Risk regulation in Islamic banking: Does Saudi Arabia need to adopt the risk regulation practices of Basel?

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RISK REGULATION IN ISLAMIC BANKING:

DOES SAUDI ARABIA NEED TO ADOPT

THE RISK REGULATION PRACTICES OF BASEL?

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Abstract

Proponents of Islamic finance often argue that the success of Islamic banks in the UK and Malaysia during the 2007-8 Financial Crisis is proof of the proposition that all Islamic banks (IBs) are immune from sub-prime-mortgage type shocks. The implementation of Basel practices in Saudi Arabia will be very difficult and is likely through various challenges. However, it is arguable that such practices may bring about change in a substantial way in the UAE market. Thus, this thesis will discuss features of IBs in the UK and Malaysia, and discuss the areas in which the Saudi market is mired in less risk than conventional markets in the UK and Malaysia. Using a qualitative methodology, this research sought to answer the primary research question, that is, "Does Saudi Arabia Need to Adopt the Risk Regulation Practices of Basel?" To be able to accurately answer this main question, it is necessary to determine whether the standardisation of accounting practices and regulatory principles can enhance Islamic finance organisations. It is likewise necessary to determine whether the Basel framework can be internalized by Islamic financial institutions to solve issues such as the inadequate coordination of financial markets in Saudi Arabia. The research sought to consider whether legal secularisation could be reconciled with Islamic models of finance in order to standardise banking processes across jurisdictions. It is vital to discuss this research problem as it is evident that Islamic banks are, by design, "safer" than conventional banks, which take fewer risks than conventional banking systems. Its ability to withstand the 2007-8 Financial Crisis can serve as example to other banking systems to follow to prevent the debilitating effects such a crisis can provide to the global financial system and the worldwide economy as a whole. This paper also discusses inherent risks in dealing with Saudi banks caused by structural weaknesses in the Saudi economy, further caused by a lack of transparency. Research from the content analysis and literature review demonstrated that certain components of Malaysian banking and banking in the UK, including Basel Frameworks (I, II, and III) can be adopted by the Islamic financial model in order to improve the overall banking structure in Saudi Arabia. Whilst Islamic accounting standards do not need to be as rigorous as some Basel Frameworks discussed in the study, implications for positive social change in Saudi Arabia include adopting policies which specialise in clearing defining risk management and policies which focus on improving corporate governance and bolstering transparency in Saudi markets. The central argument of this research therefore, is that the incorporation of pertinent Basel components, as well as those from the Malaysia and UK banking system, into the KSA banking system, will bring about improvements to the latter's overall banking structure.

Table of Contents

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Declaration

I hereby declare that the work in this thesis is my own work and has been generated by me as the result of my own original research.

Where other sources of information have been used, they have been acknowledged. This work has not been submitted in substance for any other degree or award at this or any other university or place of learning, nor is being submitted concurrently in candidature for any degree or other award.

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List of Abbreviations

AAOIFI; Accounting and Auditing Organization for Islamic Financial Institution

ATD; Assets to Deposits

BAFIA; Banking and Financial Institutions Act

BASEL; Basel Committee on Banking Supervision

BIMB; Bank Islam Malaysia Berhad

BNM; Bank Negara Malaysia

CAMELS; Capital Adequacy, Asset Quality, Management, Earnings, Liquidity,

CB; Conventional (i.e non-Islamic) Bank

DIB; Dubai Islamic Bank

FCA; Financial Compliance Authority

FSA; (former) UK Financial Services Authority

IB; Islamic Banking Institution

IFSB; Islamic Financial Service Board

IIFM; International Islamic Financial Market

IMF; International Monetary Fund

KSA; Kingdom of Saudi Arabia

LOFSA; Labuan Offshore Financial Services Authority

PLS; Profit and Loss Sharing

PSIA; Profit sharing investment account

SAC; Shari'a Advisory Board

Table of Authorities:

List of Cases

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Legislation - Secular

Insolvency Act, Act no 360 of 1967, (MY), s 33.

Enterprise Act 2002, (UK) Part X

Limited Partnership Act 1907 (UK)

Legislation - Sura, Hadith, Fatawa

Sûrah al-Hadîd, verse 11

Sûrah al-Taghâbun, verse 17

Fatwa No 92029 of Rabee' Al-Aakhir 4, 1427 / 3 May, 2006

Hadith no. 3383, found in Abu Dawood. Sahih Sunan Abu Dawud, Al Beyooh wa Al Egazat. Part 3, Chapter 27, p. 677. [Eng. Trans 2/445 no. 1694].

Hadith no 3.488: Sahih Al-Bukhari, book 37

Glossary of Arabic terms

Arbun	عربون	contract allowing for down payment deposit with an option of revocation akin to a call option in the conventional sense
Aqd		contract
bai al-arbun		deposit which one loses if one opts to revoke the contract
bai al-muajjal	بيع اجل	Sale for which payment is made at a future fixed date or within a fixed period. In short, it is a sale on Credit
bai al-salam		Deferred delivery sale; A type of sale in which the sale price is paid immediately and delivery of a specified sale item is deferred for a stipulated period.
Bai` Bithaman Ajil		A contract that refers to the sale and purchase transaction for the financing of assets on a deferred and an instalment basis with a pre-Agreed payment period. The sale price will Include a profit margin.
Bai` al Inah		fictitious sale
Bai` al-`Istisna		Contract for the making of an asset in the future
Darūrah		An exigency in the event that if the necessary act is not done, then it shall lead to the destruction of five fundamental needs
Dhaman		A contract of guarantee whereby a guarantor shall underwrite any claim and obligation that should be fulfilled by an owner of the asset. This concept is also applicable to a guarantee provided on a debt transaction in the event a Debtor fails to fulfill his debt obligation.

Fataawa-singular Fatwa		religious opinion concerning Islamic law
Ghārār		Deceptive uncertainty where details concerning the sale contract are unknown or uncertain.
Haram		an action which is absolutely forbidden and punishable
I`ādat Al Shirā’		
Ijarah Thumma Bai`		A contract which begins with an Ijarah contract for the purpose of leasing the lessor’s asset to the lessee. Consequently, at the end of the lease period, a lessee will purchase the asset at an agreed price from a lessor by executing a purchase (Bai`) contract.
Ijārah		Arabic term for renting and leasing
Istisna`		A purchase order contract of assets whereby a buyer will place an order to purchase an asset that will be delivered in the future. In other words a buyer will require a seller or a contractor to deliver or construct the asset that will be completed in the future according to the specifications given in the sale and purchase contract. Both parties to the contract will decide on the sale and purchase prices as they wish and the settlement can be delayed or arranged based on the schedule of the work completed.
Kafālah		Indemnity letter issued by a guarantor - to guarantee the payment obligation should the guaranteed party fail to fulfil its contractual obligations. In other words, the issuer commits itself to pay a specified amount to the beneficiary in the event of non-performance of obligation by the guaranteed party.
Mubādalah	مبادلة	Swap

Mudarabah	مضاربة	A Mudarabah contract is a profit sharing contract in which the capital provider agrees to share the profits between themselves and the entrepreneur at an agreed ratio or percentage. Under the Mudarabah contract, the bank will have agreed to give the depositor a share of its profits in return for the investment, based on a pre-agreed ratio. Investment financing through Mudarabah is a commitment to participate in the risk associated with business ventures, with the aim of sharing the profit generated from a given business venture. Parties to the Mudarabah contract will only benefit if the venture is successful. Should the project fail, the financier will lose his investment, whereas the businessman will only lose the time and effort expended on the project. In general, conditions imposed and agreed on by both parties limit the mobilisation of the funds raised under a Mudarabah contract, such as wages of entrepreneurs, types of business venture or investment, as well as profit and loss sharing among the funds. Mudarabah, unlike Musharakah, does not entitle the capital provider to an executive function in the management of the business venture.
Muḍārib		Labour provider
Maslahah		Public interest
Maysir		Gambling
Murabaha -		cost plus sale
Rahn		A contract to pledge a specified asset as security against a debt to benefit a community. Whereby the creditor (Murtahin) is entitled to hold custody of the Zakat Alms giving asset. In the event of default by the debtor (Rāhin), the creditor may sell the asset.
Riba		Interest

Salam		A Salam contract is an agreement to purchase, at a pre-determined price, a specified kind of commodity not available with the seller, which is to be delivered on a specified future date in a specified Quantity and quality. The institution offering Islamic financial services, as the buyer, makes full payment of the purchase price Upon execution of a Salam contract. The commodity may or may Not be traded over the counter or on an exchange.
Sukuk,	صكوك	Sukūk (certificates) each of which represents the holder's (certificates) proportionate ownership in an undivided part of an underlying asset where the holder assumes all rights and obligations to such an asset.
Tahawwut		Hedging
Tawarruq		Purchasing an asset with deferred price, either on the basis of sale contract without the disclosure of the asset cost or price and profit margin to the buyer) or Murābahah, then selling it to, then selling it to a third party to obtain cash. Monetization of commodities
Wakālah		An agency contract where the customer (principal) appoints the institution off contract with the bank offering Islamic financial services as an agent- Wakīl- to carry out business on their behalf.

List of Figures

Chapter 1: INTRODUCTION

1.1 Research Background

In the midst of the global financial crisis of 2008-2010, the Vatican's official newspaper, *Osservatore Romano*, expressed in an article translated and cited by Bloomberg that "the ethical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service."[1] It further criticised the conventional financial system for having "grown too much and badly in the past two decades." Although the Vatican sought to show the stark unlikeness between the risk averse religious financial system and the risk-seeking and profit-obsessed conventional financial system, it described Islamic finance as client-oriented and ethical; and suggested that Western banks could use sukuk[2] or Islamic bond/financial certificates which require payment for the time-value of money as collateral.[3]

Some active members of civil society also took a moralistic stance towards the conventional financial system as demonstrated in a column by Ann Pettifor in *The Guardian*:

> Let us make no bones about it. The financial crisis is a major spiritual crisis. It is the crisis of a society that worships at the temples of consumption, and that has isolated and often abandoned millions of consumers now trapped on a treadmill of debt. It is the crisis of a society that values the capital gains of the renter more highly than the rights of people to have a home, or an education or health. It is the crisis of a society that idolises money above love community, wellbeing and the sustainability of our planet. And it is a crisis, in my view, for faith organizations that have effectively colluded in this idolatry by tolerating the sin of usury.[4]

Establishing a link between the recent financial crisis and moral deficiencies in the management of conventional financial institutions was not the prerogative of religious institutions and civil society opinion leaders. Many commentators identified unethical practices in the market and argued that there was a connection between these practices and the financial crisis. Calomiris suggested a connection between the crisis and the devious

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[1] L Totaro, "Vatican Says Islamic Finance May Help Western Banks in Crisis" (*Bloomberg* 4th March, 2009).
[2] All Romanised transliterations of Arabic words used are listed, with Arabic original text, possible alternative spellings and dictionary definitions, in the Lexicon.
[3] *Ibid.*
[4] A Pettifor , "Face to Face" (*The Guardian* 11 October 2008).

practice of issuing unrealistic and risk mortgage loans to customers with low or no income.[5] Mian and Sufi argued that the genesis of the crisis was the packaging of loans in such a way as to conceal the actual risks.[6] Skreta and Veldkampon their part laid the blame at the door of specialists with unreliable ratings,[7] while Posner argued that the risky investment policies of financial institutions led to the credit crunch.[8] Brunnermeier blamed the culture of serving self-interests;[9] and the HM Treasury attributed the crisis to the lack of effective controls at both the corporate and national levels.[10]

Given the nefarious and pervasive consequences of the financial crisis and the ensuing recession, many questions were also raised about the sustainability of the conventional banking system and the need for appropriate mechanisms for recapitalizing and restructuring banks.[11] Interestingly, the link between the financial crisis and moral deficiencies favour the recommendation of an alternative system purportedly built on ethics and benevolence, such as Islamic finance. Ahmed argues that the Islamic finance model may have attenuated the severity of the financial crisis because it encourages businesses to generate only a fair and legitimate profit and insulates the market from the potential systemic risks that result from excessive leverage and speculation.[12] He also posits that Islamic banking allows credit primarily for the buying and selling of real goods and services and requires the creditor to share in the risk of default by prohibiting the sale of debt.[13] Zerban *et al* argue that Islamic finance would not lead to a credit crisis because such crises are caused by the deviation from basic motivation of investment which is to promote social welfare and long-term growth. These are values that Islamic finance still promotes unlike conventional finance that focuses on the unabated pursuit of short-term gains through innovations and deregulation.[14] Chapra similarly argues that Islamic finance may effectively minimise the frequency of subprime

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[5] CW Calomiris, "The Subprime Turmoil: What's Old, What's New, and What's Next?" (2009) 15 *The Journal of Structured Finance* 1, 6-52.

[6] A Mian and A Sufi, "The Consequences of Mortgage Credit Expansion: Evidence from the 2007 Mortgage Default Crisis" (2009) 124 *The Quarterly Journal of Economics* 4, 1449-1496.

[7] V Skreta and L Veldkamp , "Ratings Shopping and Asset Complexity: A Theory of Ratings Inflation" (2009) 56 *Journal of Monetary Economics* 5, 678-695.

[8] RA Posner, *A Failure of Capitalism. The Crisis of '08 and the Descent into Depression* (Harvard University Press 2009).

[9] M Brunnermeier, "Deciphering the Liquidity and Credit Crunch 2007-2008" (2009) 23 *Journal of Economic Perspectives* 1, 77-100.

[10] HM Treasury, *Reforming Financial Markets* (Cm 7667, London HMSO 2009).

[11] S Khatimada, *Did the Financial Sector Profit at the Expense of the Rest of the Economy? Evidence from the United States* (ILO 2010).

[12] A Ahmed, "Global Financial Crisis: An Islamic Finance Perspective" (2010) 35 *International Journal of Islamic and Middle Eastern Finance and Management* 4, 306-320.

[13] *Ibid*, p 319.

[14] A Zerban, EH Elkady and RF Oma, "Islamic Finance and Global Financial Crises: How to Keep Finance on Track?" (2012) *Tropics in Middle Eastern and African Economies* 14, 190-222.

mortgage crisis because it focuses primarily on brick-and-mortar businesses, injects discipline in the market and reduces instability by restricting short sales, sales of debt, excessive uncertainty and gambling.[15]

As such, although Islamic financial institutions neither participated in asset-transformation nor dealt with large risk transmission bodies acting in a coordinated undifferentiated manner, they have been held by many commentators to represent a safer alternative. This point is reinforced by the fact during the financial crisis many conventional financial institutions turned towards their respective governments for help. Thiruvengadam of the *Wall Street Journal* reported at the time that a sum of $2.98 trillion was spent by the US government on bank bailouts.[16] On the other hand, the Saudi American Bank (SAMBA) and Riyad bank, both of Saudi Arabia, did not show any losses, except for the reduction in profitability. Also, the Al-Rajhi Bank, a Gulf based Islamic banking giant, reported a small increase in profits, from $1.72bn to $1.73bn between 2008 and 2009.[17] The policy to protect the biggest companies from failure through low-interest loans and subsidies is based on the idea that the products of these companies are universal necessities that maintain the welfare and security of the State.[18] This is related to the principle of "too big to fail" which encourages eligible banks to take greater risks.[19]

During the crisis many conventional financial institutions failed due to mismanagement and it would have been consistent with the free market capitalist theory that underpins conventional finance to allow the free market forces to dismantle them organically.[20] Thus, the predominant system of finance capitalism was undermined given that there was less reliance on entrepreneurship and profits to hedge against inevitable risks[21] and there was also much reluctance to endorse speculation.[22] It is in this light that Islamic finance has been presented

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[15] UM Chapra, "*The Global Financial Crisis: Can Islamic Finance Help Minimise the Severity and Frequency of Such a Crisis in the Future?"* Paper presented at the Forum on the Global Financial Crisis (Islamic Development Bank 25 October 2008)

[16] M Thiruvengadam, "*US Bailout So Far Total is $2.98 Trillion, Official Says*" (The Wall Street Journal 31 March 2009).

[17] Citigroup, *2008 Annual Report* (New York Citigroup 2009); RBS, *Annual Report and Accounts 2008* (Godarburn RBS 2009); SAMBA, *Consolidated Financial Statements and Auditors Reports for the Year Ended 31 December 2008*. (Riyadh 2009); UBS, *Annual Report 2008* (Zurich/Basel UBS 2009).

[18] IB Yeagar, "How to Avoid International Financial Crises" (1998) 17 *Cato Journal* 3, 257-65; A Meltzer, "Asian Problems and the IMF" (1998) 17 *Cato Journal* 3, 267-74.

[19] M Miskhin, *The Causes and Propagation of Financial Instability: Lessons for Policymakers*, Paper presented for a Symposium on Maintaining Financial Stability in a Global Economy (Wyoming 1997).

[20] MA Martinez, , *The Myth of the Free Market. The Role of the State in a Capitalist* (Sterling: Kumarian Press 2009), 281-282.

[21] F Boldizzoni, *Means and Ends: The Idea of Capital in the West 1500-1970* (Palgrave Macmillan 2008), 128-32.

[22] T Palley, *From Financial Crisis to Stagnation* (Cambridge: Cambridge University Press 2012) 218.

by its proponents as a more reliable alternative system given that it has a strong affinity with central planning. . Proponents of Islamic finance stress what they purport to be humanitarian values and the fair distribution of resources by the Islamic State;[23] given that speculation (*Gharar*) and interest are prohibited. It is often stated that for these reasons, Islamic financial institutions did not take part in asset-transformation prior to the 2007 financial crisis.

Proponents of Islamic Banking (IB) assert that it has been proven, since the crisis, that Islamic banking is a good alternative to conventional banking. In 2015, PwC estimated that "the global Islamic finance market has grown at 23% CAGR to over $1.2 Trillion and is expected to reach $2.6 trillion by 2017."[24] Those proponents argue that IB is at least not open to making the same measure of losses due to its avoidance of risky interest-based derivatives such as collateralised debt obligations, and this is said to be a sign of the moral purity of IB practices.

Yet the author can find few studies[25] that focus attention on distressed or failed Islamic financial institutions and their internal systematic approaches as a means of analysing failure through inattention to risk management. This is odd, for despite the glowing comments of many academics about the moral character of Islamic banking, there are some stunning examples of contraventions of law, dodgy accounting, poor operational practices and Shari'a non-compliance which have led to the failure of IBs such as Islamic Bank Ltd (IBZA) in South Africa in 1997.[26]

Prior to its failure, IBZA's largest Shari'a non-compliance was accumulating riba-based property debt which, weighed against its heavy promotion of Shari'a compliance, was at odds with its own ethical charter and public image.

There is substantial and substantive literature dealing with conventional bank (CB) distress and failure. Muslim proponents of such literature often point to the theoretical literature on Islamic banking which shows IBs to be more stable. This is said to be because the

[23] G Rice and M Al-Mossawi, "The Implication of Islam for Advertising Messages: The Middle Eastern Context" (2002) 11 *Journal of Euromarketing* 3, 71-95; H Mirza and A Fatemeh, "Developing an Islamic Principles-Based Marketing Framework" (2013) 3 *Journal of Basic and Applied Sciences Research* 3, 189-95.
[24] J Ashruff , *Islamic Finance, Creating Value* (2015). Retrieved from https://www.pwc.com/m1/en/publications/islamic_finance_capability_statement.pdf.
[25] M Nathie, "Islamic Bank Failure: A Case Study" (2010) 2 *ISRA International Journal of Islamic Finance* 1, 7-34.
[26] KPMG, The Inspector's Report (20 November, 1997), pursuant to an order by the High Court of South Africa (*Registrar of Banks v Islamic Bank Ltd,* in liquidation, Case No 25286/97).

endogenous linking of returns on deposits with returns on assets of an IB serves as a disciplinary device, increases the efficiency of the bank and the financial system and serves as a stabilization mechanism saving the banks from deposit runs in crisis situation. The PLS feature, which appears on both the asset and liability sides of the balance sheet, is claimed by IB proponents to add to the stability of individual banks, and to avoid the domino effect, or a contagion effect that can influence the entire banking system. In this way, it assists in maintaining the stability of the financial system as a whole.[27]

But in citing the failings of CBs and decrying the moral nature of the sub-prime crisis, proponents of IBs often ignore the crash of IBZA, the distress of Kuwait Finance House (KFH), which suffered heavy losses due to large exposure to the construction industry in 1984,[28] or the distress of the Islamic International Bank of Denmark that lost more than 30% of its equity between 1985 and 1986 which Grais and Pelligrini[29] blame on excessive risk-taking and heavy exposure to a single borrower.

Around September 1982 Kuwait's *Souk al-Manakh* (an unofficial over-the-counter stock market) collapsed, which collapse was attributed to highly speculative short sales associated with a small group of dubious and unregulated companies –incorporated in Kuwait, Bahrain and the UAE. Not long after, five banks - Faisal Islamic Bank of Egypt, the Dubai Islamic Bank, the Khartoum-based Tadamon Islamic Bank, the Qatar Islamic Bank and Kuwait Finance House, lost heavily in the collapse of Bank of Commerce and Credit International, supposedly buying Shari'a compliant assets which in fact did not exist, and showing a massive failure of directorial and Shari'a oversight.[30]

The collapse of Ihlas Finance House in Turkey, the country's largest IB at the time with over 40% of the sector deposits, in 2002 was caused by the illegal misappropriation of almost US$1billion, virtually the entire value of the deposit base, through connected lending to shareholders, concealed by the rapid growth of deposits – indeed, a national Ponzi scheme.[31]

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[27] SS Ali, "Financial distress and bank failure: Lessons from closure of Ihlas Finans in Turkey" (2007) 14 *Islamic Economic Studies* 1 & 2.
[28] Nathie, N_25 above.
[29] W Grais and M Pellegrini, *Corporate Governance in Institutions Offering Islamic Financial Services Issues and Options* (World Bank Policy Research Working Paper 4052 November 2006) 4.
[30] The Asian Wall Street Journal, *BCCI Creditors Granted More Time* (9 April, 1992).
[31] Grais, N_29 above.

Evidence shows IFH's collapse was precipitated by a combination of risky lending, rapid expansion, and questionable central bank regulation amongst others.

The Central Bank of Malaysia (Bank Negara Malaysia) had to negotiate a rescue package after the Bank Islam Malaysia incurred losses of about £80 million in 2005. Provision for bad loans were around £120 million and the gross non-performing loan portfolio was nearly £350 million ultimately 40% of the bank was sold overseas for approximately £170 million. The bank returned to profitability two years later[32]

The IMF reports that during approximately the same period as the financial crisis in Western countries, IBs in Qatar and the UAE, fared relatively worse than Conventional Banks. IBs hold about 27 percent of total banking assets in the subject countries.[33] The IMF concludes that "An aggregate test for the whole sample indicates that, on average, the difference between the cumulative impacts of the crisis on the profitability of the two groups of banks is insignificant." However "the nonperforming loan ratio for IBs remained slightly higher than that for CBs."[34]

In relation to bank failures in mature economies, a report by the Basel Committee [35] finds that one-off failures are not tied to economic conditions but to the failure of banks' true capital positions caused by accounting and valuation inadequacies as well as bad credit risk. [The sentences beginning with "It could therefore be argued…." and ending with "…by many commentators" have been deleted as recommended by examiners]

The Qur'an favours entrepreneurship and the accumulation of wealth, since the Prophet (Peace and Blessings be upon Him) was an honest entrepreneur who managed his wife's wealth.[36] The Prophet (Peace and Blessings be upon Him) also refused to put a ceiling for prices in the market, preferring to leave this to market forces.[37]

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32 AMET Ahmed and W Grais, *Islamic Finance and Economic Development: Risk, Regulation, and Corporate Governance* (John Wiley & Sons 2014).

33 M Hasan and J Dridi, *The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study* (IMF Working Paper September 2010) 16-17.

34 *Ibid.*

35 Basel Committee on Banking Supervision, *Bank Failures in Mature Economies* (Working Paper No. 13 April 2004).

36 H Hosseini, "Notions of Private Property in Islamic Economics in Contemporary Iran: A Review of Literature" (1988) 15 *International Journal of Social Economics* 9, 51-61.

37 *Ibid.*

A more reasonable argument is that put forward by Warde that although what is religiously permissible is not always advisable from a purely business perspective, and Islamic financial institutions are not somehow miraculously immune from incompetence and fraud, these institutions are less likely to be as adversely affected as the conventional institutions during a crisis.[38] He gave two reasons: First, given their strong link to the "real economy" involving brick-and-mortar businesses, Islamic banks are less likely to be exposed to the risks created by institutions that gobble toxic intangible assets. Secondly, Islamic investors do not necessarily enter or leave the Islamic market on the basis of the profits and losses attached to classes of assets. Thus, Islamic institutions often have elbow room to adjust their practices and products.[39] As will be shown below, this argument is double-edged. It does not only endorse Islamic finance but also promotes non-standardisation given that it is the elbow room or flexibility that enables Islamic banks to adjust their practices and products in light of changes in their environment.

1.2 Brief History of Islamic Finance

The process of integrating Islamic banking into the global banking system began in the 1970s[40] and it has transformed significantly since then, partly due to religious commitment and partly due to material change. In 2010, Davies and Green put the total capital value of Islamic instruments at more than $500 billion; and over the last decade this has almost certainly expanded at an annual rate of between 10% and 15%.[41] However, the transformative events during this time have not allowed for certain pertinent questions to be decided conclusively.

The proponents argue that the recent growth of Islamic finance in non-Muslim regions such as Europe, especially during the recent financial crisis shows that Islamic finance may be safer choice for the economies of many countries across the globe.[42] This is an easy argument

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[38] I Warde, *Islamic Finance in the Global Economy,* (2nd Edition, Edinburgh University Press 2010) 173-4.
[39] *Ibid.*
[40] FA Al-Omar and M Iqbal, *Challenges Facing Islamic Banking in the 21st Century*, Proceedings of the Second Harvard University Forum on Islamic Finance: Islamic Finance into the 21st Century (Cambridge, MA Center for Middle Eastern Studies 1999) 243-53; M Ariff, "Islamic Banking" (1988) 2 *Asian-Pacific Economic Literature* 2, 46-62.; MK Hassan and MK Lewis (Eds), *Handbook of Islamic Banking* (Cheltenham, Glos Edward Elgar Publishing 2007); M Khan and MI Bhatti, "Development in Islamic Banking: A Financial Risk-Allocation Approach" (2008) 9 *The Journal of Risk Finance* 1, 40-51; A Saed, *Islamic Banking and Interest: A Study of the Prohibition of Riba and its Contemporary Interpretation* (Boston Brill 1999).
[41] H Davies and D Green, *Banking on the Future: The Fall and Rise of Central Banking* (Princeton, NJ Princeton University Press 2010) 229.
[42] F Syed , *Islamic Banking is not For Muslims Alone* (DnaIndia, 2012).

to make given that there has only been one real failure of Islamic finance and that was precocious, during the Dubai property bubble.[43] It is submitted that the small incidence of failure so far is a mere historical accident and a function of IF being still at the developmental phase. The author will argue that the coming shock in KSA can be reduced by standardisation and harmonisation of accounting measures which will allow for appropriate risk management and liquidity. This is the problem that this thesis addresses. The next section expatiates on the problem.

1.3 Statement of Research Problem

Towards the end of last century, Islamic banking emerged globally as a substantive system and IBs now offer products and services in competition with conventional banks (CB). The concept of Islamic banking is often associated with the buying and selling of Shari'a compliant products and the promotion of economic behavioural norms derived from the Qur'an.[44] The system has been mainstreamed in many Muslim majority nations,[45] but CBs still operate in parts of those nations. IBs also operate in non-Muslim countries that have allowed the establishment of some form of Islamic banking. As the author will show,[46] the impact of the recent financial crisis on Islamic banks was less severe than on conventional banks. Beyond the obvious deduction that Islamic banks were not involved in asset transformation involving toxic assets based on interest,[47] the fact that some commentators established a link between moral deficiencies in conventional banking and the financial crisis has given many to understand that Islamic banks may be a less problematic alternative given that they promote ethical finance and eschew speculation and reckless risk-taking.[48] However, the author will demonstrate[49] that IBs at least in the Gulf region take just as speculative risks, albeit of a different sort, and ones which appear to be Shari'a compliant.

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[43] *Ibid.*

[44] HG Rammal and R Zurbruegg, "Awareness of Islamic Banking Products among Muslims: The Case of Australia" (2007) 12 *Journal of Financial Services Marketing* 1, 65-74.

[45] Islamic Financial Services Industry Development, *Ten Year Framework and Strategies* (Islamic Research and Training Institute 2006).

[46] in chapters 5 and 6

[47] H van Greuning and Z Iqbal, *Risk Analysis for Islamic Banks* (The World Bank Washington, D.C. 2008).

[48] A Malik, MS Malik and H Shab, "An Analysis of Islamic Banking and Finance in West: From Lagging to Leading" (2011) 7 *Asia Social Science* 1, 179-85; T Rachman and M Hossaim, "Analysis of Investment Cost: The Case of Islamic Banks in Bangladesh" (2013) 9 *JIEBF* 1; Strategic Performance Plan 2013-2015: Identifying Strategic Goals and Key Result Areas, Kuala Lumpu, Malaysia.

[49] in chapter 7

Ariff, one of the pioneer researchers in the field of modern Islamic banking, claims that a key selling point of Islamic banking is that it looks at overall feasibility and viability of a borrower's project rather than the size of the collateral.[50] This is unlike conventional banking where the security offered by the borrower against a loan is of utmost importance to the latter's legal relationship with the bank. Hence, profitable projects which might be turned down by conventional banks (except may be merchant or investment banks) for lack of proper security would be picked up by the Islamic banks due to their ethos of profit and loss sharing.[51]

Although the risks embedded in such projects are logically high, the Islamic banking sector may be said to be instrumental in economic development since the institutions invest in the riskier end of the markets.[52] It is however perfectly in keeping with the core philosophy of Islamic finance, that profit, loss and risk must be shared. If one does not take a risk, one does not deserve to make a profit. Conventional finance is seen to unjustly place too much of the burden of risk on the debtor.[53] Proponents argue that this is not reckless risk-taking given that the depositors are aware of the fact that these banks pool their resources to make Shari'a compliant investments that may generate a profit or result in a loss.

Islamic banks engage in risk sharing with the depositors and borrowers rather than engage in risk transfer as in conventional banks. This is why some of the main concepts in Islamic finance include profit-sharing or *Mudahraba*, safekeeping or *Wadiah*, and joint venture or *Musharaka*. Islamic banking is also similar to investment banking and management and therefore has the advantage of less volatile income streams and stable earnings.[54]

Despite the above advantages, a major challenge hindering the growth of Islamic banking is the non-existence of a prudential regulatory body or lead regulator that manages risks and errors at the prudential level by setting standards and entering into memorandums of understanding with the Shari'a boards or advisory councils of financial institutions or other self-regulatory bodies.[55] The lack of standardisation is firstly due to underdevelopment (or

[50] Arriff, N_40 above.
[51] *Ibid.*
[52] *Ibid.*
[53] I Abraham, *Riba and Recognition: Religion, Finance and Multiculturalism* (Paper presented to the Conference of the Australian Association for the Study of Religion Monash University 2008).
[54] KT Law, *The Business of Investment Banking: A Comprehensive Overview* (2nd Edition, London Wiley 2005) 3-4.
[55] N Ali, *Islamic Finance: Current Legal and Regulatory Issues* (Harvard: Islamic Finance Project 2005).

what El-Aksheik and Tanega calls "infancy")[56] of the sector, secondly due to the fact that there are no standard or universal laws per se even governing the entrepreneur's behaviour, and thirdly due to under-reporting of risk factors. Islamic Juris consults have generally sought to distinguish between morality, religion and the law.[57]

This is because despite the claim that Islamic finance is ethical finance, there is nothing intrinsically ethical about it in Islamic jurisprudence (*fiqh*). *Fiqh* is a logical normative discourse and its hermeneutical premise does not correspond with what may be described as a category of law (*al-qanun al-Islami*). It is a positive system of rules that has been applied over the centuries in different regions in varying degrees of flexibility.[58]

As such, prudential regulation is particularly important here because although the risks associated with capital and collateral in Islamic markets are low, the risks of insolvency and liquidity are relatively very high.[59] Thus, the absence of a regulatory framework within which Islamic banks may be supervised and controlled increases confusion as to the content of the relevant Islamic legal rules. Moreover, the conflict in opinions over Shari'a creates systemic risks since different Shari'a boards or advisory councils will put different interpretations on the applicable verses of the Qur'an, which means that there cannot be a uniform regulatory framework.

There have been attempts to standardise Islamic finance. The Islamic Financial Services Board (IFSB) was created in 2002 to perform the role of a lead supervisory authority in the markets of the States involved in the body's creation.[60] It has since issued global prudential standards and rules for the Islamic market. However, the standards and rules on capital adequacy[61] mirror those set under Basel II;[62] except for the fact that risk weights based on the supervisory slotting criteria of Basel II is replaced by discretionary rules governing

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[56] AAA Al Elsheikh and J Tanega, "Sukuk Structure and Its Regulatory Environment in the Kingdom of Saudi Arabia" (2011) *Law and Financial Markets Review* 183, 184-5.

[57] V Cattlelan, "Islamic Finance and Ethical Investments" in Khan, F.M., and Porzio, M. (eds), *Islamic Banking Finance in the European Union. A Challenge* (Cheltenham Edward Elgar 2010) 79-80.

[58] *Ibid.*

[59] L Errico and M Farahbaksh, "Islamic Banking: Issues in Prudential Regulations and Supervision" (IMF Working Paper WP/98/30 1998).

[60] AME Ahmed, *Islamic Banking: How to Manage Risks and Improve Profitability* (Hoboken John Wiley & Sons 2011) 36.

[61] IFSB, *Capital Adequacy Standards for Institutions (Other than Insurance Institutions) Offering Only Islamic Financial Services* (Kuala Lumpur IFSB 2005).

[62] Basel Committee on Banking Supervision, *International Conversion of Capital Measurement and Capital Standards: A Revised Framework* (BCBS 2004).

specialised financing under the Mudaraba and Musharakaschemes.[63] The IFSB was created to act in the same capacity as the Basel Committee on Banking Supervision (BCBS) but its role seems superfluous, since it merely reiterates the rules set by the latter. In the same vein, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) based in Bahrain has set standards that it hopes would serve as benchmark for Islamic financial institutions around the world. Some commentators argue that these standards also closely reflect those of Basel II on capital adequacy.[64] This is the same with regard to the similarity between the International Islamic Financial Market (IIFM) and the International Capital Market Association, although both associations are collaborating on setting standardised rules governing the floating and trading in Sukuk.[65]

It is surprising that the Shari'a boards or advisory councils of Islamic banks have not simply been requested to implement international standards in a manner that accords with their interpretation of the Shari'a law. This seems to be the most practical way of achieving harmonisation or standardisation. There are two arguments in favour of non-standardisation. The first is that the lack of standards may be credited with the growth of Islamic finance over the past decades. If it is assumed that growth in finance and banking is directly linked to innovation based on freedom of contract or association,[66] then the fact that Islamic financial institutions are not required to adopt compulsory standards may be said to have encouraged innovation. This contention is based on the argument that supervision by a lead regulator is often otiose since the financial system is based on the multiplier effect and financial leverage and therefore intrinsically unstable.[67] Moreover, the system relies almost exclusively on confidence.[68] Banks generally hold only a percentage of the money deposited in their accounts (to comply with reserve requirements) and lend the rest. Thus, given that they use short-term borrowing to finance long-term assets, they are often confronted with maturity mismatch between assets and liabilities.[69] It follows from here that they can manage the different related risks (credit and liquidity especially) during normal times. However, during

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[63] N Schoon, *Islamic Banking and Finance* (London Spiramus 2010) 171-9.
[64] van Greuning, N_47 above.
[65] *Ibid*.
[66] J Ellig, "Introduction" in Ellig, J. (ed), *Dynamic Competition and Public Policy* (Cambridge, Cambridge University Press 2001) 13-14.
[67] MM Prates, *Why Prudential Regulation Will Fail to Prevent Financial Crisis: A Legal Approach* (Working Paper Series No 335 Banco Central do Brasil 2013) 5.
[68] RM Lastra, *Central Banking and Banking Regulation* (London Financial Markets Group LSE 1996) 69; G Simmel, *The Philosophy of Money*, translated by T Bottomore and D Frisby (3rd Edition, London Routledge 2004) 173.
[69] *Ibid.*, 78-83.

times of distress or where there is a run on the banks, it is only the sustained confidence in the banks that will save the illiquid institutions from being overwhelmed.[70] Hence, since depositors in Islamic banks rely on the bank's commitment to Islamic precepts, the confidence is sustained even during crisis; and there is no need for standardised rules and a lead regulator.

However, there is a surprising lack of evidence to the effect that non-standardisation has effectively encouraged innovation in Islamic finance or that the confidence of depositors remains strong during times of crisis because of the banks' commitment to implement Islamic principles. The mere fact that banks in the UK and in Malaysia were substantially unaffected by the sub-prime crisis does not mean that there is a relationship between non-standardisation and survival. It will be argued in subsequent chapters that the relative infancy of IB meant that there was little innovation of products which could have caused a crisis in the UK and in Malaysia; the Dubai housing bubble is proof that there are Shari'a compliant products that if not correctly used can lead to a similar crisis for a bank or even a whole economy, because of essentially the same root cause.

To be able to determine the appropriate answers to this thesis' research questions, it is necessary for this thesis to first seek to determine whether the risks in the financial system such as the lack of flexibility amongst institutions and the lack of unitary regulatory control have impeded or enhanced the development and growth of Islamic banking. The central argument of the thesis is that the incorporation of pertinent Basel components, as well as those from the Malaysia and UK banking system into the KSA banking system will bring about improvements to the latter's overall banking structure. To be able to prove this claim, it is vital to first consider the risks to Islamic finance prior to any presumption of Islamic innovation based on freedom of contract. This central argument takes into account the risks of complying or not complying with international standards and the laws inherent of particular jurisdictions. Once answers to such determination are achieved, the research will then proceed to answer the core thesis questions based on an in-depth analysis of available literature.

[70] Prates, N_67 above, 6.

In interpreting the applicability of the central argument to Islamic banking, we have identified three abstract issues that apply to Islamic banking in general, namely,

- The absence of an accurate measure
- The absence of a legal framework, and
- The incompatibility between conventional regulations and Islamic banking.

Before we discuss each of these issues in detail below, it is important to recognize that these issues will need to be translated into more detailed risk factors for the purposes of concrete risk analysis. There are potentially an extraordinary number of particular risk factors depending on the specific details of the case study in question. These various risk factors are discussed in detail in Chapter 7.

1.4 The Absence of an Accurate Measure

As will be shown in Chapter 2, a review of the extant literature reveals that there is no measure by which to determine whether a product is Shari'a compliant. Compliance usually depends on the interpretations of the Qur'an and the *Sunnah* by the relevant Shari'a supervisory board, and these differ over time and from region to region.

No set of legal determinations authoritatively represents the Islamic legal system. It is a cumulative system of juristic investigations into the *Quran*, represented by several competing schools of jurisprudential thought. These schools diverge on legal methodology and hermeneutical approaches but each is considered equally authoritative. [71]

Nonetheless setting standards that would govern the interpretation and implementation of the relevant rules remains an arduous task. Although the International Financial Reporting Standard (IFRS) has successfully harmonised accounting standards across hundreds of countries around the world,[72] some Muslim scholars and academics claim that IFRS is not suitable for Islamic banking. Shafi and Zakaria conducted in-depth interviews of Shari'a officers, accountants and academics in Malaysia and captured their views on how practitioners of the local Islamic financial industry deal with the IFRS standards.[73] The

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[71] KA El Fadl, "Islamic Law, Human Rights and Neo-colonialism" in C Miller (ed) *War on terror* (The Oxford Amnesty Lectures 2006 (Manchester University Press 2009) 195

[72] Z Shafi and N Zakaria, "Adoption of International Financial Reporting Standards and International Accounting Standards in Islamic Financial Institutions from the Practitioners' Viewpoint" (2013) 13 *Middle-East Journal of Scientific Research* 1, 42-49.

[73] *Ibid.*, 45.

interviewees revealed a number of concerns. First, the terminologies used in the IFRS should be "Islamicised." For example, the term "interest" is used in the IFRS to refer to cash flows calculated over a time period, but this translates to riba which is prohibited by the Qur'an and should be discarded away with in order for Muslims to implement the IFRS. Also, the application of time value of money principle that is upheld in the IFRS is allowed under the Shari'a only for exchange contracts that involve deferred payment and it is prohibited in debt-based transactions (*qard*). The interviewees said they were therefore reluctant to comply with the IFRS but complied fully with the resolutions of the Shari'a Advisory Council (SAC) of the Central Bank of Malaysia (BNM).[74] However, these resolutions do not involve harmonised standards but instead comprise a list of general concepts or assumptions that are deemed Shari'a permissible by SAC.[75]

The findings of the study conducted by Shafi and Zakaria may however be contrasted with that conducted by Alsaqqal and Sawan in the Dubai and Abu Dhabi stock markets that reveal that the benefits of implementing the IFRS in the United Arab Emirates (UAE) markets far outweigh the difficulties and costs.[76] In fact, of the 10 most cited difficulties and challenges, only one concerns the disparity between the IFRS and the Shari'a. It is fair value and it is ranked fourth.[77] The researchers also enquired about "cultural issues" and the *Zakat* (obligatory alms) requirements rank first in the list of cultural issues, while language is ranked second, and UAE pride is ranked third.[78] The absence of consensus on what is permissible under Shari'a therefore raises the question of whether there really is an Islamic banking "system" that exists independently of the conventional system or the former is not simply an attempt at Islamicising the latter. In other words, the non-standardisation of rules may point to the fact that Islamic banking has so far been an unsuccessful (so far) attempt to mould conventional banking in light of the precepts of the Qur'an.

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[74] *Ibid.*
[75] *Ibid*, 47.
[76] I Alsaqqal and N Sawan, "The Advantages and the Challenges of Adopting IFRS in UAE Stock Market" (2013) 8 *International Journal of Business and Management* 19, 1-23.
[77] *Ibid.*, 12.
[78] *Ibid.*, 13; OH Abd-Elsalam and P Weetman, "Introducing International Accounting Standards to an Emerging Capital Market: Relative Familiarity and Language Effect in Egypt" (2003) 12 *Journal of International Accounting, Auditing and Taxation*, 1, 63-84.

1.5 The Absence of a Legal Framework

Shari'a compliant banking needs to be determined legally. In other words, the recognition and measurement of an Islamic financial transaction or product should defer to its legal form rather than worry about the 'substance' of it. This argument is related to the secularisation of the legal order under Islamic law.[79] Malaysia, Turkey and Indonesia are amongst the few nations around the world with a predominantly Muslim population that do not have Islam as the religion of the State and in which there is, on the other hand, a clear separation of State and religion.[80] Thus, the Shari'a is often regarded as the Islamic legal order and corresponds to the legal situation in most Islamic States.[81] Nonetheless, as noted above, the Shari'a cannot be uniformly applied and depends on the interpretations of the relevant authorities. This implies that normative claims about the Shari'a based on logic (*fiqh*) would actually be closer to the legal form. The *fiqh* has been succinctly defined as "the mundane effort to understand, interpret and implement the Shari'a" or "the way the divine revelation is put into practice in the world."[82] However, given that the *fiqh* is itself not standardised, it may be difficult to refer to it as the legal order. This is compounded by the fact that there are no set rules governing the interpretation of the Shari'a or the process by which the fiqh is developed and established.

Thus, the main problem as regards the legality of Islamic banking transactions and products stems from that of legal secularisation in Islamic States. Conventional banking transactions and products are not confronted with similar problems because they do not have an economic background. The Supreme Constitutional Court of Egypt recently held that the provision of Article 2 of the Egyptian Constitution of 1971 (as amended on 22 May 1980) to the effect that the principles of the Islamic Shari'a constitute the major source of the legislation, may be interpreted as implying that the legislators are only bound by the "definite rules" or "general principles and immutable sources of Islamic law" of the Shari'a. They are not bound by "specific rules" that are open to interpretation or independent reasoning (*ijtihad*) in light to the "change in time and clime" as long as the interpretation conforms to the overall spirit of

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[79] B Krawietz (ed) "Introduction" in Krawietz, B., and Reifeld, H. (eds), *Islam and the Rule of Law. Between Shari'a and Secularization* (Berlin: Konrad-Adenauer Stiftung 2008) 11.
[80] *Ibid.*, 11-12.
[81] *Ibid*, 12.
[82] *Ibid.*, 123.

the Shari'a.[83] It may therefore be said that the set of legal rules governing the Shari'a compliance of Islamic banking products and transactions constitute "specific rules." This implies that Islamic products and transactions that are Islamic only in form and not substance are not Shari'a compliant.[84] However, this further raises the question of which market ought to determine what constitutes the "substance" of Shari'a; the Malaysian Islamic finance market or the London and European finance market or and Middle Eastern finance markets?[85] This question fits well into the debate of substance and form.

Some practitioners have suggested that the doctrine of 'substance over form' is applicable to all financial transactions conducted under Islamic laws and a convenient way around the problem of disclosure is to present the legal aspect in the notes to the accounts.[86] The insistence on reporting requirements is based on the fact that Islamic financing is effected through sale or lease rather than straightforward lending as is the case with conventional financing. This viewpoint is also supported by verse 282 of the Qur'an:

> O ye who believe! When ye deal with each other in transactions involving future obligations in a fixed period of time, reduce them to writing; let a scribe write down faithfully as between the parties; let not the scribe refuse to write; as Allah has taught him, so let him write …

Also, para 111 of AAOIFI-FAS 2 defines "reliability" as follows:

> That based on all the specific circumstances surrounding a particular transaction or event, the method chosen to measure and/or disclose its effects produces information that reflects the substance of the event or transaction.

However, the emphasis on reporting does not solve issues such as that involving *Zakat* (obligatory alms) calculation, accounting and taxation. These calculations may be modified and recorded or not, depending on the circumstances. Thus, it may be argued that Islamic finance thrives on non-standardisation of the relevant or "specific" rules of Shari'a. To this extent, standardisation may be deemed to be counterproductive since it essentially entails imposing a given interpretation by the advisory council or supervisory board of one institution on other institutions operating in different circumstances.

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[83] *Ibid*, 123-124.
[84] O Agha, "Islamic Finance: Principle before Profit" (2009) 2 *Berkeley Journal of Middle-Eastern and Islamic Law* 1, 125.
[85] *Ibid*, 129-30.
[86] van Gruening, N_47 above.

1.6 The Incompatibility between Conventional Regulations and Islamic Banking

It has been argued that the banking rules and regulations and guidelines in the Western world are based on conventional banking and do not suit Islamic banking as such.[87] Islamic law prohibits trade in pork-related products, alcoholic beverages, and tobacco, as well as gambling, but it permits slave-trading. Shari'a also prohibits the charging of interest (*riba*). Also, there are several persons who belong to several Shari'a supervisory boards of different banks and may therefore not pass the fit and proper test in the UK due to conflicts of interest.[88]

This was not raised as a concern when the former UK lead regulator, the Financial Services Authority (FSA), in a briefing note published in 2006,[89] identified Islamic banking as a growing subsector within the UK banking sector. The FSA authorised the operations of Islamic Bank of Britain in 2004, making it the first authorised Islamic Bank in the country.[90] The European Islamic Investment Bank was the first Islamic investment bank to get authorisation from the FSA.[91] In the FSA's own words, IB is an innovative financial service and does not justify the regulation of Islamic banks in a different manner than conventional banks. Thus, Islamic banks are regulated same way as any other financial institutions with "no obstacles, no special favours."[92] While this open and transparent approach is much appreciated, it does create certain problems for the Islamic Banks.

These banks take 'saving' deposits but unlike a normal savings account, they do not guarantee a fixed income or even the full repayment of the original deposit as the funds are invested in profit and loss sharing schemes (*Musharaka*). These are non-interest bearing, equity-based investments which can generate a loss as well as a profit and directly conflict with the view that the FSA takes on saving deposits.[93] The possibility of a loss means that, absent adequate risk management and liquidity measures, Islamic banks have much higher levels of insolvency and liquidity risks. They must therefore be treated differently in order to

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[87] J Sole, *Introducing Islamic Banks into Conventional Banking Systems* (IMF Working Paper WP/07/175 2007).
[88] S Hasan, *Shari'a Governance in Islamic Banks* (Edinburgh, Edinburgh University Press Chapter 4 2012).
[89] FSA, *Islamic Banking in the UK* (London FSA 2006).
[90] Malik, N_48 above, 181.
[91] Schoon, N_63 above, 9; S Aioanei, "European Challenges for Islamic Banks" (2007) 10 *The Romania Economic Journal* 25, 7-20.
[92] FSA, N_90 above, 1.
[93] A Udovitch, *Bankers Without Banks: Commerce, Banking and Society in the Islamic World of the Middle Ages in Dawn of Modern Banking* (New Haven Yale University Press 1979) 263.

ensure that these risks are mitigated. It may then be argued that standardised rules may ensure that all Islamic banks comply with appropriate risk-weighted capital adequacy ratio.[94] They may also require all Islamic banks to show that they have liquidity support from a viable non-financial institution or community. Also, where a lead regulator applies standardised rules, it may screen the products and contracts of all Islamic banks and ensure that counterparty risks are generally properly assessed for risk and then mitigated by well-organised clearance and settlement processes.

1.7 Purpose of the Thesis and Research Questions

1.7.1 Purpose of the Thesis

It is the main purpose of this thesis to determine if Saudi Arabia needs to adopt the risk regulation practices of Basel. To be able to find out, the thesis aims examine the risk management practices and accounting standards of Islamic financial institutions in determining how the efficacies of Islamic financial institutions can be improved. In order to find out, the research will set out to achieve the following objectives:

- Determine how issues of legal secularisation may be reconciled in Islamic models of finance, particularly Islamic financial institutions;
- Determine whether risk management practices can be improved by standardising banking across jurisdictions;
- Determine whether the standardisation of accounting practices and regulatory principles can enhance Islamic finance organisations;
- Determine whether the Basel framework can be internalized by Islamic financial institutions to solve issues such as the inadequate coordination of financial markets in Saudi Arabia;
- Determine whether legal secularisation could be reconciled with Islamic models of finance in order to standardise banking processes across jurisdictions; and,
- Employ a content analysis among three markets, namely, Malaysia, the Islamic Bank of Britain and Saudi Arabia, to determine which accounting standards and risk management practices from each market are beneficial in improving financial and legal efficacy in Saudi Arabian financial institutions.

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[94] Errico, N_59 above.

1.7.2 Research Questions

The primary research question where the majority of the investigation of this dissertation is based is as follows:

Does Saudi Arabia Need to Adopt the Risk Regulation Practices of Basel?

The subsidiary questions that naturally follow from the initial research question are provided hereunder:

- Why should Saudi Arabia adopt the risk regulation practices of Basel and other specific jurisdictions risk management practices of the UK and Malaysia?
- Can the Basel framework and other specific jurisdictions risk management practices of the UK and Malaysia be internalized by Islamic financial institutions to solve issues such as the inadequate coordination of financial markets in Saudi Arabia?
- How are the issues of legal secularisation to be reconciled in Islamic models of finance, particularly in Islamic financial institutions?
- How can risk management practices be improved by standardising banking across jurisdictions?
- Can the standardisation of accounting practices and regulatory principles enhance Islamic finance organisations?
- How may one employ a content analysis across the three markets of Malaysia, the Islamic Bank of Britain, and Saudi Arabia to determine which accounting standards and risk management practices from each market are beneficial in improving financial and legal efficacy in Saudi Arabian financial institutions?

1.7.3 Research Methodology

In light of the research problem stated above, the researcher employed two distinct methodologies to assess the regulation of Islamic banking in Saudi Arabia so as to determine how the regulatory principles and guidelines may be standardised or allowed to operate independently in a methodical manner. The methodology that was developed and applied in this study optimises the use of the content analysis method to study risk contents, both in diversity and in depth, in three markets: Malaysia as the main focus, the UK in order to debunk a particular argument made in relation to the apparent success of the Islamic Bank of

Britain in avoiding the consequences of the 2006-8 financial crisis, and Saudi Arabia, as that market are the main components in achieving the central argument of this thesis. To reiterate, this thesis argues that the incorporation of pertinent Basel components, as well as those from the Malaysia and UK banking system into the KSA banking system will bring about improvements to the latter's overall banking structure.

The tools used to develop the methodology include the legal doctrinal analysis and axiology. This research is conducted based on a specific question: Is the IB system of KSA sufficiently robust to survive the eventuation of a credit risk? If the answer to this question is in the positive, then there is little need for this thesis. However, as will be shown throughout this study, the question cannot be answered by a simply yes or no. A detailed scrutiny of the IB and CB banking systems worldwide is necessary to come up with a credible answer, one that will help answer the primary research question. A major (although not the sole) determining factor will be whether the KSA's IB system has sufficient liquidity to absorb any shock caused by the eventuation of such a risk.

The apologists for IB adopt a similar methodology: they mistake historical co-incidence for cause and effect. They point to the survival of IBs in Malaysia and in the UK during the recent sub-prime-related financial crisis as evidence of IB being a superior system to CB and then deduce from the fact that the Basel standards did not apply to Malaysian banks in 2007 that Basel standards need not apply to IBs in 2015. In so doing they draw comfort from their belief as an article of religious faith that IB is more humane and ethical than CB.

Critical examination is an important tool in this thesis. In effect, the major case study on Malaysia will probe the weaknesses in similar case studies in an attempt to prove that there is no cause and effect relationship between the particular risk and liquidity standards adopted in Malaysian Islamic banking prior to 2007 and its substantial avoidance of the damage from the sub-prime crisis.

The minor case study on the Islamic Bank of Britain will use what little material is available to demonstrate that the lack of exposure to toxic assets was a historical accident, and not a feature of design. It will juxtapose the failure of the Dubai property market as proof of that proposition. It will demonstrate, nevertheless, that the IBB managed to make losses during the financial crisis which were proportionally on a par with any British conventional bank and that if this is what a bank does when constrained by moderate risk controls, moving to less substantial risk controls is hardly going to improve profitability.

The choices of Malaysia and of the UK, for the purpose of this thesis, is based on two main factors: the key importance of Malaysia as an Islamic banking hub and the key importance of London as a banking hub in general, which is building the number of Islamic banks and Islamic windows in conventional banks in an attempt to compete with other financial centres for the market in Islamic financial services and products. Prime Minister Cameron seeks to fund much of the need for new investment in British infrastructure from Islamic banking.[95] The British Islamic banks possess £12bn in assets and this downplays those of the assets of banks in the Muslim states of Bangladesh, Pakistan, Egypt and Turkey. And there are also 55 colleges and professional institutions offering education in Islamic finance in Britain – representing a number unparalleled anywhere else globally.[96]

The legal doctrinal analysis is the traditional form of legal scholarship.[97] The researcher laid stress on the primary sources of law: the general principles and immutable sources of Islamic law and applicable statutes, regulations and case law. They are analysed in order to determine whether they are apposite as regards the regulation of banking activities and products, and what changes may be made. This implies that the research approach is inductive whereby the researcher critically reviews the extant principles, statutes and regulations and identifies patterns to support a theory on the standardisation[98] or methodical non-standardisation of Islamic regulation with international accounting standards, ISO 31000:2009 and its predecessors[99] and the requirements of Basel I, Basel II and Basel III. It follows from the above that the relevant legal rules are assessed from a positivist and objective perspective. Thus, there is no attempt to formulate or reinforce extant ideological viewpoints which have guided the analysis of previous researchers. In seeking to be objective, the researcher therefore assessed current regulatory rules and procedures as they are applied in the EU (and therefore in the UK), in Malaysia and in KSA. This thesis avoids normative analyses or any attempt at expanding the scope of the *fiqh*. This is because of the need to be detached from

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[95] World Islamic Economic Forum, *UK Excellence in Islamic Finance*, Message from Prime Minister of the UK, David Cameron (UK Government official publication for World Islamic Economic Forum London 2013).
[96] M Phillips, *Britain's a World-Leader in Sharī`a Banking - But We Haven't Grasped the Sinister and Dangerous Implications* (Daily Mail UK 11 February 2009).
[97] EH Tiller and FB Cross, "What is Legal Doctrine?" (2006) 100 *Northwestern University Law Review* 1, 517-33.
[98] RA Posner, "The Present Situation in Legal Scholarship" (1981) *Yale Law Journal* 90, 1113-1130.
[99] HM Treasury, *AS 4360* (1994).

the cultural and political influences on the application of the rules and procedures.[100] Hence, although politics and culture have played a major role in shaping regulatory policies, both in KSA, in Malaysia and in Western countries, the difficulty of ascertaining this role, coupled with the fact that this would be beyond the scope of this study, constitutes the motivation to carry out a positivist doctrinal analysis.

An analysis of the Malaysian and British cases will provide a base for the thesis on which to analyse the preparedness of the KSA's IB system to face similar shocks. Firstly, those risks will be explained. Secondly, it will be shown that the standards of the AAOIFI are insufficiently robust to identify, measure and mitigate the risks so presented. Thirdly, it will be shown that international standards, including ISO 31000:2009 and those of the IASB, would properly identify, measure and mitigate those risks. Along the way, it will be demonstrated that there is nothing particularly ethical or humane about the wholesale concealment of major structural flaws in the Sa'udi economy. Nonetheless, given the link between Islamic banking, ethics and moral values, the researcher would also defer to axiology. Axiology is a branch of philosophy that examines subjective judgements about values. Heron and Reason stated that values are guiding principles for human conduct.[101] Thus, certain values guide the legislators in enacting certain regulations, as well as the Shari'a advisory councils of Islamic banks in endorsing products and services. Heron and Reason further argued that researchers should be able to demonstrate axiological skills by identifying and articulating their own values as a basis for making judgements about the research they are conducting.[102] Saunders *et al* also provide an interesting interpretation of this argument. They state that researchers should write down their own statements of personal values in relation to the topic they are studying.[103] This will be of value not only to the researcher but also to the other stakeholders in the research, including the target audience, as well as the persons that assisted and guided the researcher.[104] For researchers themselves, this would heighten the awareness of value judgements they would make in drawing conclusions from the interpretation of the data collected. For the other stakeholders, it would give them a clearer understanding of the value judgements that the researcher has made and with which

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[100] HJ Morgenthau, "Positivism, Functionalism and International Law" (1940) 34 *American Journal of International Law* 2, 260-284.
[101] J Heron and P Reason, "A Participatory Inquiry Paradigm" (1997) 3 *Qualitative Inquiry*, 3, 274-294.
[102] *Ibid*., 280.
[103] M Saunders, P Lewis and A Thornhill, *Research Methods for Business Students* (4th Edition, London Prentice Hall 2007) 108.
[104] *Ibid.*

they may or may not agree.[105] This methodology is subjective (as opposed to the doctrinal analysis) but is very important in this context because many rules governing Islamic finance are not based on established precepts but on the interpretation of Qur'anic verses by a given Shari'a advisory council in a particular bank or country.

The assessment of regulation from both the objective (positivist) and subjective (normative) perspectives represent the interdependence between propositional knowledge and experiential knowledge,[106] and to the extent that I discuss matters in KSA it is informed by the interdependence between propositional knowledge and my own lived experience.[107] This chapter discussed two very juxtaposed banking structures. The first banking structure which was discussed is the banking structure used in Europe and other western countries. Further, this conventional system is profit-based and risk-seeking whilst the second structure, the Islamic financial structure, is risk averse and religion-based. Whilst some opponents to the Islamic banking structure describe it as a structure that is ethical and client-oriented, western structures have been described as self-interested. In summation, Islamic finance is steeped in prohibiting the sale of debt and conventional models encourage debt in an all-encompassing way.

1.8 Summary

In this chapter, we provided signposts of how Islamic banking survived the credit crisis of 2008-09. The thesis promoted by many scholars has been that Islamic banking survived because they had less exposure to the financial instruments that had exploded during the crisis. Specifically, Islamic banking was simply not open to the business of issuing and trading risky interest rate based financial derivatives. In light of this assertion which presumes that in effect the risk management practices of Islamic banking was the cause of their survival, we have formulated our research aims, objectives, central argument, research question and methodology so that this presumption may be examined in detailed depth. In accomplishing the overall purpose of this thesis, it is essential to focus on how Islamic financial institutions can be improved via risk management and accounting standards, and whether the risk standards imposed by the Basel Accords could be used as a basis for a

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[105] *Ibid.*

[106] EG Guba and YS Lincoln, "Competing Paradigms in Qualitative Research" in NK Denzin and YS Lincoln (eds), *Handbook of Qualitative Research* (London: Sage 1994) 71.

[107] *Ibid.*

comparative methodological framework across the Malaysian, UK and Saudi Islamic banking sectors. The primary research question, i.e., "Does Saudi Arabia need to adopt the risk regulation practices of Basel?" and the other subsidiary questions, especially including "Why should Saudi Arabia adopt the risk regulation practices of Basel and other specific jurisdictions risk management practices of the UK and Malaysia?," allows us to engage in the scholarly literature in innovative ways that are closer to market practice as practitioners themselves would have to adopt, adapt and evolve their Islamic banking institutions to new risk regulations. It is in light of this motivation of improving the institutional practices that we can justifiably examine the specific risk categories and factors that effect Islamic banking across jurisdictions, and specifically within each jurisdiction. It is part of this research's argument that the philosophy and preferred methods of risk management practices should be the core of what distinguishes excellent Islamic banking from the otherwise unexceptional. We turn our attention now to those unique risk characteristics of Islamic modes of financing.

Chapter 2: UNIQUE RISK CHARACTERISTICS OF ISLAMIC MODES OF FINANCING

2.1 Introduction

As shown in Chapter 1, the expansion of the Islamic market over the recent decades has been met with peremptory demands for innovative products and mechanisms for hedging and risk management. However, unlike the conventional Western market, products and services offered in the Islamic market ought to be Shari'a-compliant.[108] Nonetheless, these products and services are used within the framework of different Islamic financing schemes that seek to comply with different and sometimes contradictory rules of the Shari'a, while simultaneously expanding trade between financial institutions and intermediaries. As noted in Chapter 1, the products and services, as well as the schemes, are distinguishable on the basis of the risks inherent in them, and these risks would attach insofar as Islamic financial institutions provide credit or handle payments are required to offer only Shari'a-compliant products and services.[109]

There is no steadfast paradigm, as well as any clear ideal or philosophy and this may be attributed to a number of reasons, including the complexity of the risk-return trade off in Islamic finance and the limited knowledge of risks inherent in Islamic financial products and services. Nonetheless, there are modes of financing that are widely used by Islamic banks in many Islamic markets across the world. These modes of financing have unique risk characteristics and this Chapter seeks to examine these unique risk characteristics. The emphasis on the modes of financing here is important because they are the instruments that provide an alternative to conventional interest-based banking, and they are implemented on the basis that they eventually lead to a fairer and more equitable distribution of resources in society.[110]

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[108] Ahmed, N_12 above

[109] H van Gruening H and SB Bratanovic, *Analysing Banking Risk: A Framework for Assessing Corporate Governance and Risk Management* (3rd Edition, World Bank, 2009) 258.

[110] M Choudhry, *Bank Asset and Liability Management Strategy: Trading Analysis* (John Wiley & Sons, Hoboken, 2007); MF Khan, "Guaranteeing Investment Deposits in Islamic Banking System" (2003) 16 *JKAU: Islamic Econ* 45; A Habib "Withdrawal Risk, Market Discipline and Efficiency in Islamic Banking" in T Khan and D Muljawan (eds) *Islamic Banking Stability: The Role of Risk Management, Regulation and Supervision* (Islamic Research and Training Institute, Jeddah, Islamic Development Bank, 2006).

This Chapter begins with a brief examination of the concept of 'risk' under Islamic law. This is important because the concept has no direct equivalent in Arabic, and the term closest to risk, *Gharar*, is prohibited by some interpretations of the Shari'a. The unique risk characteristics of four modes of financing widely used by Islamic banks across the world will then be examined. These include the PLS financing modes (*Mudaraba* and *Musharaka*), Islamic savings and investment deposits, the *Murabaha* financing mode, and the *Istisna*. Prior to analysing the risks that these modes of financing carry, the way in which they are used by Islamic banks will be discussed briefly.

2.2 The Concept of Risk or Uncertainty

As noted in Chapter 1, the term 'risk' is used here to described the vulnerability of asset values and opportunities for the Islamic bank to generate additional income. As rational institutions, they ought to factor in the vulnerabilities in their operational strategies and take advantage of the opportunities to create additional wealth. As noted above, the term closest to 'risk' in Islamic literature is '*Gharar*' and unlike the former, the content of the latter is subject to much uncertainty.[111] It has been held to signify some kind of uncertainty, risk or hazard exposing oneself or one's property to damage without being aware of the exposure or damage.[112] It may be related to the concept of *Taghreer* which means deception or misrepresentation.[113] Thus, where a person exposes himself or his property to damage while aware of the exposure, he will be liable for deceiving the other party. Nonetheless, it is uncertain whether a transaction imbedded with risk or *Ghārār* would be voidable and not void, depending on whether the party that exposed the transaction to the risk was honest. What is certain is that it is 'uncertainty or ambiguity in a contract which may render it void.'[114] The definitions used by the Hanifi and Sha'fi Schools is also similar to that used by UNCTAD: 'uncertainty over the existence of the subject matter of sale.' However, Ibn Hazm of the Zahiri School emphasised the honesty and ignorance of the parties by stating that '*Ghārār* in sale occurs when the purchaser does not know what he has bought and the seller does not know what he has sold.' Given the lack of standardised rules, there is much

[111] A Al-Saati, "The Permissible Gharar in Classical Islamic Jurisprudence" (2003) 16 J KAU: Islamic Econ 3, 5-7.
[112] *Ibid*, 6.
[113] *Ibid.*
[114] UNCTAD, *Islamic Finance and Structured Commodity Finance Technique: Where the Twain can Meet* (UNCTAD, 2006) 27.

difficulty determining the degree of uncertainty that would result in *Ghārār* and the consequence of *Ghārār* in a transaction.

The Qur'an does not expressly prohibit *Gharar*. It states as follows:

> 'And do not eat up your property among yourselves for vanities, nor use it as bait for the judges' (2: 188)
>
> 'O ye who believe! Eat not up your property among yourselves in vanities; but let these be amongst your traffic and trade by mutual good will' (4: 161).

These passages are cited in the analysis of *Ghārār* because it is assumed that the term 'vanity' is used in them to refer to uncertainty and ignorance.[115] However, it is difficult to establish a link between vanity and uncertainty or ignorance. Despite the uncertainty as regards the meaning and content of *Gharar*, some previous Islamic scholars reported that it was prohibited by the Prophet's (Peace and Blessings be upon Him and his Companions) companions in trading.[116] Thus, where *Ghārār* is identified in a transaction, it is considered null and void. It has further been noted that the prohibition extends to all forms of *Gharar*.[117] Despite the above, it may not be said that *Ghārār* is the direct equivalent of risk given that all financial transactions are embedded with several types of risk, and there are even more risks inherent in many Islamic transactions. What this demonstrates is that the first obstacle to developing a framework for the standardisation of risk management in Islamic banking is the lack of consensus on what constitutes 'risk.' For the purposes of this dissertation, Gharar will be defined as *excessive* risk. Mehran, Morrison, and Shapiro define excessive risk as having an element of a breakdown in control.[118]

2.3 The Profit/Loss Sharing Schemes

There are two widely used profit/loss sharing (PLS) schemes in Islamic markets: the *Musharaka and* the *Mudaraba*. These are modes of financing that involve the investment in selected projects by banks and sharing in the profits and losses with the entrepreneurs or owners of the projects. The origin of *Musharaka may* be traced to the '*Sharika*' which means

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115 Al-Alim YH (1415 AH), *Al-Maqasid Al-Ammah li'l Shari'a Al-Islamiyyah*, 415-520.
116 Al-Amidy, *Al-Ihkham ft Usul Al-An-Ahkam* (1332 AH) 2/257-272.
117 *Ibid.*
118 H Mehran, A Morrison and J Shapiro, *Corporate Governance and Banks: What Have we Learned from the Financial Crisis?* (Federal Reserve Bank of New York Staff Reports. No. 502. June 2011. JEL classification: G01, G21, G32, G39).

partnership.[119] Thus, the *Musharaka is* a form of partnership or joint venture in which profits are shared on an agreed ratio while losses are shared in proportion to each partner's investment.[120] All the parties to the *Musharaka* are required to provide capital and take part in the management of the project. However, the agreement is concluded once the principal amount on the loan is repaid.[121] A distinction should be made between the *Musharaka* and fixed income investments (bonds or money market securities) whereby the investor makes a loan to a corporate or government borrower who promises to pay a fixed amount of interest on a regular basis on a predetermined maturity date. At maturity the corporate or government borrower then returns the principal amount or par value of each bond to the investor.[122] Given that Islamic law prohibits the charging of *Riba*, Islamic banks cannot accept fixed income investments.

Nonetheless, the *Musharaka is* similar to fixed-income securities that create an obligation to pay dividends or other form of income. In conventional financial markets, companies may raise money to finance acquisitions or buy equipment by giving up equity to the investor and repaying the principal on the loan at maturity. Similarly, in Islamic markets, the *Musharaka* mode of financing enables businesses to raise money for projects by giving up a share of the projects to the bank. They then share in the profit and losses in accordance with their contributions to the projects. The difference between the *Musharaka* and fixed income securities is that the bank investing in the *Musharaka* agreement does not accept any payment for the use of its money. However, the profits earned by the bank through the investment may be deemed to be a fee paid to the bank as a form of compensation for the use of its money. This relates to the argument on the legitimacy of the *Sukuk* or Islamic bond or financial certificate which essentially requires the payment for the time-value of money and may be deemed to be similar in appearance to *Riba*. Equally, in many cases, there is a guaranteed return and repurchase obligations from the issuer.[123] Thus, it is uncertain whether Shari'a actually prohibits the payment for the time-value of money or payment for anything agreed by the parties as interest. However participants in Musharaka schemes, as well as *Sukuk* investors know that they are investing in assets and not currency, and rely only on the return

[119] LH Lahsasna, *Sharí'a Non-Compliance Risk Management and Legal Documentation in Islamic Finance* (John Wiley & Sons Singapore 2014).
[120] *Ibid.*
[121] I Ferbianto, "Adapting Risk Management for Profit and Loss Sharing Financing of Islamic Banks" (2012) *Modern Economy* 73, 74.
[122] SE Simko, *Strategic Fixed Income Investment* (John Wiley & Sons Hoboken 2013) 4-5.
[123] MT Usmani, *Sukuk and their Contemporary Applications* (AAOIFI, 2007) 3-4.

on the assets that take the form of rent. Thus, the appeal of the *Musharaka and Sukuk* to Islamic bankers and entrepreneurs depends on the fact that they are Shari'a-compliant, as well as enhance the productivity or value of the underlying asset.

On the other hand, the *Mudaraba* mode of financing is also widely used by Islamic banks across the world. The term *Mudaraba* generally refers to an agreement between two or more persons whereby one person provides the finance and the other provides the expertise and/or labour and management to conduct a business that is geared towards making profits.[124] The latter is called the *Mudarib*, while the capital provider is referred to as the *Rabb al-mal*. The *Mudarib* uses the funds in the manner agreed by the parties (such as to buy specific equipment), and then returns the principal and a share of the profits to the *Rabb al-mal* over an agreed period of time. The *Mudarib* might neither guarantee the capital nor the profits, although he may provide guarantees or financial sureties. Also, the *Mudarib* is not liable for any losses except for misconduct, negligence[125] or breach of the terms of the contract.[126] Despite the fact that the parties have agreed and make purchases and payments in accordance with the terms of their agreement, the *Mudaraba* contract is not binding before the *Mudarib* begins carrying out the project and it may be terminated unilaterally by any of the parties.

Essentially, the main difference between this particular interest-free banking product and a conventional interest-based banking product is that, under the latter, the profit is fixed in advance or is a simple linear function of some other benchmark rate, and irrespective of the extent to which the borrower has profited or lost money from the underlying enterprise. In the former, the profits and losses on a physical investment are shared between the creditor and the debtor according to a formula which relies on the astuteness, judgment and hard work of the *Mudarib* - matters which can not necessarily be guaranteed. [127]

Although the Shari'a standards maintained and promoted by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) are not observed by Islamic financial institutions around the world, they provide guidance that may be helpful in the standardisation of rules governing the buying and selling of products and services in the

[124] UNCTAD, N_116 above, 20.
[125] van Greuning, N_47 above
[126] UNCTAD, N_116 above, 20.
[127] HA Hamoudi, "The Impossible, Highly Desired Islamic Bank" (2014) 5 *William & Mary Business Law Review* 1, 104,115.

Islamic financial market.[128] According to the AAOIFI Guidelines 2008, the *Mudaraba* contract may be terminated by either party under the following circumstances: the unilateral act of one of the parties before the commencement of business activity; where both parties agree to terminate the contract; at the conclusion of the contract's maturity date; where the funds for the scheme are exhausted due to sustained losses; where the *Mudarib* passes on; and the liquidation of the institution acting as the *Mudarib*. It is arguable that the bankruptcy of the person acting as the *Mudarib* may also lead to the termination of the *Mudaraba* contract. Although the *Mudarib* is not required to use the *Mudaraba* fund as his personal fund the general law of England prohibits the intermingling of trust and personal funds.[129] There is a *fatwa* supporting the proposition that the Mudaraba contract requires the capital fund to be held as trust property,[130] and if it is sufficiently clear to constitute a trust document, the *Mudarib*'s bankruptcy should not have any relation to the *Mudaraba* contract apart from the fact it may prevent him from effectively carrying out the functions of the *Mudarib*. There is common law authority however that a bankrupt may not be a trustee,[131] and the better view is therefore that a *Mudarib* ought not become bankrupt and that proper risk management ought require the capital to be returned in such an event.

2.3.1 The Unique Risk Characteristics of the PLS Schemes

Given the absence of the requirement of collateral, there is a relatively high level of risk and hazard that Islamic banks have to confront. They are required to have very high expertise in evaluating projects, taking into account the local fiscal policies and the accounting and auditing systems of the entrepreneurs. This even more challenging where the bank invests in several PLS schemes at the same time. The most pressing challenge is therefore the identification of specific risks to which each project is exposed.[132] This implies that additional monitoring costs are incurred by the bank, and the depositors of the bank must be

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[128] AAA Karim, *Accounting and Auditing Standards for Islamic Financial Institutions* (Proceedings of the Second Harvard University Forum on Islamic Finance: Islamic Finance into the 21st Century Cambridge, Centre for Middle Eastern Studies, Harvard University 1999) 239-40.

[129] As to this breach of fiduciary duty and the trust in favour of the owner of capital which would arise as a consequence see *Lloyds Bank plc v Rosset* [1991] 1 AC 107 *Stack v. Dowden* [2007] UKHL 17 *Gissing v Gissing* (see especially Lord Reid [1971] AC 886 at 896 - 897 and Lord Diplock at 909)*Muschinski v Dodds* (1985) 160 CLR 583 (High Court of Australia)

[130] M Safari, M Ariff, and S Mohamad, *Sukuk Securities: New Ways of Debt Contracting* (Wiley Singapore 2014) 58.

[131] *Miller v Cameron* (1936) 54 CLR 572 at 575 (High Court of Australia); *Bainbrigge v Blair* (1839) 1 Beav 495; 48 ER 1032; *Re Barker's Trusts* (1875) 1 Ch D 43.

[132] V Sundarajan and L Errico L, *Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead* (IMF Working Paper WP/02/192 2002).

prepared to take the risk of losing the entire deposit in an investment made by the bank. This is especially problematic given the depositors have not consented to invest, albeit indirectly, in the PLS scheme. Also, banks may find it especially challenging to invest in PLS schemes in countries where there are no credible rating institutions that monitor citizens and businesses and ascertains their credit rating on a consistent basis.

Before banks enter into a financing contract, they must evaluate imperfect information about a prospective *Mudarib* whether they are creditworthy. Information supplied by an applicant can be difficult to verify, and other information may be hard or costly to obtain. The information that a prospective *Mudarib* provides to a bank might be sufficient to make a decision as to whether or not to enter into a PLS without a *kafala*. However, the information is usually incomplete – and therefore asymmetrical - in the sense that a potential *Mudarib* will know more about the risk of his proposed project, his ability to work, his state of health and his personal capacity, than he reveals to the bank.[133] There is a further problem that a potential *Mudarib* will often have a more favorable view of his/her own abilities and propensity for hard work than an objective view would justify.[134]

Due to this information asymmetry, poor credit decisions would result in the increase in the number of non-performing loans. This is particularly the case where the borrower has no collateral to lose. With only his own time and effort to lose, there is nothing a bank can do to induce a borrower's effort to avoid repayment problems. Thus, absent a *kafala*, or guarantee of the borrower's behavior, loan terms may have little feedback effect on behavior, particularly of higher-risk borrowers who are more difficult to induce into exerting effort.[135] Ironically, it is the Islamic banking institution with a high appetite for risk that is more likely to invest in the PLS schemes.[136] This shows that *Ghārār* may not be the equivalent of risk since there are many risks embedded in the PLS financing modes that Islamic banks use in lieu of the interest-based financing modes of conventional banks. The PLS schemes have not been challenged on the grounds that they are *Gharar*. They are actually promoted as models of Islamic banking. Islamic banking institutions investing in these schemes are however forced to function as universal banks whereby they provide a wide variety of financial

[133] JE Stiglitz and A Weiss, "Credit Rationing in Markets with Imperfect Information" (1981) *American Economic Review* 71, 393.
[134] PK Berger, *The Role of Fear for Entrepreneurial Venture Creation: Causes of Failure* (Springer 2015) 218.
[135] W Edelberg, *Testing for Adverse Selection and Moral Hazard in Consumer Loan Markets* (US Federal Reserve Board Publication February 2004).
[136] van Greuning, N_47 above, 16-23.

services, beyond the traditional services provided by commercial banks. These include receiving deposits and providing working capital finance.[137] Universal banking therefore combines commercial banking, investment banking and insurance, and was particularly popular in former West Germany whereby the banks provided both short-term and long-term loans, made direct investments in other firms, conducted business in securities, and drew resources from bonds, savings certificates and time deposits.[138] Islamic banks currently provide all these services and the advantages of one financial institution providing a range of financial services include lower average cost of marketing, higher output and products of a better quality. Where the banks have been able to communicate positive, complete and accurate information about their portfolio risks to stockholders, the confidence in their stock was enhanced.[139] By expanding the scope of services, they spread the fixed cost of managing client relationship over a wider set of products.[140] Also, they may be able to capitalise on their good reputation established in one product or service to market other products or services; and customers would also save on searching and monitoring costs.[141] Also, there is no credit risk inherent in universal banking given that in the event of liquidation of the project in which the bank has invested, the bank has no liability over the debtors as it is a type of partnership. Thus, no capital amounts may be claimed before the obligations of the entrepreneur or *Mudarib* are met.[142]

However, there are also many disadvantages. Universal banking leads to the reduction of competition; and financial risks are then concentrated at individual universal banks.[143] This implies that the risks inherent in the products and services of such an institution are systemic. Thus, any failure would have far reaching consequences on the entire financial system. As such, the bank that provides a wide variety of financial products ought to have the requisite capacity and risk management mechanism to identify and mitigate the various types of risk involved. However, previous studies have shown that only the largest Islamic banks have the requisite capacity or the expertise to set up an effective mechanism to identify and mitigate

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[137] KC Shekhar, *Banking Theory and Practice* (19th Edition, Vikas Publishing, Mumbai, 2005) 22.
[138] H Francke and M Hudson, *Banking and Finance in West Germany* (Routledge New York 2012) Chapter 3.
[139] CW Calomiris, "The Cost of Rejecting Universal Banking' in Lamoreaux NR and Raff DMG," *Coordination and Information: Historical Perspectives on the Organisation of Enterprise* (University of Chicago Press 1995) 292-293.
[140] van Greuning, N_47 above, 268-9.
[141] H Askari, Z Iqbal and A Mirakhor, *New Issues in Islamic Finance and Economics: Progress and Challenges* (John Wiley & Sons, 2009).
[142] RA Salem , Risk Management for Islamic Banks (Oxford University Press, Oxford) 5.
[143] V Dutta and K Singh, *Commercial Bank Management* (McGraw Hill Education, New Delhi, 2013) 21.

the risks.[144] Determining the quality of a potential *Mudarib* produces various adverse selection problems—especially when debt is available from conventional banks. IBs will attract applicants with inside and undeclared knowledge that their project is highly risky, and those who inflate their declared expectations of profit in the hope of being quoted a lower profit-share ratio by an IB.[145] Consequently, IBs need have to undertake costly project appraisal and that cost is properly passed on to the *Mudarib*. IBs also need to get a kafala for each loan in order to manage the risk, or to take managerial share-holdings. Secondly, the moral hazard problem also exists with Islamic banking after the loan is made. Relating the bank's return to the *Mudarib's* declared profit automatically gives the borrower an incentive, absent an audit (the cost of which increases the costs to the *Mudarib*) to under-report declared profit or take extra expenses and inflated wages. [146]

The study of the behaviour of some Islamic banks in the market conducted by Iqbal reveals that many Islamic banks actually avoid the PLS financing schemes altogether for reasons including the reluctance to keep detailed records of customers, the difficulty of expanding the banks' operations due to limited opportunities to re-invest retained earnings, the increased costs resulting from the need to set up monitoring mechanisms, the unwillingness of depositors to be involved in long-term projects, and the difficulty of obtaining information about the entrepreneurial abilities of the customers.[147] That is, the cost of countering information asymmetry is too great. Other studies have revealed that Islamic bankers are reluctant to implement PLS schemes because they are deemed to have higher credit risk, especially as regards the payment to bankers of their due profit share by counterparties.[148] These banks are also exposed to high market and liquidity risk, as well as high volatility in gains or loss of capital.

Nonetheless, the main risk inherent in the PLS financing modes that Islamic banks find difficult to ascertain and manage is the equity investment risk. This is the risk that arises from entering into a partnership with the goal of participating or providing financing for a particular business activity as specified in the contract. Given that it is a form of partnership

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[144] Ahmed, N_12 above; Salem, N_145 above; van Gruening, N_47 above.
[145] V Nienhaus, "*Profitability of Islamic PLS Banks Competing with Interest Banks: Problems and Prospects*" (1983) *Journal of Research in Islamic Economics*, 37-47
[146] Hamoudi, N_129 above.
[147] M Iqbal, *A Guide to Islamic Finance* (Risk Books, London, 2007) 22.
[148] INCEIF, *CIFP Part 1 Study Material, Islamic Economics and Finance: Theory and Ethics* (INCEIF, Kuala Lumpur, 2006) 8.

or joint venture, the party that provides the finance does so in for form of equity, not debt. Accordingly the IB shares in the business risk.[149] However, in both the *Mudaraba* and *Musharaka*, the provider of finance is a silent partner with no control power over the management after the activities have commenced, rather like a limited partner in general law, despite the fact that in the case of failure it bears all the loss (*Mudaraba*) or part of the loss (*Musharaka*). As at general law, being the “limited”[150] partner, the bank is highly exposed to the risk of capital loss. This is the risk of incurring loss due to the decrease in value of a capital asset (in this case, investment).[151]

The equity investment risk that the IB as the financing partner faces is different from equity price risk, which is the risk of changes in the equity prices of investments in marketable securities.[152] It is a risk of total equity from failure of the business, as opposed to a fall in the market price of a security.

Nonetheless, in both instances, the bank is required to reduce the risk by combining its stock portfolio with a protection overlay for price risk management.[153] According to Berenberg Bank:

> Protect overlay management is generally understood to be the targeted management of specific price risks of an underlying portfolio by means of derivatives, such as forwards, options and swaps. It is implemented in isolation from the underlying portfolio, in a separated overlay portfolio… [Whenever a] liquid hedging instrument is available... By clear separation of the alpha and beta management, systematic protect overlay management reflects the on-going progress in the splitting of the value chain in asset management…. As risk management [f]or a stock portfolio, its simplest form is ongoing hedging with put options. Trend-following futures strategies offer a dynamic alternative. [154]

That might work for large businesses but it won’t work for small ones which do not trade in an asset for which a derivative such as a forward contract might be available. Generally it will work for organisations which produce goods better than those which produce services: there are forward contracts for wheat, wool and coffee beans but not for haircuts, bicycle repairs or meals served in cafeterias. Further, even in large businesses, such a risk

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[149] Ahmed, N_60 above, 32.
[150] Limited Partnership Act 1907; Limited Liability Partnerships Act 2000.
[151] Ibid, 56.
[152] M Heiden, *Dynamic Hedging of Equity Price Risk with an Equity Protect Overlay: Reduce Losses and Exploit Opportunities*, Euromoney Hanbook GIFR (Euromoney Publications, London, 2006) 2.
[153] *Ibid*, 2-3.
[154] *Ibid.*

management strategy requires detailed and accurate information about the positive performance of the asset or stock over the past years in order for liquid hedging to be possible.[155] Unfortunately, previous studies have shown that it may often be difficult to collect such information about assets in many Islamic markets around the world that have large informal sectors. This is what Mannan described as ‘a vast non-corporate and voluntary sector’ that dominates the industry.[156] However, it is interesting that Mannan then argues that the existence of this vast informal sector implies that the free market mechanism whereby resources are made available on the basis of purchasing power rather than need is not appropriate for Islamic economic analysis.[157] This argument is however flawed: although different Islamic markets are comparable, due to the common pledge to abide by rules of the Shari’a, they are not necessarily indistinguishable because the rules of the Shari’a have been interpreted in diverse ways by different Islamic regulators and traders.

One of the reasons for the diversity could be that different Islamic markets have different levels of development. For example, the Bangladeshi market has a larger informal sector than the UK market[158]; and the UK market therefore provides for opportunities to trade in more sophisticated products and services.

The informal sector of the Bangladeshi economy, for example, employs workers producing more than 40% of the gross domestic product of that country, generally in industries not requiring high capitalisation. [159] It is difficult to see how participants in the informal market can even keep basic books. That is one reason why there is a problem of lack of standardisation or methodical non-standardisation, particularly with *fatawa*: less sophisticated markets which operate on principles of micro-lending often don’t require the same degree of formal oversight because of the small scale and interconnectedness of the borrower’s

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155 *Ibid.*

156 MA Mannan, *New Frontiers of Islamic Banking in the 21st Century with Special Reference to Informal and Voluntary Sector Banking* (Proceedings of the Second Harvard University Forum on Islamic Finance: Islamic Finance in the 21st Century, Centre for Middle Eastern Study, Harvard University 1999) 275; MH Hosseini and F Aidi, “Developing an Islamic Principles-Based Marketing Framework” (2013) 3 *Journal of Basic and Applied Scientific Research* 189, 190.

157 Mannan, N_159 above, 276. A Hassan, A Chaci and SA Latiff, SA, “Islamic Marketing Ethics and its Impact on Customer Satisfaction in the Islamic Banking Industry” (2008) *Journal of Islamic Economic* 23.

158 Asian Development Bank and Bangladesh Bureau of Statistics. *The Informal Sector and Informal Employment in Bangladesh* (Philippines Asian Development Bank 2012).

160 *Ibid.*, 28

community.[160] As such, it is ill-advised to assume that all Islamic markets are generally indistinguishable.[161]

In managing the equity investment risk, the bank also has to deal with the problem of moral hazard that arises from the fact that the bank may be risk-averse but the entrepreneur may have a strong appetite for risk.[162] This, like a person's skills or ability, is difficult to assess objectively. The depositors are then confronted with a risk of loss of capital although they have not willingness accepted to invest in the project of an entrepreneur with a high risk appetite.

The level of risk however reduces significantly where the parties opt for the *Musharaka*, instead of a PLS financing scheme. This is because in the *Musharaka* scheme, both parties invest funds into the project and the capital of the entrepreneur is also at risk. The moral hazard problem is minimised because the entrepreneur is most likely to be more cautious. The bank also has the option of taking active management of the project under the *Musharaka* scheme. Nonetheless, Islamic banks have been reluctant in practice to adopt both PLS financing modes because they carry significant credit and liquidity risk, as well as equity investment risk. Thus, the banks that adopt these financing modes may lose their competitiveness in the international or non-Islamic market because unlike conventional commercial banks, they are required to handle variability in costs, revenue and profitability by actively hedging financial risk.[163] After examining the operation of several Islamic banks, Ferbianto therefore concludes these banks have been reluctant to adopt PLS financing modes for the following reasons:

- The modes are laden with risk but the banks generally have a low appetite for risk.
- The additional monitoring costs required from adopting and implementing the modes.
- The relative lack of transparency in many Islamic markets, as well as the difficulty of accessing information about assets.

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[160] M Yunus, B Moingeon and L Lehmann-Ortega, "Building Social Business Models: Lessons from the Grameen Experience" (2010) 43 *Long Range Planning*, 2–3, 308-325.

[161] D El-Hawary, W Grais and Z Iqbal, "Regulating Islamic Financial Institutions: The Nature of the Regulated (World Bank Policy Research Paper 3227 2004).

[162] Mannan, op cit, 33.

[163] A Iqbal and A Mirakhor, *An Introduction to Islamic Finance: Theory and Practice* (2nd Edition, John Wiley & Sons Singapore 2011) 233.

- The reluctance and/or unwillingness of depositors to take risks which may be explained by the low level of trust between the depositors and the financial system as a whole. Thus, it is generally difficult for Islamic banks to find depositors that are willing to take the risk and participate indirectly in the PLS schemes.

- The problem of information asymmetry due to lack of reliable credit rating institutions that can monitor borrowers or entrepreneurs and share information about their payment history. Islamic banks equally require more resources to be able to monitor their customers or potential customers and determine their credit worthiness, as well as which loans are potentially non-performing.[164]

2.4 Risk of Inconsistent *Fatawa*

Finally, there is a risk of a fatwa being issued which renders haram what was previously considered halal. This is a risk separate from being non-compliant with Shari'a *ab initio*. [165] This might affect repayments.

For example, On Jan 28th, 2009, the Anjuman Committee[166] of the town of Kolar in the state of Karnataka, in south India, issued a fatwa banning all Muslims from repaying their microfinance loans claiming that paying interest was haram. The fatwa led to immediate non-repayment by Muslims clients. As a result, borrowers in Muslim-dominated groups faced, after the ban, a greater repayment burden compared to borrowers in Hindu-dominated groups. The relevance of a minor group of defaults on the basis of an inconsistent fatwa being issued cannot be grasped without an understanding of the argument over the status of *sukuk* and other banking instruments in the Gulf region after AAOIFI's Sheik Taqi Usmani opined that 85% of Islamic bonds were *haram*, [167]which contradicted long-standing opinions in their favour:

In the 1930s, Syrian scholar Marouf al-Daoualibi suggested that the Qur'an bans interest only on consumption loans, not investment loans, and in the 1940s Egyptian jurist al-Sanhuri argued that the Qur'an sought chiefly to ban [compound]... interest. A more extreme and

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164 Ferbianto, N_123 above, 74.
165 A Arakcheev, V Baklanova and J Tanega, "Islamic Money Management: A Western View" (2011) 6 *Capital Markets Law Journal* 2, 238.
166 An *anjuman* is a social organization of Muslims in most of the cities and towns of South India.
167 See for example http://news.bbc.co.uk/2/hi/business/8401421.stm

recent example is the opinion of the mufti of Egypt, Shaykh Muhammad Sayiid Tantawi, who in 1989 declared that interest on certain interest-based government investments was not forbidden *Riba*, because the gain is little different from the sharing of the government's profits from use of the funds, thus joining the thin ranks of prominent religious figures who have issued *fatwas* declaring clear interest practices permissible. This *fatwa* aroused a storm of controversy, with opposition from nearly all traditional religious scholars and warm praise from secular modernisers. Later he went even further, saying that interest-bearing bank deposits are perfectly Islamic, and more so than 'Islamic' accounts that impose disadvantageous terms on the customer. [168]

Some might argue that not all interest is riba and that interest on bank deposits and interest charged on loans are lawful if they are not excessive (5-15%). They do so on the basis of the saying of the Companion of the Prophet (Peace and Blessings be upon Him), Umar Ibn Khatab who noted that the Riba related verse was the last verse revealed and that the Prophet (Peace and Blessings be upon Him) did not explain it in detail. `Umar delivered a sermon on the pulpit of Allah's Messenger (Peace and Blessings be upon Him), saying… "I wish Allah's Apostle had not left us before he had given us definite verdicts concerning … various types of *Riba*." On the basis of that saying there is a minority opinion that banks invest and their profits are passed on to the depositors. Since all parties are happy and no one is victimized, it is perfectly lawful to take interest from the bank [169]

Indeed, this appears to have been the situation at least for Muslims in non-Muslim countries before the establishment of accessible Islamic banking! For example, Bilal Cleland's excellent history of Muslims in Australia[170] charts their integration into that society from the first migration of Afghan camel drivers in 1860; there is no evidence of any Muslim co-operative banking prior to the 1980s in that country, despite Cleland's claim of workers being paid, saving and giving money to charity. There are opinions both in favour and against this practice:

The relaxation of what would otherwise be a Qur'anic prescription continues for as long as it is found beneficial to the society, because "necessities justify that which may be unlawful."

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[168] F Vogel and SL Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Kluwer Law 1998).
[169] Qur'an 2:275; Ibn Majah, Sunan Ibn Majah, tr. M. T. Ansari (New Delhi, 2000), Book of Inheritance, Vol. 4, #2267
[170] B Cleland, *Muslims in Australia: A Brief History* (Islamic Council of Victoria 1980).

There are counter-rules to prevent the misuse of the permissibility and relaxation. One such counter-rule, as laid down by some jurists, reads as, "one can't exceed the permission given one".[171] To take another example, IBs in India have mobilized only 0.37 per cent of the savings of Indian Muslims, and only 13 per cent of urban Indian Muslims have an account in an Indian IB.[172]

Of the many possible and contradictory deductions which might be drawn from the facts set out in this section, one is that if borrowers are given a good reason which "excuses" paying a debt, they will. Some Hindu borrowers in the same community, hearing of the *fatwa*, also refused to repay.[173]

On the other hand, the fact that some of the investments made by the compulsory pension fund (EPF) in deeply Islamic Malaysia are *Haram* does not stop Malaysians from investing for their retirement in it, or enjoying the profits made.[174]

In summary, there are many more risks for IBs than for CBs, mainly based on the requirement for profit-sharing but in part on uncertainty of *fatawa*, each of which create a special risk for investors. In the next part of this chapter I will demonstrate how these risks are passed onto investors and depositors in IBs.

2.5 Savings and Investment Deposits

These may take the form of profit sharing investment accounts and may be restricted or unrestricted. There may be restrictions on withdrawals before maturity date or no restrictions on withdrawals. In both instances, the depositors rely entirely on the bank's ability to generate a profit from investments made using their deposits.[175] The investment accounts are then required to support part or all of the losses on the asset value, and this creates a problem of moral hazard for the Islamic banks. Nonetheless, demand deposits are not deemed to be simple deposits of money that may be withdrawn without prior notice but interest-free loans

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[171] SM Hasanuzzaman, The Economic Relevance of the Shari`a Maxims (1998). Retrieved from http://www.islamic-world.net/Archives/economics/economic_revelance_03.htm.

[172] M Iqbal and DT Llewellyn, *Islamic Banking and Finance New Perspectives on Profit-Sharing and Risk* (Edward Elgar Publishing 2002).

[173] X Giné, K Krishnaswamy and A Ponce, *Strategic Default in Joint Liability Groups: Evidence from a Natural Experiment in India* (World Bank 2011).

[174] NB Razak and SB Dali , *Managing Halal and Haram Investment in The Case of EPF's Malaysia* (1 Proceedings of PERKEM VIII 2013) 345-354.

[175] H Hamza and Z Saadaoui, "Investment Deposits, Risk-taking and Capital Decisions in Islamic Banks" (2013) 30 *Studies in Economics and Finance* 244, 244-5.

(*Qard hasan*).[176] This implies that they may be invested freely by the banks, and the investments may generate profits or loss. As such, it is the banks and the depositors that generally face most of the risk. Hence, savings and investment deposits may subject to excessive risk-taking by the bank – on its own behalf and as agent (*Wakalah*) for the depositor - and this may threaten the solvency of the bank while deterring potential depositors, especially in countries like the UK and Malaysia, the subject of the examinations in this thesis, where depositors have a choice between IB and CB. This is supported by the fact that despite the cultural differences and emphasis on Islam, there is nothing to suggest that the depositors in Islamic savings accounts are not similarly motivated as depositors in savings accounts of conventional (Western) banks. Modigliani and Brumberg[177] relying on the Keynesian notion of savings[178] noted that the main motive of saving is the maximisation of a person's lifetime utility or accumulation of wealth for retirement. They however stated other motives which include increasing the estate of one's heirs, adjusting income to irregular consumption, meeting emergencies, and accumulating assets in order to reduce uncertainty about future income.[179] Their emphasis on the accumulation of wealth for retirement is due to the fact that any asset on the portfolio of the individuals they observed usually satisfied more than one motive simultaneously.[180] They then argued that their saving behaviour was determined by income and consumption to the extent that they became net savers during their working years and dis-savers during retirement.[181]

Although Modigliani and Brumberg generalised their findings without necessarily taking into account the cultural influences on the individuals studied, it is submitted here that the above argument should logically be true for Muslim workers as well. Indeed this is the substance of the Malaysian Government's compulsory Employee Provident Fund.[182] However, Jalaluddin argued on his part that the Muslim saves money in order to fulfil his obligations to his family and the Lord under Islamic law.[183] In this light, it would be important to take into account the social welfare dimension of saving in Islamic markets. This is because the savings are deemed to be investments that create opportunities for increasing the welfare of the entire

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176 *Ibid.*
177 F Modigliani and R Brumberg, "Utility Analysis and the Consumption Function: An Interpretation of Cross-section Data" in Kurihara EE (ed), *Post Keynesian Economics* (Rutgers University Press, New Brunswick, 1954) 391-3.
178 JM Keynes, *The General Theory of Employment, Interest and Money* (Maruzen, 1936).
179 Modigliani, N_181 above, 393.
180 *Ibid.*
181 *Ibid.*
182 Razak, N_178 above.
183 AKM Jalaluddin, "Savings Behaviour in Islamic Framework" (1992) 2 *Economic Bulletin* 71.

Muslim community.[184] Jalaluddin's argument is supported by the Qur'an (17: 29) which commands that individuals should 'not spend everything so that [they] become blameworthy and destitute.' Also, the Hadith from Al-Bukhari intimates that the Prophet (Peace and Blessings be upon Him) used to sell the dates of the gardens of Bani Nadir and store for his family so much as would cover their needs for a whole year.[185] Nonetheless, this does not imply that there is empirical evidence that Islamic customers would necessarily prioritise their religious obligations over emergency and future needs. The empirical study conducted by Haron and Shanmugam provide some support to the above argument since its findings are to the effect that the return from the deposit is not a major incentive for Islamic bank customers to maintain funds with Islamic banks.[186] However, Sukmana and Yusef contradict the above argument because their findings indicate that there is a positive relationship between the level of deposits in Islamic banks and the rates of profit generated by the use of the deposits.[187] These findings are also similar to those of a much wider study conducted by Rohmah using the Autoregressive Distributive Lag model. The latter study shows that the level of investment deposits in Islamic banks is directly related to the return on the deposits and national income in the long-run: for example, rentals to a bank on a shared-housing mortgage reflect the long-term interest rate for a conventional mortgage of the same type, and shares of profits from mortgage businesses therefore reflect the national average.[188] Forward purchase contracts such as a commodity *murabaha* are based on the conventional profile of a fixed-income instrument.

Under commodity *Murabaha*, an investor appoints an agent to enter into an initial purchase and subsequent sale of any commodity, such as metal or oil, with a third party on behalf of the investor. The sale is arranged at the purchase price of the commodity plus a mark-up, which is normally tied to an accepted short-term index, such as LIBOR. Details of the

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[184] *Ibid.*
[185] RA Kasri and SH Kassim, "Empirical Determinants of Saving in the Islamic Banks: Evidence from Indonesia" (2009) 22 *JKAU: Islamic Econ* 181, 186.
[186] S Haron and B Shanmugam, "The Effect of Rates of Profit on Islamic Bank's Deposit: A Note" (1995) 12 *Journal of Islamic Banking and Finance* 18, 27.
[187] R Sukmana and RM Yusof, *Are Funds Deposited in Islamic Banks Guided by Profit Motive? An Empirical Analysis on Malaysia* (Paper presented at the 4th Global Conference on Business and Economics St Hugh's Colleg Oxford University 2005).
[188] N Rohmah, *Determinants of Islamic Banks' Deposits in Indonesia: An ARDL Modelling Approach* (Unpublished Thesis, International Islamic University of Malaysia, 2006).

arrangements may vary depending on the underlying commodity, timing of purchase and sale, institutions involved and settlements. [189]

Where there is a choice, persons appear to invest where the profits are, making due allowance for the risks, as long as the investments are not in *haram* industries.[190]

While some studies find that the profit motive is not an important driver of the behaviour of Islamic depositors or investors, others show that although the latter are happy to invest in Islamic banks, and that their decisions are guided by the level of returns on the deposits or rates of profit generated by their deposits or investments. It follows that the behaviour of depositors in Islamic markets is driven by a variety of motives in the same as the behaviour of depositors in non-Islamic markets. Hence, the theory developed by Modigliani and Brumberg[191] should also apply to Islamic depositors. Any asset on the portfolio of an Islamic depositor would satisfy more than one motive simultaneously.

The asset will fulfil the depositor's obligation under Islamic law, as well as increase the estate of his heirs or adjust his income to irregular consumption or meet emergencies or uncertainties about future income.

It is difficult to endorse the argument developed by Jalaluddin, Kasri and Kassim, and Haron and Shanmugam, as shown above. This is because if the Muslim saves money mainly to fulfil his obligations to his family and the Lord under Islamic law, then Islamic banks would not have difficulty finding depositors that are willing to invest in PLS schemes as discussed in the previous section. Were those theorists correct, PLS schemes would not pose any credit risk since Islamic banks would be guaranteed of a steady flow of investment funds from depositors that seek to fulfil their obligations under Islamic law. Thus, it may only be logical to assume that although religious belief may be one of the main reasons for choosing an Islamic bank (together with other factors such as benefit of products offered, service quality, and reputation of the bank), the behaviour of Islamic depositors is largely determined by income and consumption to the extent that they become net savers during their working years and dis-savers during retirement.

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189 Arakcheev, N_168 above, 238, 244.
190 Razak, N_178 above.
191 Rohmah, N_192 above, 391-3.

2.5.1 Unique Risk Characteristics

Following from the above, the rate of return on saving and investment deposits in Islamic banks creates uncertainty as regards the real value of the deposits. Islamic banks have to confront a withdrawal risk due to the fact that depositors motivated by income and consumption would be concerned by a lower rate of return. Thus, a lower rate of return may influence their decision to withdraw.[192] Since under the PLS schemes, withdrawal may be made in full before the commencement of activity, the withdrawal risk is relatively very high in Islamic banking. In this regard, asset preservation with regard to minimising the risk of loss as a result of a lower rate of return will be very important. In other words, Islamic banks have to develop effective asset preservation strategies that determine the level of risk they face and the level of control they are comfortable with. This is important because it would be impossible to set up a viable banking system that does not guarantee the protection of depositors' money.[193] However, Islamic banks seem to provide only two options to depositors: savings that do not grow for depositors that require security; and savings that may be lost in part or entirely, for depositors that would like their savings to grow significantly. Thus, higher returns are only guaranteed for depositors willing to take higher risks. The number of depositors willing to take higher risks with their savings is logically quite limited in many Islamic societies given that guaranteeing deposits and paying a reasonable return on them is a *Darurah* (need);[194] and shown above, the behaviour of depositors is determined by income and consumption.

Depositors are in much more difficult situation than investors because the former are forced to rely solely on the bank's asset preservation strategies and the legal framework within which the bank operates. The investors on the other hand can seek other guarantees since they exercise some control over the use of their money. Thus, they can monitor the use of the money closely and audit the projects. For the depositor, it would even be unfair to expect him to devise strategies for protecting his deposits. Banks ought to be set up with the capacity to assess investments, choose and diversity, and minimise risks, especially the risk of loss of capital. Hence, ideal and fair or just (*Al-adl*) Islamic banking would provide depositors with

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[192] A Habib, "Withdrawal Risk, Market Discipline and Efficiency in Islamic Banking" in T Khan and D Muljawan (eds), *Islamic Banking Stability: The Role of Risk Management, Regulation and Supervision* (Islamic Research and Training Institute, Jeddah, Islamic Development Bank, 2006).
[193] Khan, N_112 above.
[194] *Ibid.*

similar guarantees, else Islamic banks would continue to be confronted with a very high withdrawal risk. It follows, that given the motivation of depositors, the absence of the guarantee of the principal amount of deposits creates an unjust system that undermines the interests of potential depositors that cannot afford to take any kind of risk on their deposits. The latter would usually be less privileged members of society and their welfare is likely to be reduced if they are forced to rely solely on the preservation strategies of banks and regulation. It further follows that the capacity of banks to mobilise resources is adversely affected since they only attract privileged members of society who are not risk averse. There is therefore a strong case for Islamic regulators to ensure that Islamic banks guarantee the principal amount of their deposits, or at least seek guarantees from borrowers such that there is an incentive for borrowers not to dissipate capital through negligence or mismanagement, and that there is some form of asset backing on which the bank as agent *(wakil)* for its depositors can call if the borrower is in difficulty.

This is not the same as a bank guarantee. It is a guarantee given to a bank, not a guarantee given by a bank. There is a standard form of bank guarantee issued by the International chamber of commerce world business organisation (URDG 758) which is standardised internationally. Banks may issue a counter guarantee but in this case it would be issued to depositors. The guarantee envisaged in this section is a loan guarantee which could be used with respect either to debts or the conduct of an enterprise.

Amongst the arguments that support the permissibility of *kafalah* on *mudharabah* capital are the following:

Past Islamic jurists were unanimous in their opinion that when losses occur in a *mudharabah* contract, the loss is to be borne by the provider of capital and not the *mudharib* as the *mudharib*'s status is only as *amin* (trustee). A capital guarantee by the *mudharib* was not permissible. However, if it can be proven that the loss was clearly due to the *mudharib*'s negligence or intentional design, then the mudharib is to make good the capital to the investor. In British law this is analogous to a breach of a fiduciary duty. The lack of skill canvassed in the previous section is to be seen as negligence according to some scholars but not others.

Contemporary Islamic jurists have made studies on the acceptable level of capital in *mudharabah* contracts that can be guaranteed according to the perspective of Islamic jurisprudence. The main issue of concern in relation to capital guarantee is whether the guarantee given will cause the *mudharabah* contract to be nullified since it violates the *muqtadha `aqd* (the main objective of a contract).[195]

They have submitted several solutions on *mudharabah* capital guarantee, including a third-party guarantee based on *tabarru`* (voluntarily given), and a third-party guarantee based on *qardh* (debts);

Guarantees issued by a third party who has no connection whatsoever with the *mudharib* if it is done by way of *tabarru`* and is not included as a condition in the actual *mudharabah* contract.

The Shari'a Council for AAOIFI allowed for third-party *kafala* other than by *mudharib* or investment agent or business partner towards the liability of investment losses, where the the guarantee given is not tied to the original *mudharabah* contract. Kafala literally means guarantee. It is defined as a contract which combines one's *zimmah* (liability) with another person's *zimmah*.

A guarantee exists only in respect to an established liability (fungible, non-fungible, a person, or an action) guaranteed by a debtor, where it is possible to collect from the guarantor, in respect of a guaranteed financial debt must be valid and binding liability. [196]

It is not permissible to take remuneration for issuing a letter of guarantee, if the remuneration is intended as consideration for the guarantee per se, since the amount guaranteed and the duration of the guarantee are usually taken into consideration in computing remuneration, so the guarantees cannot be traded. [197] They can therefore be used to secure the deposits and investments of depositors in IB.

The *Mudarib* may for example be required by the regulator to compensate for any loss of the principal amount of the capital in a PLS scheme. Also, the recipient of the capital may be required by the regulator to repay more than the principal amount; although this may be deemed to be payment of *Riba*. But then again where banks guarantee all deposits, both

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[195] Retrieved from http://docslide.us/documents/guarantees-for-mudharabah-capital.html
[196] AZM Shaarani, *Shari'a Contracts : Tabarru` (Charity) Contracts*. Retrieved from http://e-muamalat.gov.my/sites/default/files/kertas_ilmiah/2011/03/tabarru_contract zakirullah_ibfim__portal.pdf.
[197] *Ibid.*

savings and investments, the depositors would receive a profit from the investments in PLS schemes. It is suggested that there is no risk of loss, and that this may then be contrary to the principle of *Al-kharaj bi-aldama*, which is derived from the Hadith and requires the entitlement to profit to be dependent on liability for attendant risk of loss.[198] However this is only, is suggested, in accounts without FSCS deposit guarantees. Most accounts in the UK are only guaranteed to £85,000. Depositors with deposits above the limit may also receive additional funds in the form of a share of their savings following any distribution of assets as part of the insolvency process. How much they receive depends on the dividend in the liquidation of the bank.[199]

So whilst Shari'a emphasises the importance of mutual risk-bearing in investor-entrepreneur relationships, the limits of the Deposit Guarantee Scheme may mean that all guaranteed accounts up to £85,000 are guaranteed. Hence, Islamic banks may be required by the regulator to guarantee the principal amount of all deposits and only a certain percentage of investments. As pointed above, in the absence of guarantees, Islamic banks are confronted with a relatively high withdrawal risk. It must nonetheless be pointed out that there are many deposit schemes based on contracts such as *Wadi'ah Yad Dhamana* (guaranteed safekeeping) and *Al-Qard* (loan) whereby the principal deposits are guaranteed irrespective of the bank's profitability. This implies that some depositors may actually guarantee the full amount of their deposits without relying on the bank's strategy or the regulator. However, this is only in cases where the banks are willing to accept such contracts.

Because of the operation of the FCSC Deposit Guarantee Scheme, however, this does not present a new business model for banks – most deposits in the UK would fall under this scheme.

2.6 Murabaha Financing

This is also referred to as *Tawarooq* and is a fiduciary sale (*Bayu-al-amanah*). It is related to other types of sale that are geared towards fixed and secured profits such as deferred payment sale (*Bai' bithaman 'ajil*), the purchase with delivered delivery (*Bai' al-salam*),

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[198] J Iqbal, *Islamic Financial Management* (Global Vision, 2009) 217; S Al-Suwailem, "Risks in Turbulent World: Inside from Islamic Finance" in RAA Karim and S Archer (eds) *Islamic Finance: The Regulatory Challenge* (John Wiley & Sons Singapore 2013) 85.
[199] EC Council Regulation on Insolvency Proceedings (1346/2000).

commissioned manufacturing (*Bai' al-istisna*) and the *Ijara* (leasing).[200] The *Murabaha* financing mode is set up like a buyer's credit and used for complex structured financings in Islamic markets. It may also be used for securitisation, whereby assets are financed on the back of fees to be paid by the buyer or borrower under long-term contracts.[201] It therefore involves the purchase of an asset by the Islamic bank from a third party broker and the sale of the asset to a borrower at a cost plus a specified profit. However, the borrower or customer defers the payment of the sale price or pays in instalments as agreed by the parties. The borrower may enter into a subsequent contract to sell the assets to the broker for the cost price. The transactions are *Riba*-free and therefore compliant with the Shari'a. There are certain obligations imposed on the seller to ensure that no interest is charged and excessive profits are not made. Thus, the seller must expressly mention the cost it has incurred on the assets for sale and sell them to another party by adding a declared profit or mark-up.[202]

The *Murabaha* financing mode may be used by Islamic banks in different ways, depending on the market. However, they generally use this instrument in asset financing, buying and selling property, import-export and microfinance.[203] Nonetheless, they are not supposed to be used where the PLS financing modes (*Mudaraba* or *Musharaka*) are practicable, and where the risks can be shared more equitably between the seller and the buyer.[204] This implies that the *Murabaha* should not be the bank's first choice of financing despite the fact that unlike the PLS modes, it ensures a more predictable income and carries less risks. However, it is uncertain the extent to which Islamic banks abide by this rule given that, as noted above, studies have shown that the use of the PLS financing schemes declined significantly at the turn of last century. Yousef for example found that the bulk of investments undertaken by the Islamic banks studied included short-term financing through the *Murabaha* and debt-based contracts.[205] Iqbal and Molyneux also noted that many Islamic banks prefer debt-like instruments similar to the *Murabaha* to provide external finance.[206]

There is a problem with the sale of the property on terms: Many modern personal property security laws apply to any transaction such as *Murabaha* that, in substance, creates a security

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[200] M Obaidullah, *Islamic Financial Services* (Islamic Economic and Research Centre, King Abdul Aziz University Jeddah 2005) 113-5.
[201] *Ibid.*
[202] Iqbal, N_166 above, 233.
[203] *Ibid.*
[204] *Ibid.*
[205] TM Yousef, "The Murabaha Syndrome in Islamic Finance: Laws, Institutions and Politics" in Wilson R (ed), *The Politics of Islamic Finance* (Edinburgh University Press, Edinburgh, 2004) 63-80.
[206] Iqbal and Molyneux, N_176 above.

interest. In the past, courts have determined that where the transaction was in fact a financing one – that is, in cases including a *Murabaha* - the interest has to be perfected under the relevant personal property security regime.[207]

Also, a study conducted by UNCTAD on structured commodity finance in the Islamic market revealed that the *Murabaha* financing accounted for more than half of all the financing provided by Islamic financing institutions across the world.[208]

This has been criticised:

> Islamic liquidity funds established under *Murabaha* agreements expose their investors to a number of additional risks above and beyond those borne by [conventional] investors…. The structure established to manage the commodity exposure is operationally cumbersome and could be expensive to run. The presence of an escrow agent entails additional operational and regulatory/legal risks. [209]

Accordingly, Islamic liquidity funds established under *Murabaha* agreements are unlikely to be viewed as comparable with conventional MMFs or direct investments in short-term securities in terms of their risk/return characteristics. Investors in conventional MMFs can be, in turn, disadvantaged by the presence of Islamic liquidity schemes in their funds due to the non-transparent nature of their cash flows.[210]

These risks are in no way alleviated by the many practical guidelines that the parties are required to follow. The bank may for example take constructive or actual possession of the asset before selling it to the borrower. Constructive possession is particularly important in banking transactions given that in many cases, the assets are intangible and do not change hands, and there are only cash-flows between the broker, bank and borrower. The bank is therefore able to buy and sell the assets and generate a profit without actual possession of the asset. However, the bank cannot rescind the agreement in the event of late payment or non-payment but may charge an additional margin taking into account the time value of money that was not paid in time. Nonetheless, it is uncertain whether the borrower or customer may not challenge the charging of the additional margin as Riba, which is prohibited by Shari'a. This is equally the case with ay any penalties for late payment that the bank may impose.

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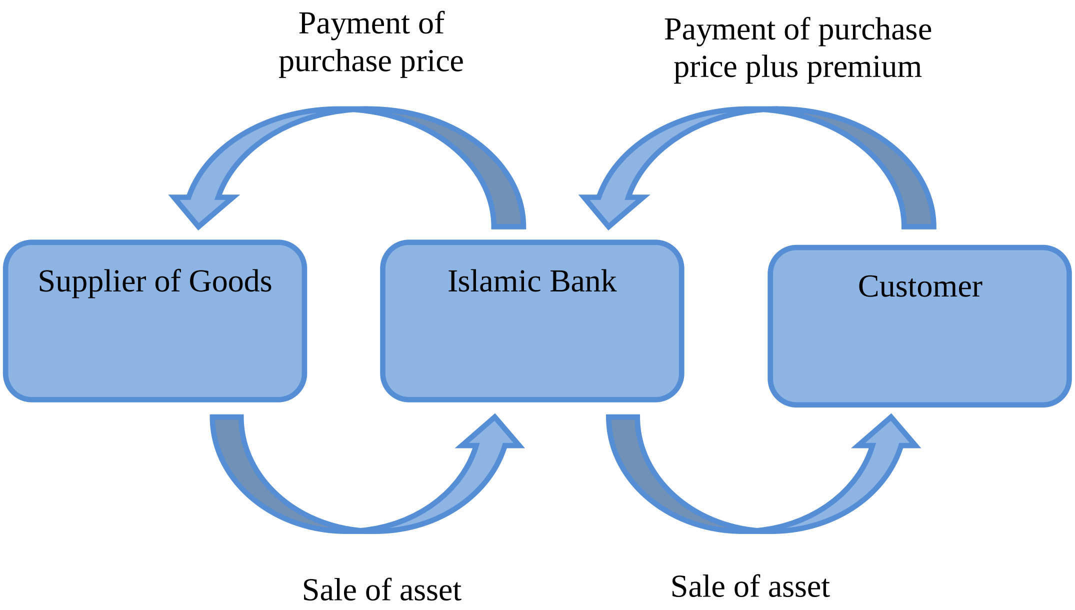
[207] I Davies, "The Reform of English Personal Property Security Law: Functionalism and Article Nine of the Uniform Commercial Code" (2004) 24 *Legal Studies* 295-321.
[208] UNCTAD, N_116 above.
[209] Arakcheev, N_168 above.
[210] *Ibid.*

The *Murabaha* contracts are attractive to banking institutions because the rate of return is predetermined or fixed, the evaluation and monitoring of projects does not require many resources, and the risk of default is low compared to the PLS financing schemes. They are also attractive to entrepreneurs because the rate of return is fixed along a specific payment period, there is no charge per se for default, and the asset or commodity that is being purchased is treated as collateral.[211]

Figure 1: A Murabaha contract



2.6.1 Unique Risk Characteristics

Despite the above advantages, the use of the *Murabaha* as a financing mode carries several risks that must be taken into account by the Islamic bank. The risks include price risk, default risk, commodity risk and market risk. They are examined in the subsections below.

[211] R Ismal "Assessing the Moral Hazard Problem in Murabahah Financing" (2009) 5 *Journal of Islamic Economics, Banking and Finance* 101, 102.

2.6.2 Price and Default Risks

The price risk is based on the volatility of the price of the asset during a given financing period. The bank as the purchaser of the asset at spot value is required to declare the price and resell the asset to the borrower or customer at the same price plus an agreed profit. The fact that the market price may have changed significantly before the bank sells the product to the customer is not taken into account.[212] Thus, the customer or borrower might potentially benefit unjustly from the transaction where the price of the asset or commodity being financed has increased significantly since the bank purchased the asset. Equally, the customer may suffer a potential loss where the market price of the asset has fallen significantly since it was purchased by the bank. Given the lack of standardisation, there is no steadfast Shari'a-compliant means by which the customer or bank may avoid the loss. In practice, they are forced to continue with the *Murabaha* contract until maturity in the hope of realising a gain from the price margin on the basis that the price of the asset subsequently improves.[213] In other words, they are required to continue with a bad deal and incur a loss even where it is evident to the parties after the commencement of the activities that they are going to incur a loss. This may be unduly harsh where the loss would impel the borrower or customer towards insolvency. The customer may be held to have worsened the insolvency by negligence or failure to act. It is therefore not surprising that in many cases, borrowers have terminated the *Murabaha* agreement immediately on the grounds of financial difficulty with the hope of subsequently entering into another contract in future where the price of the asset has improved.[214]

The bank using the *Murabaha* financing mode is also exposed to the risk of default. The default risk is relatively very high because the payment of the asset by the customer or borrower is on a deferred basis. Thus, the bank ought to assess the borrower's credit record before entering into such an agreement with the latter. Also, where the borrower is unable to pay, there are few options available to the bank. It is required to extend the payment period until the borrower is able to continue payment in accordance with the Qur'an (2: 280) or it may terminate the agreement with the obligation of the borrower to complete payment at a later date. The bank may also sell the asset in the market given that the asset functions as

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[212] *Ibid*.; Iqbal, N_166 above, 233.
[213] Ismal, N_217 above, 103.
[214] *Ibid.*

collateral in the contract. The proceeds of the sale may then be used to pay all or part of the outstanding balance.[215] In each of the instances discussed above, the bank incurs additional costs in order to receive full payment, but the bank might also not recover in full. Moreover, the bank's predetermined cash flow on the asset side which has been adjusted with its liability is interrupted, as well as its predetermined profit that was calculated on the basis of the duration of the *Murabaha* contract.

It makes sense for Islamic banks to carry out extensive investigations of the borrower before they may agree to enter into *Murabaha* contracts with them. It's not only a question of moral integrity. The banks should also be able to ascertain the borrower's experience in dealing in commodities, or possibly using them as part of a manufacturing process, given that they may be faced with a moral hazard where the latter pretends to be insolvent in order to stop making payments. Under the *Insolvency Act 1986* (UK) there are certain procedures for declaring insolvency and the borrower ought be required to comply with secular law in order to so cease. In such an event, the borrower's default due to insolvency would be considered an 'honest' default under the Shari'a and may enable the borrower to be released from his obligation to continue the contract. Thus, where the borrower does not need the asset any more, he may adopt the devious course of declaring bankruptcy after using the money allocated for payment of the asset to purchase some other asset at a lower price in the market.

Nicholas Foster claims that there is no insolvency law known as a branch of law in Shari'a. [216] The development of *fiqh* on this point will require thought by scholars and is outside the scope of this thesis; any breach of trust, whereby debts are not paid due to a debtor's immoral default, ought however be treated as theft. As an interim measure, a *kafala* will help secure the interest of the bank and its depositors. There is also English authority suggesting that English law and not Shari'a will apply in cases where Islamic finance and insolvency intercept.[217]

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[215] Iqbal, N_166 above, 233.

[216] N Foster, *Operating with a Truncated Legal System: Financial Law without Insolvency Law* (SOAS Law of Islamic Finance Working Papers Series, Paper no 5 University of London 2013).

[217] *Islamic Investment Co. of the Gulf (Bahamas) Ltd. v. Symphony Gems N.V.*, [2002] All ER (D) 171 (Feb) (QBD: Comm Ct) it was argued that an impugned contract was contrary to Shari'a and should not be enforced. However, the governing clause was clear and unequivocal. It provided: "This Agreement and each Purchase Agreement shall be governed by, and shall be construed in accordance with, English law." Tomlinson J therefore rejected the argument saying: 'in my judgment, it is absolutely critical to note — that the contract with which I am concerned is governed not by Sharī`a law but by English law.' See also to similar effect, *Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Ltd*. [2004] EWCA Civ 19, [2004] 1 WLR 1784 (CA), [2004] 4 All ER 1072.

2.6.3 Commodity Risk

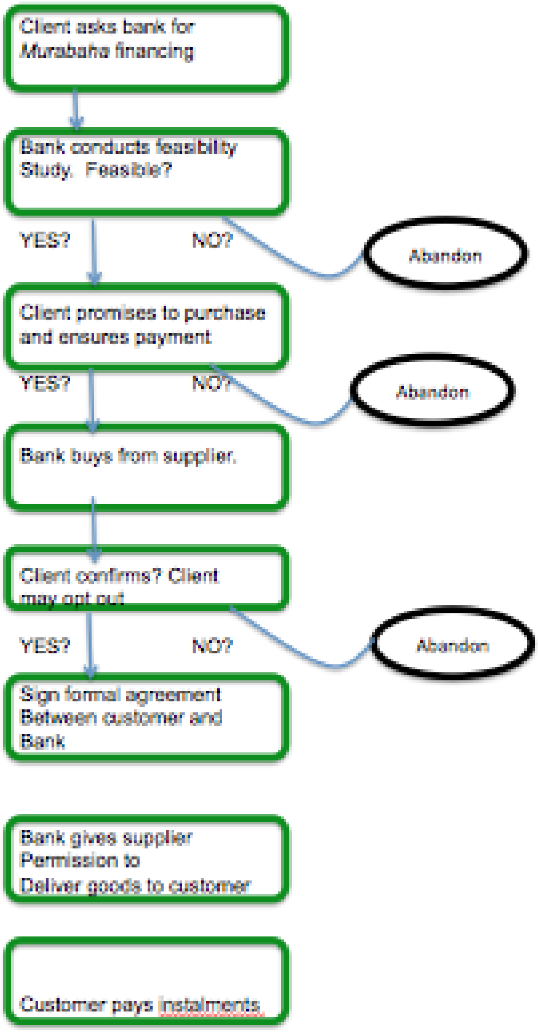
Closely linked to the price and default risks is the commodity risk. This concerns the uncertainties of the market value of the asset or commodity in the future, as well as of the size of the income in the future due to fluctuation in the prices of the assets or the borrower's inability to complete payment. Islamic banks have confronted this risk with the issue of consumer loans. It must be noted that Shari'a-compliant consumer loans are different from consumer loans in conventional or Western markets. The Shari'a-compliant consumer loans may be described as charitable loans (*Qard hasan)* that are provided by Islamic banks to consumers under *Murabaha* contracts whereby the banks have to take the risk that they will not be reimbursed.[218] This is the risk that CBs take with unsecured loans such as most credit cards. Islamic banks also provided cars to customers under *Murabaha* agreements with payments to be made in instalments. However, due to the strong demand for finance by customers in many Islamic markets, many of the customers immediately resold the cars for ready cash in order to pay the banks in full and make a quick profit.[219] The banks therefore incurred high transaction costs that were not covered where the consumers immediately paid fully. Thus, in the absence of a standardised Shari'a-compliant option, some banks in Saudi Arabia decided to simply replicate the Western consumer loan mechanism in the manner that they deemed was Shari'a-compliant. The banks hold a small portfolio of fungible commodities that are sold to customers on the basis of deferred payment. The latter then appoints the bank as its agent for selling the same commodities, which the bank does.[220]

Thus, what essentially happens is that the bank buys an asset or commodity from Party X and then delivers the asset to Party Y. As noted above, there are several risks as regards the fall in the market price and the default by Party Y. Also, Party X may fail to deliver the goods where they are physical commodities, or where the goods are delivered, they may be of poor quality. Party Y may then refuse to pay for the goods of poor quality or goods that have simply not been delivered. In order to mitigate this risk, the banks replicate the Western consumer loan mechanism in the manner that they deem is Shari'a-compliant. Thus, they establish an agency relationship with Party Y in its dealings with Party X. Thus, in case of the delivery of goods of poor quality or non-delivery of the goods, it would be as a result of Party

[218] UNCTAD, N_116 above.
[219] *Ibid.*
[220] *Ibid.*

Y's failure to ensure that Party X fulfils its contractual obligations. Also, Party Y is put in a position where it cannot refuse its obligations towards the bank.

Figure 2: How a Murabaha contract works



In the English case of *Islamic Investment Company of the Gulf (IICG) v Symphony Gems NV & Ors*,[221] IICG and Symphony Gems entered into a Murabaha financing agreement in January 2000, whereby the latter was responsible for identifying precious stones and their sellers. On the basis of its request, IICG was supposed to buy the precious stones at the on spot value and sell to Symphony Gems at the declared price plus an agreed profit; and payments by the latter had to be made in instalments. One month after they entered into the agreement, Symphony Gems identified a seller in Hong Kong and upon its request, IICG paid

[221] [2008] EWCA Civ 389.

for 92,000 carats of precious stones from this seller. However, the seller failed to deliver the precious stones and Symphony Gems also refused to begin making instalment payments. Tomlinson J held that the failure of the seller to deliver the precious stones was in part due to the failure of Symphony Gems to make the necessary arrangements. Thus, it had to pay IICG as agreed under the Murabaha agreement.[222] The English High Court did not enforce the Murabaha contract per se given that the Shari'a is not part of English law and Islamic law is not a choice of law in England and Wales, but an analysis of the judgment shows that individual elements of Shari'a could have been interpreted as terms of the contract.[223]

It is unlikely, given Tomlinson J's comments about Shari'a not being part of English law that English law will reach the accommodation with Shari'a that Malaysian cases have reached in the period after 2007. There, cases such as *Bank Kerjasama Rakyat Malaysia Bhd v PSC Naval Dockyard Sdn Bhd*,[224] *Arab Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd* [225] and *Bank Islam Malaysia Bhd v Azhar Osman*[226] have interpreted the Malaysian Contracts Act 1950[227] to allow for equitable relief, in effect, if a party avoids a contract on grounds related to Shari'a, so that a party to such a contract must account for any benefit received to the other even if the contract is haram.

Whilst Malaysia has also solved the problem of the lack of congruence between common law and Shari'a by inserting new provisions into Part VII of the Central Bank of Malaysia Act which aim at resolving issues pertinent to Shari'a matters[228], the lack of any such legislative changes in the UK means that in order to avoid any risk caused by a lack of a legal remedy for Murabaha contracts, the contractual provisions will need to be drawn to specify, in longhand as it were, as particular conditions of each contract, the "solutions" found by the Malaysians, perhaps as overarching principles of interpretation.

A sufficient degree of clarity will be needed to avoid the terms of the contract being void for uncertainty.[229] In *Scammell v Ouston*[230] Lord Maugham said of such unclear cases that the

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[222] UF Moghul and AA Ahmed, "Contractual Forms in Islamic Finance Law and Islamic Investment Company of the Gulf (IICG) v Symphony Gems NV & Ors: A First Impression of Islamic Finance" (2003) 27 *Fordham International Law Journal* 150.
[223] *Beximo Pharmaceuticals Ltd and Ors v Shamil Bank of Bahrain EC* [2004] EWCA Civ 19.
[224] [2008] 1 CLJ 784; [2007] MLJ 722
[225] [2008] 5 MLJ 631; [2009] 1 CLJ 419
[226] [2010] 5 CLJ 54 [2010] 1 LNS 251
[227] Malaysian Contracts Act 1950, Section 66.
[228] Malaysian Contracts Act 1950, Sections 51-58.
[229] *Willesden v. Webb* [1937] Q.W.N. 8. (Queensland)

consensus ad idem would be "a matter of mere conjecture". The enforcement risk with contracts which do not spell out the necessary Shari'a terms with sufficient specificity, are that the parties may well find their hopes of judicial resolution disappointed since a court cannot enforce a contract which it cannot interpret.[231]

2.6.4 Other Risks

Islamic banks are exposed to other risks that may be linked to the market in which the assets are bought and sold. The Murabaha financing mode has given Islamic banks a liquidity management mechanism for tri-lateral transactions involving several banks, and sometimes hedge funds where the transactions are carried out in the international market.[232] In local markets, they have enabled Islamic banks to finance working capital requirements by buying and selling inventories to the end users of the financing. The assets may be bought from broker A by the Islamic bank and then sold to the borrower on deferred payment terms. The latter then sells the assets at spot price to broker B who pays for the assets. Broker B in turn sells the assets to broker A at spot price. As such, in the end the borrower is left with cash and the bank is left with a payment obligation that comprises the principal and a declared profit. The profit, as mentioned above, is derived from the sale of the assets by the bank to the borrower. In international markets, the fixed-rate *Murabaha* products have to compete with retail product offerings that are based on floating benchmarks. However, the Islamic deposits have much shorter tenor compared with investments that are exposed to floating rate. Also, Islamic banks are at a disadvantage because of the prohibition of *Riba*, and thus the absence of sophisticated tools to manage interest rate risk. The tools that are required to manage any fluctuations such as hedging solutions ought to be Shari'a-compliant and this has been difficult to achieve because of the lack of standardisation of requirements. Thus, hedging solutions that are purported to be Shari'a-compliant generally remain unattractively priced in comparison to the solutions of conventional financial institutions.[233]

Given the prohibition of *Riba*, Islamic hedging solutions are based on profit rate swap rather than the interest rate swap of conventional institutions that manage exposure to the

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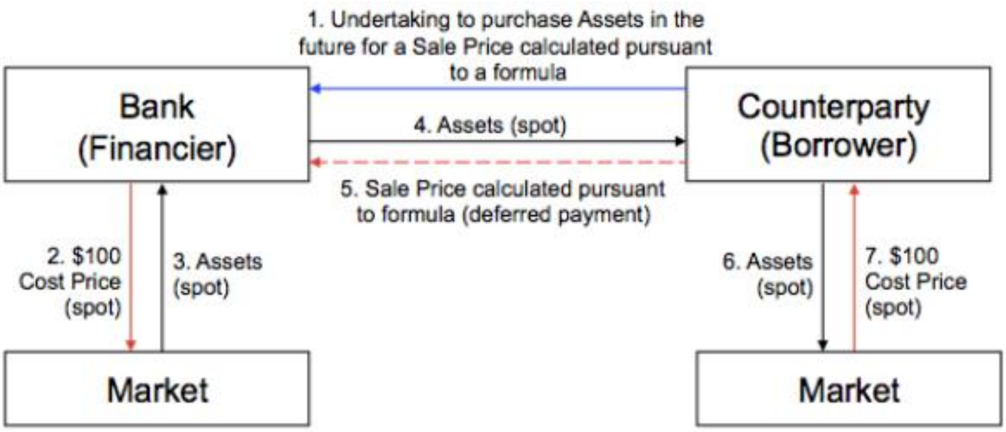
[230] [1941] A.C. 251, 255.
[231] *Duggun v. Barnes* [1923] V.L.R. 27, 29; (Victoria) see also *Rudd v. Commissioner of Stamp Duties* (1937) 37 S.R. (N.S.W.) 366, 381 per Davidson J (New South Wales).
[232] Choudhry, N_112 above, 11.
[233] Iqbal, N_166 above, 233-5.

fluctuations of the interest rate.[234] The profit rate swap is geared towards protecting Islamic financial institutions from movements in borrowing rates and therefore constitute a risk control mechanism.[235] Thus, given that this hedging solution is generally Shari'a-compliant (does not deal with interest rates), it is acceptable in Islamic finance and may ensure that Islamic investors that require balance-sheet management may obtain the same benefits as investors in conventional institutions that charge interest.[236] Through the profit rate swap, Islamic institutions with fixed and floating rates agree to exchange profit rates through the execution of a number of contracts called W*a'ad* contracts. The terms of these contracts ensure that the swap reaches maturity.

Figure 3: How a traditional Wa'ad contract works



Thus, through the *Wa'ad* contract, a party unilaterally promises to exchange profit rates until the swap reaches maturity or expires.[237] Hence, each counterparty is required to provide a *Wa'ad* ensuring that it enters into the relevant Commodity *Murabaha*. In this light, the parties can ensure that the transactions under the *Murabaha* will be free from the charging of *Riba*, as well as from *Gharar*, and any form of gambling, *Maysir*. The principal is not exchanged and the parties must ensure that it is netted off using a set off called *Muqasah*.[238]

[234] S Yankson, "Derivatives in Islamic Finance: A Case of Profit Rate Swaps" (2011) *7 Journal of Islamic Economics, Banking and Finance* 39, 47.
[235] *Ibid*., 47-9.
[236] *Ibid.*
[237] MA Qasi, "The Binding Nature of Wa'ad (Promise) and its Application in Islamic Finance" (2012) 3 *International Journal of Business and Social Science* 206, 208.
[238] *Ibid*, 208-10.

Kok has suggested a series of formulas to explain the costs and benefits to each party of such an arrangement. He constructs a financial derivative to mitigate some of the risks inherent in the underlying assets, which is a complicated method to structure an option, but has essential features which I summarise below.

Underlying Shariah-compliance can only be achieved through Shariah-supervisory board. Kok says that further research is required to ascertain if the product structure is in fact Shariah-compliant. However, based upon a broad set of Shariah-compliant screening rules the product abides by:

- Commodity in question is *halal*
- There are clear lines of *owners*hip
- Transaction contains no *riba*
- *Wa'ad* premia to bank are *justified* on the basis of organisa*tion* of contract and risk bearing.

There is an end hedge which incorporates an element of risk-sharing, to comply with Shari'a principles although the purchase of commodities does not amount to a plausible investment. There is a combination of the use of a *mushcah*, *murabaha*, and *wa'ad* but there must be active management of the investment sum to justify the partnership in the first place and to keep Shari'a compliance.

The want for risk-sharing has meant that one additional party had to be included into the contact in what would otherwise be achieved with a straightforward *wa'ad*. The inclusion of the third party, which accounts for the *wa'ad* element of the structure, creates additional uncertainty. Islamic finance requires proof of ownership of commodities before any sale can take place. Where possible, the structure has taken into account ownership of commodities before sale but the *wa'ad* element creates subjectivity as to whether ownership is required before the agreement of the *wa'ad* contract.[239]

[239] SK Kok, *Islamic Finance in the Global Economy: An Exploration of Risk Management and Governance within Shari'a Finance* (Ph.D Thesis, University of Liverpool March 2014) 244.

Rice says that there is a tension with such an arrangement, in that the complexity of the structure makes it too expensive to operate in comparison with a CB product of similar type:

> Capitalization on arbitrage… requires the payment of various transactions costs. In Islamic finance, those transactions costs are incurred due to conducting otherwise unnecessary transactions …as well as the additional legal and jurist fees required to structure a product and certify it.[240]

He sees that this will lead to pragmatism amongst practitioners of IB:

> To the extent that classical Islamic jurisprudence is generally understood by contemporary jurists to forbid conventional financial practice, movement towards strict adherence to Islamic principles requires movement away from conventional finance. To the extent that profitability is tied to efficiency of the Islamized analogues of conventional financial practices, the profit motive dictates movement towards conventional financial practice, and thus away from strict adherence to Islamic principles as understood by contemporary jurists who are active in this industry.[241]

As such, despite the absence of standardisation, it may be posited that there are generally three ways in which hedging solutions are implemented in a manner that may be deemed to be Shari'a-compliant. These include:

i. the use of back to back interest free loan,
ii. the use of Wa'ad based contracts, and
iii. the use of Murabaha based contracts.

The back to back interest free loans neither carry any interest nor benefit and may hardly be used in conventional markets or in transactions involving large amounts because they do not take into account the tenor and are imbedded with a high risk of loss of capital. The *Wa'ad*-based contracts are more sophisticated and are widely used in some markets by Islamic institutions. They involve the unilateral unconditional promise by a party looking for a hedge to buy a specific currency at a given date in future. The other party that undertakes to sell the currency is not bound to proceed with the promise.[242] This creates uncertainty as regards the promise's commitment to the agreement. Also, a unilateral promise may not form the basis of a valid contract under the Shari'a as applied in many Islamic countries, as well as under the

[240] MA El-Gamal, "Limits and Dangers of Shari'a Arbitrage" (2004) *Proceedings of the Sixth Harvard University Forum on Islamic Finance, 9.*
[241] *Ibid.*, 10.
[242] Qasi, N_243 above.

law of contract of many conventional jurisdictions such as the UK. As such, the party making the unilateral promise has to confront a high market risk.

With regard to the *Murabaha* contracts, as noted above, the bank and the customer enter into separate agreements whereby the bank buys an asset or commodity at spot value and sells it to the customer for the purchase price plus agreed profit, on the basis of deferred payment. Thus, both the bank and the customers eventually resell the asset or commodity in the Islamic market in order to recover the initial investment. Nonetheless, the cost of incorporating an asset or commodity in the transaction may be prohibitive thus impelling Islamic banks to seek other means of hedging their exposures.

In the UK this would be subject to the provisions of the *Insolvency Act 1986*, but there is no extant fatwa or AAOIFI procedure covering insolvency.

2.7 Istisna

This involves a pre-paid forward sale whereby the bank purchases a good of a specific description and specified quantity and delivers the good at an agreed price.[243] The good may be in the process of manufacturing and the payment may be in instalments or at various stages of process, depending on the agreement by the parties. The goods are therefore acquired by specification or order and the parties may agree not to specify the delivery date. However, the manufacturer would be expected to deliver the goods within a reasonable time after completion. These modes of financing are often used for both short and long-term arrangements involving the purchase of raw materials or the processing of raw materials or the marketing of tertiary products.[244] The parties must however specify the nature and quality of the good and the manufacturer must commit to producing the good as described. It is important to note that after the commencement of the manufacturing process, the Istisna contract cannot be terminated by either party, except where the goods delivered do not correspond with the description. Where they are as described, the buyer is obliged to accept and pay for them and the contract is deemed to be satisfied after the goods are delivered.[245] This implies that where a party changes its mind before the manufacturing process begins, it

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[243] UNCTAD, op cit, 16.
[244] *Ibid.*
[245] *Ibid.*

may unilaterally terminate the contract. The same applies to the PLS financing modes as indicated above.

Islamic banks generally use *Istisna* contracts to finance high-tech industries such as the building of ships, trains and aircrafts.[246] The instalment stage payments are then made over the period of the manufacturing. Thus, the bank only pays part of the cost up front and then makes regular instalment payments at subsequent stages of the process. *Istisna* contracts are also used for financing housing construction or the manufacture of specific equipment. The bank finances the manufacture through an Istisna contract. They are also used for pre-export finance, whereby the bank buys all goods for which an export contract has been established. The goods that will be exported are pre-purchased by the bank.

In light of the above, it is not surprising that *Istisna* contracts are quite complex. They may be syndicated or structured as securitisation or include financing portions of different maturities and profit rates. The bank would require detailed information about the goods from the buyer or investor, as well as information about the security offered, such as guarantees by the government or parent company. The buyer and seller have to also deposit security bonds before the bank may allow the buyer to order the goods as its agent. The buyer then has to reimburse the bank by paying in instalments or as agreed by the parties. Where the buyer wishes to pay in instalments after the goods have been delivered, it may enter into a lease agreement (*Ijara*) with the bank. The manufacturer on the other hand is required to provide a performance bond, as well as a guarantee to repay the progress payments that have been made by the bank in the event of non-delivery or the delivery of goods that do not correspond with the description in the contract. The manufacturer is equally required to assign the insurance for the goods to the bank. The latter usually requests manufacturers to provide a letter of credit in favour of the party that supplies the materials to be used for the manufacture. This enables the banks to control the use of their funds by the manufacturer. The *Istisna* financing mode therefore has similarities to the PLS financing mode, as well as the *Murabaha*. However, it carries some unique risks that must be taken into account by the bank in deciding whether to use it or not.

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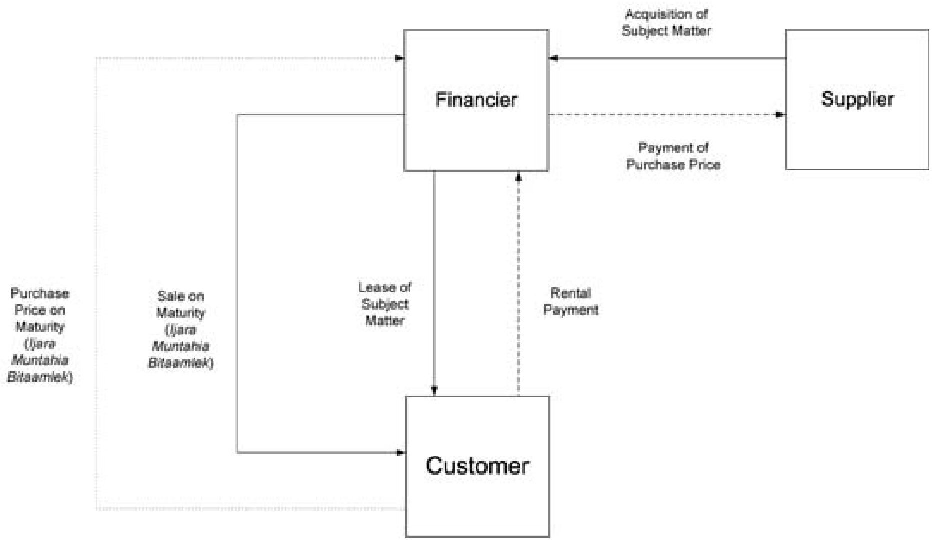
[246] *Ibid.*

Figure 5 shows an ijara contract in diagrammatic form, and is a simplified version of one sourced from Clayton Utz.

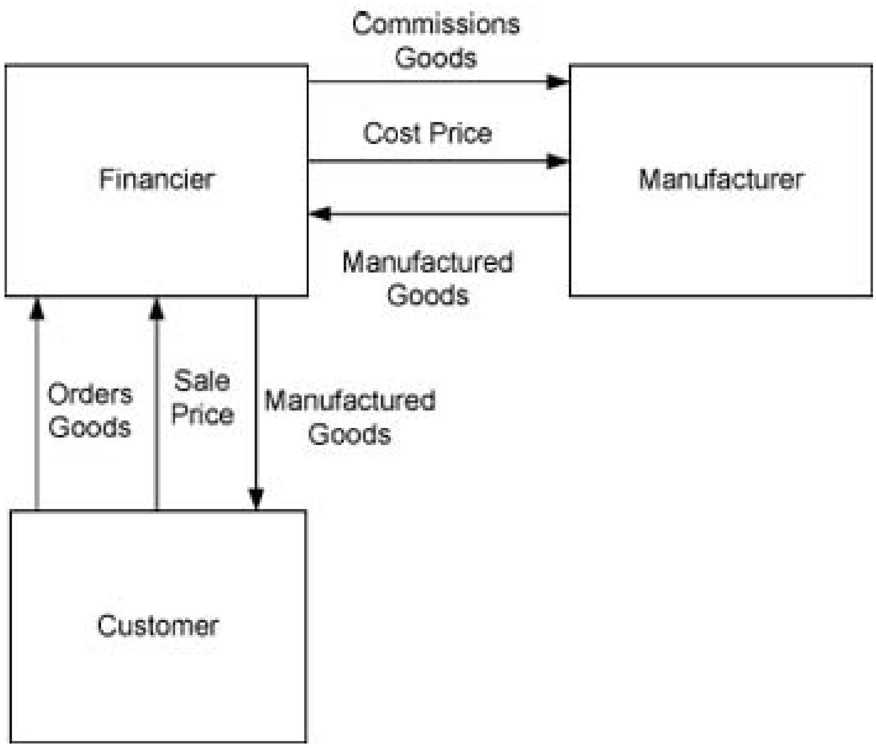
Figure 4: An Ijara contract



Source: Modified from Clayton Utz

Figure 6 shows an Istisna'a contract in diagrammatic form.

Figure 5: An Itsisna contract



Source: Modified from Clayton Utz

2.7.1 Unique Risk Characteristics

Given the complexity of *Istisna* contracts and the fact that the Islamic bank has to rely on the manufacturer and buyer, the bank is exposed to two main risks, namely the manufacturer's performance risk and the buyer's payment risk or credit risk. The risk of non-performance, or counterparty risk, is the risk that the obligation will not be fulfilled. This is additional to any credit risk or settlement risk and any other factors that would influence the likelihood of the obligation of being fulfilled. If the manufacturer does not deliver the goods as described, to the quality and in the quantity described in the contract, and the purchaser rejects the goods, the bank may suffer a loss. The performance risk may also include the risk of loss due to improper monitoring or control. Thus, the bank has to take into account the manufacturer's credit standing and ensure that the latter has no history of non-performance or underperformance in terms of production quality.[247] There is no standard form to the author's

[247] S Gatti, *Project Finance in Theory and Practice* (Elsevier, London, 2008) 35.

knowledge which allows for the collection of information as to past claims or defaults of a manufacturer for Islamic financial purposes – which is odd, because there are detailed standard questionnaires used in both conventional banking for everything from applications for standard loans to applications for credit card merchant facilities, and also standard questionnaires in insurance, franchising disclosures and retail tenancies. Such required disclosure would reduce risks, albeit at a compliance cost.

Arbitration with respect of insubstantial non-compliance, such as would not enliven the rule in Hong Kong Fir, [248]would also reduce risk. Malaysian practice[249] is to allow revision of the agreed price of the *istisna`* asset after the delivery of the asset to the purchaser if the seller has failed to comply with the agreed specifications. In this case, the revised price of the istisna` asset is subjected to the agreement of the contracting parties, but a solution may form part of the terms of the existing contract, for example a term of the dispute resolution process set up in the contract allowing an assessment of value by a referee or arbitrator in a Shari'a compliant manner where there is less than a specified variation from the sample or specification.

The bank must also take into account the risk of non-payment by the buyer. Thus, the bank must also ensure that the buyer has no history of defaulting. This risk is particularly important because as noted above, the bank is unable to terminate the agreement in the event of honest default or default that is purported to be honest. Moreover, it cannot use penalty rates as deterrents against payments. The bank is therefore forced to rely excessively on the use of the commodity as collateral, which may exacerbate the buyer's credit risk. Where the value of the commodity proves to be too volatile, the potential recovery value of the loan may be reduced significantly.[250] In cases of *istisna'a*, it is permitted for the bank, or the manufacturer, to acquire *kafala* or *rahn* (collateral) from the client, and therefore credit risk in *istisna'a* should be minimal. Taking collateral does not mitigate the risk completely, because collateral usually comprises illiquid assets, and determining the market value of these assets may be problematic particularly if they are non- fungible such as goodwill. It is also hard to liquidate such assets.

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[248] *Hong Kong Fir Shipping v Kawasaki Kisen Kaisha* [1962] 2 QB 26.

[249] Istisna`: Concept Paper Islamic Banking & Takaful Department, Central Bank of Malaysia/Bank Negara Malaysia (2010) CP 028-10, Sections 12 to 14.

[250] S Archer and A Haron, "Operational Risk Exposures of Islamic Banks" in S Archer and RAA Karim (Eds.) *Islamic Finance: The Regulatory Challenge* (Chichester: John Wiley & Sons Pte Ltd. 2007) 52.

It must also be pointed out that the buyer has no contractual relationship with the manufacturer. Thus, the bank is liable in the event of non-performance by either party, unless the bank insists on a tri-lateral agreement such as in the case of the Mubaraha contract. As such, where an agreement involves all three parties, the bank may only be a guarantor to the manufacturer or contractor once the goods are delivered, enabling the buyer to have direct recourse to the manufacturer.[251] As was shown in figure 2, at each stage where a client can abandon the contract, the risk is with the bank.

2.8 Summary

This Chapter has examined the unique risk characteristics of four modes of financing widely used by Islamic banks. It however began with a brief examination of the concept of 'risk' under Islamic law. It noted that the term closest to 'risk' in Islamic literature is '*Gharar*' and unlike the former, the content of the latter is subject to much uncertainty. It is uncertain whether a transaction imbedded with risk or *Ghārār* would be voidable and not void, depending on whether the party that exposed the transaction to the risk was honest. The Qur'an does not expressly prohibit *Ghārār* and there is nothing to suggest that 'vanity' that is prohibited by the Qur'an may be interpreted to include the uncertainty or ambiguity which Ghārār describes. Nonetheless, some previous Islamic scholars reported that it was prohibited by the Prophet's (Peace and Blessings be upon Him and his Companions) companions in trading to the effect that where *Ghārār* is identified in a transaction, it is considered null and void. This would however imply that *Ghārār* is not the direct equivalent of risk given that all financial transactions are embedded with several types of risk, and there are even more risks inherent in many Islamic transactions. Moreover, Islamic banks are required to give priority to the PLS financing modes and it was shown that these modes carry even more risks. The understanding of risk in this context relates to the ambiguities about the fulfilment of contractual obligations and uncertainties about the loss of capital. This is similar to *Ghārār* as defined in Islamic literature and it is therefore very unlikely that *Ghārār* is prohibited under Islamic law. Thus, what this demonstrates is that the first obstacle to developing a framework for the standardisation of risk management in Islamic banking is the lack of consensus on what constitutes 'risk.' It is also shown that the lack of consensus and standardisation of the

[251] B Kettell, *Introduction to Islamic Banking and Finance* (John Wiley & Sons Hoboken 2011) 108-109.

concept of risk constitute an obstacle to the uniform use of financing modes by Islamic banks, as well as the mitigation of the risks inherent in these modes.

The PLS financing modes were said to involve the investment in selected projects by Islamic banks and sharing in the profits and losses with the entrepreneurs or owners of the projects. The *Musharaka* is a form of partnership or joint venture in which all the parties are required to provide capital and take part in the management of the project and profits are shared on an agreed ratio while losses are shared in proportion to each partner's investment. The *Mudaraba* on the other hand refers to an agreement between two or more persons whereby one party (the Islamic bank) provides the finance and the other party provides the expertise and/or labour and management to conduct a business that is geared towards making profits. In both instances, there is no requirement of collateral and this creates a relatively high level of moral hazard that Islamic banks have to confront. The depositors in the Islamic bank have not consented to invest, albeit indirectly, in the PLS scheme but they may lose their money because of a non-performing loan. Greater disclosure is properly to be required from entrepreneurs, although there is currently no standard requiring this.

Also, and absent such disclosure requirements, banks are required to have very high expertise in evaluating projects, taking into account the local fiscal policies and the accounting and auditing systems of the entrepreneurs. Also, additional monitoring costs are incurred by the banks. Equally, since the banks have to act as universal banks, competition is reduced and financial risks are then concentrated at the individual universal banks. It was however noted that the main risk inherent in the PLS financing modes that Islamic banks find difficult to ascertain and manage is the equity investment risk. This is the risk that arises from entering into a partnership with the goal of participating or providing financing for a particular business activity as specified in the contract.

The next mode of financing discussed were the savings and investment deposits in Islamic banks. It was noted that they may take the form of profit sharing investment accounts and may be restricted or unrestricted. There may be restrictions on withdrawals before maturity date or no restrictions on withdrawals, but in both instances the depositors rely entirely on the bank's ability to generate a profit from investments made using their deposits.[252] It was also

[252] Z Hamat, *Islamic Banking: The Lessons And Challenges In Malaysia & Beyond* (Association of Islamic Banking Institutions Malaysia, undated) 21.

noted that Islamic banks using this mode seem to provide only two options to depositors: savings that do not grow for depositors that require security; and savings that may be lost in part or entirely, for depositors that would like their savings to grow significantly. Thus, higher returns are only guaranteed for depositors willing to take higher risks.[253] This implies that Islamic banks have to confront a high withdrawal risk due to the fact that depositors motivated by income and consumption would be concerned by a lower rate of return. Hence, a lower rate of return may influence their decision to withdraw.

The *Murabaha* financing mode was also examined. It was noted that it is set up like a buyer's credit and used for complex structured financings in Islamic markets. It may also be used for securitisation, whereby assets are financed on the back of fees to be paid by the buyer or borrower under long-term contracts. Nonetheless, this mode is not supposed to be used where the PLS financing modes (*Mudaraba* or *Musharaka*) are practicable, and where the risks can be shared more equitably between the seller and the buyer. Thus, it should not be the bank's first choice of financing despite the fact that unlike the PLS modes, it ensures a more predictable income and carried less risks. It was however noted that it is uncertain the extent to which Islamic banks abide by this rule given that previous studies have shown that the use of the PLS financing schemes declined significantly at the turn of last century and the *Murabaha* financing mode accounted for more than half of all the financing provided by Islamic financing institutions across the world. However, this mode carries the following risks: price risk, default risk, commodity risk and market risk. The Islamic bank is also exposed to other risks that may be linked to the market in which the assets are bought and sold. In international markets, the fixed-rate *Murabaha* products have to compete with retail product offerings that are based on floating benchmarks. However, the Islamic deposits have much shorter tenor compared with investments that are exposed to floating rate. Also, Islamic banks are at a disadvantage because of the prohibition of *Riba*.

The last mode that was examined is the *Istisna*. It was shown that it involves a pre-paid forward sale whereby the bank purchases a good of a specific description and specified quantity and delivers the good at an agreed price. However, *Istisna* contracts are quite complex. They may be syndicated or structured as securitisation or include financing portions of different maturities and profit rates. The bank would require detailed information about the

[253] H Hasroleffendy, "Islamic Property Financing in Malaysia: Appraisal and Practical Recommendations" (2011), 2 *International Journal of Business and Social Science* .

goods from the buyer or investor, as well as information about the security offered, such as guarantees by the government or parent company. The buyer and seller have to also deposit security bonds before the bank may allow the buyer to order the goods as its agent. It was shown that the bank is exposed to two main risks, namely the manufacturer's performance risk and the buyer's payment risk or credit risk. The risk of non-performance is the risk that the obligation will not be fulfilled. This comprises credit risk and settlement risk and any other factors that would influence the likelihood of the obligation of being fulfilled. Also, given that that the buyer has no contractual relationship with the manufacturer. Thus, the bank is liable in the event of non-performance by either party, unless the bank insists on a tri-lateral agreement such as in the case of the *Mubaraha* contract.

Chapter 3: RESEARCH METHODOLOGY

3.1 Introduction to Methodology

This chapter will discuss the research methodology, including, research design, research strategy, research method, research process, how data was collected, what data was collected, how was data analysed and examined and how content analysis was conducted relating to the case studies. The aim of this chapter is to elucidate the relationship between the Central Argument (see Chapter 1) and the methodology used to create not only the theoretical framework but also the content analysis of the case studies. By way of making this methodology explicit, it is important to note that the flow of ideas is from the central argument to the major abstract issues that are implied by the central argument, and how these major abstract issues have been translated into the specific risk factors used in the content analysis. As the objectives of this research include the assessment of how issues of legal secularisation may be reconciled in Islamic models of finance and the determination of whether risk management practices can be improved by standardising banking across jurisdictions, the main methodology employed a content analysis between three markets: Malaysia, the Islamic Bank of Britain, and Saudi Arabia. As a qualitative analysis was a primary method, the purpose of choosing these three markets was to determine which accounting standards and risk management practices from each market are beneficial in improving financial and legal efficacy in Saudi Arabian financial institutions. In order to make the logic of this methodology comprehensible, we shall first define the research design.

3.1.1 Research Design

The research design includes primarily the aims and objectives of the methodology and the various methodological components that allow us to develop a coherent structure for a detailed version of the Central Argument. The specific aim throughout this work is how Islamic banking could be improved in Saudi given the conceptual architecture of the risks as defined by the Basel Accords and the experience of specific case studies embodied in the UK and Malaysia in Chapter 4 and 5, respectively. This is a top-down approach and thus, the relatively large or more generalised ideas drive the conceptualisation of more and more specific components in the argument and flow of analysis. In other words, while risk is the fundamental conception in the central argument, it also drives the componential structure of the research design. Thus, the conceptual component of the Basel Accords is its identification of generic risk categories, and for purposes of our research design, these generic risk categories across credit, market and operational risks, logically imply further specification of risks to the country and banking sector levels. The originality of this methodology is that it extends the logic of the top-down approach to a specification of risks to both the Islamic banking level and the country level, differentiating between the two. Thus, the research design is to carefully carve out the most general meanings of risk to Islamic banking with the provenance of the Basel definitions of generic risks and the specific case situations that we will elucidate for the UK and Malaysia. It is important to keep in mind that this research design is aimed at improving the Saudi situation both at the national and local level of Islamic banking.

3.1.2 Research Strategy

From the research design, our research strategy is to clarify the definitions and meanings of risk at the general level of the latest Basel Accord, i.e. Basel III, and to show how these sorts of generic risks are further re-interpreted at the country level and particular situational levels which we have called "case studies" in Chapter 4 and 5. This means that the details of risk assessment and risk analysis at the level of Islamic banking in Saudi may be developed along the axes of the most general and universal meanings of risk as held by the international banking community adhering to Basel standards, and at the same time, may be compared to the practices used in the case studies that we have examined in the UK and Malaysia. It is important to emphasize that this methodology is not a mere comparison of the *de jure* factors of each jurisdiction in relation to the regulation of Islamic banking, but that our research strategy is strictly focused on providing a way for the Saudi Islamic banking situation to be improved by means of a comparison to different logical levels, one internationally generic and the other, particularities of country level laws and central banking policies. We could say without necessarily making a fine point about it that the methodology is fundamentally relational in that the components of generic risks from the international level and the country and Islamic banking levels are applied purposefully to make improvements to the Islamic banking system of Saudi. The implementation of the research strategy is captured by the specific steps undertaken in the research method.

3.1.3 Research Method

We have employed a socio-scientific method for this dissertation. It follows the classical Aristotelian scientific method of making observations of phenomena or facts, coming to a definition of the essential qualities of the phenomena such that one can make certain predictions of the phenomena.[254] The observations and definitions of the facts are the models that we use in the research and in our work, we have developed two levels of models, one may be called generic and the other specific. In both the generic and specific, our interest is in developing risk models that may be applicable to the Saudi situation. We have presented our reflections of the Saudi situation as our primary observable phenomena, and the generic risk model based on the Basel Accords and the relatively more specific risk models applied to the country-level and company-level phenomena. Although we have not theorised on the fundamental nature of risk, we have assumed that risk may be divided *ab libitum* to whatever phenomenon that may be called into question. This flexibility in research method comes from the idea that the most general risk is conceptually the most inclusive, and therefore, other forms of risks are sub-parts of this most inclusive general risk concept. Logically, this means that the various forms of risk analysis offered in this dissertation are coherent to the most general or most generic form of risk.

The most generic form of risk reflects the top-down approach of the research method from the most general to the relatively more specific types of risks and how these various forms of risk analysis are applied to the Saudi situation, the UK and the Malaysian cases. It is important to note that at the particular level of risk models, we have examined a large variety of standard risk factors in the case studies including, liquidity risk in sections 4.5 and 5.4.9, credit risk in section 4.6.2, operational risk in section 5.4.4, market risk in section 5.4.5, trading book risks in section 5.4.7, Shari'a compliance risks in section 5.4.8, compliance risks in section 5.4.9 and governance in section 5.3. We list some of the major forms of risk analysis used as part of the research method

3.1.4 Research Process

Given the above research method and strategy, we undertook a research process that included data collection, identification of relevant data, and determined how the data would be

[254] HP Cooke and H Tredennick, *Aristotle: Categories. On Interpretation. Prior Analytics* (1938).

examined and analysed. We also conducted a content analysis of the material that was already available in the case studies. The data for the case studies was collected by gathering information from web-based scholarly literature, and official resources including government sources in Saudi, the UK and Malaysia, previous PhD dissertations were initially evaluated as well as from company financial reports in the public domain and academic journals. After gathering the basic data, we performed a financial analysis of the balance sheets of relevant institutions, i.e, the IBB in Chapter 6 and BNM and BIMB in Chapter 5. This analysis provided original insights into the genuine financial and management risks of these entities. The first case study is divided into two parts. The first part assesses the Central Bank of Malaysia and the second, a major Malaysian retail bank, Bank Islam Malaysia Berhad. The format of the second case study is somewhat novel, as befits a thesis claiming to present an original contribution. It looks at the losses made by IBB, and seeks to establish what the Malaysian banks did that IBB did not (and vice-versa), so that in Chapter 7 of this thesis, lessons can be drawn for Sa'udi Arabia, which is seeking to become both a centre of Islamic Banking and to sustain its economy in the face of falling oil prices.

The content analysis was conducted between Saudi Arabia, the UK, and Malaysia, in order to answer the questions of whether the concept of risk could be used to enhance Islamic finance organisations and whether the Basel framework can be internalised by Islamic financial institutions to solve issues such as the inadequate coordination of financial markets in Saudi Arabia. Whilst, the following two chapters provide a study of the risk management issued under the Basel regime, each chapter will assess the risk management framework formalised under Basel III with the precise aim of assessing its relevance and utility in Islamic banking contexts and institutions in KSA in Chapter 7.[255]

3.1.5 Content Analysis

As the content analysis involves the analysis of three markets (ie: Malaysia, the Islamic Bank of Britain, and Saudi Arabia), the sample is the UK, the UAE, and Malaysia. In light of the research problem stated above, the researcher employed two distinct methodologies to assess the regulation of Islamic banking in Saudi Arabia so as to determine how the regulatory

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[255] The Basel Committee for Banking Supervision (BCBS) published "Basel III: A global regulatory framework for more resilient banks and banking systems" in December 2010. The paper was revised in June 2011 and, together with the BCBS's 13 January 2011 press release entitled "Basel Committee issues final elements of the reforms to raise the quality of regulatory capital", is known as Basel III.

principles and guidelines can operate independently in a methodical manner. The methodology that was developed and applied in this study optimises the use of the content analysis method to study risk contents, both in diversity and in depth, in three markets: Malaysia as the main focus, the UK in order to debunk a particular argument made in relation to the apparent success of the Islamic Bank of Britain in avoiding the consequences of the 2006-8 financial crisis, and Saudi Arabia, as that market is the main topic of this thesis. Set against the spread and circulation of global banking standards, the following case study chapters will therefore, draw briefly on the regulatory structure and reforms instituted in the UK in the wake of their financial, as well as the limitations and failures of the UK's ongoing attempts to effectively transpose, into its own domestic law, the related risk standards provided for under EU Capital Adequacy directive (CAD).[256] The case study on UK risk management reforms has, it will be argued, exposed mutual risk vulnerabilities shared by both conventional and Islamic financial institutions. In a subsequent chapter, and by employing the research method and technique of comparative analysis, the thesis will proceed to consider the potential impacts, failures or, even, irrelevance of the Basel risk evaluation models in Islamic finance contexts in KSA. The two case studies examine the different contexts of Islamic banking as found in the UK and Malaysia from the perspective of central bank authority and the private sector. To clarify the basis of the comparative methodology, it is important to distinguish comparisons between individual entities that happen to be in different jurisdictions, and the legal and regulatory contexts in which these entities exist. Thus, we are not drawing comparisons between institutions or companies per se, but rather between the legal and regulatory contexts of Malaysia and UK wherein Islamic banks exist. By comparing the legal and regulatory contexts of the two jurisdictions contextualised with specific institutional case studies, it is possible to make inferences about what type of legal and regulatory context may be more conducive for the development and growth of Islamic banking in Saudi.

[256] CRD IV (Directive 2013/36/EU). CRR (Regulation 575/2013): Part Two (Articles 25-91) and Part Ten (Articles 465-520). EU rules on capital requirements for credit institutions and investment firms aim to put in place a comprehensive and risk-sensitive framework and to foster enhanced risk management amongst financial institutions. The Basel III rules have been implemented in the EU from the beginning of 2014. As a regulation, CRR will have direct application in each EU member state, whereas CRD IV will need to be transposed into local laws.

3.2 Case Study Methodology

3.2.1 UK Case Study – IBB

In light of the above discussion, the next two chapters proceed to offer a comparative analysis of two apparently distinct legal and financial systems. In the first, with relatively well prudential controls, Islamic banking is competing well with conventional banking. In the second, it is failing, despite being bound by EU regulatory requirements. The case studies highlight deficiencies in the existing risk management framework adopted by Al Rayan Bank, formerly known as the Islamic Bank of Britain (IBB), in the UK, despite legislative reform efforts and institutional restructuring of the banking regulatory authorities. The losses of IBB, amounting to 25% of the Bank's deposits, as will be seen in Chapter 6, occurred despite the specific rules relating to PSIAs and specific Basel II rules respecting risk management. These deficiencies are particularly stark when viewed against the successes of the Malaysian Islamic Banking sector.

3.2.2 Malaysian Case Study – Islamic Central Bank and BNM

The case study on Malaysia considers the impacts of these reforms on the Malaysian IB sector, which remains well capitalised albeit remaining largely reliant on debt based (as opposed to equity based) modes of financing.[257] The regulatory and institutional framework for managing and mitigating risks in the Malaysian IB sector is fairly well established and defined, relative to less developed markets in the GCC wherein enforcement related challenges and incoherency around the interpretation of Shari'a restriction on certain modes of financing continue to impede regulatory progress.[258] In view of the rapid growth of Islamic banks operating in Malaysia, the thesis will consider the implementation of Basel rules in Malaysia, highlighting the apparent tension that exists between global banking standards and the regional standards issued by the IBSB, while throwing light on remaining

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[257] MRFB Ellias, *Pricing of Murabahah And Ijarah Product in Malaysia: A Critical Analisis From The Shari'a Perspective* (Tesis Sarjana, Kulliyyah of Islamic Revealed Knowledge and Human Science, International Islamic University Malaysia 2007) 46-53.

[258] M Meera, A Kameel and D Abdul Razak, "Islamic Home Financing Through Musharakah Mutanaqisah and al-Bai Bithaman Ajil Contracts: Comparative Analysis" (2005) 9 *Journal of The International Association for Islamic Economics* 2, 7.

challenges faced by Malaysian Islamic finance institutions in the course of complying with these rules. [259]

3.3 Risk Management Methodologies

A comprehensive survey of empirical findings and data supports the conclusion that many Islamic banking institutions have continued to retain high levels of capital, while surviving the worst effects of the global financial crisis by adopting two critical strategies: 1) the effective implementation of global capital adequacy thresholds (the bank was well capitalised during the onset of the crisis) and 2) its recourse to standardised methods and criteria for calculating risk weighted assets (to reflect more optimal risk-return trade-offs). The techniques described above are, of course, not unique to Islamic Banking. Indeed, these risk management techniques are in line with the raft of regulatory reform measures adopted under the meta-supervisory authority of the global banking regulatory body, the Basel Committee. The extent to which IBs have been able to minimise or prevent credit risks, relative to CBs, is worthy of greater consideration.

Basel standards and procedures on capital management and risk regulation have attained the status of 'soft' law and, in this quality, have achieved near universal recognition and applicability.[260] As such, Islamic finance institutions have come under pressure to bring their own practices and standards into line with global benchmarks, in response to increasing normative demand for minimal levels of integration and harmonisation in the domain of banking related risk regulation. It is also arguable that Islamic banks are likely to adopt Basel standards in the hopes of remaining competitive. In the particular contexts of the UK and of Malaysia, there's plenty of competition about. Southeast Asia's three largest banks are all Singaporean: DBS Group Holdings Ltd., Oversea-Chinese Banking Corp. and United Overseas Bank Ltd, and each easily swamp any Malaysian bank in terms of size.[261] As at June 2010, Malaysia's IB Islamic banking structure had accumulated a total RM303 billion in assets or about 19.6 per cent of the total assets of the total banking sector of RM1.5 trillion.

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[259] *Ibid.*

[260] UK Prudential Regulation Authority (PRA) Policy Statement (PS7/13) Strengthening capital standards: implementing CRD IV, feedback and final rules (December 2013) (the PRA Policy Statement).

[261] Y Liau and E Chew, *Malaysia Megabank Dream Fades as Merger Stalls: Islamic Finance* (Bloomberg, 14 January, 2015)> retrieved from http://www.bloomberg.com/news/articles/2015-01-13/stalled-merger-puts-the-brakes-on-malaysia-s-islamic-megabank-dream.

Islamic Sukuk comprised 57 per cent or RM172 billion of the total bond issuance of RM301.75 billion.[262]

Regulatory asymmetries in the distribution of risks, regulatory burdens and fair competition are likely to make Islamic territories and markets less hospitable to foreign firms who may otherwise which to trade and operate within them.[263] On the other hand, the growing market in Islamic finance is, as of yet, relatively embryonic and unstructured, particularly in relation to emerging products such as Islamic Insurance, Islamic derivatives or the growing markets in Sukuk securities.[264] Further, as the Malaysian and British case studies show,[265] Muslims in those countries use disproportionately small amounts of IB services where there are competing CB services.

As such, and in an increasingly porous marketplace, where global flows of capital and finances have cross border effects, there is great need for knowledge transfer and 'learning', in respect of best practises on risk management (stress tests, internal self-regulated mechanisms on reporting and restoring liquidity and credit related shortfalls). This suggests that the restrictions on instrument type in the Dubai Islamic Bank and Emirati Islamic Bank models will likely to become entrenched due to local regulatory capture, possibly because of the immaturity of both the market and the regulatory system of the Emirates.[266] Something that is arguably easier in the presence of a legal system that is less well-adapted to the legal protections and developed rules and jurisprudence of the broader and more globalised models. Zulkifli writes with respect to regulations in Dubai, for example:

> [Minimalism in regulation] … is mainly practiced by the GCC countries with the exception of Oman and Saudi Arabia. Unlike the reactive approach, the minimalist model allows slight intervention on the part of regulatory authorities. The regulatory authorities expect IFIs to have proper Sharí'a governance system without specifying the requirements in details. There is no restriction on multiple appointments of the Sharí'a board to seat in various institutions at one particular time. Some jurisdictions in the GCC countries such as Bahrain, Dubai and Qatar favor the adoption of the AAOIFI Governance Standards. The minimalist approach prefers the market to develop its own

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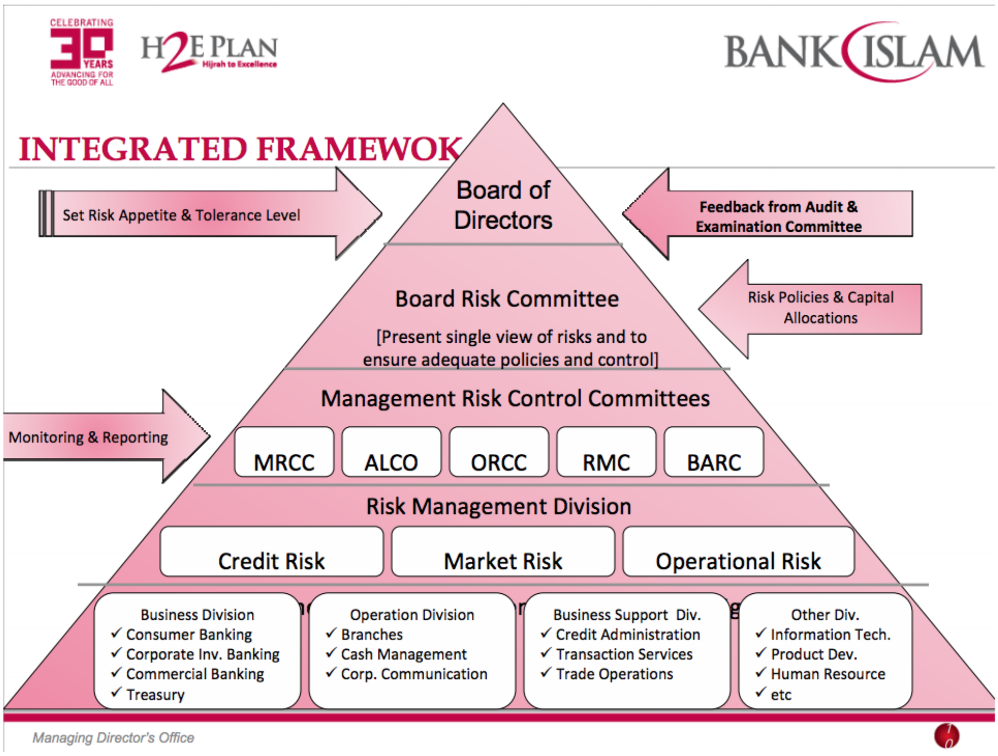
262 Samat, N_258 above.
263 I Akkizidis and SK Khandalwal, Financial Risk Management for Islamic Banking and Finance (New York Palgrave Macmillan 2008).
264 ALMA Gafoor, *Interest-free Commercial Banking* (Apptec Publications, 1997).
265 in chapters 5 and 6
266 Z Hasan, *Regulatory Framework of Sharí'a Shari'a Governance System in Malaysia, GCC Countries and the UK* (Kyoto Bulletin of Islamic Area Studies 3-2 2010) 82–115

Sharí'a governance system rather than greater intervention on the part of regulators.[267]

It is likely that competitive pressures will force banks to improve their self-regulation, and to this extent the position of both Malaysian and UK IBs, each of which face significant home pressures. For example, BIMB's self-regulation in the Malaysian market, where there are other domestic IBs is strongly influenced by its need prove the high quality of its risk management. With such careful risk management in place, depositors and investors are aware that their funds will not be wasted, even though PLS schemes allow for them to be lost, as BIMB's official presentation to Bank Negara shows in the figure below.

Figure 6: BIMB Risk management framework



Source: BIMB presentation on risk management to Bank Negara Malaysia.

The figure shows an elaborate framework of risk management and states the responsibilities of each department regarding risk. A higher level on the pyramid is equivalent to a higher responsibility. It also shows how in the information collected in the whole banking structure and to who does each department have to report. According to Ernst and Young, this includes

[267] *Ibid.*, 83.

such internal infrastructure as banking software, which in Gulf States such as Oman must be Shari'a compliant, although this last requirement has not yet become part of Malaysian law[268]

3.4 Rationale for Case Studies

The selected case studies offer a framework of comparison, thus situating the study of Islamic banking institutions, specifically their exposures to credit risk, in from within a broader discussion of global and domestic risk regulation response. One cannot study responses to risk regulation and the measures taken to safeguard the solvency, liquidity and profitability of internationally active banks, whether Islamic or conventional, without first examining the global standards set and promoted by the Basel Committee on Banking Supervision. Established as a mere reporting requirement, the Basel framework on banking regulation has evolved, over successive phases of implementation, into a fully integrated regime for the supervision and implementation of standards on minimal regulatory capital, liquidity and disclosure requirements.[269] On the one hand, such standards though voluntary and strictly speaking only binding upon the OECD member states that have formally incorporated these standards in their domestic legal systems, have progressively hardened to form a strong compliance pull on non-member states, and influential players in the banking industry. Conversely, despite the development of global standards, the vast majority of banking institutions remains subject to the laws of their domicile.[270] The tools used to develop the methodology include a legal doctrinal analysis and axiology. This thesis is based upon a specific question: Is the IB system of KSA sufficiently robust to survive the eventuation of a credit risk? A major (although not the sole) determining factor will be whether the KSA's IB system has sufficient liquidity to absorb any shock caused by the eventuation of such a risk. The apologists for IB adopt a similar methodology: they mistake historical co-incidence for cause and effect. They point to the survival of IBs in Malaysia and in the UK during the recent sub-prime-related financial crisis as evidence of IB being a superior system to CB and then deduce from the fact that the Basel standards did not apply to Malaysian banks in 2007 that Basel standards need not apply to IBs in 2015. In so doing they draw comfort from their belief as an article of religious faith that IB is more humane and ethical than CB. Critical

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268 Retrieved from http://emergingmarkets.ey.com/islamic-banking-assets-with-commercial-banks-in-the-gcc-reached-us445-billion-at-the-end-of-2012-ernst-young/

269 DK Tarullo, *Banking on Basel: The Future of International Financial Regulation* (2008); C Brummer, "How International Financial Law Works (and How It Doesn't)" (2011) 99 *Geo. L.J.* 257.

270 M Kahf, *Basel II: Implications for Islamic Banks*, In Jakarta, Indonesia the 6 Basel Committee on Banking Supervision (A Framework for Dealing with Domestic Systemically Important Banks 2012).

examination is an important tool in this thesis. In effect, the major case study on Malaysia will probe the weaknesses in similar case studies in an attempt to prove that there is no cause and effect relationship between the particular risk and liquidity standards adopted in Malaysian Islamic banking prior to 2007 and its substantial avoidance of the damage from the sub-prime crisis.

The minor case study on the Islamic Bank of Britain will use what little material is available to demonstrate that the lack of exposure to toxic assets was a historical accident, and not a feature of design. It will juxtapose the failure of the Dubai property market as proof of that proposition. It will demonstrate, nevertheless, that the IBB managed to make losses during the financial crisis which were proportionally on a par with any British conventional bank and that if this is what a bank does when constrained by moderate risk controls, moving to less substantial risk controls is hardly going to improve profitability.

The choices of Malaysia and of the UK, for the purpose of this thesis, is based on two main factors: the key importance of Malaysia as an Islamic banking hub and the key importance of London as a banking hub in general, which is building the number of Islamic banks and Islamic windows in conventional banks in an attempt to compete with other financial centres for the market in Islamic financial services and products. Prime Minister Cameron seeks to fund much of the need for new investment in British infrastructure from Islamic banking[271]. The £12bn in assets of Britain's Islamic banks are said to dwarf those of Muslim states such as Pakistan, Bangladesh, Turkey and Egypt. And there are also 55 colleges and professional institutions offering education in Islamic finance in Britain – more than anywhere else in the world. [272]

The legal doctrinal analysis is the traditional form of legal scholarship.[273] The researcher laid stress on the primary sources of law: the general principles and immutable sources of Islamic law and applicable statutes, regulations and case law. They are analysed in order to determine whether they are apposite as regards the regulation of banking activities and products, and what changes may be made. This implies that the research approach is inductive whereby the researcher critically reviews the extant principles, statutes and regulations and identifies

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[271] WIEF, N_97 above.
[272] Phillips, N_98 above.
[273] Tiller, N_99 above.

patterns to support a theory on the standardisation[274] or methodical non-standardisation of Islamic regulation with international accounting standards, ISO 31000:2009 and its predecessors[275] and the requirements of Basel I, Basel II and Basel III. It follows from the above that the relevant legal rules are assessed from a positivist and objective perspective. Thus, there is no attempt to formulate or reinforce extant ideological viewpoints which have guided the analysis of previous researchers. In seeking to be objective, the researcher therefore assessed current regulatory rules and procedures as they are applied in the EU (and therefore in the UK), in Malaysia and in KSA. This thesis avoids normative analyses or any attempt at expanding the scope of the *fiqh*. This is because of the need to be detached from the cultural and political influences on the application of the rules and procedures.[276] Hence, although politics and culture have played a major role in shaping regulatory policies, both in KSA, in Malaysia and in Western countries, the difficulty of ascertaining this role, coupled with the fact that this would be beyond the scope of this study, constitutes the motivation to carry out a positivist doctrinal analysis.

An analysis of the Malaysian and British cases will provide a base for the thesis on which to analyse the preparedness of the KSA's IB system to face similar shocks and it will also determine whether the Islamic model can adopt Basel standards to follow more conventional methods of banking, which in turn, may solve inconsistencies in the Islamic finance model. Thus, risks that Malaysian and British financial institutions take will be explained. In addition, it will be shown that the standards of the AAOIFI are insufficiently robust to identify, measure and mitigate the risks so presented. Lastly, it will also be demonstrated that international standards, including ISO 31000:2009 and those of the IASB, would properly identify, measure and mitigate those risks. Along the way, it will be also be illustrated that there is nothing particularly ethical or humane about the wholesale concealment of major structural flaws in the Sa'udi economy. Nonetheless, given the link between Islamic banking, ethics and moral values, the researcher would also defer to axiology. Axiology is a branch of philosophy that examines subjective judgements about values. Heron and Reason stated that values are guiding principles for human conduct.[277] Thus, certain values guide the legislators

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[274] Posner, N_100 above.
[275] HM Treasury, N_101 above.
[276] Morgenthau, N_102 above.
[277] Heron, N_103 above.

in enacting certain regulations, as well as the Shari'a advisory councils of Islamic banks in endorsing products and services.

The assessment of regulation from both the objective (positivist) and subjective (normative) perspectives represent the interdependence between propositional knowledge and experiential knowledge,[278] and to the extent that matters in KSA are discussed, it is informed by the interdependence between propositional knowledge and my own lived experience.[279]

3.5 The Global Framework on Risk Regulation and the Basel Accords

In an integrated market, banking institutions are exposed to a number of risks with severe and wide-ranging implications for shareholders, investors and stakeholders alike. Risk management, is the general term given to the set of corporate governance approaches used to preserve and restore value (of assets).

Banking institutions are exposed to five broad categories of risk: i) credit default risks which arise from defaults on lending agreements;[280] ii) underwriting risks, faced by insurers and guarantors who assume risks on the liabilities side; within a complex supply chain involving multiple agents has the effect of making the origin of risk more difficult to establish[281]; iii) liquidity risk impacting the solvency and long term interests of banks and its shareholders[282]; iii) market risks including interest and of rate of return risks which impact the profitability and competitiveness of banks;[283] iv) operational risks involving external and internal pressures and changes which affect the day-to-day operation of a particular bank with adverse impacts on certainty of financial outcomes and that bank's capacity to retain profits and absorb losses;[284] and finally v) institutional risks involving transactional costs which may stem from, amongst other factors, regulatory and administrative burdens, e.g. accounting and reporting requirements as well conflicts of law and procedures among different states

[278] Guba, N_108 above.
[279] *Ibid.*, 71.
[280] The current simplified standardised approach is in Annex 11 of the Basel II framework.
[281] Solvency II Directive (2009/138/EC)
[282] Principles for Sound Liquidity Risk Management and Supervision, 2008, Retrieved from www.bis.org/publ/bcbs144.htm.
[283] General market risk is dealt with at Paragraph 709 of the Basel II Framework. Notes on the current version are found at http://www.bis.org/publ/bcbs158.pdf.
[284] Operational risk- capital at risk is dealt with in Annex II to Basel Committee on Banking Supervision Consultative Document Operational risk – Revisions to the simpler approaches, issued in October 2014. Retrieved from http://www.bis.org/publ/bcbs291.pdf.

(leading to investor uncertainty and divergence in judicial outcomes and dispute resolution procedures).[285]

The above defined risks are to some extent an inevitable feature of a globalised market place, characterized by transnational flows of finance, investment and capital---the effects of which can no longer be contained within state borders.[286] It is this feature as well as the pathologies of the financial system that appear to be a perpetual and cyclical state of crisis, which explains its enduring interests to academics, managers and regulators alike.[287]

The accelerating trend towards decentralisation, de-regulation (or self-regulation) and liberalisation from the late eighties is commonly attributed as a significant, if not primary, cause and determinant of the 2007 financial crisis.[288] In the aftermath of the crisis, the question of whether re-regulation of the financial industry is the best way and means of correcting systemic failures and 'gaps' in the banking sector have, of course, resurfaced with haste. The Basel Committee on Banking Supervision was established in response to increasing demand for minimal banking standards.[289] The creation of this body lead to perhaps the most comprehensive set of reform instruments for risk management known to the banking sector: the Basel accords.[290] Under the ambit of this global regulatory architecture, banking sector has been progressively made subject to the standards formulated by the Basel Committee since 1988. Though attempts have been made to mitigate forms of credit and liquidity risk through the introduction of global capital and liquidity related risk management standards, most notably in the form of the Basel Accords, the existence [291] of uniform rules and corporate governance standards remains, to a large degree, wanting. This chapter will

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[285] C Alexander, (Ed.) *Operational Risk: Regulation, Analysis and Management* (London FT-Prentice Hall 2003); C Alexander and J Pezier, *Aggregation of Firm-Wide Market and Credit Risks* (ISMA Centre Discussion Papers in Finance no. DP2003-13 2003). Retrieved from http://www.ismacentre.rdg.ac.uk/dp; F Allen and AM Santomero, "The Theory of Financial Intermediation" (1997) *Journal of Banking and Finance* 21, 1461–1486; P Artzner, F Delbaen, J Eber, and D Heath, "Coherent Measures of Risk" (1999) *Mathematical Finance* 9, 203–28.

[286] AM Slaughter, *A New World Order* (2004).

[287] MB Gordy, "A Comparative Anatomy of Credit Risk Models" (2000) *Journal of Banking and Finance* 24, 119–49.

[288] S Ghani, *Global Financial Crisis of 2007 Analysis of Origin & Assessment of Contagion to Emerging Economies Lessons & Challenges for Financial Regulation* (Ph.D Thesis University of Grenoble 2013).

[289] Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems, December. Basel Committee on Banking Supervision (2010b), Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring, December.

[290] HM Ennis and DA Price, *Basel III and the Continuing Evolution of Bank Capital Regulation* (Richmond Federal Economic Brief 1 2011).

[291] Tarullo, N_276 above; Brummer, N_276 above; T Oatley and R Nabors, "Redistributive Cooperation: Market Failure, Wealth Transfers, and the Basel Accord" (1998) 52 *Int'l Org.* 35; PH Verdier, "Transnational Regulatory Networks and Their Limits" (2009) 34 *Yale J. Int'l L.* 113.

proceed to investigate and test these issues in the Islamic banking context through the use of two case studies.

3.6 Discussion of Methodological Challenges and Restrictions

The experiences of individual banks and the national regulatory architecture set in place to address questions of risk are highly variegated. This caveat aside, this thesis attempts to draw broad and general conclusions by way of assessing the EU framework on capital adequacy and management, focusing on the UK's and Malaysia's implementation of Basel standards, and comparing these with the application and operation of global standards in the Islamic finance context. Two methodological challenges are presented as a result: the first is the similarities and difference between national responses and measures between states. The case study on the UK is of course not representative of EU states as a whole, and any conclusions drawn from the study are likely to be over-inclusive.[292] These methodological challenges are to some degree unavoidable given the scope and dimensions of the line of enquiry I have chosen. Consequently, the UK case study will demonstrate the need for stringent risk controls in the face of calls by some Islamic theorists for a relaxation of the same because, those theorists opine, Shari'a compliance alone is necessary to ensure the integrity of the Islamic Banking, as if moral purity alone would safeguard the interests of depositors.[293]

The experience of BIMB is clearly to the contrary; the writer found no legislation requiring the publication of information such as the strategies appearing below and can only assume that, because BIMB publishes material of this nature and its competitors apparently do not (or at least the writer could not locate any despite a diligent search) that BIMB publishes its strategies as well as its disclosures to maintain a competitive edge. The writer has found 10 separate, clearly worded documents including many easy-to-comprehend diagrams.

This is unsurprising, given the competitive nature of the sector and the predominance of ethnic Chinese in the Malaysian economy. Malaysia's ethnic Chinese form a well-defined 29% of her population. The *Bumiputera* in Malaysia comprise the politically predominant

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[292] UK Prudential Regulation Authority (PRA) Policy Statement (PS7/13) Strengthening capital standards: implementing CRD IV, feedback and final rules (December 2013) (the PRA Policy Statement).

[293] F Dierick and others, "The New Basel Capital Framework and Its Implementation in the European Union" (2005) *ECB Occasional Paper* 42.

Malays and other indigenous groups, constituting 67 per cent of the population in 2010,[294] and have a protected position under the affirmative action provisions of the Malaysian Constitution.[295] Singam estimates that the Chinese controlled 60% of the private, corporate and domestic share capital of Malaysia's economy prior to the financial crisis, absolutely dominating majority business and economy in the region.[296]

It seems reasonable to draw the inference that Islamic banks, in order to compete, have to appear as well-managed as the international banks operated by the Chinese both in Malaysia and offshore. BIMB has attracted much custom and its annual reports show it to be profitable.

Unlike BIMB, the bank formerly known as Islamic Bank of Britain, and now known as Al Rayan Bank does not, in its documents dealing with pillar 3 disclosure under Basel,[297] include anywhere near the same amount of detail – merely 20 pages - and indeed includes only one diagram. It appears that IBB simply does not wish to compete in terms of excellence in corporate governance with other British banks and, as I will demonstrate in chapter 6, its loss of funds equivalent to 25% of customer deposits between 2004 and 2009 indicates that it either has rather bad risk management or rather bad corporate governance, or both. Its appeal, that it is an Islamic Bank, has, as I demonstrate, failed to garner significant patronage from Britain's 2.7 million-plus Muslims, less than 50,000 of whom have become customers.

The challenge with the study of IBB is that there is simply not enough material, either published by IBB or apparent from other researchers, to draw definitive conclusions. This in itself is illustrative, as if the directors felt that there was no need to expand on available knowledge outside the bare legislative minimum.

The following figures illustrate the various strategies of methods used by the Islamic Bank of Malaysia to manage risk.

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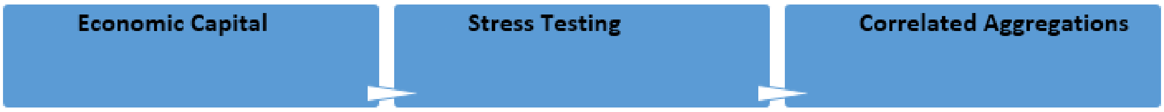
[294] HA Lee, "Affirmative Action Regime Formation in Malaysia and South Africa" (2014) *Journal of Asian and African Studies* 10.
[295] See in particular Article 153.
[296] K Singam, "Corporate Governance in Malaysia" (2003) 15 *Bond Law Review* 1, Article 13.
[297] Retrieved from http://www.alrayanbank.co.uk/media/153392/pillar-3-disclosure-document-31-dec-2012-final.pdf.

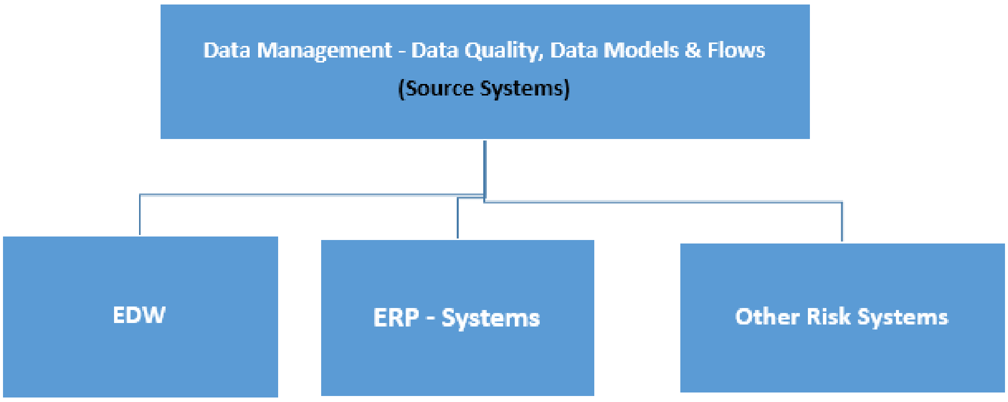
Figure 7: BIMB Risk Management Strategies

Source: BIMB presentation on risk management to Bank Negara Malaysia.

Figure 8: BIMB Risk Management enabler



Market Risk	**Credit Risk**	**ALM**	**Operational Risk**
IR, EQ, FX Risk	Risk Weighted Assets	GAP Analysis	Loss Data
Stress Testing	Stress Testing	Stress Testing	Qualitative Assessments
Liquidity Risk	Potential Future Exposure	Liquidity Risk	Control Testing
Market VaR	Credit VaR	Net Income Margin	Workflow
-	Credit Scoring	-	Capital Calculation



Source: BIMB presentation on risk management to Bank Negara Malaysia.

Figure 8 shows what are the strategies that can be taken at a management level to identify, minimize and report risk. Figure 9 shows a more technical approach to risk management and presents what are the methods to quantify risk of every type.

As the writer will demonstrate in Chapter 5, sweeping claims or criticisms cannot be made in connection with the, arguably, limited applicability and transferability of such standards in Islamic markets. Indeed, Malaysia has been selected primarily due to its mixed nature: Islamic and conventional banks operate in parallel. IBs in Malaysia stand at the forefront of several important standards setting functions, specifically their attempts to reconcile Islamic Finance Service Board (IFSB) standards with global standards developed under the Basel framework.[298] However, at present, the banking sector in Malaysia remains heavily reliant on debt modes of financing, exactly the mode of financing which distinguishes conventional

[298] Islamic Financial Services Board (2005a) Capital Adequacy Standard for Institutions (Other than Insurance Institutions) Offering only Islamic Financial Services. December, http://www.ifsb.org/standard/ifsb2.pdf.

banking from Islamic banking.[299] In many respects, it is only by examining equity or non-debt based modes of financing that the Basel framework, specifically on credit risk regulation, can be subjected to critical scrutiny. The argument employed in the foregoing analysis is that Islamic banks, as a general trend, have and continue to remain well leveraged even at the apex at the 2008 crisis. Nonetheless, this thesis proceeds from the premise that IFIs remain susceptible to additional kinds of credit risk exposures. These additional risks arise directly from the specific Shari'a related requirements that govern the operation and conclusion of Islamic contracts and instruments- namely the risk and profit sharing (and interest forbidding) conditions which they (are in theory) required to satisfy.

Of course Basel is not the only form of regulation and the advantage in the hermeneutical analysis of Islamic Bank of Britain as against the Malaysian case study - using what we know about one to fill in the gaps in the other - is that there is, Islamic regulation aside, a remarkably similar regulatory framework borne of the fact that Malaysia was a British colony until 1958. Accordingly Malaysia has a Bankruptcy Act 1967 with an interesting twist: a person who becomes bankrupt either with insufficient book-keeping records, possibly with a "lavish lifestyle" or otherwise with debts of more than twice his or her assets cannot be discharged until he or she pays a dividend of at least 50 piasters in the dinar.[300] In England and Wales, bankruptcy is governed by Part IX of the Insolvency Act 1986, and now the majority of bankruptcies will be discharged after only 12 months.[301] The greater consequences of bankruptcy in Malaysia vis-à-vis the UK may indicate a greater prudence in those who might suffer it in the former, leading to greater prudence.

Banking institutions active in Malaysia have emerged as key actors in the development and growth of Islamic debt markets, including the emerging market in Islamic derivatives. However, the share of non–debt based instruments that form part of the financial profile of Malaysian banks remains, as yet, trivial. As such, the case study on Malaysia is supplemented by a broader discussion on the adaptability and propriety of global and regional standards as applied to specific financial instruments and modes of financing. In doing so, this chapter highlights the particular risks to which IBs are more greatly exposed compared with

[299] H Hasan, "Islamic Property Financing in Malaysia: Appraisal and Practical Recommendations" (2011) 2 *International Journal of Business and Social Science* 2.
[300] Act no 360 of 1967, (MY), s 33. http://www.agc.gov.my/Akta/Vol.%208/Act%20360.pdf.
[301] Enterprise Act 2002, (UK) Part X.

conventional systems, and vice versa. The advantages of this as against the GCC minimalist approach will be demonstrated.[302]

3.7 Summary

In this chapter, we provided a general methodology with specifics on research design, strategy, and process that included identification and determination of which data would be examined and analysed. Since our methodology interfaces with risk management approaches of the Basel Accords, it is important to keep in mind that the facts of our case studies were initially evaluated in terms of the risks found in the company financial reports as reported in the public domain and academic journals. We performed a financial analysis of the balance sheets of relevant institutions, i.e, the IBB in Chapter 6 and BNM and BIMB in Chapter 5 which gives us the fundamental data to assess the risks of the Islamic banking institutions. The methodology is not that far away from the practice of risk management as it practiced by corporate finance analysts and other professionals in the engaged in assessing the legal and financial risks of companies. This practice-oriented methodology has provided original insights into the genuine financial and management risks of those entities and forms a firm basis for further investigations into the nature and types of risks that Islamic banking institutions may have.

[302] See chapter 5

Chapter 4: THE LIMITS OF BASEL IMPLEMENTATION IN ISLAMIC FINANCIAL INSTITUTIONS

4.1 Introduction: Basel II as a General Framework for Risk Management

Regulators remain preoccupied with risk management approaches and discourses owing to the duality of the ends and objectives it is presumed to serve: on the one hand, the stabilization of expectations around market value and, on the other hand, the protection of public (e.g. consumer) interests. Indeed, it is these aims that led to the creation of the BCBS in 1974.[303] The governing board of the Basel Committee comprises representatives from each of the G10 countries. The meta-regulatory role of the Basel committee and other global supervisory bodies cannot be understated given their standard setting functions.[304] In global economies, the demand and need for a general body with broad supervisory powers and authority to set and monitor standards grows more pressing, not least of the disparate or 'contagion' effects of global flows of finance and capital. The actions (or collapse) of a bank can trigger profound effects not merely on the solvency of that individual institution but equally for interlinked firms and businesses that depend on credit and liquidity of that bank, as well, ultimately, as the stability of economies and markets as a whole. [305] Also, because so many banks purportedly follow the Basel standards, there may arise a regulatory risk of synchronization.

4.1.1 BASEL I: The Introduction of a Global Framework for Regulating Banks

The Basel Accord (Basel I) can be seen as a globalisation and internationalisation of regulation within the Conventional Banking system or the group of banks that do their business in Western Europe and in the United States.[306] Western Banks are based on the conventional banking theories that state that banks realize profits by purchasing deposits at a low interest rate and then reselling them at a high interest rate, because of their competitive

303 The Basel Committee for Banking Supervision, *Strengthening the Resilience of the Banking Sector* (Consultative document 2009). Retrieved from www.bis.org; MS Barr and GP Miller, "Global Administrative Law: The View from Basel," 17 (2006) *Eur. J. Int'l. L.* 15; The Basel Committee on Banking Supervision, *International Convergence Of Capital Measurement and Capital Standards: A Revised Framework* (2006); HS Scott, (ed.) *International Finance: Transactions, Policy, and Regulation* (2006) 306.

304 The Basel standard will apply to all banks in the European Union and the U.S.

305 A Ackerman, "Jamie Dimon Says Regulations Will 'Stifle' Economic Growth" *Wall St. J. Deal J. Blog* (Apr. 5, 2011) retrieved from http://blogs.wsj.com/deals/ 2011/04/05/jamie-dimon-says-reuglations-will-stifle-economic-growth/.

306 A Wignall and P Atkinson, "Thinking Beyond Basel III: Necessary Solutions for Capital and Liquidity" (2010) *OECD Journal: Financial Market Trends* 1.

advantage at gathering information. Conventional banks have some advantages over Islamic banks, such as a long history, the use of interest which account for a large part of the revenues, not sharing losses with customers, asking for collateral and utilizing large amounts of capital.[307] Subject to the requirements under Basel I, banks are required to observe minimal capital requirements. These requirements are designed to minimise and prevent credit risks. Otherwise put, Basel I represented a comprehensive and somewhat novel attempt to introduce stricter and more transparent levels of institutionalised capital management and responsibility among key banking institutions operating in key OECD countries.[308] The governing logic and rationale of the Basel regime was the advancement of internationally convergent and minimally harmonised standards for regulating the way financial institutions measure risks in order to assess and calculate the minimum levels of capital they should conserve and hold in reserves in order to have acceptable levels of institutional liquidity and reduce their risk exposures.

As indicated earlier, banks remain largely subject to the laws and procedures of the country in which they operate. Regulatory diversity across states and individual banking institutions can create asymmetries in the actual management of risks, including the methods by which those risks are measured (as a proportion of certain categories of assets and the total capital structure of the bank as a whole) as well as the ways in which banks calculate minimum capital requirements as a percentage of their risk weighted assets. The absence of clear and consistent rules and procedures can also generate broader effects on the stable functioning of markets as a whole, contributing to market uncertainty or unfair competition, for instance, through the unequal distribution of costs associated with complying with regulations in one state, relative to another. This is where the importance of the Basel provisions is made apparent, as the minimum capital requirements and the risk valuation can help banks to better manage their resources.

From one perspective, Basel I clearly represents a baseline rather than the attempt to instantly globalise best practice in a way that might effectively require Islamic banks to adopt a Western model of banking. This approach was taken forward by the Basel II agreement. However, one can argue that the Basel baseline fails to adequately reflect important

[307] S Mohamad, T Hassan and B Mohamed, "Efficiency of Conventional Versus Islamic Banks: International Evidence Using the Stochastic Frontier Approach (SFA)" (2008) 4 *Journal of Islamic Economics, Banking and Finance* 2, 107-130.
[308] Wignall, N_317 above.

differences in the structure and principles underlying Islamic finance relative to conventional banks.[309] One key difference, as discussed in previous chapters, is caused by IB following the principles of Sharí'a. This set of rules and guidelines prevent accepting interest or fees for loans of money.[310] Also it is forbidden to invest in businesses that provide goods or services that are contrary to Islamic principles, such as pork or alcohol. Following the principles of Sharí'a results in differences in the assets and liabilities structure of IB, because over 60% of their funding derives from profit sharing investment accounts that are usually based on a *Mudarabah*, a profit sharing and loss bearing contract.[311] Furthermore, transactions with commodities and real assets in Islamic finance are a source of additional operational risks and an immediate issue is how to separate commercial transactions from financial intermediation in order to ensure stability in this segment.

The profit and loss statement and the balance sheet are also clearly different, as shown in the table below:

Table 1: Classification of Islamic banking using financial statements[312]

Financial statement	Conventional bank	Islamic bank
Profit & Loss	Net interest income + Financial services income + Capital gains - Operating expenses - Amortisation of goodwill - Charge for doubtful loans = Gross Profits - Income taxes = Net Profits	Net income + Financial services income + Capital gains - Operating expenses - Amortisation of goodwill - Charge for doubtful loans = Gross Profits - Income taxes = Net Profits (from profit shares, services fees and excess over all expenses)

As the table above indicates, conventional bank reports net income on loans and subtracts the interest paid to the depositors and capital providers. The difference is that an Islamic bank does not accept or pay interest but reports net income from profit-shares agreement and fee

309 Mohamad, N_318 above.
310 Vide fn **Error! Bookmark not defined.**
311 Sundararajan, N_322 above. "Profit Sharing Investment Accounts--Measurement and Control of Displaced Commercial Risk (DCR) in Islamic Finance" (2011) 19 *Journal of Islamic Economic Studies* 1, 41-62.
312 M Ariff, "Islamic Banking: A Variation of Conventional Banking?" (2007) 3 *Monash Business Review* 1, 4-5.

incomes from activities similar to sales or leases. Profit share income may be from different forms of lending activities such as profit shares (mudarabah) or joint-venture (musaraka) or some other specialized form of finance.

The items in the table are similar, but the entire report is conditional on income reporting that avoids interest and is not related to activities prohibited by Islam. Bonds are called sukuk bonds and contain no obligations to pay interest coupons as is the case in conventional bonds. In exchange, the issuer has some assets that provide rental incomes and from those the investor is paid. The equity can also be called musharaka fund, but it means the same as equity.

4.1.2 BASEL II: Objectives, Rationale and Structure

Following widespread criticism of Basel I, the BCBS undertook a series of far-reaching amendments to the first of the accord. The second of the accords, or Basel II as it is commonly known, was initially published in 2004 in light of concerns over the expanding debt financed markets in securities, credit swaps and derivatives. Accordingly, the amended standards under the second agreement represented a more rigorous attempt by the Committee to integrate Basel capital standards with national regulations, once again in pursuit of minimally harmonised, robust and coherent capital measurement and capital adequacy requirements. [313] Again, the Basel Committee established guidelines and qualitative benchmarks for assessing the amount and quality of capital that banks ought to retain and conserve in order for them to reduce, manage and counter the effects of a range of risk exposures---liquidity, operational and macroeconomic.[314] The public demand for strengthened regulation and risk supervision of banks, however, was to be balanced against another no less compelling set of imperatives which lie at the core of the conventional banking system: profit maximisation, free market competition and the effective functioning of financial markets.[315] The main purpose of Basel II was to set out standards for the regulation of the capital of the internationally active banks. However, Basel II failed to reduce liquidity risks and also amplified it by allowing hybrid financial instrument to be

[313] International Convergence of Capital Measurement and Capital Standards of the Basel Committee on Banking Supervision (Press Release October 27, 1998).

[314] *Revisions to the Basel II Market Risk Framework* (March 2009) Retrieved from http://www.bis.org/publ/bcbs148.pdf; Basel Committee on Bank Supervision, *Guidelines for Computing Capital for Incremental Risk in the Trading Book* Retrieved from http://www.bis.org/publ/bcbs149.pdf.

[315] Barr, N_314 above.

treated with the same certainty reserved for equity. The financial crisis of 2007-2008 made it clear that Basel II was not effective, because the requirement for tier 1 capital did not discourage, limit or prohibit excessive hybridization.

Basel III, as opposed to Basel II's broad definition of tier 1 capital,[316] includes restrictive definitions of tier 1 capital,[317] a new leverage ratio,[318] a new capital surcharge for systemically important banks,[319] a framework for counter-cyclical capital buffers,[320] measures to limit counter-party credit risk[321] and short and medium-term quantitative liquidity ratios.[322] Basel III strengthens capital adequacy by increasing the quantity and the quality of capital held by banks.[323] A weighted common equity capital ratio of 4.5 percent is set in place and a conservation buffer of 2.5 percent.[324] If a bank falls below the conservation buffer, it will face restrictions on paying dividends and discretionary bonuses.[325] In this way, Basel III sets an effective floor of 7 percent.

Were the cause of the 2008 meltdown solely a failure of the design of capital ratios in Basel II, one might understand that the architects of Basel III would concentrate solely on a reform of the architecture. But as Baltali and Tanega, point out,

> Shortly before Northern Rock was declared insolvent and taken over by the UK government in 2007, it had reported the highest capital ratio of any leading British bank…just fifteen days before its bankruptcy on September 15th, 2008, Lehman Brothers boasted a Basel-type tier 1 capital ratio of… almost three times the regulatory minimum.[326]

Though first published in 2004, the Basel accord was not fully adopted and implemented into the national legal system of many key G10 and OECD countries, including crucially the US

[316] Bank for Int'l Settlements Basel Comm. On Banking Supervision, International Convergence Of Capital Measurement And Capital Standards: A Revised Framework – Comprehensive Version (2006) [hereinafter International Convergence 2006], ¶ 49 Retrieved from http://www.bis.org/publ/bcbs107.pdf.

[317] Bank for International Settlements, Basel Committee on Banking Supervision, Basel III: A global regulatory framework for more resilient banks and banking systems, (June 2011), [hereinafter Basel III: Capital], ¶¶ 49-56. Retrieved from http://www.bis.org/publ/bcbs189.pdf.

[318] *Ibid.* at ¶¶ 151-67.

[319] *Ibid.* at ¶ 32.

[320] *Ibid.* at ¶¶ 136-51.

[321] *Ibid.* at ¶¶ 97-121.

[322] *Ibid.* at ¶¶ 34-47.

[323] *Ibid.* at ¶ 7.

[324] *Ibid.* at ¶¶ 50, 129.

[325] *Ibid.* at ¶ 129.

[326] C Baltali and J Tanega, "Basel III: Dehybridization of Capital" (2011) 8 *New York University Journal of Law & Business* 1, 1.

and UK till after 2008. [327] In capsule, the governing logic and rationale, which together animate the Basel II agreement, can be reduced, in general, to the following rule or principle: the greater the risk to which the bank is exposed, the higher the levels of capital which a bank must hold as a means of safeguarding its solvency and overall stability. This is better than fractional-reserve banking, where banks accept deposits and hold reserves for a fraction of the deposit liabilities. However, in both cases, if a bank run is experienced, the liquidity risk is not eliminated and the bank can find itself in a position of being unable to meet its obligations.[328]

As part of the general raft of measures intended to enhance the risk sensitivity of banks, the qualitative capital requirements introduced in Basel I were now supported by with two additional pillars which sought to empower the BCBS with increased powers of supervisory review and market discipline. [329] In a second innovation, the regulatory framework of the BCBS now established a closer link between credit risk and other types of risk namely market and operational risk by integrating each of the factors these into the calculation of minimum capital requirements, [330] although, as the case study of the IBB in chapter 6 will demonstrate, possibly with insufficient attention to the fact that it is difficult to measure a change in governance culture.[331] A third reform was aimed at promoting a responsible form of self-regulation on the part of internationally active banks themselves ----thereby reducing the scope and probability of competitive inequality resulting from, for example, high regulatory-compliance costs. To this end, Basel II introduces a set of exemptions for banks with advanced management and auditing capabilities by enabling them to design and implement their own internal risk management systems.[332] This has a particular impact on the Islamic banking community, as the ability to manage potentially much greater exposure to the asset types and equity based finance of Islamic banking can appear fundamentally different to the debt-based asset portfolio of Western banks. Again, as the case study in chapter 3 and chapter 6 show, this did not prevent IBB from making massive losses, although conversely in Malaysia as the case study in chapter 5 will demonstrate, the competition in the banking

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[327] Press Release of October 27, 1998 and International Convergence of Capital Measurement and Capital Standards of the Basel Committee on Banking Supervision.BIS, 2006; p. 2
[328] Sundararajan,N_322 above.
[329] International Convergence 2006
[330] *Ibid.*
[331] RM Gisselquist. “Developing and Evaluating Governance Indexes: 10 Questions” (2014) 35 *Policy Studies* 5, 513-31.
[332] R Gallati, Risk Management and Capital Adequacy (New York McGraw-Hill 2003) 346.

system between Islamic and conventional banks has produced a governance structure designed to make investments in IBs as profitable as investments in other banks.

4.1.3 BASEL II: Political Economy in Relation to Islamic Finance

In the discussion of self-regulation and reform, it is important to discuss the political economy of Basel II in relation to Islamic finance. For instance, it is arguable that a challenging task facing regulators of the financing industry is to avoid excessive influence against Islamic interests by those who they are supposed to be regulating. For instance, some critics point out that the heavier the regulation and the fewer the amount of players in the financial industry, the greater the incentives are for the industry to try and "influence" the regulators of the financial industry.[333] Further to this point, as regulatory costs generally create a countervailing lobby against regulation, regulators become persuaded by the bankers' position.[334] In addressing the research question of whether the Basel framework can in fact be internalised by Islamic financial institutions, the Islamic position first needs to note the mis-match between points of regulation and the points of market failure that regulation should be addressing. The Islamic financial structure is so intertwined with religious influence that its pervasive nature is seen in the way that regulations are adopted, and thus, politically motivated. It is also arguable that the more market failure and regulation miss each other, the more likely that regulators and regulation alike will be more susceptible to excessive influence, more so than their more conventional counterparts seen in the West.

4.2 BASEL III: A Landmark for Banking Regulation

Basel II sought to address the above shortcomings with some success. In the aftermath of the financial crisis, the Basel Committee has issued a further set of reforms under the Basel III framework.[335] The core proposals of the Committee are fleshed on in the policy document "Basel III: A global regulatory framework for more resilient banks and banking systems". Basel was published in June 2011. While, once again, the regulatory proposal contained within that document constitutes a 'soft' disciplining instrument which remains non-binding on member and non-member states of OECD and non OECD states until formally

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[333] S Griffith-Jones and A Persaud, *Management of Volatility, Financial Liberalization and Growth in Emerging Economies* (ECLAC Headquarters Santiago April 24-25, 2003).
[334] *Ibid.*
[335] Press Release, Bank for Int'l Settlements, Basel III rules text and results of the quantitative impact study issued by the Basel Committee (Dec. 16, 2010), available at http://www.bis.org/press/p101216.htm.

implemented in national law, its ‘normative pull’ is significant.[336] Indeed, Basel III was cemented as a de facto global standard through its formal adoption and recognition by the European Union[337] and the United States.[338] It has proven to be the global standard for risk assessment and risk measurement for internationally active banks in the world. Most of the Saudi banks already conform to the Basel capital adequacy requirement, having a capital adequacy between 11% and 16%.[339]

Drawing its impetus from the effects of the financial crisis, global stakeholders in the international banking complex seized upon the pressing need to improve the sector’s capacity to manage risks and absorb losses stemming from known and unknown financial and economic shocks and stresses. Furthermore, since 2010, national authorities presiding over conventional and Islamic banking organisations have taken legislative steps to implement global regulatory banking standards and protocols, with the aim of subjecting banking institutions domiciled or operational in their territories to strengthened risk management and corporate governance disciplines. In capsule, the Basel III framework established four sets of reforms intended to the redress the ‘gaps’ in banking regulation and risk exposures.

These reforms can be summarised as follows: a) New Capital adequacy thresholds: it increases the threshold minimum capital ratio that banks are expected to institute and observe to 8%[340] ; b) Classification of risks: the delineation of relatively strict and detailed eligibility criteria on for different types of capital held by a bank (e.g. the capital structure of a bank) as a proportion of its risk weighted assets (RWA),[341] c) Loss Absorption measures: the introduction of measures intended to facilitate greater loss absorbency of unredeemed stock,[342] d) Liquidity related rules: the institution of new rules designed to limit the build-up

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[336] Basel Committee for Banking Supervision, Consultative Document: Strengthening the Resilience of the Banking Sector 13 (2009) [hereinafter Strengthening the Resilience of the Banking Sector] Retrieved from http://www.bis.org/publ/bcbs164.pdf; P Jackson and others, *Capital Requirements and Bank Behaviour: The Impact of the Basel Accord 21* (Basel Committee on Banking Supervision, Working Paper No. 1, 1999). Retrieved from http://www.bis. org/publ/bcbs_wp1.pdf; Basel Committee on Banking Supervision, Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework (2006) [hereinafter Basel II] Retrieved from http://www.bis.org/publ/bcbs128.htm.

[337] Retrieved from http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm#crd4

[338] Jackson, N_347 above.

[339] BS Alrawashdeh and B Rahman, “To What Extent Saudi Banks Committed to the Decisions of the Basel II Committee” (2013) 1 *Merit Research Journal of Art, Social Science and Humanities* 5, 67-75.

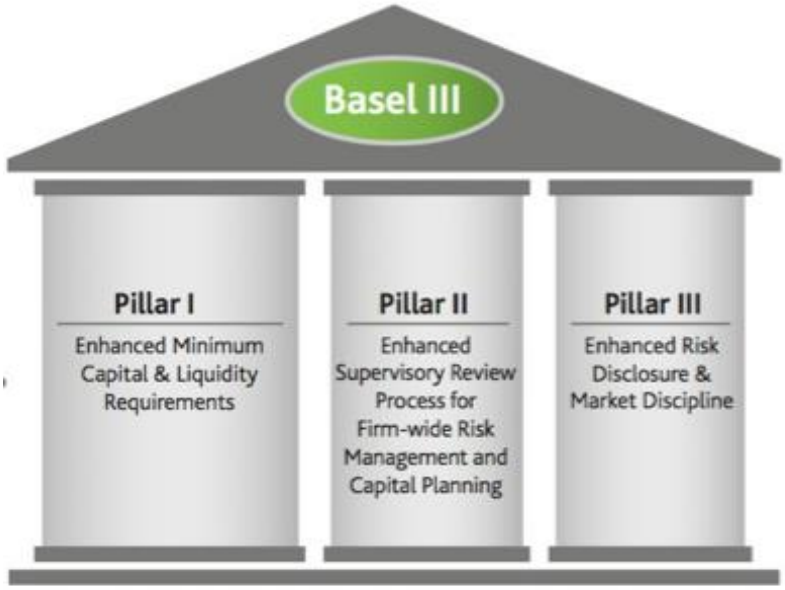
[340] Basel III: Capital, ¶ 94.a.

[341] Basel III: Capital, ¶ 50.

[342] Basel III: Capital, ¶ 36.

of excessive leveraging[343] e) enhanced supervisory process for capital planning (Pillar 2) and f) strengthened market disciplines against abuse and stricter disclosure rules (Pillar 3). [344]

Figure 9: The three pillars of Basel III



Unlike the previous accords, and as the above diagram suggests, Basel III is focused on mainly the risk of "bank run" by requiring different levels of reserves for specified financial products. In the above figure the pillars of Basel III are illustrated, along with the main regulations of each one. Instead of replacing the previous accords, Basel III works alongside them. The third pillar especially has a role in increased market transparency. In this way, it is easier to see problems with the assets or organization structure of financial institutions before they happen.

4.2.1 New Definition of Own Funds and Regulatory Ratios

The new framework makes significant advancements on Basel I and Basel II, specifically by formulating new guidelines on risk computations; new capital and solvency ratios and a slight modification of capital structure classifications (Tier 1 and Tier 2). The Basel III has significantly redefined capital under the new framework. Renewed importance has been

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[343] Bank for International Settlements, Basel Committee on Banking Supervision, Basel III: The Liquidity Cover Ratio and the liquidity risk monitoring tools, (January 2013), [hereinafter Basel III: Liquidity Cover Ratio], ¶ 1, Retrieved from http://www.bis.org/publ/bcbs238.pdf.

[344] Bank for International Settlements, Basel Committee on Banking Supervision, Review of the Pillar 3 Disclosure Requirements, (June 2014). Retrieved from http://www.bis.org/publ/bcbs286.pdf.

given to forms of capital grouped under Tier 1, representing the banks' own capital including hybrid capital and common equity. [345]

New rules and criteria have also been formulated in respect of Tier 2 capital. As to the above outlined reforms, for instance, require banking institutions to strengthen the loss absorbency of Tier 2 instruments. Under the Basel III framework, a guideline is issued for assessing the trigger point at which financial institutions and instruments should be deemed non-viable and correspondingly converted to common equity, regulated under Tier 1, or otherwise written off from the balance sheets.[346] This rule responds to the financial liabilities absorbed by national governments and taxpayers (rather than shareholders) through 'toxic' debt accrued from non-viable instruments and asset and the rescue operations that resulted from government bailouts and (quasi) re-nationalisation of banking assets and liabilities. The result is that certain financing instruments, for instance issuances without loss at the point of viability, are excluded from Tier 2. Tier 2 under Basel III consists of hybrid instruments with a maturity of not less than five years.[347] Most instruments defined as Tier 2 capital will tend to have a longer maturity. However, regulatory amortisation will apply in the final five years to maturity. Tier 2 securities usually carry cumulative costs, for instance loans or preference shares issued by states (involving structured distributions which have the characteristic of being non-viable at the point of loss absorption, non-deferrable and cumulative).[348]

The Basel Committee has noted that banks have become very skilful at developing new instruments to generate Tier 1 capital. Under the Basel II framework, instruments which are more accurately regulated under the Tier 2 capital but which are used to generate Tier 1 capital are made subject to stricter capital requirements, namely such forms of capital cannot be in excess of 15% of a banks' total Tier 1 capital. This requirement will be phased under Basel III to reflect the enlarged definition and classification of Tier Common Equity Capital.[349]

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[345] Basel III: Capital, ¶ 52.
[346] Basel Committee on Banking Supervision, Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework(2006) [hereinafter Basel II]. Retrieved from http://www.bis.org/publ/bcbs128.htm ibid
[346] *Ibid.*
[347] Basel III: Capital, ¶ 58.
[348] Basel III: Capital, ¶ 57.
[349] Basel Committee for Banking Supervision, *Consultative Document: Strengthening the Resilience of the Banking Sector* 13 (2009); Allen & Overy, *Capital Requirements Directive IV Framework Capital and Capital Adequacy* (Client Briefing Paper 2 January 2014). Retrieved from http://www.allenovery.com/SiteCollectionDocuments/Capital%20Requirements%20Directive%20IV%20Framework/Capital%20and%20Capital%20Adequacy.pdf.

Interestingly, perhaps in light of the greater involvement and input of market actors, as mandated under Basel III, the framework formalises additional risk weighting requirements relating to securitized assets, the use of general market indicators on the value correlation of assets, disclosure of off balance counterparty credit risk in the trading books, credit valuation of risk charges and so on.[350] Further discussion as to the regulatory definition and application of these financial measurement tools and benchmarks fall outside the scope of this discussion. However, it is worth noting that these additional requirements will have a profound impact on the bank's risk weighted assets, and the means by which an institutions stock portfolio is assessed and calculated. The difficulty is that as governance of a borrower is hard to measure, the risk weighting to be given to an investment in a PLS arrangement with a borrower, or in a sukuk, may well be misleading in an Islamic context, which provides lessons for KSA as will be discussed in chapter 7.

For example, as Arakcheev, Baklanova and Tanega point out,

> Islamic liquidity funds established under Murabahah agreements conduct commodity settlements on a daily basis. Therefore, the cash accumulated in the … account needs to be reinvested daily. [This] process ……….entails significant operational risk.[351]

Indeed, the more assets held by a bank on its trading book, the more risk weighted assets it will be required to hold as a proportion of its total capital under both tier 1 and tier 2. [352] This has a particular impact on IBs due to the much higher amount of assets held through both direct equity holding and via permitted instruments.

4.2.2 Capital Buffers

The new Basel rules also established requirements on the capital buffer which banking institutions must hold in reserves. The buffer requirement takes two forms: a countercyclical buffer and a capital conservation buffer, both regulatory 'backstops' intended to prevent against unsustainable leveraging practices and liquidity shortages.[353] Capital conservation buffers is assessed as 2.5% as a proportion of the banks Risk Weighted Assets.[354] The

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[350] Basel Committee on Banking Supervision, *Progress Report on Basel III Implementation* (2011) Retrieved fromhttp://www.bis.org/publ/bcbs203.pdf; Allen & Overy, *Ibid.*.; DE Getter, *U.S. Implementation of the Basel Capital Regulatory Framework* (April 9, 2014). Retrieved from https://www.fas.org/sgp/crs/misc/R42744.pdf.
[351] Arakcheev, N_168 above.
[352] Basel III: Capital, ¶ 94.
[353] DE Getter, Macroprudential Oversight: Monitoring Systemic Risk in the Financial System (CRS Report R40417).
[354] Jackson, N_347 above.

regulatory purpose served by the capital conservation buffer is the strengthened capacity of banks to absorb losses during periods of financial and economic stress. [355] To supplement this backstop measure, thus securing adequate level of institutional liquidity on the part of banks, a countercyclical buffer with a conservation range of 0% – 2.5% of common equity or any other fully loss absorbing capital is also established under Basel III.[356] The ratio percentage applied under the countercyclical buffer is assessed in accordance with specific regulatory and financial conditions of each individual state.[357] The latter of the above mentioned regulatory buffers is therefore State-rather-than-institution dependent to reflect different macro-monetary and fiscal contingencies, primarily with the systemic aim of protecting banks from exposures to macro market and regulatory risks associated with, for instance, lenient credit or short loan initiatives (as well as other factors leading to excessive credit growth).[358]

Under the capital buffer requirements, internationally active banks will be able to continue operating even if capital conservations thresholds are triggered as they experience losses. However, should their reserves dip into this regulated conservation range; banking institutions are required to observe quantitative restrictions on their distributions and pay-outs. Accordingly, where banks do not hold adequate capital for this buffer, Basel III restricts the distribution of dividends, share buybacks or bonus payments until the required conservation buffer thresholds are restored (2.5% of Risk weighted assets).[359] Furthermore, if minimum capital requirements are breached, banks are now subject to strict supervisory sanctions and disciplining mechanisms: so, as will be demonstrated in Chapter 6, IBB needed a capital increase of £20 millions in the form of a share placement to the Abu Dhabi Islamic Bank to prevent insolvency.

The following figure shows what are the minimum levels of different indicators that have to be met by financial institutions and what are the dates for implementing them.

[355] Basel III: Capital, ¶ 122.
[356] Basel III: Capital, ¶ 136.
[357] Basel Committee on Banking Supervision, (2011), Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement.
[358] Latham and Watins, Regulatory Capital Reform under Basel III (2011 Report) Retrieved from http://www.garp.org/media/583507/regulatorycapitalreformbaseliii_nicolaides032311.pdf
[359] Basel III: Capital, ¶ 142.

Figure 10: Phase-in arrangements

Annex 2: Phase-in arrangements (shading indicates transition periods)
(all dates are as of 1 January)

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Leverage Ratio	Supervisory monitoring		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
Minimum Common Equity Capital Ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer						0.625%	1.25%	1.875%	2.50%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)				20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.125%	9.875%	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital			Phased out over 10 year horizon beginning 2013						
Liquidity coverage ratio	Observation period begins				Introduce minimum standard				
Net stable funding ratio		Observation period begins						Introduce minimum standard	

Source: Bank for International Settlements, available at: www.bis.org/press/p100912b.pdf.

The requirements will not be introduced all at once; an adjustment period will be given to financial institutions with intermediary targets for capital requirements, leverage ratio and more. As it is shown in the figure, as 2019 grows nearer, the requirements will be increasing steadily until the final targets are attained and the risk of the financial institutions that follow this framework is diminished substantially.

4.2.3 Liquidity Rules

The capital framework is supplemented by new simplified, non-risk based rules on liquidity conservation, specific those comprising the Liquidity Coverage Ratio. The new rules operate to reduce and constrain the build-up of risky and unsustainable leverage in the banking sector, while introducing measures intended to enhance the solvency and stability of banks against shocks, including liquidity disruptions.[360] Furthermore, the framework sets introduces new rules aimed at encouraging banks to use stable and reliable sources of finance and funding as part of their risk profiles. The relevant criteria is defined and formulated under the

[360] Basel III: Liquidity Cover Ratio, ¶ 1.

Basel guidelines on Net Stable Funding Ratio (NSFR).[361] Cumulatively, this standard aims to improve the ability of the banking system to absorb losses through internal institution of higher capital requirements and buffers.[362]

The formula for the liquidity cover ratio is:

$$\frac{\text{Stock of high quality liquid assets}}{\text{Total net cash outflows over the next 30 calendar days}}$$

This ratio has to be over 100%.[363]

The formula for the net stable funding ratio is:

$$\frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}}$$

This ratio also has to be over 100%.[364]

The two ratios discussed have distinct but complementary rationales. The first, the LCR aims to enhance bank's short-term liquidity profile but requiring banks to hold buffer reserves which can cover any temporary funding shortages over a 30 day period. The Net Stable Funding Ratio (NSFR), by way of contrast, addresses medium and long term considerations, namely the institutional liquidity of banking institutions under stress over a period of one year. The NSFR ratios have been the subject of some controversy. Since banks are profit driven entities, rules on liquidity retention may limit banking short term trading capacity (e.g. short selling, subject to regulatory authorisation, and so on). [365] This also effectively renders emergency liquidity problematic in some respects, as the existence of liquidity that is set aside for crises may effectively be barred from use unless and until that liquidity requirement is eased. In addition, the assumptions under which the ratios are set are based around WB stress modelling.

This risk and stress modelling and the Basel reforms are presented in order to examine their suitability in an Islamic environment. Even if they are not tailored specifically for Islamic

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[361] Bank for International Settlements, Basel Committee on Banking Supervision, Basel III: The Net Stable Funding Ratio, (October 2014), [hereinafter Basel III: The Net Stable Funding Ratio], ¶ 1. Retrieved from http://www.bis.org/bcbs/publ/d295.pdf.
[362] Morgan Stanley Research Paper on European Banks (April 2011).
[363] Basel III: Liquidity Cover Ratio, ¶ 22.
[364] Basel III: The Net Stable Funding Ratio, ¶ 9.
[365] Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (June 2006). Retrieved from http://www.bis.org/publ/bcbs128.pdf.

financial institutions, these reforms contribute toward a healthier banking system worldwide and their importance can't be understated.

Table 2: Summary of Basel reforms and framework for implementation

Regulatory Element	Proposed Requirement
Higher Minimum Tier 1 Capital Requirement	Tier 1 Capital Ratio: increases from 4% to 6%[366] The ratio will be set at 4.5% from 1 January 2013, 5.5% from 1 January 2014 and 6% from 1 January 2015 The total capital comprising tier 1 and tier 2 must be at least 8%
New Capital Conservation Buffer	»» Used to absorb losses during periods of financial and economic stress[367] »» Banks will be required to hold a capital conservation buffer of 2.5% to withstand future periods of stress bringing the total common equity requirement to 7% (4.5% common equity requirement and the 2.5% capital conservation buffer) »» The capital conservation buffer must be met exclusively with common equity »» Banks that do not maintain the capital conservation buffer will face restrictions on pay-outs of dividends, share buybacks and bonuses
Countercyclical Capital Buffer	»» A countercyclical buffer within a range of 0% - 2.5% of risk weighted assets and other fully loss absorbing capital will be

366 Basel III: Capital, ¶ 50.
367 Basel III: Capital, ¶ 122

	implemented according to national circumstances[368] »» When in effect, this is an extension to the conservation buffer
Higher Minimum Tier 1 Common Equity Requirement	»» Tier 1 Common Equity Requirement: increase from 2% to 4.5%[369] »» The ratio will be set at 3.5% from 1 January 2013, 4% from 1 January 2014 and 4.5% from 1 January 2015
Liquidity Standard	»» Liquidity Coverage Ratio (LCR): to ensure that sufficient high quality liquid resources are available for one month survival in case of a stress scenario.[370] Introduced 1 January 2015 »» Net Stable Funding Ratio (NSFR): to promote resiliency over longer-term time horizons by creating additional incentives for banks to fund their activities with more stable sources of funding on an ongoing structural basis[371] »» Additional liquidity monitoring metrics focused on maturity mismatch, concentration of funding and available unencumbered assets
Leverage Ratio	»» A supplemental 3% non-risk based leverage ratio which serves as a backstop to the measures outlined above[372] »» Parallel run between 2013-2017; migration to Pillar 1 from 2018

368 Basel III: Capital, ¶ 139.
369 Basel III: Capital, ¶ 94.b.
370 Basel III: Liquidity Cover Ratio, ¶ 1.
371 Basel III: The Net Stable Funding Ratio, ¶ 2.
372 Basel III: Capital, ¶ 152.

	Minimum Total
Minimum Total Capital Ratio	»» Remains at 8%[373] »» The addition of the capital conservation buffer increases the total amount of capital a bank must hold to 10.5% of risk-weighted assets, of which 8.5% must be tier 1 capital »» Tier 2 capital instruments will be harmonized; tier 3 capital will be phased out

If the above framework is adopted in Islamic finance, there will be advantages and disadvantages. The disadvantage is that the accord is made with conventional banking in mind and risks caused by the specific features of Islamic banking, such as profit sharing, will remain the same. However, as was previously shown in Table 1, the balance sheets of Islamic banks have a similar asset structure and they are susceptible to the same risks. In this way the positives outweigh the negatives, because implementing the Basel framework in Islam will lead to greater financial stability.

4.3 Criticisms of the Basel III Framework

Under the landmark Basel III framework, all banks subject to the national implementation of the Basel regime are expected to gradually phase in higher capital requirements over an implementation phase than began in 2013 and runs through to 2019.[374] In part a response to unsustainable forms of leveraging, the Basel III reforms are designed to facilitate more responsible lending practices in the economy, and to mitigate banking exposures to market, credit and operational risks moving forward.

The capital rules and amendments promulgated under Basel III have not avoided criticism. Indeed, there is some debate as to whether the revised capital structure standards effectively support the Basel Committee's proclaimed commitment to strengthened capital resilience and market stability. One criticism relates to the "threshold deduction rule" which exempts three categories of major types of investment in the calculation of common equity tier capital

[373] Basel III: Capital, ¶ 131.
[374] Morgan Stanley, N_373 above

thresholds: mortgage related financial services and equity rights, short term and deferred tax assets resulting from imbalance in taxation rates and common shares held in unconsolidated financial entities.[375] By removing these the list of countable assets, the Basel Committee undermines the spirit and purpose of its own regulatory reforms, specifically the risks of excessive and double leveraging in the banking industry.[376]

From a top down perspective, the Basel framework, including the revised rules issued under Basel III, do not yet appear to be particularly well adapted to the regulatory particularities of Islamic financial structures and the contracts and principles that underpin them. If one can make the claim that Basel III has now been crystalised as an international standard, questions are raised as to the extent to which the component elements of the Basel framework can be adapted to Islamic banks and the IFSB standards.[377] As Chapra has argued: "Since the existing architecture of the conventional financial system has existed for a long time, it may perhaps be too much to expect the international community to undertake a radical structural reform of the kind that the Islamic financial system envisages. However, the adoption of some of the elements of the Islamic system, which are also a part of the western heritage, is indispensable for ensuring the health and stability of the global financial system." [378]

The most important of the reforms concern the newly revised Basel III capital requirements. Thus the next section offers a more theoretical discussion of the some of the key challenges faced by Islamic finance markets in the implementation of the Basel accord.

4.4 Analysis of the Basel Reform and their Implications for IFIS

The next section will reflect briefly on the perceived impact of the Basel framework on the existing regulatory architecture. Perhaps the greatest regulatory gain of the revised Basel architecture with respect to emerging Islamic finance market concerns its potential to spread

[375] Basel Report on Definition of Capital 2011 http://www.bis.org/publ/bcbs198.pdf
[376] A Harzi, " The Impact of Basel III on Islamic Banks", A theoretical study and comparison with conventional banks. Paper presented first time at the research chair "ethics and financial norms" of University Paris 1 La Sorbonne and the King Abdul University (Jeddah) available at http://cenf.univ-paris1.fr/fileadmin/Chaire_CENF/pdf/The_impact_of_Basel_III_on_Islamic_banks_-_chaire_Paris_1.pdf
[377] Islamic Financial Services Board. (2005a) Capital Adequacy Standard for Institutions (Other than Insurance Institutions) Offering only Islamic Financial Services. December, http://www.ifsb.org/standard/ifsb2.pdf.
[378] Chapra, N_15 above.

and consolidate good governance practices on transparency, auditing and reporting and disclosure.[379]

At the level of institutional change and structure, conventional banks are now subject to stricter and more costly reporting and disclosure requirements. Under Basel II, supervising authorities are able to pierce the veil of a bank's financial statements, to the extent that they are adequate and accurate, with the aim of scrutinizing their capital structure and adequacy. In Chapter 7, the writer will discuss the difficulty this poses for Sa'udi banks; against the well-documented statements of the BIMB, as will be demonstrated in Chapter 5, there is little transparency in the IBB as shown in chapter 6.

Moreover, as Basel standards gain near universal recognition, regional actors with supervisory and standard setting authority, such as the Islamic Finance Services Board have had greater impetus to standardize their own capital adequacy and risk mitigation strategies and approaches. Sharí'a guidelines on compliant finance and banking practices are also partially codified in the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI's) accountancy Standard (standards 1) and accounting Standard (standards 2).[380] By extension, the Basel framework establishes a global benchmark, while, in theory, being sufficiently open and revisable so as to enable regional actors such as the IFSB to adapt and devise their own standards and practices which are more adapted to regulatory practices of Islamic markets, structures and instruments.

As part of the Basel package of reforms, requirements on minimum common equity have increased 3.5 times from 2 percent to 7 percent which factor in an additional capital conservation buffer. The NPVL trigger poses operational challenges for traditional banking institutions, though perhaps less so for Islamic banking institutions given that capital structure of the former tends to be held in the form of common equity capital.[381] Nonetheless, whether for Islamic or conventional banks, banks are likely to experience challenges in determining when the trigger threshold for non-viability has been reached. This determination will fall to the relevant regulatory bodies with discretion to decide conversion

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[379] OETB Mohamed and A Diaw, *The Implementation of Basel II by Islamic Banks: The Case of Bank Islam Malaysia Berhad* (The International Centre for Education in Islamic Finance (INCEIF) Kuala Lumpur, Malaysia VOLUME 1 – Issue 2 September 2011).

[380] Retrieved from http://www.aaoifi.com/en/standards-and-definitions/shari%E2%80%99a-standards/.

[381] Saed, N_40 above; Ellias, N_264.

or writing off an instrument will result in more adverse effects still, namely that such actions will lead a particular institution to itself become non-viable or operational. In such cases, that authority may recommend that further public investment or support into tier II capital assets may be favourable as against the alternatives. However, such tests, and the power vested in the relevant authority to apply it, are subjective and therefore liable to attract administrative law related criticisms of possible arbitrariness, uncertainty and lack of transparency. In the leading case of *Anisminic Ltd v Foreign Compensation Commission*,[382] it was recognized that although a decision-maker may have the jurisdiction to enter into the inquiry, actions (or omissions) done in the course of the inquiry, including acting subjectively rather than objectively and therefore failing to consider all that is relevant or considering matters which are irrelevant, may subsequently result in the decision-maker exceeding jurisdiction during the process of reaching a decision.

On the other hand, an objective "trigger" test for assessing when ratio levels fall under acceptable levels and applicable to all possible scenarios cannot be easily designed. This may present jurisdictional issues when a banking institution forms part of a broader conglomerate or banking group and correspondingly issues financial instruments under Tier 2 for its recognition under the consolidated capital of the group or conglomerate to which it belongs (in addition to its own capital base). Where this occurs, discretion to avail of the NVLA may also be given to home regulator in which the company is seated. In such an event, there may be a conflict over which authority is to have the final say over whether a particular capital instrument is subject to the conversion or writing off or 'winding up' safeguards: the home or host regulator or regulators, particularly if there are subject to differing assessments as to the continued viability of a financial institution or instrument. [383] Furthermore, Islamic banks have less developed risk management capacities than more established conventional banking structures. The Basel framework is applied on a consolidated basis to internationally active banks. In this way, the risk of a whole banking group is examined.[384] The framework recognises the need for suitable capitalisation on a stand-alone basis, but it does not prescribe

[382] [1969] 2 AC 147

[383] M Abdullah, S Shahimi and AG Ismail, (2011). Operational Risk in Islamic Banks: Examination of Issues" (2011) 3 *Qualitative Research in Financial Markets* 2. Retrieved from http://www.ukm.my/fep/perkem/pdf/perkemVI/PERKEM2011-1-2B4.pdf

[384] Basel III: Capital, ¶ 51.

how to measure the solo capital requirements that are left to the individual supervisory authorities.[385]

Ideologically, Islamic banks utilise Islamic modes in financing and indeed Islamic modes of contracts, each subject to distinct, non-uniform disclosure and auditing rules. Moreover, Islamic banks cannot rely upon on the western system of trading in debts thus allowing them to profit from the difference in interest rates between deposits and loans in a conventional bank. Under Sharí'a principles, the rationale underpinning Islamic banking is directed to the maximisation of shareholders' and depositors' wealth since each are treated as joint partners with the bank.[386] Moreover, the *Hadiths*, Islamic guidance, on banking prescribes that Islamic financial arrangements prevent forms of main usury and monopoly towards the overarching goal of economic and social development for Islamic societies. With respect to the relationship with depositors, Islamic banks are not compelled to return investment deposits or guarantee a certain interest for the depositor, incurring certain risks for the depositor or at the very least reducing incentives for forms of equity investment, since banks bear no liability for losses in cases of default or non-performance. This, as will be demonstrated in chapter 5, has led to an increase in efficiency in the Malaysian BIMB; loss-making banks do not gain depositors when there is a viable alternative. If the loans do not comply with Sharí'a principles, depositors, including sovereign creditors, are exposed to credit default exposures. Otherwise, depositors bear loss and receive profit without the participation of the bank. Hence, there are fundamental differences in instruments, fiduciary responsibilities and market orientation found in Islamic banks and conventional banks, which necessarily entails differences in the nature and size of risks faced by each of them.[387] However, CBs generally score better in efficiency measures than IBs [388] and inefficiency is itself a corporate governance risk to investors. This will be revisited in the lessons to be learned by Sa'udi banks in chapter 7 when learning from the Malaysian and British examples presented in chapters 5 and 6.

A critical examination of the relevant literature and empirical studies suggests that conventional understanding and strategies for managing credit risks are not fully applicable

[385] Basel III: Capital, ¶ 80.
[386] H Abu Hussain and J Al-Ajmi, "Risk Management Practices of Conventional and Islamic Banks in Bahrain" (2012) 13 *The Journal of Risk Finance* 3; R Arunkumar and G Kotreshwar, *Risk Management in Commercial Banks (A Case Study of Public and Private Sector Banks)* Indian Institute of Capital Markets 9th Capital Markets Conference Paper (2005).
[387] Sundararajan, N_322 above.
[388] Hassan, N_318 above.

when transposed to Islamic structures and markets. As commentators have suggested, where in the case of the Islamic financial market "lending operations have been replaced with investment and partnership contracts, credit risk management becomes more important and critical."[389] Therefore, credit and counterparty risks posed to Islamic institutions are distinct from those faced by conventional banking models, in part because such institutions do not permit access to conventional derivative instruments and associated risk management techniques owing to Sharí'a considerations.[390] Furthermore, Sharí'a compliant markets in the issue of, for instance, Sukuk trust certificates and prospectuses (issued by sovereign actors who are moreover, exposed to credit risks) are still relatively nascent.[391] As such, given the apparent absence of general and coherent legal framework for regulating these markets, counterparties may lack the necessary rights and remedies in the event of default of breach of contract, or, otherwise, enjoy access to the kind of sophisticated risk management mechanisms familiar to conventional banking systems. [392] Risks concerning credit and counterparty have been discussed in the previous chapter. However, because IB lack the financial instruments WB commonly use, mitigating these risks is difficult. Perhaps it would be a good idea for IB to use Islamic forms of guarantee as are done in Malaysia, such as kafalah, in order to limit their exposure to these types of risks.

4.5 Liquidity Risk

Liquidity risk is defined as the exposures faced by individual banking institutions should they fail to satisfy and fulfil financing commitments and contractual obligations, on the liabilities' side. These may include the repayment of dividends or restoration of deposited funds due counterparties. These exposures may result from market disruptions, for instance credit shortages and downgrade which may in turn reduce the liquid assets available to the bank in a given period. Diversity in sources of funding reduces such risks, as does a well-managed asset profile in which speculative sources of funding are appropriately balanced the amounts of liquid cash held in reserve.

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[389] Mohamed, N_390 above.

[390] The Limitations of Basel Credit Risk Assessment Standards and Approaches In the Islamic Banking Context, Section 4.5.1.

[391] Iqbal, N_166 above; M Abdul-Majid, DS Saal and G Battisti, Efficiency in Islamic and Conventional Banking: an International Comparison (Springer Science + Business Media, LLC 2009).

[392] Meera, N_265 above.

The new structural rules on liquidity conservation proposed under Basel III as discussed above are designed to curb the very forms of excessive, under regulated and high risk leveraging profile of major Anglo-American banking institutions that later catalysed the 2008 financial crisis.[393] Otherwise put, the Basel II framework provides for regulatory ceiling on permitted range of balance sheet derivatives and repos. Regulatory netting of this kind is clearly in the public interest of consumers and stakeholders in the conventional banking system. In the light of the above, a report issued by Federal Reserve indicates the projected growth of Risk Weighted Assets additional to increases made under Basel II requirements ranges in the estimates of between 10 and 30%.[394] This is because of the capital structure of European and American banks, the diverse financial instruments in which they European deal and trade on the assets and liabilities side, as well as the amount and volume of assets recorded on their trading books compared with major aspects of Islamic banks.

Such reforms will, nonetheless, have a more muted impact on Islamic finance markets, where banking institutions are prohibited from taking short positions from the outset, owing to their violation of Sharí'a principles. Historically, Islamic banks have already proven to be well capitalised in respect of their risk exposures and, moreover, due to Sharí'a related restraints unable to finance their commercial ventures through leveraging. Due to their corporate model and capital structure of Islamic banks, moreover, Islamic banks lack market access, including investments in financial instruments such as credit derivative swaps, Repo, bonds, interest rate swaps and so forth.[395]

A case in point, a capital adequacy report pooled from 18 banks in the aftermath of the financial crisis in 2011 indicates that capital held by Qatari institutions remained at 22.8 %, more than double than minimal requirements under Basel. [396] As further evidence, a later Morgan Stanley report on the aggregate consequence of Basel implementation on three major Qatari institutions highlights the limited effects of its capital based reforms.[397] In other words, the risk profiles (market, credit and operational risks), aggregate increase or decreases in

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393 Federal Register, "Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies" (2012) 77 *Federal Register* 3. Retrieved from http://www.gpo.gov/fdsys/pkg/FR-2012-01-05/pdf/2011-33364.pdf.

394 Comprehensive Capital Analysis and Review 2012: Methodology and Results for Stress Scenario Projections (March 13, 2012). Retrieved from http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20120313a1.pdf.

395 SS Al-Harran, *Musharakah Financing: Concept, Principles and Financing* (Institute for Policy Research Malaysia 1993).

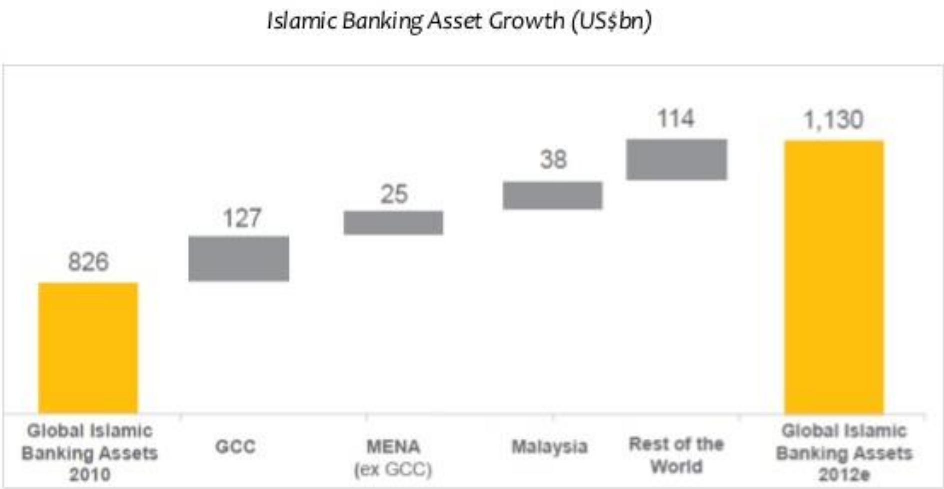
396 Al Khaliji, *Investor Guide* (October 2011).

397 Morgan Stanley, N_ 373 above.

capital retention and conservation and pre-financial crisis internal models for computing and measuring risk ratios remain largely unmodified and unaffected by the 2010 Basel reforms.[398]

Based on general trends, it appears that Islamic banks will hold relatively low amounts of risk weighted assets compared with their conventional counterparts. Certainly, the risk weighted increases are projected to be relatively stable relative to trends predicted in traditional financial system; particularly with respect to investment and debt financed instruments traded in secondary markets e.g. credit derivatives, interest rate swaps.

Figure 11: Islamic banking: Origin and current state



Source: E&Y – World Islamic Banking Competitive Report 2011-2012

On the whole, data captured on banking institutions domiciled and operative in markets in, among others, Qatar and Malaysia indicate that Islamic Banks remain well capitalised even at the peak of the financial crisis. In contrast, potential for conventional banking systems in Europe and the US to raise and retain funds will be significantly impacted by the Basel III reforms. Indeed, banking systems in these regions will be required to oversee far reaching changes to their business models, risk profile and funding strategies.[399] Of course, the actual impact of the Basel III regulatory capital standards cannot be fully quantified with accuracy, and will continue to depend on the risk and capital profiles of individual banking institutions and the regulatory structures in which they are embedded.

[398] *Ibid.*; Al Khaliji, N_408 above; van Greuning, N_47 above.
[399] Al-Harran, N_407 above, 290.

The graphic below shows the haircut effect Basel III had on certain banks. The haircut is the percentage by which an asset's market value is reduced for the purpose of calculating capital requirements, margin and collateral levels. It is debatable if these haircut effects influence financial market procyclicality.

Figure 12: Basel III haircut effects

MS European Bank Coverage		Post Periphery haircut					
		Sov. Haircut Effect	Core Tier 1 Adj	As % of RWAs	As % of TNAV	As % of Mkt Cap	Deficit to 9% CT1
France	BNP Paribas	3,097	54,023	8.5%	5.3%	7.7%	(3,127)
	Crédit Agricole Groupe	685	51,276	8.6%	2.4%	5.2%	(2,364)
	BPCE	811	33,789	8.2%	6.1%	11.4%	(3,471)
	Société Générale	234	29,822	8.0%	0.7%	1.4%	(3,748)
Belgium	KBC Bank	1,160	11,072	10.0%	12.1%	17.5%	0
Germany	Commerzbank AG	903	22,859	8.7%	4.1%	10.0%	(675)
	Deutsche Bank AG	435	32,082	7.8%	1.8%	1.7%	(5,058)
Italy	Banca Popolare di Milano	361	2,784	6.0%	13.8%	50.3%	(1,409)
	Banco Popolare	716	5,683	5.9%	10.3%	33.0%	(2,930)
	Intesa Sanpaolo	2,313	30,537	9.4%	6.9%	11.6%	0
	Mediobanca	175	5,934	10.8%	2.7%	3.4%	0
	Banca Monte dei Paschi di Siena	1,563	9,237	8.7%	15.5%	35.4%	(311)
	Unione di Banche Italiane	497	7,360	7.7%	6.4%	18.4%	(1,196)
	UniCredit SpA	2,469	38,149	8.2%	6.3%	13.8%	(3,718)
Nordics	Danske Bank	653	101,019	11.4%	0.6%	6.9%	0
	DnB NOR	0	96,899	11.4%	0.0%	0.0%	0
	Svenska Handelsbanken	0	77,346	14.1%	0.0%	0.0%	0
	Nordea Bank AB	0	19,846	10.5%	0.0%	0.0%	0
	SEB	445	91,116	12.7%	0.6%	4.9%	0
	Swedbank	2	75,461	14.5%	0.0%	0.0%	0
Spain	Banesto	184	5,381	8.5%	3.3%	5.9%	(317)
	Bankinter	104	2,296	7.6%	3.9%	4.9%	(438)
	BBVA	899	27,874	8.7%	3.1%	2.8%	(1,041)
	Banco Popular	405	8,512	9.4%	5.2%	8.3%	0
	Banco Sabadell	218	4,904	8.9%	4.0%	5.9%	(68)
	Banca Civica	853	3,447	7.8%	21.8%	71.5%	(539)
	Caixabank	754	15,889	10.8%	4.4%	5.7%	0
	Santander	972	52,408	9.0%	1.9%	1.8%	0
UK	Barclays Plc	752	42,785	9.8%	1.7%	3.1%	0
	Lloyds Banking Group Plc	4	38,880	10.1%	0.0%	0.0%	0
	Royal Bank of Scotland Group Plc	362	47,639	10.4%	0.7%	2.2%	0
	HSBC Holdings Plc	753	125,009	10.4%	0.6%	0.7%	0
	Standard Chartered Plc	0	31,120	11.6%	0.0%	0.0%	0
Austria	Raiffeisen Bank International	35	8,555	9.0%	0.6%	0.8%	0
	Erste Bank	236	11,181	9.3%	3.0%	3.7%	0
		Total Recapitalisation Requirement					**(30,411)**

In light of the above, the Basel approved Net Stable Funding Ratio[400] and Liquidity Coverage Ratio[401] may function to place undue regulatory burdens on Islamic banks, namely by requiring them to retain levels of liquidity for wholesale funding of their commercial

[400] Basel III: The Net Stable Funding Ratio, ¶ 1.
[401] Basel III: Liquidity Cover Ratio, ¶ 1.

activities in excess of the risk exposures faced by such banks given the unique and risk averse quality of Sharí'a compliant trading portfolios of Islamic banks. To clarify, IBs do not have access or exposure to the very lending based operations and debt funded instruments and markets (derivative based markets or specific operations such as short selling) that the Basel III rules on liquidity and funding requirements are specifically designed to temper and constrain.

4.6 Why Credit Risk Remains the Greatest Challenge to the National and International Standardization and Regulatory Efforts

This thesis attempts to look at the Basel reforms in order to assess the actual application of its standards and procedures in connection with the variety of practices, modes of financing and ideological orientation of Islamic banking institutions, with the particular emphasis of what Sa'udi banks can learn from the success or otherwise of the implementation of the Basel mechanisms in IBs in Malaysia and Britain, particularly in terms of bank profitability.

Islamic banks cannot adopt Basel III without tailoring it to the regulatory standards and accounting practices as enshrined in the AAOIFI's market discipline and disclosure or the Islamic Financial Services Board rules on capital adequacy. Moreover, it is only by assessing actual practices of Islamic banks that we are moved to consider whether Islamic banks are better insulated against risks exposures than conventional banks and whether such strengths can be linked to the specific ideological or architectural specificities of Islamic banking regimes, including the ethical dimensions of Islamic banks and its, presumptively, more conservative, less speculative approach to managing risks.[402] Islamic finance markets and its provision of Sharí'a -compliant financial services continue to hold attractions for Muslims and non-Muslims alike.

In the modern economy, debt markets are a central driver of financial markets. Indeed, the funds generated from credit and lending arrangements effectively finance the banking sector. As a starting point, it is important to establish the key indicators by which to assess the level of risk posed to the banks which are object of this case study and to, therein, evaluate the successes and challenges they face. According to mainstream financial thinking, namely the set of assumptions that have conventionally be formulated in terms of the Capital Asset

[402] *Ibid.*

Pricing Model (CAPM), [403] the level of risk is proportional to the level of return, meaning that high risk will yield high return for the investor and vice versa.[404] If this model is taken to be accurate and based on sound assumptions, any financial institutions, in order to remain profitable and solvent, should seek to generate returns that can offset the risks involved in contracts and transactions (for instance, those resulting from lending and borrowing policies).[405] There are several problems with CAPM, such as not being able to explain the variation in stock returns, because low beta stocks may offer higher returns than it was expected.[406] Also it is assumed that investors prefer lower risk to higher risk at a certain expected return, but this is not true because risk as defined in CAPM also gives the opportunity to investors to win more, so it is reasonable to assume that some investors will prefer higher risk. Further, it is conventionally assumed that market portfolio does not include works of art or real estate, just stock indexes, so the real market portfolio is not present.[407]

4.6.1 Managing Credit Risk

The next section briefly examines the novel challenges faced by the growing industry in Islamic banking, focusing on one particular category of risk: credit risk. Credit risk is the catch all term used to assess the possibility and probability that an asset or loan becomes irrecoverable owing to instances of debtor default or other factors delaying the settlement or agreement.[408] Credit risk can also be understood as the risk that occurs when the value of a credit portfolio alters due to unforeseen changes in the credit-honouring ability or quality of the issuer, contracting party or trading partner.[409] For others, credit risk arises when the bond issuer, borrower or country party defaults on a credit agreement and is unable consequently to satisfy the terms of a lending contract by repaying the sums they owe. [410] Others describe credit risk in the following ways: the point at which a debtor defaults on a loan, a bond

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[403] Z Bodie, A Kane, and AJ Marcus, *Investments* (7th International ed. Boston McGraw-Hill 2008) 303.
[404] T Achon, *Bank Performance and Credit Risk Management* (Dissertation University of Skovde, Sweden 2008).
[405] A Nasar, Investment Partnership in Islamic Banks (Beirut Scientific Press, 2010).
[406] J Campbell and M Vicera, *Strategic Asset Allocation: Portfolio Choice for Long Term Investors* (Clarendon Lectures in Economics 2002).
[407] R Roll, "A Critique of the Asset Pricing Theory's Tests" (1977) *Journal of Financial Economics* 4, 129–176. doi:10.1016/0304-405X(77)90009-5.
[408] Akkizidis, N_270 above; S Archer, N Ariffin and R Karim, "Risks in Islamic banks: Evidence from Empirical Research" (2008) 10 *Journal of Banking Regulation* 2, 153–16; Archer, N_256 above.
[409] AJ McNeil, R Frey and P Embrechts, *Quantitative Risk Management: Concepts, Techniques and Tools* (Princeton Series in Finance Princeton University Press Princeton, NJ and Arunkumar and Kotreshwar 2005).
[410] *Ibid.*

issuers' failure to make good on payments owed to the bondholder or the failure to make good on a promise payment in the context of a trading arrangement.

Irrespective of slight difference in scholarly definitions and identification of credit risk, the case studies below suggest that most financial institutions and the products they offer will contain aspects of the above defined types and sources of credit risk. These risks can have severe impacts on the value of a financial institution's assets and its continued stability and solvency. In the broader picture, statistics suggest that credit risk represents around 70 percent of the aggregate risk faced by banks while the remaining 30% can be attributed to operational and market related risks.[411] Indeed, as the case study on Europe and the UK regulatory responses to the crisis and its subsequent implementation of Basel reforms will demonstrate, credit risk was a key catalyst of regulatory reform, the partial re-nationalisation of near insolvent banks and the increased powers of the Bank of England. The principal regulatory challenge, therefore, is to determine the extent and severity of risks related to particular types of instruments and modes of financing, and, secondly, to assess whether there is a correlation between the structure and products of banking institutions and their capacity to mitigate and manage such risks.

In conventional banking, lending operations are, according to the above definition, considered to be an activity which entails some degree of credit risk. The situation changes when we consider Islamic financial institutions. Islamic banks are subject to the supervisory authority of the Islamic Financial Services Board which defines credit risks in more open ended terms as the risk that arises from the possibility that counterparty won't honour their obligations under a relevant agreement.[412] This definition has been accepted by the Islamic Financial Services (IIFS) and consequently applied to specific and sui generis Islamic contracts such as *Murabaha*h, Diminishing *Musharakah* and *Ijarah* , covering the risks relating to financing of account receivables (*Murabaha* contrast) and leasing related payment receivable agreements (*Ijarah* agreements).[413]

4.6.2 The Limitations of Basel Credit Risk Assessment Standards and Approaches in the Islamic Banking Context

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[411] Arunkumar, N_397 above.
[412] Kahf, N_277 above.
[413] AAOIFI (2003a), Section 2/3, Standard No. 2, p. 122; Nasar, N_417 above.

Significant questions are posed as to the extent to which the minimum capital requirements of Islamic banks should be measured in accordance with "one size fits all" techniques devised under Basel II accord. One general criticism is posed to the extent to which the Basel reforms have a direct effect on the internal culture of particular banking systems and institutions. Basel III has been criticized for its paper burden and risk inhibition by the Institute of International Finance, an organization of several banks that stated that it would hurt their business and economic perspectives. The OECD estimated that implementing Basel II will reduce the annual GDP growth in the US by 0.05 – 0.15%.[414] After all, the Basel framework was the product and response of global crisis in macro monetary management. The committee's response to such 'gaps' was the creation of generally applicable capital standards to be implemented with the oversight of the relevant supervisors. The underlying aim of the global banking regulation framework is to facilitate the stability of the financial system as a whole, rather than of particular financial entities, or the internal capacity of less developed banks to implement risk management techniques such as stress testing.[415] Even where the solvency of specific banks is addressed by regulators, it is through the particular lens of how that bank's capital resilience, or lack thereof, will impact on other banks which transact with it as linked actors within a multi-layered financial system.[416]

From a legal-normative perspective, the above analysis implicates the largely procedural nature of the disclosure requirements and the minimal harmonisation of capital adequacy framework formalised under Basel. Given that Basel accords were primarily designed to regulatory needs and demands of its member states, OECD and G10 countries, and, more broadly, to accommodate regulatory diversity across states, banking institutions and financial markets, this procedural emphasis of the framework is perhaps inevitable.[417] This reinforces the criticism that the Basel framework does not take into account the differences between the Islamic modes of financing and the conventional banking instruments and capital structures.[418] Certainly, the capital structure of banks, on both liabilities and assets side, is

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[414] P Slovik and B Cournède, *Macroeconomic Impact of Basel III* (OECD Economics Department Working Papers, OECD Publishing 2011).

[415] T Fiennes, "Supervisory Implications of Islamic Banking: A Supervisor's Perspective" in S Archer and RAA Karim (Eds.) *Islamic Finance: The Regulatory Challenge* (Chichester: John Wiley & Sons Pte Ltd. 2011).

[416] Wignall, N_317 above.

[417] A Strauss and J Corbin, *Basics of Qualitative Research: Grounded Theory Procedures and Techniques* (Newberry Park, CA Sage Publications 2000).

[418] L Hamidi, "The Theory and Practice of Islamic Management Style: The Experience of Bank Muamalat Indonesia" (2006) 10 "*Review of Islamic Economics* 2, 115-131; A Hassan, "Risk Management Practices of Islamic Banks of Brunei Darussalam" (2009) 10 *The Journal of Risk Finance* 1; T Hassan, S Mohamad and M Bader, "Efficiency of

sufficiently different from conventional banks to raise questions over the utility and applicability of the risk and capital measurements proposed under the Basel framework. For instance, while conventional banks manage both claims made by a bank which are balanced against payments and distributions on the balance sheets of a bank, Islamic banks have a third component which represents neither a claim on the part of the bank part nor a share of the owners' equity.[419] This section investigates these forms in further detail below.

The Basel capital regulation framework draws its relevance from two interrelated assumptions: 1) to offset risks, banks must hold and conserve enough capital and 2) such risks are broadly comparable to the liability and equity claims made on the bank relative to the assets held by that bank as reflected on the balance sheet. Thus, the working assumption on which the Basel framework is based is that the more claims placed on the bank as an inverse proportion of the capital it retains at any one moment in order to finance its various obligations, the greater that bank's exposure to risk (e.g. shortages in liquidity and defaults on credit payments). This model may be reflective of the steep rise in leveraging, and the pre-2010 absence of standards for regulating capital conservation over financial cycles in CB.[420] Yet, on the other hand, the assumptions on which such a model is based are not directly applicable to Islamic banking in several important ways. For instance, in IB, funds deposited may be used by banking authorities as part of a profit-sharing agreement, such as the previously discussed *Mudarabah* contract.[421] Similarly, the bank may hold unrestricted deposits as an investor in an agency contract. The bank receives compensation from its initial investment in the form of a lump sum or as a percentage of the profits generated from a particular project of public investment enterprise (for instance sukuk contracts).[422]

These two different types of contracts cannot be classed as liabilities, conventionally understood, since they do not constitute a claim on the bank. Indeed, the AAOIFI standard 2 (on disclosure rules) specifically precludes banks from treating these as liabilities. Liabilities on the payment side of the balance sheet, as defined under this code, represent only those claims made on a bank which creates binding obligations. Subject to the regulatory rules

Conventional Versus Islamic banks: Evidence from the Middle East" (2009) 2 *International Journal of Islamic and Middle Eastern Finance and Management* 1, 46-65.

[419] T Khan, *Credit Risk Management: A Framework for Islamic Banking* (Islamic Banking: Risk Management, Regulation and Supervision Jakarta, Indonesia 2003); Khan, T., & Ahmed, H. (2001). Risk Management: An Analysis of Issues in Islamic Financial Industry. Islamic Research and Training Institute, 5.

[420] *Ibid.*; Nasar, N_417above.

[421] Islamic Finance: Theory and Practice. Basingstoke: Macmillan Press. Sundararajan and Errico, N_135 above.

[422] Nasar, N_417above.

governing restricted and unrestricted deposits for each of these types of contracts, both deposit based arrangements can generate commercial losses and profits. However, crucially, the bank is under no obligation to return the original principal to third party investors, or act as a guarantor in the event of default or non-performance of the terms of the contract by the counter party.

Another set of deposit holdings concern unrestricted deposits which, in accordance to the above mentioned Islamic accounting codes, can be treated as a "liability" for the purposes of a bank's disclosure and accounting responsibilities. This is because the source of financing is of a hybrid nature: investment in these profit sharing arrangements may derive from the banks own capital or outsourced from external streams of financing, the later of these creating strict liabilities. [423]The bank then takes the total capital merged from both sources and uses or reinvests those sums on a discretionary basis. These forms of investment are subject to the specific rules governing "equity of unrestricted investment account holders".[424] The AAOIFI's Financial Accounting Statement sets on rules of disclosure in the above respect, which requires transparency on "disclosure of the balances of these deposits, additions and withdrawals of their holders, profits/losses from operations during the period…… whether as a percentage of balances invested, a share of net profit or a given lump sum."[425]

4.6.3 Asset Structure of Islamic Banks

The next section will briefly examine, specific modes of Islamic modes of financing in order to assess how such takings are accounted for on the balance sheet, and the qualitative impacts they have in the weighing of risk in the context of Islamic banking practices. It will subject to criticism and challenge the Basel frameworks ongoing emphasis on capital adequacy at the expense of other risk exposures of relevance to the sound functioning of Islamic and conventional institutions and intermediaries alike.[426]

Data gathered from 7 Islamic banks from the years 2000 and 2001 suggests that banks have fairly distinct assets and accounting practices.[427] Their financial statements indicated that the

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[423] Al-Harran, N_407 above.
[424] Section 4/1/3 Ibid.
[425] *Ibid.*
[426] Fiennes, N_427 above.
[427] Islamic Bank, Bahrain Islamic Bank, The ABC Islamic Bank, Bahrain, Shamil Bank, Bahrain and Qatar Islamic Bank for the years 2000 and 2001; Al Khaliji, N_408 above.

majority of claims and assets stemmed from *murabahah* claims, investments *musharakah* and *mudarabah*, investment in securities, investment in real estates (*sukuk*), and investments in leased assets. The study suggests that while Islamic banks have failed to establish and apply uniform accounting and auditing standards, many states have taken steps to disclose information relating to their credit weighted assets, as well as their capacity to fulfil capital adequacy thresholds.

4.6.4 Debt Financed Instruments

The most common mode of Islamic financing relates to agreements in which debt is owed by beneficiaries to a transaction. These include sale of commodities and the Islamic contract known as *ijarah.* One such sale based transaction as discussed concerns *murabahah,* and can take the form of a lump sum which matures at a future date or sums payable in instalments. In a *murabahah* contract, banks may make claims on state sovereigns, public sector entities, other banking institutions, and insurance or securities companies, retails agents and so on. On the accounting side of matters, these receivables are assessed at net value after *deductions. Moreover, according to the AAOIFI-FAS 2: "Short-term and long-term murabahah* receivables shall be recorded at the time of occurrence, at their face value. *Murabahah* receivables are measured at the end of the financial period at their cash equivalent value, i.e., the amount of debt due from the customers at the end of the financial period less any provision for doubtful debts."[428]

Debt financed modes also include *Istisna* contracts which are entered into by three parties on the terms of the provision of future debts in addition to the profit gained by the bank by beneficiary parties. Payments are received by the contractor, in addition to the bank profit, and are issued in instalments (sometimes having different maturities at different stages of the transaction). AAOIFI-FAS 10 stipulates that received payments recouped through financing of *Istisna* contracts by crediting parties should be treated as equivalent to other claims registered on the balance sheets of a bank.[429]

Other exchange and sale based Islamic modes of financing include the *musharakah* contracts. IBs may prefer this instrument as an alternative of *murabahah* because of its reduced risks.

[428] AAOIFI (2003a),Section 2/3, Standard No. 2, p. 122
[429] *Ibid,* Section 2/2 (b), Standard No. 10, p. 301; Basel II: Implications for Islamic Banks 307

Musharakah contracts, notably, allow scope for the financing Islamic bank to "buy out", thus releasing them from any future financial obligation, at the point of which debt documents are received. In effect, the banks acts as guarantor of a documentary credit which creates temporary futures claims with a "procedural"[430] counterparty. Once commercial documents have been provided, the bank is released from any further liability.

Salam contracts constitute another Sharí'a compliant mode of debt financing. Here, the bank lends sums expressed in cash amounts to a customer (in accounting terms this is documented as a sum of the principal debt expressed as a cash value). However, the bank cannot profit from the lending arrangements. [431]Accordingly, two contracts are operating in parallel for the purposes of auditing and accounting: one concerns the claims made by the bank on return of the nominal value of a loan, and second, the Salam entry on the 'outgoing' side of balance sheet in which any changes on the real value of the loan at maturity (due to inflation, pricing increases and so on) are deducted or reduced from the total balance to be paid by the debtor party so as to ensure that no profit accrues to the bank.

4.6.5 Equity-based or Non-debt Creating Islamic Financial Modes

Non debt financing modes of finance include *mudarabah* and *musharakah*[432]. In these types of instruments, and an expression of their non-debt creating character, the beneficiaries are not liable for payment of the principal debt, or any returns on the amount credited to them, save in circumstances when there is fault or negligence on the part of the debtor counterparty. As per the rules stated in the AAOIFI-FAS1, which governs requirements relating to the disclosure and auditing of financial statements, any arrangement based on the above contracts must be recorded on the balance books as non-debt creating investments rather as a debt owed by a beneficiary.[433] As to the substantive regulation of financing governed by *mudarabah* and *musharakah* contract, the AAOIFI's financial standards No. 3 and 4 expressly preclude their interpretation and application as a debt creating instrument which creates liabilities for the beneficiary. Rather, for the purposes of a bank's balance books these must be earmarked as investments and be disclosed as through financial statements which

[430] AAOIFI (2003a),Section 2/3, Standard No. 2, p. 122.
[431] Al-Harran, N_407 above
[432] MPBM Isa, A Ab Rahman, HMB Hashim and AMB Embong, "Shari'a Views on the Components of Profit Rate in Al-Murabahah Asset Financing in Malaysian Islamic Bank" (2012) 6 *The World Academy of Science, Engineering and Technology International Journal of Social, Education, Economics and Management Engineering* 7.
[433] Standard No. 1, AAOIFI, op cit., p. 87 Section 4/1, see also its annexed example on p.110. 310

reflect any profit and losses at specific stages at which a particular project or transaction is financed. Thereafter, if payments are settled either partially or wholly at a date prior to being recorded on a financial statement, subsequent entries must reflect any remaining losses or gains and document remaining balances until such point as the outstanding amount if fully satisfied. The standards applicable also take consideration of unanticipated decreases in the market value of commodities or assets financed under *musharakah* and *mudarabah*, or for any losses stemming from the default of the counterparty.[434]

Prominent scholars such as Chapra and Khan [435]have detailed exhaustively the unique types of credit risks inherent, or implicit, in, IB structures and contracts. The injunction on these debt derived instruments, structures and instruments discussed in chapter 2 create market barriers for prospective investors and consumers wishing to avail of such products and services, with possible adverse impacts on the competitiveness of Islamic markets and institutions, relative to their conventional counterparts. Moreover, counterparties are more likely to default on agreements. Agency costs may also be higher in Islamic Profit-Sharing arrangements. For instance, risk exposures may include the counter party risks or the accounts receivable on trading books held to maturity. In the above respect, Salam contracts risks exposures may arise from counterparty's failure to supply commodities on time or to the agreed quantity. Likewise, as discussed in chapter 2 and 3 parties to *Istisna* contracts are subject to various performance related risks[436], including the possible failure of the bank to honour the conditions of a contract, or the subcontractors' unwillingness or inability to render required services under contract.

4.6.6 Analysis

The unique nature of Islamic contracts and financial products suggest credit risks and complexities which are not rendered explicit or adequately captured by traditional risk management strategies and approaches, including those advanced under Basel II.[437] Indeed, IB institutions are exposed to other kinds of externalities than envisioned under the Basel

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[434] Archer, N_256 above.
[435] U Chapra, I Khan and J Tariqullah, *Regulation and Supervision of Islamic Banks* (Jeddah Islamic Research and Training Institute, Islamic Development Bank 2000).
[436] See section 2.6 Istisna.
[441] H Hesse, "Islamic Banks and Financial Stability: An Empirical Analysis" (2008) 8 *International Monetary Fund Working Paper* 16; Cooperation Council for the Arab States of the Gulf. Retrieved from http://en.wikipedia.org/wiki/Cooperation_Council_for_the_Arab_States_of_the_G ulf.

framework. To take one further example instance, under the principles of Sharí'a law, Islamic banks are not permitted to impose penalties on a counterparty who has defaulted on agreement, in contrast with conventional banking institutions with the power and ability to sanction non-payment through charges or by recovering overdue interest. [438] The absence of this sanctioning power is evidently open to abuse by a contracting counterparty in the knowledge that default on a payment will not incur any further penalty or charge.

The prominent scholar Khan [439] has argued that the possibility and practice of counterparty default remains the greatest risks to Islamic financial institution; a risk for which there remains an absence of appropriate mitigating strategy or punitive remedy except administrative measures used to bar that party from continuing to operate. [440]These administrative measures foreclose the possibility of selling off or compensation for losses incurred by the bank on default, exposing that bank to significant risk. Indeed, the absence of a remedy may ultimately be a central impediment to the growth of the Islamic finance market, stifling investor security and confidence and undermining the stability and solvency of particular institutions and economies as a whole. Information gathered on risk perception by Islamic banks on the relative risks involved in different mode of Islamic financing are, by turns, highly revealing. Those instruments which rely most heavily on the Sharí'a-endorsed profit sharing, including *musharakah* and *mudarabah* are perceived to carry the highest risk.[441] That is because the beneficiaries are not liable for payment if there is no fault or negligence from their part, so it is an investment that does not create an obligation of payment.[442]

There are numerous other reasons why *musharakah, mudarabah* and profit and loss sharing contracts in general are risky, such locking capital for a long period of time in conditions of uncertainty, the process of estimating a return rate is difficult especially when there is

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[441] H Hesse, "Islamic Banks and Financial Stability: An Empirical Analysis" (2008) 8 *International Monetary Fund Working Paper* 16; Cooperation Council for the Arab States of the Gulf. Retrieved from http://en.wikipedia.org/wiki/Cooperation_Council_for_the_Arab_States_of_the_G ulf.
[441] H Hesse, "Islamic Banks and Financial Stability: An Empirical Analysis" (2008) 8 *International Monetary Fund Working Paper* 16; Cooperation Council for the Arab States of the Gulf. Retrieved from http://en.wikipedia.org/wiki/Cooperation_Council_for_the_Arab_States_of_the_G ulf.
[441] H Hesse, "Islamic Banks and Financial Stability: An Empirical Analysis" (2008) 8 *International Monetary Fund Working Paper* 16; Cooperation Council for the Arab States of the Gulf. Retrieved from http://en.wikipedia.org/wiki/Cooperation_Council_for_the_Arab_States_of_the_G ulf.
[441] H Hesse, "Islamic Banks and Financial Stability: An Empirical Analysis" (2008) 8 *International Monetary Fund Working Paper* 16; Cooperation Council for the Arab States of the Gulf. Retrieved from http://en.wikipedia.org/wiki/Cooperation_Council_for_the_Arab_States_of_the_G ulf.
[442] See section 4.6.4 Equity based or non-debt creating Islamic financial modes

government participation and these returns are low. The entrepreneurs may also contribute to the problem, by not disclosing information in a proper and timely manner, by having low ethical standards and by having unsuitable management skills. There is also operational risk cause by inconsistencies in accounting standards and extra expenditures caused by monitoring the projects.

As discussed above, while the RWA held by European and US banks will increase as a result of Basel III, Islamic banks will due on quasi trading books may be subject to greater effects, owing to the fact that such contracts deal in the trade and exchange of commodity structured products, the pricing of which will be dictated by the stability or volatility of the markets. Market related indicators endorsed under Basel II and III or otherwise used to evaluate economic stress may also have direct impacts on price fluctuations of assets and commodities traded on the Islamic stock markets. [443]

From a legal-regulatory "conflicts of law" perspective, a number of challenges are presented by the fact that supervisory bodies in different countries tend to rely on their own Sharí'a experts, resulting in judicial conflicts and the issuance of contradictory statements or judgements on the permissibility of a given instrument. Thus, financial products that are permissible in some countries may well be decreed against principles of Sharí'a law in others. Such disparity could impede the cross-border trade and use of Islamic products and thus stunt growth in this industry. It could also result in competition obstructing forms of regulatory arbitrage. The AAOIFI has, in the above regard, emerged as a dominant player, particularly in its attempt to pursue greater harmonization of Sharí'a -based rulings across jurisdictions.[444]

Looking at this in more detail, it is apparent that the emphasis in Basel III is largely on capital adequacy. A question however remains around how much the buffers and leverage ratios designed to ensure a robust model of capital adequacy enforcement for a debt based Conventional Banking model can be held to apply as effectively to the fundamentally asset and equity backed IB model.

The central change in Basel III is the heavy enforcement around liquidity risk, with banks now forced to meet liquidity requirements that are based around a partially equity-driven

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[443] Hassan, N_318 above; van Heuring, N_47 above.
[444] Archer, N_256 above.

method of testing capital adequacy for all banks. Yet this arguably presents risks due to different conceptualisation of banking models; if Basel III is written for fundamentally debt-based banking operations, it is perhaps unsurprising that it addresses the risk of that rather than the risks around equity based banking and the inability to take on many forms of debt. This has very specific impacts on the assumptions around buffers, leverage ratios and liquidity risk, largely because it appears a base assumption in the Basel III documents that these will be matched by a more traditional exposure to debt.

The IFSB must, of course, deal with Basel III as a condition of entry to the international banking markets; it is impossible to conceive of a modern banking institution obtaining both large/institutional investor support and reinsurance without doing so. The liquidity risk mitigation identified and required by Basel III reforms must therefore be integrated with the needs of IB institutions and their fairly unusual balance sheets and operational requirements. Because they are following Sharí'a principles, IB products have different risks from those belonging to WB and a Basel III amendment has to be created that expresses the exact capital risk requirements for this type of market.

As noted above, Tier 1 assets must be above 6% of RWA, Tier 1 and 2 above 8% RWA, and at least 75% of Tier 1 assets must be common equity tier 1. Tier 3 has been eliminated, but it is perhaps notable that the less mature review of asset quality in IB is likely to result in considerable issues around mark to market valuations and tier quality assessment.[445]

The bank obviously has access to bank capital and demand deposits in the usual way, but differs from the usual emphasis in Conventional Banking due to the heavy emphasis on profit sharing investment accounts. These do not correlate perfectly with Western investment accounts, in that both unrestricted investment accounts (UIA) and restricted investment funds (RIA) do not necessarily attract management fees.

Both RIA and UIA are commonly offered through a *Mudarib* contract, meaning that the bank has no fees for management in the standard *Wakalah*/agency contract model that would be used in most Western banking. This has several obvious and non-obvious impacts on both the quality of the asset and the valuation of that asset for market value and tier assessment. Banks often offer profit share on UIA that is not based on the performance of the underlying assets,

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[445] Al-Harran, N_407 above.

but is more commonly the equivalent of an index linked return. This has several risks for the bank. Firstly, the bank is exposed to loss to an unusual degree; in the event that the assets invested in differ in a major way from index performance, a liquidity issue exists that does not at all apply in the *Wakalah*/agency model. Secondly, the technique of mitigating loss by passing the IBs share of profit as a *Mudarib* to the account holder means that a withdrawal of investment may leave the bank considerably out of profit in the immediate quarter, something that appears inconsistent with such a core asset for liquidity management. The reserves needed are referred to in the 3 and 4 IFSB as Profit Equalisation Reserve (PER) and Investment Risk Reserve (IRR). These are both essentially designed to cover losses for the account holder by offering funds from the bank, reducing volatility of the investment. This presents the IB system with two familiar problems, and one major issue with assessment of the underlying instruments.

Firstly, in the same way as an interest-bearing account presents investment risks for the bank, the UIA is an acceptance of risk due to loss mitigation through the use of the PER and IRR. This risk therefore applies to the shareholders and institution, and presents much more of a liquidity issue for a bank that deals primarily in equities than might be expected for a Western bank. The issue here is that IBs tend to lend to the IB served sector, a specialized market under various Islamic jurisdictions. Because the risk is not diversified, there can be more problems than usual in the case of a bank run. This inability to diversify risk though the use of a debt portfolio to match the equity portfolio arguably increases systemic risk for the bank, and indeed it is notable how little of the risk that applied to IBs in areas such as Dubai/UAE was correctly evaluated. An example of this is shown in the Al-Tamimi[446] assessment of the UAE's national and foreign banks risk just prior to the Dubai crash, and whilst it is clear that many of the Western banks were also underpricing systemic risk it is notable that the IBs in the area were doing so whilst providing the same equity-based portfolios following Basel III standards. In this way, it can be seen that the lack of portfolio diversity that created overexposure to certain sectors and market risks in the Western market crash was present in the bailed out Dubai IBs.[447] This is crucial given the requirements of balancing that Basel III

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[446] H Al-Tamimi, A Hussein and FM Al-Mazrooei, "Banks' Risk Management: A Comparison Study of UAE National and Foreign Banks" (2007) 8 *The Journal of Risk Finance* 4, 394-409.

[447] MM Hasan and J Dridi, *The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study* (IMF Working Papers 2010): 1-46.

introduces; IBs have an obvious disadvantage in that they have massive restrictions on effective exposure to the debt markets for religious regulatory reasons.

One response to this is the holdings of high quality liquid assets (HQLA). These assets can be converted into cash with negligible to no loss of value, and whilst these cannot be explicitly or implicitly used to secure or finance transactions, they obviously provide a non-cash short term source of liquidity. These are assessed as reserves, cash, and Basel II 0% risk rated marketable securities. These can decrease in value, but crucially offer potential exposure to value increases during a flight to quality. This is however an extremely expensive way to balance the risks of such dependence on the equities market, and offers little of the ability to adjust to risk that can be provided by a balanced portfolio.[448] In specific Islamic transactions, especially in *Musharakah* and *Mudarabah* contracts, the bank is more of a business partner than a company that provides financing. A large part of the risk of the borrowing company is supported by the bank. In this way, there is a large counterparty and liquidity risk and HQLA can make the bank's balance sheet look better even after unfavourable events.

There are key governance principles that have to be respected by banks in the case of *musharakah* and *mudarabah* contracts, such as ensuring that the management of the Islamic banking institutions have adequate resources and qualified personnel with sufficient knowledge and understanding of the concept, application and risk associated to them. Ensuring that the bank has enough resources for these exposures is a priority and HQLA are helpful in this matter. Even in the case of Istisna contracts, which is essentially a forward contract, having HQLA is welcomed, in the case there are large difference between the forward price and the spot price of the delivered goods that may affect the performance of the banks.

4.7 Summary

This chapter serves as a comprehensive analytical summary of the major risk factors required by the Basel Accords and shows how Islamic finance products may be assessed under a Basel risk management framework. Basel Accords are standards that apply to all internationally active banks and thus, include Islamic banks that are connected to the global market place. As we argued in Chapter 3, banking institutions are exposed to a number of risks with severe and

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[448] Hassan, N_318 above; van heuring, N_47 above.

wide-ranging implications for shareholders, investors and stakeholders alike and a large portion of these risks for banking institutions are defined with the Basel framework. In Chapter 4, after detailing the risk framework of Basel, we then examined some of the major Islamic financial products to illustrate how Basel risk policy, measurements and regulatory supervision are likely to be significant considerations of Islamic banking policy and management.

In brief, Basel technical risks are now major considerations and part of the normal features of a globalised market place, characterized by transnational flows of finance, investment and capital where the risk transmission effects can no longer be contained within state borders. Given the increasing trend to interconnectedness and the pathologies of the financial system that we mentioned in Chapter 3, the question arises whether the minimal banking standards established by The Basel Committee on Banking Supervision providing the most comprehensive set of reform instruments for risk management known to the banking sector can improve the risk management of the Islamic banking sector. Though attempts have been made to mitigate forms of credit and liquidity risk through the introduction of global capital and liquidity related risk management standards, most notably in the form of the Basel Accords, it is reasonable to hypothesize that only at the local level and by a content analysis that we will be able to perceive and determine whether risk management may succeed in Islamic banking institutions. We turn now to examine this hypothesis by investigating the details of risk and risk management in the Islamic banking through two Malaysian case studies.

Chapter 5: TWO MALAYSIAN CASE STUDIES: BANK NEGARA MALAYSIA (BNM) AND THE BANK ISLAM MALAYSIA BERHAD (BIMB)

5.1 Introduction

This case study examines the types of risks to which Malaysian Islamic Banks are exposed in general. However, in order to examine these issues in greater depth and detail, the case study will focus on two particular banking institutions; the Bank Islam Malaysia Berhad (BIMB) and the Bank Negara Malaysia (BNM).[449] The reason for including BNM in this analysis is due to the fact that the primary function of the BNM is to issue currency and complete banking activities. The secondary function of the BNM is to behave as an adviser the Malaysian Government to regulate the country's financial institutions. The justification behind including the BNM in the analysis is motivated by legislation in Malaysia passed in 1958 and in 2009. In 1958, the Central Bank of Malaysia Act 1958 was passed. In 2009, the Central Bank of Malaysia Act 2009 was instated, which repealed the Act of 1958. The main differences in the Acts are the bank's regulatory powers. For instance, a side by side comparison between the two Acts illustrates that up until 2009, the Bank functioned primarily as a financial institution. Prior to 2009, the Bank of Malaysia functioned as an organisation in which to issue currency in Malaysia, keep reserves safe, act as a banker/financial adviser to the Government, promote monetary stability and a sound financial structure, and to promote reliable operation of national payment settlements in Malaysia, as outlined in section 4 of the Act. As these functions are arguably inherent in most banks, these primary functions notably shifted in 2009. In 2009, the primary functions of the Bank were to formulate and conduct monetary policy in Malaysia, to regulate and supervise financial institutions subject to laws enforced by the Bank, to provide oversight money and foreign exchange markets, to exercise oversight over money and foreign exchange markets, to exercise oversight on a progressive and inclusive financial system, and to act as a financial agent of the Government. The inclusion of regulatory principles of the Bank to include the term "agent" earmarks a shift and an elevated nature in the Bank. The 2009 Act was instated in order to positively earmark powers and autonomy of the Bank, which did not exist in 1958. In addition, the governance

[449] Bank Negara Malaysia. Risk Weighted Capital Adequacy Framework (Basel II-Risk Weighted Assets Computation), BNM/RH GL001-22, 2001.Bank Negara Malaysia. Capital adequacy framework for Islamic banks BNM/RH/GL/002-14, 2002a

framework of the Bank strengthened with the accountability and transparency of the Bank. [450] Further, it is arguable that 2009 marked a new era in Malaysia which brought greater powers to the Bank of Malaysia.[451] From a historical standpoint, the case analysis would be oddly muted in the advancements of Malaysian banking if the BNM were not discussed in the wider discussion of Malaysia banking, simply because the Bank has taken on a more regulatory role than conventional banking in recent years. Thus, the next sections of the analyses will include the structure and operational role of the BNM.

In the first section, the chapter sketches out the background and financial landscape in which the Malaysian banking system operates, highlighting the prudential regulatory reforms implemented with particular focus on capital adequacy. The BNM has developed several guidelines on the implementation of international standard and has, moreover, sought to reconcile these with other relevant national and regional standards, including the IFSB standards, to which its banking operations are made subject.[452] As part of this analysis, the chapter will highlight any tensions or divergences in the Basel framework and standards issued by the Islamic Financial Services Board (IFSB). The chapter will therefore proceed to examine how Malaysian banks have sought to implement IFSB and its standards and integrate these with requirements related to Basel II and Basel III. This will prepare the ground for an assessment of the credit risk management strategies of Malaysian banking institutions, the merits of these systems, and the relative strengths and weaknesses of the regulatory framework, informed by a comparison with the UK framework both pre- and post the break-up of the FSA in 2012-3.

5.2 Why Choose Malaysia?

Malaysia is nominally a Muslim-majority country, with a 54% per cent of its 28 million strong populations self-identifying themselves as belonging to the Islamic faith. Yet under 20% of banking assets are held in the IB sector, and strong cross-border flows particularly with Singapore[453], a State of Malaysia prior to independence in 1965[454], mean that

[450] The explicit addition of 'financial agent' of the Government to the 2009 Act denotes a shift in the purpose of the Bank. The 1958 Act contained no discussion on the Bank as a "financial agent," but rather outlined the functions of the bank as an "adviser" and "banker."

[451] Governance, Communications and Organisational Development (2009). The Central Bank of Malaysia Act 2009. BNM. http://www.bnm.gov.my/files/publication/ar/en/2009/cp05_001_whitebox.pdf

[452] IFSB (2005), *Capital Adequacy Standards for Institutions (Other than Insurance Institutions) Offering Only Islamic Financial Services*, Kuala Lumpur: IFSB.

[453] Equity, DBS Bank (Singapore) Group Research. 5 Aug 2014

Singaporean banks compete for ordinary business with Malaysian ones whether CB or IB, for the approximately $350 US billion revenues that the Asia-Pacific banking sector is projected to generate in 2015 from the 41% of the global market expected to be centred in the region.[455] The reason for selecting Malaysia is the best and most appropriate case study by which to assess and evaluate the claims made in preceding chapter relates to the relative stability of Sharí'a compliant Islamic financial institutions, particularly in relation to its sound implementation of risk management standards and strategies, relative to those established in other Muslim countries. For instance, countries such as Saudi Arabia have yet to establish a robust Islamic legal framework dedicated to banking supervision and risk management. Other countries such Iran, Bahrain and the U.A.E have yet to fully internalise and enforce corporate governance related rules and procedures.[456]

The competition both between Singaporean and Malaysian banks on the one hand, and Islamic and conventional banks on the other, is the main instructive factor in choosing Malaysia. The instructive value for KSA is clear: banking in the KSA will be a competitive industry, and investors have a clear choice of whether to invest in a KSA bank, or, for instance, a British or UAE bank, each of which will be Shari'a compliant.

Malaysia was, moreover, a somewhat pioneering actor in evolving Islamic finance market, in being the first South-East Asian country to establish a Sharí'a compliant legal and financial framework in which Islamic banks could flourish and compete within its domicile.[457] However, as the study shows, this experience is not the only reason that Malaysia has experienced substantially higher levels of growth compared with other Islamic finance institutions operating in the same sector.[458]

A further reason, consequently, for selecting Malaysia as the choice of case study relates to its seeming capacity to withstand global stresses and shocks, even in the face of the contagion

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[454] For general historical data on the financial history between the two countries see http://www.mas.gov.sg/~/media/MAS/Monetary%20Policy%20and%20Economics/Education%20and%20Research/Research/Economic%20Staff%20Papers/2000/MASOP018_ed.ashx

[455] McKinsey on Payments September 2012, 14

[456] H Fathiyah, *Capital Structure and Performance of Islamic banks and IBS Commercial Banks in Malaysia* (Presented at the National Seminar on Islamic Banking and Finance, KUIM 29-30 August 2006).

[457] See for examples BNB reports on Financial Reporting and Corporate Governance related requirements First Level Executive, Prudential Financial Policy Department, Bank Negara Malaysia and http://www.bnm.gov.my/guidelines/01_banking/02_financial_reporting/Financial%20Reporting.pdf and http://www.bnm.gov.my/guidelines/01_banking/04_prudential_stds/Ft_Proper_Criteria_280613.pdf

[458] Khan, N_431 above; Khan and Ahmed, N_431 above.

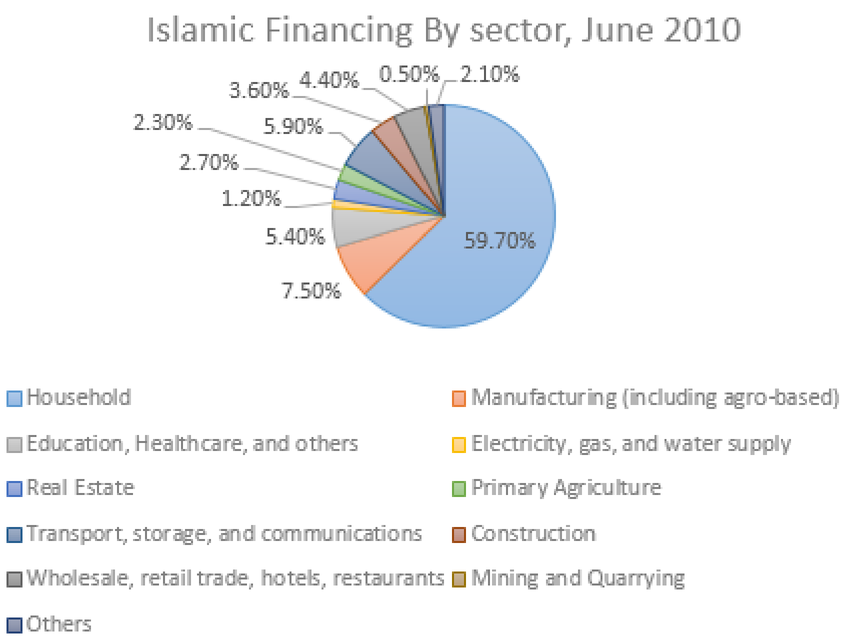
effects of the most recent financial crisis. Malaysian banks have continued to remain stable even in the face of systematic and unsystematic risks. This resilience can be attributed in large part to the institutional liquidity of the banking sector. On the whole, banking institutions have operated with high levels of capital adequacy, and, moreover, significantly above the regulatory minima proposed at each successive phase of Basel, Basel II and Basel II implementation.

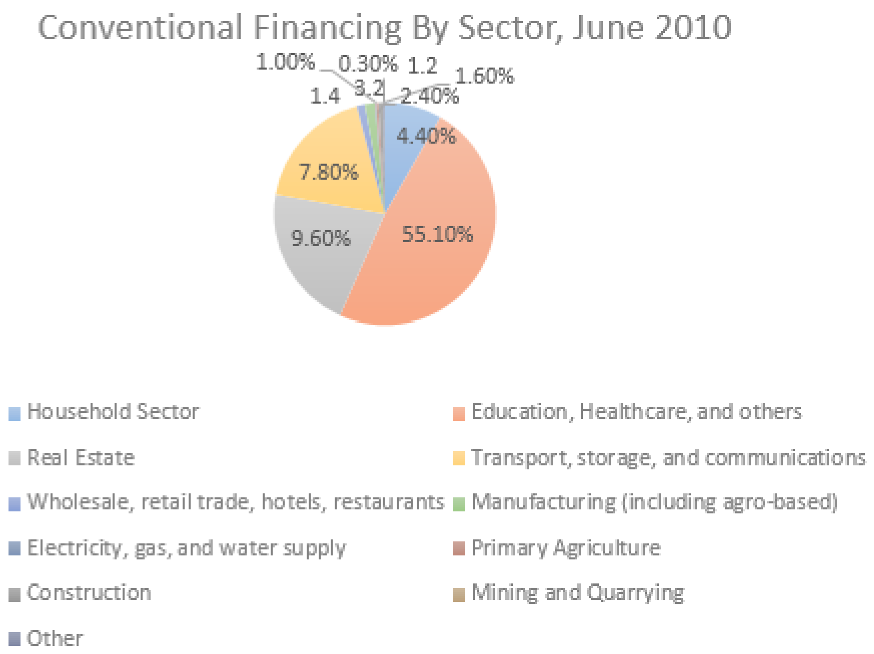
The Malaysian banking sector has established itself a highly successful niche market, demonstrated by high levels of growth from year to year. On one view, this success highlights consistent demand by Muslim consumers for alternatives to conventional banking initiatives and products. On another view, it highlights the ingenuity of Malaysian bankers and regulators in developing Shari'a compliant products, possibly ahead of the competition. Finally, it demonstrates that a stable legal environment is necessary for the proper establishment of a bond or sukuk market where there is strong legal protection for depositors and investors.[459] In the broader picture, net financing has increased substantially over two business cycles (from 2007-2011 and from 2011 to current), rising from 7.1 percent at the end of 2000 to 17.8 percent at the close of 2010. [460]In nominal terms, net financing amounts to RM1 325 billion, which reflects a significant increase over the past five financial years. [461]

Figure 11, taken from the official source of Bank Negara, because of its official provenance, shows the sources of financing by Malaysian banks.

[459] Singam, Kamini (2003) "Corporate Governance in Malaysia," Bond Law Review: Vol. 15: Iss. 1, Article 13.
[460] Balin, B.J., (2008), Basel I, Basel II, and Emerging Markets: A Nontechnical Analysis; Bank Negara Malaysia, (2014, 2012, 2011), Annual Report ; Fathiyah, N_468 above.
[461] Hamim Syahrum Ahmad Mokhtar, Syed Musa Alhabshi and Naziruddin Abdullah 2007, "Determinants of Islamic Banking Efficiency in Malaysia" Paper presented to IIUM International Conference on Islamc Banking and Finance, IIUM Institute of Islamic Banking and Finance, 23-25 April 2007. Harker, P. T. and Zenios, S.A. 2000, "Performance of Financial Institutions: Efficiency, Innovation, Regulation" Cambridge University Press.

Figure 13: Sources of financing by Malaysian banks





Source: Bank Negara Malaysia[462]

462 Bank Negara Malaysia. Capital adequacy framework for Islamic banks – Disclosure requirements (Pillar 3). BNM/RH/GL 007-18, 2007.

Non-performing loans (NPL) have been also been on a downward trend in recent years, with the industry reporting a gross NPL ratio of 2.69 percent in 2011. Since 2007, the ratio has been decreasing with the NPL ratio in 2014 being less than half of the ratio in 2007.[463] For instance, assets raised overseas increased from RM3.3 billion in 2002 to RM258 billion in 2010. The rapid and steady growth of the Malaysian sector has been attributed to, among other factors, product diversification, including expansion of new and innovative Islamic financial instruments and products, including capital markets including the Takaful---the Sharí'a compliant--- insurance based market and the growing market in Sukuk products. Its market penetration may, additionally, be in part linked in turn to growing investor confidence in the risk regulatory capabilities and international management systems of the Malaysian banking sector and supporting legislation[464], reflecting the continuous attempts by institutions such as the BNB to undertake capacity building initiatives and implement corporate governance practices.[465]

The below figure shows investment projects by Malaysian Banks, and is taken from the official source of Bank Negara.

[463] Muhammad Syukri Bin Shamsuddin ,Basel III Implementation: Challenges and Opportunities In *Malaysia* In Basel III Implementation: Challenges and Opportunities (Chapter 6). http://www.seacen.org/content.php?id=54&pid=702003-100328

[464] Singam, Kamini (2003) "Corporate Governance in Malaysia," Bond Law Review: Vol. 15: Iss. 1, Article 13.

[465] Bank Negara Malaysia. Capital adequacy framework for Islamic banks – Disclosure requirements (Pillar 3). BNM/RH/GL 007-18,2007 and Hamim Syahrum Ahmad Mokhtar, Syed Musa Alhabshi and Naziruddin Abdullah 2007, "Determinants of Islamic Banking Efficiency in Malaysia" Paper presented to IIUM International Conference on Islamc Banking and Finance, IIUM Institute of Islamic Banking and Finance, 23-25 April 2007.

Figure 14: Investment projects by Malaysian banks

7. APPROVED INVESTMENT PROJECTS

	Unit	2008	2009	2010	2011	2012	2013(a)
7.1 Approved Investment Projects							
Number of projects approved		919	766	910	846	804	144
Potential employment	'000s	101	64	97	101	77	17
Total proposed capital investment	RM mil	62,785	32,637	47,177	56,087	41,052	11,739
Domestic	% of total	26.6	32.1	38.4	39.1	49.2	28.6
Foreign	% of total	73.4	67.9	61.6	60.9	50.8	71.4
7.2 Foreign Investment in Approved Projects (by Selected Countries)							
Australia	% of total	*28.4*	*1.5*	*0.2*	*0.9*	*0.4*	*1.2*
France	% of total	*0.5*	*0.1*	*0.7*	*0.5*	*6.9*	*0.1*
Germany	% of total	*9.6*	*1.9*	*6.7*	*5.7*	*3.3*	*0.9*
Japan	% of total	*12.1*	*31.8*	*13.9*	*29.6*	*13.4*	*20.2*
Singapore	% of total	*4.3*	*9.0*	*7.4*	*7.3*	*10.6*	*4.8*
Taiwan	% of total	*2.0*	*3.2*	*3.5*	*4.1*	*0.8*	*0.5*
United Kingdom	% of total	*1.8*	*1.5*	*1.2*	*0.7*	*2.9*	*0.0*
USA	% of total	*18.8*	*10.6*	*40.4*	*7.4*	*1.4*	*30.1*
Others	% of total	*22.3*	*40.4*	*26.0*	*44.0*	*60.3*	*42.2*
TOTAL	**RM mil**	**46,099**	**22,145**	**29,057**	**34,149**	**20,845**	**8,385**

Note : (a) Data from January- March 2013

Source : Malaysian Investment Development Authority

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Source: Bank Negara Malaysia[466]

A further reason why Malaysia was chosen for the purpose of a case study relates to its hybrid nature: despite being governed by principles of Islamic law, the Malaysian banking sector shares many features in common with conventional banking: it is professional managed, subject to professional standards including internally devised corporate governance approaches and policies, prudential (regulated) supervision, and is, more generally, orientated to free market competition. Finally, the country was selected due to the availability of data on regulation, risk management and accounting practices from 1997 to 2014.

Viewed in the above light, Malaysia provides a useful frame of reference for the development of the immature systems of other Muslim countries. However, notwithstanding the apparent success of the Malaysian Islamic finance banking sector particularly with reference to its implementation of capital adequacy standards and ratios, the Malaysian banking sector is not without its limitations and challenges. These will be discussed below.

[466] Bank Negara Malaysia. Capital adequacy framework for Islamic banks – Disclosure requirements (Pillar 3). BNM/RH/GL 007-18,2007.

5.2.1 Institutional and Regulatory Framework

The hybrid Malaysian financial sector has proved itself adaptive and competitive in the face of the changing demands of a global economy since its inception. Islamic Malaysian financial institutions, some of which are subsidiaries and affiliates of conventional banking structures, operate according to a legislative framework467 in accordance guiding principles of Sharí'a law. In Malaysia, commercial banks represent the most prevalent banking institution in the industry. To date, 19 domestic commercial banks operate in Malaysia. Those banks provide familiar services which including taking deposits, approving and issuing loans and advance to their customers, the provision of credit card services, facilitating leasing options and underwriting of private debt securities.

It has been suggested that:

> Islamic bank products [in Malaysia] are modelled after existing conventional bank products. For every conventional product there is a corresponding Islamic substitute with Sharí'a compliance. Islamic banks offer 'differentiated' products by simply adopting conventional risk and return profile, subject to Shari'a constraints. Thus, the products offered by Islamic banks, in the first stage of evolution, are very similar but not identical to that of conventional banks.[468]

Capital held by commercial banks account for 58 percent of the market share, while the remaining locally incorporated internationally active banks account for 20% of assets in the relevant sector.[469] Investment banks domiciled in Malaysia, on the other hand, are involved in trading operations including the bonds and equities market, underwriting services, mutual funds and the general provision of fee based advice and financing activities. Investment banks will also accept deposits, providing these exceed RM500,000. Moreover, many of these banks and their affiliates have joined forces to form corporate groups. Thus a number of domestic Malaysian banks have affiliates in the sector, including investment and IB branches and subsidiaries. Others have affiliates in the insurance sector, offering takaful (Islamic insurance) as well as other services.

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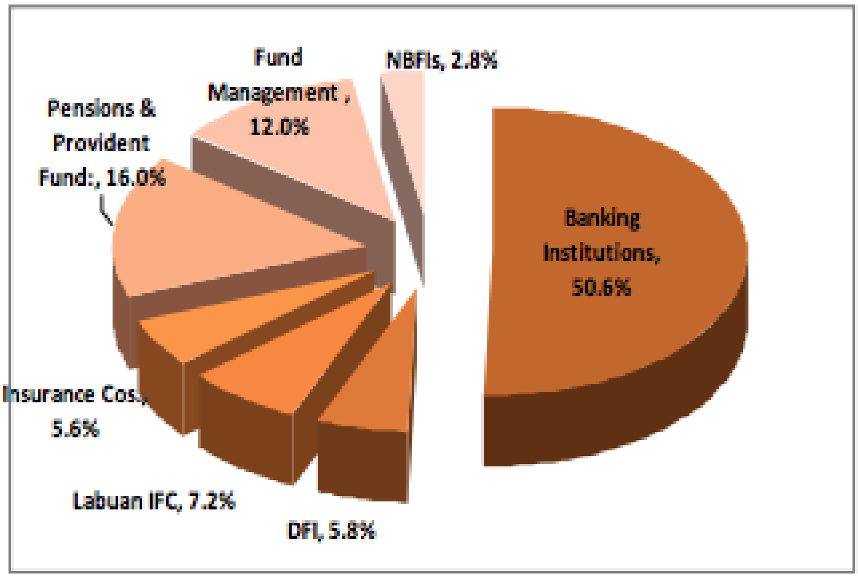
[467] Banking and Financial Institutions Act 1989 covers all banks, whilst additionally for Islamic banks, the Islamic Banking Act 1983 came into effect on 7 April 1983.

[468] Ariff, Mohamed *Islamic Banking In Malaysia: Industry At Crossroads* INCEIF Research Bulletin no 3, 24 June, 2014. http://www.inceif.org/research-bulletin/islamic-banking-malaysia-industry-crossroads/

[469] Muhammad Syukri Bin Shamsuddin ,Basel III Implementation: Challenges and Opportunities In *Malaysia* In Basel III Implementation: Challenges and Opportunities (Chapter 6) at 184 . http://www.seacen.org/content.php?id=54&pid=702003-100328.

Islamic banks have a substantial presence in the evolving Malaysian banking context, accounting for 18% of banking assets, equivalent to RM 353 Billion.[470] Indeed, Malaysia has emerged as a key competitor and asset holder in the Islamic finance market. In the last statistics produced, and outside the bloc of gulf countries, Malaysia holds ten percent of market share in the IB sector. To some extent, this is supported by exchange controls: From 1 September 1998, the Malaysian Government implemented a series of measures to insulate the economy from the risks and vulnerabilities of the external economic developments and to effect a stable exchange rate regime.[471] The overall composition of banking structures regulated under the supervisory control of the Bank Negara Malaysia (BNM) is represented in the following figure.

Figure 15: The composition of Malaysian banking structures.



Source: IMF. List of acronyms: DFI, Development Fund. Labuan is a tax free island which is part of Malaysia - their equivalent of the Isle of Man or Guernsey. NBFI is non-Bank Financial Institution.

Broadly speaking, the government of Malaysia has adopted a highly interventionist, "top down" stance in the development and evolution of the Malaysian banking sector. Prior to 1989, all Islamic finance institutions were requirement to submit to perhaps the first

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470 Khan, T. and Ahmad, H. 2001. Risk Management An Analysis Of The Issues In Islamic Financial Industry. Occasional Paper no.5. Jeddah: IRTI, 2001. http://www.pdf-finder.com/RISKMANAGEMENT-AN-ANALYSIS-OF-ISSUES-INISLAMIC-FINANCIAL-INDUSTRY.html

471 Bank Negara press release, Measures to Regain Monetary Independence, 1 September 1998 http://www.bnm.gov.my/?ch=en_press&pg=en_press_all&ac=482&lang=en

comprehensive Islamic regulatory instrument of its kind --- the *Islamic Banking Act* 1983. This Act established the Central Bank of Malaysia (Bank Negara Malaysia or BNM); this regulatory authority is endowed with principal supervisory- rule making, administering and enforcing—powers for regulating Islamic Banks subject to its jurisdiction.[472] In this capacity has authority to issue licences to individual banks and sanction non-compliance with minimum capital adequacy requirements. At a policy level, BNM is authorised to set and modify general rules and standards on banking practices nationally.

The 1989 Act has since then been superseded by two key constitutive instruments: the *Financial Services Act* 2013 which governs conventional financial institutions and the *Islamic Financial Services Act* 2013. Investment banks are furthermore subject to the regulatory rules and controls enacted under the *Capital Market and Securities Act* 2007, which is administered by the Securities Commission Malaysia.

Among one of its most distinctive features, and a potential factor of the relative success of its Islamic finance institutions, markets and products, is the support Malaysian banks receive from the state government and from public stakeholders. It should be noted, however, that of the banks that operate in Malaysia, conventional or Islamic, none are nationalised or directly owned by Government. Nonetheless, internally domiciled banks do benefit from comparatively high levels of state and private interest by various interest groups. One instance is the injection of liquidity by state linked initiatives and corporations such as the Employment Provident Fund (EPF)[473], the government-run pension agency which has investment income of RM10.63 billion (£1.79 billion on 1 July 2015) for the first quarter ended 31 March 2015, on total investment assets of RM663.75 billion, a year-on-year growth of 20.33 per cent compared with RM8.83 billion recorded in Q1 2014. Islamic financial institutions hold 40% of EPF funds (approximately £45 billion), and it is submitted that although the figure held 10 years ago was somewhat less, it together with the exchange controls of 1998 provided a cushion to the shocks of the financial crisis.[474]

[472]Fathiyah, N_468 above; Archer, N_256 above.

[473] Retrieved from http://www.bnm.gov.my/files/publication/ar/en/2005/cp08.pdf

[474] Retrieved from http://www.kwsp.gov.my/portal/en/news-listing-page?p_p_id=newslisting_WAR_newshighlightsportlet&p_p_lifecycle=0&p_p_state=normal&p_p_mode=view&p_p_col_id=column-3&p_p_col_pos=1&p_p_col_count=3&_newslisting_WAR_newshighlightsportlet_jspPage=%2Fdisplay%2Fnews_content.jsp&_newslisting_WAR_newshighlightsportlet_redirect=%2Fportal%2Fen%2Fweb%2Fkwsp%2Fnews-listing-

The next section will focus on the implementation of the Basel framework in the Malaysian finance market, focusing on two Islamic financial institutions: the Bank Islam Malaysia Berhad BNM and BIMB.

5.2.2 The Application of Basel Capital Adequacy Framework in Malaysian Banks

The Basel I framework was first adopted in Malaysia in 1989. It was later revised to incorporate reforms designed to limit market risk exposures as set forth in the regulatory instrument the Market Risk Amendment. Under a further set of state amendments, the national adoption of the Basel framework was once again amended and revised to reflect the proposals contained in Approach for Credit Risk, Basic Indicator Approach and Standardised Approach for Operational Risks of the Basel II package.[475] Other reforms implemented under Basel II include the Pillar I guidelines on the Internal Ratings-Based approach for Credit Risk and Internal Models Approach for Market Risks; the procedures associated with the supervisory Review process and disclosure requirements elaborated under Pillar 3.

The trend and capacity of the Malaysian banking system to hold capital in excess of Basel minimum requirements has remain stable over the past decade. Indeed, the banking as whole in Malaysia has exceeded a 15% capital ratio threshold over the past 4 years.[476] Testament to the above Malaysian Islamic Finance Institutions was reported to have stood at 22.2% as of September 2014, while its Core Capital Ratio (CCR) accounted for 21.7 percent.[477] This figure is commensurate with nominal holdings of approximately RM47 billion in excess minimum 8% capital thresholds.[478] Indeed, even at the summit of the financial crisis in 2008, Malaysian banks maintained relatively high levels of liquidity, with the average RWCR amounting to 13.1 percent. [479]

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page&_newslisting_WAR_newshighlightsportlet_primaryKey=10005&_newslisting_WAR_newshighlightsportlet_isDetailPage=true

475 Basel Committee on Banking Supervision, (2012), a Framework for Dealing with Domestic Systemically Important Banks.

476 http://www.bnm.gov.my/guidelines/01_banking/01_capital_adequacy/12_nt_007_25.pdf.188; Malaysia Treasury Department, (2011), Statistics for GDP of Malaysia 2005- 2011.

477 Muhammad Syukri Bin Shamsuddin, Basel III Implementation: Challenges and Opportunities In *Malaysia* In Basel III Implementation: Challenges and Opportunities (Chapter 6) at 184 . http://www.seacen.org/content.php?id=54&pid=702003-100328

478 Basel Committee on Banking Supervision, (2012), A Framework for Dealing with Domestic Systemically Important Banks

479 ibid

In keeping with general financial trends in Malaysia, the capital structure of most banks operating in Malaysia, including Islamic banks such as BIMB and the BNM discussed below, largely consists of common equity, which as discussed above is constitutive of Tier 1 capital (which is subject to stricter capital ratio and buffer requirements as per the Basel framework). In contrast with counterpart institutions operating in the UK and the United States, for instance, Malaysia banks are according to some authors' estimates, projected to retain capital levels double the minimum levels specified under the Common Equity Tier 1 (CET1), and this, moreover, even after the capital conservation buffer is factored in. Once again, this excess is attributed to prudent profit and liquidity retention regulatory strategies.[480]

Malaysian banking institutions have, in other words, been able to safeguard their assets and retain high levels of institutional liquidity due to a strategic policy of prudential earnings retention and increased reserves. To some extent this is a combination of the effect of exchange rate controls and the high savings in the government-sponsored Employee Provident Fund.[481] According to the Bank for International Settlements, increasing reserve requirements is less distortionary to an economy than direct controls on bank lending, and costs the authorities very little. It appears to be the large amount of national savings that in part ensures that the Malaysian banks have a sufficient profit to absorb any detriment caused by their high capital reserves.[482] Furthermore, the Malaysian banking industry has proved its responsiveness to the Basel framework approved risk management and supervision recommendations as formulated under Pillar 2 and 3.[483] Nonetheless, commentators have also suggested that the Malaysian banking institutions will however, like many CBs, experience decrease in their capital ratios, particularly in Tier 1 capital, as the Basel III framework is fully rolled out.[484] This is even assuming that Malaysian banks are not affected by unexpected unsystematic pressures, or otherwise reform their internal banking activities and balance sheet profiles, for instance through the introduction of new financial instruments or

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480 Bank Negara Malaysia. Capital adequacy framework for Islamic banks – Internal capital; Adequacy assessment process (Pillar 2). BNM/RH/GL 002-22, 2002.

481 World Bank, https://openknowledge.worldbank.org/bitstream/handle/10986/15548/multi_page.txt?sequence=2, 21

482 CGFS Papers No 33 Capital flows and emerging market economies Committee on the Global Financial System January 2009, 53 http://www.bis.org/publ/cgfs33.pdf

483 Bank Negara Malaysia, BNM/RH/GL 001-33 Prudential Financial Policy Department Risk-Weighted Capital Adequacy Framework (Basel II) – Internal Capital Adequacy Assessment Process (Pillar 2)

484 Bank Negara Malaysia, (2011), Annual Report. Bank Negara Malaysia, (2011), Financial Stability and Payment Systems Report.

through reducing their risk weighted assets.[485] Decreases in capital ratios, relative to previous levels, is linked to the new capital measurement models formulated in Basel III under which fair value gains previously assessed under Tier II are now deducted from the common equity Tier 1, in contrast with Basel II where deductions were calculated as a risk weighted percentage of a given Bank's total capital.[486] However, this computational change will have the greatest impact on bank with relatively low capital ratios to begin with. The BNM and BIMB, the key institutions focused on in this case study, as suggested above, relatively high ratios in excess of the 8 per cent regulatory minimum.[487]

Preparing the ground for a larger assessment of the extent to which the Basel framework is sufficiently responsive to the particularities of Islamic finance sector, and the principles which underpin it, the next section considers to which global standards, including those developed by the BCBS, AAOIFI and IFSB to protect the rights of PISA holders. Under the Basel framework, capital charges are applied only to operational risks under Basel thus failing to factor in additional credit risks unique to Islamic contract and PSIA agreements (e.g. lack of penalties in event of debtor default). Both Bank Negara[488] and the IFSB[489] has established a different formula for calibrating the risk weight of assets financed by Islamic banks depending on nominated contracts. The BNM in particular has issued guidelines which seek to integrate the Basel recommendations with the local standards issued by the IFBS.[490] In particular, these standards provide the specific treatment for the computation of credit risk weighted assets for seven classes of Islamic contracts undertaken by Malaysian IBs. Some Islamic banking products may carry different titles and have variations in contractual structures which have led BNM to require that, for the purpose of computing the risk-weighted asset amount, IBs focus on the risk structure and exposure of the products.[491]

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[485] Bank Negara Malaysia BNM/RH/GL 001 - 21 Prudential Financial Policy Department Risk-Weighted Capital Adequacy Framework (Basel I – Risk-Weighted Assets Computation), 3

[486] Khan, T. and Ahmad, H. 2001. Risk Management An Analysis Of The Issues In Islamic Financial Industry. Occasional Paper no.5. Jeddah: IRTI, 2001. http://www.pdf-finder.com/RISKMANAGEMENT-AN-ANALYSIS-OF-ISSUES-INISLAMIC-FINANCIAL-INDUSTRY.html

[487] Bank Negara Malaysia, (2011), Monthly Statistical Bulletin, December. Bank Negara Malaysia, (2011), Financial Sector Blueprint 2011-2020.

[488] Bank Negara Malaysia,BNM/RH/CP 028-11 Prudential Financial Policy Department Operational Risk Management Page 2/23, 27 June 2014, http://www.bnm.gov.my/guidelines/01_banking/04_prudential_stds/Operational_Risk_Management.pdf

[489] Archer, N_256 above.

[490] Bank Negara Malaysia,Capital Adequacy Framework (Basel II - Risk Weighted Assets) 27 June 2013 http://www.bnm.gov.my/guidelines/01_banking/01_capital_adequacy/3_gl_caf_rwa_010713.pdf

[491] Bank Negara Malaysia,Capital Adequacy Framework (Basel II - Risk Weighted Assets) 27 June 2013 para 2.47, p. 22 http://www.bnm.gov.my/guidelines/01_banking/01_capital_adequacy/3_gl_caf_rwa_010713.pdf,

At the same, IFSB standard setting practices represent an attempt to introduce a clear legal framework, supervisory review, transparency and other good governance and risk management elements into Islamic finance, dealing amongst other things with higher regulatory expectations for more transparency, and the need for the effective management of risks and capital.[492]

While countries such as Saudi Arabia lack the legal infrastructure to properly monitor and implement such measures, Malaysia, BIMB and BNM, the banks used for the case studies suggest positive developments in this respect. At a time where the competitive financial landscape is being redrawn by advances of technology, new institutional arrangements, the evolving international regulatory reforms, changing operating models, rising consumer expectations and increased competition, [493] IFSB standards are evolving to ensure the pursuit of an effective functioning and sound Islamic financial structure, post-crisis. The IFSB has made significant advancements in leading the efforts to review specific measures put forward by the Basel Committee for possible adoption in Islamic finance.[494]

5.2.3 Assessing Malaysian IFIs

As a general point of scholarly enquiry and interest, the case study also implicates questions of a constitutional nature. Islamic financial institutions operating in Malaysia are subject to the rules and standards developed under the Basel framework, as are all other financial institutions in Malaysia.[495] However, they are also subject to the rule and decision making authority of yet another, this time local and context-specific, standard setting body: the Islamic Financial Services Board. [496] The questions posed but not yet answered is: How do the rules and standards generated by these distinct (one global, one local) regimes co-exist? Do they co-exist and overlap (is there comity or constitutional coherence?) Or, alternatively,

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[492] Governor Dr. Zeti Akhtar Aziz, Governor's Welcoming Address at the 10th IFSB Summit 2013 - The Future of the Islamic Financial Services Industry: Resilience, Stability and Inclusive Growth16 May 2013. http://www.bnm.gov.my/index.php?ch=en_speech&pg=en_speech_all&ac=465, reprinted Gateway magazine (South-South Information Gateway), June 2013, 12 http://www.ssig.gov.my/wp-content/uploads/2013/08/BuletinSSIG_24thEdition_June2013.pdf

[493] To show that I'm not being Islamocentric, this quote comes from the Australian Submission to the Financial System Inquiry March 2014, pp 43 ff. http://fsi.gov.au/files/2014/04/Reserve_Bank_of_Australia.pdf

[494] Governor Dr. Zeti Akhtar Aziz, Governor's Welcoming Address at the 10th IFSB Summit 2013 - The Future of the Islamic Financial Services Industry: Resilience, Stability and Inclusive Growth16 May 2013. http://www.bnm.gov.my/index.php?ch=en_speech&pg=en_speech_all&ac=465

[495] Bank Negara Malaysia, BNM/RH/NT 007-25 Prudential Financial Policy Department Islamic Banking and Takaful Department Implementation of Basel III

[496] Islamic Financial Services Board Capital adequacy standard for institutions (other than insurance institutions) offering only Islamic financial services, 2005a. Available at: www.ifsb.org.

does the relation between two regime represent a paradigmatic constitutional conflict ("constitutional pluralism"), or in private law terms, a conflict of laws. If so, does or should the standards of one regime take precedence or claim ultimate authority over the standards and decisions of the other? This questions will be assessed in a less theoretical, and more practice orientated register, namely by way of discussion of the extent to which Islamic standard setting bodies have been able to customise and adapt the Basel standards to the financial, contractual and regulatory specificities of Islamic finance, markets and structures---and, crucially, the extent to which 'gaps' and divergence remain. In the above light, the next section will consider the Bank Negara Malaysia (BNM) adoption and refinement of the Islamic Financial Services Board (IFSB) standards and guidelines on capital management and risk reduction.

The application to Saudi Arabia is clear. Faced with international competition, Malaysia has strengthened its market share in IB by its strict regulation, its strong capital buffers and by a standardised approach to Shari'a which provides authoritative *fatawa* which support new innovations in financial products and services.[497] KSA must do the same. As will be seen in chapter 7, having *sukuk* which a leading scholar says are not Shari'a compliant, and having a weak regulatory structure without the backing of the rule of law, is not likely to provide a banking centre which can compete with Malaysia or with the UK.

5.3 Reconciling the Regulatory Standards of the Basel Committee and the Islamic Board of Financial Services: The Case of the Bank Islam Malaysia Berhad (BIMB)

The following section examines the implementation of Basel II and III by BNB. Specifically, the BNM addressed the question how to appropriately measure and set capital adequacy ratios of bank licenced under the relevant constitutive instruments, including, namely the IBA 1983 (IBA) and *Banking and Financial Institutions Act* 1989 (BAFIA) respectively. The BIMB was the first Islamic Bank to be established in Malaysia in 1983, under the auspices of the IBA 1983. As Central Banker, Bank Negara Malaysia emerged as a central actor in the

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[497] For an example of a new and innovative financial product, the Mubādalah al-Arba`ah Profit Rate Swap (PRS), see the Product Standard for that product appearing in the Malaysian IFSB *Islamic Financial Services Industry Stability Report* 2013 Appendix 3.

development and circulation of IFSB standards, infusing them with concrete content in order to facilitate their practical application and implementation on the part of the banking industry as a whole. [498] The BNM has been a pioneering institution in developing customised guidelines that aim to integrate Basel II accords and the IFSB standards to better adapt to the novel aspects of Islamic markets, products and contracts by using analogy with concepts arising in the Qur'an and the *Sunna*.[499] It has been able to circumvent the difficulty of بدعة *bid'ah* which roughly translates as novelty, but which has the negative connotation of being somewhat heretical if it suggests that the Qur'an is not complete in itself, and needs novelty added to it.[500]

The IFSB is an international body with its technical committee under the Chairmanship of a Member of the Saudi Arabian Monetary Authority (SAMA)[501], and with the Governor of SAMA as a Member of the Board[502]. It is responsible for setting standards with international reach. [503]The prudential standards and guidelines it develops and promulgates, are much like those issued under the Basel framework, intend to promote and enhance the effective functioning and capital integrity of the Islamic financial banking institutions, capital markets and the insurance industry. For the most part, the standard setting activities of IFSB are largely in line with the regulatory and fiscal goals of OECD and BCBS in respect of the banking sector.

To so do, IFSB has outlined 4 overarching standards which all Islamic financial institutions are called upon to observe in the operation of their commercial activities. These standards demonstrate the pragmatic approach of Malaysia's SAC in researching methods in which innovations in terms of fatawa can be made in keeping with Islamic tradition, and at the same time conform to the regulatory structure and requirements formalised under Basel II:[504]

i) The introduction of capital adequacy standards for all entities offering Islamic financial services, with the exception of insurance companies. These standards were issued in 2005.

498 Bank Negara Malaysia, (2011), Notification to Industry on Basel III Implementation.
499 Kettell, Brian The Islamic Banking and Finance Workbook: Step-by-Step Exercises to Help You Master the Fundamentals of Islamic Banking and Finance, Wiley, 2011, 13.
500 Ghazālī, Muḥammad , Within the Boundaries of Islam: A Study on Bid'ah, The Other Press, 2010 , 104
501 Dr Ahmed Abdulkarim Alkholifey, from 10 December 2013
502 Dr. Fahad Al-Mubarak, Governor of SAMA.
503 Islamic Financial Services Board. (2005a) Capital Adequacy Standard for Institutions (Other than Insurance Institutions)Offering only Islamic Financial Services. December, http://www.ifsb.org/standard/ifsb2.pdf
504 Islamic Financial Services Board. (2005b) Guiding principles of risk management for Institutions (Other than Insurance Institutions) Offering only Islamic Financial Services. http://www.ifsb.org/standard/ifsb1.pdf

ii) The provisions of guidelines and practices on finance sector specific risk management applicable to Islamic institutions excluding Takaful or Islamic insurance as otherwise known. These standards were issued in 2006

iii) New rules governing company disclosures on capital structure and risk management profiles with the aim of promoting accountability and transparency, again excluding Takaful related services. These standards were issued in 2007.

iv) Regulatory guidance for supervisory control and oversight of Islamic financial services, with the exception of the insurance industry and mutual funds. These standards were issued in December 2007.

The standards issued by the IFSB while influential remained largely open ended and indeterminate. To this end, the BNM has formulated a number of guidelines which cohere with both the Basel II framework and IFBS standards, but are sufficiently well adapted to reflect the specific risks related challenges and profiles of banks operating in the relevant markets. In contrast with the IFSB standards which are voluntary and 'soft' in nature, the guidelines issued by the BNM are defacto binding on institutions who participate in the BNM initiative. In the context of Malaysia, the Basel reforms were implemented in a three stage process.[505] The standards on capital adequacy set forth by the BNB were implemented beginning 2008. The internal rating systems developed and advocated by the BNM were subsequently rolled out in 2010.

Before assessing the implementation of Basel III and its impacts on the Malaysian IB sector, it is worth noting the two guidelines developed by the BNM which brings into close contact, conflict and coherence the standards issued under Basel and the standards developed by the IFSB: on the issue of the capital adequacy ratios and measurement methodologies applied by the relevant banks. The first of the guidelines concerns the risk weighted capital framework.

The risk weighted capital framework developed by the BNM, and instituted by the finance policy department of Malaysia, largely corresponds to Basel II rules on risk weighted assets.[506] All financial institutions are obliged to integrate this framework into their internal

[505] Mohamed, N_390 above.

[506] Bank Negara Malaysia. Risk Weighted Capital Adequacy Framework (Basel II-Risk Weighted Assets Computation), BNM/RH GL001-22, 2001. Bank Negara Malaysia. Capital adequacy framework for Islamic banks. BNM/RH/GL/002-14, 2002a. Bank Negara Malaysia. Capital adequacy framework for Islamic banks – Internal capital adequacy assessment process (Pillar 2). BNM/RH/GL 002-22, 2002.

risk management and measurement system for the purposes of computing the minimum capital requirements banks must meet to offset and minimise risk exposures. For example, IFSB's GN-6 Guidance note on quantitative measures for liquidity risk management in institutions offering Islamic financial services [excluding Islamic insurance (*takāful*) institutions and Islamic collective investment schemes] was issued in April 2015.[507] Not only does it cover liquidity risk management for Muḍārabah or Wakālah instruments[508] but it also allows for a deposit insurance scheme for PLS Investment accounts and deposits[509], and deals with derivatives such as Sharī`ah-compliant hedging assets (e.g. Islamic swaps).[510]

By the end of 2011, BNM declared its intention to rollout the Basel III reforms package in accordance with the globally agreed 5 year implementation timeframe (beginning in January 2013).[511] The first component of these reforms implemented concerns the Capital Adequacy Framework (Capital Components). BNM accepted the new capital structure and threshold standards and proceed to begin plans for their formal internal implementation in January 2013. This complied with the principal rationale of the Basel II framework: firstly, to further clarify the definition of eligible regulatory capital held by financial institutions, secondly, to secure institutional liquidity, and then to impose greater restraints and criteria on the quality and level of capital held in reserves. The proposals adopted by BNM generally converge with the minimum requirements formalised under the Basel framework. [512]

The second guideline of interest concerns attempts by BNM to integrate regulatory requirements relating Pillar II of Capital Adequacy Framework for International Banks (CAFIB) into the internal operations and risk management system of Islamic banks active in Malaysia. Such requirements relate specifically to the institution of supervisory review processes for governing the capital management of Islamic banks. Under its 2007 standards, BNM retains the right to impose higher capital thresholds or prudential restraints on specific Islamic banks where the application of general CAFIB standards institutions are found to be insufficiently tailored to their risk profiles.[513] After 2011, BNM also steered the introduction of an Internal Capital Adequacy Assessment (ICAAP) which was subsequently implemented

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[507] Downloadable from http://www.ifsb.org/standard/GN-6%20GN%20on%20LRM%20(April%202015)-final.pdf
[508] in part 2.3.1.1, from para 52 on page 17
[509] In part 2.3.1.2 , from para 56 on page 19.
[510] in para 121on page 32.
[511] Risk-Weighted Capital Adequacy Framework (Basel 1 - Risk-Weighted Assets Computation) ***updated 2009/10/23*
[512] ibid
[513] Bank Negara Malaysia. Capital adequacy framework for Islamic banks – Disclosure requirements (Pillar 3). BNM/RH/GL 007-18, 2007

by a number of Islamic banks in accordance with the directives issued under the IFSB and BNB guidelines.

The BNM has also instituted its own internal risk management systems for assessing credit, market and operational risks with bearing on continued solvency, stability and capital adequacy.[514] Such measures include the BNM's dividend approval schemes which factors in continual supervisory assessment of the results of stress tests and supervision of capital management practices.[515] The BNM, moreover, continues to develop policies and controls to ensure that capital to risk ratios are sound and reflective of the bank's real earnings, growth projections and risk profiles. In capsule, the BNM approved framework sets out standardised approaches for assessing and measuring i) credit, ii) market and iii) a Basic Indicator Approach for assessing operational risks including a standardised and alternative approach The Standardised Alternative Indicator. [516]

With respect to the Basel III approved NVLA trigger, BNM has in its Capital Adequacy Framework (Capital Components) attempted to reduce the scope and potential for discretionary decision making (and any resulting arbitrariness or lack of transparency) by prescribing situations and contexts in which the bank and the Malaysia Deposit Insurance Corporation may consider a bank, or instrument, to be non-viable.[517] Under Basel III, the applicable jurisdiction retains discretion to determine whether the threshold has been met for triggering the NVLA safety mechanism is that in which the capital has been given recognition for the purposes of capital adequacy regulation. To pick a non-Islamic country that does this, for example, Australia does this with Prudential Standard APS 160 and Prudential Practice Guide CPG 110 Internal Capital Adequacy Assessment Process and supervisory review.

The Basel III reform introduced a requirement to ensure loss absorbency of capital instruments through a Non-viability Loss Absorption (NVLA) trigger. NVLA aims to minimise the use of taxpayers' money when financial institutions suffer financial distress, so as to avoid any implicit expectation of government support. Previously, taxpayers' money

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[514] Bank Negara Malaysia. Capital adequacy framework for Islamic banks – Disclosure requirements (Pillar 3). BNM/RH/GL 007-18, 2007.

[515] http://www.bnm.gov.my/guidelines/01_banking/02_financial_reporting/Financial%20Reporting.pdf

[516] ibid

[517] Basel Commttee on Banking Supervision. (2006) International convergence of capital measurement and capital standards: A revised framework. June, doi: h_p://www.bis.org/publ/bcbs128.pdf

would always be provided to save troubled banks, and indeed most European banks that were saved during the 2008 financial crisis would not have needed taxpayer funds if the capital instruments were used to absorbed their losses and had tier 1 and 2 instruments been converted into shares. [518]

As Khalid et al argue, BNM's innovation with respect to its corporate governance and standard setting approach (es) lies in its attempt to balance a strong emphasis on risk management, on the one hand, with flexible approaches to an evolving and somewhat novel marketplace. It is worth therefore stating their claims in full:

> BNM's approach to prudential regulation and supervision has also evolved in response to the changing landscape and maturity of the financial sector. The prudential framework has gradually moved away from overly prescriptive regulations and a one-size-fits-all approach to a more principled-based regime that is adaptive to changing market conditions and innovations. With the growing maturity of the market and its players' capabilities, this approach facilitates differentiated regulation and supervision based on the size, complexity and risk of individual banking institutions. It also emphasises improved disclosures to achieve more effective market discipline. Greater flexibility is accorded to institutions that have strong risk management and corporate governance practices in place. The principled-based regulatory regime is reinforced by the adoption of a risk-based approach to supervision. In 2006, the Risk-Based Supervisory Framework (RBSF) for the supervision of financial institutions was further enhanced to facilitate the early identification of emerging risks and provided a more structured and forward-looking approach to assess financial institutions' risk profiles and risk management systems.[519]

The guideline on Pillar 2 as advanced under Basel II supplements the above discussed IFSB and Islamic accounting standards by imposing general disclosure requirements on Islamic banks. Islamic banks are, accordingly, required to submit qualitative and qualitative information relating to credit, market, operational risks. Such risks also include, importantly, disclosures pertaining to their trading book, PSIAs and rate of return risk.

Having discussed how Basel affected a central bank, the next section considers the unique risks to which IFIs are exposed by situating its discussion in the context of a Malaysian retail bank's implementation of the Basel II and III guidelines.

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[518] bin Shamsuddin, Muhammad Syukri *Basel III Implementation: Challenges And Opportunities In Malaysia , in* Karunaratne, J P R, ed, *Basel III Implementation: Challenges And Opportunities* The South East Asian Central Banks (SEACEN) Research and Training Centre Kuala Lumpur, Malaysia, apparently undated. Retrieved fromhttp://www.seacen.org/file/file/2014/RP92/BASEL%20-%20chapter%206.pdf.

[519] Khalid, N.M., Paharodzi, D. and Yeo, R. "Pro-cyclicality Impact of Basel II in Malaysia" in SEACEN (2008) „Understanding and Addressing the ProCyclicality Impact of Basel II in the SEACEN Countries" SEACEN Centre for Research and Training, Kuala Lumpur, Malaysia, 2008, 47

5.3.1 The Implementation of the Basel Recommendations by the Bank International Malaysia Berhad

The following section examines the implementation of Basel II and III by BIMB. BIMB was the first Islamic Bank to be established in Malaysia in 1983, as provided for in the IBA. Established as a single branch, the bank now has 93 branches and over 600 terminals nationwide. Testament to the bank's expanding commercial presence both nationally and globally, BIMB was listed on the main board of the Bursa[520] in January 1992. Following this development, the Bank's capital reserve increased exponentially, rising from RM 80 million (Malaysian Ringgit) in June 2009 to 1.7 Billion.[521] BIMB has also won international recognition from professional bodies, winning the Best Brands in Banking-Islamic Banks by The Asia Pacific Brands Foundation (APBF).[522]

Diaw and Mohamed cite that of 2014, BIMB s total assets stood at RM 27,488,204,000 with total equity of RM 1,519,553,000.[523] It boasts a comprehensive list of more than 40 innovative and sophisticated Islamic banking products and services, comparable to those of their conventional counterparts.[524] BIMB has issued annual reports documenting its capital levels and risk weighted assets in respect of various categories of risk exposures. BIMB relies heavily on the Capital Adequacy standards for Islamic Banks in managing its credit, market and operational risks. To calculate its risk weighted assets, the Standardised Approach for credit and market risks is employed, while the Basic Indicator Approach is adapted to BIMB's internal operations in the assessment of operational risks. BIMB has also developed its own tools and internal system for measuring Value-at-Risk (VaR) to determine market risks.[525]

These approaches do not, however, properly measure risk of default[526] and there is a need for the IFSB to design such a measure. The focus in VaR is clearly on downside risk and potential losses. Its use in banks reflects their fear of a liquidity crisis, where a low-

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520 formerly known as the Kuala Lumpur Stock Exchange

521 Misman, FN and Faridah Najuna Risks Exposure In Islamic Banks: A Case Study Of Bank Islam Malaysia Berhad (BIMB), School of Economics and Finance La Trobe University

522 Mohamed, N_390 above.

523 IFSB 2005, "Guiding Principles of Risk Management for Institutions (Other than Insurance Institutions) Offering only Islamic Financial Services", Islamic Financial Services Board.

524 Rahman, Dato' Ahmad Tajudin Abdul, Workings of an Islamic bank - Case study of Bank Islam Malaysia Berhad Speech at the Fourth International Conference on Islamic Economics, Banking and Finance Loughborough, United Kingdom August 13 - 15, 2000

525 Mohamed, N_390 above.

526 Hersch Shefrin, "Beyond Greed and Fear", Harvard Business School Press, 2000.

probability but nevertheless catastrophic occurrence creates a loss that wipes out the capital and creates a client exodus. They don't relate to Islamic finance[527] firstly because of the PLS method which puts part of the risk of default onto the depositor; secondly because persons with investments in PSIA cannot necessarily retrieve them at call, and thirdly because the VaR approach reflects in part the cost of capital, [528]or riba in other words, a concept which is haram.

Furthermore, as suggested earlier, the capital structure of BIMB, as with most banking institutions operating in Malaysia consists of high quality Tier 1 capital, in other words paid up capital, common equity and reserves. As the figures reported by Misman and Bhatti suggest, the Bank has retained sufficient liquidity to meet offset its on-balance and on-balance exposures (loan growth, deposit withdrawals and other capital intensive obligations, in addition to development appropriate strategies for mitigating credit, market, interest rate and operational risks. [529]

In respect of the three exemptions permitted under Basel III (mortgage related financial services and equity rights, short term and deferred tax assets resulting from imbalance in taxation rates and common shares held in unconsolidated financial entities), BIMB has adopted a less permissive stance, choosing to include the above items in the list of deductible assets for the purposes of computing their capital ratios. The regulatory framework of BIMB may therefore appear more interventionist and punitive compared with that of the relevant banking authorities in the UK and USA. However, BIMB insists that such measures are necessary for maintaining the capital integrity and liquidity of the banking infrastructure, not least in the face of the lessons learned from the irresponsible leveraging practices adopted by Western banks in the run up to the financial crisis. The BNM has however sought to lessen the possible regulatory burdens or impacts on competition resulting from such rules by setting in place a transition period during which banks have opportunity to phase in deductions incrementally.

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[527] Aldohni, Abdul Karim The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia, Routledge, 2011, 155.

[528] VALUE AT RISK (VAR), undated and un-named paper, Appendix 1 page 32, http://people.stern.nyu.edu/adamodar/pdfiles/papers/VAR.pdf

[529] Khan, M. and Bhatti, M. I. (2008). Development in Islamic banking: a financial risk-allocation approach. The Journal of Risk Finance, 9 (1), 40-51.

5.4 Potential Effects of the Basel II Accord on the Islamic Financing Modes and Risk Exposures

The following section considers the possible impact of risk exposure in BIMB and the extent to which global standards have mitigated their effects. According to internal Bank Islam documents, risk management in IB is not significantly different from CB, but there are additional risks that are unique to IB. BIMB manages risk in terms of "uncertain future events that could influence the achievement of the Bank's objectives, including strategic, operational, and financial and compliance objectives", which include unique Shari'a related risks. The Committee of Basel II defines operational risks as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events." [530]

5.4.1 Credit Risk at BIMB

Unsurprisingly, credit risk is identified as the highest risk factor by BIMB. Indeed, the annual report of BIMB issued in 2014 indicates that credit risk constitutes the highest risk factor (i.e. RM 9,619892,000 over RM 11,133,458,000).[531] Furthermore a breakdown of the sources of financing in BIMB sheds greater light on the risks associated with certain instruments and contracts. Interestingly, funds generated through consumer financing amounts to over two-thirds of BIMBs total financial portfolio.[532] In the Islamic context, credit risk is the most important in BIMB and in Islamic Finance Institutions more generally, given the dependence on debt financed instruments as opposed to the equity based contracts. [533] Boumediene has demonstrated on the basis of empirical research that the credit risk in money lent on PLS is less, but that nevertheless Islamic banks make losses because the lesser amount of risk is nevertheless managed poorly.

The difference between both types of Banking is that the latter includes Investment tools fueled by Investment accounts which are managed through PLS principle. This provides a powerful and compliant securitization to IBs. It was demonstrated empirically, in this article,

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[530]. Monzer Kahf. Basel II: Implications for Islamic Banking 300

[531] BIMB 2012, 2014, Annual Report and Financial Statement 2014 Website 'down' but previously available at http://www.bankislam.com.my/en/Pages/AnnualReports.aspx?tabs=4

[532] Rahman, Dato' Ahmad Tajudin Abdul, Workings of an Islamic bank - Case study of Bank Islam Malaysia Berhad Speech at the Fourth International Conference on Islamic Economics, Banking and Finance Loughborough, United Kingdom August 13 - 15, 2000, 8

[533] Mohamed, N_390 above.

that IBs have lower credit risk than Conventional Banks. The problem of management of this risk by IBs is not due to shortage of risk management tools.

Diaw and Mohamed argue that this is perhaps a consequence of the disparities found in the weighting of assets to liabilities in many Islamic partnership contracts. They state, *"Such imbalances could be addressed if global standards took greater account of the liabilities side of Islamic contracts as presented in a bank's balance sheet."*[534] Boumediene says that credit risk has not been empirically measured in Malaysia, the only study up until the time of his paper being on the basis that the proportion of allowance for loan loss to total assets was a proxy for credit risk. He argues that the devil is in the partnership contract or loan contract, and that where IBs study the achievability of every project with due diligence, there is less likely to be a credit default. He argues that in cases of PLS, portfolio diversification and higher returns, which are not tied to any referenced rate, will absorb any loss.[535]

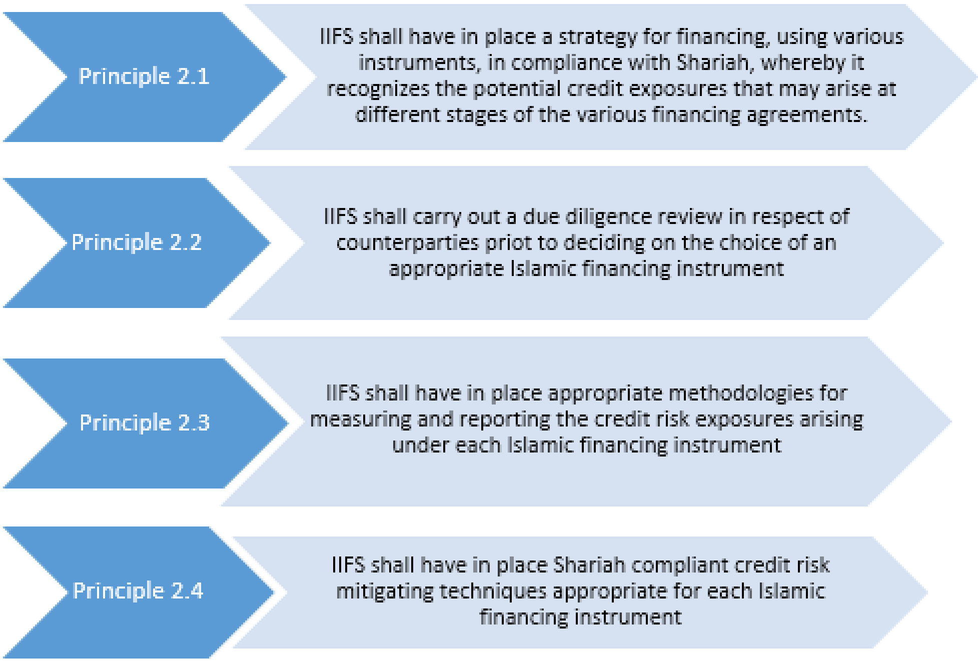
This assumes that there is a profit, but that is a matter of market risk more than of credit risk. The risk to be managed is a business risk, and as much a matter of corporate governance as of management of any other risk. The following figures indicate the risk management procedures at BIMB, in diagrammatic form, were sourced from Bank Islam, and are included because of their official provenance.

Figure 16: Credit risk management in Islamic banks

[534] See diagram 9, infra, for a sample balance sheet.
[535] Boumediene, Aniss, Is Credit Risk Really Higher in Islamic Banks? Sorbonne University, August 2011, http://ssrn.com/abstract=1689885

Source: Bank of Islam

Figure 17: IFSB Published Standard on Credit Risk



Source: Bank of Islam

Let us briefly examine the liabilities side of an Islamic bank's balance sheet. Ahmad and Pandey[536] have written that, for example, a *mudaraba* contract is reflected on both the asset and liability side of the balance sheet of a bank. On the liability side, the contract between the bank and the depositors is known as unrestricted Mudaraba in which the depositors agree that their funds to be used by the bank's discretion, to finance an unrestricted list of profitable investments and expect to share the overall profits earned with the bank.

Further, as van Greuning and Iqbal argue,

> The structure of a typical balance sheet has demand deposits and investment accounts from customers on the liability side and … the equivalent of conventional banks' loans to customers on the asset side. This pattern reflects the nature of banks as intermediaries, with ratios of capital to liabilities at such a low level that their leverage would be unacceptable to any business outside the financial services industry...While the types of liabilities present in an Islamic bank's balance sheet are nearly universal, their exact composition varies greatly... When compared with conventional banks, balance sheet risk profile of Islamic banks is different. First, the foremost feature of an Islamic bank is the 'pass-through' nature of the balance sheet.

[536] Ahmad, Mareyah Mohammad and Dayanand Pandey, Are Islamic banks better immunized than Conventional banks in the current economic crisis? Paper delivered to the 10th Global Conference on Business & Economics, Rome, October 15-16, 2010

> This feature removes the typical asset- liability mismatch exposure of a conventional bank, as the Islamic bank's depositors' return is linked to the return on the assets of the bank. However, this feature also introduces some operational issues, such as estimation and accrual of ex-post returns and the treatment of intra-period withdrawal of deposits. [537]

Second, the nature of assets of two institutions is different. Whereas a conventional bank tends to stay with fixed income very low credit risk debt securities, an Islamic bank's assets are concentrated on the asset-based investments which has credit risk but are also backed by a real asset. As a result, the lending capacity of the Islamic banking sector is bound by the availability of real assets in the economy.[538] No weighting however applies with respect to any provision for a doubtful debt or any risk which seems more likely to eventuate than at the commencement of the loan or investment.

In a concluding section, this chapter will assess the Sharí'a compliant practice of including deposit shares on the liabilities sides of Islamic financial statements and its broader implications for the assessment and measurement of capital requirements on particular banking institutions.

5.4.2 Debt Based Risks

It is worth noting, in connection with the above discussion, that home financing in Malaysia is largely based on debt based modes of financing, for example financing the sale of a home. Indeed, debt-based financing using baybithaman are widespread and have been since the BIMB opened in1983.[539] In turn, one risk posed to BIMB concerns the agency costs entailed by monitoring the high number of counterparties involved.

BIMB adopts credit risk reduction techniques formally endorsed under Basel II, for example tools devised to promote risk diversification and other information related measures such as hedging of funds. BIMB also employs risk management techniques endorsed by the CAFIB.[540] Its guidelines prescribe restrictions on the forms of collateral used for leveraging

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[537] van Greuning, N_47 above.

[538] Ahmad, Mareyah Mohammad and Dayanand Pandey, Are Islamic banks better immunized than Conventional banks in the current economic crisis? Paper delivered to the 10th Global Conference on Business & Economics, Rome, October 15-16, 2010

[539] Aiza Mohd Jamil and Abdul Rahim Abdul Rahman 2007, "Efficiency of Islamic and Conventional Commercial Banks in Malaysia: A Data Envelopment Analysis (DEA) Study" Paper presented to IIUM International Conference on Islamic Banking and Finance, IIUM Institute of Islamic Banking and Finance, 23-25 April 2007.

[540] BIMB 2012, 2014, Annual Report and Financial Statement 2014 Website 'down' but previously available at http://www.bankislam.com.my/en/Pages/AnnualReports.aspx?tabs=4

including procedures aimed at enhancing legitimate expectations, certainty and predictability.[541] BIMB's internal processes and systems monitor the market value of collateral including prudential guarantees against defaults (kafalah) which qualify for preferential risk weights for the purposes of determining capital adequacy thresholds,[542] weighed against the bank's fixed or liquid assets.

In its annual report for 2013, BIMB says, under the heading of Pillar 3:

> The management of credit risk is principally carried out by using sets of policies and guidelines approved by the Board Risk Committee ("BRC"), guided by the Board of Directors' approved Risk Appetite Statement. The Management Risk Control Committee ("MRCC") is responsible under the authority delegated by the BRC for managing credit risk at strategic level. The MRCC reviews the Bank's credit risk frameworks and guidelines, aligns credit risk management with business strategies and planning, reviews credit profile of the credit portfolios and recommends necessary actions to ensure that the credit risk remains within established risk tolerance levels. The Group's credit risk management governance includes the establishment of comprehensive credit risk policies, guidelines and procedures which document the Group's financing standards, discretionary powers for financing approval, credit risk ratings methodologies and models, acceptable collaterals and valuation, and the review, rehabilitation and restructuring of problematic and delinquent financing.
>
> The management of credit risk is being performed by two distinct departments within the Risk Management Division ("RMD").... The combined objectives are, amongst others:
>
> o To build a high quality credit portfolio in line with the Group's overall strategy and risk appetite;
>
> o To ensure that the Bank is compensated for the risk taken, balancing/optimizing the risk / return relationship;
>
> o To develop an increasing ability to recognize, measure and avoid or mitigate potential credit risk problem areas;
>
> o To conform with statutory, regulatory and internal credit requirements.
>
> The Group monitors its credit exposures either on a portfolio basis or individual basis through annual reviews. Credit risk is proactively monitored through a set of early warning signals that could trigger immediate reviews of (a certain part of) the portfolio. The affected portfolio or financing is placed on a watch list to enforce close

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541 Akkizidis, N_270 above.

542 BIMB 2012, 2014, Annual Report and Financial Statement 2014 Website 'down' but previously available at http://www.bankislam.com.my/en/Pages/AnnualReports.aspx?tabs=4

monitoring and prevent financing from turning impaired and to increase chances of full recovery.[543]

5.4.3 Non-Debt Based or Equity-Based Risks

In conformity with the firms commercial and governance objectives, both the BNM and BIMB have expressed their commitment to offering financial services and products that are fully compliant with principles of Sharí'a law. To enhance compliance, BNM has issued the Guidelines on the Governance of Sharí'a Committee for the Islamic Financial Institutions known as the BNM/GPS1. Further, Securities Commission of Malaysia issued the Registration of Sharí'a Advisers Guidelines 2009 which setting up the criteria for the registration of a Sharí'a adviser in the capital market sector.[544]

Islamic banks are authorised to accept three types of deposits: commercial investments in the form of restricted deposits; unrestricted deposits, and retail banking products in the form of deposits made in current accounts. Recourse to Sharí'a based contracts based on murabahah, international murabahah and international Tawarruq were introduced into the Malaysian market through products offered by foreign bank such as Kuwait Finance House and al-Rajhi Bank set up.[545] However, while there has been a slight increase in equity or non-debt based modes of financing as a percentage of risk weighted assets, rising from 1percent in 2009 to around 5 percent in 2012 such contracts represent a relatively small share of the emerging IB market in Malaysia.[546]

The above case study can be contrasted with countries such Saudia Arabia, Qatar or Kuwait in which equity or non-debt based modes are more heavily relied upon in the asset profiles of key banking institutions. Once again, we are called upon to consider the equity of unrestricted deposit holders participating in profit sharing investment agreements (PSIA), namely with relevance to credit risk exposures faced by investing counter parties in such agreements: all parties, including banking institution, share losses, as well as profits, in the event that debtor defaults. [547]This novel aspect of Islamic non-debt based remains a key issue even in states

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543 2013 BIMB Annual report at p128.

544 Zulkifli Hasan Regulatory Framework of *Sharí'a* Governance System in Malaysia, GCC Countries and the UK Kyoto Bulletin of Islamic Area Studies, 3-2 (March 2010), pp. 82–115, 83.

545 Sundarajan, V. 2007, "Risk Characteristics of Islamic Products: Implications for Risk Measurement and Supervision" in Archer, S and Karim, R. A. A. 2007, "Islamic Finance: The Regulatory Challenge", John Wiley & Son (Asia) Pte Ltd. Shaari A. H. and Fadhilah, A. 2001, "Rating of Malaysian Commercial Banks: A DEA Approach", Banker's Journal Malaysia, Vol. 118, pp. 5-18.

546 Central Bank of Malaysia, 2012 Reports.

547 Sundararajan and Errico, N_135 above.

such as Malaysia where, precisely because of the high risks involved in PSIA agreements, such modes of financing are typically less favoured than debt based modes of financing (where risk is lower and return probability higher).[548] Boumediene argues with respect to these novel forms of financing:

> There are mainly two opinions on the subject. The first opinion is that: if Islamic banks respect the rules of Sharí'a in their contracts, "reshaped" modes of financing are not less Islamic than the original ones. The opposite opinion says that Ijarah and murabahah are not ideal modes of financing and should be utilized only when and where the original modes cannot be used. Moreover, "murabahah is only a device to escape from interest".[549]

Consistent with AAOIFI financial accounting statement No. 2, any funds deposited into customer accounts are treated as loans which the banks guarantees to lenders. Islamic banks are, in such *mudarabah* contractual arrangements,[550] authorised to use these funds as they see fit. This has important consequences for Islamic banks with respects to the weighting of risks. If we consider once again that the assets and liabilities are recorded on the balance sheet under disclosure guidelines, and for the purposes of assessing capital adequacy ratios, the natural conclusion one can draw accordingly is that such discretionary uses and investment of unrestricted deposits should be treated as eligible common equity as held by shareholders (as defined by Basel III). This is especially the case since primary research collated from a sample study of 7 banks has indicated that a proportion of funds taken from unrestricted deposits used to finance *mudarabah* contract are often left untouched for periods (and, therefore, not reinvested into relevant projects and initiatives. Certain legal questions implicating issues of contractual fairness, equity and unjust enrichment are raised correspondingly: should depositors be held liable for responsible for any breaches of contract, including default on payments or non-performance of the terms of a contract, even in such periods when a percentage of those unrestricted deposits are not being used as a mode of financing.

The writer believes this to be an inefficient form of financing because of the risks, but believes that these can be managed by regulatory intervention, and draws conclusions for his target country of Saudi Arabia in Chapter 7.

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[548] *Ibid.*
[549] Boumediene, Aniss, Is Credit Risk Really Higher in Islamic Banks? Sorbonne University, August 2011, http://ssrn.com/abstract=1689885
[550] See Chapter 4.6.5.

Despite this inefficiency, then the corresponding percentage of idle funds held in common equity should not be taken into account when considering how to assess and assign risk (between credit risk distributions relating to two types of common equity: equity in use and idle equity). On previous instances, and in accordance with the spirit of altruism and principles of equity and fair distribution of profits and losses which is assumed to be at the core of Shari'a law and Islamic finance, shareholders and banking management have demonstrated a willingness to relieve the owners of unrestricted deposit accounts of any liabilities arising from default and non-performance of debtors and contractual parties financed through PSIAs.[551] Yet, such discretionary practices may have significant consequences, undermining the legitimate expectation of loss bearing parties, include investment equity holders, as well as the stability and profitability of the IB system as a whole. To counteract such risks, banking institutions would be required to absorb greater losses. In turn, credit risk would be distributed more equally among equity shareholders and equity investor counterparties. More equitable distribution of credit risk is normatively demanded by the mere fact that PSIA agreements funded by unrestricted deposits are, under AAOFI codes, subject to mandatory reporting requirements: any losses and profits obtained from these agreements should be reflected in an IB's accounting and auditing statements, owing to the power as an agent (*wakalah*) invested in that bank to use, invest and redistribute such funds at its own discretion. One can logically extrapolate from this requirement that the authority to use such assets should be matched by equal and proportionate claims (liabilities) on that bank.[552]

To the extent that due diligence has identified which projects will produce better profits under PLS, this form of investment of depositors' funds is superior to CB because it is likely to produce a higher return. The growth of the value of EPF (pension fund) earnings which are Shari'a compliant, which was discussed earlier in this chapter, is evidence of the fact that Islamic financing instruments, once poorly performing counterparties are excluded, are at least as profitable as conventional instruments subject to equal levels of diligence and management.

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[551] Harzi, N_387 above; Archer, S. and Karim, R. A. A. 2007,"Islamic Finance: The Regulatory Challenge", John Wiley & Son (Asia) Pte Ltd.

[552] BIMB 2012, 2014, Annual Report and Financial Statement 2014 Website 'down' but previously available at http://www.bankislam.com.my/en/Pages/AnnualReports.aspx?tabs=4; Mohamed, N_390 above.

5.4.4 Operational Risks

At this juncture, it is worth considering other risks to which Islamic banks are subject. Of the risk factors identified by the Basel Committee on Banking Supervision, operational risk exposures take second place behind credit risk. Indeed, based on BIMB's 2013 annual report operational risks are represented as a risk quotient of percent as a proportion of its risks weighted assets. This figure has changed from 11 percent in 2009 to less than 8.3 percent in 2013.[553]

BIMB employs the IFSB standardised basic indicator approach for the purposes of identifying and calculating minimum capital requirements to offset and manage operational risk exposures. Operational Risk capital charge is calculated using the BIA as per BNM CAFIB Guideline, which implements the Basel III capital structure with effect 1 January 2013 The BIA for operational risk capital charge calculation applies an alpha (15%) to the average of positive gross income that was achieved over the previous three years by the Group. The RWA amount is computed by multiplying the minimum capital required with a multiplier of 12.5 (reciprocal of 8%).[554]

Sources of operational risk can be endogenous to a company, and result from mismanagement by individuals or by internal shifts (collective labour action and so on) or as consequence of failures in process or systems. Equally, they may arise from externalities including government action, force majeure, social upheaval or shifts in macro-economic policy making and planning. As in most banks, the risk management department at BIMB is responsible for identifying and developing responses to such risks, where such risks can be anticipated (external pressures on a bank which due to their unpredictable and uncontrollable causes and effects cannot be managed as well as internal risks, if they can at all.) BIMB is also responsible for evaluating the risk culture, including the spending and saving trends of its customer, with the aim of mitigating and preventing excessive or irresponsible consumer banking and banking policies.[555]

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[553] *Ibid.*
[554] 2013 BIMB Annual Report, Financial Statements, 110.
[555] Risk Management, presentation by Thijs, Jeroen P.M.M. Chief Risk Officer Chief Risk Officer BIMB, undated. http://www.bankislam.com.my/en/Documents/Shari'a/RiskMgmtinIslamicBkg.pdf

5.4.5 Market Risk at BIMB

As per the figures published by BIMB, its market risk exposure have remained low even at the pick of the crisis, standing at around 3 percent at 2009, which as a nominal sum of its total risk weighted assets is estimated to be worth around RM 297,754,000. In the intervening years this figure has risen only slightly. By 2014, the percentage of market risk as a portion of RWA counts for per cent.[556]

Accordingly, BIMB has in its own risk management guidelines, as indicated in its 2009 and 2014 annual reports, highlighted 6 factors of market risk, including: Rate of return or profit risk, equity investment risks, interest and foreign exchange related risks, displaced commercial risks, trading book risks, and liquidity risks.[557]

Prima facie, given that Islamic banks are largely prevented from trading on secondary markets, including trading of commodities on the stock market, such risks (for example volatility in market prices, or excessive leveraging) appear to be fairly trivial and minor in Islamic financing arrangements, compared with conventional banking. Nor do their financial positions tend to include short term securities. Indeed, Islamic banks have a relatively limited market share in the trade of short term securities and secondary exchange markets, not least because once such stock is purchased, it is then typically converted from 'temporary' assets to debts on sale and transfer to a third party for deferred or instant payment.

However, such risks could present future challenges, if not contained and well managed. Indeed, Malaysian banks, as with the Islamic finance sector as a whole, are not immune to sudden shocks or other macro-economic pressures affecting their institutional liquidity and funding capacity. As the Islamic markets grow in size and maturity, Sharí'a compliant institutions may be exposed to new and particular risks. One relevant factor is that while conventional banks have access to a number of derivative instruments and management techniques which enable them to hedge themselves against market and credit risks, Islamic banks do not have access to risk hedging strategies in part owing to judgments on the (ill)egality of such instrument as issued by Islamic scholars and Sharí'a compliance.[558] I

[556] BIMB 2012, 2014, Annual Report and Financial Statement 2014 Website 'down' but previously available at http://www.bankislam.com.my/en/Pages/AnnualReports.aspx?tabs=4
[557] *Ibid.*
[558] Fathiyah, N_468 above; Archer, N_256 above.

have noted the contrary opinion of Boumediene[559] as to Shari'a compliance of these instruments earlier in this chapter, and suggest, as I will argue in respect of my recommendations for KSA in chapter 7, that the matter is one of Shari'a standardisation.

5.4.6 Trading Book Risks

A second set of market and credit related risks of importance for Islamic banks concerns what the Basel III framework has labelled trading book risks.[560] Prima facie, given that Islamic banks are largely prevented from trading on secondary markets, including trading of commodities on the stock market, such risks (volatility in market prices, excessive leveraging etc.) appear to be fairly trivial and minor in Islamic financing arrangements, where short-selling is haram,[561] compared with conventional banking. Nor do their financial positions tend to include short term securities. Indeed, Islamic banks have a relatively limited market share in the trade of short term securities and secondary exchange markets, not least because once such stock is purchased, it is then typically converted from 'temporary' assets to debts on sale and transfer to a third party for deferred or instant payment.[562] Nonetheless, Malaysian Islamic banks such as BIMB offers products and hold assets with unique elements and risks.[563] These include investments in forms of real estate which are typically sold in property markets,[564] long term investments in the development of business and public sector enterprises and investments in sister companies.[565] For example, in 2013, according to the BIMB annual report, the amount of financial assets available-for-sale were RM 12.4 billion and financial assets held-for-trading were RM 1.2 billion.

Although some of the more novel investments[566] such as investments in subsidiary and associate companies can be accommodated under the Basel framework on risk-weighted

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[559] Boumediene, Aniss, Is Credit Risk Really Higher in Islamic Banks? Sorbonne University, August 2011, http://ssrn.com/abstract=1689885

[560] Basel Committee on Banking Supervision (2013) Consultative Document Fundamental review of the trading book: A revised market risk framework; Revisions to the Basel II Market Risk Framework, March 2009, http://www.bis.org/publ/bcbs148.pdf and Basel Committee on Bank Supervision, Guidelines for Computing Capital for Incremental Risk in the Trading Book, http://www.bis.org/publ/bcbs149.pdf.

[561] Masood,Omar and Shahid M. K. Ghauri, The Rightful Way of Banking, Cambridge Scholars Publishing, 2015, 169

[562] RM 353 million in FY 2013: 2013 BIMB Annual Report, p 55.

[563] Ahmad, Mareyah Mohammad and Dayanand Pandey, Are Islamic banks better immunized than Conventional banks in the current economic crisis? Paper delivered to the 10th Global Conference on Business & Economics, Rome, October 15-16, 2010

[564] 2013 BIMB Annual Report, p 42

[565] I BIMB 2012, 2014, Annual Report and Financial Statement 2014 Website 'down' but previously available at http://www.bankislam.com.my/en/Pages/AnnualReports.aspx?tabs=4

[566] Boumediene, Aniss, Is Credit Risk Really Higher in Islamic Banks? Sorbonne University, August 2011, http://ssrn.com/abstract=1689885

assets for market risk in the trading book,[567] they often possess features which are distinct from the kind of investments envisioned by the Committee.[568] Other types of investments e.g. sukuk securities (the Islamic equivalent of fixed bonds) may appear to be rather unfamiliar to conventional financial markets,[569] and consequently are not typically recognised as trading book assets in the conventional sense as formalised under Basel. Yet, while the weight of these risks are qualitatively lower that the exposures associated with the exchange markets,[570] they do create trading books risks for Islamic banks which are higher than associated with short run securities.[571]

In Ijarah-based leasing agreements, to take another example, future claims are made on lessees for the provision of future rental payments (by Islamic banks). Accordingly, as governed under Standard 8 of the AAOIFI, leased assets are treated as equivalent to fixed-assets and are, accordingly, made subject to the regulatory requirements applicable to assets acquired through investment. However, such contracts ought to be treated novel in so far as they create claims on, both, the part of the lessee and or purchaser.[572] This is because a distinction is made under Islamic law between lease agreements which are still in effect and those which are concluded with a transfer of ownership. Ownership, according to AAOIFI, take effect at the end of a lease, period usually through sale of that property for its nominal or non-nominal value. However, if sold during while the lease contract is in effect, the price to be obtained for that asset is, under Islamic law, to be no more than the sum value of aggregate rental instalments. [573] Such an arrangement may prove inequitable to the leasing parties: the ceiling placed on the proceeds generated from sale of a rental agreement still-in-effect may not, for instance, reflect the value on maturity of the rented asset, as well as any losses incurred by the lessor upon sale of that asset for below market value.

In the ending-with-ownership Ijarah, by way of contrast, the lessor assumes liability for the asset including through payment of insurance premiums and so forth which have the effect of restricting any future claims made by a lessor on the lessee (insurance or supportive

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567 Categories 11 and/or 12
568 Masood,Omar and Shahid M. K. Ghauri, The Rightful Way of Banking, Cambridge Scholars Publishing, 2015, 165
569 Sole, Juan, Introducing Islamic Banks into Conventional Banking Systems, IMF Monetary and Capital Markets Department Working Paper WP/07/175 , 2007
570 Boumediene, Aniss, Is Credit Risk Really Higher in Islamic Banks? Sorbonne University, August 2011, http://ssrn.com/abstract=1689885
571 Risk Management, presentation by Thijs, Jeroen P.M.M. Chief Risk Officer Chief Risk Officer BIMB, undated. http://www.bankislam.com.my/en/Documents/Shari'a/RiskMgmtinIslamicBkg.pdf
572 Fathiyah, N_468 above.
573 Ibid, Section 2 of Standard 8

maintenance costs and so forth). Such modes of financing and the potential imbalances they create on the claims of counterparties cannot be detailed at any length here, but a good diagrammatic representation can be found prepared by the Public Bank of Malaysia. [574]The above analysis simply intends to illustrate the rather novel credit risks associated with the claims and receivables which result from Islamic modes of financing. Such risks may be mitigated through collateral and other risk hedging related mechanisms as found in conventional banking systems, and outlined under the Basel II proposals. However, some challenges remain.

One challenge is that while the AAOIFI Standard differentiates between a binding promise to take ownership, known as the concept of Wa'ab, and, on the other hand, a non-binding promise, it offers little guidance on how such promises are to be recorded in the balance sheets of a bank.[575] Rather, such transactions are generally accounted for in off balance sheet transactions. This creates possible inequities between two types of contract. In the case of the 'in operation' ijarah contract, the commitment to purchase is binding on the lessee regardless of the quality of the leased asset on maturity.

A second challenge raises broader issues. The above discussion does not yet address how the rebalancing of credit risks in the above discussed types of Islamic contract should be assessed for risk. In other words to what extent can Basel III approved risk methodologies for measuring and calculating capital to risk requirements be applied to the above Islamic instruments in the context of Islamic banks, as distinct from the risk parameters applied in conventional banking systems. Were risks being uniformly managed well, one might conceivably argue that the minimum shareholder equity requirement as assessed under CET1 under Basel III should be modified, with lower RWA thresholds established for Islamic banks than would apply to conventional banks under the existing framework. This would reflect the specificities of Islamic contract in which the usual parity between liabilities as claims made on the bank and the minimum capital held by that bank as a percentage of it risk weighed assets is made more complex by a third component not reflected in traditional accounting practices (namely the binary assets-liabilities trade off normally accounted for in

[574] Natashah Amirah Hassan, lead author, https://prezi.com/kdwjvcmpodw9/copy-of-car-financing/

[575] Harzi, N_387 above; Archer, S. and Karim, R. A. A. 2007,"Islamic Finance: The Regulatory Challenge", John Wiley & Son (Asia) Pte Ltd.

the conventional bank's balance sheet): the owners of or investors in unrestricted deposits who bear sole liability for losses in the event of default.

Two comments spring to mind: PLS schemes are riskier for the depositor, because deposits or investments can be lost. Therefore, there ought to be less need for a capital reserve in respect of such deposits. However, the existence of capital reserves may mean that there is less risk of deposits being lost. Secondly, as I will demonstrate in Chapter 6, the losses made at IBB even with Basel capital limits indicate that the RWA thresholds may well have seemed overcautious at BIMB but that this relates more to internal factors than the nature of Islamic finance as a whole.

The IFSB regulatory framework has, arguably, failed to fully account for the indirectly discriminatory application of capital measurement and risk weighting techniques in connection with these more sui generis categories of trading book related assets. Indeed, to address these imbalances, the disclosure and minimal capital ratios rules formalised under BF Pillar 1 would require significant modification and reform. In turn, such modifications would accordingly be reflected in IFSB capital measurement guidelines and best practices. Such reforms are needed not least of all because primary research taken from 7 banks, over various periods dating back to 2002, has indicated that trading book and quasi trading investments account for between 5% to 26.3% of those institutions' total assets. [576]

To address such deficiencies, standard setting bodies such as the IFSB as well as nominated supervisory authorities including the BNM in Malaysia are, as argued by Abdou Diaw and Mohamed, only as effective as their capacity to reflect the high risk exposures inherent in profit sharing investments, particularly the fair credit distribution of financing modes based on unrestricted deposits.[577] Moreover, a number of these Shari'a compliant modes of financing are entirely neglected under the existing international banking regulatory regime. By setting qualitative benchmarks which exerts an increasingly powerful 'compliance pull' on OECD contracting members and non-members alike, the Basel standards may generate potentially anti-competitive or discriminatory effects for Islamic institutions (and developing nations) relative to conventional banks. Indeed, to the extent that they are treated as

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[576] Harzi, N_387 above; Archer, S. and Karim, R. A. A. 2007,"Islamic Finance: The Regulatory Challenge", John Wiley & Son (Asia) Pte Ltd.

[577] Mohamed, N_390 above.

equivalent (on a 'like for like' basis) to counterpart trading book assets, such investments are subject to regulated risk weighting parameters in the margin of 150%-350%. However, given the competitive environment in which BIMB finds itself, compliance is, it is submitted, a point which attracts custom from those who would otherwise see the apparently less risky conventional banks, owned by ethnic Chinese, as more profitable or safer than Shari'a compliant banks such as BIMB.

5.4.7 Shari'a Compliance Risks

As discussed above, it is uncommon for IB institutions to trade or hold assets in derivatives and other secondary markets, given the injunction on such forms under Shari'a principles. Given the haram on Riba, the payment and receipt on interest, traditional debt markets cannot flourish in Muslim majority states. Under Islamic law, money and monetisable assets must be traded at par value and cannot, therefore, cannot form the basis of any secondary exchange arrangement where debt or the leveraging and financing of debt is traded for the purpose of acquiring profit. As such, the rescheduling of debt for the purposes of profit accrued through interest is not permitted in Islamic markets owing to the prohibition on interest. By extension, debt financed instruments such as interest rate swaps or conventional derivative markets such as credit derivatives and detachable options are forbidden under principles of Islamic law.[578] Accordingly, established Islamic financial contracts such as Murabaha and Istisna' cannot be traded in or leveraged as secondary markets as securitized instruments but only as principal contracts which involve the exchange of money between lender and borrower. [579]

Derivative markets have been contentious therefore due to concerns that they contravene religious injunctions on interests, gambling and undue risk taking. While the creation of derivative based products for the purposes or speculating or increasing returns continues to be prohibited, in recent years the opposition to derivative based instruments has softened, and financial entities operating in Malaysia as elsewhere have utilised Islamic derivatives --- including sukuk markets and credit default swaps--- as a means of hedging against currency related shifts and shocks, credit exposures, and interest rate fluctuations. This follows the

[578] Khan, T. and Ahmad, H. 2001. Risk Management An Analysis Of The Issues In Islamic Financial Industry. Occasional Paper no.5. Jeddah: IRTI, 2001. http://www.pdf-finder.com/RISKMANAGEMENT-AN-ANALYSIS-OF-ISSUES-INISLAMIC-FINANCIAL-INDUSTRY.html
[579] Fathiyah, N_468 above; Archer, N_256 above.

creation of the Islamic International Financial Markets organization as a joint enterprise of authorities of Brunei, Indonesia, Bahrain, Sudan, and Malaysia. And Pakistan, with the aim of the standardisation of Islamic financial products, documentation and related processes at the global level.

IIFM claims to have achieved Sharī`a harmonization through the functioning of an international Sharī`a Advisory Panel, which has permitted the enabling of two documentary structures concerning derivatives:

(a) Master Agreement for Treasury Placement (MATP) (2008); and

(b) International Swaps and Derivatives Association (ISDA)/IIFM *Mubādalah al-Arba`ah* (profit rate swap) product standard (2012), which is to be used for Islamic hedging purposes.

(c) The ISDA/IIFM *Mubādalah al-Arba`ah*, which is a consequent aspect of the ISDA/IIFM *Tahawwut* (Hedging) Master Agreement introduced in 2010, is an agreement to exchange profit rates between a *Mu`addal Ribh Thābit* (fixed rate) party and *Mu`addal Ribh Mutaghayya*r (floating rate) party.[580]

BIMB, for instance, holds some derivative based instruments or *Tahawwut* including profit rate swap and forwards in its asset profile as a means of hedging various market related risks.[581] It is no surprise that the establishment of these Islamic derivatives by the IIFM coincided with three interesting developments in the field of Islamic world finance:

i. International Sharí'a Research Academy for Islamic Finance in 2008;
ii. Islamic Financial Services Board (IFSB) in 2002; and
iii. Labuan Offshore Financial Services Authority, also in 2002.

Othman sees these three events as part of the Malaysian government push to establish the country as a world Centre of Islamic finance;[582] clearly having established pre-eminence in Shari'a scholarship through the research academy, Malaysia will be able to implement Shari'a-compliant reforms which will entrench its dominance of a competitive market.

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580 Islamic Financial Services Industry Stability Report 2013, p. 88. http://www.ifsb.org/docs/IFSB%20-%20IFSI%20Stability%20Report%202013%20(Final).pdf

581 BIMB 2012, 2014, Annual Report and Financial Statement 2014 Website 'down' but previously available at http://www.bankislam.com.my/en/Pages/AnnualReports.aspx?tabs=4

582 Othman, Jaizah, 2013, Analysing Financial Distress in Malaysian Islamic Banks: Exploring Integrative Predictive Methods, Ph.D thesis, Durham University, 87.

The design and application derivative financial instruments in the IB context are founded upon distinct rationales and principles, at odds with the risk transferring rationale of its conventional counterparts. The fledgling market in Islamic derivative based produced are rooted in concept of *wa'ad* as a means of managing market risk factors. Indeed, Islamic capital markets bodies such as the International Islamic Financial Market (IIFM) and the International Swaps and Derivatives Association (ISDA) have been engaged in efforts to develop uniform standards and guidelines on the use and development of derivative instruments that comply with Shari'a. The standards issued by the ISDA were consolidated in the "*Tahawwut* Master Agreement "; an instrument which is gaining greater recognition and adoption by Islamic banks. Many of the principles on which *Tahawwut* is based closely resemble the standardised rules and procedures which govern derivative markets in conventional banking.[583]

The Tahawwut system has proven controversial, as are many laws of shari'a concerning finance. [584] Hasan writes that some Shari'a scholars are reluctant about full harmonization of Shari'a standards because it offends the fundamental premise of *Ijtihad*, the process of deducting Shari'a rules from their authentic sources. If rules become standard, and imposed by secular legal authorities, then *Ijtihad* can no longer be applied, which over time damages the very reason why Shari'a can be applied in all circumstances, times and places. The trick is, apparently, to impose the rules only through Islamic sources, rather than secular ones, and to make them subject to review, again by religious authorities.

It follows that until the issue of standardisation is dealt with, this wider service offering will always lack the credibility it needs in order to attract and retain its core market, despite the need for growth and, as a consequence, developing new halal products.[585] With just one contract there are different accounting, reporting and disclosure rules laid out by IFRS (i.e conventional accounting), National Syariah Advisory Council (SAC) of Malaysia and AAOIFI. Islamic banks in Britain and Europe adhere to IFRS, Islamic banks in the Gulf region usually follow AAOIFI and in East Asia they follow SAC rules.

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583 Fathiyah, N_468 above; Archer, N_256 above.

584 Lawrence, Jonathan, Peter Morton and Hussain Khan, Dispute Resolution in Islamic Finance, Global Islamic Finance Report 2012

585 Rosly, S. A. Some Issues of Bay'Al-'Inah in Malaysian Islamic Financial Markets, (2001) 16 (3) Arab Law Quarterly, pp. 263-280.

In the Malaysian context, greater conformity with standards outlined in the new Shari'a compliant master agreement may therefore serve to enhance the attractiveness of Islamic states and markets for CBs that might otherwise be reluctant to offer Islamic products or establish subsidiaries in Islamic host countries. Islamic banks operating across borders --- including KSA's Al Rajhi Bank which operates in Malaysia --- have also taken measures to hedge more of their risk through for instance currency hedging and through the introduction of risk management techniques which aim to mitigate the effects of credit exposures and interest rate movements. In turn, greater confidence in the risk hedging capacity of both IBs and CBs such as HSBC that operate in these markets, contributes to the overall stability of the Shari'a compliant market as whole.[586] Such developments are welcomed precisely due to the growth of IBs in Malaysia as elsewhere even in the aftermath of the financial crisis.

Likewise, the growing Malaysian market in Sukuk securities adheres to Sharí'a principles through the gifting of a tangible asset in the investment, for instance the partial ownership of a property built by the investment company to the bond owner. The bond owner is then able to collect his profit as a rent, without breaching the Islamic injunction on interest. However, many scholars have questioned whether the structure of sukuk markets do not share more in common with conventional bond markets since investors will tend to receive guaranteed return in the form of a fixed percentage of the principal at maturity, based on interest rates. The existence of guaranteed returns or the invariability of repurchase obligations imposed on the issuer appear to be at odds with Shari'a restrictions. This is, apparently, a matter of pragmatism.[587] With respect to AAOIFI-FAS 17, Sukor, Muhamad and Gunawa comment:

> The examination of AAOIFI FAS 17 shows that AAOIFI has been pragmatic in its approach by considering the requirements to fulfil the need for a codified Islamic accounting standard and the need for Islamic accounting …concepts… to be developed based on Shari'a requirements.[588]

5.4.8 Liquidity Risks

Like CB systems, Malaysian banks such as BIMB have adopted a range of liquidity management strategies, including diversification of its deposit base and through lengthening

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[586] Islamic Financial Services Industry Stability Report 2013, pp 61, 88,89,96,97,182, 183. http://www.ifsb.org/docs/IFSB%20-%20IFSI%20Stability%20Report%202013%20(Final).pdf

[587] BIMB 2012, 2014, Annual Report and Financial Statement 2014 Website 'down' but previously available at http://www.bankislam.com.my/en/Pages/AnnualReports.aspx?tabs=4

[588] Sukor, Mohd Edil Abd , Rusnah Muhamad & Alwin Yogaswara Gunawa Malaysian Sukuk: Issues In Accounting Standard, (Malaysian) Jurnal Syariah (2008) 16(1) 63, 67

maturity on its deposits.[589] The Malaysian IB sector, and other cross border subsidiaries or Islamic arms of companies operating within its boundaries, have benefited significantly from the high liquidity levels of the Islamic interbank money market. It has raised capital though its investments in a spectrum of liquid (trading book) assets including Islamic commercial papers, treasury bills, negotiable instruments as well as mutually assured Islamic bank acceptances.

BIMB is required to implement conservation buffer and countercyclical buffers in accordance with Basel III. BIMB has determined, in line with its own qualitative systemic risk exposure assessments, the scope and operation of its countercyclical buffer based on its domestic credit growth and leveraging indicators. As it stands, BIMB has instituted capital buffer thresholds of 7 percent. If the capital held in its reserves falls below this level, BIMB is required to restore this level until the ratio of 7% is respected (4.5% + 2.5%).[590] However, questions remains as to whether the computation of theses buffers under Basel II is adequately adapted to the regularities of IB, specifically the availability of profit sharing investment accounts.

At first glance, Islamic banks such as BIMB are less exposed to rate of return exposures, including risks associated with variations in exchange and interest rate, principally because interest is forbidden under IB. However, IBs may be exposed to such risks indirectly through the competitive advantaged gain by CBs in Malaysia through appreciation in the interest collected and, correlatively, favourable rate of returns.[591] Factors of anti-competitiveness are assessed on an ongoing basis by the BIMB including through a daily assessment of international rate of return indicators such as the Based Finance rates. Thus, Islamic banks are able to assess the relative strengths of their lending and finance rates, as well as those offered by parallel CBs operating in Malaysia.[592]

Nonetheless, some challenges of note remain. Importantly, the asset structure of Islamic banks which display key differences from conventional banking financial statements and balance books. One can refer to the risk-return profile of deposit account on the liabilities

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[589] Fathiyah, N_468 above.
[590] *Ibid.*
[591] El-Naggar, Ahmed A. (1978): "Islamic Banks: A Model and the Challenge", in: Altaf Gauhar (ed.): The Challenge of Islam, London: Islamic Council of Europe, pp. 220-232
[592] Khan, T. and Ahmad, H. 2001. Risk Management An Analysis Of The Issues In Islamic Financial Industry. Occasional Paper no.5. Jeddah: IRTI, 2001. http://www.pdf-finder.com/RISKMANAGEMENT-AN-ANALYSIS-OF-ISSUES-INISLAMIC-FINANCIAL-INDUSTRY.html

side of certain equity or non-debt based financing modes of IB systems.[593] Profit sharing investment agreements (PISA) are or should be treated as or equivalent to common equity because they are not, strictly speaking, a liability: the bank is not responsible to the depositor for the capital and there is no guarantee of it, absent an insurance scheme as canvassed earlier in this chapter. Accordingly, unrestricted deposits owned by equity holders should be treated as distinct from the debt based products provided by mainstream banks.

The next figure shows a stylized Islamic Bank balance sheet.[594]

Figure 18: An Islamic bank balance sheet

Application of funding	Sources of funding
Cash balances	Demand deposits (amanah)
Financing assets (murabaha, salam, ijara, istisna)	Investment accounts (mudarabah)
Investment assets (mudarabah, musharakah)	Special investment accounts (mudarabah, musharakah)
Fee-based services (ju'ala, kafala, and so forth)	Reserves
Non-banking assets (property)	Equity capital

5.4.9 Compliance Risks

BIMB's published material shows that it has both the necessary knowledge capacity and information management system to assess market trends and volatility.[595] Further its internal structure helps it better comply with the Tier I and Tier II capital reserves of Basel: According to Harzi, the financial structure of an Islamic bank is essentially compounded of Tier 1 Capital (bank's own capital). Having some Tier 2 in the capital of Islamic banks is very rare as in general it is capital or hybrid capital linked to the payment of interest. And when it is the case, tier 2 capital is restricted to 50% of the total of tier1+tier 2 capital. He continues:

> So, when the redefinition of the capital has a quite important impact on [CBs…], it is not the case for [IBs…] because their capital is essentially compounded of common equity…On this point, Basel III clearly has a positive impact in terms of

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[593] van Greuning, N_47 above.
[594] van Greuning, N_47 above.
[595] Harzi, N_387 above; Archer, S. and Karim, R. A. A. 2007, "Islamic Finance: The Regulatory Challenge", John Wiley & Son (Asia) Pte Ltd.

> competitively for the Islamic banks, as the conventional banks will see their capital… decreased by a larger share than the Islamic banks, hence the former will then experience higher costs of compliance than the latter. The same phenomenon is likely to happen for Tier 2 ratios of CBs: a strong decrease because of the new regulation. Meanwhile, the Islamic banks will still have a total capital ratio (Tier 1 + Tier 2) approximately equal to their Tier 1 ratio.[596]

In this light, the requirement under Basel III for a capital reserve equivalent to 8% of the funds held in PLS accounts, which are not seen under Basel as being equity accounts, puts additional compliance costs on IBs. That said, however, if the cost is met there is no additional risk.

5.5 Analysis

The unique features of Islamic contracts may go some way towards explaining its growing appeal for non-Muslim consumers and investors, as well as its more traditional customers in Muslim communities.

On the other hand, such contracts face additional risks and externalities compared with traditional banking instruments. Consumer financing represents more than 66% of the total financing portfolio. This creates additional challenges in connection with monitoring of counterparties. Non debt-based modes of financing *mudarabah* carry high levels of risk since neither the capital (provided by participating investors) nor the profit (in transactions and projects financed by pooled resources) is guaranteed.[597] In other agreements profits accrued by participants to profit sharing arrangements are agreed in advance in accordance with a pre-agreed profit-to-capital deposit ratio. In such contracts, any loss that cannot be attributed to negligence on unlawful act is assumed by equity holding investors. Such arrangements, which are unique to Islamic finance, may ironically facilitate unequal bargaining relations and inequity, particularly in cases of asymmetrical information. Whilst Mujtaba suggests that "*Ghārār* can be eliminated by having complete disclosure of all informational elements in the deal and when a seller clearly states the purpose or object of the sale along with the price"[598] there has been little comment about the need for buyers to disclose of all informational

[596] *Ibid.*
[597] *Ibid.*
[598] Mujtaba, B. Islamic Banking and Finance: Definitive Texts and Cases. - (2012) 17 (2) *Journal of Applied Management and Entrepreneurship*, 128

elements in the deal – such as, for retail consumers, health issues or impending job losses, birth of extra children or the impending need to care for elderly parents.

So whilst PSIAs can be likened to equity agreements, investors in Islamic partnership agreements do not enjoy the same rights and privileges as they would in non-IB systems. This is, in addition to the information asymmetry, a consequence of the disparities found in the weighting of assets to liabilities in many Islamic partnership contracts, itself a broader reflection of asymmetries in credit risk distributions among shareholder investors, deposit owners and third party equity investors.

Other regulatory deficiencies extend to risk weighting on the assets side of the balance sheet. For example, the IFSB standard on capital requirements on equity based agreements sets a threshold risk-weight of 400% (equivalent to a capital charge of 32%) for risk exposures.[599] Such capital charges are prohibitively high compared with other financing instruments and thus discourage banks from offering such services. For such reforms to be made, significant changes would have to occur in the Islamic business environment and in the attitudes of consumers and commercial actors more generally. Indeed, the above risk complications offer some insight into the reasons why 95%of the assets managed by Malaysian IFIs are financed through debt instruments and Islamic contracts, in comparison with the relative low percentage of equity based financing. Banks have proven reluctant to enter into equity like partnership contracts on the asset side, precisely because of the high risk of credit default involved in *mudarabah* and *musharakah*. Rather, they favour debt financing precisely because, like CBs, they can make such investments in the knowledge that they can anticipate relatively secure profit gains from leveraging.

These risk complications, as suggested earlier, are not adequately addressed by the Basel III accords. It is for this reason that greater attention should be given to regional and context standards issued by the IFSB which have been elaborated specifically with such risks in mind.) Moreover, greater consideration should be given to the extent to which such standards complement or conflict with the Basel II accords. Remaining challenges concern the lack of experts in Malaysia with knowledge and capacity to fully interpret and implement Basel III related regulatory requirements or assess complex market trends (e.g. volatility and price

[599] Harzi, N_387 above.

fluctuations). Basel II tends to work to the advantage of larger banking institutions who are able to fully implement the accords and its risk measurement criteria, thus enabling them to qualify for lower capital charges (meaning that they are able to benefit from less stringent capital reserve limits).

5.6 Summary

In this chapter, we showed the growth in the Malaysian sukuk securities market adheres to Sharia principles by way of structures whereby there is a gifting of a tangible asset in the investment. We also showed that Islamic banks are able to access the relative strengths of their lending and finance rate as well as those offered by parallel conventional banks operating in Malaysia. In order to understand how these product offerings can come into being from a business perspective, we highlighted the style of Islamic banking balance sheets. In addition, we discussed the unique features of Islamic contracts that may go some way towards explaining its growing appeal non-Muslim consumers and investors. Their appeal to non-Muslim consumers and investors comes not only from a differentiation in products, but also meeting the investors' risk appetite.

Chapter 6: CASE STUDY UK: THE ISLAMIC BANK OF BRITAIN

In this chapter, I will firstly review some of the literature which has been produced in recent times and which concerns the fact that, supposedly, the Islamic Bank of Britain fared better during the recent financial crisis then did CBs. I will demonstrate that because the time that the Islamic bank was incorporated and registered was lighter than the time most sub-prime mortgages were advanced in Britain meant that it is an historical accident only that the IBB was not affected by the sub-prime crisis. I will then point to the Dubai property bubble to prove that the IBB could have been affected by the sub-prime crisis, had it not been constrained by FSA lending guidelines and its own marketing program. I will show that despite its exposure to sub-prime mortgages, IBB suffered significant losses and failed to engage the confidence of the Muslim community, possibly but not necessarily as cause and effect.

This study will take a different path to that in the preceding chapter – it will attempt to use what we know about IB in Malaysia to fill in what we do not know about IB in the UK, so as provide lessons which might be drawn to inform the choices which ought be made by bankers and regulators in KSA. The knowledge in this chapter and the next chapter will be formed through perceiving relationships between the observed phenomena in IBB as viewed against the context of Malaysian practice, and by exploring the phenomena of IBB practice in relation to other similar kinds of phenomena as demonstrated in the Malaysian case study in chapter 5.

6.1 The Establishment of Islamic Finance in the United Kingdom

Former Governor of the Bank of England, Lord George chaired a working group to investigate obstacles to the establishment of an Islamic finance industry in England in 2001.[600] Since then, the UK and its capital, London, has, according to the magazine, Islamic banking, become the European hub for the Islamic finance.[601] The UK has proven to be a flourishing and profitable investment market, growing at an average annual rate of 68.1% between 2001 and 2005.[602] It now boasts some of the best education in the area of IB in the

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[600] Parker, Mushtak, George: Who put Britain on Islamic finance map Arab News, 20 April 2009 http://www.arabnews.com/node/323391

[601] http://www.islamic-banking.com/resources/7/newhorizon%20previouse%20issues/newhorizon_aprjun07.pdf

[602] Tameme, Mohammed Elkhatim Mamoun Demand and Supply Conditions of Islamic Housing Finance in the United Kingdom: Perceptions of Muslim Clients Ph.D thesis, University of Durham July 2009

world, and was an early European example of accommodation of Islamic practices which prohibit riba. In England, this meant changes to legislation covering capital gains tax, value added tax, some capital allowance tax and stamp duty on land transfers[603]. The UK now boasts a secretariat in an Islamic finance and a task force in Islamic finance, the latter led by a Minister.[604]

As a result of the legislative changes, the market for Islamic financial services group swiftly, with Islamic windows being opened in several British banks, together with the opening of Britain's first fully fledged Islamic bank, set up with its major shareholders being leading Middle Eastern banks. The UK had four wholesale Islamic investment banks by 2013, and a Shari'a compliant mutual fund was first formed to invest in the London metals exchange in 1997. The growth was said to even be a means to solve the problem of the financial exclusion of Muslims in the UK[605]

However, things have not gone necessarily according to plan, with HSBC closing its Islamic window in 2012[606] and with IBB Al Rayan having consolidated losses of approximately 25% of total depositor funds by the end of 2009. So whilst, by 2013, it was fair to say that 716 Islamic financial institutions in the world made over 13.1 billion US dollars in profits, it would appear that the retail sector of IB in the UK is not part of that picture. In 2014, *The Economist* reported on September 13, 2014, that the total value of all sharia-compliant assets including sovereign sukuk was approximately $2 trillion. I investigate the apparent failure of the IBB in particular to live up to the standards set by Islamic financial institutions in Malaysia in this chapter.

In discussing the advancement of the IBB, the political will of the UK government as a factor for progressive development should be discussed. For instance, as the UK grows as a financial hub for Islamic finance, it is imperative that the IBB finds a way to enhance the symbiotic relationship between Islamic methods of finance and conventional banking

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[603] For the current version see https://www.gov.uk/sdlt-shared-ownership-property#paying-sdlt-in-stages-initial-transaction. For details of the starting date and details of operation see http://www.express.co.uk/news/uk/235769/Islamic-law-used-to-dodge-stamp-duty

[604] UK: Open Door Policy, New Horizons Magazine, Islamic Institute of Banking and Insurance, London, April 2007, 24 http://www.islamic-banking.com/resources/7/newhorizon%20previouse%20issues/newhorizon_aprjun07.pdf

[605] Warsame, Mohamed,Hersi (2009) The role of Islamic finance in tackling financial exclusion in the UK. Doctoral thesis, Durham University.

[606] Gulf Islamic banks ready to step in as HSBC pulls back , Reuters, 18 October, 2012, http://uk.reuters.com/article/2012/10/18/islamic-finance-retreat-idUKL6E8L972C20121018

structures. For instance, in 2013, David Cameron once noted that “[he wanted] London to stand alongside Dubai and Kuala Lumpur as one of the great capitals of Islamic finance anywhere in the world.”[607] The political will to want Islamic finance models to co-exist with conventional banking standards is a strong one, as there are implications that could affect the relationship (financial and otherwise) between Britain and many Islamic nations. Despite the fact that HSBC closed its Islamic window in 2012 and there have been major losses from 2008-2012, it is clear that there is an imperative to want the IBB and other similar models to do well, despite low uptake and low levels of confidence displayed by some investors and Muslim bankers.

A comparative time-line between what is happening in the relevant UK housing, banking and regulatory spheres with what is happening within the IBB suggests the contrary and is most conveniently shown in the form of a table rather than as a narrative.

Table 3: Timeline of events concerning the Islamic Bank of Britain, 2002 – 2014.

Year	Event- outside IBB	Event – IBB
2002	Sub-prime lending commences in large volumes in Britain. Property boom continues unabated.	
2003	Amendments to Stamp Duty Land Tax legislation allow Islamic mortgages without adverse tax implications to individuals.	
2004	Property boom continues with many properties sold in order to leverage into more, or more expensive, properties.	In August IBB, formerly a private financial house owned in part by the Abu Dhabi Islamic Bank granted banking licence in UK.
2005	Defaults commence across UK housing	IBB Starts with two branches in 2005.

[607] Independent (2013). David Cameron unveils plans to make London a Mecca for Middle East Wealth. Adam Withall. http://www.independent.co.uk/news/uk/politics/david-cameron-unveils-plans-to-make-london-a-mecca-for-middle-east-wealth-8911301.html

	market as interest rates begin to rise. According an HSBC case study, the Muslim families in the UK have taken out 134,000 conventional mortgages worth GBP 9 billion. The SDLT provisions were extended to equity sharing arrangements. Government legislated for Murabaha instruments as a purchase and resale arrangement.	Marketing strategy is to appeal to Muslims, not to the general public, and to offer Shari'a compliant lines. Therefore repayment rates are fixed and not variable, and deposits tend to be higher because of the partnership principle. Initially the bank had only two branches; one in Birmingham and another in London, but in the last five years the network of branches has expanded and now (in 2009) there are eight branches in the major cities where the Muslim community has a considerable segment of population. In London there are four, two in Birmingham, one in Leicester and one in Manchester. In the annual report of 2008 of the IBB, the statement of the chairman indicates that the bank has shown a steady growth in the year and generated more income and profits and loss decreased up to 15%. IBB mortgages are on fixed repayment schedules and not affected by default. However, persons whose interest rates with conventional banks are fixed do not suffer from increases in repayments.
2006	Government legislated for diminishing Musharaka or diminishing shared ownership for property or asset financing arrangements. SDLT relief extended to corporate entities.	Between the years ending 31 December 2005 to 31 December 2006, there was a 120% rise in customer number at IBB and the bank's customer deposits grew by 76% to GBP 83.9 million from GBP 47.7 million. In addition, the bank

		opened two new branches in 2006, reaching a total of eight across the UK.
2007	Sub-prime crisis reaches new heights. On 9 August 2007 bad news from French bank BNP Paribas triggered sharp rise in the cost of credit, and made the financial world realise how serious the situation was. At the height of the property market in 2007, sub-prime mortgages – frequently granted to people with little proof of income or ability to repay – made up more than 7% of the UK loans market. The UK stock market goes through a period of volatility. Banks begin to stop lending to each other due to market fears over exposure to potential losses on high-risk US mortgages.	IBB has not purchased any CDOs and is therefore not affected by any reduction in the value of its portfolio. IBB is supported by its shareholders as it cannot borrow money in Britain which might be tainted with riba. Its shareholders are major Gulf financial institutions and they stand ready to assist it. Because its borrowers are on fixed repayments they tend not to have defaulted. However many of the properties are worth less than they were when the loan monies were advanced.
2008	Saturday January 26 The Financial Services Authority is criticised for "systematic failure of duty" by the Treasury select committee. MPs recommend new protection for depositors, and new powers to allow authorities to spot and tackle banks at risk earlier. Wednesday March 26 The Financial Services Authority admits there was a lack of sufficient supervision over Northern Rock. House prices have fallen at their fastest rate since 2002, with International Monetary Fund believing that British house prices were still overvalued by	IBB launches its new mortgage product. Research has been unable to establish how many mortgages were advanced prior to the launch of the 2008 product. However, as the capitalization of IBB only reached £37 million in 2009, there cannot have been many mortgages. Deposits from customers reach £153,280,754 Loss for 2008 £5,910,700

	as much as 30% and could fall sharply. Mortgage lending levels are at their lowest in nearly four years, and the FTSE 100 index has crept below levels registered in 1997. Unemployment rose to 5.8% and was predicted to reach 10%.	
2009	Greater London house prices down over 20% on two years earlier, from an average figure of £249,455 to an average figure of £200,441. However average savings for the period per head of population do not drop below £1900.	IBB reported a loss £9.5 million in 2009. Customer deposits of over £186million, customer financing at £46million and nearly 50,000 customers in its 2009 financial statements. Deposits from customers reach £ 185,975,992 However net income falls from £4,495,781 in 2008 to £1,209,741 in 2009.
2010	RBS assets climb to £1453.58 b in 2010. Barclay's assets climb to £1489.64 b in 2010.	IBB reported a loss of £8.1 million. It receives a £20million capital injection from founding shareholder Qatar International Islamic Bank.
2011	Muslim population of England and Wales 2,706,066. Muslim population of Scotland (2009 figures) 75,300	IBB reported a loss of £8.99 million for 2011.
2012	HSBC Amanah, the Sharia-compliant arm of HSBC, withdraws its retail offering from the UK in October 2012. This leaves only the Islamic Bank of Britain (IBB) to service the roughly 2.7 million Muslims living in Britain.	IBB creates competitive products 79 per cent of applications for its 24-month fixed-term deposit product were from non-Muslim customers in the 3 months to Feb 2013. A variation of the sub-prime mortgage, with loans to 80% of valuation, boasts a fixed rate of "rental" of 4.19% for two years then a variable

		rate of 3.99% above a floating base rate.[608]
2014	Sovereign Sukuk	Islamic Bank of Britain becomes the first country outside of the Islamic world to issue Sovereign Sukuk. The UK's first sovereign receives orders totalling £2.3 billion

6.2 Comment on IBB

IBB were not interested in the sub-prime market. IBB offers house financing through diminishing Musharikah. Here, the bank partially invests with the "borrower" in the property and gradually reduces its share with each instalment paid by the "borrower" until the bank's investment reaches zero. At the end of the service term, ownership in the house completely transfers to the "borrower". The bank charges rent on its equitable portion. Banks normally use the participatory models in combination with others to create services,[609] although an early problem seems to be that at least in the early days of retail banking, the area of mortgages was immature and lacked a consistent and standardised specification products. According to Lord George, 'There were no really standard products, so we couldn't identify a Sharí'a mortgage. It was hard to fit this into the regulatory and legal framework because the definition of a Sharí'a mortgage differed from one place to the next.' [610]

IBB used Ijarah (lease) model for leasing capital assets like cars.[611] It offers five savings portfolio types for partially tax exempt pension funds, all of which are claimed to be Shari'a

[608] http://www.telegraph.co.uk/finance/personalfinance/savings/9873834/How-Britain-is-giving-up-on-saving; http://news.bbc.co.uk/2/hi/business/7521250.stm,http://www.theguardian.com/business/2008/mar/26/northernrock, http://www.theguardian.com/business/2008/apr/10/mortgagelendingfigures.property, local futures group 2008; Halifax, http://np.netpublicator.com/np/n28118167/Raconteur---Islamic-Finance-Singles.pdf; http://www.relbanks.com/europe/uk,http://www.alrayanbank.co.uk/useful-info-tools/about-us/latest-news/jan-dec-2010/27-10-10/, UK Excellence in Islamic Finance, UK Government official publication for World Islamic Economic Forum, 2013. Table compiled by the author.

[609] 'Islamic home purchase plan', Islamic Bank of Britain [Online]. Available at: http://www.islamic-bank.com/home-finance/buy-to-let-purchase-plan//

[610] Andreasyan, Tanya Lord Eddie George: The steady hand behind Islamic finance in the UK, New Horizons Magazine, Islamic Institute of Banking and Insurance, London, April 2007, 21 http://www.islamic-banking.com/resources/7/newhorizon%20previouse%20issues/newhorizon_aprjun07.pdf

[611] 'Islamic home purchase plan', Islamic Bank of Britain [Online]. Available at: http://www.islamic-bank.com/home-finance/buy-to-let-purchase-plan//

compliant, and each of these operate as a managed trust investment vehicle with investments in real estate, shares (equities) and sukuk. No fund appears to invest in financial instruments such as derivatives.[612]

IBB's point of difference was that it was the first Islamic bank in Britain not operating as a branch of a foreign bank. It was a small bank, and by 2009 only had eight high Street branches.[613] According to an interview carried out by Kok with an un-named but supposedly leading Islamic academic, and reported in 2014, IBB looked to many customers to be just like any other bank.

> Islamic Bank of Britain are regulated like any other UK bank so one of the sticking points when they first wanted to get their licence was that they had to get their licence, they had to... guarantee your deposit... 100% if I put my salary cheque every month in... [IBB] and they go bust next month then… I'm guaranteed 100% to get that money back and of course the issue of IBB was well, you know, nominally they would be profit and loss sharing so… if they make a loss they can't guarantee and if they make a profit then you get something that doesn't get called interest but looks like interest and one of the things they had to do was persuade what was then the [FSA…] that they had to take an undertaking that if necessary they would borrow money from the Bank of England which the Bank of England couldn't guarantee would be Sharia compliant that they would use to make good any money they lost on current accounts and they had to do that to get a licence...[614]

In other words, the IBB must insure against losses and must offer the depositor the return of deposits up to £85,000 in the event of losses. The legal requirements are precisely what they would be as to a CB and an unambiguous repudiation of Shari'a. However, the FSA has indicated that "after the event" the depositor has the right to decline the repayment and accept the loss for his or her own account, and the FCA has not withdrawn that guarantee as nearly as the author can establish. [615] It was a very small participant in a very crowded banking sector, and it is unsurprising that it offered less risky loans, which therefore were not subject to foreclosure nearly as often. Another reason for failing to compete in the sub-prime market is that "Islamic financing agreements, even for Non-PLS methods, are not as straightforward as conventional loan contracts and according to anecdotal evidence also take longer to process." [616]As has been shown elsewhere in this thesis, it is possible to devise a sharia compliant sub-prime mortgage. It simply has different rates of payment, payable at different

[612] http://www.alrayanbank.co.uk/media/263286/pb1842-al-rayan-discretionary-portfolio-service-brochure.pdf
[613]. Rahman, Naeem, Attitudes of Muslims towards Islamic Banking and Finance, Ph.D thesis, Durham University, 2012, 93.
[614] Adapted from Kok, Seng Kiong, *Islamic Finance in the Global Economy: An Exploration of Risk Management and Governance within Shari'a Finance* Ph.D Thesis, University of Liverpool March 2014.
[615] Hamoudi, N_129 above, 136.
[616] Pejman Abedifar, Philip Molyneux, Amine Tarazi. Risk in Islamic Banking. 2012.<hal-00915115>, 12

times of the cycle of the mortgage, as rental rather than as interest payments. The rental figures don't need to be fixed, but merely referencing to a particular figure, such as, possibly, increase in the housing price index or a fixed measure of rises or falls in consumer prices. However, IBB did not offer these. But despite the lack of exposure to sub-prime mortgages, IBB managed to lose £45 million, needing an infusion of £20 million from Qatar.[617] If it wasn't a matter of risky products, it must have been a problem of risky management – either poor risk management or poor corporate governance, or possibly both.

6.3 Corporate Governance

There is little discoverable material on the IBB's corporate governance. The only comments made by the World Bank in a relevant publication [618] relate to governance in accordance with Shari'a. Also, very little can be gleaned from Abdul Karim Aldohni's two helpful books,[619] apart from the fact that IBs in Britain, like CBs, are formed in accordance with the *Companies Act 2006*.[620] Aldohni does, however, raise the interesting point.[621] He refers to a method (Arabic form استثمار وكالة) whereby Islamic financial institutions manage funds on behalf of their customers. This involves providing agency (*wakalah*) services against specific fund management fees. The above issues will be assessed below.

6.4 Analysis

As table 6.1 shows, the British market for subprime mortgages was well serviced by 2004, and it would not have been advantageous for IBB to compete in this market. Two reasons immediately present themselves. Firstly, as Abedifar, Molyneux and Tarazi point out, Islamic banks have limited access to wholesale funding. They could not borrow extra funds to on-lend, and are not authorized to use interest-based assets, like bonds, for security.[622] It is unclear whether additional funds could have been obtained from Abu Dhabi, although when additional share capital was needed to save the IBB from insolvency, it was supplied as share

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[617] Qatar Inc. Inches Up, *Qatar Today* JUNE 22, 2013 http://www.qatartodayonline.com/qatar-inc-inches-up/
[618] Grais, Wafik and Matteo Pellegrini, Corporate Governance and Sharī`a Compliance in Institutions Offering Islamic Financial Services World Bank Publications, 2006
[619] Islamic banking in the United Kingdom: is the current legal and regulatory framework capable of hosting an Islamic banking sector, University of Leeds (School of Law), 2008, and The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia, Routledge, 2012
[620] Aldohni, Abdul Karim the Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia, Routledge, 2012, 79.
[621] Ibid, 104
[622] Pejman Abedifar, Philip Molyneux, Amine Tarazi. Risk in Islamic Banking. 2012.<hal-00915115>, 11

capital from Abu Dhabi. Secondly, this is simply a matter of pragmatism: subprime mortgages are called subprime mortgages because borrowers who present a risky profile can borrow more money, but the right of interest charged reflects the amount of risk engaged in by the bank. Under sharia compliant loans, the rate of mark-up or trading profit, often reflective of the market interest rate, would simply be adjusted for higher amount of risk. However, given the amount of competition in the market place, Muslims needing sub- prime loans would have been able to go to sub-prime loan originator. Abedifar's team found that loan quality, (implicit) interest income and expenses of Islamic banks were less sensitive to domestic interest rates compared to their conventional counterparts, and this is possibly due to the fixed nature of the various mortgage and other finance contracts. However, they found that the sensitivity of IBs' stability to interest rates did not significantly differ from CBs and that IBs otherwise mimicked CBs in terms of returns offered or rents or interest extracted, and also terms of insolvency risk.[623] In a competitive market such as the UK, where there are both conventional and Islamic banks there is less pressure on Islamic banks to provide high risk products due to the established nature of the competition. The point of difference for small Islamic banks in non-Muslim majority countries such as the Islamic Bank of Britain may well be the lack of high risk products. A Muslim wanting a high risk product can simply go to a conventional bank, which may reduce the appeal of banks such as the IBB.

As demonstrated in chapter 5, where IBs are competing with CBs not on the basis that one is Islamic and the other not but on the basis of commercial return, as in Malaysia, the product mix needs to be more attractive and the need for IBs in Asia to compete with CBs for investment funds has, as was demonstrated, led to the creation of the Islamic International Financial Market and its approved products of hedges and swaps. Whether low-risk products are made uncompetitive by this lack of product differentiation is a question outside the scope of this thesis, but the apparent lack of demand for them, given the low number of customers IBB had, might indicate an affirmative answer. As was discussed in chapters 5, in countries with Muslim majorities or near majorities like Malaysia and Saudi Arabia, there is increasing pressure on banks in these countries to provide higher risk products, as the IIFM has in fact done with the introduction of hedging products in the years after 2008.

[623] Ibid.

Despite the lack of competition for high risk mortgages arising from the differentiation between Muslim and non-Muslim banks, however, the IBB accumulated losses of over £45 million in its first 5 years of operation. This is surprising given the unpopularity of Islamic home financing plans. With respect to Muslim households, in 2009 17 percent of them owned their homes outright. Nearly 20 percent of the respondents to the study carried out by Tameme had conventional mortgages whereas, in contrast, less than two percent had Islamic mortgages. Within the Muslim households' owner-occupations 75 percent have conventional home mortgages and only 8.3 percent had Islamic home mortgages.[624]

It is difficult to ascribe a reason for this. Lord George[625] seemed to be of the view that the problem was a lack of standardization of Islamic mortgages, and IBB did not release its current version of its mortgage plan until more than four years after it had its banking license.[626] It is also possible that the time lag itself played a part. Also, the complexity of Islamic mortgages may be relevant. If the attack on Islamic mortgages printed in the Express newspaper in 2012 is true,[627] the need to have an offshore special purpose vehicle for the transaction is an extra level of expense and more than unusually complex. However, El-Gamal suggests that the SPV model is the most prevalent one at least in the USA and there is no reason to suspect that the English practice is any different.[628] It follows that conventional mortgages either are, or at least appear to be, simpler and cheaper.

A brief survey of the timeline shows that contrary to the glowing predictions in many of the theses and other commentaries surrounding IB in Britain and the IBB in particular, IB is generally unsuccessful. There are many ways of assessing the raw data by a simple exercise in hermeneutics: that is, to logically analyze some data using tools supplied by other data so as to produce a fortiori argument. If it is true that 79% of customers for one product are not Muslim, and one extrapolates from that that 79% of all customers are not Muslim, one can

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624 Tameme, Mohammed Elkhatim Mamoun Demand and Supply Conditions of Islamic Housing Finance in the United Kingdom: Perceptions of Muslim Clients Ph.D thesis, University of Durham July 2009, 252.

625 Parker, Mushtak, George: Who put Britain on Islamic finance map Arab News, 20 April 2009 http://www.arabnews.com/node/323391

626 Raconteur- The Sunday Times, http://np.netpublicator.com/np/n28118167/Raconteur---Islamic-Finance-Singles.pdf

627 http://www.express.co.uk/news/uk/235769/Islamic-law-used-to-dodge-stamp-duty

628 El-Gamal, Mahmoud A, 'Limits and dangers of Shari [ah Arbitrage', in S. Nazim Ali, *ed,* Islamic Finance: Current Legal and Regulatory Issues, Cambridge, Massachusetts: Islamic Finance project, Islamic Legal Studies, Harvard Law School. 2005,117-31.

divide the number of Muslims into total bank deposits to establish that the average Muslim has invested £320 or less in IBB. If the contrary is true and all of the IBB customers apart for the users of that particular product are Muslim, the figure drops to under £70. Given the 2009 figure of national savings at over £2000 per person, this means that the average Muslim, assuming that Muslim savings are no different from non-Muslim savings, has invested less than 16% of his or her savings in what is now the only retail Muslim bank in Britain (on the 79% assumption) or under 3% (on the zero assumption).

The causes of this are unsure, and the mere fact that IBB made large losses in the first five years of its existence may not establish a cause and effect relationship. Because of the specific nature of IB, many of the reasons ascribed by the Turner Report for the losses of British banks in general as a result of the sub-prime induced financial crisis cannot be attributed to the IBB, so the reasons for the loss of confidence which affected, say, Northern Rock, cannot be visited upon IBB. This is because concerns about the massive growth and increasing complexity of the securitised credit model, or high leverage in multiple forms, or the complexity and opacity of the structured credit and derivatives system, or even the rapid growth in interest based mortgage lending and the extension of mortgage credit to social categories which would not have previously enjoyed access does not affect a bank which is not based on riba.

Some might argue that the difficulties of Islamic banking are caused by the need for Basel compliance, but Basel compliance, as demonstrated in chapter 5, did not harm the performance of BIMB. Nor do the annual reports of BIMB make any claim that Basel compliance caused any losses either financially or of confidence for depositors and investors in Malaysian IBs. Indeed, as demonstrated, deposits increased. This is not the case in England. There have been consecutive losses. Has Basel compliance been the cause?
Ashby and White[629] suggest that the key problem with Basel II is its obsession with mathematical models, the idea being that somehow better, more quantitative, capital models mean better risk management. They argue that the provision of effective rules and guidance for the management of risk for banking institutions and not just insurers would have provided a better outcome, and note that the FSA actually scrapped its own proposals to issue a Handbook on risk management systems and controls to banks. Accordingly the losses made

[629] Ashby, Simon and Nigel Waite, Global Banking Crisis: A Response from the Financial Services Research Forum Financial Services Research Forum, 2010, 16.

by IBB in 2004-09 might not be entirely the fault of that institution, but the fact that there were insufficient standards published by the FSA does not excuse the failure to adopt authoritative risk management standards which were in place elsewhere in the UK [630] and it follows that a failure of the FSA to prescribe what ought to have been part of good internal management culture or good risk management culture is no excuse in and of itself for bad internal management culture or bad risk management culture. Curiously the concept of risk management is originally Arabic - the word for livelihood or sustenance, رزق, where there is a chance of loss, being pronounced “risk”; it is unlikely that IBB management were therefore unfamiliar with the concept.

So it might be poor corporate governance, with a poor understanding of risk and its management, which caused the losses in IBB – and in particular, a failure to follow the example of both Audit and Treasury in the adoption of AS/NZS 4360: 1994. The IBB continues to make losses, with a retained deficit in 2010 equivalent to approximately £20 per British Muslim. This is hardly a model which encourages confidence. In 2009, £20 million of foreign capital was needed to prop up the bank, without any apparent improvement in the ranks of financial position as shown in its annual report for 2009.

A loss of confidence in investors and depositors might reasonably follow. If the 79% figure is correct, then it is possible that there are only 11,000 Muslim customers of the bank. However, even if all of the 50,000 customers reported in 2009 were customers of the bank that means that less than 2% of British Muslims had become customers of IBB by the time the 2009 reports were closed? That is, some 2.6 million British Muslims have chosen not to invest in, or borrow from, IBB. It is possibly for a related reason that HSBC closed its IB window in Britain in 2013. Regardless of the causes of the poor management practices, a lack of standardization which would have allowed the IBB to undertake even more risk would have risked higher losses. If it is accepted that the loss of depositor funds may be a deterrent, then risk of the loss of more depositor funds through a riskier investment strategy would present a higher deterrent.

These massive losses, and the lack of confidence which appears to flow from them, arose even with the stringent regulatory supervision of the FSA prior to 2012. There was no

[630] *Basel II* might not have provided them but there were international standards in place from 1994 in both Audit and Treasury within the UK. See generally The National Audit Office’s supporting Innovation: Managing risk in government departments. 2000 The Stationery Office, London, http://www.nao.gov.uk/publications/nao_reports/9900864.pdf and HM Treasury’s Management of Risk: A Strategic Overview 2001 the Stationery Office, London http://www.cabinet-office.gov.uk/civilservice/publications/risk.pdf. Both adopt AS/NZS 4360: 1994

suggestion even in the bank's 2010 report that the losses were caused by over - regulation, and indeed, as Ashby and Waite argue,[631] losses in other banks prior to 2010 were caused by under regulation. It follows that, and in Chapter 7 I will argue that, any suggestion that regulations on IB ought to be relaxed, or reduced because of some cultural difference or religious imperative, would be harmful to both depositors and shareholders of banks such as IBB. I will base my argument in part on the findings of the Turner report,[632] which found that improvements in the effectiveness of internal risk management and governance within banks were essential. According to the Turner Report:

> While some well-run banks were affected by systemic developments over which they had no influence, there were also many cases where internal risk management was ineffective and where boards failed adequately to identify and constrain excessive risk taking. [633]

Turner called for improved professionalism, independence of risk management functions, higher technical competence in senior risk managers, risk management considerations to be embedded in remuneration policy, and improvements in the skill level and time commitment of non-executive directors.[634] There are persons who argue in favor of such a relaxation, and they have completed Ph.D. theses at British universities. One such is Hamid, who argues that the IB industry has its ideological foundations in a Qur'anic business ethics and stakeholder theory which can be traced back to traditional jurisprudential concepts in Islamic law. He argues that the current practices in IB fail to follow an ethically sound stakeholder model because of competitive pressures from the conventional financial industry and is thus modelled more on the neo-liberal shareholder profit maximization ideology, which aims at ensuring that the shareholders get maximum returns, thereby foregoing the interest of other stakeholders. [635]

This argument that adopting Conventional Banking practices is only done in an attempt to maximize shareholder profits would be persuasive had the IBB not managed to lose something over £45 million in its first five years of operation. It is possible that the reverse is true; competitive pressures might ensure that investment account holders get more protection,

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[631] Ashby, Simon and Nigel Waite, Global Banking Crisis: A Response from the Financial Services Research Forum Financial Services Research Forum, 2010, 15-20.

[632] The Turner Review - A regulatory response to the global banking crisis, Financial Standards Authority, March 2009 ("Turner") http://www.fsa.gov.uk/pubs/other/turner_review.pdf

[633] Turner, at pages 90-91

[634] Turner, at pages 92-93

[635] Hamid, Sheharyar Sikander (2014) *Efficacy of corporate governance theories in determining the regulatory framework for Islamic finance institutions.* PhD thesis, University of Warwick.

but the author cannot see why one would set up a bank in which the aim was that the depositors would actually lose money. Hamid thinks that the problem is Shari'a compliance, and were there not difficulties in reconciling inconsistent Shari'a rulings there might be some validity in this suggestion. There is little inconsistency in international accounting standards, and the author sees no validity in the direction of Hamid's argument that there is a correlation between western accounting standards and resistance to Shari'a.

The many previous discussions and articles comparing and contrasting IB with the requirements of the Basel Accords seem to focus on the immorality of sub-prime lending. They proceed from the basis that because IB is not based on the immoral payment of interest, and because it allows for depositors in a PLS system to make a loss, that depositors will not press their bank to engage in risky transactions. The marketplace shows a lack of confidence, and it is evidenced by the losses made by the bank which those for whom it was established demonstrably fail to support. Under true PLS conditions each depositor would have lost a shilling in the pound for each year of trading between 2004 and 2009.[636] And whilst profit-sharing investment accounts are Shari'a compliant, the lack of governance rights of a pious Muslim over the beneficiary of his or her investment gives cause for concern when such losses are incurred year after year.[637] We hope that this brief forensic examination has shown that if an Islamic bank can have consolidated losses of about a quarter the value of its total depositor funds in five years under fairly stringent controls, reducing controls of the risks such a bank can take would hardly make matters better.

6.5 Summary

In this chapter, we discussed the differences between Islamic banks and conventional banking with an Islamic window. From the perspective of the conventional bank, an Islamic financial product is simply another one of a number of structured products within their portfolios. This is completely different from an Islamic finance product which is originated from an Islamic bank in that the Islamic financial product is an integrated part of the Islamic bank. The strength of Islamic banking therefore can be said to come from its liquidity and its whole risk management view of this liquidity.

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[636] Which is five pence in the pound in the new money, but a shilling in the pound sounds better.
[637] Archer, Simon and Rifaat Ahmed Abdel Karim Profit-sharing investment accounts in Islamic banks: Regulatory problems and possible solutions, (2009) 10 *Journal of Banking Regulation*, 300–306.

Another distinctive feature of the strength of Islamic banking discussed in this chapter is its resilience to the manifestation of reputational risk. This is exemplified by the case study of IBB where investors loss 25 percent and despite this huge reputational catastrophe, the market for Islamic banking grew to 716 Islamic financial institutions in the world with over 13.1 billion US dollars in profits as reported in 2013 and by 2014, the total value of all sharia-compliant assets including sovereign sukuk grew to approximately $2 trillion.

We showed a timeline of announcements concerning the management and performance of IBB with a list of regulatory and economic events that were considered challenges to the development of Islamic banks in the UK. This case study should therefore be considered a case in point where despite heavy regulation in the banking sector, i.e., in the form of the adoption of Basel rules by the Financial Conduct Authority, Islamic banking can experience large losses.

Chapter 7: **POLITICAL ECONOMIC ISSUES IN SAUDI ARABIA & THE DEVELOPMENT OF ISLAMIC FINANCE**

7.1 Introduction

In contrast to the case studies conducted on the UK and on Malaysia, this chapter focuses on Sa'udi Arabia. Arguably, there is insufficient reliable evidence from KSA on which to base a case study, but there are sufficient comparisons available between KSA, Malaysia and the UK for lessons to be drawn with respect to reforms needed in the banking system of KSA in order to render it Basel III compliant, to reduce risk to investors and depositors and to ensure the stability and integrity of the banking system itself. Given that Islamic principles in and of themselves were insufficient to avoid the stock market crash of 2006 in KSA, the exercise is a compelling one.

7.1.1 Lack of Transparency and Difficulties in Compiling Data

Complaints made about data access from KSA include missing data, gaps in time series, difficulty accessing data (lack of transparency), inadequate sub-national data, and low levels of institutional support/capacity. [638] This is often seen as being a function of corruption. The opacity of trade in KSA means that according to Kurzmann, one would need a rate of return which was 5.69% higher than one might earn in the USA or some 6% more than one might earn in the UK in order to justify the additional risk of doing business in KSA.[639] In days where returns on investment in AAA rated government bonds are at around 3%, the lack of reliable data is a key factor in why, according to the rather dated data of Kurzmann, the return one would need in order to justify an investment in KSA would need to be approximately 3.5 times that of a comparative investment in the UK.

7.1.2 Brief History of Saudi Banking

Saudi banks were foreign owned from their inception, the first bank being Dutch owned, the Netherlands Trading Society. For many years it was the only operating bank in Saudi Arabia and served as the Central Bank, maintaining the country's gold stock and processing oil

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[638] Galal, Ahmed and Bernard M. Hoekman, Arab Economic Integration: Between Hope and Reality Brookings Institution Press, 2003, 25

[639] Kurtzman, Joel , Glenn Yago and Triphon Phumiwasana The Opacity Index: The Global Costs of Opacity Measuring business and investment risk worldwide MIT Sloan Management Review October 2004

royalty payments.[640] KSA had its first Sa'udi owned private bank, the National Commercial Bank, in 1934, owned by the Al-Kaaki and Mahfuz families, which also owned large trading companies. In 1966, a new Banking Control Law giving SAMA broad regulatory powers was promulgated and a few more foreign banks were licensed.[641]

By the mid-1960s two more had opened, and by 1974 there were 12 Sa'udi owned banks, with 72 permanent branches and offices, as well as 10 foreign banks in KSA. These included the successor of the Netherlands Trading Society is the Saudi Hollandi Bank, which has had majority Sa'udi ownership since 1974.[642] By 1980, the total number of bank branches had risen to 247 and covered almost the entire country. Total employees in the sector were around 11,000.[643]

The KSA's Monetary Authority (SAMA) has long had a keen interest in KSA's financial stability. It acted as a source of emergency liquidity assistance (through soft deposit placements) to some of the banks facing acute liquidity problems or potential insolvency in the 1980s as a result of the drop in the oil price, which I discuss below.[644] In an attempt to avoid another financial crisis, it is understandable that SAMA would take necessary steps to ensure financial stability in the Middle East, but it is arguable that these precautions marked a position in wanting to pause the development of Islamic finance in the international world as an over-precaution. The difficulties of the mid-1980s led to a significant increase in banks' capital with the encouragement of SAMA. During the period 1988-93, seven of the 12 Saudi Banks increased their capital through new share flotation. As a result, the capital and reserves for the banking system had doubled from SAR 15 billion at end-1988 to SAR 30 billion by end-1993.[645] By 1990, the number of bank branches had reached 1,036 and staff numbers had reached 25,000. Major Saudi banks had also opened branches in the United Kingdom, Bahrain, Beirut and Turkey. [646]

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640 Tschoegl Adrian E. Foreign banks in Saudi Arabia: a brief history, (2002) 11 *Transnational Corporations*, 123,128.

641 Al-Suhaimi, Jammaz Consolidation, competition, foreign presence and systemic stability in the Saudi banking industry, BIS papers no 4, 128, http://www.bis.org/publ/bppdf/bispap04n.pdf

642 Vassiliev, Alexei The History of Saudi Arabia, Saqi, 2013, 157; Tschoegl Adrian E. Foreign banks in Saudi Arabia: a brief history, (2002) 11 *Transnational Corporations*, 123; National Commercial Bank website - http://www.alahli.com/en-us/about-us/corporate-profile/Pages/AlAhli-History.aspx

643 Al-Suhaimi, Jammaz Consolidation, competition, foreign presence and systemic stability in the Saudi banking industry, BIS papers no 4, 129, http://www.bis.org/publ/bppdf/bispap04n.pdf.

644 Saleh, Gehan, The Dynamic Relation Between Stock Prices and Exchange Rates in Egypt, Saudi Arabia and UAE. ProQuest, 2008, 27

645 Al-Suhaimi, Jammaz Consolidation, competition, foreign presence and systemic stability in the Saudi banking industry, BIS papers no 4, 129, http://www.bis.org/publ/bppdf/bispap04n.pdf.

646 *Ibid.*

7.2 The Current State of Saudi Banking

Saudi Arabia, which held $627bn of net foreign assets at its central bank in 2013, saw its credit risk drop to the lowest in the Middle East at the start of 2014. Five-year credit default swaps were at 72.8 basis points at one stage during 2014.[647] The starting position must be that of Saudi Electricity, which has a great degree of state support and is by far the best proxy for Saudi sovereign risk in the Eurobond market. There is not a lot of traded debt in KSA so these figures might not be indicative, but 8 months after they went on sale, Saudi Electricity's 4.211 per cent 10 year Sukuk due April 2022 were sold down 103 basis points since their opening price to 3.18 per cent[648]

This might be an aberration since according to Bloomberg News, Saudi Electricity's position might reflect the government's tiny domestic public debt stock and high foreign reserves.[649] However, increased borrowing by state-owned enterprises, which arguably benefit from an implicit sovereign guarantee, helped to increase the external debt stock from an estimated US$44bn in 2005 to US$168bn in 2014. KSA's state credit institutions had US$80.3bn in outstanding loans in September 2014, which potentially burden public finances, given the high rate of non-performing loans – which although somewhat reduced from the 1999-2003 average of around 10% have still doubled between 2004 and 2010 and are on average around 2.5%, as shown in Figure 20, combined with low domestic savings as shown in Figure 21.

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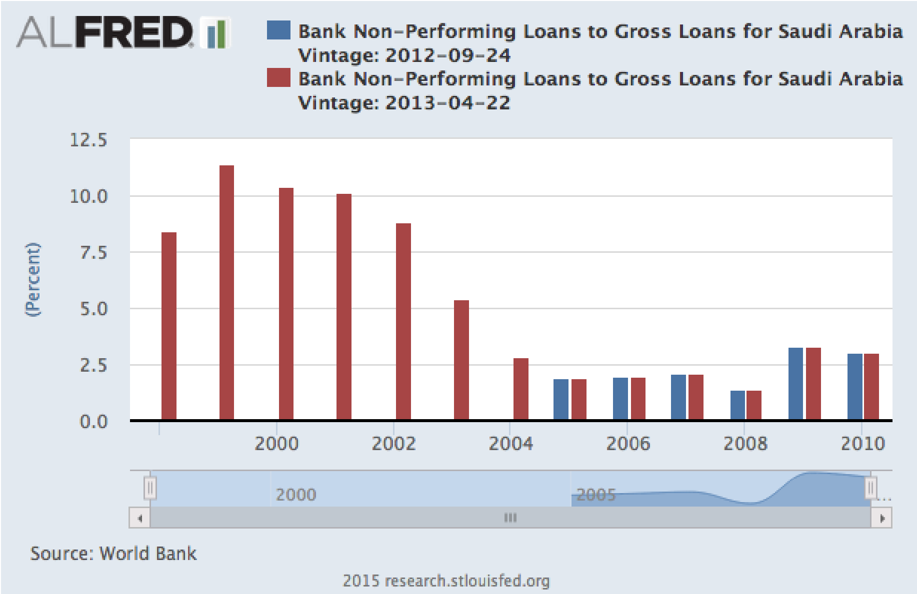
[647] Saudi Arabia – Country Risk report The Swedish Export Credits Guarantee Board http://www.ekn.se/Global/Landriskanalyser/Mellan%C3%B6stern/Engelska/Saudiarabien2013EngExtern.pdf DATE 14/05/2013

[648] *Saudi Electricity Co's Islamic debt sparkles* Bloomberg News 18 December, 2012

[649] *Ibid.*

Figure 19: The Saudi Bank non-performing loans

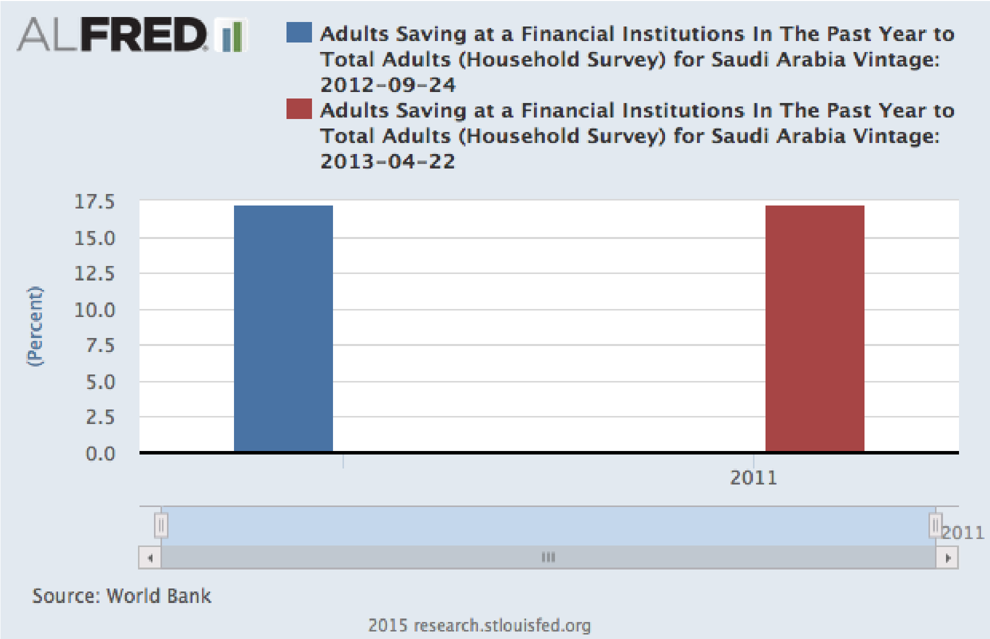


Source: World Bank (2015)

The bank nonperforming loans to total gross loans shown in Figure 14 are the value of nonperforming loans divided by the total value of the loan portfolio, before the deduction of specific loan-loss provisions where they exist. The loan amount recorded as nonperforming is the gross value of the loan as recorded on the balance sheet, not just the amount that is overdue. The Saudi figures shown in the above diagram are approximately at the same level as Armenia, Brazil, Belarus and Chile, 25% higher than figures for lesser developed and poorer resourced countries such as Indonesia, India, and Uruguay, and are 50% above figures for countries such as Australia, Austria and New Zealand.[650]

[650] World Bank (2015), *Bank nonperforming loans to total gross loans (%)* http://data.worldbank.org/indicator/FB.AST.NPER.ZS/countries

Figure 20: Adult savings in KSA



Source: World Bank

The diagram shows the percentage of adults who report saving or setting aside any money using an account at a formal financial institution such as a bank, credit union, microfinance institution, or cooperative in calendar year 2011 in KSA.

A 2012 survey conducted by Asli Demirgüç-Kunt and Leora Klapper rates people saving any money at all.[651] However, despite these liabilities and poor savings and loan-performance data, sovereign risk indicators are low, with a gross public debt/GDP ratio of 14.1%, compared with a median of 26.3% for A-rated countries.[652] Saudi FX reserves are high at more than US$770 billion, or around 100% of GDP.[653]

That's on the positive side, but at the risk of mixing metaphors, every silver lining has a cloud. Forecasts published in November 2014 by Samba Financial Group[654] (before the recent OPEC meeting) show Saudi GDP growth decelerating from 4.5% this year to 3.3% in

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[651] Asli Demirgüç-Kunt and Leora Klapper, 2012. "Measuring Financial Inclusion: The Global Findex," World Bank Policy Research Working Paper 6025) Source: https://alfred.stlouisfed.org/series?seid=DDAI06SAA156NWDB

[652] Saudi Arabia Country Risk, *The Economist* Intelligence Unit Last Updated: May 2015 https://store.eiu.com/product.aspx?pubid=310001031&pid=60000206&gid=310001031

[653] Weltman, Jeremy , *Saudi risk score plummets as oil shock intensifies*, Euromoney, 16 December, 2014. Retrieved fromhttp://www.euromoney.com/Article/3410818/Saudi-risk-score-plummets-as-oil-shock-intensifies.html?copyrightInfo=true

[654] SAMBA Saudi Arabian Economic Monitor, November 2014. Retrieved from www.samba.com/en/pdf/.../Samba_Economic_Monitor_Nov_2014.pdf

2015 and 2.9% in 2016, but more recent revisions in February 2015 put the growth figure at 1.9% for 2015 and sizeable deficits of an average 8.7 percent of GDP during the coming period. As the Saudi-American Bank reported:

> Oil prices themselves appear to have found a floor at around $50/b (Brent) a 57 percent decline from the most recent high in June 2014 of $115/b. The slump owes much to the perception that geopolitical threats are fading, but more fundamentally to supply additions in an environment of anaemic demand. OPEC has backed away from any attempt to stanch this supply, calculating that any cuts would need to be deep to generate an adequate price response and would mean an unacceptable loss of market share… Lower oil prices will clearly weigh on economic activity to some extent, but the government remains committed to supporting the local economy, even at the expense of large fiscal deficits… A weaker pace of public investment growth will clearly feed through into the contracting sector, though that will be more obvious in 2016-18…. skewed incentives that have put pressure on the public purse…[include public sector] employment, where pay and other benefits… are still more appealing to most Saudis than private sector employment. Consequently, Saudi public sector employment has increased at an annual rate of ...7 percent in the past five years. This is the main reason why real government spending has increased from an already high 51 percent of real non-oil GDP in 2010 to 59 percent last year, and explains why an oil price of $100/b—let alone one of $60/b--is no longer enough to guarantee a fiscal surplus.[655]

The price of oil has since dropped to $50 a barrel. A view of economic history which took in Argentina, once wealthy for its silver; New Zealand, for its wool and lamb once with a standard of living equal to that of the USA; South Africa, with its gold and diamonds, might see similar fates even for an oil rich country which needed a long-term figure for its major export roughly 20 per cent above what the most favorable forecast, published by a state-owned banking enterprise, predicted. Later in this chapter I will show that this is not the first time that Sa'udi banks have been hit by declining oil revenues.

This gloomy view informs the central theme of this chapter: without a very robust banking system, Saudi Arabia will fail; with however a robust banking system, Saudi Arabia may well become the central hub of IB and West Asia as Singapore and Hong Kong have become financial centers of East Asia.

There are also substantial governance problems. With respect to the theoretical and operational aspect of implementing Basel III capital regulation, the question is whether

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[655] SAMBA Saudi Arabian Baseline economic forecast 2015-8, (2015) www.samba.com/Saudi_Arabia_baseline_macro_forecast_2015_2018..

Islamic banks need to be regulated if they operate with PLS capital and deposits as their source of funds. PLS investments might have been considered as part of Tier 2 capital under Basel I, but the nature of corporate governance which saw such a loss of shareholder value in IBB means that PLS investments need an adequate weighting in capital risk calculations. KSA has not yet, possibly due to the infancy of the sector, implemented improved internal risk measurement techniques or actual reporting. There is no impetus for an investor, therefore, to have confidence in any particular IB's operations in KSA.

It has been suggested that because Islamic banks undertake profit and loss sharing in projects via *mudaraba* and *musharaka*, they ought to have higher capital levels to compensate and that these be calculated differently than for conventional banks. For example, demand deposits might appear on the balance sheet in the banking book and investment deposits ought to be reported off balance sheet via the trading book, although AAOIFI supports the notion that investment deposits be reported on balance sheet.[656]

A failure of the banking system could be fatal to the interests of the citizens of KSA. Not only would a life savings and pension be potentially lost, but as was seen in the USA in the early 1930s, the failure of any one bank will infect other banks with the potential of bringing the entire economy to a halt.[657] The contrast between the British situation and the potential for KSA could not be greater: British depositors had their deposits guaranteed; the share capital of IBB dropped the equivalent of 25% of all funds held on deposit, and that was even with Basel II capital management standards. The potential losses to a KSA citizen saving for his or her retirement would be much more, it is suggested, than 25%, unless, as recommended by Turner,[658] far more stringent management controls then those which existed in the UK prior to 2010 were introduced.

The effect that bad management has not caused a failure in the KSA banking system so far, when it is liquid because of oil revenues, does not mean that it could not happen in the future, as happened in Dubai, if and when that money runs out. As I demonstrated in the case of the IBB in chapter 6, 25% of depositors' funds were lost, only to be replaced in part by a capital

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[656] Brown, K, Hassan, K. and Skully, M. (2007). *Operational efficiency and performance of Islamic banks,* in M. Khabir Hassan and Mervyn K. Lewis (eds.), Handbook of Islamic Banking. Cheltenham: Edward Elgar, 96, 106

[657] Gelinas, Gelinas, Saudi Arabian Baseline economic forecast 2015-8, (2015) www.samba.com/SEncounter Books, 2013, 21

[658] The Turner Review - A regulatory response to the global banking crisis, Financial Standards Authority, March 2009.

injection from one of its shareholders, the Abu Dhabi Islamic Bank. Expecting a foreign bank to come to one's aid is possibly not a good risk management strategy for KSA bankers.

The way to ensure a robust IB system is, to extent that it is compatible with Shari'a law, to reduce every conceivable risk to the investor, not only to make IB Basel III compliant but where possible to ensure the highest level of confidence by transparently providing the highest level of compliance with relevant international standards.[659]

7.3 The Risks of Islamic Banking in Kingdom of Saudi Arabia

Arakcheev, Baklanova and Tanega show how the political economy creates certain costs to the market acceptability which raise additional risks due to their operational complexity, lack of transparency, and the need for additional investment screenings and third-party involvement in ascertaining Shari'a compliance.[660] The next section will assess these issues in greater detail.

7.3.1 Legal Risk: Inconsistency of Fatwas

This section will discuss the inconsistency of fatwas with respect to a lack of legal development and opinion in the Sunni and Shiite faiths. It should be noted that Jurisprudence in Sunni Islam is remarkably decentralized. For instance, Sunnis, unlike Shiites, never developed a clerical order or hierarchy, so there is no institution in Sunni Islam charged with establishing definitively which legal opinions are authoritative and which are not. So whilst the opinions of certain jurists gain authority over time as they are cited positively by subsequent jurists in their own legal opinions, there is neither a formal clergy nor any ordination process among Sunni religious scholars.

For that reason, using KSA's judicial system also involves risk. Despite growing pressure from foreign investors for greater transparency and rule of law, KSA rarely recognizes overseas arbitration awards and rulings. It is, however, risky for companies to rely solely on the KSA judicial system to protect their interests.

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[659] There's nothing new in this suggestion: it appears for example in Vinnicombe, Thea and David Park,*The Implications Of Islamic Jurisprudence For The International Harmonization Of Accounting Standards,* (2007) 6 *Financial Reporting, Regulation & Governance*, University of the Sunshine Coast, Queensland, Australia, p.1

[660] Arakcheev, N_168 above.

Shari'a law is not in any sense a uniform legal code, but rather, a legal framework within which considerable disputation occurs. Foster[661] cites Taqi Usmani of the Accounting and Auditing Organization for Islamic Finance Institutions as saying that 85 % of Islamic bonds are in truth not Islamic.[662] He is not the lone critic in this area. Vogel and Hayes write:

> In the 1930s, Syrian scholar Marouf al-Daoualibi suggested that the Qur'an bans interest only on consumption loans, not investment loans, and in the 1940s Egyptian jurist al-Sanhuri argued that the Qur'an sought chiefly to ban compound interest. A more extreme and recent example is the opinion of the mufti of Egypt, Shaykh Muhammad Sayiid Tantawi, who in 1989 declared that interest on certain interest-based government investments was not forbidden riba, because the gain is little different from the sharing of the government's profits from use of the funds, thus joining the thin ranks of prominent religious figures who have issued fatwas declaring clear interest practices permissible. This fatwa aroused a storm of controversy, with opposition from nearly all traditional religious scholars and warm praise from secular modernizers. Later he went even further, saying that interest-bearing bank deposits are perfectly Islamic, and more so than 'Islamic' accounts that impose disadvantageous terms on the customer.[663]

The response of the AAOIFI to Sheikh Taqi Usmani's remarks was hardly transparent, but it has represented an interesting and flexible way to present a Shari'a compliant method of delivering the security of capital and of return that international markets demand. It made a resolution in relation to musharakah sukuk and other equity-based sukuk (EBS), which disallows the two credit enhancements in EBS, namely the use of a top-up mechanism when the actual profit is less than the expected profit; and what is effectively a capital guarantee. The fatwa does however allow the use of a reserve account to cover any shortfalls and the distribution on the account, as well as purchase undertakings to buy the assets for its net value, market value, or a price to be agreed at the time of their actual purchase as this will not lead to a guarantee of principal.[664]

Arguably, senior Wahhabi *'ulama,* (legal scholars), form part of the state apparatus in KSA and wield considerable influence. Despite this, significant parts of the administration are run according to secular principles, including the regulation of Saudi banks. Inconvenient fatwas have been repeatedly ignored and sometimes '*ulama* have been forced to issue new fatwas

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661 . Foster John, *How Shari'a-compliant is Islamic banking?* BBC News, 11 December 2009, http://news.bbc.co.uk/2/hi/business/8401421.stm

662 According to Foster, Usmani is the leading proponent of modern day's Islamic finance. There are however on-line comments that Usmani himself has sold fatwas to the highest bidder.

663 Vogel, Frank and Samuel Hayes, (1998) *Islamic Law and Finance: Religion, Risk and Return* the Hague: Kluwer Law International 46.

664 Bloomberg ISRA monthly publication, June 2014, 3

acquiescing to new facts.[665]

According to Foster, Islamic bankers who were unable to get approval for one banking product or another from one Shari'a scholar simply called another or another until a suitable fatwa could be obtained. Thus, Malaysian products are often deemed Shari'a complaint, but they are not deemed as such in the more austere Gulf, or at least, as was demonstrated on the last preceding page, by scholar, Taqi Usmani.[666]

Yet Malaysian Muslims appear to be more supportive of Malaysian IB than British Muslims are of British IB, on the basis of the percentages of each population which use the IBs in their respective countries. It would appear that one reason for this is that Malaysia has a simple system of a single Shari'a Committee whose fatawa appear on a single website, accessible by subscription. The most important fatawa are listed publicly. The collection is in both English (for the international audience) and Bahasa (for the Malaysian and Indonesian Muslim audiences) and over 150 fatawa are issued to the Central Bank of Malaysia.[667]

The last chapter showed that a lack of consistent fatawa has led to situation where some scholars rated products which had first been certified as halal and by other scholars as haram. A situation where a senior and respected scholar can brand 85% of sukuk issued in GCC states, as *haram,* where 65% of them are sovereign or semi-sovereign issues, does not engender the confidence of the world community.[668]

Islamic tradition has a history of practices and institutions known as Khisba'h حسبة , specifically set up to ensure that citizens observe Shari'a law. The (Arabic for "verification") is a religious institution under the authority of the states that fulfils the obligatory duty under Shari'a of enjoining "what is right and forbidding what is wrong." As Shari'a law controls in principle economic activities as much as individual behaviors, the Hisbah institutions such as the Committee for the Propagation of Virtue and the Prevention of Vice extends to regulating business trading, monitoring and supervising commercial activities, market places and other secular affairs.

[665] German Federal Ministry for Economic Co-operation and Development, *Business Corruption in Saudi Arabia,* http://www.business-anti-corruption.com/country-profiles/middle-east-north-africa/saudi-arabia/show-all.aspx
[666] Of the many reports of the Sheikh's comment see for example http://news.bbc.co.uk/2/hi/business/8401421.stm and see also Vogel, Frank, and Samuel L. Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (1998) Kluwer Law.
[667] Islamic Finance Knowledge Repository, http://ifikr.isra.my/home
[668] Arakcheev, N_168 above.

Several commentators have commented on the ethics of IB and social accountability of the system.[669] They seem to be based on accountability to Allah and on that basis spend little time discussing accountability to humans. This seems to be no need to raise in any of the literature for accountability to be done to any person before the Day of Judgment. This may well suit the Islamic clients of an Islamic bank, but it is unlikely to suit a non-Islamic client who may well want continuous disclosure. It was further noted by Zubairu particularly in relation to Saudi Arabia that there were no measures designed to check whether any particular investment of an Islamic bank protected or harmed the natural environment. Zubairu found over all that they were poor disclosure practices, even for institutions that claimed to be operating on Islamic principles. Whilst the banks were committed to borrowers there was little disclosure with respect to vision statements mission statements commitments to the community charity and a benevolent loans and even a description of products and services. Zubairu claims to be surprised by these findings because Islamic banks as social and economic institutions are expected to disclose "more on these dimensions that reflect accountability and justice not only to society, but ultimately to Allah."[670] Zubairu complains that Zakat, the Islamic charitable tax, which is one of the five pillars of Islam, was not appropriately mentioned by any of the Islamic banks.

For example, fees and charges are levied on debt-based transactions, the most popular of which is the Murabaha. مرابحة Murabaha which is the most widely used financing method used by Islamic banks today, involves a bank purchasing a good required by a customer and then re-selling the good to the borrower at a pre-determined profit repayable by installments.[671] To be truly in line with Islamic principles, the bank must take actual ownership of the good before reselling it to the client. However the practice today in Islamic banks more closely resembles conventional interest-based financing whereby the bank does not take actual ownership of the good in question, but rather advances the client with the money to purchase the good, and which the client pays back over time with an added amount which the Islamic banks call profit but in reality is considered a "back door" interest.[672] As

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[669] See for example Abdulrazaq, M.T. Banking and Taxation In The name Of God and the Law Wednesday, 28 August 2013, http://naijatax.blogspot.com.au/2013/08/banking-and-taxation-in-name-of-god-and.html; Iqbal and Llewellyn, N_176 above.; Iqbal, M. and Molyneux, (2005). Thirty Years of Islamic Banking: History, Performance and Prospects. Palgrave Macmillan.

[670] Zubairu, op. cit, 46

[671] Institute of Islamic Banking and Insurance (1990) http://www.islamic-banking.com/murabaha_sruling.aspx

[672] Razali, Siti Salwani , *The Principles Of Ghārār In Bai Bithaman Ajil Contract*, Proceedings of The MFA Conference 2008 Parallel Session III (D)

Razali shows, the mark- up added to the original cost of the good is equal to or, in some cases, even higher than the amount of interest that a borrower would pay in conventional banking practice. He cites a Malaysian example:

Financing amount: RM 100 000.00
Profit Rate: 8%
Monthly instalment is computed using the agreed profit rate on a constant rate of return and monthly rest.
Financing Period: 20 years
Installment per month: RM 837.00
Selling Price= (RM 837.00 x (20 x 12) + 0 = RM 200, 880.00

As a result, the bank experiences a small amount of risk in exchange for a comparatively profitable return on an asset-backed basis.

Elsewhere in this chapter there is a criticism of the 28% profit made by GCC banks on credit cards, which have allowed persons earning even modest monthly salaries to accumulate on average four months of debt per person and an average of almost two credit cards per person.

7.3.2 Valuation Risks

Islamic financial institutions face a variety of types of risks related to Islamic modes of investments and finance. It is important to have realistic valuations of assets in order to assess the value of guarantees to be required and in order to assess how much money is required as an investment in order to secure an adequate partnership between the provider of Capital and the entrepreneur. Proponents of Islamic finance argue that it advocates risk sharing, transparency, promotion of entrepreneurship, and discouragement of speculative behaviour. If too much money is provided to the entrepreneur, there is a danger that the risk profile of the joint venture will not adequately secure the funds advanced.[673]

But how much is too much? The problem is structural: the method of valuation used in IB appears to be deficient. The IASB is able to specify the use of valuation techniques which have recourse to the use of interest rates, the AAOIFI which works without interest rates is

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[673] BEN ARAB, Mounira, (2008) *Managing Risks and Liquidity in an Interest Free Banking Framework*: The Case of the Islamic Banks, Vol. 3, No. 9 International Journal of Business and Management 80

largely silent with respect to explicit details. The IASB provides a method for calculation of value of impaired and distressed assets; Islamic standard requires recognition if impairment is probable, however, it is largely silent on the issue of measurement. The Islamic standard requires recognition when information becomes available indicating that an event will most probably result in the impairment of an asset. The issue of uncertainty is not addressed and the standard does not consider the recognition of a contingency.[674]

Basel III itself attempts to deal with the question of valuations in the following manner:

> When the Effective EPE model is calibrated using historic market data, the bank must employ current market data to compute current exposures and at least three years of historical data must be used to estimate parameters of the model. Alternatively, market implied data may be used to estimate parameters of the model. In all cases, the data must be updated quarterly or more frequently if market conditions warrant… the bank must create several benchmark portfolios that are vulnerable to the same main risk factors to which the bank is exposed. The exposure to these benchmark portfolios shall be calculated using (a) current positions at current market prices, stressed volatilities, stressed correlations and other relevant stressed exposure model inputs from the 3-year stress period and (b) current positions at end of stress period market prices, stressed volatilities, stressed correlations and other relevant stressed exposure model inputs from the 3-year stress period.[675]

This still assumes that a three-year snapshot of past performance is a sufficient indicator of future performance. The writer sees three main reasons why this might not be the case.

Firstly, oil provides 80-90% of government revenue, and the government has as yet shown no inclination to garner new non-oil sources of revenue. Recent falls in oil prices, in part due to Saudi overproduction in an attempt to weaken competition from Russia and Venezuela, has rendered state finances heavily exposed.[676] This has caused Saudi Arabia's sovereign risk score to worsened by three points, pushing it to the lower end of the A rating band.[677]

The Economist Intelligence Unit expects the fiscal account in 2015 to return its widest deficit since 1987, and stay in deficit in 2016, although there are sufficient reserves to cover this

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[674] Vinnicombe, Thea and David Park,*The Implications Of Islamic Jurisprudence For The International Harmonization Of Accounting Standards,* (2007) 6 *Financial Reporting, Regulation & Governance*, University of the Sunshine Coast, Queensland, Australia, p.

[675] Basel III: A global regulatory framework for more resilient banks and banking systems. p 30.

[676] *Recession in Russia, revolt in Venezuela? The knock-on effects of tumbling oil prices,* Guardian, 16 October 2014, http://www.theguardian.com/news/datablog/2014/oct/16/datablog-low-oil-prices-chill-producer-economies

[677] Saudi Arabia – Country Risk report The Swedish Export Credits Guarantee Board http://www.ekn.se/Global/Landriskanalyser/Mellan%C3%B6stern/Engelska/Saudiarabien2013EngExtern.pdf DATE 14/05/2013

deficit. However, because oil accounts for around 90% of export and government revenue, the state of play with respect to oil prices could begin to damage the economy as early as 2018 if they remain at the present historic lows.[678]

Given the huge amount of foreign reserves held by KSA, the oil price ought not to begin to affect the value of the Sa'udi riyal for some time, especially as oil is paid for in dollars. This should cushion it from the blow to the entire national value felt for example by Australia, when the major export, iron ore, fell in price by half: the Australian dollar lost a quarter of its value between 2012 and 2015 and so did, therefore, every asset of everyone in Australia. Were a shock of this nature to affect the KSA, the foreign borrowings, valued in US dollars or Euros, would suddenly cost many more riyals to pay back.

Secondly, KSA has poor governance metrics. Corruption is also widespread both according to Transparency International's "Corruption Perception Index,"[679] and the World Bank "Worldwide Governance Indicators".[680]

Even within corporations, the adoption of corporate governance standards is not uniform and the Capital Markets Authority compels the adoption of regulations, which merely constitute "guiding principles", for example:

> Article 8: Policies and Procedure related to Disclosure
> The company shall lay down in writing the policies, procedures and
> Supervisory rules related to disclosure, pursuant to law. [681]

The State owned shipping company, Bahri, for example, has adopted a corporate governance policy which simply allows for the company to adopt policies aimed at securing the company's financial stability and instituting an annual monitoring review program, without specifying what those policies might be, or how the annual review might be conducted.[682]

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[678] Saudi Arabia Country Risk, *The Economist* Intelligence Unit Last Updated: May 2015 https://store.eiu.com/product.aspx?pubid=310001031&pid=60000206&gid=310001031

[679] KSA ranks 66th place of 176. www.transparency.org/research/cpi/overview

[680] Saudi Arabia ranks worst of the six Gulf countries in the Gulf Cooperation Council. Al-Kuwari, Duha Mission *impossible? Genuine economic development in the Gulf Cooperation Council countries* http://www.lse.ac.uk/middleEastCentre/kuwait/documents/Mission-impossible-genuine-economic-development-in-the-GCC.pdf

[681]Corporate Governance Regulations in KSA issued by the Board of Capital Market Authority Pursuant to Resolution No. 1/212/2006 http://www.cma.org.sa/En/Documents/ CORPORATE%20GOVERNANCE%20REGULATIONS-2011.pdf

[682] BAHRI Corporate Governance Regulations adopted 20 December, 2009. http://www.bahri.sa/Bahri_Corporate_Governance_English.pdf

When comparing these regulations with the equivalent Malaysian or British ones, the level of disclosure required pales by comparison.[683]

There is a history of poor governance in KSA banks. In 1982, SAMA had to step in when irregularities appeared in the operations of Saudi Cairo Bank. Two senior managers were involved in unauthorised trading in bullion, and Saudi Cairo Bank had concealed accumulated losses that exceeded its share capital. SAMA took legal action against the managers and required the bank to issue new shares and double its capital in 1986. The increase was taken up entirely by the Public Investment Fund as an "investor of last resort".[684]

Thirdly, the Dubai bubble shows that some property speculation takes more than three years to unravel. Relatively sudden crashes in commodity prices can render lending on plant and equipment used in mining risky, as witness the falls in iron ore and oil prices over the last two years [as of April 2015].[685] Those industries begin to shed workers and housing in those areas loses value. Indeed whole national economies begin to falter (Venezuela and oil, Australia and iron ore).[686] The PLS makes depositors liable for the entire financial shock suffered by the borrower and the fact that there may be a pledged asset to be sold does not make the depositor's situation any easier than would be a depositor in a conventional bank. Indeed it probably makes it worse, because whilst realised values of security often differ widely from book values, the methodology of establishing book values for Islamic banks is, as the writer has demonstrated in this section, fatally flawed.

Fourthly, as Arakcheev, Baklanova and Tanega point out, *Murabahah* incurs credit risk- which includes market risk, which encompasses interest rate risk, foreign exchange risk, and spread risk, from its daily exposure to through its escrow agent. [687] This combination of risks is inherited in the investment process and depends, inter alia, on the general level and volatility of interest rates, currency fluctuations, presence of hedges. In a market kept

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683 Errico, N_59 above.; Prates, N_67 above; Lastra, N_68 above.

684 Al-Suhaimi, Jammaz Consolidation, competition, foreign presence and systemic stability in the Saudi banking industry, BIS papers no 4, 131, http://www.bis.org/publ/bppdf/bispap04n.pdf

685 On Venezuela and oil, http://www.bbc.com/news/business-29643612, On Australia and iron ore, Iron ore price crash erases $74b in market value, Australian Financial Review, 20 April 2015, http://www.afr.com/business/mining/iron-ore/iron-ore-price-crash-erases-74b-in-market-value-20150419-1mo522

686 On Venezuela and oil, http://www.bbc.com/news/business-29643612, On Australia and iron ore, Iron ore price crash erases $74b in market value, Australian Financial Review, 20 April 2015, http://www.afr.com/business/mining/iron-ore/iron-ore-price-crash-erases-74b-in-market-value-20150419-1mo522

687 Arakcheev, N_168 above.

buoyant by high oil prices, Arakcheev, Baklanova and Tanega argue that these risks are sufficiently mitigated by the high quality of such securities. If prices fall because the fatal flaw in the Sa'udi economy which is identified in this chapter, leads to a fall in the Riyal where sukuk and murabahah contracts are denominated in USDs and Euros, the situation may well be different.[688]

7.3.3 Could There be an Islamic Sub-prime Crisis?

In a sense the security of the sukuk market is just as confected as conventional credit securities was the housing price bubble. It may well be argued that what caused the global financial crisis of 2007 was not the way that the loans on American and British real estate were packaged, allowing interest rates to rise from a low rate to a high rate after so many years. This is a view expressed for example by Suleman Muhammad Ali of Meezan Bank Limited,[689] and in my respectful view it is self-serving and wrong.

I will demonstrate that a sub-prime scenario with respect to housing could equally occur with rental amounts or instalment repayments under an Islamic loan such as *Murabahah* مرابحه . I will then demonstrate that the sub-prime crisis was caused by lending on an asset regardless of the debtor's inability to repay on the false belief that the value of the asset will increase. I will finally demonstrate that not only could there be an Islamic sub-prime crisis resulting from perfectly acceptable practices supported by *fatawa* from the central Shari'a Committee used by the Central Bank of Malaysia, the committee approving the practices discussed in the case study in this thesis, but there is because of the conditions described in Sa'udi Arabia in the foregoing part of this chapter a real possibility of a totally halal, totally Shari'a compliant but nevertheless totally devastating meltdown of the Sa'udi banking system unless the methodologies and systems used in KSA are harmonized with international standards, including but not limited to those of Basel III.

The crisis did not arise because loans were made to people who had no real prospect of repayment. In fact, making "benevolent loans" or interest free loans قرض حسنه to the poor in an attempt to alleviate their poverty is at the heart of Islam. Indeed it is possible that the

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[688] *Ibid.*

[689] Suleman Muhammad Ali, *The Subprime Crisis and the Lessons for the Islamic Finance Industry*, NEW HORIZON, April 2013, 15, viewed at www.islamic-banking.com

first low-interest period of a sub-prime type mortgage to a Muslim borrower could be a benevolent loan with low instalments and the balance of the period could be a Murabahah with high instalments, without infringing Islamic principles.

The sunnah of the Prophet (Peace and Blessings be upon Him) is very clear on this issue. It is reported that the Prophet (Peace and Blessings be upon Him) said,

> In the night of the journey, I saw on the gate of heaven written, 'reward for *tzadaqah* is ten times and reward for *qard al-hasan* is eighteen times'. So, I asked the angel, how is it possible? The angel replied, "Because a beggar who asked had already had something but a borrower did not ask for loan unless he was in need.[690]

Ibn Kathîr's commentary on the Qur'ân explains the meaning of a "beautiful loan"[691]: *"Whatever you spend, then Allah will replace it, and on Him will be the reward of whatever you give away in charity. Allah considered giving charity as if it is a loan to Him."* [692]

Low-doc, no-doc loans to persons with no income and no assets have been decried by critics of western decadence as immoral. However, Ibn Kathîr says, writing of beneficial loans:

> Umar bin Al-Khattab said that this Ayah refers to spending in Allah's cause. It was also said that it pertains to spending on children. What is correct is that it is more general than that. So all those who spend in the cause of Allah with good intentions and a sincere heart fall under the generality of this verse." [693]

So an Islamic bank lending to a poor person to save him or her from homelessness would be acting morally and to the highest standards. At the end of the initial period, the face value of the loan *(asl al-qard)* is to be paid off from the proceeds of a *Murabahah*. This allows an initial period where the poor person is helped to his or her feet, and thereafter a *Murabahah* with high instalments still does not breach the ban on *riba*.

The fatwa of Saleem and Abozaid emphatically declares that any benefit that a Muslim lender gets without harming or burdening a Muslim borrower should not be prohibited. They declare that the issue of prohibited benefit it is that a haram benefit can harm the borrower, but a halal loan can bring benefit to the two parties and no harm to any one of them. Such a loan doesn't contradict any Shari'a principle will not be prohibited "especially when we know that

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[690] Ibn Hisham & Ibn Majah, cited by Saleem, Mohammad Yusuf and Abdulazeem Abozaid *Benefiting From Loan Contracts*, http://www.kantakji.com/media/9499/file716.pdf

[691] *Sûrah al-Taghâbun*, verse 17

[692] Abdul-Rahman, Muhammad, Saed *Tafsir Ibn Kathir* (Part 28): Al-Mujadila 1 to At-Tahrim 12

[693] *Sûrah al-Hadîd*, verse 11

Shari'a does not prohibit interest which will not harm anyone."[694]They explain the juristic saying "any loan which results in a benefit is considered usury" a general rule, which cannot be applied where the borrower wholeheartedly gives more than what he borrowed on the condition that it is not a condition of the lender.

Saleem has written a fatwa, on behalf of the Shari'a Committee at the behest of the Central Bank of Malaysia,[695] which declares that financing settlement - in the scenario the writer proposes, of the benevolent loan - through the issuance of debt securities to the original financier, - in the scenario the writer proposes, of the Murabahah - which will indirectly create new financial obligation, is allowed by Shari'a. The rescheduling and restructuring method must be implemented by taking into consideration the Shari'a requirements such as, the existence of an unambiguous contract, a Shari'a compliant sale asset, and terms and conditions which are not contrary to Shari'a. Saleem cites the following as the basis for his *fatwa*:

> Islamic restructuring of debt through a separate issuance of debt securities to the original financier involves a scenario in which the existing contracting parties enter into another separate and independent contract. Generally, there is no Shari'a impediment for the contracting parties to execute another separate and exclusive contract amongst them. The issuance of debt securities… to the original financier is viewed as a transaction which does not affect the validity of the existing financing contract. [696]

This *fatwa* seems to be at the heart of the case study cited elsewhere in this thesis. That is to say, the strength of IB in Malaysia is based on some fairly flexible *fatawa*.

It follows that the purchase of housing in a property bubble by a no-income, no-assets borrower not only *could* be made possible by IB but that compassion for the poor means that it *would* be made possible. According to a further fatwa, there is, according to the view of the majority of scholars, no upper limit on the amount of the instalment, in exactly the same way as there is no rule which indicates how much profit a trader can make on his or her products from an Islamic view. According to the *fatwa* of Rabee' Al-Aakhir,

> "A Muslim tradesman should not be greedy… and only interested in material things... in his business. Rather, the moral conduct should be his major concern... and he should

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[694] Saleem, Mohammad Yusuf and Abdulazeem Abozaid (2013) *Benefiting From Loan Contracts*, International Shari'a Research Academy For Islamic Finance, p.8 http://www.kantakji.com/media/9499/file716.pdf

[695] 38th meeting of the Shari'a Committee dated 28 August 2003

[696] http://ifikr.isra.my/fatwa/-/fatwa/getFatwa?_7008_WAR_fatwaportlet_fatwaId=4091

consider the circumstances of the public ...in all his dealings"[697]

The writer has not been able to find any ruling which restricts the rate at which a bank calculates instalments. It follows that as long as the instalment rate is fixed, so that the contract is certain in advance, there is nothing to stop an Islamic version of sub-prime lending as the writer has described it. There is no impediment to an IB selling its interest in the Murabahah. The difference is that what an Islamic bank would be selling is not a collateralized debt obligation but an actual share in real estate, which would have a greater value and depending on the terms of the underlying contract be just as saleable on an open market as any other interest in property.

There is also a Malaysian Central Bank *fatwa* permitting the structure I have proposed:

> It is permissible and is not tantamount to the sale of debt with debt, which is prohibited by the Shari'a… [if] the transfer of beneficial ownership that is reflected in the contract documentation is sufficient, accepted and recognized by the Shari'a [because the] sale of debt with a debt, which is prohibited by the Shari'a, does not arise because the transfer of ownership takes place automatically given that the underlying asset used in the transaction is the lender's remaining legal interest in the property. The documentation on the sale and purchase agreement is the main evidence for the transfer of ownership. Therefore, the investor has the right to sell the asset to a third party without referring to or executing the transfer of ownership with the borrower. There is also reference to a floating rate of instalment payment which would in effect allow for a floating rate of interest, due to the principle of *muoasah* (offset) which arises where two parties are indebted to each other and the debts are settled based on the payment of the difference between the two debts amount. [698]

I have previously discussed the Malaysian moves to have an international voice on Shari'a-compliance finance in Chapter 5 and therefore, the above *fatwa* may have more than a local significance. According to the writer's understanding of that *fatwa*, the gain or loss on the effective market rate is permitted as an amendment to the instalment amount in the contract if the contracting parties are convinced that the outcome of the application represents the actual loss suffered by a party to the contract as a result of market changes. This also allows a penalty to be charged by the lender as a result of a default by the borrower. If interpreted according to the view of Sanhuri, an eminent modern jurist, it will allow a floating instalment rate because if the terms of the calculation of the instalments are certain, the contract is not

[697] Fatwa No 92029 of Rabee' Al-Aakhir 4, 1427 / 3 May, 2006 viewed at http://library.islamweb.net/
[698] Shari'a advisory committee, 54th meeting dated 27 October 2005, http://ifikr.isra.my/fatwa/-/fatwa/getFatwa?_7008_WAR_fatwaportlet_fatwaId=4043

affected by lack of knowledge about the material terms of contract. Such a contract is therefore not rendered *haram* because of *Ghārār*. Sanhuri says that *Ghārār* takes place only when it is not known whether the subject matter exists, or if it exists at all, whether it can be handed over to the buyer, or when want of knowledge affects the identification of the genus or species of subject matter - none of which relate to real estate transactions - or when it affects its quantum, identity, date of a future performance or other necessary conditions. It follows that a clear and transparent method of calculating installments according to an Islamic market rate indicator, rather like the Central Bank of Malaysia's Islamic Market Swap Rate for debt defaults, as mentioned in the cases study in this thesis in chapters 5 and 6 would allow the final element of a sub-prime mortgage as an Islamic concept, as long as the profit component was part of a *mudaraba* and not *riba*.[699]

Furthermore, there is authority for the proposition that an Islamic form of CDO would be halal. *Surah al-Baqarah* (2:275) makes it crystal clear that the Lawgiver prohibits riba and permits sales transactions in contracts of exchange are clearly allowed in Shari'a, whether payment is spot or deferred; and the latter, by definition, creates debt. From the Shari'a point of view, IB products are initially permissible as long as the elements of usury, uncertainty, injustice, and all other *haram* activities are eliminated. Why, then, should we call for restrictions on the use of debt-based instruments when the original rule for them is that they are *halal*?[700]

Saleem allows the issue of receiving a brokerage commission for acquiring a loan for someone, with the condition that the broker informs the lender of the financial status of the person seeking the loan. As he states,

> Some people might not be able to find someone who can give them a loan, due to the fact that they lack acquaintances. [Therefore…] they need the assistance of someone who is of prominence in the community to help them. "[701]

7.3.4 The Benefits of Islamic vis a vis Conventional Banking?

Suleman Muhammad Ali criticizes the sub-prime debacle for being based on the following

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[699] . Razali, Siti Salwani , *The Principles Of Ghārār In Bai Bithaman Ajil Contract*, Proceedings of The MFA Conference 2008 Parallel Session III (D) , p.4

[700] Badri, Ustaz Mohd Bahroddin, *Islamic Financing: Are Debt-Based Instruments Not Islamic*? ISRA *Islamic Finance Space* Issue 02, International Sharí'a Shari'a Research Academy for Islamic Finance, December 2014, 16

[701] Saleem, Mohammad Yusuf and Abdulazeem Abozaid (2013) Benefiting *from Loan Contracts*, International Shari'a Research Academy for Islamic Finance, p.11. http://www.kantakji.com/media/9499/file716.pdf

assumptions, and he paraphrases Warren Buffet, CEO of Berkshire Hathaway, speaking at the *Financial Crisis Inquiry Commission* in June 2010, as follows:

> Housing prices would not fall dramatically. Free and open financial markets would most effectively support market efficiency and stability, directing funds to the most profitable and productive uses; Concepts embedded in mathematics and physics could be directly adapted to markets, in the form of various financial models used to evaluate credit risk; Economic imbalances, such as large trade deficits and low savings rates indicative of over consumption, were sustainable. Stronger regulation of the non-banking financial system and derivatives markets was not needed. [702]

Suleman Muhammad Ali then claims that the prevalence of those assumptions, the increase in demand for housing and the cheap supply of credit resulted in a boom in the construction industry to increase the supply of housing to meet the demand. [703]

In the writer's view exactly the same criticism can be made about the issue of sukuk. Let us examine these in turn. Firstly, as the SAMBA report indicates, oil prices have fallen to an unsustainably low level. If as it is suggested, oil prices are some $43 per barrel under way they need to be in order to assist sustain KSA's level of foreign reserves with its current level of spending, then assuming a production of 1.8 million barrels of crude oil per day, sales of oil are some $28.25 billion per year beneath they need to be.[704] Whilst at this level it would take a total of some 30 years to deplete the country's foreign reserves to zero.[705] It is worrying that even at an optimum sales price, according to the report, KSA will still be losing $15 per barrel in the medium to long term.[706] It is not entirely unreasonable to suggest that the $85 optimum price reflects the cost at which the non-Arab world can produce alternatives to oil.[707]

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702 Saleem, Mohammad Yusuf and Abdulazeem Abozaid (2013) Benefiting *from Loan Contracts*, International Shari'a Research Academy for Islamic Finance, p.11. http://www.kantakji.com/media/9499/file716.pdf; but *the Guardian* had a similar report of the testimony: http://www.theguardian.com/business/2010/jun/02/warren-buffett-financial-crisis-inquiry-live; the entire testimony is on youtube at www.youtube.com/watch?v=UqOX2tAvRbU.

703 Suleman Muhammad Ali, *The Subprime Crisis and the Lessons for the Islamic Finance Industry*, NEW HORIZON, April 2013, 16, viewed at www.islamic-banking.com

704 http://www.economist.com/news/leaders/21651821-chaos-middle-east-casts-saudi-arabia-arab-worlds-leader-it-must-reform

705 see for example http://www.economist.com/news/briefing/21651829-new-leaders-saudi-arabia-want-increase-its-clout-they-face-hard-task-challenged

706 SAMBA Saudi Arabian Economic Monitor, November 2014. www.samba.com/en/pdf/.../Samba_Economic_Monitor_Nov_2014.pdf; SAMBA Saudi Arabian Baseline economic forecast 2015-8, (2015) www.samba.com/Saudi_Arabia_baseline_macro_forecast_2015_2018..

707 Berman, Arthur Who Is Saudi Arabia Really Targeting In Its Price War? Oilprice.com 20 April 2015 http://oilprice.com/Energy/Crude-Oil/Who-Is-Saudi-Arabia-Really-Targeting-In-Its-Price-War.html

It is not the first time that this has happened in KSA. When oil prices tumbled from the all-time high in 1981 and continued to decline for the next five years, the resultant economic slowdown put significant pressure on the quality of banks' assets. Government revenues rose to SAR 333 billion by 1981, but dropped to just SAR 74 billion by 1987. Credit to the private sector, which had increased over 500% during the period 1976-81, grew only at an annual rate of less than 4% per year in the same period.[708]

It is a matter of common knowledge that alternatives to oil have become progressively cheaper in the last few years and it may well be that the market average oil price does not even return to $85 per barrel. It is also a matter of record that the Chancellor of Germany, Ms Angela Merkel, announced that Europe will reduce greenhouse gas emissions by 40% from 2010 levels by 2050.[709]

The KSA has based its infrastructure spending on the basis of an increasing demand for oil, a higher oil price than its own figures says is possible. This will put pressure on the Saudi economy, and ultimately lead to a drop in the value of the Saudi currency. Saudi consumers of electricity for example, pay in local currency but their sukuk bonds have to be repaid in USDs or Euros. This will further harm living standards and cause a need for even more austerity as money is taken away from needed public works in order to pay foreign debt. There is nothing new about this theory - it has caused devaluations in the currency of many commodity producing nations including, during the Asian Financial Crisis of 1997, Malaysia, Indonesia, South Korea and Thailand. [710]

An analysis of that crisis demonstrates that as foreign reserves become depleted, the value of the local currency will fall further. This leads to a crisis in the value of the secured assets, assuming that the sukuk is secured or that there is any guarantee pledged, as they of course are valued in the local currency. An electricity business, to take the Saudi Electric *sukuk* as an example, is only worth what the locals can afford to pay for it. This presents a risk to investors which has clearly not yet been priced into the valuation of the *sukuk*.

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[708] Al-Suhaimi, Jammaz Consolidation, competition, foreign presence and systemic stability in the Saudi banking industry, BIS papers no 4, 128, http://www.bis.org/publ/bppdf/bispap04n.pdf

[709] http://www.theguardian.com/world/2015/jun/08/g7-leaders-agree-phase-out-fossil-fuel-use-end-of-century

[710] Ping, J. (2005). *The Asian financial crisis: the International Monetary Fund's increasing importance*, in Anne Cullen & Stuart Murray, eds, *The globalization of world politics: case studies from Australia, New Zealand and the Asia Pacific*, 3rd ed., Oxford University Press.

Secondly, Suleiman complains that little emphasis on the credit quality of such loans since the brokers' focus was merely to earn large profits through origination fees in the short term in the form, *inter alia*, of profits from the sale of collateralized debt obligations. The writer demonstrated earlier in this chapter that similar fees are permitted both for brokers of mudurabah loans and, by extension, for brokers of sukuk. Suleiman complains that the banks dealing in CDOs were not concerned about their long- term quality or the defaults that would arise if housing prices started to fall. A similar criticism can be made of Islamic mortgage brokers and sukuk brokers, for which we need look no further than the Dubai housing bubble, where, for example, Dubai Islamic Bank and Abu Dhabi Islamic Bank each required a government bailout during the global financial crisis.[711] Although, as argued in this paper, the crisis in Dubai was one of its government's own making, the crisis demonstrated the weakness of the IB system.

Sukuk structures have been used in a number of sovereign and semi-sovereign issues, in Malaysia, Qatar, Pakistan and Bahrain, Dubai and the German Bundesstaat of Saxony-Anhalt (the first non-Islamic Sukuk issuer) and in each case brokers received fees. [712] Fees on broking sukuk for Sa'udi Electric for example were earned by, among others, Al Rajhi Capital, a division of Al Rajhi Bank, the biggest Islamic bank in the world.[713] According to Al Rajhi's website, in 2014 Saudi Arabia ranked second in the global sukuk new issuances with a share of about 13%, with assets of SAR 273 billion (USD 72 billion).

Al Rajhi Capital manages over US$6 billion of assets and earns heavily from brokerage, with a brokerage charge of 1% and an annual management fee of 0.25%. This contributed to the Bank's recorded SAR 7.4 billion in net profit in 2013.[714] Given that the average time that a bond is held, according to the Al Rajhi website, is four years, the average amount derived annually from fees relating to sukuk brokerage and maintenance is some SAR 110 million. It cannot therefore be said that Al Rajhi brokers have no incentive to sell sukuk. I summarise my arguments as follows: the criticism Suleiman raises of collateralised debt obligations can just as easily be raised against sukuk.

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[711] UAE Islamic Banks Repay Government's Crisis Support (April 7, 2013). Retrieved June 9, 2013 from http://www.reuters.com/article/2013/04/07/islamic-banks-uae-idUSL5N0CU03J20130407
[712] http://www.alrajhi-capital.com/en/documents/sukuk-brochure-eng.pdf
[713] Ibid.
[714] http://www.alrajhibank.com.sa/en/investor.../annual-report-2013-en.pdf

The third most important criticism raised by Suleiman is that according to the proponents of collateralised debt obligations, stronger regulation of the non-banking financial system and derivatives markets was not needed. The proof that proponents of IB are not immune from this criticism is the gap between Islamic and general accounting standards as outlined earlier in this chapter. There is a further argument that the Kafala or guarantee bonds issued for many sukuk such as those in Dubai were worthless, or at least unenforceable due to the poor legal framework in the issuing country. That is, there were regulations but the regulations were valueless.[715]

As to the fourth criticism made by Suleiman, of increasing indebtedness in Western countries, there are no reliable Sa'udi figures available to me. However there are figures from the UAE that strongly suggest a trend to growing indebtedness.

> The proliferation of personal finance and credit cards has been amongst the glaring examples of this epidemic. A survey conducted in UAE in 2011 found that a quarter of UAE residents have debts of over $68,000 while more than 20% are not even aware of the size of their outstanding debt. Another 40% of residents have personal loans of between $27,000 and $54,000. The result also showed that 12% of its residents own more than six credit cards, with 15% of these cards bearing outstanding balances of over $27,000… the total consumer debt in GCC countries at $139 billion…. The tawarruq facility is a highly profitable business where customers often end up paying an effective profit rate based on APR of 12% to 28%! [716]

The level of indebtedness cannot be measured in the same way as the indebtedness of US or UK citizens prior to the global financial crisis due to a difference in methodology for measuring tax liabilities, student loans and contingent liabilities such as variable interest rates on mortgages. However the debt is computed, it appears that in terms of purchasing power parity, the average UAE citizen in 2011 has a similar debt profile to the average UK or US citizen in January 2015: Outstanding consumer credit—reflecting Americans' total debt outside of mortgages—grew 4.18% or $11.56 billion to $3.33 trillion in January,[717] but if divided by the population figure shown on the popular US government website "Popclock" was approximately 319 million at that time.[718] The average non-mortgage debt per head was

[715] Lahlou, M.S. and J.A. Tanega (2007) Islamic Securitisation: Part II - A Proposal for International Standards, Legal Guidelines and Structures University of Westminster, School of Law, Journal of International Banking Law and Regulation Volume 22 Issue 7, 359.
[716] Kasri, Noor Suhaida & Shamsiah Mohamad, *Unethical Profit-Making and Islamic Banking Practices* ISRA *Islamic Finance Space* Issue 02, International Shari'a Research Academy for Islamic Finance, December 2014, 13-14.
[717] U.S. Consumers' Credit-Card Debt Falls in January, Wall Street Journal, 6 March, 2015
[718] http://www.census.gov/popclock/

therefore only some USD10,400. According to the popular my-budget website, the median US wage for 2011 was USD 26,965,[719] for an average working week (for full time employees) of 46.7 hours. This high figure is not adjusted for the number of part-time workers who average 25.7 hours a week, and whose income figures bring the median wage down.[720] The estimated median wage for full time workers in 2011 was around USD 40,000.[721] Accordingly average debt was about 40% of median salary for all workers or 25% of median salary for full-time workers.

For the corresponding period the median salary for all of those paid in actual money in the UAE, working an average 53-hour week, was AED 39000[722] or approximately USD 10620.[723] This figure includes, apparently, full-time and part-time workers.[724] UAE salaries are far higher than those in many other GCC countries, with Sa'udi mid-level managers earning a shocking 25% less than their Emirati counterparts in their countries of birth.[725] However, shockingly, one worker in 12 in the UAE does not receive income in cash[726] so the figures are a bit hard to compare.

Whilst the ILO does not publish accurate figures on Sa'udi wages, Migrant Rights Worldwide claims that the 80% of the Saudi labor force that are "guest workers" – some 5.6 million workers – earn, if they are Filipino, only USD 9 daily.[727] This does not sound like a great platform on which to build a massive infrastructure program, much less to issue sukuk to the world market in order to fund it.

In summary, given the much lower incomes across the GCC than in the US, the fact that 47 million GCC residents[728] owed around USD 3000 per head or some 29.5% of annual salary, and were working at least 275 hours per year to maintain their lifestyles than their US

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719 http://www.mybudget360.com/how-much-do-americans-earn-what-is-the-average-us-income/
720 McGregor, Jena *The average work week is now 47 hours* Washington Post, September 2, 2014.Retrieved fromhttp://www.washingtonpost.com/blogs/on-leadership/wp/2014/09/02/the-average-work-week-is-now-47-hours/
721 http://www.mybudget360.com/how-much-do-americans-earn-what-is-the-average-us-income/
722 Qingxia Tong *Wages Structure in the in the United Arab Emirates* Institute for Social & Economic Research (ISER) Working Paper No. 2 July 2010
723 http://www.xe.com/currencycharts/?from=USD&to=AED&view=5Y
724 Qingxia Tong *Wages Structure in the in the United Arab Emirates* Institute for Social & Economic Research (ISER) Working Paper No. 2 July 2010
725 Nayab, Muhammad Kashif Employment and Salary Trends In The Gulf 2010-2011, GulfTalent.com, 2011.
726 Qingxia Tong *Wages Structure in the in the United Arab Emirates* Institute for Social & Economic Research (ISER) Working Paper No. 2 July 2010
727 http://www.migrant-rights.org/2010/06/filipino-workers-rule-saudi-arabia/
728 Hyslop, Leah , *GCC population to reach nearly 50 million in 201*3, The Telegraph, 22 February, 2012. Retrieved fromhttp://www.telegraph.co.uk/expat/expatnews/9095696/GCC-population-to-reach-nearly-50-million-in-2013.html

counterparts, is a clear refutation of Suleiman's fourth point.

In short, my view is that IB in its present stage, at least as it is practiced in KSA and its neighbors', is a collateralized debt obligation-type crisis waiting to happen. The capital adequacy of IBs at present may look healthy, but no amount of capital reserve will help a bank where the assets in which it has invested, as a body, lose their value because of the materialization of these valuation risks. Further, any adverse economic change to consumers as a whole in a country such as KSA, such as a reduction in wages paid by the Government due to a need for austerity measures will present an economic shock to investors.
The asymmetrical knowledge that this might happen is one form of sovereign risk as well. Are there any other forms?

7.3.5 Sovereign Risk and Risk of Corruption

No regulatory system can regulate sovereign risk. Sovereign risk (or political risk) is a situation where the political and economic situation creates credit risks.[729] It also includes government corruption,[730] as was seen in the Dubai bubble affair. One major international developer now warns in respect of developments in Bahrain, Egypt, Lebanon, Morocco, Oman, and UAE:

> The common thread in the results is that the broad-level country risk factors – such as political and sovereign risk and corruption – dominate shopping center pricing in emerging markets when it comes to emerging markets, these have far greater impact on investor decision-making than, for example, consumer demand or real estate specific factors.[731]

Possibly political and sovereign risk and risk of corruption are worse in Islamic countries without an advanced legal system where the courts are not independent of the State, that is, there is no separation of powers between the judiciary and the rulers. Those countries have little accountability or transparency in Government and little or no free media which can serve to keep any of the branches of Government in check. The risk to investors, and to the IBs in which they invest, is increased because much of the information on which a rational investment decision is based comes either from court reports or from the media. Companies which are publicly sued for debt on a regular basis are clearly credit risks; where a legal

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[729] See for example https://www.eiu.com/handlers/PublicDownload.ashx?mode=m&fi=risk-section/country-risk-service.pdf
[730] See for example Moser Christoph et al, (2006) *Political risk and export promotion: evidence from Germany* Deutsche Bundesbank Discussion Paper Series 1: Economic Studies No 36/2006, Frankfurt a.M.
[731] CBRE *Emerging Markets Offer Excellent Shopping Centre Development And Investment Opportunities* 2013 http://www.cbre.de/de_en/news_events/news_detail?p_id=15892

system either does not facilitate these actions or does not facilitate them to be reported, the lack of transparency obscures the risk.

The strength of the Malaysian system, which it inherits from the British, is a strong tradition of respect for the rule of law with clear statements of what statute and precedent are, and severe enforcement mechanisms. By contrast, in the KSA our anti-corruption commission has been accused of being toothless by the Shoura Council's human rights committee of failing to fight corruption in the country, handling fewer cases,[732] and only clawing back two sums over two consecutive years.[733] As of August 1, 2015, the draft law on anti-corruption has still not passed the Shoura Council for assent by the King.[734]

Capital adequacy restrictions are no safeguard against the corrupt theft of a bank's capital. The question is whether others in the KSA share this same understanding.

7.4 Discussion

One of the most important features of Basel II and III is their continuous changes to the methodologies of assessing risk. For example, there are significant changes in the risk weighting of assets for determination of capital requirements. Depending on the supervisory assessment of banks' risk management capabilities, these changes would give the banks the option to adopt either a) the Standardised Approach, b) Foundation Internal-Ratings Based Approach, or c) the Advanced Internal-Based Rating Approach. The ultimate objective is to develop risk management culture in banks by requiring lesser capital for the adoption of appropriate policies by banks.

The difference in the nature of Islamic modes of finance makes the risks of Islamic banks' assets different from those created by interest-based lending. This makes the risk-weighting system more complex in assessing the quality of assets. This is because assets are not risk-weighted individually in the old Basel system, but rather grouped and bucketed according to the different risk categories. The internal ratings-based approach removes this problem by requiring the probability of default (quality) of each asset to be determined individually.

[732] Caseload dropped from 2,622 in 2013 to 1,278 in 2014: http://www.arabnews.com/saudi-arabia/news/767096
[733] http://www.arabnews.com/saudi-arabia/news/767096
[734] Shoura to study anticorruption law http://www.arabnews.com/saudi-arabia/news/755136

Let us, for example, take the Sa'udi construction market. Looking to the West for a moment, it is conceded that the sub-prime market allowed borrowers who possibly ought not to have received loans to buy real estate because of excessive liquidity in the CB system. However it was not that excessive liquidity alone which caused house prices to rise, as witness the fact that in the UK house prices are still rising despite a distinct lack of liquidity in the CB system in 2015[735] and indeed despite falling living standards in the UK.[736] So ratings in the UK based on real estate in the UK seem to be relatively reliable.

The situation in KSA differs. Currently, there is a large supply of office space and hotels under construction in Riyadh and Jeddah. As the projects are completed, the market will need time to absorb the new supply, which may lower occupancies, lease rates and possibly sale prices.[737] Arab News, a State publication in KSA, reported on 19 April 2013 with respect to a decree on land values which is yet to fully take effect:

> Real estate experts say the King's ruling will see a drop in real estate prices. Some expect a huge decline in rents because the land will be available to citizens within a year…They believe there has been a real estate bubble in the Kingdom, which will soon be deflated by the government's action to either build houses and provide them to citizens at reduced prices, or provide land and construction loans. [738]

Prudent risk evaluation, based on an understanding of long term macro-economic trends, might be more beneficial for the KSA's banking system.

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[735] Turner, Camilla , *House prices rise to ten times average salary*, The Telegraph, 17 Jun 2014 http://www.telegraph.co.uk/finance/property/house-prices/10905333/House-prices-rise-to-ten-times-average-salary.html

[736] Cribb, Jonathan, et al (2015) *Living Standards: Recent Trends and Future Challenges*, IFS Briefing Note BN165 IFS election analysis briefing note 7, London.

[737] Interview with Jamil Ghaznawi, national director and country head-KSA of Jones Lang LaSalle. http://www.arabnews.com/economy/news/768906

[738] Real estate experts expect the housing bubble to burst soon, Arab News, 19 April 2013, http://www.arabnews.com/news/448684

Chapter 8**: CONCLUSION AND RECOMMENDATIONS**

8.1 Introduction

In this chapter, the conclusions and findings based on the established primary, subsidiary and other initial research questions will be provided. To be discussed also, as part of the conclusion are the efforts of the IBB to coexist with Islamic financial structures. From the Malaysian and IBB case studies using a content analysis approach of the two banks, it is clear that risk management practices can be reconciled with Islamic banking practices to a certain extent. The extent to which a pragmatic approach is justified, includes a solution that justifies Shari'a compliant rhetoric in discussing specific elements that can be reconciled with conventional banking methods. Thus, the following sections will discuss how components of Malaysian and European banking can be adopted by the Islamic financial model, in order to improve the overall banking structure in Saudi Arabia.

8.2 Malaysian Case Study – Islamic Central Bank and BNM

The Malaysian case study considered the impacts of regulatory reforms on the Malaysian IB sector, which remained well capitalised while remaining largely reliant on debt based (as opposed to equity based) financing.[739] The regulatory and institutional framework for managing and mitigating risks in the Malaysian IB sector was found to be well established and defined, relative to less developed markets in the GCC wherein enforcement-related challenges and inconsistencies of the interpretation of Shari'a restriction on certain modes of financing continue to obstruct regulatory progress.[740] We considered the implementation of Basel rules in Malaysia, highlighting the apparent tension between global banking standards and the regional standards issued by the IBSB, while elucidating the remaining challenges faced by Malaysian Islamic finance institutions in the course of complying with these rules.[741]

8.3 Risk Management Methodologies

We have also shown that a comprehensive survey of empirical findings and data supports the conclusion that many Islamic banking institutions have retained high levels of capital, while

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[739] Ellias, N_264 above.
[740] Meera, N_265 above, 5-30.
[741] *Ibid.*

surviving the worst effects of the global financial crisis. They have done so by adopting two critical strategies: 1) the effective implementation of global capital adequacy thresholds (the bank was well capitalised during the onset of the crisis) and 2) its recourse to standardised methods and criteria for calculating risk weighted assets (to reflect more optimal risk-return trade-offs). These techniques are not unique to Islamic Banking, however. Indeed, these risk management techniques are aligned to regulatory reform measures adopted under the meta-supervisory authority of the global banking regulatory body, the Basel Committee. We believe that the extent to which IBs have been able to minimise or prevent credit risks, relative to CBs, is worthy of greater consideration.

Much is made of the success of Malaysia's IB system but the research does not include the period of the rapid decline of the Malaysian currency during the Asian melt-down of 1997. The research starts somewhat later in most cases. One who had bought Malaysian Ringgit with his or her Saudi Riyals or Emirati Dinars in 1996 would have lost approximately one-third of his investment over the period of 1996 to 1999.[742] If that investment had been in a Malaysian company extracting minerals from neighbouring Islamic Indonesia and the investment been in rupiah, the currency loss would have been 80%.[743]

Nevertheless, as has been demonstrated, the Malaysian IB system is growing – in part because it competes with a non-IB system in the same country dominated by banks owned predominantly by ethnic Chinese interests, including Standard Chartered, a major shareholder of which is the Singapore sovereign wealth fund's Tamasek.[744] The writer infers that there is a race to the top to show that the IB system can compete on roughly equal terms, so that a Muslim investor with a choice will invest in an IB rather than a CB. The figure of the 51% of the Malaysian population who are Muslim has not translated to a 51% share, or even half that, for the IB sector of the entire Malaysian banking system. The figure, however, is better than the loss-making IBB, which as the only retail IB in the UK only achieved a client base roughly equivalent to 2% of the Muslim population of the UK. Losses have also been made by IBB, a bank which was subject to the Basel regulations, of 25% of the value of its

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742 J Sachs, S Radelet, R Cooper and B Bosworth, *The East Asian Financial Crisis*: *Diagnosis, Remedies, Prospects* (Brookings Papers on Economic Activity 1998) 90.

743 T Lane and others (1999), *IMF-Supported Programs in Indonesia, Korea, and Thailand: A Preliminary Assessment* (Occasional Paper 178 Washington DC: International Monetary Fund 1999). Retrieved from http://www.imf.org/external/pubs/ft/op/op178/op178.pdf.

744 R Mogg, *Are Sovereign Wealth Funds a Threat to Australia's National Security?* (Master thesis U.S. Army Command and General Staff College 2008).

deposits.

What lessons can the Saudi banking system learn from this? It is true that the most recent macro-economic shock affecting UK, North America and much of Europe was brought about by the collapse of the sub-prime mortgage market, but that did not affect, for example, the Australians whose economy seemingly sailed through the crisis bolstered by high commodity prices, a fairly isolated banking system and a pro-active government stimulus package. As of August 1st, 2015, the UK and US economies show some sign of improvement, the Australians, struck by weak commodity prices, are experiencing economic difficulties with their currency, which is down by about a quarter against the pound in the last two years. KSA, struck in 2015 both by a budget deficit, which threatens to wipe out the country's entire reserves held at the central bank within six years,[745] is facing a similar shock. The KSA's GDP is growing at only 1.09% and the oil sector to decline by 7.17 percent.[746]

Applying the principles of Shari'a to loans made for infrastructure or even housing in Malaysia or Indonesia in 1997, or in the last 10 years to loans in the UK, Australia or Venezuela would not have protected depositors from loss in those countries. In the first part of this chapter the writer argues for a series of robust internationally accepted standards, which are or can be modified so as to be compliant with Shari'a law, to be introduced to govern Shari'a banking. To some extent these are already part of good banking practice in developed economies, and some pre-date all three Basel accords. This might help protect depositors in KSA, if valuations are calibrated to take account of the parlous state of the Sa'udi economy and in line with the standards previously suggested.

On the other hand, no amount of capital reserves will protect a bank from basically bad risk management – and it doesn't matter what sort of risk it is: if it is managed badly, it will hurt the banking system. If the banking system is built on an incorrect view of future income streams, from which an incorrect view of local economic growth follows, complicated further by corruption and a weak internal regulatory framework, capital reserves alone will not protect against falling asset prices but prudent risk management practices might. In 1987, the incorrect assumptions in Western countries were based on share prices; in 2006, the

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[745] Arab News (25 December 2014) Retrieved from http://www.arabnews.com/economy/news/679501.

[746]Arab News, *King says growth to continue as KSA unveils largest budget,* (27 December, 2014). Retrieved from http://www.arabnews.com/featured/news/679576

assumptions in the USA and the UK were based on land prices, as they were in Dubai in 2008. In 2015 in KSA, they are based on the oil price. The adoption of Basel III capital ratios will only assist KSA if risk management, valuation and corporate governance standards are also rigorously applied.

8.4 Conclusions

To provide pertinent conclusions, it is necessary to present the questions posed at the early portion of the thesis along with the corresponding answers. As mentioned numerous times within the thesis, the primary research question and the main purpose of this research is to find out whether or not Saudi Arabia needs to adopt the risk regulation practices of Basel. This thesis question will be answered upon discussion of the other subsidiary and initial questions posed throughout the study.
To reiterate, the following subsidiary questions were posed:

- Why should Saudi Arabia adopt the risk regulation practices of Basel and other specific jurisdictions risk management practices of the UK and Malaysia?
- Can the Basel framework and other specific jurisdictions risk management practices of the UK and Malaysia be internalized by Islamic financial institutions to solve issues such as the inadequate coordination of financial markets in Saudi Arabia?
- How are the issues of legal secularisation to be reconciled in Islamic models of finance, particularly in Islamic financial institutions?
- How can risk management practices be improved by standardising banking across jurisdictions?
- Can the standardisation of accounting practices and regulatory principles enhance Islamic finance organisations?
- How may one employ a content analysis across the three markets of Malaysia, the Islamic Bank of Britain, and Saudi Arabia to determine which accounting standards and risk management practices from each market are beneficial in improving financial and legal efficacy in Saudi Arabian financial institutions?

Likewise, a specific question that served as root of this thesis was asked, i.e., “Is the IB system of KSA sufficiently robust to survive the eventuation of a credit risk?” Chapter 2 provided the answer to this initial question. It served as premise to the central argument of this thesis. It noted that the term closest to ‘risk’ in Islamic literature is ‘*Gharar*’ and unlike the former, the content of the latter is subject to much uncertainty. It is uncertain whether a transaction imbedded with risk or *Ghārār* would be voidable and not void, depending on whether the party that exposed the transaction to the risk was honest. Therefore, the first obstacle to developing a framework for the standardisation of risk management in Islamic banking is the lack of consensus on what constitutes 'risk.' However, Chapter 2 examined the unique risk characteristics of four modes of financing widely used by Islamic banks and was able to show that Islamic banks are required to give priority to the PLS financing modes and it was shown that these modes carry even more risks.

Furthermore, it was shown in Chapter 3 that banking institutions are exposed to a number of risks with severe and wide-ranging implications for shareholders, investors and stakeholders alike and a large portion of these risks for banking institutions are defined with the Basel framework. Likewise presented are the IBB in Chapter 6 and BNM and BIMB in Chapter 5 which gives us the fundamental data to assess the risks of the Islamic banking institutions.

As such, in answer to the initial question, it cannot be guaranteed that KSA can survive the eventuation of a credit risk. These risks are inherent to the banking system, whether Islamic or conventional. Otherwise, there is no further need to continue with this research. Given that, it is necessary to delve into further analysis of literature to gain answers to the other foregoing questions.

On the question, "Why should Saudi Arabia adopt the risk regulation practices of Basel and other specific jurisdictions risk management practices of the UK and Malaysia," the answer was distributed all throughout the thesis. It was shown that despite the strength inherent among IB systems, it is nevertheless shrouded with risks that may render it unable to survive financial crises. To make improvements in its structure therefore, it can incorporate some of the risk regulation practices of Basel and other specific jurisdictions risk management practices of the UK and Malaysia as provided in the literature analysis and case studies.

These findings lead to the next question, "Can the Basel framework and other specific jurisdictions risk management practices of the UK and Malaysia be internalized by Islamic financial institutions to solve issues such as the inadequate coordination of financial markets in Saudi Arabia?" Chapter 4, after detailing the risk framework of Basel, examined some of the major Islamic financial products to illustrate how Basel risk policy, measurements and regulatory supervision are likely to be significant considerations of Islamic banking policy and management. It was also established in the Chapter that Basel accords are standards that apply to all internationally active banks and thus, include Islamic banks that are connected to the global market place. From the aforementioned literature review and analysis, including the details provided in the preceding sections of this paragraph, it was clearly shown that the Basel framework and other specific jurisdictions risk management practices of the UK and Malaysia be internalized by Islamic financial institutions to solve issues such as the inadequate coordination of financial markets in Saudi Arabia.

The question on legal secularisation and how it can be reconciled with Islamic models of finance, particularly in Islamic financial institutions is answered through the detailed consideration of cases studies conducted on the Malaysian, Saudi and UK banking systems. As to the question on how risk management practices be improved by standardising banking across jurisdictions, various data also from the same case studies, including those in this chapter were provided to explain how this can be incorporated within the IB system.

As regards the question, “Can the standardisation of accounting practices and regulatory principles enhance Islamic finance organizations,” it was first shown that setting standards that would govern the interpretation and implementation of the relevant rules remains an arduous task among IBs. Although the International Financial Reporting Standard (IFRS) has successfully harmonised accounting standards across hundreds of countries around the world,[747] some Muslim scholars and academics claim that IFRS is not suitable for Islamic banking. This is the main reason why the three banking markets were presented and analysed, i.e., to determine which accounting standards and risk management practices from each market are beneficial in improving financial and legal efficacy in Saudi Arabian financial institutions. As literature and the case studies showed, these accounting practices and regulatory principles can be “Islamicised” and permitted by SAC, thus enhancing the Islamic finance organizations through the adoption of Basel standards. The proofs to this claim are shown in Chapters 3 to 5.

In answer to the last subsidiary question, “How may one employ a content analysis across the three markets of Malaysia, the Islamic Bank of Britain, and Saudi Arabia to determine which

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[747] Shafi, Z., and Zakaria, N. (2013) “Adoption of International Financial Reporting Standards and International Accounting Standards in Islamic Financial Institutions from the Practitioners’ Viewpoint” *Middle-East Journal of Scientific Research*, 13(1): 42-49.

accounting standards and risk management practices from each market are beneficial in improving financial and legal efficacy in Saudi Arabian financial institutions," Chapters 5 and 6 provided a complex but comprehensive explanation on how this can be done based on the case studies conducted on the banking concerned systems.

To sum it up therefore, it is clear that the answer to the primary research question, i.e., "Does Saudi Arabia need to adopt the risk regulation practices of Basel," is in the positive. To do so would lead to considerable improvement to the Islamic banking system that can very well prevent highly adverse effects to the financial stability as a whole. The IB system proved its strength when faced with the recent financial crisis but to adopt the Basel risk regulations can enhance its strength and further develop its structure. It is a matter of prevention over cure.

8.5 Recommendations

The following recommendations are based not only on the foregoing analysis and findings but also on other pertinent issues that were not given further focus and analysis in this thesis:

a. That risks being managed in accordance with ISO 31000, and that full disclosure in accordance with the Basel requirements be made by every enterprise seeking to borrow money in KSA.

b. That the directors and managers of every enterprise in KSA which borrows money from a bank be personally liable in a Shari'a compliant manner for funds which are mismanaged, stolen, or use other than in accordance with prudent business management practices. That such persons not be able to evade responsibility on the basis that they do not have day-to-day supervision but as directors have only general management duties.

c. That no funds be advanced to a corporation within KSA which does not have an effective corporate governance strategy.

d. That absent a uniform Shari'a supervisory council ruling, representatives of the SACs of each country prepare a Shari'a best practice manual. Where best practices cannot be agreed upon, national variations be allowed, with the manual detailing a summary of the justifications for each.

e. That to the extent allowed by Shari'a, each SAC include, in each fatwa, the reasons or justifications by which that resolution was arrived at or achieved.

f. The risk-weighted capital adequacy ratio for an Islamic bank should be higher than ratio (of at least 8.5 percent) set by the Basel II because of specific reasons inherent to the operation of Islamic banking, as well as more general reasons that are part of the high-risk environment in which most Islamic banks operate.

g. An appropriate risk-weighting structure for an Islamic system should have the *Mudarabah* contracts carrying the highest risk weight, followed by the two other main PLS modes, namely *musharaka* and direct investment. The lowest risk weight should be assigned to the non-PLS modes fully secured by a mortgage. All the other non-PLS modes should be assigned a risk weight somewhere in between the lowest *one in th*e system and the one assigned to Musharaka and direct investment.

h. Unrestricted accounts shoul*d carry t*he same risk weighted assigned by Basel II *of 100%*. This creates the need to establish an institution that would help set regulatory standards an*d a frame*work for supervisory oversight for Islamic financial institutions.

i. There will also be the need *to train* Islamic financial institution regulators *and super*visors within KSA for developing effective internal ri*sk manage*ment, rating and control system*s and app*ropriate corporate culture in these banks. This will, *in turn*, improve the external rating of these banks and help them not only in utilising their equity capital more efficiently but also in enhancing their *growth an*d stability.

These recommendations come as a conclusion to what was discussed in Chapter 4. *The level*s of the indicators that the Islamic financial institutions must meet have to be a little higher than in Western banks because of the characteristics of the region. Also products specific to Islamic banking, such as *mudarabah* and *musharaka* have to be identified for the high risk they pose to a financial institution and calculated accordingly when the risk exposure of a company is estimated.

8.6 Other General Conclusions

It should be possible for a group of bankers to run a banking system which does not rely on theft or fraud, putting other people's money into their own pockets, lies or deceit. It should be possible for the operators of a banking system to live up to their ideals, so that when they say that this system and the products comply with an ethical standard they can be believed. It is said, but it has been demonstrated in this thesis, that this is not the case, without strong oversight and rigorous risk management and reporting standards. Transparency is an important tool in the management of risk. It is a lot harder to mismanage or steal when one is under the public eye than when one is not.

Indeed, Shari'a is meant to be such a dynamic process. The fact that there is no bankruptcy code does not mean that people do not incur debts. Whilst on the topic of developments in Shari'ait would be of great assistance if banks who sought Shari'a certification for financial products did so in a standard and transparent way, which fully complied with requirements of Shari'a. Indeed, ensuring this should be the duty of every member of a Shari'a advisory board. However, as our early Jurists say, no two people are alike: just as their faces differ so their thinking greatly differs.[748]

There are many approaches taken by members of a Shari'a advisory board in order to ensure that the banking products under their certification comply with the Shari'a guidelines. Some deem the high-road approach to the relationship the better whilst others look for a more collaborative relationship.

Similarly, there are a few significant and some subtle variations between different members of Shari'a advisory boards, and different boards, and their attitude towards innovations in Shari'a. Some will evaluate the Shari'a, confer with other scholars, possibly from other boards or countries, and debate the issues and make a decision to follow a path that is loyal to Shari'a and its traditional process, whilst others will simply consult whoever they deem to be the senior and respected scholars they follow.

With regard to the risk of the Fatwa process, it is important to understand that there is always a reference to the Qur'an and usually together with a reference to a Hadith, and sources are quoted, as are opinions of modern and ancient scholars. However, there is a significant risk that differences emerge as to whether the arguments are presented in terms that are favourable to the customers of a bank or to both depositors and borrowers. In order to mitigate this risk, the customers, depositors and borrowers should be able to ask, evaluate and question the substance of the Fatwas, so that each party is certain of their duties for Shari'a compliance on the deposit or the loan. Further, the scholarship of scholars ought to be transparent, so that individuals can distinguish on whose fatwa they are relying: how knowledgeable is this person, how learned and experienced is this person, and how did this

[748] Book of the Jews, Proverbs 27:19. If one face cannot reflect another face, one thought cannot reflect another thought; yet all are made in a Divine Image, and this is pre-ordained by Allah.

person (or body of persons) reach this decision?[749] These recommendations, we hope, will help to ensure that the Fatwa process is not mired in arbitrary actions.

8.6 Summary

In this chapter, we have shown highlights of how the Malaysian banking system operates with brief illustrations of the Central Bank and a private bank, BNM, with the general point being that Malaysia Islamic banking sector has grown dramatically and currently successfully includes 51 percent of the population. This means that a majority of the population have chosen to invest Islamic banks over the large incumbent Chinese conventional banks. We have also discussed that while UK is regulated under the FCA and the Basel Accords, which evidences central bank ***de jure*** risk controls that are rigorous, the Islamic IBB Bank suffered a 25 per cent loss to its investors and depositors. These losses showed that banking regulation no matter how rigorous is not sufficient to protect against management risk at an Islamic bank. These two case studies provide numerous lessons that Saudi Arabia may take advantage of including but not limited to taking up the positive coordination and guidance of central authority and the private market in the Malaysian example and avoiding the rather hands off approach of the UK. By incorporating the lessons of the two cases, we hope that the Saudi Arabian Islamic sector may continue to improve economically with increased transparency and enhanced customer participation. More importantly, this chapter provided the answers to all the research questions posed throughout the thesis based on the analysis of literature and the corresponding findings.

[749] The Post/Ha-Do'ar 42:39 Jerusalem/Al Quds, (27 September 1963), 752-9

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