Basel II and Regulatory Framework for Islamic Banks

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[Abstract: *The unique nature of Islamic banking requires regulators to evaluate related risks and benefits. Even though Islamic banks offer profit and loss sharing accounts and therefore expose limited risk of insolvency, systemic risks still exist and deserve much attention. We discuss these risks in terms of different types of account holders, credit customers and economic system as a whole. The problems faced by financial systems to integrate Islamic banking and our suggested remedies are the main focus. Deposit insurance schemes for Islamic banks are an issue of recent academic debate. On the one hand, it helps the competition with conventional banks and brings financial stability. On the other hand, it is objected due to religious concerns. Regulation should be keen to both sides of the debate. The nature of different types of accounts becomes the center of the issue. High ratio of current accounts and their utilization with the profit and loss accounts require regulatory concern. Investment account holders' rights within the organization compared to equity holders is another regulatory concern. The risks associated with Islamic credit transactions, their illiquid nature, lack of lender of last resort and inability to utilize short term money markets are some of the risks that do not exist for the existing financial intermediaries. Basel II introduces a new approach to evaluating credit risk. Although the scope of Basel II does not include Islamic banks, the new models of credit risk rating introduce compatibility for Islamic banks. To maintain financial stability and control risk, regulators should ensure that international regulations such as Basel II should be adopted by Islamic banks. Such regulation will also help Islamic banks to be able to compete internationally and enjoy privileges of compatibility.]*

1. Introduction

The main difference between Islamic banks and conventional banks is the exclusion of interest. While the operations of Islamic banks seem similar to those of conventional banks, there are major differences. Llewellyn (2001) lists these as; the mix of contracts on the liabilities side of the balance sheet, the quasi-equity nature of investment deposits implying that some depositors share in the risk of the bank, a wider variety of modes of financing and asset mix of banks, and the risk sharing characteristics of the contracts issued and who bears risk.

In terms of deposits collected, Islamic banks collect deposits in two forms, current accounts and investment accounts. Current accounts are very similar to those available at conventional banks with the exception of any interest. It is usual for conventional banks to pay some but very little interest to current accounts. Islamic banks do not pay interest to these accounts at all. The services provided other than interest is very similar between the two types of institutions. Investment accounts, however, are very much different. Conventional banks offer time deposits and promise a fixed rate of return. The principal and the interest are guaranteed by the bank and any bank failure is insured by the deposit insurance schemes. Investment accounts at Islamic banks participate to the risk of investment with these bank. Any profit or loss accumulated through these accounts is passed on to the account holders. Thus the amount of profit is not promised and there is a chance of loss of principal. Deposit insurance in Islamic

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banks protects the current accounts where available but not the investment accounts. Investment account holders at Islamic banks are vulnerable to bad investment decisions and banking failures including misconduct.

The differences also exist for credit transactions. Conventional banks collateralize any utilized credits whereas some of the Islamic credit instruments cannot be collateralized at all. Murabahah and ijarah transactions are similar to trade-financing and operational leasing transactions at conventional banks, respectively. Therefore the risks posed to customers and to the bank are similar in nature. Such risks are considered low relative to equity participations. Musharakah and mudarabah partnerships in Islamic banks are transactions where collateralization is not possible. Although any participation of Islamic bank is secured with the assets of the partnership, any liability thereof is also participated by the Islamic bank. Such liability is the responsibility of the Islamic bank alone in mudarabah transactions and shared with other partners in musharakah transactions. The fact that Islamic bank has no management rights in mudarabah partnership makes it vulnerable to associated risks. Managerial rights in musharakah transactions require corresponding managerial skills that result in associated risks. Any risks through equity participation of Islamic banks are also passed on to the investment account holders. Therefore any failure or mismanagement on the Islamic bank and on the partnership directly results in losses.

In the early stages of the Islamic banking, equity participation was the primary credit utilization methodology, whereas today such participations constitute a very low percentage of the assets (about 6.0 % and 19%)(Chapra and Khan, 2000). Such trend is due to several reasons. The main reason is the fact that Islamic banks operate within interest bearing economies and compete with conventional banks. All regulatory framework and supervision is directed towards products of conventional banks. Instruments such as murabahah and ijarah are more convenient to utilize within these circumstances. Also, the risk level associated with equity participations makes Islamic banks very conservative in terms of project selection and creates a tendency towards trade related instruments (Chapra and Khan, 2000).

Despite the differences, Islamic banks have many similarities with conventional banks. They conduct financial intermediation. Except for Sudan, Iran and Pakistan, Islamic banks compete with conventional banks. These countries include: Algeria (1), Bahamas (1), Bahrain (7), Bangladesh (3), Brunei Darussalam (2), Egypt (2), Indonesia (1), Iran (12), Jordan (2), Kuwait (1), Malaysia (2), Pakistan (3), Qatar (2), Saudi Arabia (1), Sudan (13), Tunisia (1), Turkey (5), United Arab Emirates (3) and Yemen (2). The importance of Islamic banks within each economy that they coexist with conventional banks is provided in Table 1.

Table 1 Selected financial figures for Islamic banks and for conventional banks for the 19 countries where Islamic banks operate

(Thousand of US Dollars)	Year	Total	Total	Total	% of Market	% of Market
Number of Banks		**411**	**64**	**347**	**15.57%**	**84.43%**
		All	**Islamic**	**Conventional**	**Islamic**	**Conventional**
Loans	2002	505,383,319	58,564,690	446,818,629	11.59%	88.41%
Loans	2001	497,606,526	69,300,868	428,305,658	13.93%	86.07%
Loans	2000	495,145,769	116,638,461	378,507,308	23.56%	76.44%
Loans	1999	449,567,899	96,120,001	353,447,898	21.38%	78.62%
Fixed Assets	2002	19,715,333	2,773,090	16,942,243	14.07%	85.93%
Fixed Assets	2001	19,720,726	3,510,021	16,210,705	17.80%	82.20%
Fixed Assets	2000	17,847,920	6,758,194	11,089,726	37.87%	62.13%
Fixed Assets	1999	16,939,848	5,861,634	11,078,214	34.60%	65.40%
Total Assets	2002	1,126,695,543	132,135,866	994,559,677	11.73%	88.27%
Total Assets	2001	1,114,631,294	149,229,165	965,402,129	13.39%	86.61%
Total Assets	2000	1,095,932,093	223,272,903	872,659,190	20.37%	79.63%
Total Assets	1999	993,367,109	177,700,412	815,666,697	17.89%	82.11%
Customer & Short Term Funding	2002	934,003,534	113,246,918	820,756,616	12.12%	87.88%
Customer & Short Term Funding	2001	921,927,397	124,025,964	797,901,433	13.45%	86.55%
Customer & Short Term Funding	2000	873,399,971	167,403,328	705,996,643	19.17%	80.83%
Customer & Short Term Funding	1999	802,595,458	125,042,571	677,552,887	15.58%	84.42%
Equity	2002	106,358,733	11,194,457	95,164,276	10.53%	89.47%
Equity	2001	97,029,410	10,664,704	86,364,706	10.99%	89.01%
Equity	2000	88,103,263	13,286,790	74,816,473	15.08%	84.92%
Equity	1999	70,147,503	9,027,731	61,119,772	12.87%	87.13%
Net Income	2002	15,558,691	2,300,606	13,258,085	14.79%	85.21%
Net Income	2001	4,075,413	1,542,070	2,533,343	37.84%	62.16%
Net Income	2000	11,589,934	2,209,955	9,379,979	19.07%	80.93%
Net Income	1999	-1,051,917	1,078,110	-2,130,027		

Source: Bank Scope Database, Bureau van Dijk, release 165.2, update April 2004.

Islamic banks account for the 15.57% of the total market in terms of number of banks. 11.73% of the total assets belong to Islamic banks. Similar percentage holds for loans and customer & short term funding figures.

The asset and liability structure of Islamic banks is unique. The risks exposed to each stakeholder of Islamic banks are also unique. The main concern is the fact that such unique structure may require a different type of regulation and supervision. It may be argued that as long as investment deposits are participating in the risks, Islamic banks should not require banking regulation. However, regulation of banks is needed for many reasons (Chapra and Khan, 2000): lowering systemic considerations, protecting current account holders, ensuring compliance with Shari'ah, and securing a place for Islamic banks accepted in the international markets.

As long as Islamic banks operate as financial intermediaries they will pose systematic risks to the entire financial system. Authority to collect deposits is a privilege given to conventional banks and to Islamic banks only. Any failure to meet depositor demand will result in systemwide consequences. Therefore, Islamic banks as deposit collecting institutions, expose systematic risk to the economy overall.

Only the investment accounts participate to the investment risks of Islamic banks. Current account deposits are kept at Islamic banks for safekeeping. They are guaranteed and do not earn any return. Therefore they should be kept out of any investment activity. However, “In some Islamic banks these accounts constitute more than 75% of total funds under management” (Khan and Ahmed, 2001). It is a natural result that Islamic banks combine these accounts into investment pools. Of course, the Islamic bank would assume any profits or losses arising from the utilization of such accounts within investment pools. The problem is that the amount of loss may exceed the amount of equity within the Islamic bank and may force to dip in to deposits. Therefore, current account holders should be protected against risks that they do not want to be exposed to.

Islamic banks perform their operations in accordance with the rules and regulations of their domicile. They also comply with Shari’ah regulations as much as possible. Islamic banks are expected to provide acceptable returns, safe banking environment and Shari’ah compliant instruments to customers. Although Islamic banks may claim full compliance with Shari’ah, regulation and supervision should be enforced inline with customer expectations.

The aim of this paper is to discuss the regulatory and supervisory framework for Islamic banks in line with suggestions of Basel II. Section 2 of the paper explains the unique risks exposed by Islamic banks to different stakeholders. Section 3 discusses the internal and external auditing issues related to Islamic banks. Section 4 is about supervision over Islamic banks with special emphasis to Fiqhi issues and explains the required regulatory framework in line with Basel II. The final section explains the problems associated with current regulatory regimes and their effects on Islamic banks.

2. Risks posed by Islamic banks

2.1Financial system

Unique financial instruments of Islamic banks carry unique risks for different stakeholders. However, inability to utilize money markets makes Islamic banks more susceptible to liquidity risk. Inexistence of markets that trade Islamic products or lender of last resort for Islamic banks require them to keep higher levels of liquidity. Inability to borrow for short term needs makes them vulnerable to deposit withdrawals. For such reasons, Islamic banks should keep liquidity levels that are higher than conventional banks.

It should be considered that any liquidity carried by Islamic banks does not earn any yield. Instead, they are kept either as cash or as deposits with other banks including the central bank. On the other hand, conventional banks' liquid assets portfolio includes marketable securities and earns some yield. Therefore, the trade-off between profitability and liquidity becomes more troublesome for Islamic banks. The tendency to keep lower liquidity exposes additional risks for the financial market overall. Any withdrawal runs in Islamic banks will result in similar tendencies for other conventional banks. Marketwide reactions by deposit holders will be inevitable. Table 2-1 shows the liquidity levels for conventional and Islamic banks. Considering the fact that Islamic banks do not have any other resort to get short term financing, the difference between conventional and Islamic banks are very small.

Table 2 Liquid assets/Customer and short term funding for Islamic and conventional banks

Year	2002	2001	2000	1999
Islamic Banks	35.33%	54.65%	49.43%	39.71%
Conventional Banks	37.86%	43.38%	41.76%	43.74%

Islamic banks are also very susceptible to the risk of withdrawals for many reasons that are unique to Islamic banking products. Instruments such as murabahah, ijarah, salam, and istisna have fixed payment schedules with mark-up rates that compete with interest bearing financial instruments. Therefore, Islamic banks' credit portfolios are susceptible to any market changes. As a result any profits distributed to investment accounts may be different from those paid to time deposits of conventional banks. Such differences may result in customer withdrawals, and Islamic banks do not have any control over it. As a result Islamic banks are exposed to market risks and withdrawal runs. It is possible for Islamic banks to employ profit stabilization techniques by lowering the percentage of profit paid to shareholders on investments and increasing the profit share of investment accounts. Such practices, however, have effects within markets where fluctuations are limited within a certain range.

Islamic banks also pose systemwide risks to Islamic banking *per se*. Any failure of an Islamic bank will result in loss of public confidence towards Islamic banking overall. Also, failure in terms of financial or in terms of compliance with Shari'ah will result in questionable banking practices of the sector. Considering the fact that most of the customers of Islamic banks prefer Islamic banks because of their compliance with Shari'ah and any misconduct may cause loss of customers. Therefore, it is imperative for Islamic banks to be regulated in terms of Shari'ah compliance.

2.2 Current account holders

As mentioned earlier current account holders of Islamic banks should not be exposed to any risk. Such funds should not be bundled within investment pools. They should be insured against bank failures. Since illiquid banks cannot meet withdrawal demands, some sort of deposit insurance may be established for current accounts, as long as such funds are not bundled with investment accounts. Extending deposit insurance to current accounts swaps the provider of insurance with current account holders and requires appropriate regulation and supervision.

The risk that current account holders are exposed to is the risk of bank failure. The greater risk, however, is the fact that current accounts are bundled with the overall investments. Excluding them from investments, on the other hand, will affect the profitability of Islamic banks in great respect. Capital adequacy measures should include safety nets for any losses that may be due to investment of current accounts.

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI, 1999) suggests a formula for the capital adequacy ratio: $CAR = OC / (W_{OC+L} + W_{PLS * 50\%})/$, where CAR is the capital adequacy ratio, W_{OE+L} is the average risk weight of assets financed with the Islamic bank's own capital and liabilities other than investment accounts, W_{PLS} is the average risk weight of investment accounts. AAOIFI requires the CAR to be equal to 8 percent.

Another concern for current account holders is the fact that these accounts should receive a compensation for their invested funds. As long as these funds are used to finance investments and associated with risks, they should be receiving their share of the profit. Any claim in profits should bring distribution of loss with it. However, involuntary utilization of funds should entitle them only to profits and not to the losses, much like a bonus scheme.

2.3 Investment (profit and loss sharing) account holders

Investment account holders participate directly to any profit or loss earned from investments. That is why these accounts are called profit and loss sharing (PLS) accounts. PLS accounts do not receive any guarantee for their return and for their principal. The performance of the Islamic bank is directly reflected upon these accounts. Therefore, treatment of these accounts in terms of risk should receive special attention.

As far as the capital adequacy is concerned, AAOIFI (1999) suggests that the risk weighting for PLS accounts should be 50% for capital adequacy measurement. Hassan and Chowdhury (2004) argues that the 50% risk weighting of AAOIFI should be increased to 100% due to following reasons:

1. It is necessary to have higher capital requirements for Islamic banks to be accepted within the international financial markets.
2. Increased ratio will provide extra safety net for current accounts.
3. Higher capital will promote confidence for less diversified asset portfolios of Islamic banks.
4. Higher capital is needed to provide protection for current and PLS account holders against equity participation credit instrument that bears higher risk.
5. Higher capital is needed for availability of collateral for default cases.

It is therefore necessary to provide protection to all investment funds whether they are financed by PLS accounts or current accounts. It is also suggested to have a separate capital adequacy measure for current accounts and PLS accounts (Khan and Ahmed, 2001, Chapra and

Khan, 2000). However, capital adequacy should measure the risk exposed to utilized investment funds. Considering the magnitude of current accounts within investment accounts, treating them differently from PLS account may result in lower capital allocation for current accounts.

2.4 Partnered businesses

Islamic banks pose risks to businesses that are provided with Mudarabah and Musharakah facilities and vice versa. Any associated risk arising from partnered businesses will be reflected upon the Islamic bank. The issue is more complicated than currently regulated and the main required difference for Islamic banks lies in this respect. Although indirect risks also exist for conventional banks, they are more vital for Islamic banks, especially for equity participation facilities.

Islamic banks establish partnership schemes through mudarabah and musharakah facilities. They are becoming susceptible to any associated risks that may arise from operations of such partnerships.

Any foreign exchange exposure that a partner company assumes will become the foreign exchange exposure of the Islamic bank. For instance, assume that the partnership imports a product from a country and the transaction is denominated in US Dollars. The partnership wishes to sell the product in its domicile with the local currency. The partnership may undertake such transaction with a murabahah and foreign trade financing. The Islamic bank as a partner will be exposed to foreign exchange risks associated with the trade. It will also be exposed to foreign exchange risk through murabahah transaction. Although the Islamic bank treats them as separate transactions and allocates different risk weights, it is still the same exposure. The Islamic bank may lose as a partner and as a bank undertaking the murabahah. Inability to make a loan repayment due to unexpected changes in foreign exchange rates is also the concern of conventional banks, but their repayments are collateralized.

Same concerns arise in terms of unsystematic risks. The line of business of the partnership may face difficulties and may result in business specific losses. Islamic banks may not have any control over the problem. For instance, assume that the partnership deals in marine construction. If the government starts promoting marine construction in other parts of the country, then any investment made to date may become obsolete.

Since Islamic banks are susceptible to business specific risks and risks arising from direct equity participations, supervision and regulation may have to be extended to partnered companies. In practice, the number of companies that each Islamic bank involves with makes such proposal unrealistic. However, the fact is, all investment and current account holders become partners in companies that Islamic bank is a partner to. Therefore, they have a right to evaluate each partnership. Considering the fact that current accounts are protected by the deposit insurance schemes where available, they may be excluded. However, inexistence of deposit insurance schemes exposes them to investment risks without any compensation and their right for extended transparency should not be limited. The same situation applies to stock exchanges where stockholders become partners in companies through stock purchases that they make with the intermediation of stock exchanges. Although such direct ownership is not the case for Islamic banks and investment deposit holders, an indirect partnership exists. Also, similar situation applies to mutual funds and closed end funds.

Similar transparency requirements should apply to partnerships of Islamic banks The same analogy can be extended to include the regulatory framework and include supervision of capital markets board as a supervising authority for Islamic banks. Therefore, although Islamic banks are not mutual funds and they are not stock exchanges, the fact is that their operations are similar to those in terms of intermediating equity participation. This results in the application of appropriate regulation to Islamic banks' equity participation operations.

3. Internal and external rating

Chapra and Khan (2000) explains the external rating of businesses and banks as an important aspect for Islamic banking. They also explain the need for Islamic rating agency. The unique products and procedures of Islamic banks require specialized rating process. Such process should include specialized models and rating systems designed in accordance with Islamic banks and associated risks. Basel II proposes internal ratings based (IRB) approach for banks to differentiate their risk measurement systems. Equity participations are also handled differently under IRB approach. Islamic financial instruments such as mudarabah and musharakah benefit from such special treatment. Model-based approach under Basel II also provides flexibilities for banks to allocate risk measurements and credit rating for portfolios of similar risks. However, banks need necessary infrastructure and model descriptions for variety of risks. To generate a standardized risk measurement system, Islamic banks will also require extensive resources and enough experience in various types of risks to draw upon.

It is imperative for Islamic banks to have an external rating for their operations and for their credit portfolios. As part of transparency efforts, it may be easier for Islamic banks to have an internal rating scheme. Combined with external rating, the achievement would be to ensure transparency without sacrificing sensitive information. It is argued that, by providing detailed information about credit portfolio, Islamic banks are providing information that earns them competitive advantage. Also, not all of the stakeholders are able to understand the complexities involved in financial statement analysis. Therefore, any transparency in terms of credit portfolio may not achieve the desired result. On the other hand, external rating will produce a rating for the Islamic bank and its credit portfolios that is on a relative basis. Such rating may be used for comparison purposes.

However, it is imperative for Islamic banks to be rated according to procedures designed for Islamic banks. Rating procedures designed for conventional banks will not include risks that are unique to Islamic banks. Rating schemes are needed to include musharakah and mudarabah transactions. The issue of collateralization should also be incorporated within the rating scheme. Although, credits utilized through equity participations may seem uncollateralized, the stake at the assets of the partnership and their valuation should be an integral part of the rating system.

Islamic banking is a concept that needs much research and development. While many scholars adopt studies of conventional banking into Islamic banking, rating is one of the areas, such adopting may be limited. It is ideal that Islamic banks become more active in Mudarabah and Musharakah transactions. The evaluation process of such partnerships is a major factor that keeps Islamic banks away from them. One company who is in the market for credit may want to shop for terms and conditions, which mean many Islamic banks have to allocate precious time and resources for a project that may not be worthwhile. The credit customer may be a very valuable credit customer but the new project may not be. An external rating process designed to evaluate projects and potential partners for Mudarabah and Musharakah transactions would expedite the process. A rated company with a rated project may be able to shop for terms and conditions of different Islamic banks. Credit committees may be less reluctant to enter into such partnerships. While each Islamic bank would have its own criteria, an external rating scheme may be used for shortlisting projects for evaluation. Islamic banks may also be able to construct syndications for large size credit risks.

4. Regulation and supervision over Islamic banks

Hassan and Chowdhury (2004) lists the reasons for regulation and supervision for Islamic banks. These reasons that may be different from regulation necessities for conventional banks arise from the nature of Islamic banking products. To operate a system, which is designed for interest bearing instruments, brings many complexities and these are reflected on the stakeholders of Islamic banks. The regulation and supervision should aim to protect the right of each stakeholder.

Current account holders are exposed to investment risks. The losses on investments may deplete the capital and may force Islamic banks to default on their liabilities. The same risk applies to investment deposits but since they participate to risk directly, their concern is centered on the capital level of the Islamic bank and on the regulation of Islamic bank in terms of misconduct and excessive risk. Such regulation is necessary for Shari’ah compliance as well.

The financial system should also be protected against systemic effects of Islamic banks’ withdrawal runs. Since investment funds are financed with PLS accounts, current accounts and equity, and since PLS accounts and current accounts can be withdrawn at any time, Islamic banks are susceptible to the risk of withdrawals. Such susceptibility creates a systemic risk and proper regulation should be enforced.

The Islamic banks coexist with conventional banks within financial systems designed for interest bearing instruments and conventional banking. This is reflected upon the Islamic banks as a competitive disadvantage. Islamic banks suffer from application of such rules and regulations, and require tailor made regulation for their unique products. Suggestions of AAOIFI and Islamic Financial Services Board (IFSB) should be integrated into local regulations, and Islamic banks should be regulated accordingly. Any incompatibility will result in risks exposed to Islamic banks to financial system by Islamic banks. The inexistence of lender of last resort for Islamic banks is an important aspect and should be integrated into the banking systems.

Centralized supervision should be achieved for Islamic banks for several reasons. The products and procedures of Islamic banks should be standardized. The internal and external rating facilities should be standardized. Shari’ah compliance of Islamic banking products should be standardized. Fiqhi issues related to Islamic banking should be resolved by a centralized supervisor. Such centralization is likely to raise overall efficiency.

Transparency for Islamic banks requires regulation. Hassan and Chowdhury (2004) explain the reasons for improved transparency:

1. Islamic banks established international operations and these are subject to different regulations. Such operations also expose Islamic banks to extended international risks.

2. Banks expanded their activities outside of their traditional domain.
3. Banks increased the number of sophisticated financial products.

Compliance with Shari'ah also carries great importance for Islamic banks. The reason for existence for Islamic banks is to offer Shari'ah compliant products. While each of the products should comply with Shari'ah, the bank overall should comply as well. The fact that customers of Islamic banks expect Shari'ah compliance, regulation should be extended to check for such compliance. Standardized Fuqua and centralized Shari'ah boards will help standardized operations between Islamic banks and increase public confidence.

Within the last decade, there have been more conventional banks who wish to provide their Muslim customers with Islamic banking products. It is also common for international financial intermediaries to provide Islamic banking products for Islamic banks. The common procedure is to facilitate an Islamic banking window or Islamic banking section. While legal entities do not have religion, it is not common to hear an Islamic bank to offer non-Islamic banking products through non-Islamic banking windows. This is because the shareholders, employees and customers have certain expectations from the Islamic banks. Islamic banks face many challenges to survive side by side with conventional banks. There are many costly steps taken to comply with Shari'ah. Keeping liquid assets as cash without any interest earning is just one of these costs. There are many conventional banking products that are not offered to Islamic banking customers. The system overall has associated costs. It may not be possible to disintegrate operations from each other in terms of costs and returns. When an Islamic bank calculates the return that it will distribute to deposit holders, all the costs, including costs of Shari'ah compliance, are integrated. A process of credit utilization cannot be stripped from associated support facilities. Doing so would be unfair competition. Therefore, in terms of compliance with Shari'ah, conventional banks that offer Islamic products through specialized windows should receive special attention. It is, therefore, imperative that Islamic windows of conventional banks keep their Islamic operations totally separate from their conventional banking operations. It is better to have separate branch with independent accounting system to run such Islamic banking operation by the conventional banks.

In terms of accounting standards, Islamic banks follow the regulations of their domicile. Application of International Accounting Standards (IAS) is possible if IAS is accepted throughout their countries. In addition to IAS, standards prepared by AAOIFI should be implemented to the accounting framework. Accounting standards prepared specially for Islamic banks will provide better accounting practices that are in line with Islamic financial products. They will also ensure reliability of financial statements and comparability.

"Regulation is necessary to ensure economic stability and better banking performance, but it should not cross the limit. That is, the regulation should be cautious and balanced one and it should not exert any undesirable influence of grave consequences on the economy and banking arena." (Hassan and Chowdhury, 2004).

Llewellyn (1999) lists the economic rationale for regulation and supervision in banking and financial services: potential systemic problems; correction of market failures; need for monitoring financial firms; the need for consumer confidence; potential grid lock with associated adverse selection; moral hazard associated with safety net arrangements; and obtaining a degree of preference for assurance and lower transaction costs.

Hassan and Chowdhury (2004) maintains the systemic issues as central to the banking regulation. This is because: the pivotal positions of banks in the financial system; the potential systemic dangers resulting from bank runs; the nature of debt engagements; and the moral hazard associated with safety nets. They also suggest regulation to be viewed in the wider context of a regulatory regime. The suggested regime has seven core components: rules by regulatory agencies, monitoring and supervision by official agencies, incentive structures faced by regulatory agencies and banks, role of market discipline, intervention arrangements, role of corporate governance arrangements; and accountability arrangements for regulatory agencies. Some of the reasons for suggesting regulation to be viewed in a wider concept, as a regulatory regime are: regulation may be inflexible and monopolistic; alternative routes to regulation may be cheaper; prescriptive regulation is not effective to reduce bank failures; regulation may impair other mechanisms for financial stability.

4.1 Regulatory issues pertaining to Basel II

"Basel II also requires Islamic banks to meet legal and regulatory standards as specified in Basel II. Some opine that Islamic banks should not be subject to all regulatory measures specified by Basel II, but they should be subject to regulations similar to corporations due to the participation of the investments depositors in the risk of Islamic banks" (Hassan and Chowdhury, 2004). There are several reasons for Islamic banks to comply with the Basel II regulations. Islamic banks are at the early stage of growth and their sizes are normally small to medium. In order for them to gain international recognition, Basel II compliance becomes a cornerstone. Also, as long as AAOIFI and IFSB suggestions can be added to the Basel II, the regulatory framework will bring standardization for Islamic banks.

The new Basel regulatory framework aims to establish greater market discipline which is necessary for the stability of international financial system. It is also required for the purposes of leveling the field. Chapra and Khan (2000) suggests that the Islamic financial system realize this by participation of the risks by the banks and the depositors, directly or indirectly. "Such a sharing of risks should help motivate depositors to choose carefully the bank in which they place their deposits and to demand greater transparency in the affairs of the bank they choose." (Chapra and Khan, 2000).

Promoting market discipline through greater transparency and disclosure is suggested as the third pillar of Basel II. Six categories are identified for financial disclosure and transparency: financial performance, financial position, risk management strategies and practices, risk exposure, accounting policies and basic business, management and corporate government information (Hassan and Chowdhury, 2004).

The interrelation of different financial institutions also brings challenges. Regulation of commercial banks, investment banks, insurance companies and mutual funds were traditionally done separately. "To protect the soundness of each sector and its positive role in enhancing the soundness of the financial system, inter-sector activities are prohibited." (Chapra and Khan, 2000). However there is a tendency to merge regulatory frameworks to include wider range of financial institutions such as Financial Services Authority of England. Basel II regulatory framework suggests supervision in line with such developments. Inclusion of Islamic banking will further enhance the Basel II applications and will bring international recognition to Islamic banks. The nature of different Islamic products is that they are similar to those of conventional banks, mutual funds, leasing companies, venture capital companies and risk participation companies. Such unique financial structure is very much in line with the international trend and Basel II.

5. Problems with regulatory framework in terms of Islamic banking

5.1 Deposit insurance

Deposit insurance is a concept in conventional banking that is widely used. In fact most of the regulatory framework is designed to include deposit insurance schemes. Supervisory authority protects the rights of deposit holders through insurance. Islamic banking does not provide such insurance and therefore poses more risk to deposit holders. The supervisory authority should be concerned about deposit holder rights as much as systemic risks.

5.2 Current accounts

Current account holders make deposit for the safekeeping of their funds. Islamic banks usually bundle these funds to make investments. Islamic banks take risks without the consent of current account holders and make profit. In turn, these profits are not distributed to the account holders. If these funds are spread through other deposit pools, then the profits are distributed to investment deposit holders. If these funds are invested separately then the profits are left for the Islamic bank and therefore the shareholders. Considering the risk involved with current accounts without the consent of deposit holders, supervisory authority should seek insurance for current accounts. The issue of profit rights of current accounts is an issue of Fuqua and should be resolved.

5.3 Profit and loss sharing accounts

Islamic banks provide credit participations with the funds invested by profit and loss sharing deposit holders. Their representation within the Islamic bank’s decision process is an issue for supervisory authority. The participation of investment account holders to management process and become an active stakeholder may not be feasible in practice. Their representation within the board of directors may become cumbersome. Considering the number of investment account holders will raise the question of who will do the representation. An external representative may be appointed or regulatory authority may hold a seat at the board of directors for the purpose. Supervisory authority may appoint a member to board of directors to represent investment deposit holders.

Pooling of deposits is a usual practice of Islamic banks. The ideal process for Islamic banking to match the deposits and credits is to assign each deposit to a credit issued. However, in practice, this is not possible. Even the maturity structures cannot be matched perfectly. The deposit holders will always want the shortest maturity for the highest return and credit utilizing customers will always want to have the longest maturity for the lowest cost possible. Thus, the Islamic banks have to pool the funds into maturity segments. When an application for a credit is processed, appropriate pool is selected for the utilization. Pooling may also be done to match the currency denomination matching. The problem arises with the fact that returns to each pool may be adjusted by changing the percentage of profit that is assigned for the Islamic bank and shareholders. Islamic banks earn their living from their share of returns. It is up to the Islamic bank to change the ratio of its share in favor of the deposit holders as long as shareholders consent to such sacrifice. Such methodology may provide steady returns but it brings regulatory problems. If shareholders have consent to sacrifice their share to provide better returns to deposit holders, it is for the sake of enhancing Islamic banking. But if such reduction is done among different deposit pools with different degrees, then rights of deposit holders are violated. Such violation should be under supervision of the regulatory authority on behalf of deposit holders. Regulatory authority should control for the methodology.

Investments have the tendency to lapse to medium to long term. Islamic banks try to match different maturity structures of deposits and credits. In case of withdrawals, Islamic banks cannot call the credits like conventional banks do. They cannot borrow money from money market as well. Thus, Islamic banks face unmatched maturity related liquidity risk. The maturity structure of PLS accounts should be regulated. For instance, if there are no PLS accounts above and beyond six months, Islamic banks should issue credits with similar terms. PLS account holders deposit their money to Islamic banks to invest their money in investment opportunities that have maturities equal to the account maturity. Supervisory authority should regulate such actions. If Islamic banks make investment in correlation with account maturity structures then Islamic banks would not face any liquidity risks. The withdrawal rights of investment account holders should be regulated as well to include a period for Islamic banks to liquidate associated credit facilities.

5.4 Shari'ah knowledge

Most of the supervisory authorities lack knowledge of Shari'ah in terms of banking. Thus, it becomes troublesome for the supervisory authority to regulate accordingly. Any assistance that may be required by Islamic banks for their operations will not be met. Also, any supervision and regulation will be made based upon the experiences gained from conventional banks. However, the differences between Islamic banks and conventional banks fail such attempts. For most effective regulation, Islamic banks should be regulated and supervised by authorities who have extensive knowledge and experience in Islamic banking.

For instance, Islamic banks should own the goods that are being sold with mark-up. Many regulatory regimes do not allow banks to own real goods. Thus Islamic banks cannot issue invoices or certificate of ownerships. Also, buyers in murabahah transactions have a right to cancel the contract. Islamic banks cannot honour such cancellation after purchasing goods.

Regulatory authority should resolve such matters and should provide assistance for Islamic banks. Any issue resolved outside of official books will pose risks for the Islamic bank and will not be available for legal audit. Any unresolved matters will be soft spots for misconduct and regulatory authority should suggest solutions. In case of lack of experience and knowledge, consultation with IFSB should be seen as an alternative centralized effort to resolve Islamic banking related issues.

5.5 Capital adequacy

Islamic banks operate with many products that do not exist in conventional banking. These unique products bring many risks that require unique risk measurement and capital adequacy measure. Islamic banks should adopt Basel II and integrate suggested systems to their operations for many reasons (Hassan M.K. and Chowdhury M.A.M., 2004). Any failure of an Islamic bank will generate systemic risk for the financial system overall. Furthermore, any failure will damage the Islamic banking sector. Also, in order for Islamic banks to receive international recognition they will have to fulfill many criteria, and compliance with international standards is one of them.

According to AAOIFI (1999), capital of Islamic banks is exposed to three types of risks: commercial risk, fiduciary risk and displaced commercial risk. They also suggest that PLS accounts should not be included in the risk bearing capital. All assets financed by the debt bearing liabilities and own capital should be included in the calculation of capital adequacy ratio. The weight of PLS accounts within the capital adequacy calculation should be 50 percent of total PLS.

Separate capital adequacy standards may be applied for PLS accounts and current accounts in order to establish comparability (Khan and Ahmed, 2001, Chapra and Khan, 2000). Muljawan *et al* suggests that the amount of PLS accounts should not exceed the combined amount of equity capital and the mark-up amount of trade related credit instruments. Hassan and Choudhury suggests that the suggested risk weight of 50 percent by AAOIFI for investment accounts should be raised to 100 percent to determine capital adequacy as per Basel II.

5.6 Liquidity

While credit risk, market risk and commercial risk play very important roles in the financial sustainability of the Islamic banking, liquidity risk can be hazardous if enough attention is not paid. Supervisory authority provides lender of last resort and deposit insurance schemes for the banking industry which cannot be utilized for Islamic banks. Thus, Islamic liquidity solutions should be emphasized. Lender of last resort should be provided on a non-interest basis for Islamic banks. Products such as *sukuk* should be promoted to enable Islamic banks to hold marketable securities that can be liquidated with ease and speed and without much loss when needed.

In terms of liquidity, Islamic banks are at a disadvantage in some aspects. However, it is important to evaluate the matter as an advantage for Islamic banks. The regulatory authority requires all banking institutions to keep reserves and to have certain percentage of liquid assets. Islamic banks are no exception. Banks are allowed to keep their liquidity in terms of cash and/or cash like items. The notion of marketable security is very common for conventional banks as a liquidity precaution. Islamic banks have no such option. While earning interest on marketable securities, conventional banks rely on liquidity of markets to cash in their marketable securities. In times of market wide liquidity crises, such markets become illiquid. Either banks have to sell their assets at great losses or they have to suffer the consequences of their cash shortage. The marketable securities become unmarketable. These securities may even be government securities. As long as there is no buyback guarantees, the depth of security markets are primary concerns of conventional banks. Islamic banks, on the other hand, do not keep their liquidity precautions as marketable securities. They either keep them in cash or in terms of current accounts at international financial intermediaries. There is no dependence on security markets. This is, of course, at a cost.

In terms of regulation of Islamic banks, liquidity is a concern for Islamic banks, which is above and beyond their liquid assets which is actually kept liquid. Due to the inexistence of lender of last resort, Islamic banks should always keep more liquidity than conventional banks. However, when comparing the rate of liquidity, the regulator should compare liquidity relatively.

The actual liquidity of marketable securities should be of great concern. Previous liquidity crises should set an example for the actual depth of such securities market.

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