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Introducing Islamic Banks into Conventional Banking Systems

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Abstract

Over the last decade, Islamic banking has experienced global growth rates of 10-15 percent per annum, and has been moving into an increasing number of conventional financial systems at such a rapid pace that Islamic financial institutions are present today in over 51 countries. Despite this consistent growth, many supervisory authorities and finance practitioners remain unfamiliar with the process by which Islamic banks are introduced into a conventional system. This paper attempts to shed some light in this area by describing the main phases in the process, and by flagging some of the main challenges that countries will face as Islamic banking develops alongside conventional institutions.

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I. INTRODUCTION

Islamic banking is steadily moving into an increasing number of conventional financial systems. It is expanding not only in nations with majority Muslim populations, but also in other countries where Muslims are a minority, such as the United Kingdom or Japan. Similarly, countries like India, the Kyrgyz Republic, and Syria have recently granted, or are considering granting, licenses for Islamic banking activities. In fact, there are currently more than 300 Islamic financial institutions spread over 51 countries, plus well over 250 mutual funds that comply with Islamic principles. Over the last decade, this industry has experienced growth rates of 10-15 percent per annum—a trend that is expected to continue.

Despite this rapid expansion, in most conventional banking systems, Islamic finance is still uncharted territory for most practitioners and policy-makers. Since current trends indicate that Islamic banking will continue to increase its penetration of conventional systems, policy-makers and practitioners need to become acquainted with this process and its implications for financial supervision. This paper seeks to fill this void in the literature.

The paper, however, is not an introduction to Islamic banking (for this I would refer the reader to the excellent and recently published book by Iqbal and Mirakhor, 2007, or Ayub 2002). Instead, the paper focuses on the process by which Islamic retail banking is implanted in traditional financial systems. Drawing from the experience of several countries which have introduced Islamic banking over a period of time, the paper delineates the main phases of the process, with the intention of underscoring the main challenges faced by supervisors and practitioners at each stage. It also discusses some of the main elements required to build a supporting financial infrastructure that conforms to Islamic principles.

The sequence of steps to introduce Islamic banks that is discussed below should not be seen as a rigid template from which countries may not deviate. Such a rigid scheme would hardly be realistic, as countries' specific circumstances will vary substantially in practice. Instead, the goal is simply to discuss a series of stepping stones in the road to introducing Islamic banks, while simultaneously flagging some of the main issues that, sooner or later, are likely to arise as this industry develops. In this sense, the stages below should not be viewed as strictly sequential, but rather as overlapping layers of the same process.

The paper is structured as follows: Section II discusses some preliminaries with which the authorities should be familiar before introducing Islamic banks; Section III explains the different phases in the development of Islamic banking; Section IV discusses the role that the supervisory authority should play in this process; Section V explains the different elements that are needed to build a supporting Islamic financial infrastructure; finally, Section VI concludes.

II. PRELIMINARIES BEFORE INTRODUCING ISLAMIC BANKS

Owing to the growing demand by the Muslim population in Western countries and also to the increasing interest of Islamic investors (mostly from the Gulf region) to diversify geographically their portfolios, conventional banks are increasingly becoming interested in entering the market of Islamic financial products. Unfortunately, it is often the case that these institutions, as well as the supervisory agencies overseeing them, are not entirely familiar with the gamut of principles governing Islamic banking.

Besides the well-known Quran admonishment against *riba* (interest), *gharar* and *maisir* (contractual uncertainty and gambling), and *haram* industries (prohibited industries such as those related to pork products, pornography, or alcoholic beverages), there are other principles that must be observed by practitioners and supervisors in order to comply with Islamic jurisprudence.

Practitioners need to understand these principles in order to be able to provide the services and products demanded by consumers that want to comply with Islamic principles. At the same time, supervisors need to know the challenges that these new financial products and institutions will impose on the regulated entities, as well as the potential implications of the interaction between Islamic and conventional banks.

This section reviews four areas of paramount importance that practitioners and supervisors need to appreciate in order for Islamic banking to be successfully introduced into a conventional system: (i) compliance with the Shariah, (ii) segregation of Islamic and conventional funds, (iii) accounting standards, and (iv) awareness campaigns.[1]

Shariah Compliance

Islamic finance in based on the principles established by the Shariah as well as other jurisprudence or rulings, known as *fatwa*, issued by qualified Muslim scholars. Admittedly, some of the issues covered by these rulings can be quite complex, forcing the institutions involved to often seek the assistance of experts in interpreting them.

As a result, it has become a common practice for Islamic banks to appoint their own board of Shariah scholars. Nevertheless, since expertise in these matters is still relatively scarce in some countries, different Islamic banks often share the same scholars. This phenomenon has the beneficial side-effect that it promotes consistency across the services and products offered by these institutions.

Therefore, the first measure that an institution wishing to offer Islamic products must undertake, is to appoint a Shariah board or, at a very minimum, a Shariah counselor. This initial step is essential for the future operations of the institution, as it will help minimize Shariah risk, which is the risk that the terms agreed in a contract do not effectively comply with Islamic jurisprudence and thus are not valid under Islamic law. In consequence, the contract could be declared (partially) void in a Shariah court.

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[1] Some of the following material draws from Yaquby, 2005.

The importance of seeking Shariah expertise can be emphasized by means of an example, drawn from Wilson (1999). Kleinwort Benson was a pioneering investment bank which set up an Islamic investment fund in London in 1986. The fund aimed at drawing funds from the Gulf region. Initially, the fund experienced difficulties in attracting investors, as it lacked a Shariah board, and thus it was viewed with reticence by Gulf investors. After some time, a Shariah board was appointed and the fund took off successfully.

Financial regulators should also appoint their own Shariah experts, which would provide advice on the instruments and services offered by the institutions in their jurisdiction. Consultation with these experts would be crucial to ascertain whether the regulations issued by the supervisor with regard to Islamic institutions, as well as the licensing of different activities, are compatible with Islamic principles.

An additional important aspect for the regulator is that its rulings and decisions are consistent with those of the Shariah boards of foreign supervisory agencies. An important effort towards achieving international consistency was the creation of two multilateral institutions: (i) the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), which issues internationally recognized Shariah standards on accounting, auditing, and governance issues; and (ii) the Islamic Financial Services Board (IFSB), which issues standards for the effective supervision and regulation of Islamic financial institutions. The roles of the two institutions are discussed in more detail below.

Finally, the Islamic Fiqh Academy, inaugurated in 1988 in Jeddah under the auspices of the Organization of the Islamic Conference, has earned the respect of Muslim scholars around the world. Although not officially binding, its rulings and opinions on economic and financial matters are certainly taken into consideration by Islamic finance practitioners and policy-makers.

Segregation of Funds

An important principle behind Islamic finance is the desire to maintain the moral purity of all transactions. The funds intended for Shariah-compatible investments should therefore not be mixed with those of non-Islamic investments. This requirement is not based on the assumption that the activities of non-Muslims are intrinsically impure. The rationale behind this principle is rather one of prudence, in the sense of taking all the necessary precautions to ensure that Islamic funds do not become mixed with other funds that may be involved with *riba*, *gharar*, or *haram* activities.

Therefore, in order to ensure compliance with Islamic principles, conventional banks wishing to offer Islamic products must guarantee and publicize that the funds devoted to conventional activities will not be mixed (commingled) with those destined for Islamic activities. In operational terms, this requires that banks establish different capital funds, accounts, and reporting systems for each type of activity. In this sense then, when a conventional bank opens an Islamic window, to a large degree, it is in fact establishing a separate entity from the rest of the bank.

Accounting and Auditing Standards

The rapid expansion of the Islamic financial industry that started in the 1970s was not initially accompanied by the creation of a set of internationally recognized accounting rules. In consequence, Islamic institutions around the globe had to resort to developing their own accounting solutions for their new products, rendering comparisons across institutions difficult, and sometimes even giving the impression of lack of transparency.

The need for a body of accounting standards purposely designed to reflect the specificities of Islamic products became even more pressing as new and more complex instruments were being marketed. To close this widening gap, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was created in 1990. One of the main goals of this organization is to design and disseminate accounting and auditing standards that can be applied internationally by all Islamic institutions.[2]

The AAOIFI also plays a crucial role in pursuing the harmonization of Shariah-based rulings across jurisdictions. As mentioned above, the fact that supervisory bodies in different countries tend to rely on their own Shariah experts, may result in contradictory statements regarding the acceptability of a given instrument. Thus, financial products that are permissible in some countries, could be deemed as non-Islamic in others. Such disparity could discourage the cross-border use of Islamic products and constrain the growth potential of this industry. It could also result in pernicious regulatory arbitrage.

In those jurisdictions where Islamic finance is still nascent, regulators and financial institutions should familiarize themselves with the standards set by the AAOIFI, and apply them to the maximum extent possible. The application of already tested accounting and auditing conventions could alleviate the burden on supervisors facing the new challenges imposed by Islamic banking.

Furthermore, the pursuit of international consistency would not only ease the task of supervising internationally active institutions, but it would also ultimately favor the regulated institutions, as Islamic transactions would become better understood, and thus more attractive for Muslim and non-Muslim investors across the world. It would additionally foster the integration of Islamic institutions into the international financial community.

Awareness Campaigns

The speed and degree of success with which Islamic banking will emerge in conventional systems will largely depend on whether potential depositors and investors are well informed about the opportunities and risks at hand, and on whether Islamic banking is perceived as a transparent and well-regulated activity.

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[2] For more details on this organization see www.aaoifi.com .

Furthermore, from a prudential standpoint, it can be argued that guaranteeing that depositors are well informed, at least in the initial stages, should also be seen as a regulatory duty. Consumers should be duly informed of all the risks they run when entering into new contracts, as the public will have a better understanding of conventional deposits than of Islamic deposits (such as *mudarabah*, safe-keeping, etc.)

In consequence, regulators should communicate to the public what types of Islamic institutions and products will be supervised. Regulators should also require institutions offering Islamic products to actively pursue awareness campaigns. For instance, commercial banks should inform investment (*mudarabah*) depositors of the profit-and-loss nature of their deposits. In practice, these tasks can be easily accomplished by simply providing an explanatory prospectus to interested customers.

III. Phases in the Introduction of Islamic Banks

This section attempts to broadly define the main stages through which a country is likely to pass as Islamic banking develops. The steps presented here have been distilled from several country experiences, and do not constitute a rigid template outside of which it is impossible to create a favorable environment for Islamic institutions.

Although country experiences tend to differ, there are some traits that are common in most, if not all, cases and thus can be used as guideposts by other countries lagging in this process. An additional caveat to bear in mind is that the transition between stages will typically not be clear-cut. On the contrary, elements of several different stages may develop simultaneously and even coexist for some time.

This section reviews three broad stages: an initial stage where selected Islamic products are offered; a second stage where full-fledged Islamic banks are allowed to operate; and a third stage where non-bank Islamic financial institutions develop and expand the range of Islamic financial products available.

Finally, the case of Malaysia is presented as an illustration of the different phases discussed (Box 2). This country is singled out for its long commitment to Islamic finance, spanning over 30 years, and because it has pioneered many of the areas where Islamic banking has most fruitfully developed.

A. Offering Selected Islamic Financial Products

Setting Up Islamic Windows

An increasing number of commercial banks around the world are considering the possibility of offering Islamic financial products. In many countries, this interest responds to the banks' desire to offer services to a growing Muslim population, but it is also motivated by the wish to tap the growing pool of international investors attracted to Shariah-compliant products.

At first, a commercial bank may only want to probe the potential of this market, and thus may be interested in launching a pilot project. The bank can take advantage of its existing branch network to open so-called *Islamic windows*, through which to reach the potential new clientele.

An Islamic window is simply a window within a conventional bank via which customers can conduct business utilizing only Shariah compatible instruments. At the inception of the Islamic window, the products typically offered are safekeeping deposits—on the liability side of the bank—and Islamic trade-finance products for small and medium companies—on the asset side of the bank.[3] As mentioned in the previous section, opening an Islamic window will require the bank to establish the appropriate firewalls to avoid the commingling of Islamic and conventional funds.

As the activities of the Islamic window expand, the bank may consider fully segregating the window into a separate subsidiary (see sub-section B below). However, before going from a window to a full subsidiary, banks must meticulously ascertain the profitability of their Islamic business lines, as profits from the Islamic window could be overstated.[4] This is due to the fact that, typically, the overhead costs of the window (e.g., computer systems, building maintenance costs, support personnel, etc.) are borne by the parent bank, but will need to be financed by the Islamic subsidiary in the future.

It must be pointed out that reliance on Islamic windows, as a take-off platform for moving into the Islamic financial industry, has been a more common practice in South East Asia and Western countries than in the Middle East, where the tendency has been to establish stand-alone Islamic banks—e.g., in Kuwait and more recently Syria.

Islamic Investment Banking

An additional channel through which Islamic finance is swiftly penetrating conventional systems is via investment banking activities. Indeed, in an increasing number of Western countries, conventional banks are offering products specifically designed to attract Shariah-compliant investors.

In the last few years, the proliferation of Islamic instruments has been spectacular, and has encompassed a vast range of modalities: from sovereign sukuks (such as the €100 million sukuk issuance by the German state of Saxony-Anhalt in 2004), to corporate sukuks (like the first-ever US sukuk, issued by the Texas-based oil group East Cameron Partners for an amount of US$166 million), and to more sophisticated investment vehicles (such as Société Générale's pioneering Shariah-compatible hedge fund[5]). These deals often arise from the

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[3] See Iqbal and Mirakhor (2007) for a description of Islamic financial instruments.

[4] See Malaysia Institute for Economic Research (2000).

[5] See *Financial Times* of Friday, December 22, 2006

interest by borrowers to tap the large pool of resources available in the Gulf Cooperation Council (GCC) and some Asian countries, as well as from the lenders' desire to avail themselves of investment opportunities in Western countries while complying with Islamic jurisprudence.

Although these types of products are likely to flourish—particularly in countries with sophisticated conventional financial systems—there is a disconnect between the growth prospects of the Islamic investment banking and retail banking industries in Western countries. The advancement of the latter is tied to the geographical and demographical trends of the Muslim population in these nations, whereas Islamic investment banking benefits from today's high cross-border capital mobility.

B. Licensing Full-Fledged Islamic Banks

Once a conventional bank has operated an Islamic window for some time and has gathered a sizeable customer base for its Islamic activities, it may decide to establish an Islamic subsidiary, or even fully convert into a full-fledged Islamic bank. By following either of these two routes, the bank may benefit from economies of scope and concentration of knowledge and expertise. The bank will be able to offer, under one roof, a wider range of Shariah-compliant banking products than through the Islamic window alone. For example, it may be better equipped to fully engage in Islamic investment banking activities, such as underwriting sukuk issuances or managing Shariah-compliant investment and hedge funds, or to manage its own treasury and money market operations.[6]

The advantage of opening a subsidiary over a full conversion is that, with the former, the parent bank may continue servicing its conventional customers, while the subsidiary expands its Islamic activities in clear separation from the conventional business. On the other hand, a full conversion signals the bank's firm commitment to operate under Shariah principles, thus enhancing its credibility.

Although it does not seem to be a widespread concern within the industry, it must be mentioned that some Shariah scholars have raised concerns regarding the legitimacy of establishing Islamic subsidiaries or banks using capital from conventional banks (see Abd Rahman, 2006, and Yaquby, 2005). The concern arises because it is not guaranteed that the funds provided by the parent bank will originate from Islamic compliant sources, and hence, the subsidiary's initial capital may be Islamically unacceptable. Although there is an ongoing debate over this matter, one of the proposed solutions is to allow the formation of the new Islamic institution, if it commits to making future charitable donations as a way to purify the original funds.

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[6] In the case of Islamic windows, the treasury department of the parent bank is typically in charge of managing the liquidity requirements of the bank as a whole, which poses the threat of mixing conventional and Islamic funds.

Be that as it may, the transition from a conventional to an Islamic bank also presents operational challenges, as a number of items in the bank's balance sheet will be tied to interest-bearing transactions. Finance practitioners have devised strategies that rely on several Islamic products (e.g., *ijara*, *tawarruq*, diminishing *musharaka*) to circumvent this problem.[7] For illustrative purposes, Box 1 describes the use of *tawarruq* in the conversion process.

Finally, licensing Islamic banks, and windows, will increase the supervisory burden on the regulator, since there will now be a new type of institution/activity that requires its own regulatory framework. In other words, in addition to the Basel I or Basel II Capital Accords, supervisors will have to be familiar with the application of the IFSB standards for Islamic banks.

In order to build the appropriate expertise and resources to oversee Islamic banks, the supervisory authority could temporarily restrict the number of Islamic licenses it grants. Such a strategy has been pursued, for example, by the Kuwaiti authorities since 2003. The Central Bank of Kuwait (CBK) initially limited to three the number of Islamic banks allowed to operate. This policy was adopted in order to allow the CBK to develop enough capacity and proficiency to supervise this new segment of the banking system, and to initially let the infant Islamic banks develop in a somewhat protected environment (see IMF, 2004).

Box 1: The Use of *Tawarruq* to Make the Transition from Conventional to Islamic Balance Sheets

When a conventional bank decides to fully convert into an Islamic institution, it must ensure that all the items in its balance sheet are compatible with the Shariah. Therefore, it will have to transform all its loans and deposits into non-interest bearing assets and liabilities, such as, for instance, *murabaha* (cost-plus financing) contracts, in the case of assets, or *mudarabah* (profit-and-loss sharing) deposits, for its liabilities.

The bank could rely on a *tawarruq* instrument in order to convert an existing loan (bearing interest) into an Islam compatible instrument. A *tawarruq* is a contract whereby a customer requests a bank to acquire a specific commodity (e.g. metal or wool) on his behalf. The customer will repay the bank the cost of the commodity plus an agreed margin in installments[8]. The customer then requests the bank to sell the commodity right away in the commodity spot market. Hence, through this transaction, the customer can obtain immediate financing (via the spot sale of the commodity) which will be repaid at later dates (via the installment payments to the bank).

A *tawarruq* can be used to transform an existing debt contract into an Islamic instrument. The

[7] See also Adam (2005) and AAOIFI (2003).

[8] Same as in a *murabaha* contract.

[9] According to Al-Awan, 2006, the use of *tawarruq* in a number of GCC countries is partially supported by the *Maliki* and *Hanbali* schools of Islamic jurisprudence. This product, however, has been criticized by the Islamic Fiqh Academy and by the AAOIFI.

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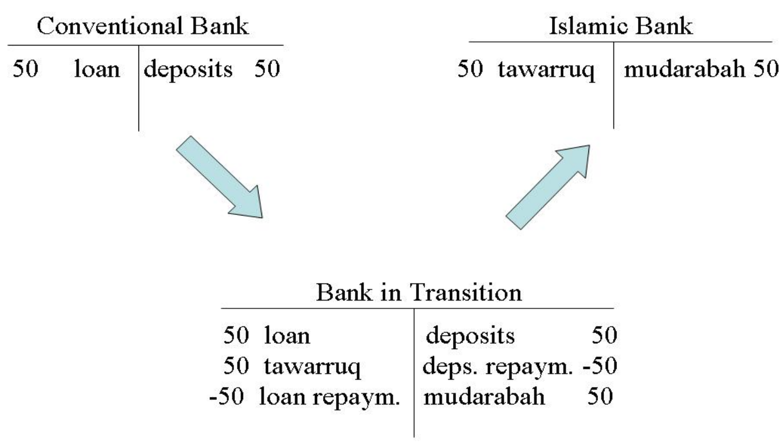
procedure is best explained with an example (see figure below). Suppose that some years ago, the bank had extended a loan for an amount of $100 to be repaid over 10 years at a 5 percent interest rate. Suppose also that at the time of the bank's conversion, the customer has already paid half of the loan principal, and so it has a remaining debt of $50 with the bank. The bank and the customer then enter into a *tawarruq* contract by which the bank will buy for the customer $50-worth of commodities and then sell them on his behalf. The customer then uses the $50 received from the spot sale to cancel its loan with the bank. Note that at this point the customer owes the bank $50 by virtue of the *tawarruq* contract, but not as an interest-bearing loan. In repayment for the bank's purchase of the commodities, the customer will include in the installment payments to the bank an amount commensurate with the forgone interest on the loan.



It must be acknowledged that, although the *tawarruq* accomplishes the goal of transforming interest-bearing contracts into interest-free instruments, it is seen as controversial by some Shariah scholars. In fact, while it is used in the Middle East, it is not always permitted in other jurisdictions.[9]

C. Introducing Non-Bank Islamic Financial Institutions and Instruments

As full-fledged Islamic banks increase their operations, and it is clear that there is a segment of the population interested in these products, other financial institutions and products may appear in the market. Since the menu of Islamic financial institutions and products is continuously growing, it would not be possible to list and discuss all of them in this paper. Instead, I will only consider three areas in which newly established Islamic banks are likely to participate as they explore new business opportunities. Namely, insurance products (*takaful*) , investment funds and sukuks, and derivative instruments.

Takaful

Conventional non-mutual insurance is not permitted in Islamic finance for two primary reasons. First, the insurer-insured relationship does not comply with Shariah teachings as it involves the trading of uncertainty. That is, the insured party pays the insurer for an object (i.e. the monetary compensation in case of an accident) that she may never receive (i.e. if the accident never takes place). This trading is similar to gambling (*qimar*), and thus forbidden. The second reason stems from the investment practices of insurance companies, which often hold interest-bearing assets. On the other hand, *takaful* is based on the concept of mutuality among insured parties, as in conventional mutual insurance. That is, several individuals agree to pool resources with the understanding that in case of need, each of them is entitled to draw resources from the pool.

Islamic insurance (*takaful*) companies are likely to develop alongside Islamic banks. As is the case in conventional systems, Islamic banks may start promoting their own *takaful* products or own *takaful* companies (e.g., in the same way as in bancassurance).

Investment funds and sukuks

In more sophisticated financial systems, Islamic investment funds and sukuk issuances will also emerge next to conventional funds and bonds. The emergence of these markets will largely depend on whether an adequate legal framework is in place. For example, regarding sukuks, the legal framework should provide clear rules for the establishment, management, and accounting of special purpose vehicles (SPVs), which are a vital ingredient in sukuk issuances.[10] If this framework is absent, it is likely that investors will revert to round-tripping their funds. That is, domestic borrowers and lenders will conduct deals in foreign markets to take advantage of more favorable legal environments.

Derivative instruments

Derivative contracts are another instrument widely used by financial institutions in advanced systems. These instruments are often used to hedge and reduce the risks associated with certain transactions, and as such, it could be argued that they perform a vital role in promoting economic activity by allowing the diversification of risk.

Nonetheless, from the standpoint of Islamic jurisprudence, the use, and trading, of some conventional derivatives (such as currency and interest-rate swaps or options) is controversial. Numerous scholars have pointed out that these derivatives should be viewed with reticence because they may easily involve excessive uncertainty (*gharar*), may encourage speculative behavior (*maisir*), or may involve the trading of debts. This does not imply, however, that other Islamic instruments with derivative-like features with which to help agents reduce risks are not allowed in Islam. In fact, there are already some Islamic instruments that partially resemble conventional derivatives or that could form the basis for designing Shariah-compatible derivatives.[11]

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[10] See, for instance, Solé (2007) "Developing Bond and Sukuk Markets in Kuwait".

[11] For example, Bai-Salam contracts, or the recently developed in Pakistan Istijrar contracts. See Bacha (1999) for a short discussion on these two instruments, as well as on some Islamic jurists' views on derivative instruments. Similarly, as pointed out in Ayub (2002, p.105), the concept of *arbun* (down-payment) could be

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Despite their reservations, Islamic scholars and practitioners acknowledge the important benefits for financial institutions of having access to some sort of hedging instrument. In consequence, there are several initiatives underway to develop these instruments further.[12]

D. Full Islamization of the Financial System?

The decision of whether to completely transform a country's financial sector into a fully Islamic system is a choice that will be based primarily on political and religious grounds. With the existing evidence at hand today, it is not possible to assert whether a purely Islamic financial system would be more or less efficient than a conventional one at intermediating financial flows.

Obviously, it is in countries with a predominantly Muslim population that a tendency towards full Islamization is more likely to develop. Two notable examples of this trajectory are Iran and Sudan.[13] Iran's transition towards a fully Islamic financial system started with the enactment of the 1983 Usury Free Banking Law, which abolished interest-based banking operations. Similarly, Sudan pursued the full Islamization of its financial system with the promulgation of the 1992 Banking Law, which aimed at eliminating interest from banking, as well as from all government transactions.[14]

On the other hand, there are also some Muslim countries that have allowed mixed financial systems to coexist for long periods. In some instances, the results of this coexistence have been remarkably beneficial, such as in Bahrain and Malaysia. In both cases, the presence of a dual system has given these nations a substantial competitive edge to establish themselves as well-diversified international financial hubs, appealing to both Islamic and conventional investors. Furthermore, the cross-fertilization between the two systems has led institutions based in these countries to pioneer several groundbreaking initiatives in different fields of Islamic finance.

Be that as it may, one important caveat to consider regarding the full Islamization process, is the fact that the gamut of Islamic financial instruments is still significantly smaller than in

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invoked to justify the design of option-like securities. This author also cites a resolution by the Fiqh Academy (from May 9th-14th, 1992) stating that "Option contracts as currently applied in the world financial markets...are not permissible in Shariah."

[12] The International Swaps and Derivatives Association (ISDA) and the International Islamic Financial Market (IIFM) have signed a cooperation agreement to develop Shariah-compliant derivatives.

[13] See Iqbal and Molyneux (2005) for an interesting account of the advent and expansion of Islamic banking in Iran and Sudan, as well as in other nations.

[14] Since the signature of the Comprehensive Peace Agreement in January 2005 between the Government of Sudan and the Sudan People's Liberation Movement (SPLM), conventional banks have been allowed to operate in this country.

conventional finance (e.g., lack of derivatives and hedging instruments, or money market instruments in many countries).

Therefore, the premature Islamization of a mixed system, where sophisticated conventional instruments are widely used, could act as a severe brake on financial (and economic) activity. In consequence, it may not be until further progress has been made in all areas of Islamic finance, that the more sophisticated mixed financial systems could move smoothly towards greater Islamization.

Box 2: The Introduction and Development of Islamic Finance in Malaysia

Since the early 1970s, Malaysia has progressively introduced Islamic finance into its economy. Starting with a few very specialized Islamic institutions, the Malaysian financial system has evolved to become a well-functioning, and internationally integrated, mixed financial system, in which conventional and Islamic financial institutions work alongside each other. In this regard, Malaysia can be seen as a blueprint to consider by those countries wishing to introduce Islamic finance. The success of Malaysian Islamic financial institutions is clearly evidenced by their ability to attract capital from international investors, as well as by the response of the local Muslim population.

The growth of Islamic finance in Malaysia is partly attributable to the government's intentional policies to develop this industry. While most of the financial institutions providing services were privately owned at the beginning of this process, the Malaysian government has always been attentive to the needs of these institutions and has been keen to provide a favorable environment for them.

Four broad stages of development can be drawn from the Malaysian experience. This box highlights the main elements of each stage, with a view to proposing the milestones in a possible road map for other nations.

First Stage: small Islamic institutions begin operations
In 1963, a small Islamic financial institution was allowed to operate: this was an Islamic savings fund, which managed small funds for individuals preparing for their pilgrimage to Mecca. A few years later, after the enactment of the 1983 Islamic Banking Act, the first Islamic bank (Bank Islam Malaysia Berhard) was granted a full-fledged banking license and started operations. To facilitate the liquidity management of this bank—but also as part of the strategy to develop Islamic finance in general—the government started issuing Shariah compatible investment certificates under the 1983 Government Investment Act.

Second Stage: conventional banks begin to operate Islamic windows
Under a pilot program, three conventional banks were allowed to open Islamic windows under certain restrictions, such as no commingling of funds. By relying on their wide branch networks, conventional banks could offer Islamic products to larger segments of the population than if they were only allowed to open one Islamic branch. In January 1994, Bank Negara Malaysia established the Islamic Interbank Money Market to allow Islamic institutions to adjust their portfolios according to their short-term financing needs.

Third Stage: some conventional banks fully convert to Islamic banks
After a certain period of operating Islamic windows, some conventional banks accumulated a sufficient critical mass of Islamic customers to make viable a full conversion of the bank into an Islamic institution. In October 1999, the second fully Islamic bank (Bank Muamalat) was created as a result of the merger between Bank Bumiputra and Bank of Commerce, which had been operating Islamic windows. The Islamic assets and liabilities of the merging banks were transferred to the newly created Bank Muamalat.

Fourth Stage: introduction of other Islamic financial institutions and markets
In 2001, the government established the Islamic Capital Market, where several kinds of Islamic securities could be issued and traded in a secondary market. In June 2005, the Dow Jones launched the

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Islamic Malaysia Index, which tracks over 45 Shariah-compliant companies. Also in 2005, the Malaysian Parliament approved the creation of the Perbadanan Insurans Deposit Malaysia (PIDM) to administer the deposit insurance system. The PIDM covers conventional and Islamic deposits alike, and it will undertake the resolution of failed conventional and Islamic banking institutions, when needed. Finally, as a reward for all these efforts, the country has witnessed the full integration of the domestic Islamic banking system into the international financial community.

IV. The Role of the Supervisory Authorities

The role to be played by the regulatory authority in systems with emerging Islamic banks is two-fold: on the one hand, there is the traditional prudential supervision aspect; but there is also a vital developmental role that is equally important. This section discusses each of these aspects in turn.

A. Prudential Supervision

As is the case in conventional systems, the supervisory authority must ensure the stability of the financial system as a whole, as well as the proper conduct of individual institutions. Therefore, the regulator will have to undertake similar supervisory and regulatory functions regarding Islamic institutions as the one already performed vis-à-vis conventional institutions.

Regarding the implementation of prudential supervision *per se*, it is a somewhat common misunderstanding that, since Islamic banking is largely based on profit-and-loss sharing agreements, Islamic institutions do not need to be supervised at the same level as conventional banks. In fact, as already pointed out by Errico and Farrahbaksh (1998) and El-Hawary *et al.* (2004) among others, there are certain features of Islamic banks that warrant prudential regulation to a similar degree as traditional banks. In particular:

- **Moral hazard considerations.** Such considerations arise from the risk-sharing nature of investment deposits, in which depositors provide the funds that the bank invests in the activities it deems profitable. Given that Islamic banks can pass a substantial part of the investments' losses onto depositors, banks could potentially be induced to undertake riskier projects than if they had to guarantee all deposits, as in conventional banks.[15] Furthermore, investment depositors require also greater guarantees than company shareholders do. This is due to (i) the highly leveraged nature of Islamic banks (the high leverage owing to the presence of demand deposits), which may induce banks to take on excessive risks, and (ii) the fact that investment depositors lack voting rights and cannot influence the bank's strategies.

[15] It must be noted that, this moral hazard effect will be partly mitigated by the level of competition existing in the banking system. That is, as Islamic banks compete with each other, they will try to minimize the losses they pass on to depositors in order to retain/attract customers. As a matter of fact, in practice, banks use the *investment risk reserve* to protect depositors from some risks.

- **Safeguarding the interests of demand depositors.** Demand depositors in Islamic banks face the same risks as demand depositors in conventional banks and thus merit the same level of protection.

- **Systemic considerations.** While the failure of a corporation would not have contagion effects, the failure of a bank could very well result in the public's loss of confidence in the stability of the banking system as a whole, thus triggering a generalized bank run.

- **Shariah compliance.** As mentioned in section II, supervisors must have an understanding of whether Islamic banks' activities are compatible with the Shariah. In some countries, private Islamic banks have their own Shariah advisors. However, setting up a Shariah consultative board at the supervisory agency would be beneficial in countries where Islamic banks are present.

Finally, and as mentioned above, the spread of Islamic finance in an increasing number of countries has hastened the need for a set of internationally accepted regulations. To satisfy this need, the Islamic Financial Services Board (IFSB) was created in 2002, with the mandate to develop prudential and regulatory standards for the Islamic industry, and to identify and publicize recognized international best practices in several areas.

In this regard, and paralleling the development of the Basel II Capital Accord, the IFSB issued in 2005 two regulatory standards on capital adequacy and risk management for Islamic institutions. It is also planning to issue additional standards in other important areas, such as corporate governance and the supervisory review, among others.[16] Regulatory bodies newly acquainted with Islamic banking should establish a working relationship with this organization.

B. Industry Development

The authorities are also called to play a decisive developmental role, as they can affect the degree of success with which Islamic banking is introduced into a conventional system. In this sense, the role of the supervisor is not only to guarantee financial stability, but also to foster an environment where Islamic banking can offer a suitable response to customers' demands for Islamic products. This is not to say that regulatory advantages should be given to Islamic institutions, but rather that a level playing field should be provided. In fact, it is likely that in the initial stages of the process, some Islamic transactions will fall into legal voids and thus may not be permitted by the existing legal framework, or may be viewed with reticence by the general public.

[16] See the IFSB's guidelines "Capital Adequacy Standards for Institutions (Other than Insurance Institutions) Offering Only Islamic Financial Services" and "Guiding Principles of Risk Management for Institutions (Other than Insurance Institutions) Offering Only Islamic Financial Services".

In other words, the authorities' attitude should be akin to the British Financial Services Authority's stated policy of "no obstacles, no special favours".[17] It is in this spirit, for example, that the FSA has issued secondary regulation for Islamic mortgages.[18] Under the new legislation, buyers of Islamic mortgages will enjoy the same degree of regulatory oversight as buyers of traditional mortgages.

In sum, the authorities should strive to ensure that (i) Islamic principles are well-understood by practitioners, (ii) transactions fall under the umbrella of prudential regulations, and (iii) customers of Islamic institutions are afforded the same level of regulatory protection as those of conventional banks.

To achieve these goals, it may be useful to establish consultative working groups between the regulatory body and representatives of the Islamic financial community. These working groups would seek to identify the challenges faced by the Islamic banking industry, and to advise on the adequate regulatory responses.

The Kingdom of Bahrain constitutes a good case study to underline the important role that the authorities can play in promoting the development of the Islamic financial services industry (Box 3).

Box 3: The Emergence of Bahrain as an Islamic Financial Center

While it is true that the Kingdom of Bahrain partly owes its success to a number of external circumstances that gave it a leading advantage, the Bahraini authorities also undertook prompt and resolute actions to maximize and materialize this advantage.

During the 1970s, the Lebanese civil war impeded Lebanese banks from being able to continue to satisfy the growing demand for financial services in the Gulf region.[19] Bahrain took advantage of this situation, as well as of its favorable geographical location and of its relatively educated population to start developing its own financial services industry.

In particular, in 1975, the authorities approved the Offshore Banking Regulations, which allowed the entry of foreign banks without being subject to some of the existing banking regulations (as long as they dealt with non-residents only). The favorable regulatory environment gave the Kingdom a clear advantage with respect to its neighbors to draw in a substantial number of financial institutions. Shortly after that, the first Islamic bank (Bahrain Islamic Bank) was licensed in 1979, and since then, at least 27 other private Islamic financial institutions have been established. The range of products offered by these entities covers the whole myriad of existing Islamic products, from basic deposits and financing arrangements, to more complex Shariah-compatible investment funds.

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[17] See the FSA's Briefing Note BN016/06, "Islamic Banking in the UK", available at www.fsa.gov.uk

[18] See the FSA's PN041/2006, "Home reversions and Islamic mortgages get new consumer protections", available at www.fsa.gov.uk

[19] See Brodhage and Wilson (2001).

(continued)

An additional crucial ingredient in Bahrain's success story was the government's unequivocal commitment to attracting leading financial institutions and to leading multilateral initiatives to develop the sector. As a result of these efforts, Bahrain is today the location for the headquarters of important organizations such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the International Islamic Rating Agency (IIRA), the International Islamic Financial Market (IIFM), and the Islamic Liquidity Management Center (ILMC), among others. The presence of these organizations, along with an important number of private financial institutions, makes Bahrain a center of constant financial innovation.

V. Building a Supporting (Islamic) Financial Infrastructure

Well-functioning banking systems require a certain infrastructure to guarantee the efficient and safest allocation of funds. In conventional systems, banks are supported in their daily activities by a series of elements that make their operations more reliable and cost-efficient. Among the cornerstones of a banking system, this section will underline three elements which will be discussed from the perspective of Islamic banks: the deposit insurance scheme, the interbank money market, and sovereign securities as tools for systemic liquidity management.

Before proceeding, a caveat should be made. In the areas to be discussed below, a consensus on best practices has not yet emerged; hence the diverse country experiences. Furthermore, some areas (such as the design of Islamic money markets) are currently being developed. For these reasons, the discussion will try to provide some specific guidance where available, but, in its absence, it will point to some of the relevant organizations currently working on these issues.

A. Deposit Takaful (Insurance)

It is a widely accepted principle in conventional systems that deposit insurance is a powerful means to build and maintain public confidence in deposit taking institutions. Certainly, the same principle applies to Islamic banks, and thus, countries where these institutions are emerging should consider setting up protection schemes (i.e., deposit takaful) for Islamic depositors.

Besides its financial stability benefits, a deposit takaful (DT) may also have several advantages from a developmental perspective. Particularly in low-income countries, where there is typically a lack of public trust in the banking system, a well-designed deposit takaful would encourage participation in the banking system and reduce the fraction of the population that is under-banked.

Regarding the design of the DT, it is important to recall that insurance as it is understood in conventional finance is not permitted in Islam (see footnote 9). Therefore, the DT will have to be designed in a way that complies with the Shariah. As noted by the International

Association of Deposit Insurers (IADI, 2006), several important issues need to be decided upon before launching a DT. These include the following:

- the scheme's coverage. Should the DT cover all Islamic deposits, or only those that are demand deposits?
- its funding and investing policies. How should the DT be funded? Where should it invest its assets?
- the resolution process for dealing with failed banks.

Presently, most countries in which there are Islamic banks lack an explicit deposit takaful. Instead, some countries have opted for implicitly guaranteeing depositors in Islamic banks within the general deposit insurance. This raises a potential conflict with Shariah compliance, as the funds of the deposit insurance fund may be invested in interest-bearing assets.

The proper course of action is to establish an explicitly Shariah-compatible deposit takaful. A pioneering example is Turkey which, in July 2003, allowed Islamic banks to create an Islamic deposit takaful (see IADI, 2006). In a similar spirit, the Malaysia Deposit Insurance Corporation is planning to launch a deposit protection scheme by 2008, insuring conventional and Islamic deposits alike. In this scheme, the premiums collected from Islamic deposits will be kept, and invested, separately from the premiums from conventional deposits (see Parliament of Malaysia, 2005).

Nevertheless, as pointed out in IADI (2006), there is one potential problem with the Malaysian scheme since it is designed to cover all Islamic deposits, irrespective of whether they are profit-and-loss sharing deposits (*mudarabah*) or not. Covering *mudarabah* deposits may generate serious moral hazard implications, as well as violate the risk-sharing nature of the *mudarabah* deposits, where it is intended that the depositor (*mudarabi*) bears the risk of losses. On the other hand, if most deposits are *mudarabah* deposits, then not including them under the coverage would limit the impact of the DT in increasing the stability of, and the public's confidence in, the banking system.

In the author's opinion, guaranteeing *mudarabah* deposits against a bank's failure could be justified as a way to insure depositors against the bank's malpractice. That is, the deposit takaful would reimburse the lost deposits if it is proved that the bank's failure was due to intentional mismanagement or negligence.

To research all the above issues and to elaborate a consensus on best practices, the IADI has set up a Standing Committee on Islamic Deposit Insurance.[20]

[20] See the address given by Mr. Jean Pierre Sabourin (President of the IADI) "Visioning on Deposit Insurance," at the 2006 International Open House of the Korea Deposit Insurance Corporation, Seoul, Korea, June 16, 2006.

B. Islamic Interbank Money Market

By their very nature, banks combine in their balance sheets short-term liabilities with long-term assets, resulting in maturity mismatches. Banks try to minimize the potential risks resulting from these mismatches by actively managing their liquidity needs—typically through interbank money markets. Given that conventional interbank markets are interest-based markets, Islamic banks cannot use these markets to manage their liquidity positions, and therefore an alternative market design is required.

For a number of years, however, Islamic banks in conventional systems have operated with no access to tradable short-term treasury instruments with which to channel excess funds to other Islamic banks. This has restricted their growth potential by forcing them to hold substantial cash reserves. Additionally, the absence of these instruments has also curtailed the authorities' ability to conduct monetary policy operations (see section C below).

Two important attempts aimed at filling this void have been carried out in Malaysia and Bahrain. First, the Malaysian Interbank Islamic Money Market has been operating since 1994 with several Islamic instruments. Second, and in a similar vein, the Bahrain Monetary Authority established the Liquidity Management Center (LMC) in 2002 with the goal of allowing Islamic banks to handle their liquidity needs. [21]

C. Islamic Sovereign Securities[22]

Government Securities

Besides their role as borrowing vehicles for the state, government securities are also significant tools for the conduct of monetary policy, as commercial and central banks often use them for repo operations. This section will briefly discuss some of the existing Islamic government instruments with the intention of providing the reader with a general sense of how these securities are used in practice for monetary operations. However, this section does not intend to provide an overview of all the existing instruments. [23]

As in other fields within Islamic finance, Malaysia has made noteworthy innovations regarding Islamic government securities. In 1983, the Malaysian government pioneered the

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[21] See the websites of the Islamic Interbank Money Market (www.iimm.bnm.gov.my) and the Liquidity Management Center (www.lmcbahrain.com) for a detailed description of the instruments admitted for trading in these markets.

[22] I am indebted to the personnel of the Central Bank of Sudan, the Sudan Financial Services Company, and the Central Bank of Kuwait for multiple discussions on this topic.

[23] Sundararajan *et al.* (1998) and Ul-Haque and Mirakhor (1998) provide a good, although slightly outdated, description of some of the basic instruments used in Islamic systems. Ayub (2002), in turn, provides a short panoramic on the use of Islamic government securities in a number of countries.

issuance of Islamic sovereign certificates—known as Government Investment Issues (GIIs)—an instrument which the government has continued to issue.

These certificates were introduced to provide Islamic banks with a sovereign instrument in which to invest their short-term excess liquidity. However, since the GIIs were initially issued under the modality of benevolent loans (*qard al-hasan*), they were not tradable among banks.[24] To circumvent this limitation, in 2001, the government started issuing GIIs based on *bay al-dayn* (debt trading), which can be traded in a secondary market, and hence are a better tool for promoting interbank transactions.[25]

Another country that has made important advances in this area is Sudan. Having a fully Islamic financial system, Sudan has developed instruments to raise financing for the government as well as to manage systemic liquidity. Two types of certificates allow the Sudanese government to raise financing at different maturities: Government Investment Certificates, which are based on a pool of *ijara*, *salam*, and *murabaha* instruments, are used to raise long term financing; Government Musharaka Certificates, based on equity partnerships, have maturities of one year. Additionally, the central bank has also issued, although in smaller quantities, its own *ijara* certificates (commercially known as *shijabs*). The Central Bank of Sudan typically trades with banks the three types of instruments in order to affect liquidity in the banking system.

In 2001, the Bahraini authorities introduced two types of sukuks to satisfy the needs of Islamic banks. The intention was to replace some of the sovereign's conventional borrowing with Islamic instruments, so that (i) Islamic banks would face a level playing field vis-à-vis traditional banks in terms of investment opportunities, and (ii) the authorities could engage Islamic banks in the conduct of monetary policy. Consequently, *ijara* and *al-salam* sukuks were issued as long-term and short-term sovereign instruments, respectively.

Mirroring the use of treasury bills in conventional systems to manage systemic liquidity, the Central Bank of Bahrain uses *al-salam* sukuks to engage Islamic banks in its monetary operations. Under an *al-salam* sukuk, the government agrees to sell forward to Islamic banks a commodity (typically aluminum in the case of Bahrain) against a spot payment. Simultaneously, the Islamic banks designate the Bahraini government as their agent to sell the commodity to a third party upon delivery. The price of the future sale determines the return of the sukuk, while the initial spot payment from the Islamic banks to the central bank constitutes the liquidity withdrawal.

Central Bank Securities

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[24] Recall that Islam prohibits the trading of debts, unless it is at par value.

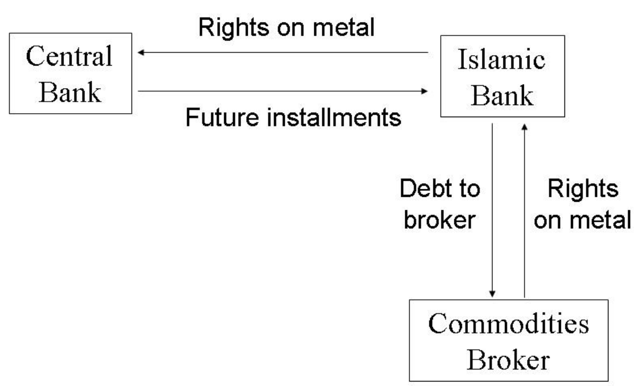
[25] Again, there is controversy regarding this instrument, which is rejected by some Middle East scholars on the grounds that it involves *riba*.

It is important to note that in the examples above the sukuks are issued by the governments, but used by the central banks for their monetary policy operations. However, there are countries with Islamic banks where the government does not issue Islamic paper, and thus the central bank needs to find alternative ways to conduct open market operations with Islamic banks. Therefore, the central bank may have to issue its own Islamic instruments in order to create a tool to manage the system's liquidity.

One possibility is for the central bank to securitize some of its assets (e.g., the central bank's building), as in the Sudanese *shijabs* mentioned above. Note, however, that the potential issuance size of this security will be somewhat capped by the value of the central bank's assets, thus effectively limiting the amount of liquidity that can be drained from the market via this instrument.

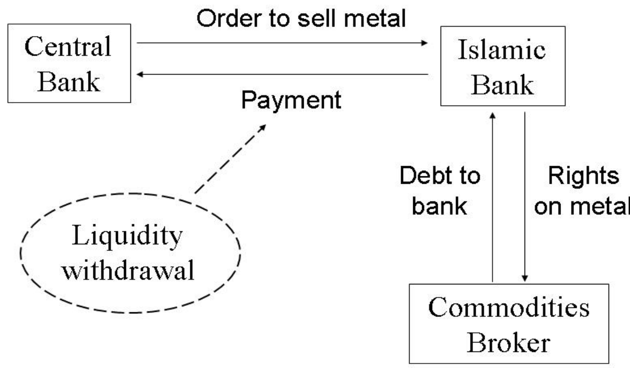
An alternative approach has been followed in Kuwait, where the central bank has recently designed a type of monetary policy operation based on *tawarruq* to manage the system's liquidity. As explained in Box 1, a *tawarruq* is a commodity-based instrument which allows its originator to obtain immediate financing. The use of this instrument for liquidity management purposes can be best explained as a two-step transaction (see figures below). The following description explains how a central bank can use a *tawarruq* to absorb liquidity from the market—to inject liquidity, the flows described would simply have to be reversed.

Step 1



Step 1: Suppose the central bank desires to absorb excess liquidity from the market. For this, it will approach Islamic banks and ask them to purchase some commodity on its behalf. The banks, in turn, will contact commodity brokers and agree on a specific price. At this point, the Islamic banks do not transfer funds to the broker. The central bank agrees to repay the Islamic banks at a future date the cost of purchasing the commodities plus a margin (as in *murabaha* contracts).

Step 2



Step 2: Subsequently, the central bank requests the Islamic banks to resell the commodities—typically at the same price and to the original commodity broker, who will cancel the debt acquired in step 1 by the Islamic banks. The Islamic banks, however, make a payment to the central bank, out of their own treasury, equal to the value of the spot sale of the commodities. This payment is what constitutes the liquidity withdrawal, while the cost of the monetary operation is determined by the future installment payments over the spot payment.

VI. Concluding Thoughts

Islamic banking has been making headway into an increasing number of Western countries. This is indeed a trend that is likely to carry on, as oil-exporting nations continue to accumulate wealth, GCC and South East Asian Islamic financial markets develop further, and companies in Western nations keep on competing to attract international investors.

Nonetheless, despite the rapid growth of Islamic finance in the last few years, many supervisory authorities and practitioners are unfamiliar with the process by which Islamic banks are introduced into a conventional system. This paper has attempted to shed some light in this area, by identifying the main traits in the process, and by flagging some of the main challenges that countries will face as Islamic banking develops alongside conventional institutions.

As Islamic finance keeps expanding, the supervisory authorities will have to ensure that these new institutions become fully integrated with the rest of the financial system. The integration process will not only entail allowing Islamic institutions to operate, but also providing a comprehensive regulatory framework, as well as developing a supportive financial infrastructure.

Understanding Islamic banking is also essential from a financial stability perspective, at least on two accounts. First, Islamic banks may become systemically relevant as they grow and increasingly interact with systemically important conventional banks. Second, the current lack of Islamic hedging instruments results in the concentration of risks in a smaller number of institutions. Overseeing the concentration of risks and its potential impact on Islamic financial institutions should become a daily task for the regulatory authorities.

Finally, it should be emphasized again that, fortunately, a number of multilateral institutions have been recently created in order to provide assistance to governments in the matters discussed above, and to issue standards and best-practice guidelines for this industry. Therefore, it is firstly to these multilateral organizations that governments newly acquainted with Islamic finance should turn to for advice. In addition, the authorities should engage in dialogue with the local interlocutors of this industry, in order to promote an open and fluid exchange of information and ideas.

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