Prudential standards for Islamic Banking

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Islamic Banking

- System of banking consistent with Shari'a
- Key principles – Riba, Haram, Gharar, profit/loss sharing, safekeeping, trust and partnership.
- Underlying philosophy
  - No time value of money & No usury.
  - Money is just a medium and not a resource
  - All financial transactions must be backed by a trade in real assets or investment.
  - No asymmetrical reward sharing – returns solely in line with risks assumed.
  - Ethical and social responsibility.

Islamic Vs. Conventional Banking

- No Lending but investment or financing a trade.
- Asset-based financing vs. Cash-flow based lending
- Revenues are from fees and not interest.
- Prohibition on contracts involving Gharar – no derivatives, particularly for proprietary book - taking bets.
- Financing or any association with entities involved in activities deemed as Haram are not allowed.

Islamic vs. conventional banking

- Funding options do not include interest-bearing deposits
- Investors get a product closer to that of CIF.
- An Islamic Bank's (IB) operation is close to that of an Asset Manager.
- Products are more complex; awareness and understanding among customers is poor.
- IB market is evolving – customers are not demanding

Islamic Contracts used in IB

- Murabaha – Cost-plus financing
- Mudarabah – profit/loss sharing
- Ijarah – Leasing
- Istisna – Long-term Deferred Delivery Sale
- Musharaka – Equity participation partnership
- Salam – Deferred Delivery sale
- Waqf – Trust
- Wadiah - Safekeeping or custody

Typical IB products

Assets – what the bank lends

- Murabaha – very popular for short-term credit
- Salaam contracts – also used for short-term credit and Forex purchase deals.
- Ijarah Contracts – for term lending, residential and commercial mortgage financing
- Istisna contracts – for project financing in infrastructure, lending, construction sectors
- Musharaka investments – PE & venture capital type investments for SMEs & large LBOs.
- Mudarabah – investments made by IB (as a Mudarib) using funds from its PSIAs.
- Mudarabah contracts are also used for syndicated financings.

Typical IB products

Liabilities – what the bank borrows

- Mudarabah accounts – Parallel to time deposit in conventional bank.
- Mudarabah accounts are PSIAs – of both restricted and Unrestricted variety.
- Commodity Murabaha – often used for for short-term borrowing in the inter-bank market. Also used for deposit taking.
- Salaam contracts –used for Currency purchases in the forward markets.
- Amanah or Qard – used for accepting deposits for safe-keeping with no returns. Capital has to be protected.

Prudential Risks for an Islamic Bank

- All the prudential risks of conventional banking apply equally to IBs
- Lack of financial intermediation
- Contracts used by Islamic banks have more complex risk profiles
- Lack of hedging tools and relatively shallow markets
- Need to distinguish risks and address them
- Effective accounting standards to address issues peculiar to IB

Issues unique to Islamic banks

- Necessity to co-exist and compete with conventional banks
- Potential bank-specific & systemic impact due to deposit outflows
- Need to smoothen returns on PSIAs to retain deposits and to prevent rapid outflows
- Measure, monitor and manage Displaced Commercial Risk (DCR)
- Capital adequacy to cover DCR
- Lack of consensus on use of some products and use of hedging tools.

Prudential approach

- Approach to prudential regulation is similar to that for conventional banking
- Prudential regulation approach based on Basel standards for conventional banking
- Risk management and capital adequacy standards are same as that applicable to conventional banks
- In addition, IBs are subject to capital adequacy requirements to cover DCR
- Special issues arise due to peculiarities of contract structures and shari'a issues.

Global standards

- IFSB leads the way in establishing global standards for prudential risk management and capital adequacy for IBs.
- IFSB follows a rigorous approach to develop and implement global standards.
- Development involves survey of extant practices, benchmarking, public consultation and final public hearing
- IFSB has addressed all key areas including Basel II, though its standards continue to evolve.
- AAOIFI plays a significant part, focussing on accounting and auditing standards

IFSB – Key standards

- IFSB-1: Guiding principles for risk management in Islamic FIs (IFIs)
- IFSB-2: Capital adequacy standards for IFIs other than takaful firms
- IFSB-4: Disclosures to promote transparency and market discipline for IFIs
- IFSB-5: Guidance on key elements of Supervisory Review process for IFIs
- GN-1: Guidance note on recognition of ratings og External credit assessment institutions
- IFSB-7: Capital adequacy standards for sukuks, securitisations & real estate investments

Standards under development

- Currently there are 2 exposure drafts out for public consultation
- GN-2: Guidance note on capital adequacy for commodity murabaha transactions
- GN-3: Guidance note on practice of smoothing the profits payout to Investment account holders
- In addition, IFSB is currently at work on developing standards for liquidity risk management and stress testing

DFSA's approach

- Consistent with IFSB standards for the most part
- DFSA prudential rules are applicable to IFIs in full, similar to conventional firms.
- In addition, IFIs managing PSIAs are subject to DCR capital requirements.
- DFSA's prudential rules specify methodologies to calculate risk capital requirements for the main contracts used by IBs
- Requires IBs to adopt AAOIFI standards

DFSA
Dubai Financial
Services Authority

Thank You