



Management

## THE IMPORTANCE OF A CAPITAL ADEQUACY FOR ISLAMIC BANKS

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### Abstract

Conceptually, an Islamic bank has an equity-based capital structure, dominated by shareholders' equity and investment deposits based on profit and loss sharing [PLS]. There is no need for capital adequacy regulations if the Islamic banks are structured as pure PLS-based organizations. However, due to informational asymmetry and risk aversion by investors, there currently exist fixed claim liabilities on the Islamic banking balance sheets. This necessitates the imposition of capital adequacy requirements, which aim at maintaining systemic stability by achieving two fundamental objectives. First, capital regulations should protect risk-averse (assumed unsophisticated) depositors. This requires a minimum equity capital cushion and an optimal assets-liabilities composition. Second, capital regulations should give the right incentives to shareholders to promote prudent behavior by the banks. This requires analysis of the effect of financial participation by shareholders on Pareto optimality, and analysis of potential behavior by shareholders when facing financial uncertainty.

**Keywords:** Capital Adequacy; Risk; Islamic Banks; CAMELS; AAOAFI.

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### 1. Introduction

The fact that deposits in Islamic banks are not treated as a liability on the balance sheet does not mean that they should not have a minimum capital requirement and improved corporate governance as Emphasis on improved corporate governance and having minimum capital requirement go hand in hand with the need for improvements in risk management standards. Sound risk management practices will minimize adverse consequences faced by financial institutions during periods of uncertainty. Robust internal controls to provide qualitative standards are also necessary to complement the quantitative analysis of risk to provide a check and balance in the capital adequacy framework for Islamic bank.

### **Research Problem**

The importance of research is to study the possibility of managing the capital adequacy framework for Islamic banks in an optimal manner.

### **Research Importance**

The importance of research is highlighted by the capital adequacy framework for Islamic banks as a result of their reliance on investment in excess liquidity on short term financing models rather than long term financing formulas to control liquidity and risk mitigation. The profit return of Islamic banks is uncertain and risky expected in the cost of capital.

### **Research Objectives and Methodology**

The objective of the research is to determine the size of the capital adequacy framework for Islamic banks and how to address and limit them in accordance with the requirements and standards of Basel International Banking Supervision in the field of risk management.

## **2. Materials and Methods**

The researcher used descriptive, analytical and historical methods in preparing the research.

## **3. Results and Discussions**

### **Risk Monitoring and Measurement**

The new Basel accord, don't directly address specific requirement of Islamic banks even though, not all regulators of Islamic banking view this as a negative issue. Basel II will oblige Islamic banks to identified the risks inherent in Islamic financial instruments.(reference commented Dr. Zeti Aktar, governor of bank Negara Malaysia)

### **CAMELS**

Basel II reflects evolutionally CAMELS, as a meant to analyze the following factors effectively for the safety and soundness of the banking system, bank by bank:

- Capital adequacy
- Asset quality
- Management / administration
- Earnings
- Liquidity
- Sensitivity

The AAOAFI and IFSB allow the evolve CAMELS to adapt further to the realities of the business of an Islamic bank.

### **Market and Operational Risk**

Islamic banks have unique balance sheet features that have a direct impact on their exposure to the risks, for instance, Khan points out that traditional banks face market risk mostly in the

trading book. In contrast, Islamic banks face the market risk in their banking book since instruments such as Murabaha, Ijarah, Salam, Musharaka and Mudaraba all reflect a commercial risk that bundle market risk and credit risk. The commercial aspects and underdeveloped secondary market for Islamic instruments mean that the duration of the commitment ties the transaction strongly to the original reference rate.

## Credit Risk

When it comes to credit rate features, the primary issue is that the conventional bank charges penalty interest, which considers Riba. On the one hand, should the issue of collection arise, can an institution appoint and pay a third party to collect late or defaulted payment for a fee to be paid by the defaulting party? On the other hand, each Islamic process has a distinctive

- Mudaraba/Musharaka: These may be structured to approach loan-like conditions as with the declining balance Musharaka, but such transactions are not necessarily collateralized, and there is more variability in the definition of a default event.
- Salam/ Istisna'a: These clearly entail counterparty performance risk in a way that makes the separation of market risk from default risk difficult. In the case of catastrophic counterparty failure, the risk is high. Istisna'a also entails specific and unique sub-contractor and agency risks.
- Murabaha: Typically, this is collateralized, but the baseline default risk includes counterparty risk due to the fact that the client's promise to purchase is not always deemed to be a binding matter (a jurisdiction matter).

When risks are conglomerated, each Islamic institution has its own unique profile depending upon its distribution of assets across the different processes, and then to obligors. These lead to a potentially complex array of credit, liquidity, market and reputation risks.

Given the preponderance of Islamic banks in emerging markets, the small size of Islamic banks, and the unique risk profiles of their instruments, the most applicable system in the IRB approach. The localized and unique experience of each Islamic bank, its risk concentration in specific asset classes, means that it is more likely to adjudicate, given the dearth of statistical data, the probability of a loss given default (LGD) of the facility or the probability of default (PD) of the obligor or both than either a ratings-based system or a models-based approach.

In the framework of Basel II, with the approval of supervisors, banks can use their own interest assessments of their asset risk components for meeting regulatory capital requirements. These components include PD, LGD, exposure at default (EAD), and effective maturity of facility (MOF). The foundation IRB approach lets banks use their own PDs, but the supervisors assign LGDs, EADs and MOFs. The advanced IRB approach allows banks to use their own PDs, LGDs, EADs, MOFs.

## Risk Weighting Islamic Financial Transactions: A New Proposal

Under the new Basel II rules, the risk weightings will become more textured and ratings-driven. Khan, in a ground-breaking study with Habib Ahmed at IRTI, surveyed the risk perceptions at

Islamic banks relating to the degree of risk per transaction type. They derived the following rankings with '1' not a serious risk and '5' a critically serious risk.

- Musharaka 3.69
- Diminishing musharaka 3.33
- Mudaraba 3.25
- Salam 3.20
- Istisna's 3.13
- Ijarah 2.64
- Murabaha 2.56

### **The Importance of Good Governance for Banks and Banking Supervision**

The absence of good governance in banks will result in a high degree of failure as it happened in large international corporations such as Enron, Parmalat, and Cadbury in the foregoing years. Each crisis had its unique story, and till now the surrounding circumstances of these crises have not been revealed, because not all the facts have been disclosed. Nevertheless, we can, in general, attribute a great deal of these collapses to the management failure and failure to fulfill the good governance principals which would guarantee security and safety for the institution. The major failure factors are:

- 1) The board of directors' failure to understand and evaluate the risks assumed by the institution when practicing its job, and failure to apply accountability to the CEO and the staff.
- 2) Conflict of interests and the members of the board, as well as the executive management are not independent so that decisions in favor of persons are passed on the account of others.
- 3) Internal auditing is either weak or does not exist; if it appears to be sufficient, it will be only on paper without any actual implementation.
- 4) Failure of internal and external auditing to uncover embezzlement, and even supporting and encouraging it sometimes.
- 5) Improper organizational structure; deals are designed in a way that lacks transparency and prevent market parties from making a clear image of the institution's status.
- 6) Moreover, the governance culture in institutions collapsed as they adopted unethical behavior and thwarted any problem-solving attempts in the institution.

### **The Importance of Corporate Governance in Islamic Banks Supervision and Management**

The success, advancement and prosperity of the Islamic banking sector does not mean that it is immune against financial crises, which hit international institutions including traditional banks making them fail to continue and get out of the market; Islamic banks affect and are affected by what happens in international banking arena. The Gulf crisis, for example, led to a decrease in all banks' deposits; the storm reached the biggest banks including Islamic ones with good capital solvency and strong reputation in the Islamic banking arena; the breakdown of the Credit and Commerce Bank led to vast losses in a number of Islamic banks that managed to tolerate and absorb them because of their great assets, huge capitals and profits; they announced specifying allocations to cover the losses.

This crisis proved the importance of having sufficient risk-based capital according to the requirements of Revised Basel Framework for capital adequacy, on one hand, and the necessity to apply corporate governance in Islamic banks management and supervision, on the other hand. The institutional governance system is a wide range of principals, ethics, systems, procedures and policies, through which the institution is controlled and guided and its path is identified, so that to reflect the nature of the relationship based on the theory of deputization between three major stakeholders in the institution: shareholders, board of directors, and the executive management, where the CEO, according to the theory of deputization, deputizes the owners represented by the board of directors to manage the institution in accordance with the interests of the depositors and shareholders based on the following principals:

- 1) Transparency,
- 2) Disclosure.
- 3) Accountability

The institutional governance system includes appropriate incentives for the board of directors and top management to urge them to achieve the goals in favor of the company and its shareholders and to continuously follow up and encourage the institution to achieve the optimum use of resources.

The governance concept is relatively new, although it is an important element to enable banks to manage the risks they face when performing their job. A bank, basically, invests the shareholders', depositors' and investment account holders' money, which implies many risks and requires a competent management that can face the potential risks to avoid the bank their consequent losses, especially that the failure of any bank will lead to negative consequences on the stability of the banking system, the financial sector and economy as a whole, because the banking sector is one of the most sensitive and vulnerable sectors to the extent that monetary literatures considers it the concrete basis and the safety and security valve for economy as a whole.

The Islamic banks dependency on principals that are deeply-rooted in the Islamic economy and built on doctrine, the ethical factor and real basis, does not devalue the importance of institutional governance in the management of risks that are higher than those of traditional banks due to subjective reasons which lay in the nature of Islamic investment instruments, and to objective reasons because the institutional, legal and regulatory environment of Islamic banks has not completed yet. Here, we do not underestimate the role of the Sharia Control Board in the bank as one of the most important and prominent self-management instruments used to judge the safety of bank's operations and the staff performance efficiency, and their abidance by banking policies and administrative procedures.

Striving for accuracy makes us look at the Islamic banks experience, which is a big success story not only in the Islamic world, but in the entire world, as an experience that still needs a further practice to complete its real picture. There are still a lot of controversial and undetermined points in the Islamic banks' work. The most important ones are:

- 1) Interests: which some jurisprudences legitimate and some illegitimate. Islamic banks consider interests off-balance sheet items (illegitimated gains) that are to be used as donations, for example, upon the recommendations of the bank' Sharia Control Board.

- 2) Earmarked investment accounts: they are accepted by the bank from the customer after identifying the investment's type and nature, where the investor takes the profit and assumes the loss, according to the Sharia's rule: the loss vs. the profit. The bank gets a share from the raised profits for being the customer's agent without assuming any losses or risks for the investment. It is worth mentioning that investment accounts constitute about 30% of the money that is available to Islamic banks. Though investment account holders have better luck than others (deposit account holders) in profit making arena, they are subject to a wider range of risks:
- A chance for bank's management (insider dealing) to get information concerning a bad loan causing losses to investment accounts.
  - An investment account gets the return on the maturity date. If returns are transferred to profit equalization accounts to reduce the return's fluctuation impact, it may cause profits or losses to investment accounts at the expense of the past or future investment account, these risks can be included within the securities and mutual fund industries. It is worth mentioning that these risks are well-known to market players, especially to the investment account holders. This does not imply any violation to market rules, instructions and laws, but the Islamic banks themselves should, based on their awareness of these risks, adopt internal policies to deal with them.

### **The Relationship between Internal Auditing and Corporate Governance in Islamic Banks**

Internal auditors are concerned with monitoring the degree of respecting the Sharia. Considering that external auditors are not experts in the Islamic Sharia, the supervisory boards usually insist on reviewing and assuring the competence of internal auditor, and evaluating him/her based on:

- To which limit the external auditor depends on the outputs of the internal auditor.
- The quality of internal auditor's reports, and how their outputs are used by the executive management and the board of directors.
- The internal auditor's work must be risk-based not inspection-based. The internal auditor is asked to review the bank's internal evaluation systems annually at least, in order to monitor and update them if necessary. The auditor also evaluates the institutions with which the bank deals in the context of the bank's risk management and assessment, and not risk pricing as that is prohibited in Islamic banks.
- Internal auditor's independency.

### **An Internal Auditor is required to Report Annually and Biannually On**

- The bank's safety and transparency standards.
- The appropriateness of the policies and procedures.
- The quality the bank's management.
- The historical database in place.

We highlight here the necessity to distinguish between auditing and inspection, which is involved in:

- Evaluating the qualitative factors in the procedures of administrative practices.
- Future horizons (the effect of present decisions on the bank's future status)

- Understanding the risks that the bank is subject to.

### **Rationales for Applying Good Corporate Governance Principles in Islamic Banks**

- 1) The absence of a unified body that is a reference framework for all Islamic banks in the world; there are deep disagreements (in both opinion and jurisprudence) stemming from the fact that there're different jurisprudential schools which hinders clinching many disputes in the work of Islamic banks.
- 2) The Islamic banks' philosophy of prohibiting in-advance specification of return and the principal of dividing profit and loss necessitate the provisions of a good institutional governance system to ensure that the management and the owners will not harm the depositors, investment accountholders and other stakeholders of the Islamic finance channels.
- 3) The absence of Islamic accounting standards until this moment though the Accounting and Auditing Organisation for Islamic Financial Institutions is taking confident steps in achieving a package of Sharia accounting standards. However, the rapid growth of banking sector (four times the traditional ones) and the development of Islamic finance and investment instruments leave a wide space for jurisprudence and the consequent disagreements among Sharia auditors and states.
- 4) Completing an appropriate organizational structure is difficult due to the rapid growth of Islamic banks that is not accompanied with similar growth in human resources that are qualified and experienced in Islamic investment.
- 5) The human nature which tends to prioritizing self-interest, especially that not all Islamic banks' members of staff have enough religious commitment.

### **Challenges Faced by Islamic Banks in the Context of Applying Corporate Governance System**

- Competition of traditional banks, especially that some groups, even educated ones, have a deeply rooted idea that there is no difference between dealing through interest and dealing through murabaha; some even prefer to borrow through interest, which makes it very important and pressing for Islamic bank to launch creative and innovative awareness campaigns.
- No complete understanding of the Islamic banking system's dynamics, which need continuously modernization and amendment of procedures and practices to reduce the risks that are deeply-rooted in the Islamic banking system, outweighing those of the traditional banks.
- Achieving integration between the good institutional governance system and the central bank's supervision on the Islamic banks according to the central bank's laws, the law of banks and the detailed regulations and instructions issued by virtue of them, along with internal and external auditing and the Sharia supervision.
- Ensuring the necessary training in the context of qualifying the staff as a precondition to apply the good institutional governance system in the bank.
- Planting commitment in Islamic banks' employees, starting from the similarities between them and traditional banks.
- Achieving transparency and disclosure of Islamic bank's operations.

- Removing the gaps in some of the Islamic investment instruments, from which some breaches, favoring and realizing the interests of some accountholders on the account of other accountholders.

#### **4. Conclusions & Recommendations**

- By issuing its statement on capital adequacy (AAOIFI) is commended for taking the first step towards a unified approach, but there is need for greater co-operation and commitment by Central Banks and regulatory bodies in narrowing this gap further. There should also be a collective effort, with (AAOIFI) providing the platform, to address other issues relating to prudential aspects and best practices for Islamic banks. A regulatory framework based on a consensus view will further enhance the soundness and stability of Islamic banks. In this connection, the importance of giving serious consideration to the development of institutional arrangements must be stressed. The establishment of the Islamic Financial Services Board (IFSB) is an important move toward achieving this goal and is, no doubt, the first step in the right direction.
- corporate governance should be considered a key element of a bank's ability to understand and manage its risks. As supervisors, we should direct our resources to helping banks improve their controls, culture and clarity in respect to risk management. In so doing, I believe that we will help achieve our objective of a stable and healthy banking system that contributes to the proper functioning of the economy.
- Banks operating under this principle would only guarantee fiduciary deposits, on which depositors receive no guaranteed rate of return.<sup>3</sup> Other deposit alternatives on the liabilities side of Islamic banks would take the form of investment accounts, for which investors' principals were not guaranteed, as they were envisioned to share in the bank's profits and losses from various pools of investments. Those investments comprising the assets of Islamic banks were envisioned also to be silent partnerships, wherein the bank acts as principal, with each of its customers (would be borrowers of conventional banks) acting as an investment agent (mudarib). It is important for understanding Islamic banking today, and for developing an appropriate regulatory framework thereof, to understand how Islamic banking behavior has emerged in fact, both on the assets and liabilities sides.
- On the assets side, Islamic banks quickly abandoned the mudaraba model, due to its forms of moral hazard and adverse selection problems that are unfamiliar to bankers. Islamic bank officers are mostly ex-bankers, who are proficient at credit risk analysis for their customers, but not particularly skilled in monitoring customer behavior. Consequently, to capitalize on their comparative advantage, and to minimize losses driven by customer incompetence and/or dishonesty, Islamic banks adopted debt financing modes that were proposed by the late Dr. Sami Humud. Dr. Humud's vision was to find the closest approximation to conventional banking practice that does not violate the precepts of Islamic Law.<sup>4</sup> The instruments of choice for Islamic banks thus became cost-plus credit sales (murabaha), and lease financing (ijara), where the mark-up profit component and the rent component, respectively, are commonly benchmarked to market interest rates.



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