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The Impact of Regulation on the Future of Islamic Finance

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Islamic banking markets have grown dramatically and have exhibited increasing profitability in the last few years, with many banks growing above their respective market averages and several new players emerging. Although this recent evolution has been positive, a closer look reveals that the penetration and the growth of Islamic banking, as well as profitability levels compared with conventional peers, vary significantly between countries.

Despite the growth, market pressure on Islamic banks is mounting rapidly in all markets: they are expected to grow even faster and further to improve profitability. In this context, overall competitiveness with conventional banks is likely to become even more important to success.

Regulation, therefore, acquires a huge significance in this situation; especially because it can influence the ability of Islamic financial institutions to compete and innovate the Islamic credibility of those institutions and the overall financial performance of the industry.

There is still some debate surrounding what would be the best way to regulate Islamic banking. There has been much experimentation, resulting in a variety of frameworks. Progress is being made with many of these frameworks, with some regulatory concepts emerging as potential best practices. The regulation, however, has not yet reached the level of completeness or harmonization that exists in the conventional sector.

Recent efforts initiated by the industry show great promise in tackling these issues. Regulators, banks, and industry bodies are finding ways to share ideas and to harmonize regulatory frameworks. These efforts need to

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be intensified if Islamic banks are to compete on an equal footing with their conventional peers.

PERFORMANCE OVERVIEW AND NEED FOR CONTINUED IMPROVEMENTS [6]

Islamic finance, once considered a niche activity, is growing rapidly and is now becoming a mainstream banking choice across a large number of markets around the world.

Some of the recent growth is due to the positive influence of the rise in oil prices[7] on the GDP growth of Islamic banking countries. As GDP growth in key economies reached levels of 10–30% per year, overall banking sector asset growth in these countries witnessed growth between 13 and 42%,[8] well above the growth levels observed in typical developed markets (Exhibit 1). Islamic banks have managed to capture a disproportionate share of that growth (Exhibit 2).

To cite instances from two of the most developed Islamic banking markets, the share of Islamic banking in the overall banking sector has grown from 14.7% in 2000 to 21.6% in 2005 in Kuwait and from 6.9% in 2000 to 11.3% in 2005 in Malaysia. In fact, leading Islamic banks in these markets (KFH in Kuwait, and Islamic windows of conventional banks in Malaysia) have consistently witnessed growth rates well above their underlying market average. The situation is largely the same in most other Islamic banking markets (Exhibit 3). In 2005, specifically, Islamic banks' growth accelerated even further and reached record levels (Exhibit 4).

With a few notable exceptions, such as Al-Rajhi Bank and Qatar Islamic Bank, Islamic banks still struggle to reach profitability levels comparable to conventional peers. The return on assets of most Islamic banks, large or small, nascent or well established, has been consistently below the average of their respective markets (Exhibit 5).

What drives the profit and growth performance of the Islamic banking sector? Clearly, the managers of Islamic financial institutions, through the decisions they make, influence the profit and growth performance of their institutions. The disappointing profitability record can be attributed to three main factors.

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[6] McKinsey & Company, "World Islamic Banking Competitiveness Report, 2006" presented in the context of the World Islamic Banking Conference, 2006. Bahrain December 2005.

[7] "Arcapita: Focus on Unique Deals," *Islamic Finance Review* (January 2006): 4. The journal is published by the Bahrain Monetary Authority.

[8] Except Malaysia and Jordan, respectively at –2% and –9% asset growth.

The first factor is size: in spite of tremendous growth, most Islamic banks remain subscale[9] and have not yet managed to generate returns sufficient to cover the substantial investments they have made. Either through seeking lower-cost investments (such as outsourcing) or by fundamentally changing their business model (by partnering or merging), Islamic banks can seek scale for better performance.

The second factor is linked to the business model. While Islamic banks in general have been successful in capturing deposits, they have been less successful on the financing side. The Islamic institutions have, thus far, focused largely on the thinner margin corporate financing business rather than the more lucrative retail business, or they have invested in lower yielding instruments (for example, international *murabaha*), while their conventional counterparts have recently shifted their focus to the more profitable retail business. Greater development of higher-margin retail business, especially on the asset side, would help boost performance.

Finally, and most important, Islamic banks are still not at par with their conventional peers in either managing their businesses for optimal profitability through good service, or in tightly managing their cost base. A recent survey among retail customers of Islamic banks has shown that the majority of these customers are captive customers, that is, those that have chosen the bank not because of its products or service, but simply for its *shari'a* compliance (Exhibit 6). The survey also shows that overall levels of satisfaction with service and convenience are low (Exhibit 7). Islamic banks will have to improve their offerings to capture customers beyond the captive base, including those who mainly seek performance and convenience and are indifferent to *shari'a* compliance.

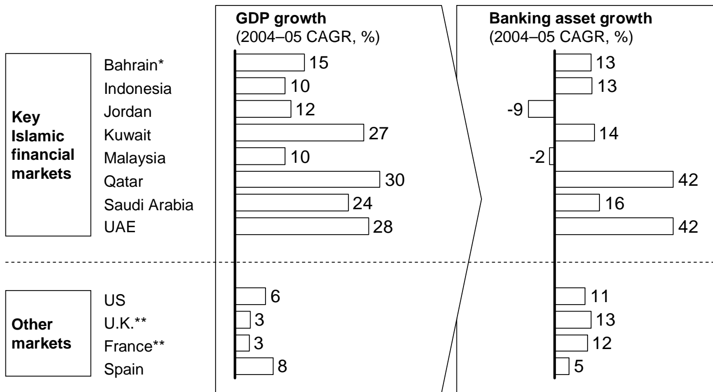
The industry is slowly coming to terms with the harsh reality of good growth but disappointing profitability. Participants in the 2005 World Islamic Banking Conference indicated that major efforts will be required in several areas of their businesses if Islamic banks are to improve their performance and meet future market expectations (Exhibit 8).

If Islamic banks start to seriously engage in performance improvement efforts, they should be able to reach levels of performance comparable to those of conventional banks. This assumes, however, that an even playing field exists between Islamic and conventional banks. Though this might seem like a natural assumption, we believe that the regulation of the financial sector has a very important role to play in the way the Islamic banking sector develops over time and compares with the conventional sector.

[9] "Islamic Banks Urged to Consolidate," *Islamic Finance Review* (January 2006): 1.

Exhibit 1

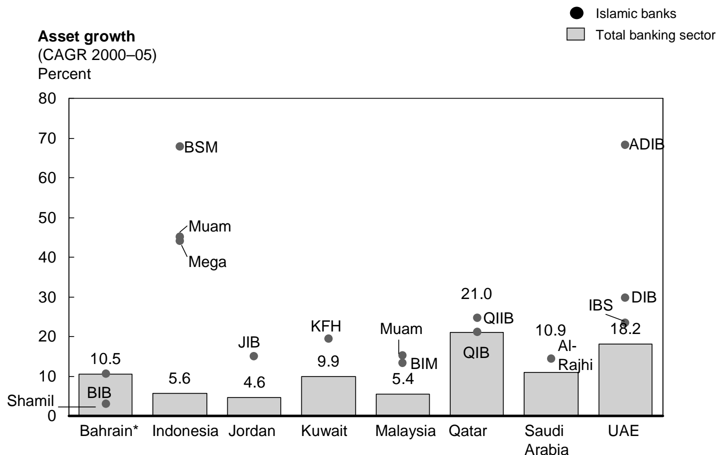
GDP AND BANKING SECTOR GROWTH IN ISLAMIC FINANCIAL MARKETS



* On-shore banks only
** Banking assets 2002–03 CAGR
Source: global insight; central banks; McKinsey analysis

Exhibit 2

COMPARISON OF ISLAMIC BANKS' GROWTH AND AVERAGE SECTOR GROWTH



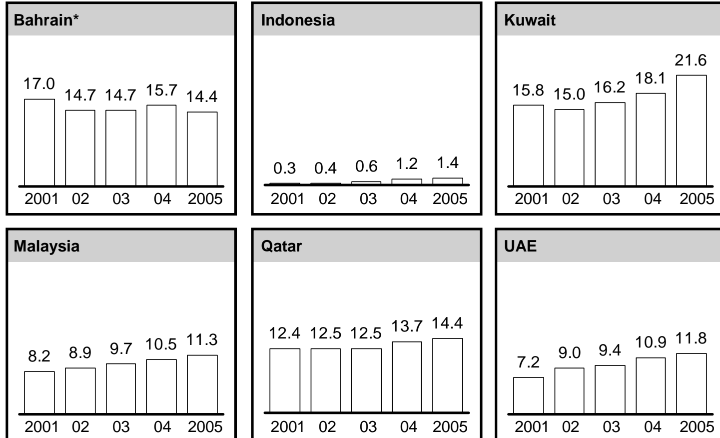
* On-shore banks only
Source: central banks; annual reports; Bankscope; IMD; capital intelligence reports; McKinsey analysis

Exhibit 3

EVOLUTION OF ISLAMIC BANKING PENETRATION

Islamic banking as part of total banking assets, percent

NOT EXHAUSTIVE



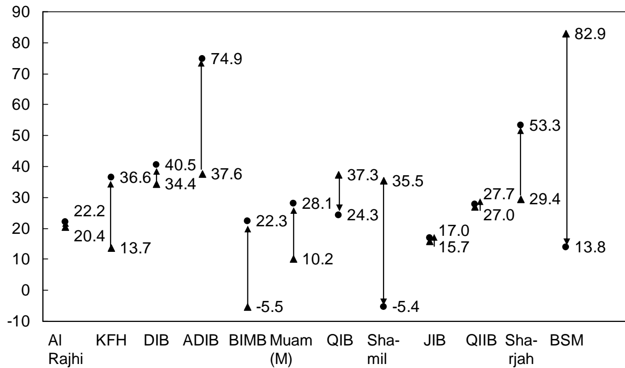
* On-shore banks only

Source: central banks; banks' annual reports; capital intelligence reports; Zawya; McKinsey analysis

Exhibit 4

EVOLUTION OF GROWTH BETWEEN 2004 AND 2005

Asset growth
(CAGR 2003–04 vs. CAGR 2004–05)
Percent

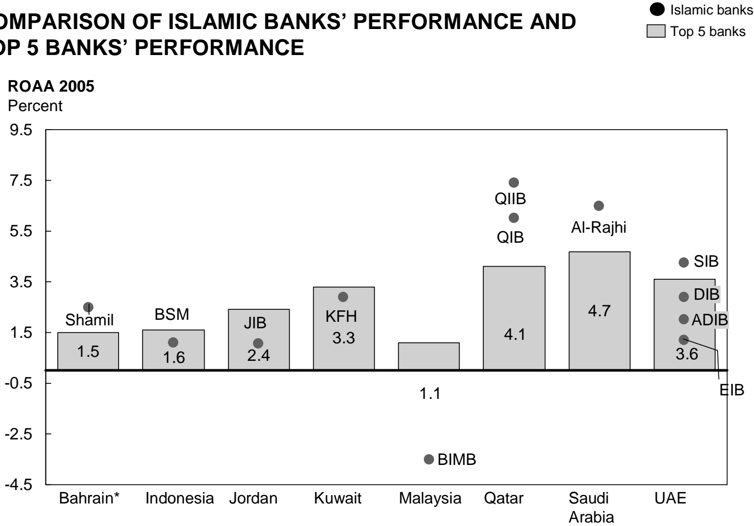


Key: KFH: Kuwait Finance House; DIB: Dubai Islamic Bank; ADIB: Abu Dhabi Islamic Bank; BIMB: Bank Islam Malaysia Berhad; Muam: Bank Muamala; QIB: Qatar Islamic Bank; JIB: Jordan Islamic Bank; QIIB: Qatar International Islamic Bank; BSM: Bank Syariah Mandiri

Source: banks' annual reports; Bankscope; McKinsey analysis

Exhibit 5

COMPARISON OF ISLAMIC BANKS' PERFORMANCE AND TOP 5 BANKS' PERFORMANCE

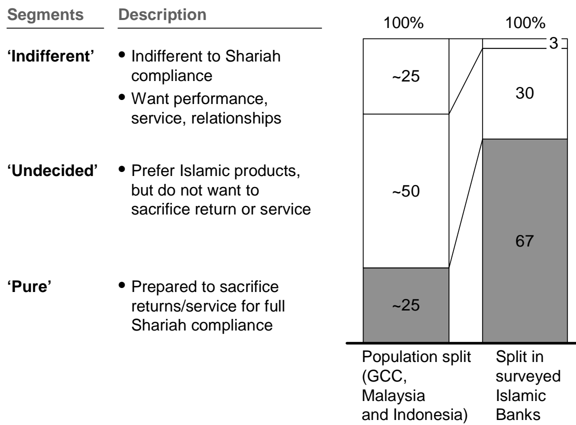


* On-shore only

Source: central banks; annual reports; capital intelligence reports; McKinsey analysis

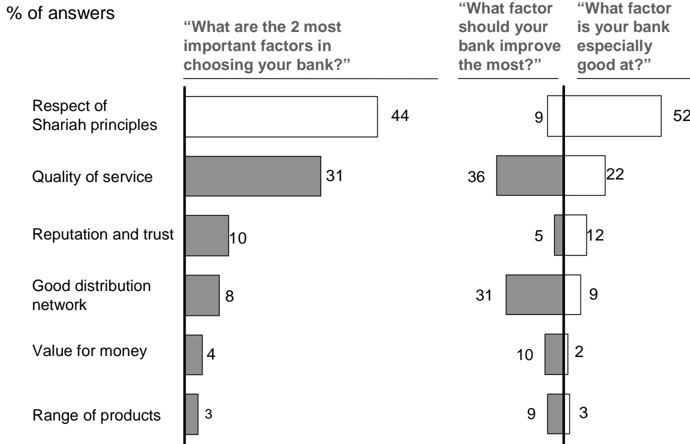
Exhibit 6

COMPARISON OF CURRENT STRUCTURE OF ISLAMIC BANKS' CLIENTELE AND POPULATION STRUCTURE



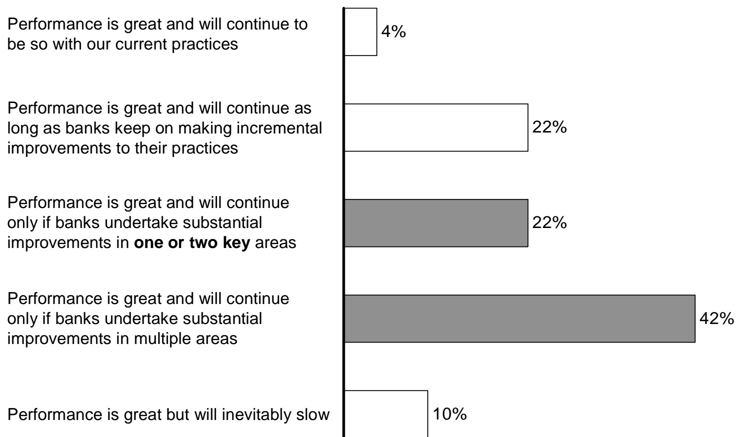
Source: 2005 Islamic Banking customer survey; McKinsey analysis

Exhibit 7



Source: 2005 Islamic Banking customer survey; McKinsey analysis

Exhibit 8

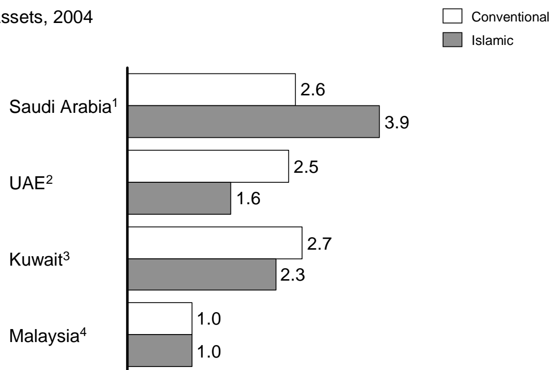


Source: 2005 World Islamic Banking Conference consensor survey

Exhibit 9

COMPARISON OF ISLAMIC AND CONVENTIONAL SECTOR PERFORMANCE BY COUNTRY

Return on Average Assets, 2004



1 Islamic banks: Al-Jazira, Al-Rajhi; Conventional banks: ANB, SABB, NCB, Riyad Bank
2 Islamic banks: DIB, SIB, EIB, ADIB; Conventional banks: EBI, NBAD, ADCB, NBD, Mashreq
3 Islamic bank: KFH; Conventional banks: NBK, Gulf Bank, CBK, BKME
4 Islamic banks: BIMB, Maybank Isl., Public bank Berhad Islamic, RHB Islamic, AMMB Islamic, Hong Leong Islamic, EON Islamic, Bank Muamalat; Conventional banks: Maybank, Bumiputra, Public Bank, RHB, AMMB, Hong Leong, EON

Source: banks' annual reports

More explicitly, the existence of specific regulations for Islamic financial institutions, or the absence thereof, can dramatically influence the ability and speed at which Islamic banks grow and improve profitability. The comparison of the performance of Islamic banks versus conventional banks in key Islamic markets clearly illustrates these differences (Exhibit 9). In Kuwait, the UAE, and Saudi Arabia, the Islamic banking sector is relatively concentrated and has largely been dominated by a single player (KFH, Dubai Islamic Bank, and Al-Rajhi, respectively). These players have been active for a long time in markets that have witnessed roughly the same economic evolution. Their performance, however, varies widely, suggesting that country-specific factors such as regulatory approaches may influence individual bank performance. Examples of such factors include the approach toward the *mudaraba* deposits and the ability of conventional banks to offer Islamic products and hence push the competition beyond *shari'a* compliance.

In Malaysia, the Islamic banking market is much more fragmented, but its performance is comparable to that of the conventional sector. Here, too, regulatory factors may be shaping the sector. For example, most of the players are Islamic windows of the dominating conventional banks, benefiting from a centralized *shari'a* decision-making process at the Central Bank.

The development of Islamic banking regulations that vary substantially from country to country could be one of the prime reasons for the wide variation observed in the growth, performance, and structure of markets across countries, and could strongly influence the evolution of these markets going forward. As the industry starts to globalize, attempts to harmonize the regulatory framework have increased.[10] It is very hard to say with certainty, at this point, if any specific model will emerge as the dominant regulatory framework in the future. What can be said is that there is still a lot of work and thinking to be done surrounding the various models if they are to be developed fully, and if convergence to a global standard is to be achieved.

IMPACT OF REGULATION ON THE DEVELOPMENT OF THE ISLAMIC BANKING MARKET

Banking regulation has the primary objective of protecting customers by promoting the stability and performance of the sector while ensuring fair and transparent practices by banks at several levels, including product development, pricing, risk and liquidity management, accounting practices, investment practices, and governance.

When regulating Islamic banking institutions, regulators have to make choices over and above the usual conventional regulation practices. As with financial innovation itself,[11] the regulatory decisions to accommodate this innovation present opportunities and risks. The key choices can be grouped in three categories:

- Structure of the regulatory framework for licensing;
- Direction setting on *shari'a* compliance;
- Approach to risk management and Basel II compliance.

Depending on the choices made by the regulator on each of these fronts, different banking sectors will emerge. In general, the outcomes will differ in aspects of competitiveness of the overall banking sector (especially of Islamic versus conventional banks), Islamic credibility, and general financial performance of Islamic banking players.

[10] "New Shari'a Standards on Way," *Islamic Finance Review* (October 2005): 2.
[11] Dalia El-Hawary, Wafik Grais, and Zamir Iqbal, "Regulating Islamic Financial Institutions: The Nature of the Regulated," World Bank Policy Research Paper 3227, (March 2004): 3.

Structure of the Regulatory Framework for Licensing

In its approach to formulating a regulatory framework for Islamic banking, a regulator can determine the degree of separation between Islamic and conventional banking.[12] Around the world, regulators have made this choice along the entire spectrum, ranging from not allowing Islamic banking (for example, Oman, most European countries) to engendering a fully *shari'a*-compliant banking sector (for example, Sudan).

In Saudi Arabia, for example, a single licensing and compliance framework (*single framework*) exists, covering conventional banks, Islamic banks, and Islamic windows. Within this context, banks can either be fully conventional, fully Islamic, or a mix of both.

In the UAE and Kuwait, two banking licenses exist, differentiating between conventional banks and fully *shari'a*-compliant institutions (*dual framework*). In these markets, by definition, a bank is either conventional or Islamic. In Kuwait, the offering of Islamic products by conventional players is only allowed for off-balance-sheet products (for example, Islamic funds) or for products offered via specialized consumer finance companies. Only Islamic banks are allowed to offer on-balance-sheet Islamic banking products (for example, *murabaha*, *ijara* finance). In the UAE, while a window license exists, to date few of the conventional players have received such a license.

In Malaysia, a third license exists for Islamic windows. In this model, banks must be either fully Islamic or conventional, or be an Islamic window of a conventional player. In fact, encouraged by the Central Bank, nearly all of the conventional players have an Islamic window license.

In addition to deciding which of these broad models to adopt, regulators can make the choice of specifically allowing or forbidding a particular product (for example, *mudaraba* accounts in Saudi Arabia), or even consciously promoting one format of banking (as Malaysia is actively promoting the growth of its Islamic banking sector). Depending on the choices made, very different outlooks for the banking sector as a whole will emerge.

[12] Zeti Akhtar Aziz, "Building the Progressive Islamic Banking Sector: Charting the Way Forward" (22 June 2005): 3 (lecture given by the Governor of Bank Negara Malaysia at a seminar on the ten-year master plan for the Islamic Financial Services Industry).

The dual licensing framework

The dual framework has the effect of protecting the Islamic banking industry by creating a regulatory barrier to conventional players wishing to offer Islamic products.

The dual model creates a walled garden around Islamic banks, protecting them from having to compete with established conventional players. As a result, Islamic banks will initially witness above-market growth since they will start by addressing the needs of “pure” customers. This protection from competion with established players may, however, lead Islamic banks to become complacent, fostering the belief that being Islamic is a sufficient criterion for success. Innovation, quality of service, convenience, and operational improvements might be overlooked, creating a rapidly expanding gap with conventional players. When Islamic banks start becoming relatively well established, the dual system, once protective, may become detrimental to future growth as banks try to expand their reach outside of the “pure” customers and make themselves attractive to a wider range of customers. If Islamic banks have initially been complacent, attracting new customers may represent a formidable challenge as it will require stepping up service, network convenience, and product quality to the level of conventional banks. If they fail in their turnaround, growth may slow down as the “pure” segment becomes saturated. In this situation, performance would also decline. As a result, Islamic institutions may not only witness lower performance than their conventional peers, but they may also lock themselves out of future growth. The result could be as dramatic as a “two-speed” banking sector.

The dual licensing system might also impact overall convenience to customers as they will have to develop multiple banking relationships if they desire access to products that do not exist in a *shari‘a*-compliant form (for example, derivatives trading, specific funds, and credit cards in some markets).

However, the dual system does present some strong advantages. Because it creates a real distinction between the two formats of banking, the system is more likely to foster the development of a credible Islamic banking sector. It could help dispel the perception that *shari‘a* compliance is just a label that any bank, conventional or Islamic, can appropriate. Yet the approach of separating regulatory and licensing models for conventional and Islamic banking is not the only way to achieve credibility for the sector. Other approaches may yield similar results without the possible long-term impact of the dual system. Regulators can, for example, envisage more micro-regulatory approaches. One way of achieving the same goal is to ensure that individual players are *shari‘a*-credible through specific regulation or audits.

The single licensing framework

If a regulator chooses to pursue a single licensing framework, it must consider the potential impact its decision may have. While a single licensing system may allow an individual bank to offer a wider range of products and to be better equipped to serve its customers, it can also negatively impact the evolution of the sector.

Within a single licensing model, the regulator must take a specific stance on product-specific regulation. Any decision that is taken may have a substantial impact on a *shari'a*-compliant bank's ability to compete. For example, the Saudi Arabian regulator had to decide on *mudaraba* accounts. As a consumer protection measure by the regulator, these accounts are not allowed. The regulator imposes the basic requirement that deposits be capital protected, which is not the case with a *mudaraba* account, where customers are considered "shareholders" in the bank and are hence exposed to risk. For "pure" customers who do not wish to deposit their funds in interest-bearing accounts, the range of available accounts was until recently limited to non-interest-bearing deposits (NIBs) and longer-term investment accounts.

If the dual system's offer increased Islamic credibility with the institutions operating there, the inverse is true of the single model system. The single model allows players to distribute Islamic products whether they are Islamic or conventional. In a nascent market, this model could actually make it more difficult to educate customers about the values of Islamic banks as customers would find it hard to really assess the difference between fully *shari'a*-compliant banks, windows, and products distributed by conventional banks. It could also raise the long debated question of whether windows are really Islamic or whether they are just a way for opportunistic conventional banks to capture a new market. In summary, the single model can lead to a questioning of the overall credibility of the sector.

Direction Setting on *Shari'a* Compliance

Islamic banking depends fundamentally on the interpretation and application of *shari'a* law to previously unknown problems. Because there is no single answer to how Islamic law should be interpreted and applied, there is currently a wide variation, domestically and internationally, in the

ways in which different Islamic banks operate.[13] Not only are there clearly several schools of thought on *shari'a* interpretation, but interpretations vary between scholars as well. Innovative banks can use their *shari'a* boards' readiness to consider new, more sophisticated products as a competitive weapon.

The current practice of an individual *shari'a* board for each bank raises several questions. How can banks guarantee a minimum quality level on their *shari'a* boards? How can banks guarantee the impartiality, fairness, and independence of their *shari'a* boards when a limited number of scholars sit on numerous boards, sometimes even those of direct competitors? How can *shari'a* boards themselves become a source of innovation for the bank? How can banks avoid adopting progressively more lenient interpretations of *shari'a* in order to compete more easily with conventional banks? Should *shari'a* interpretation become more standardized across countries?

In the face of these questions, regulators have adopted several approaches. The first approach is the *regulation of shari'a boards*. The regulator creates an "approved list" of *shari'a* scholars and vets the membership and structure of *shari'a* boards. This model, provided it is based solely on the evaluation of the knowledge and expertise of scholars and not on their beliefs or interpretations, has the advantage of creating a check on standards across the industry, while at the same time giving banks the freedom to innovate and adopt different positions in the market based on different interpretations of *shari'a*. Interestingly, this is also the model closest to traditional Islamic methods of ensuring a fair and just application of *shari'a*. This model is, for example, the model applied in Qatar.

The second approach is *market-based regulation.* It puts the responsibility on banks or independent market actors to develop methods to ensure that standards do not drop. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has, for example, driven efforts for developing generally accepted accounting principles and financial structuring of major products across the industry. Another example is the recently established Islamic Rating Agency (IIRA), which is evaluating the tightness of *shari'a* compliance verification and *shari'a* auditing in banks.[14]

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[13] Datuk Zamani Abdul Ghani, "Accelerating Growth of the Islamic Financial System through Effective Linkages and Integration, lecture delivered by the Deputy Governor, Second Annual Asian Islamic Banking and Finance Summit (20 September 2005): 3.

[14] "IIRA: Assessing 'Unique' Risks," *Islamic Finance Review* (October 2005): 6. A *shari'a* audit is the procedure by which the *shari'a* department of the bank verifies, on behalf of the *shari'a* board, whether or not the procedures that are followed in the bank fit with *shari'a* requirements (for example, that the bank staff do not talk to clients

The third approach is the *centralization of shari‘a board approvals*, where a central *shari‘a* board controls *shari‘a* standards across the market. A form of this model has already been adopted in Malaysia, where Bank Negara has its own *shari‘a* board that vets the products issued by banks and hence creates a minimum threshold to meet for the *shari‘a* compliance of products. The *Shari‘a* Advisory Counsel is “the sole authority and reference on all *shari‘a* matters pertaining to Islamic banking and finance.”[15] So far, this model is the strongest example of involvement of a regulator in controlling *shari‘a*-related aspects of the industry.

The quality of *shari‘a* rulings is an important element that should be regulated in some form or another. Regulating the *outcomes* of *shari‘a* rulings is a totally different question.

Regulating the quality of rulings can be achieved through the direct intervention of the regulator in the selection of *shari‘a* board members for banks and through regular audit processes conducted by the regulator, the banks themselves, or a third party. These approaches should be hailed and encouraged as they monitor quality while leaving the banks’ individual *shari‘a* boards with the complete freedom to issue the rulings they deem appropriate. Regulators should even consider making *shari‘a* rating mandatory once the IIRA has become a well established actor in the market.

Involving the regulator in the decision about whether a practice or a product is *shari‘a* compliant is another issue. The involvement of the regulator is generally envisaged to ensure a minimum threshold of *shari‘a* compliance. This idea is laudable but needs to be conducted with care to avoid distortion of the competition.

First of all, the central *shari‘a* board should maintain confidentiality about the product structure. The details of the product should not be communicated outside of the board's debates, in order to prevent competitors from gaining access to the product or copying it, destroying the applicant’s competitive edge. Such confidentiality is challenging to maintain as members of the central *shari‘a* board are typically chosen from among the members of individual banks’ *shari‘a* boards. Second, the centralized board should have a clearly defined mandate. It should verify compliance with clear rules and accepted interpretations but should not use its own interpretations in its debates. Indeed it might, as a whole, have a different view on *shari‘a* compliance than the *shari‘a* board of the bank filing for approval. If the central *shari‘a* board uses its own interpretation

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about interest, and that forms are filled out properly and in the right sequence for a *murabaha* deal).

[15] Zeti Akhtar Aziz, “Ensuring stability in the Islamic financial system,” speech delivered by the Governor of the Central bank of Malaysia (13 January 2004).

to assess the product, a product considered compliant by the applicant's board might be rejected by the central board, leading to a possible decrease in banks' ability to innovate.

The problem would be similar if any third party in the industry were to rule on the compliance of products, for example, if the IIRA were expanding its mandate to cover the outcome of rulings. Judgments on the *shari'a* compliance of banks would be a dangerous tool, as it could lead to banks losing credibility and also to a curb on innovation by more sophisticated or progressive institutions.

From the perspective of *shari'a* credibility, the involvement of the regulator in making *shari'a* boards and processes credible while meeting basic healthy standards is positive for the entire sector's credibility. On the other hand, the regulator's involvement in *shari'a* rulings, if this is chosen, must be conducted with utmost care to avoid constraining the competitive intensity and innovation in the industry.

Overall Performance Related to Risk Management

The implementation of the Basel II recommendations on capital adequacy and risk governance could have a significant impact on the risk-adjusted performance of Islamic banks.

Under Basel I, banks have to ensure that capital exceeds 8% of the Risk Weighted Assets (Cooke Ratio) to cover the credit risk that is inherent in a bank's portfolio. The Basel I approach barely distinguishes between different types of obligors and would allocate a risk weight of 100% to all types of credit obligations except for retail mortgages, sovereign borrowers, and banks incorporated in an OECD country. The Basel II approach introduces distinctions between the various types of obligors and allows banks to differentiate between borrowers on a much more detailed level than does Basel I.

In March 2005, the IFSB (Islamic Financial Services Board) drafted capital adequacy guidelines for Islamic banks. The draft was officially adopted in December as a prudential standard on capital adequacy for financial institutions offering only Islamic financial services (IFS). In this prudential standard, IFSB translated the Basel II standardized approach to Islamic banks' concepts and extrapolated Basel II guidelines for specific *shari'a*-compliant products that have no direct conventional equivalent. Several countries have already announced their intention to adopt IFSB standards either fully (for example, Indonesia, Malaysia[16]) or after making

[16] Governor of Bank Negara Malaysia, speech at the Annual Islamic Finance Summit in London (24 January 2006).

minor amendments (Bahrain). IFSB's prudential standard is essentially based on the standardized approach for credit risk management, while the basic indicator approach is used to cover operational risk.

Basel II already introduces significant differences in the treatment of the credit risk portfolios compared to Basel I, essentially to account for the underlying risk profiles of the portfolios. Furthermore, the IFSB's prudential standard includes notable differences in risk treatment for products structured under certain concepts such as *ijara*, *mudaraba,* and *musharaka* vis-à-vis Basel I. The risk weights for these products can be up to 400% versus 100% under Basel I, especially if the counterparty is not rated.[17]

The Islamic financial institutions that choose a standardized approach under Basel II might require significantly higher capital compared to conventional banks, especially if they are using the previously mentioned concepts. For example, under Basel II, residential mortgage financing involves a 35% risk weight for an unrated counterparty, as long as the loan is fully secured with the property. In order to create a similar product with variable pricing, many Islamic financial institutions are using the *ijara* structure, which requires a 100% risk weight.

For the Islamic banks that choose a standardized approach, the difference in risk weights could lead to a higher pricing for the same product when compared to conventional counterparts. Under the IRB approach, this difference would be significantly reduced.

Regulators should therefore actively encourage and enable banks to move toward IRB approaches. This will generally prove a challenge as most Islamic banks are small and relatively young. They lack the expertise, the infrastructure, and, most importantly, the data history to move towards more advanced approaches. The regulator could start sector-wide initiatives such as training and data pooling to enable Islamic banks (as well as small conventional banks) to achieve IRB compliance, thus maintaining their competitiveness.

One other impact of increased risk weighting beyond pricing is the potential capital adequacy requirements under the new guidelines.[18] Although most of the Islamic financial institutions have strong capital positions, some of them may still lack the same level of extra-capital cushion once the new framework is applied and operating and market risks have been accounted for. Eventually, this would lead not only to reduced return on capital (that is, performance), but would also hamper Islamic

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[17] "Capital Adequacy Standard for Institutions (Other Than Insurance Institutions) Offering Only Islamic Financial Services," Exposure Draft Number 2 (March 15, 2005): 15-17.

[18] Ibid., 26-28.

financial institutions' growth, as they will require significant contributions in capital to finance this growth.

Also, many of the Islamic financial institutions' liabilities are mainly constituted of Profit Sharing Investment Accounts (PSIA). These PSIA accounts are similar to savings accounts where the bank uses the funds available to finance its lending and investing transactions. The profit (or loss) generated by these transactions is shared with the PSIA account holders.[19] Therefore, PSIA accounts might be used to reduce the risk weighting of the assets, essentially a measure left to the discretion of national supervisors. While this could provide some capital relief for Islamic banks, it could also lead to unexpected changes in risk profiles.

Regulators should carefully examine the potential impact of applying currently developed capital adequacy guidelines to Islamic banks and consider the risks inherent in the structure of these concepts that might include some country-specific factors. They should do this before undertaking any decision with respect to the relevant capital adequacy requirements for Islamic banks. They should also take active measures to promote and enable advanced risk measurement capabilities at Islamic financial institutions. Otherwise, Basel II and other regulations might have unforeseen implications such as declining competitiveness or performance of Islamic financial institutions, or transfer of certain risks from conventional banks to Islamic financial institutions.

CONCLUSION

Despite their recent positive evolution, Islamic banks are witnessing an increased pressure to continue growing and further improve profitability. As they embark on the difficult journey of attracting new customers by stepping up service and convenience and developing new products, they might be supported or restrained by the regulatory environment in which they evolve in.

The framework that regulators choose for the industry can have a positive or negative impact on the Islamic banks' credibility, ability to compete, and financial performance. Many different regulatory models exist around the world, and each of them presents both advantages and drawbacks. None of them emerges as a clear winner.

In general, the guideline that regulators should adopt is to foster healthy competition between conventional and Islamic banks. This does not necessarily mean treating them equally (especially given the asset-backed transaction nature of the Islamic banks), but it does mean removing

[19] Ibid., 47-51.

all possible barriers to competition. This decision would naturally result in a wider choice for customers, a stronger drive for quality of service, and better prices. This decision would also be consistent with efforts from the regulator to minimize its direct influence on the sector and to make as much space as possible for self-regulation. In any case, regulators must consider carefully the implications of any decisions they may choose to make.

Recent innovations in regulation and attempts at harmonization are starting to create some consistency in regulatory frameworks and approaches across countries. While we are still far from the level of harmonization that can be seen in the conventional sector, these efforts should be praised and intensified.