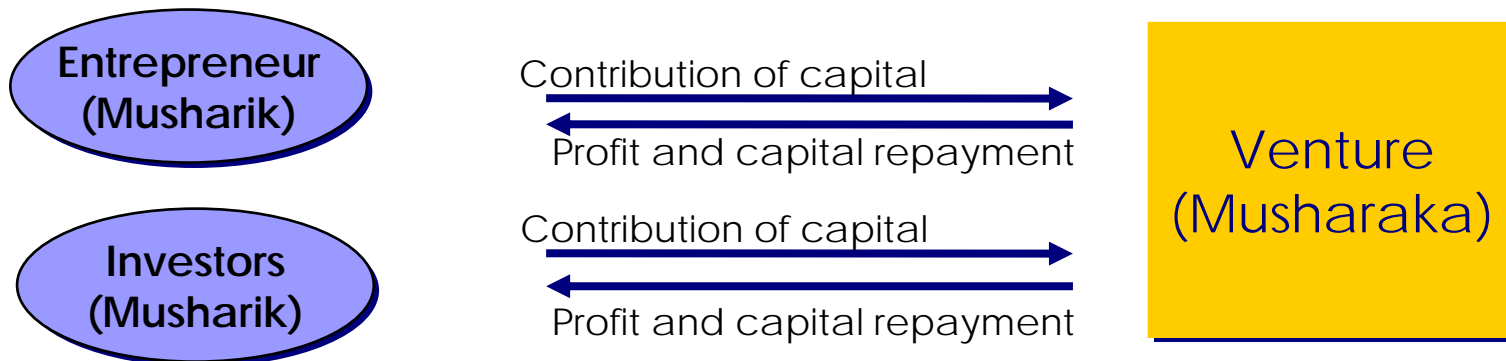




# Musharaka

- **Musharaka is a partnership (joint venture) between Bank and its client(s) whereby each party contributes to capital of partnership either to establish a new project or deal, or share in an existing project.**
- **Types of Musharaka**
  - **Constant - Under this method capital contributed by Bank remains constant throughout Contract period. All repayments made are recognized as profit**
  - **Diminishing - Bank gradually transfers its share in Musharaka to Musharik (partner)**

## Structure





# Musharaka – Inherent risks

Credit Risk	Market Risk	Operational Risk
<ul style="list-style-type: none"><li>■ <b>Counterparty Risk – Partner does not pay profit</b></li></ul>	<ul style="list-style-type: none"><li>■ <b>Diminishing Musharakah in Real estate</b><ul style="list-style-type: none"><li>□ While musharakah is performing – Islamic bank will be exposed to particular real estate price risk proportionate to its share in Musharakah</li><li>□ If musharakah fails – Islamic bank will be exposed to full amount of particular real estate price risk</li></ul></li></ul>	<ul style="list-style-type: none"><li>■ <b>Reputational Risk – When partnership fails and accruing losses</b></li></ul>
<ul style="list-style-type: none"><li>■ <b>Counterparty Risk - Occurs when withdrawing partners owe monies to Islamic bank</b></li></ul>		

Source: Islamic Financial Group, Ernst & Young, Bahrain





# Ijarah

Ijarah is a lease whereby lessor buys and then leases out an asset required by the lessee for an agreed rental amount and period in exchange for the benefits resulting from the use of the asset

## Types of Ijarah

- Ijarah - The Bank (lessor) buys and leases out assets required by the Customer (lessee) for an agreed rental fee. This does not conclude in a transfer of ownership of the leased assets to the lessee.
- Ijarah Muntahia Bimttamleek - The Bank (lessor) buys and leases out assets required by the Customer (lessee) for an agreed rental fee. It differs from Ijarah in that such an arrangement provides a promise by the Customer to acquire the ownership of the asset at the end of a specified period

## Structure





# Ijarah – Inherent risk

Credit Risk	Market Risk	Operational Risk
<ul style="list-style-type: none"><li>■ <b>Settlement Risk</b> – Customer is unable to service the lease rental as and when it falls due</li></ul>	<ul style="list-style-type: none"><li>■ <b>Price Risk</b> – When the Customer opts not to fulfill the promise or agreement to lease, the Islamic bank has to lease (or sell) at lease rentals (or selling price) which can be lower than the original total rentals to the vendor</li></ul>	<ul style="list-style-type: none"><li>■ <b>Supply Risk</b> – Supplier unable to deliver the asset and unable to meet the specified quality</li></ul>
	<ul style="list-style-type: none"><li>■ <b>Rate of Return Risk</b> – Long-term Ijarah with fixed rental is susceptible to changes in market conditions, e.g. higher return demanded by investors</li></ul>	<ul style="list-style-type: none"><li>■ <b>Reputational Risk</b> – Occurs when the leased asset is used for non Halal purposes</li></ul>

Source: Islamic Financial Group, Ernst & Young, Bahrain





# Ijarah – Inherent risk

Credit Risk	Market Risk	Operational Risk
	<ul style="list-style-type: none"><li>■ Residual Value Risk – Islamic bank will bear the potential loss due to the fair value of the asset fall below its residual value estimated at lease inception</li></ul>	<ul style="list-style-type: none"><li>■ Asset Impairment Risk – When the leased asset is destroyed (not through misconduct) the Lessor has to provide an alternative asset and failing to do so the Lessee can terminate the lease without paying rentals for the remaining duration of the Contract</li></ul>

Source: Islamic Financial Group, Ernst & Young, Bahrain



# Murabaha

- A Murabaha is a sale of an asset at cost plus and agreed upon profit mark up. The cost element of the Murabaha includes the purchase price and any other expenses incurred by the seller in obtaining the asset (e.g. shipping costs, custom duties etc.)

## Structure





# Murabaha – Inherent risk

Credit Risk	Market Risk	Operational Risk
<ul style="list-style-type: none"><li>■ Customer is unable to pay the monthly installments of the selling price as and when it falls due</li></ul>	<ul style="list-style-type: none"><li>■ Price Risk – If Customer cancels the Agreement to Purchase (AP), the Islamic bank has to sell the goods in the open market at a selling price that can be lower than the purchase price</li></ul>	<ul style="list-style-type: none"><li>■ Supply Risk – When the Customer chooses a supplier who is unknown to the Islamic bank, could result in higher risks in terms of delivery performance, quality of goods, etc.</li><li>■ The appointment of Customer (or his/her relations) as an Agent may give rise to conflict of interest (frauds)</li><li>■ Shariah Compliance Risk – Ascertain that ownership of the goods is properly transferred to Islamic bank</li></ul>
	<ul style="list-style-type: none"><li>■ Rate of Return Risk – Long-term Murabahah with deferred settlement (fixed rate) is susceptible to changes in market conditions, e.g. higher return demanded by investors</li></ul>	

Source: Islamic Financial Group, Ernst & Young, Bahrain

