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Risks and Regulation of Islamic Banks: A Perspective from a Non-Islamic Jurisdiction

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RISKS AND REGULATION OF ISLAMIC BANKS: A PERSPECTIVE FROM A NON-ISLAMIC JURISDICTION

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ABSTRACT

Islamic finance is growing rapidly, with considerable growth of Islamic finance in regions beyond its historical boundaries and increasing cross-border Islamic financial activities. MAS has been reviewing its regulatory regime to facilitate the offering of *Shariah*-compliant or Islamic financial services in Singapore, so that these can be offered as part of a full suite of financial services available in our international financial centre. In this paper, we will share a perspective of the risks and regulation of Islamic banking from the point of view of a regulator in a non-Islamic jurisdiction. Although *Shariah*-compliant financing involves trading and holding tangible assets, or risk-sharing, Islamic banks are not necessarily more risky than conventional banks. This is because there is often extensive use of risk mitigation, which leaves the Islamic bank primarily exposed to the credit risk of the customers. In our view, Islamic banks are also not less risky than conventional banks, as even though PSIAs may render an Islamic bank more resilient against risks to its solvency standing, it is still exposed to all the categories of risk that a conventional commercial bank is subject to. The major significant unique risk that Islamic banks face is *Shariah* compliance risk. Singapore has chosen not to put in place a separate regulatory framework for Islamic banking. Our approach is to look through the form of the Islamic products and assess economic substance and risks involved, and use that assessment as the basis for regulation. This Islamic finance space is an evolving one, and MAS is committed to keeping our regulatory framework responsive and relevant to this fast-growing and ever-changing industry.

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1 INTRODUCTION

1.1 Islamic finance is growing rapidly, with growth rates reportedly "at least twice as high as those recorded on global conventional financial markets"[1]. Much of the focus of activity had been in the Middle East and South and South-East Asia where Islamic finance had gained currency rapidly to meet growing interest in domestic markets there. More recently, there has also been considerable growth of Islamic finance in regions beyond its historical boundaries and increasing cross-border Islamic financial activities.[2] In addition, Islamic banks have been experiencing exceptional growth rates internationally, with leading Islamic banks now having significant market capitalisation both globally as well as in their domestic markets[3]. Islamic banking activity in international financial centres is growing, with new full-fledged Islamic banks having been established in London and Singapore in the last few years.

1.2 MAS has been reviewing its regulatory regime to facilitate the offering of *Shariah*-compliant or Islamic financial services in Singapore, so that these can be offered as part of a full suite of financial services available in our international financial centre. In this paper, we will share a perspective of the risks and regulation of Islamic banking from the point of view of a regulator in a non-Islamic jurisdiction.

2 ARE ISLAMIC BANKS MORE RISKY?

2.1 The starting point for any regulator is to understand the underlying risks of a financial institution's activities and the overall risk profile of the institution.

2.2 One of the prominent features of Islamic finance is that in conforming to *Shariah* law, any financing necessarily involves banks trading in and holding tangible assets, such as commodities and immovable property, or sharing risks with their customers through the use of partnerships or equity

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1 Moody's (April 2008), "Islamic Banks and Sukuk: Growing Fast, but Still Fragmented", Moody's Investors Service

2 Standard and Poor's (23 April 2007), "Chief Drivers Behind Islamic Finance's Global Expansion", *Islamic Finance Outlook 2008*

3 McKinsey (2007-08), *World Islamic Banking Competitiveness Report 2007-08*

participation[4]. Some commentators have suggested that these elements of trading and ownership of assets, and sharing of business risks may expose an Islamic bank to additional risks that are not typical of a conventional commercial bank that has as its main activity the provision of loans. However, in practice, Islamic banks generally make extensive use of risk mitigation. These include the use of service agency contracts with customers to assign certain responsibilities[5], agency contracts with customers for the procurement of assets, third party insurance to limit the risks of asset ownership, and special purpose vehicles to hold assets. There is also the structuring of transfer of ownership of the asset to the customer progressively through a diminishing *musharaka* (partnership), or at the end of a period as in *ijara muntahia bittamleek* (leasing with sale; henceforth referred to as "*IMB*"). Banks also commonly take collateral and/or ensure that they have recourse to customers. These risk mitigants reduce or limit the risks of asset ownership to the banks and have the effect of leaving the Islamic bank primarily exposed to the credit risk of the customer being financed.

2.3 A simple illustration of how Islamic banks are not necessarily exposed to greater or different risks is the *murabaha*-based (mark-up) asset financing, commonly used in home financing and car financing internationally. In such a transaction, the bank generally purchases the asset to be financed, and then sells it to the customer at a mark-up, to be paid on a deferred basis. The mark-up represents the profit to the bank for the transaction. As the purchase of the asset by the bank and the sale to the customer generally happen within a short period of time, the bank effectively takes on little additional risk[6] from that short-term ownership of the asset. The main risk the bank takes on is the credit risk of the customer. Such a risk is not dissimilar from the risks taken by a conventional bank making a loan. The bank can choose to take security over the underlying asset in a *murabaha* to enforce the repayment of the amount owed, which is again similar to the taking of collateral in a conventional loan. In this way, Islamic banks make use of structuring and other risk mitigants to lower the risks that they take on, and ensure that they primarily take on credit risk.

2.4 A second example is that of the IMB, which is commonly used in home financing and in project finance. A typical way of structuring an IMB is

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4 Commonly used Islamic financial structures that have such elements include the *murabaha* (mark-up) and *musharaka* (partnership) structures.

5 These service agency agreements typically make the agent (the customer) responsible for the maintenance, insurance and payment of taxes for the assets.

6 The risks that the bank is exposed to here include operational risk and legal risk from the purchase and sale.

to have the bank purchase the asset, such as the house in the case of home financing, and then enter into a lease agreement with the customer, where the cumulative value of the lease payments generally exceeds the purchase price paid by the bank. To mitigate the risks of owning the asset, the bank will generally appoint the customer as its service agent for the purpose of maintaining the asset, obtaining appropriate insurance and paying taxes on the asset. The bank will also structure the transfer of ownership of the asset to the customer by agreeing to pass the asset to the customer at the end of the lease, either as a gift or through a sale. As such, the bank is able to mitigate most of the risks of ownership of the asset. Through the techniques of risk mitigation, the bank is able to ensure that it primarily takes on the credit risk of the customer.[7]

3 ARE ISLAMIC BANKS LESS RISKY?

3.1 An Islamic bank may fund its activities by accepting *wadiah* and *qard hassan* deposits or *murabaha* funds placed by its customers. We consider these liabilities of a bank equivalent to deposits and have accorded them the same protection under the Banking Act as that given to deposits. In addition to these deposit-like liabilities, Islamic banks make extensive use of the *mudaraba* (profit-sharing) structure to collect funds in the form of Profit Sharing Investment Accounts ("PSIAs"). In such structures, account-holders contractually agree to bear the losses on the assets which they fund. These PSIAs appear to lower the risk to the Islamic bank since it can pass on the losses on its investments to the account-holder. The PSIA and the use of the *mudaraba* principle in funding the Islamic banking business is potentially an important and advantageous feature of Islamic banking, and if effective, may render an Islamic bank more resilient against risks to its solvency standing as losses are passed onto PSIA account holders rather than written off against the bank's shareholder equity.

3.2 However, in practice, the account-holder typically expects the market rate of return and a full return of his investment. While the customer has no contractual right to this, the threat or risk of redemption and withdrawals, and the reputational damage to the bank may serve as a strong deterrent to an Islamic bank considering if it should wish to exercise this

[7] There may be other residual risks from the ownership of the asset by the bank, but the extent of these depend on the risk mitigants employed by the bank and are generally limited.

contractual right to pass on losses to account-holders. Even in instances where investors understand that contractually their funds are subject to loss, they may expect their PSIA funds to have a risk profile similar to money market funds and would not accept a "breaking of the buck". Hence, better disclosure and consumer education is needed before there can be full confidence in the loss-bearing capacity of PSIA funds. PSIA account-holders will need to be fully aware of and understand the risks they are taking. This is the subject of guidelines and standards being drawn up by both the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB)[8]. Ultimately, there is no better way for an Islamic bank to impress on account-holders that their investments are subject to loss than to actually pass on such losses. At present, our view is that there does not appear to be substantive evidence that PSIAs significantly change the risks faced by Islamic banks as compared to conventional banks.

4 RISKS IN ISLAMIC BANKING NOT UNIQUE

4.1 An Islamic bank is exposed to all the categories of risks that a conventional commercial bank is subject to. There is risk to solvency if losses exceed capital. There is liquidity risk as Islamic banks, like conventional banks, are funded on a short-term basis through *wadiah* and *qard hassan* deposits, short-term *murabaha* placements as well as PSIAs which are redeemable, while deploying these funds in longer-term financing transactions. As there is a shortage of actively traded liquid *Shariah*-compliant financial instruments, Islamic banks tend to manage their liquidity position by placing out their funds on short-term basis. However, over the other hand, Islamic banks face the issue of whether some of their liquid assets can be monetised since, as under *Shariah* law, debts cannot be traded and this may impede the use of repos.

4.2 In terms of credit risk, Islamic banks do not generally face very different issues compared to conventional banks, but this depends in large measure on the extent of risk mitigation used. In some instances, Islamic banks may retain some asset and business risk. They face market risk when

[8] Some of the existing guidelines and standards include AAOIFI's FAS 5 on "Disclosure of Bases for Profit Allocation between Owners' Equity and Investment Account Holders" and IFSB's "Disclosures To Promote Transparency And Market Discipline For Institutions Offering Islamic Financial Services (Excluding Islamic Insurance (*Takaful*) Institutions And Islamic Mutual Funds)"

taking positions in tradeable instruments such as *sukuk*. The profit rate and currency risks faced by Islamic banks are similar to the risks conventional banks are exposed to, as they both offer variable and fixed rate financing but are funded primarily on a variable or short-term fixed rate basis and may also be exposed to currency mismatches. However, Islamic banks do not yet have access to the wide range of hedging instruments that conventional banks have. Thus, broadening the acceptability of Islamic hedging instruments, such as profit rate swaps, foreign exchange forward agreements and cross-currency swaps, is important to help Islamic banks mitigate these risks. They are also subject to other common risks such as operational risks. Some commentators have suggested that Islamic banks may face greater concentration risks as they are typically smaller and focused on small domestic markets. However, this is not different from what small domestic conventional commercial banks face.

4.3 In all these categories of risk common to both Islamic banks and conventional commercial banks, Islamic banks which undertake the appropriate risk mitigation measures generally fall within the same broad spectrum of risk as conventional banks and they trigger similar prudential considerations.

4.4 The major significant unique risk Islamic banks face is the *Shariah*-compliance risk. Islamic banks have to ensure that they are in compliance with *Shariah* rulings as this carries considerable reputation risk to the bank. In addition, any changes in the *Shariah* rulings may lead to banks having to unwind transactions, potentially at significant cost. Some commentators have suggested that the legal enforceability of contractual terms may be uncertain, if there is lack of clarity in certain jurisdictions as to whether *Shariah* law or the governing national law would be given precedence. While *Shamil Bank of Bahrain E.C. (Islamic Bankers) v. Beximco Pharmaceuticals Ltd. and Others* has established a precedent in the subject and English law is often the governing law for contracts, there may be occasions where assets to be enforced against reside in jurisdictions with both *Shariah* and national law and where there is still a lack of clarity.

4.5 In a few jurisdictions, regulators have set out requirements for banks to manage *Shariah* compliance risk. Some jurisdictions may have set up their own national *Shariah* boards, in an effort to harmonise the *Shariah* standards within their own borders. There are also many regulators in major Islamic finance jurisdictions that have not set up central *Shariah* boards. While MAS does not have detailed rules on the issue of *Shariah* compliance,

we view this as a matter of good management and controls on the part of the bank to maintain the confidence of its customers in the bank's soundness. MAS has often been asked whether it will set up a central *Shariah* board, and the answer has consistently been that *Shariah* interpretation is not a subject for a prudential supervisor like MAS. In any case, *Shariah* interpretations do differ between jurisdictions and even among scholars in a given jurisdiction. The bank in setting up its internal *Shariah* board will have to consider the mix of *Shariah* scholars on its board to best maintain the confidence of its customers.

5 SINGLE OR SEPARATE REGULATORY FRAMEWORK?

5.1 Having considered the risks of Islamic banking, we now turn to the question of whether a separate regulatory framework is necessary. Singapore has chosen not to put in place a separate framework for Islamic banking. From the discussion of the risks in Islamic finance above, we can see that the risks an Islamic bank takes on are not dissimilar to those taken on by a conventional bank, but, in fact, broadly fall within the same spectrum. There are varying degrees of retention of asset and business risks in the Islamic transactions, but for the majority of cases, the Islamic bank is not exposed to significantly different risks from conventional banks in a similar transaction. As such, we view the prudential and supervisory concerns as being largely similar, and have chosen to apply the same regulatory approach to both conventional and Islamic banks and financial products. The regulatory framework addresses risks – risk to solvency, liquidity risk, credit and market risk – and not whether a bank engages in *riba*-based banking or not. Fundamentally, we expect all banks, Islamic or conventional to remain focused on their core financing business. Where, at the margins, there are differences in residual risks of asset ownership and business or equity participation, we address these through supervisory oversight and exposure limits.

5.2 What our approach means is that we look through the form of the Islamic products to assess the economic substance and risks involved, and use that assessment as the basis for regulation. Where Islamic products are similar to conventional products in economic substance and risks, we accord both the same regulatory treatment. For example, in the *murabaha*-based asset financing described above, banks can treat the financing as a credit risk

exposure to the customer for the purposes of regulatory capital, as we recognise that the bank primarily takes on credit risk. In the same way, in an *IMB* transaction where the bank enters into a lease agreement with the customer and agrees to transfer the asset to the customer at the end of the lease, the bank is primarily taking on the credit risk of the customer as it expects a stream of rental payments from the customer[9]. As such, we will generally also treat the leasing as a credit risk exposure to the customer for the purposes of regulatory capital without requiring an additional capital risk charge against the leased asset.

5.3 Some jurisdictions have set up separate regulatory frameworks for the regulation of Islamic finance and these may be appropriate to the needs in those markets. These dedicated regulatory frameworks for Islamic finance, which tend to include licensing and regulatory requirements, generally also cover the same prudential areas such as capital adequacy, liquidity risks, credit and concentration risks. These address the same issues as a single regulatory framework applicable to both conventional and Islamic finance. The major difference between a dedicated Islamic finance framework and a single regulatory framework is on the issue of *Shariah*-compliance which we have discussed earlier.

6 CONCLUSION

6.1 The Islamic finance space is an evolving one. There have been rapid developments and innovations in product structures. These innovations have been driven by both the need for more diverse financing and funding structures and instruments for risk management, as well as by evolving views of what is *Shariah*-compliant. For instance, along with the growing diversification of *sukuk* structures in recent years, such as with *musharaka*- or *wakala*-based *sukuk* becoming increasingly common[10], there have also been concerns raised regarding the *Shariah*-compliance of the *sukuk* currently available in the market[11]. Regulators will have to be alert to market developments and the work of international bodies. Ultimately, any regulatory

[9] There may be other residual risks from the ownership of the asset by the bank, but the extent of these depend on the risk mitigants employed by the bank and are generally not very significant.

[10] Standard and Poor's (11 March 2008), "The Sukuk Market Continues To Soar And Diversify, Held Aloft By Huge Financing Needs", Standard and Poor's Ratings Direct

[11] The *Shariah* Committee of AAOIFI recently issued a *fatwa* that advises Islamic financial institutions and *Shariah* supervisory boards to refrain from using certain *sukuk* structures.

framework, whether it is a dedicated Islamic finance regulatory framework, or a single framework applicable to both Islamic and conventional finance, will have to be responsive and relevant to the fast-growing and ever-changing industry. This is what MAS is committed to do, whether it is in Islamic finance or more generally in all areas of financial services.

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