BANK REGULATION AND SUPERVISION IN ISLAMIC BANKING SYSTEMS

WITH A CASE STUDY OF MALAYSIA

by

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Major Paper presented to the

Department of Economics of the University of Ottawa

In partial fulfillment of the requirement of the M.A. Degree

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Ottawa, Ontario

August 2012

Abstract

Islamic principles influence the structure and performance of banks in different aspects. Based on the recent expansion of Islamic banking, the question of what prudential regulation should apply to Islamic banks has received lots of attention. It is true that Islamic banks, due to sharing profits and losses, pose lower risk to deposit holders than conventional banks, but because of insolvency and systemic risks, regulation and monitoring risks are as essential in Islamic banking as in conventional banking. This paper describes the differences between Islamic banking and conventional banking, reviews the structure of international banking regulation and supervision which is based on Basel II and Basel III, and defines the regulations and supervision framework for Islamic banks. As a successful example of the dual banking system, the structure of the banking system, regulation and supervision in Malaysia is discussed.

Acknowledgements

I would like to express my gratitude to Professor Gamal Atallah for his supervision, help, and guidance throughout my time as his student. I would like to thank my family and friends for always being so supportive.

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Glossary

Hibah	Literally means gift. In Islamic banking refers to the gifts that banks voluntarily pay to the saving deposit holders.
Istijrar	An agreement between the customer and supplier in which the supplier accepts to deliver a given product to the customer, periodically and based on the agreed price and terms of payment.
Jualah	An agreement by which Jael or the employer is obliged to pay a certain amount of money as Jaal or fee, against certain action.
Mudaraba	An agreement between two parties where one of them makes the investment and the other (called entrepreneur) uses the investment to set up business projects.
Musharaka	An agreement which concerns a mutual investment of specific and profitable business. Profit of business would be divided based on the predetermined ratios and any related probable loss is shared by both parties.
Murabahah	Selling the products with the price that includes profit margins to the agreement of both parties.
PLS	Profit and Loss Sharing

Riba	Literally means excess or addition. In Islamic banking covers both interest and usury and is forbidden under Islamic law.
Shariah	Islamic religious law derived from Quran and Sunnah.
Sunnah	The second most important source of Islamic law and refers to the practices of the Prophet Muhammad and his Companions.
Sukuk	A financial certification which is a substitute for bonds and is compatible with Islamic law.
Takaful	Means joint guarantee. It is an insurance which is compatible with Islamic law whereby members agree to contribute money in a pooling system to guarantee each other against a loss.
Wadiah	Safe-keeping deposit.

1- Introduction

As stated by Allen and Carletti (2008), there is a significant relation between the efficiency of financial and banking system and well-functioning of the whole economy. In the past few decades, financial crises such as the Argentinian, Asian, Turkish, Russian and Brazilian crises[1] encouraged the development of banking supervision frameworks at the domestic, regional and international levels.[2] There is an agreement between developed countries in converging toward common standards to improve the regulatory and supervisory issues. The Basel Committee on Banking Supervision (BCBS) was established in the context of this agreement. This Committee was established by the central bank governors of the Group of Ten countries[3] in 1974.

Countries have different rules for regulation because they belong to different law traditions, geography and colonization strategies, cultures and religions. Yet, all financial regulations are based on BCBS. While the Islamic financial and banking system has evolved over the last three decades, this growth creates the essential need to set regulatory standards and a framework for supervisory oversight for Islamic financial institutions. The important question is: in which aspects Islamic banking differs from conventional banking and what is an efficient regulatory and supervisory foundation for Islamic banking?

The paper first provides the most important structural differences between Islamic and conventional banking. In the second part, the relation between regulation and the real economy will be discussed. In the third part, the standards set by the Basel Committee on

[1] Arner et al. (2002).
[2] Lindgern et al. (1996).
[3] Belgium, Canada, France, Italy, Japan, the Netherlands, the United Kingdom, the United States, Germany and Sweden.

Banking Supervision will be reviewed. The fourth part, analyzes the fundamental Islamic banking regulation. In the fifth part, by comparing the regulation in Islamic banking and conventional banking, I argue that effective regulation and supervision is as important and necessary in Islamic banking as it is in conventional banking. In the next part, as a successful experience of dual banking system, this study provides a brief history of the banking system in Malaysia and compares the regulations of Islamic banking and conventional banking in that country. The limitations and problems of Islamic economics and the effect of the recent financial crises on Islamic banking are briefly discussed in parts eight and nine. At the end, some of the banking instruments which are compatible with Islamic law are investigated.

2- Islamic banking

An Islamic banking and financial system is banking activity that is consistent with the Quran and the Sunnah[4] and is acceptable for Muslim communities. "The money and banking system should, like all other aspects of the Islamic way of life, be made to contribute richly to the achievement of the major socio-economic goals of Islam. The system should also continue to perform the usual functions that relate to its own special field and which other banking systems perform." (Chapra, 1985, p. 34)

Comparing characteristics of conventional and Islamic banking, we can find several significant differences of banks operating between these two groups. The functions and operating modes of Islamic banking are based on the principles of Islamic law (Shariah) while conventional banking is based on debtor-creditor relationship between the depositor and the bank. The major differences between Islamic and conventional banking system are as follows:

2-1- Prohibition of fixed interest in Islamic banking

The main difference between Islamic banking and conventional banking is the prohibition of payment and receipt of a predetermined rate of interest (riba). In conventional banks, interest is considered the price of credit, reflecting the opportunity cost of money,[5] the interest rate is fixed and predetermined, the bankers pay fixed interest on deposits and charge predetermined interest through lending, while Islamic banking tries to eliminate riba from the banking system by promoting Profit and Loss Sharing (PLS) participation. Both the Quran and

[4] Sunnah is the second most important source of Islamic law and refers to the practices of the Prophet Muhammad and his Companions.
[5] Ahmad (2010).

Sunnah forbid the practice of riba so there is a consensus on the fact that Islam has forbidden the practice of riba. The first reason of prohibition of predetermined interest is because money is considered as a commodity in Islamic financial structure, thus money cannot be rented for a fixed charge. Another reason is consensus among all Islamic scholars regarding the negative impacts of interest on society, economy and morality; the major impacts are advanced by Hossain (2009):

- Earning money by interest without any effort is equivalent to economic exploitation.
- Earning money by interest decreases the incentive to work, and people are no longer motivated to earn money through labor, therefore, it has some negative effects on total welfare of a society.
- In a banking system which is based on interest, if a person who uses a loan from a public bank and runs a business becomes bankrupt, then the loss will affect the total nation, because the bank is a public property (in many Islamic countries banks are owned by government).
- Frauders can use a substantial proportion of financial funds in the name of running a business by just paying the interest rather than the principle value for an infinitely long period of time; therefore, the whole nation will be harmed by some loan defaulters.[6]

Two methods have been used by Muslim countries to relieve the economy of interest. Some countries such as Iran, Sudan and Saudi Arabia have eliminated interest from all their financial institutions. In contrast, Malaysia, Bahrain, Pakistan and a few other countries have adopted a different approach: parallel working of conventional and Islamic banking.

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[6] Hossain (2009).

2-2- Investment and Demand deposits

There is a big difference between Investment and Demand deposits in Islamic banking. Demand deposits are based on the principle of wadiah[7] and are guaranteed. But for Investment deposits which are based on mudaraba,[8] depositors are not guaranteed and as a result of improper investment decision, there is a possibility of losing the principle amount of investment deposits.[9]

Based on Errico and Farahbakhsh (1998) and in the light of aforementioned discussions, the main differences between Islamic and conventional banking can be summarized as follows. First, the nominal values of investment deposits are not guaranteed in the Islamic banks while in the most conventional banks both demand and investment deposits are guaranteed. Second, whereas the rate of return is certain and guaranteed in the conventional banking, it is nor certain neither guaranteed. Third, the mechanism to regulate final returns in the Islamic banking depends on the bank's performance since central banks regulate conventional banks regardless of their performance.

As discussed in Errico and Farahbakhsh (1998), another important difference is that the PLS principle is applied in Islamic banking. Lastly, in order to provide sufficient funds for professional investment management, "banks 'pooling of depositors" is applied in Islamic banking since this strategy is not applicable in the conventional banks.

Table 1 summarizes the main differences between Islamic and conventional banking.

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[7] Safe-keeping deposit.

[8] A special kind of financing contract where one partner provides money and another partner provides entrepreneurship.

[9] Hassan and Lewis (2007).

Table 1. Comparative review of Banking Frameworks between Islamic and conventional banking

Characteristics	Islamic Banking	Conventional Banking
Nominal value guarantee of: Demand deposits Investment deposits	 Yes No	 Yes Yes
Equity-based system where capital is at risk	Yes	No
Rate of return on deposits	Uncertain, not guaranteed	Certain and guaranteed
Mechanism to regulate final returns on deposits	Depending on banks' performance/profits from investment	Irrespective of banks' performance/profits from investment
PLS principle is applied	Yes	No
Use of Islamic modes of financing: PLS and non-PLS modes	Yes	N/A
Banks' pooling of depositors' funds to provide depositors with professional investment management	Yes	No

Source: Errico and Farahbakhsh (1998)

During the last three decades the Islamic banking system has become a competitor and substitute for the conventional banking system, especially for the Muslim world. In the light of Abedifar et al. (2012) debates, the statistics comparison between Islamic banking and conventional banking is provided in table 2.

As discussed in Abedifar et al. (2012), their sample covers 3870 observations for 553 commercial banks, across 24 countries[10] members of OIC over the period of 1999 to 2009.

[10] Algeria, Bahrain, Bangladesh, Brunei, Egypt, Gambia, Indonesia, Iran, Iraq, Jordan, Kuwait, Malaysia, Mauritania, Pakistan, Qatar, Saudi Arabia, Senegal, Syria, Sudan, Tunisia, Turkey, UAE and Yeman.

Table 2. Descriptive Statistics Comparison between Islamic and conventional banks (1999-2009)[11]

	Conventional Banks					Islamic Banks				
Variable	Max	Min	SD	Mean	Number	Max	Min	SD	Mean	Number
Total Asset(mil.$)	87.9	132	8664	4041	2448	48.1	530	7284	3732	782
Market_Share(%)	1	0	0.12	0.06	2448	1	0	0.13	0.07	782
Capital_Asset _Ratio(%)	86.93	0.01	11.07	13.38	2403	87.01	0.43	16.12	17.1	750
ROAA(%)	13.86	-16.48	2.26	1.23	2458	13.2	-12.29	2.46	1.48	715
ROAE(%)	133.3	-124.83	18.17	12.26	2429	123.65	-118.28	17.43	12.93	715
Loan_Total_Earning_Asset_Ratio(%)	100	0	22.78	53.58	2431	100	0.02	26.01	58	767
Loan_Growth(%)	325.28	-100	40.31	21.67	2047	351.73	-100	51.33	29.59	685
Asset_Growth(%)	211.08	-73.8	30.22	19.16	2265	207.08	-74.95	33.45	26.27	709
Nonintrested_Income(%)	158.45	-115.15	23.17	33.6	2405	158.92	-70.23	29.34	42.14	689
Cost_Inefficiency	287.87	1.88	31.56	57.12	2382	268.53	3.04	34.03	59.8	659

[11] Total Assets = Total assets in millions U.S.$, Market_Share = Market share of total assets, Capital_Asset_Ratio = Equity capital to asset ratio, ROAA = Return on average assets, ROAE = Return on average equity, Loan_Total_Earning_Asset_Ratio = Share of net loans in total earning assets, Loan_Growth = Annual growth rate of gross loans, Asset_Growth = Annual growth rate of total assets, Noninterest_Income = Share of non-interest income in total operating income, Cost_Inefficiency = Cost to income ratio.

		Conventional Banks					Islamic Banks				
	Variable	Max	Min	SD	Mean	Number	Max	Min	SD	Mean	Number
Bank Interest Rate Proxies[12]	Net_Interest_Margin(%)	24.83	-12.58	3.09	4.17	246	24.09	-9.42	3.39	4.19	684
	Interest_Income_Rate(%)	39.07	0.09	4.84	9.81	2351	38.7	0.01	4.38	8.02	623
	Interest_Expense_Rate(%)	26.55	0.06	3.67	5.84	2355	26.4	0.08	3.39	4.39	544
	Loan_Rate(%)	29.6	0.6	4.46	9.97	629	23.8	0.3	4.7	9.6	228
	Deposit_Rate(%)	15.3	0.1	3.07	4.81	588	16.5	0.1	3.75	5.02	188
Credit_RiskProxies[13]	Loan_Loss_Reserve(%)	60.55	0	9.38	8.72	2105	58	0	7.71	6.75	593
	Impaired_Loans(%)	76.41	0	12.97	11.14	1604	66.39	0	10.33	8.31	381
	Loan_Loss_Provision(%)	30.69	-22.52	3.18	1.7	1982	26	-22.2	3.1	1.35	574
Insolvency_Risk Proxies[14]	Zscore_rw	8.72	-1.32	1.3	3.48	1349	8.59	-0.74	1.31	3.24	388
	Zscore_P1_rw	5.39	-4.84	1.32	1.25	142	5.33	-3.28	1.11	1.13	411
	Zscore_P2_rw	8.7	-1.31	1.36	3.31	1367	8.55	-0.5	1.37	3.28	389
	Zscore	6.31	-0.77	1.02	2.87	251	5.22	0.05	0.93	2.87	75
	Zscore_P1	2.62	-2.53	0.91	0.65	226	2.04	-2.4	0.75	0.53	70
	Zscore_P2	6.28	0.09	1	2.76	252	5.2	0.7	0.92	2.77	75

Source : Abedifar Pejman et al. (2012)

[12]- Net_Interest_Margin = (Interest Income – Interest Expense) / Average Earning assets, Interest_Income_Rate = Interest income divided by average earning assets for conventional banks and mark-up income over average earning assets for Islamic banks, Interest_Expense_Rate = Interest expense divided by average interest bearing liabilities and profit payouts over average profit bearing liabilities for Islamic banks, Loan_Rate = Interest income on loans divided by average gross lending for conventional banks and mark-up income on lending divided by average gross loans for Islamic banks, Deposit_Rate = Interest expense on customer deposit divided by average customer deposits for conventional banks and profit payouts on customer deposits divided by average customer deposits for Islamic banks.

[13] - Loan_Loss_Reserve = Loan loss reserves on gross loans ratio, Impaired_Loans = Impaired loans on gross loans ratio, Loan_Loss_Provision = Loan lossprovision on average gross loans ratio.

[14]- Zscore_rw = Logarithm of rolling-window Zscore : (ROAA+Capital_Asset_Ratio)/SDROAA_rw, SDROAA_rw = Standarddeviation of ROAA over 3 years (current year and two previous consecutive years). Banks need to have three consecutive observations. Acquiring banks are excluded fromthe sample, since the volatility on their assets returns can be due to the acquisition. Zscore_P1_rw = Logarithm of ROAA/SDROAA3_rw, Zscore_P2_rw = Logarithm ofCapital_Asset_Ratio/SDROAA3_rw, Zscore = Logarithm of (M_ROAA+M_Capital_Asset_Ratio)/SDROAA, M_ROAA = Mean of ROAA over the sample periodM_Capital_Asset_Ratio =Mean of Capital_Asset_Ratio over the sample period, SDROAA = standard deviation of ROAA over the sample period (banks needs to have at leasfour consecutive observations), Zscore_P1 = Logarithm of M_ROAA/SDROAA, Zscore_P2 = Logarithm of M_ETA/SDROAA.

As we can see in table 2, there is no significant difference in mean of net interest rate between Islamic and conventional banks; precisely conventional banks have a higher income/expense interest rate and a lower deposit interest rate than Islamic banks. Islamic banks are more capitalized and profitable than conventional banks, because Islamic banks, on average, have lower levels of debt and higher non-interest income. The comparison provides crucial information about the structure of the asset portfolio of the Islamic and conventional banks. Islamic banks are limited to invest in earning assets (like bonds) so Islamic banks have relatively high ratios of net loans to total earning assets. Also the cost to income ratio in Islamic banks is higher than in conventional banks.

The results of risk measures show that the level of credit risk in Islamic banks is lower than conventional banks, but their level of insolvency is almost the same, implying that the higher returns and capital of Islamic banks are countervailed by their higher asset return fluctuations.[15]

3- Banking Regulation and the Real Economy

Banks and financial institutions improve economic activities by their crucial role as financial intermediaries. By simultaneously receiving deposits and making loans, they improve efficiency of capital allocation and reduce transaction costs. There is an agreement between scholars about the significant relationship between banks and economic performance. On the one hand, the disturbance of financial intermediaries' performance causes financial crises which lead to tension in the real economy (e.g., Agenor et al. 2004). On the other hand, there

[15] Abedifar et al. (2012).

is a strong evidence that the global financial crisis has significant effect on the performance of the banking system therefore it affects the way of regulation and supervision.

There are several reasons for bank regulation. According to Hoenig (1996), a bank failure could destroy the financial security of many individuals because, households entrusted a large share of their wealth to banks. Therefore bank regulation is necessary to protect bank depositors. A second reason which is more consistent with the current argument implies that bank regulation is a protection of the public safety net[16]. Financial safety nets protect borrowers, depositors, and taxpayers from the direct effects of financial institution failure, but it exposes the system to a moral hazard problem because financial institutions can shift some of the risks that are generated by their lending and funding activities onto the safety net, so they will take higher risks. Bank regulation is necessary to control moral hazard arising from the financial safety net. The third motivation of banking regulation is to ensure the accuracy performance of the payment system because a well-functioning payment system is required for the efficient operation of the financial system.

Banking regulation typically refers to the rules that govern the behavior of banks, whereas supervision is the oversight that takes place to ensure that banks comply with those rules (Barth et al., 2006). Countries have different rules for regulation. According to the law and financial view on financial development, rules of corporate governance and financial systems differ internationally because countries belong to different law traditions.[17] Stulz and Williamson (2003) challenge this view and argue that cultural and religious differences are more important than legal traditions. Acemoglu et al. (2001, 2002) focus on the effect of the

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[16] "In the United States, the safety net includes deposit insurance, the discount window, and the settlement guarantees for payments that go through the Federal Reserve." (Hoening , 1996, p. 4).

[17] Beck and Levine (2003).

geography and colonization strategies on the financial system. According to Tao (2007), major differences can be categorized into four types. The first is the extension of government ownership of banks. The second is the intensity of direct regulation. According to the "Core Principles" (1997), government direct regulation might be further divided into four sub dimensions, preconditions for banking regulation, ex-ante, ongoing and ex-post banking regulation. The third is the amount of measures to empower outside investors to monitor banks. The last is the comprehensiveness of explicit deposit insurance. Explicit deposit insurance is quite special, since it might be a pre-requirement prior to a banking operation, which comes into effect either on the ongoing or ex-post process. Different combinations of these four types are used in regulating banks across countries.

There are three instruments being used to stabilize the functions of banks.

3-1- Deposit insurance

Introducing deposit insurance by protecting the payment system decreases the probability of bank runs and provides a financial safety net. According to Diamond and Dybvig (1983), if a bank run occurs once in a society, it will spread through the whole banking system; this causes a prompt withdrawal of the deposits by the panicked people who cannot distinguish whether this is a bank specific problem. This lack of information ultimately leads to self-fulfilling phenomena.

Despite the fact that deposit insurance can prevent a banking crisis, this may create a risk of moral hazard. Without deposit insurance there would be competition between banks for attracting deposits, because safety is an important factor for people who want to deposit their money. Deposit insurance provides a tendency for both banks and depositors to accept excessive risks because in this case the safety of the deposits is guaranteed. Taking higher risks by the banks decreases the probability of loan reimbursement and increases the loss of capital and money creation, thus finally the economy will be more likely to collapse.

Regarding the effect of deposit insurance on the economic contracts, we can refer to a study by Hutchison and McDill (1999) and Hoggarth et al. (2005) showing that in recessions deposit insurance causes a reduction in the magnitude of output contraction. There is also another area which has attracted more attention by researchers, for example in studies by Demirguc-Kunt and Detragiache (2002), Barth et al. (2004) and Angkinand and Wihlborg (2006). They tried to find the relationship between deposit insurance and the stability of the financial system rather than the costs of instability in the financial market by using dummy variables for deposit insurance, and they found that there is a positive relation between deposit insurance and bank fragility.

3-2- Capital adequacy regulation and supervision

Bank capital works as a shock absorber against capital crunches due to the unexpected losses that lead to bunks run. Capital adequacy regulations provide not only a standard cap on capital holding of banks but also offer many bank supervisions in order to control bank's risk taking, mainly in the existence of deposit insurance. Therefore capital adequacy regulations limit banks' risk through the reduction of the impact of real economy shocks on banks and contagion effects of a crisis.

Barth et al. (2004) and Angkinand et al. (2006) discuss that bank capital adequacy can reduce the level of banks' risks. Although the effect of supervision is not significant, specific types of banking regulation and supervision can have an impact.

3-3- Bank activities regulation

In a banking system, there are two different classes of activities, traditional and securities. Since the latter is about underwriting, issuing and distributing securities, it bears more risk and so requires better monitoring, especially in the presence of asymmetric information. Now, there are some opposing arguments in the area of regulating financial activities. Some claim that getting involved in various financial activities brings about more risks and thus needs to be avoided in the case of incomplete information. On the other hand, some believe that since these risk bearing activities may extend the safety net and expand the benefits through the removal of restrictions, they lead to more competition and improved resource allocation.

It is difficult to make any conclusion whether banks should get involved in various financial activities or not since there is a lack of cross country data. There are only a few studies in this rhyme. For example, in a country level research by Barth et al. (2004) and Bystrom (2004), they came to the conclusion that the more the restrictions on banking financial activities, the more the probability of banking crisis and the less the level of development of the banking system. Another study by Gonzalez (2005) using bank level data across countries shows that the effect of restricting banks in risk bearing activities reduces their opportunities.

4- Review of world banking regulations

The current regulations for conventional banks are based on the Basel Committee on Banking Supervision in the Basel Capital Accord of 1988.These regulations cover three areas, called 'pillars':

(i) Minimum capital requirements.

(ii) The supervisory review process.

(iii) Market discipline.

4-1- The first pillar: Minimum capital requirements

Economic and regulatory capital are two terms commonly used in the analysis of the structure for bank capital regulation suggested by the Basel Committee on Banking Supervision (2004), known as Basel II. The definition of regulatory capital is clear: it is the minimum capital requirement which is determined by the regulator. The determination of regulatory capital is based on the Internal Ratings-Based (IRB) approach of Basel II. In the absence of capital regulations, economic capital will be chosen by banks' shareholders and will be determined regarding to the maximization of the banks' objective functions.

The main reason for applying capital regulations is to ensure the banking system against default risks and prevent capital crunches. In other words, these requirements are put into place to determine a sufficient level of capital in order to tolerate operating losses. In particular, the first pillar protects banks from the most three important types of risk: credit risk, operational risk, and market risk. Other risks are not considered at this stage.

Regulatory capital should be derived from the maximization of a social welfare function that takes into account the cost and benefit of capital regulation. Costs are defined as an increase in the cost of providing and maintaining a sufficient capital level and the benefits are specified as a reduction in the probability of default risks and bank failure.[18]

4-2- The second pillar: The supervisory review process

The second pillar is affected by the regulatory response of the first pillar. It also provides a framework for banks to deal with residual, pension, concentration, strategic, reputational, liquidity and legal risks. The result of the second pillar in Basel II accords is the Internal Capital Adequacy Assessment Process (ICAAP).

4-3- The third pillar: Market discipline

The purpose of this pillar is to counterpart the minimum capital requirements and supervisory regulation by developing a set of requirements regulations which will allow the market contributors to measure the capital adequacy of an institution.

Market discipline is complementary to regulation which acts as an information distributor, and facilitates the process of accessing the information for investors, analysts, customers, other banks and rating agencies. When market participants have adequate information on a bank's activities, they can better distinguish between banking organizations so that they can better prudently manage their risks and penalize their weaknesses about risks.

This information is required to be available at least twice a year, except qualitative information providing a summary of the general risk management objectives and policies which can be made public annually. Institutions are also required to create a formal policy on

[18] See Repullo and Suarez (2004) for a discussion of Basel II from this perspective.

what will be revealed, controls around them along with the validation and frequency of this information. In general, the disclosures under Pillar 3 apply to the top consolidated level of the banking group to which the Basel II framework applies.

In the following table we can see the minimum capital requirements which are mentioned in the Basel III.

Table 4 : Basel III Minimum Capital Requirements and Phase-in Arrangements

(all dates of January 1st: in percentages)

Types of Capital	Years								
	2011	2012	2013	2014	2015	2016	2017	2018	2019
Minimum Common Equity Capital Ratio			3.5	4.0	4.5	4.5	4.5	4.5	4.5
Minimum Conservation Buffer						0.0625	1.25	1.875	2.5
Minimum Total Capital Plus Conservation Buffer			8.0	8.0	8.0	8.625	9.25	9.875	10.5
Minimum Countercyclical Buffer						0.0625	1.25	1.875	2.5
Minimum Total Capital Plus Conservation and Countercyclical Buffer									13.0
Minimum Tier 1 Capital			4.5	5.5	6.0	6.0	6.0	6.0	6.0

Source : Basel III

In order to analyze the differences between regulations of Islamic and conventional banking, in the next part Islamic banking regulation will be discussed in detail.

5- Islamic Banking Regulation

Hassan and Mehmet (2009) mentions that regulation and monitoring risks is as essential in Islamic banking as it is in conventional banking due to the following reasons:

1) There are various kinds of risk bearing contracts such as a two-tire Mudaraba, according to which a bank's balance sheet of assets is fully integrated in the Islamic framework which still needs to avoid insolvency risks.
2) Development decisions need to be controlled in Islamic banking as well as in conventional banking since it is also likely that poor investment decisions occur in both banking systems due to the fluctuations in the operating environment, lack of efficient management and internal inconsistencies. Otherwise, there will be economic losses which may damage the reputation and credibility of banks and thus reduce private savings.
3) In Islamic banking system, where banks play a significant role in the financial market, weak operation of banks causes a shrink in their power to enter the world market and benefit from the global capital flows.
4) Last but not least, weak banking operations may also affect the monetary and payment policies in a way that inefficient payment procedures, especially when using indirect instruments, may reduce public confidence and delay necessary structural reforms.

Taking all the above factors into account, an Islamic banking system must implement some regulations. "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 Choudhury, 2004, p. 4).

On the other hand, Islamic banking needs to apply Basel regulations not only to introduce itself better to the world banking system but also to consider its standardization. One of the main goals of Basel regulations is to extend the disciplines for international banking which leads to a more stable system. One of the good examples in this rhyme in Islamic banking system is to level the risks between the depositors and the banks. This risk sharing calls for a more transparent and accredited banking system in which people are willing to deposit their money.

Based on research by Hassan and Choudhury (2004), there are six categories identified for transparency in the financial system: financial performance, financial position, risk management strategies and practice, risk exposure, accounting policies and basic business, management and business, management and corporate government information.

6- Regulatory framework in terms of Islamic banking

6-1- Deposit insurance

As we mentioned before in conventional banking, deposit insurance is an inevitable part of regulation while, in Islamic banking, due to profit and loss sharing there is no guarantee for principle amount. Since Islamic banking poses the higher level of risk to depositor, the role of supervision in protecting the depositor rights is vital.

6-2- Demand deposit

Safekeeping is the only reason for holding demand deposit but as Islamic banks use these funds to invest without depositors' permission, these investments pose risks to the demand deposit holders despite the fact that they were supposed to be guaranteed based on Fiqh[19]. If they can manage to separate these funds from investment funds, they will be able to gain substantial profits since in this case the profits are no longer distributed to the demand deposit holders. Therefore, this motivates Islamic banks to invest these demand deposit funds. This is one of the reasons due to which Islamic banking calls for supervision.[20]

6-3- Investment Deposits

Regarding investment issues, there are various different implications. According to Hassan and Mehmet (2009) one of these implications is pooling deposits. Any deposit holder's utility will be maximized by shorter maturity and higher returns, whereas this is completely reversed for the credit customers. Thus, the best way to have a pooling deposit is to assign each deposit to a credit issued, which makes the process so complicated.

Another problem arising in this manner is that the returns to each pool may be adjusted by changing the percentage of profit that is assigned for the Islamic bank and shareholders. For example, shareholders can increase the percentage of profits in favor of deposit holders at the expense of sacrificing some of their shares just to enhance the Islamic banking system but this should also be done in an equal way among different types of deposit holders, otherwise it will violate their rights. This is one of the other reasons why Islamic banking needs supervision.

Another area in which Islamic banking requires regulation and supervision is in dealing with unmatched maturity related liquidity risks. Islamic banking, unlike conventional banking, faces a risk in dealing with withdrawals since there is neither the possibility to borrow from a money market nor to use credits. Therefore, there is no certainty in the maturity of the

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[19] Islamic jurisprudence, the science of Islamic law based on Quran and Sunnah which covers all aspects of life.
[20] Chapra and Khan (2000).

returns. Thus there must be some regulations in maturity structure of PLS.

6-4- Shariah Knowledge

As long as in some areas of Islamic banking, there is insufficient knowledge of the shariah concepts and their adaptation with banking terms, it is difficult to do further regulation or supervision. On the other hand, most of the revisions are made based on the conventional regulations which can no longer be implemented in an Islamic banking system due to differences between these two systems. For instance, in Mudaraba, the buyer can cancel a contract whereas in conventional banking it is not possible to cancel a contract after a purchase is placed.

Here we have to refer to a regulatory authority to find a solution to resolve these special types of cases, and lastly, if there is no resource of previous experience, Islamic banking should ask IFSB[21] for further assistance.[22]

6-5- Capital adequacy

One of the other differences between Islamic banking and other banking systems is regarding certain types of products which bear risks and thus require unique methods in measuring both risks and capital adequacy. There are three types of risks a capital in Islamic banks faces: commercial risk, fiduciary risk and displaced commercial risk.

An example made in a study by Hassan and Dicle (2007, p. 24) is: "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." Moreover, separate capital adequacy standards may be applied

[21] Islamic Financial Services Board.

[22] Laldin (2009).

for PLS accounts and current accounts in order to establish comparability (Khan and Ahmed, 2001; Chapra and Khan, 2000).

Taking all the above reasons into account, there is an inevitable need of a regulatory authority which should come along to assist with further clarifications in so called special cases. This will not only affect the soundness of Islamic banking, but also will better introduce it to the International banking system.

6-6- Liquidity

Liquidity risk is one of those areas which significantly need to draw attention compared to other kinds of risks. Regulatory authority introduces different insurance schemes to deal with the risks of these kinds while Islamic banking cannot be utilized by them, thus there is a need for implementing some liquidity solutions. For instance, based on a product named Sukuk,[23] there are some marketable securities which cover the risks of liquidity as easy and quick as possible.

These marketable securities, which are called liquidity precaution in conventional banking, are kept in cash or in terms of current accounts at international financial intermediaries. Although all Islamic banks have to keep reserves and to have certain percentage of liquid assets just like any other bank, they should always keep more liquidity than conventional banks due to the inexistence of a lender of last resort.

[23] Sukuk is a financial certification which is a substitute for bonds and it is compatible with Islamic law.

7- Regulation and supervision of Islamic banking in Malaysia

7-1- History of Islamic banking in Malaysia

The first modern commercial Islamic bank was established in 1975, named Dubai Islamic bank in United Arab Emirates. Development of Islamic banking in the 1980s accelerated as the other Islamic countries implemented this method of banking. The only difference was that instead of overall replacement of Islamic banking, these countries sought to put Islamic banking as an alternative to conventional banking based on interest rates. In the light of these efforts, Islamic banking spread easily to other Islamic countries. [24]

Development of activity of Islamic Financial Institutions as well as enactment of Islamic banking Law in Iran and establishment of other banking institutions on the basis of interest free banking operations, made Malaysian Muslims to ask for establishment of similar institutions. Successful experience of Pilgrimage Fund Board in that country and also the government's tendency for establishment of alternative channels for conventional banking System for Muslims resulted in acts of Islamic banking and Governmental Investment in 1983 and eventually the establishment of the first Islamic bank in July of the same year. Religious diversity of the country and also its economic bond to the global market resulted in keeping fundamental reliance on conventional banking.[25] All the aforementioned factors made Islamic banking to be planned and implemented in parallel to conventional banking. This balance in practice has paved the way for creation and development of Islamic Financial Markets and has been of great help in the design and execution of profitable monetary and financial instruments. On the other hand fundamental reliance upon Islamic banking System

[24] Iqbal and Molyneux (2005).
[25] Sheng (1989).

has ended in accurate implementation of Islamic Principles. Therefore, investigating Islamic instruments being used in the system and also regulations and supervision, could be useful in development of Islamic banking. It is worthwhile to mention that in Malaysia, the ratio of Islamic banking to total banking was 17.4% in 2008[26].

7-2- Regulation of Islamic banking in Malaysia

Based on the acts of Islamic banking, Bank Negara Malaysia (central bank of Malaysia) imposed the following rules for Islamic banks[27]:

1) Once they get overall banking permission, they can start Islamic banking activities.
2) Their activities must be regularly supervised on the site of Bank Negara Malaysia.
3) Their governors and managers must be verified by Bank Negara Malaysia.
4) Their annual accounts and establishment of new branches must be reviewed and verified by Bank Negara Malaysia.
5) They must be compatible to regulatory requirements declared by Bank Negara Malaysia and they have to establish Sharia Advisory Council.

On the other hand, the Governmental Investment Law makes it possible for the Malaysian government to publish bonds based on Islamic Rules. This possibility enables Islamic banks to reach their liquidity goals.

In order to create all necessary Islamic banking instruments and also to solve all probable problems, Islamic banking was under monopoly of one bank till 1992. During the period of

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[26] Hasan and Diridi (2010).
[27] shamsiah (2007).

1982 to 1992 all rules and prerequisites were specified[28]. This system was known later as a **Dual Banking System** mainly because of applying two banking systems with different conditions and presumptions simultaneously. As presented by Yancop in International Islamic Banking Conference (2003), a dual banking seems necessary because of the following reasons:

1. Islamic banking is not capable of fully recognizing and sufficiently solving all the necessities of the economy.
2. Those who believe in Islam can deal with an Islamic banking system, in conformity to their religious beliefs.
3. Malaysian people are provided with newer and more developed bank alternatives and also they can choose based on their discretion between Islamic and conventional banking.
4. New financial intermediaries are created in order to support the banking system.
5. Islamic financial instruments have become more comprehensive.

Dual banking basically means a merger of Islamic banking system and conventional banking system while Muslims could benefit from the separate Islamic banking for their operations. To be permitted to operate under dual banking, banks must have acceptable records of activity under conventional banking. Secondly, they should have sufficient financial reserves. It is important to mention that regulations of activities in Islamic banking are developed strictly. This indicates that the Malaysian government is serious about Islamic banking implementation.

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[28] Azahari (2009).

Resources (deposit funds) and Expenditures (granted facilities) in a dual banking system are divided into Islamic and conventional parts. The idea is to completely separate the interest funds from interest free funds. Therefore, the notion of *window* is introduced in dual banking which means that Islamic and conventional banking can operate in parallel and they are free from any kind of legitimate doubts resulting from pooling.[29]

The structure of the dual banking system is shown in figure 1. This kind of system introduces new alternatives for the bank clients. As the figure depicts, the main property of dual banking is that both depositors and facility applicants have the opportunity of choosing between Islamic and conventional banking. Due to this property the banking market becomes more competitive in order to offer better services to customers. This process will eventually lead to the more developed banking industry.

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[29] Islamic Research and Training Institute (2004).

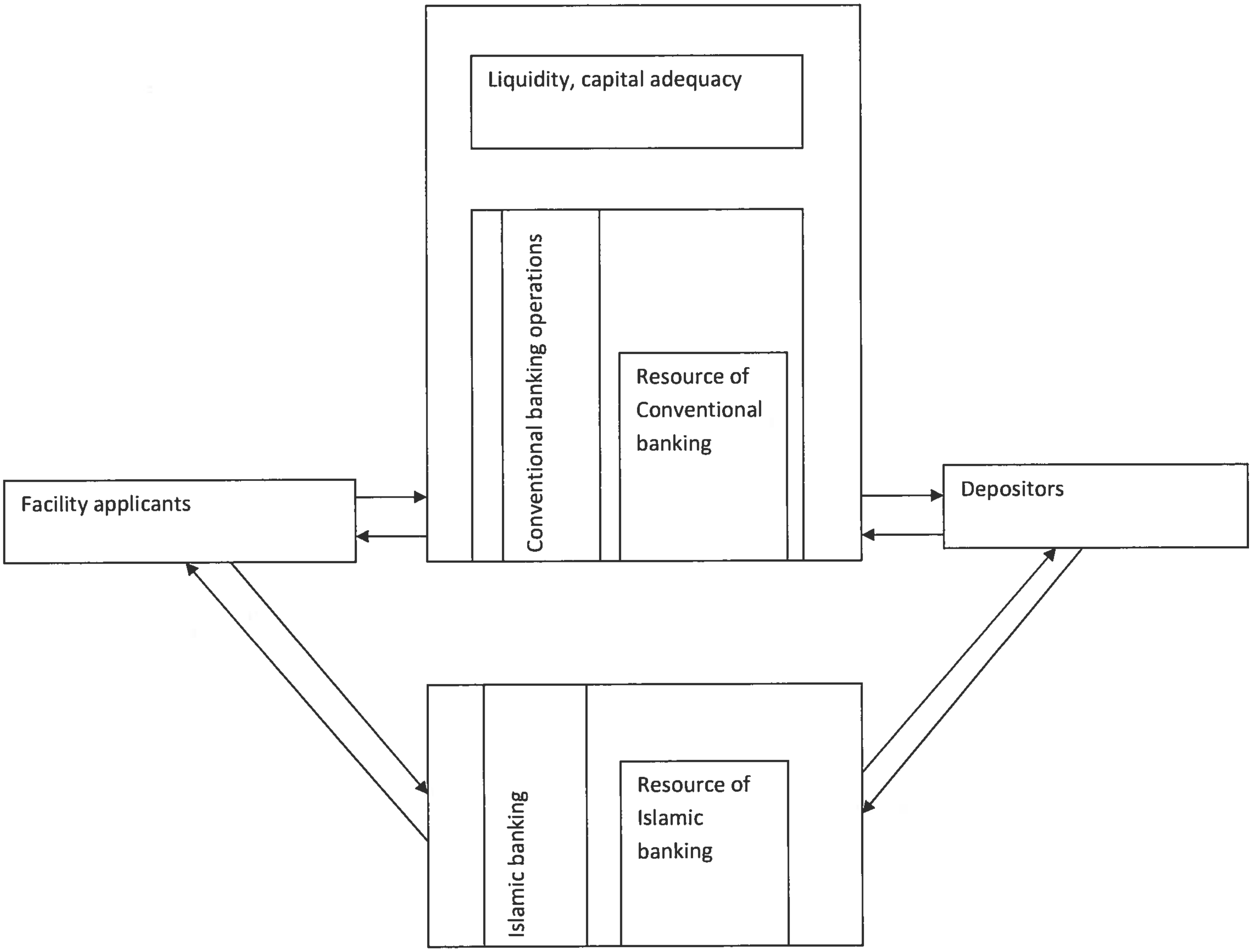

Figure 1: the structure of the dual banking system in Malaysia
Source: Adapted from the website of Bank Negara Malaysia, http://www.bnm.gov.my/

7-2-1- Interest Free Banking Plan in Malaysia (SPTF[30])

This Plan is an Interest Free Plan which distributes and promotes Islamic banking through the usage of conventional banking Infrastructures. This plan has been firstly used in 1993 through an experimental program in the three major business banks of Malaysia.

[30] Skim Perbankan Tanpa Faedah.

It also should be mentioned that Bank Negara Malaysia may impart some circulars introducing new instruments and services which could be provided by Islamic financial institutions.

7-2-2- Notions of Islamic Banking in Interest Free Banking Plan

In what follows the most important notions of Islamic banking are defined: [31]

- **Savings with guarantee:** A person who receives the deposit (the depository) is obliged to guarantee the payment of the same or part of the deposit upon the owner's request. It is possible not to allocate profits resulting from such resources to the depositor, since the depositor has the unique role of keeping properties or funds. Thus, according to the Islamic rule called Donation, the depository could donate some parts of profits as an award to the depositor upon discretion to attract depositors.

- **Mudaraba (Profit Sharing):** It is the agreement between two parties where one of them makes the investment and the other (called entrepreneur) uses the investment to set up business projects. In Mudaraba the related business profit is dividedz upon predetermined ratios. In the Interest Free Banking plan Mudaraba could be concluded in two different directions as follows:

  a) Islamic bank as an entrepreneur and the depositor as an investor.

  b) Islamic bank as a depositor and the owner of industry or services as an entrepreneur.

[31] Bank Negara Malaysia (2010).

It is important to mention that contrary to the profit, any probable loss will be the burden of the depositor.

- **Musharaka (Joint Venture):** It consists of a mutual investment of specific and profitable business. Profit would be divided based on a predetermined ratio (this ratio may be different from investment ratios of the partners) and any related probable loss shall be supported by both parties.

- **Murabahah (Cost-plus):** It means selling the products with the price that includes profit margins based on the agreement of both parties. This kind of agreement is valid only when the price, other expenses, and profit margins of the seller are specified at the time of contracting.

- **Debt trading:** It refers to those reserves of financial resources, necessary for production, trading, or services through buying/selling commercial documents and papers. It is a short-run instrument which means that the period of selling should not exceed one year.

- **Istijrar (Supply Contract):** It is an agreement between the customer and supplier in which the supplier accepts to deliver a given product to the customer, periodically and based on the agreed price and terms of payment.

- **Jualah:** Based on Jualah, Jael or employer is obliged to pay a certain amount of money as Jaal or fee, against certain action. In banking Jualah, the applicant for the facilities makes a contract with the bank in the form of installment credit and the bank performs a special task for him/her to receive Jaal in the form of installment credits from the applicant.

7-2-3- Prerequisites and Requirements of Islamic Banking

The Islamic banking system in Malaysia is a subset of the dual banking system in which Islamic banking Operation is done through conventional banks. Therefore, Islamic banking Operation as a new banking activity should be incorporated via one of the existing banks. Thus, establishment of Islamic banking activities requires some prerequisites (for existing conventional banks) and ex-post requirements declared by Bank Negara Malaysia. These requirements are discussed as follows:[32]

I. Prerequisites

- Reliable financial situation of the bank.
- No misbehavior of bank in supervisory backgrounds.
- Total compatibility with rules and regulations of Bank Negara Malaysia.
- Compatibility with the lowest Risk-Weighted Capital Ratio (RWCR) which is equal to 8% in internal trading banks and 10% in overseas trading banks.
- The minimum capital adequacy, which is separately determined for domestic and foreign banks.
- Compatibility with lending regulations of Bank Negara Malaysia.
- Employing trained professionals in Islamic banking and providing regular training courses in this respect.

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[32] Islamic banking Acts 1983, Laws of Malaysia (Act 279).

- Confirmation of Negara central Malaysia before starting the Islamic banking Operation.
- Sending proposals to Bank Negara Malaysia which includes:
  a. Work method in rendered services subject to Islamic banking.
  b. Specifying those branches which operate Islamic banking.
  c. Different kinds of deposits.
  d. Various sources of financing.
  e. Revenues resulting from investment.
  f. Separating different sources of Islamic banking funds from conventional banking.
  g. Infrastructure and structural needs such as employment training.
  h. Accounting techniques which have to be applied.
  i. Those items related to daily operations such as administrating offices, accounts, account codes and informatics.
  j. Documents and agreements related to each kind of deposits as well as financing/ investment.

II. Requirements [33]

▪ Establishment of Interest Free Banking Unit (IBU):

An Interest Free Banking unit must be established immediately after the approval of Bank Negara Malaysia. The organizational chart, in addition to any details related to the managers or employers of the unit, shall be declared to Bank Negara Malaysia. Doing so, the banks have the authority to change the organizational chart. The Interest Free Banking Unit shall: 1) Include all aspects of Islamic Banking Operation and its procedural issues; 2) Make connection among all other parts of the bank to ensure the smooth operation of Islamic banking; 3) Direct monitoring on consumption of all resources resulting from Islamic banking funds according to Islamic Rules; 4) Ensure the exact compatibility of rules and regulations which are enacted by Bank Negara Malaysia; 5) Undertake research and development for improvement of Islamic banking affairs.

▪ Interest Free Banking Funds:

The bank is ought to preserve specific amount of work funds which is periodically determined by Bank Negara Malaysia. Also, all these funds should be managed by thre Interest Free Banking Unit (no mixture of resources) and all operational as well as overhead costs related to the Islamic banking should be settled by the same funds and eventually all profits and wages stemming from Islamic banking operations should be returned to the same funds.

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[33] Bank Negara Malaysia (2009).

- **Takaful[34] Coverage:**

Facilities provided under the Islamic banking Plan, and that should be appropriately insured against probable risks. Moreover, it is recommended that whenever possible, insurance terms be compatible with the Islamic Rules.

- **Sharia Advisor:**

The bank shall appoint at least one advisor as to the religious problems of the Islamic banking Unit. However this would not negate achieving Bank Negara Malaysia consent in all religious affairs.

- **Controls:**

The bank is obligated to 1) Compile all instructions related to Islamic banking policies ; 2) Compile and observe appropriate formulas for transactions made under Islamic banking Operations; 3) Internal accounting must be under the Islamic banking operation.

- **Liquidity and Legal Reserves:**

Requirements of legal reserves and liquidities ratios have to be observed. Thus, there is no special need for reserve or liquidity ratio specific to Islamic banking.

[34] Takaful means joint guarantee. It is an insurance which is compatible with Islamic law whereby members agree to contribute money in a pooling system to guarantee each other against a loss.

7-2-4- Resources and Consumption of Funds

I. Resources of Funds

In this part based on Ahmad (1993) we refer to resource funds (deposits) in Islamic banking. An important point in this part is the high emphasis on not to entangle the resources and fund consumptions related to conventional Banking and Islamic banking, in order to refrain from creation of any kind of legal doubt for depositors and those who receive facilities. From the legal point of view, resources of funds are divided into two major categories:

A. Those accounts compatible with "deposit contract" including current and deposit accounts.

B. Those accounts compatible to "bailment of capital" (Mudaraba) which are called capital account.

It is important to mention that the system is being confined into two basic contracts. Contracts between depositor and bank are concluded via these aforementioned contracts. In a deposit contract, there is no guarantee for the payment of profit, and the depositor either makes use of current account facilities or authorizes the bank through deposit accounts, to take advantage of funds resources to provide facilities. Besides, capital accounts based on bailment of capital are basically relying on the sharing of benefits resulting from granting facilities, and profit is the basic factor of attracting depositors. In capital accounts, depositors make an agreement upon Ratio of Profit with the Islamic banking unit, which would be cited in the mutual contract. On the other hand, the Islamic banking unit could use these funds for business, projects and stock transactions. Capital accounts bear the time factor which begins from at least one month and could be variable for up to than five years.

Another important point is the wider range of options available for banks in use of financial resources. The bank is liable to use all funds resulting from deposit accounts at its discretion and the only constraint is conformity to religious rules.

1) Current Account: These accounts are accepted upon a deposit contract in which the depositor allows the bank to use all or part of the funds in those expenses deemed right. On the other hand, the bank ensures the depositor that he/she is able to withdraw all or part of the funds from his/her account, any time upon need. As a marketing policy and to attract depositors and also encourage them in keeping their deposits, the bank is authorized to pay a turnover amount to the depositors on the basis of Islamic notion of gift (Hibah). Thus, this turnover is not obligatory and has no predetermined rate.

2) Saving Account: These accounts are designed upon Wadiah in which the depositor authorizes the bank to use all or part of the funds upon discretion. The bank ensures reimbursement of all or part of the funds. In these kinds of accounts the bank also has the right to pay a turnover amount to the depositors based on the Islamic notion of gift as a marketing policy and to attract depositors and also encourage them in keeping their deposits (Hibah).

3) General Investment Accounts: These kinds of deposit accounts take place based on Mudarebah. In this kind of account a depositor has no right to interfere in how the deposited funds are consumed (invested). Opening such accounts also requires a minimum amount of deposit which is determined by the Islamic banking unit. The depositor will be informed about all terms and conditions as soon as he applies. The bank is entitled to invest these funds in short, medium or long term projects. The profit from investments is distributed based upon predetermined ratios. The depositors shall be liable to all of loss in case of it unless the loss has occurred because of negligence or mismanagement. If the depositor has a desire to extend the account, he/she could extend it upon maturity. Public investment accounts have some characteristics as below:

a. They can be opened individually or jointly.

b. The necessary amount for opening the account can be in cash, check or be transferred from current or deposit account, which in any case will take place after the money is received.

c. After the account is opened, a certificate is issued and delivered to the depositor.

4) Special Investment Accounts: In these accounts, the type of contract and operation is similar to general investment accounts, but funds resulted from each account which are subject to a minimum amount of deposit condition are preserved separately. Depositors have the right to stipulate that their money should be invested in a certain project or special economic sector. These kinds of accounts are managed by Islamic Banking Unit located in central offices and the banks negotiate profit sharing and how it will be done, with depositors.

II. Consumption of funds

In this section, we take a look at outputs of the Interest Free Banking Plan in consumption of funds which is also called investment activities, and wider use of contracts and Islamic Rules are made. As mentioned before, all resources in Interest Free Banking Plan are supplied through Wadiah and Mudaraba notion and bearing notions of gift (Habah) and profit, but there are more specific cases. In what follows the different types of investments are investigated:

- ### Purchase of Governmental Investment Issues (GII)

Banks purchase governmental securities for two reasons: 1) to have access to liquidity requirements; 2) to make use of suspended funds of the Islamic Banking. In this case the contract takes the form of loan taking.[35]

- ### Projects' Financing

According to Keenan (2010), projects are financed upon Musharaka and Mudaraba contracts:

1. **As for bail of capital:** The bank supplies the capital and all needed financial resources. On the other hand, the applicant is responsible for project management under the title of entrepreneur and in this way the bank cannot interfere in project management, despite the fact that the bank in not banned from its supervisory role.

[35] Jobst et al. (2008).

Partners negotiate the amount of profit sharing and any loss is borne completely by the bank.

2. **In terms of Partnership:** Both the bank and entrepreneurs are responsible for providing capital according to the agreed ratios. Also, they mutually have the option of management which could be delegated. Profit sharing would be agreed upon and in case of loss, each party is liable in proportion to his capital share.

- ### Possession of assets

According to Hassan (2011), possession of assets and related services in terms of type of contracts are as follow:

1. **Based on Installment sales** in which, after assessing the customer's need, the bank calculates the asset's real costs as well as expected profit margin and declares to the customer a price. The customer could reimburse the amount either as a whole or upon installments. The important point here is that if the customer is unable to reimburse the money, no interest fee shall be due upon him/her.

2. **Based on Lease** in which, the bank purchases property requested by the customer and receives from him a certain amount of money as a rental price in specified time intervals. Again, if the customer cannot pay the rentals, no interest fee shall be due upon him/her. A special case called *Lease on provision of Possession* also exists. In this case the customer undertakes to buy the property from the bank at an agreed upon price at the end of the contract period. In this case the rentals paid by the customer are considered as a part of the property's value.

- ### Trade Financing

As stated by Lahsasna (2007) trade financing could be done according to the different types of contracts like:

1. **Letters of Credit upon Proxy Contract:** The customer applies for L/C and the bank asks him to deposit the total price of the goods in the bank according to the Trust Rule. Then the bank delivers the documents to the customer, opens L/C and takes the wage from him at the end.

2. **Letters of Credit upon Murabahah:** The customer applies for L/C and asks to buy or to import the goods for him upon Murabahah. The bank opens L/C and buys the goods with his own money and sells it to the customer, to be paid totally or by installments.

3. **Letters of Credit upon Musharaka:** The customer applies for L/C and pays his share of Partnership Contract to the bank and the bank adds his share amount to it and opens L/C, handing over the documents to the customer. Eventually, selling the goods and getting a profit, the customer obtains his share.

4. **Document Warranty upon Substitution Rule:** The bank guarantees the customer against certain work to be done or loan remittance. So, the bank takes some money from the customer upon Trust and receives a wage in return.

5. **Provision of Working Capital upon Murabahah:** Based on the need of working capital like warehouse supply, spare parts, half-built products or raw material, the customer asks the bank to do purchases from his own funds or give

him proxy to do so from the same fund resources. Then, the bank sells the goods declaring the reimbursement to the customer at the agreed time which makes him/her to reimburse the amount upon maturity time.

7-2-5- Transferable Financial instruments in the Islamic Banking system

▪ Negotiable Instruments of Deposits (NID)[36]

These instruments are designed to be utilized by trading banks and eligible financial companies in order to enable internal deposits financed through the public's funds. These instruments have made improvements in the internal monetary market, since they are designed as tradable and in the form of cash.

Considering the fast growth of Islamic Banking since 1993 and the creation of the Islamic monetary market, there was a need for negotiable instruments of deposit. Thus, an Islamic version of the above mentioned instruments was designed and developed to similar ends, called Islamic Negotiable Instruments (INI). These instruments are categorized in two parts: "Negotiable Islamic Debt Certification (NIDC)" and "Islamic Negotiable Instruments of Deposits (INID)". Basically, negotiable Islamic debt certification refers to a certain amount of money which is deposited in banks and institutions and the holder is liable to get back the amount in nominal value, at a certain time in the future. INID refers to a certain amount of money deposited in banking institutions and the holder can receive the nominal value as well as a declared profit of

[36] Bank Negara Malaysia (2010).

Islamic transferable instruments of deposit, at a certain time in the future. Both these instruments are confirmed and supported by Bank Negara Malaysia and Sharia Council.

8- Problems and Limitations of Islamic Financial Economics

Due to the highly rising population of Muslims all over the world, there is a substantial need to restructure an Islamic economic system to provide them with proper services and supports. An economy is called Islamic when it acts according to the behavioral norms stemming from Quran and Sunnah. Islamic economists believe in the effectiveness and the homogeneity of these norms among all Muslim countries. They also agree that as an alternative for conventional economics, Islamic economics offers a comprehensive framework in dealing with any conceivable economic issue especially in replacement of zakat for tax and the prohibition of interest.

In consistence with Islamic Economics, it is inevitable to have Islamic financial institutions to serve people according to the norms defined in this system. Islamic banking came into existence based on Muslim countries' needs and desires but at the same time it faced some practical problems and limitations. Here we summarize some of these limitations.[37]

Islamic banks are said to share their profits or losses whereas conventional banks share their interest but, as opposed to our expectation, these shares are almost the same since Islamic banking also channels its deposits into bonds and other interest-bearing instruments due to the competition with conventional banking. As shown in table 3, the weighted average returns gained by the depositors are more or less the same in both Islamic and conventional banking regardless of their maturity dates. This is only because Islamic banks, as well as

[37] Kuran (2004).

conventional ones, avoid investing in risky assets and just a very small portion of their assets consist of loans based on original profit or loss. It is worthwhile to mention that the inflation rate in Turkey in 1990 was above 60%, thus in table 3 the nominal interest rates is adjusted.

Table 3: Nominal returns on saving deposits at Turkish banks

Term						
Month	3 months		6 months		1 year	
	Conventional banks	Islamic banks	Conventional banks	Islamic banks	Conventional banks	Islamic banks
June 1990	11.64	11.68	25.38	24.90	69.47	69.42
January 1991	12.34	12.02	25.51	24.61	56.25	57.12
June 1991	15.25	15.20	26.92	26.60	58.79	58.83
January 1992	15.68	15.58	30.51	30.46	65.11	64.30
June 1992	13.91	16.01	30.00	30.39	66.84	66.16
January 1993	14.72	15.65	29.88	30.43	66.96	64.51

Source: Kofteoglu (1994).

Notes: Figures represent weighted averages of the returns to depositors over the designated periods for all banks within the category.

As a very common and well-known example of a financial method in Islamic banking, Murabahah has yielded substantial criticism as it is a kind of a contract which is formally the same as other resale contracts with the difference that banks earn a cumbersome form of interest within a certain period of time to avoid the loss or benefit sharing risks. The only reason why Islamic banking is offering this contract is to deal with customers seeking low expected returns rather than those who prefer to borrow from conventional banks which yield higher returns.

On the other hand, Islamic banking also presents some information problems as firms would not disclose their costs and revenues information to avoid tax payments. This lack of information causes Islamic banks to lose their potential revenues based on the profit and loss sharing return system.

Moreover, another critique to Islamic banking is the way it has to deal with new needs and desires in the financial market, which must not only be served and supported by Islamic banking in order to survive in its competition with conventional banking, but also be in accordance with legitimate Islamic behavior.

Taking all the above reasons into account, we can conclude that the inefficiency of Islamic banking arises only when it operates in a conventional banking framework and the structural deficiencies of the conventional banking affects Islamic banking operations negatively. This means that it would be more efficient if it operates as a sole system in an economy.

9- The effects of global financial crises on Islamic banking

The recent financial crisis of 2008 is the largest crisis since 1930; therefore it is important to consider its effects on the regulation of Islamic banking. In order to better control the effects of the crisis and also to prevent further recessions, there is an essential need to improve banking regulation. As the IMF (2010) concludes, on the one hand Islamic banking was more stable than conventional banking during the recent financial crisis. On the other hand, the expansion of Islamic banking encountered some crucial challenges. The most important one is to establish a strong infrastructure in order to manage liquidity efficiently. This process needs a strong regulatory and supervisory system which must also be compatible with the global regulatory standards.

In the light of Chapra (2008)'s arguments, in order to analyze the effects of financial crises on banking, first we should investigate their causes. Although there were several causes, the main trigger of the recent recession was subprime mortgages. It is worthwhile to mention that subprime mortgages became more popular because there was no specific limitation on expansion of these kinds of mortgages. In order to prevent such a crisis from recurring, there is a necessity to apply a combination of three different factors. Firstly, impose the moral constraint on the "greed" of profit maximization. Secondly, control the structure of market discipline (for example, leverage). Lastly but most importantly, reform the structure of prudential regulation and supervision in order to prevent the repetition of similar crises.

Chapra (2008) compares the vulnerability of conventional and Islamic banking. Considering the fact that Islamic modes of finance (Musharaka, Murabahah, Mudaraba, Istijara) are real asset based sale and lease contracts, there is no permission to create debt without collateral, which eventually prevents the banking system form creating excessive expansion of debt.

In this rhythm Hassan (2009) mentions that if the principal of Shariah is applied accurately, it would be able to preclude the occurrence of financial recessions. For instance, if the notion of risk-sharing of Islamic banking is implemented in the commercial banking system, all the losses and benefits of investment will go through both banks and clients. This will lead to more efficient resource allocations because the bankers are also subjected to the outcome of investment. Therefore, they would act more prudently.

Considering the fact that Islamic banking was more stable and resilient than conventional banking in the economic crisis of 2008, it is logical to expect that Islamic banking will achieve a higher share of the international banking markets in the future. However, as stated by Alasrag (2010), there are some limitations on expansion of Islamic banking. Firstly, the most important limitation is the lack of uniform regulation and supervision standards for

Islamic banking. In this case the main problem is the absence of regulation which is also compatible with the non-Islamic countries. In other words, this creates difficulties for non-Islamic countries dealing with Islamic banking. The second limitation is the lack of fully Islamic financial organization which can better organize the international banking's affairs. Thirdly, the speed of innovation in accordance to Islamic financial instruments is too slow. There is an essential need to innovate some Islamic instruments in order to better manage the risks.

To conclude this argument, as this paper mentioned earlier there is a strong relation between the banking industry and the real economy. Therefore, it is also important to consider the role of Islamic banking in the recent financial crisis on the real economy. Following Chapra (2008), because of the small share of Islamic banking in the international banking industry, even if the Islamic baking works well based on Shariah, it could not have a significant effect on the international market.

10- conclusion

This paper undertook the investigation of how Islamic banking differs from conventional banking. Regarding the studies conducted in this rhyme there is a positive and direct relationship between the well-functioning of the banking system and the real economy, thus banks in both Islamic and conventional systems must implement some regulations, enforce internal governance and monitor payment and financial procedures. In order to achieve stable financial and banking systems, some standards have been established by the Basel Committee on Banking Supervision which can help both banking systems, although some of their policies are not applicable in the Islamic banking system. Islamic banking needs to implement Basel regulations not only to better incorporate itself to the global banking system but also to better integrate its standards.

Malaysia was used as a successful example of the dual banking system in this study. This country initially had a conventional banking system which was compatible with the standards of the Basel Committee. It is worthwhile to note that Islamic banking in Malaysia started with one bank in 1983 and remained under its monopoly for about ten years in order to set up the Islamic regulation more accurately and also to create more useful Islamic instruments. Still now, Malaysian bankers, as pioneers in Islamic banking, try to develop regulations and instruments of Islamic banking in order to make this system more efficient in responding to Muslims' needs.

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