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The Emerging Islamic Financial Architecture

The Way Ahead

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ABSTRACT

Increased transparency and accountability of financial institutions are strengthening the international financial system, as do proper regulation and supervision. Since Islamic finance is entirely asset-backed, it is expected to contribute to financial stability. Countries in which Islamic banks operate are regulated and supervised in the same manner as conventional banks. The infrastructure required to fortify the Islamic financial industry continues to evolve. In cooperation with other institutions, the Islamic Development Bank (IDB) has undertaken a number of initiatives to add to this stability. Initiatives include establishing specialized institutions, such as the Accounting and Auditing Organization for Islamic Financial Institutions, the Islamic Financial Services Organization, an international Islamic financial market, and an Islamic rating agency. These institutions, as well as the inherent features of Islamic finance, strengthen the international financial architecture and promote greater financial stability.

I. INTRODUCTION

The Islamic financial industry has evolved during the last three decades. Comprising Islamic commercial and investment banks, insurance companies, mutual funds and Islamic windows of conventional banks, the industry has been established due to the demand to do business and to manage money in compliance with the *shari*ᶜ*a*. According to various estimates, there are presently more than two hundred Islamic financial institutions operating in various parts of the world. The value of their combined assets is estimated to be about $150-180 billion.

During these last thirty years, the Islamic financial system has gained considerable respect in international financial circles. It is recognized as a viable and efficient alternative model for financial intermediation. A large number of multinational banks are offering Islamic financial products around the globe. Unfortunately, in the aftermath of the tragic events of 11 September 2001, misconceptions emerged regarding Islamic banks' alleged involvement in money laundering and in terrorist-financing activities. These misconceptions arose either from a lack of understanding or from vested interests.

Like conventional banks, genuine Islamic financial institutions are simply profit-seeking businesses. They are not associated with any political objectives nor are they knowingly involved in any illegal activity. In international financial centers, such as Bahrain, Islamic financial institutions are subject to essentially the same regulations as conventional banks. Central banks and other financial regulatory authorities monitor compliance. Regulations are set in accordance with international best practice, and assign prime importance to the "know thy customer rule." In Bahrain, laws were recently updated to fully comply with the recommendations of the Financial Action Task Force on Money Laundering (FATF). The Bahrain Monetary Agency has also complied with recent FATF recommendations regarding combating terrorist financing. Though Islamic financial institutions have the same legal and regulatory obligations as conventional banks, their overall legal and compliance environment is more stringent; insofar as Islamic financial institutions are subject to additional self-regulation needed to comply with the *shari*ᶜ*a*.

Of course, despite institutions' best efforts to apply "know your customer" standards, terrorists and other criminals, without the management's knowledge, can misuse any conventional or Islamic financial institution. However, we should always bear in mind that Islamic finance has noble objectives and principles, and therefore its ethically oriented owners and managers should not be subjected to the results of undue ignorance or prejudicial defamation.

Recent misconceptions about Islamic financial institutions do, however, oblige those in the industry to better articulate the highly ethical and well-regulated business of Islamic finance. While outlining some of the challenges currently facing the industry, this paper attempts to highlight some actions and responses taken by a number of institutions to improve the image of the business.

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The second section briefly discusses the importance of financial stability while underlining the causes of recent crises. The third section provides an update on the emerging Islamic financial architecture. It focuses on various measures the Islamic Development Bank (IDB) has initiated with the active support of other institutions. The fourth section highlights the way forward for Islamic finance, putting forth some considerations on its contribution to the international financial architecture. Finally, the paper concludes with some key recommendations.

II. CONCERNS WITH FINANCIAL STABILITY

Financial stability is a prerequisite for sustained economic growth and social development. Historic financial crises demonstrate that economic progress achieved over several years can be significantly reversed in a short period. Over the last two decades the international financial system has been victim to numerous crises, resulting in large losses that impacted the economic output of many countries and affected the stability and growth of the world economy adversely (see Table 1).

TABLE 1: ESTIMATED LENGTH OF CRISIS, GROSS OUTPUT LOSS AND RECOVERY TIME[i]

Country	Recovery Time	Recovery years	Gross output loss (% of GDP)
Argentina	1980-82	4	16.6
Argentina	1995-96	3	11.9
Bulgaria	1996-97	3	20.4
Chile	1981-88	9	45.5
Colombia	1982-85	5	65.1
Egypt	1991-94	5	6.5
Finland	1991-96	7	23.1
Ghana	1982	2	6.6
Hungary	1991-92	3	13.8
Indonesia	1992	9	42.3
Indonesia	1997	4	33.0
Japan	1992-present	9	27.7
Malaysia	1985-87	4	13.7
Malaysia	1997-present	4	22.8
Mexico	1994	2	9.6
New Zealand	1987-92	7	18.5
Norway	1987-93	8	19.6
Philippines	1983-86	5	25.7
Philippines	1998-present	3	7.5
South Korea	1997-98	3	16.5
Sweden	1991-92	3	6.5
Thailand	1983	2	8.7
Thailand	1997-present	4	31.5
Turkey	1994	2	9.1
United States	1981-82	3	5.4
Uruguay	1981-85	6	41.7
Venezuela	1994-96	4	14.1

In response to these crises, the international financial community reiterated the need to strengthen its financial institutions through appropriate management measures. These measures include effective regulation and supervision, corporate governance, risk management, enhanced disclosure, and transparency.

For a number of reasons, Islamic finance itself plays an important role in the stability of the global financial system. First, investment deposits of Islamic banks are based on risk sharing and asset-based financing. Second, the practice of Islamic finance takes a number of forms. Some Muslim countries implement Islamic principles on an economy-wide scale. Others allow the establishment of Islamic institutions alongside conventional institutions. Still others allow conventional institutions to write Islamic banking contracts. As a result, Islamic banking and finance function as vital parts of the financial systems of several states.

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Nevertheless, the Islamic financial system is in its evolutionary phase. Despite being fully regulated and supervised, lack of familiarity with the industry in some circles has generated some unwarranted misconceptions. The Islamic financial industry can be strengthened by suitably adapting international standards to its unique risk characteristics. Yet to remain compliant with the *shariᶜa*, some risks of Islamic financial contracts will remain unique. Provided the basic supportive infrastructure is established, the inherent features of the Islamic financial industry can themselves contribute to strengthening the global financial architecture.

A. Causes of Financial Instability

Some common causes of financial crises are:

Lack of proper regulation and supervision. Due to the lack of proper regulation and supervision, financial institutions in several developing countries are not properly capitalized, loan loss provisions are not carefully maintained, large amounts of imprudent lending exists, transparency and disclosure standards remain low, risk management and internal control systems are weak, and public sector influence is extensive. As a result, financial institutions are frequently unable to absorb even small shocks from internal or external sources.

Noncompliance with standards. For a sound financial system, compliance with international standards by governments as well as public and private sector institutions is extremely important. Noncompliance to best practice standards in financial reporting, accounting, auditing, transparency and disclosures can cause financial systems to be vulnerable to instabilities.

Currency crises. As a result of unrealistic exchange rate regimes and/or excessive speculation, the exchange rate of a currency may depreciate below normal levels. Consequently, the value of financial assets/liabilities held in a foreign currency will appreciate leaving the value of those held in a local currency to depreciate. In developing countries in which scarcity of foreign exchange is common, a currency mismatch can lead to banking and payments crises and can have domino effects.

Maturity mismatch. Maturity mismatch between short-term liabilities and short-term assets of the public and private sectors also cause financial crises. If short-term foreign exchange liabilities are high compared with the availability of liquid foreign exchange assets, foreign contractual obligations cannot be met in time, thus triggering larger financial failures.

Moral hazard. A considerable part of financial instability is attributable to deposit insurance schemes that allow inefficient financial bodies to continue to practice. As a result of such policies, some institutions become motivated to practice imprudent policies, which then weaken the overall state of the financial system.

The interest mechanism is central to most of these causes. Fast movement of short-term interest-based funds is an important basis of financial instability. High leverage and expansion of credit without any link to the real sector of the economy also contributes to this instability. Interest-based credit sponsors undesirable speculative activities in stock, commodity and foreign exchange markets. Interest-based funds dilute the capital of banks and weaken their potential to overcome a crisis when it arises. So if the interest mechanism can be avoided, the effects may be contained. This point is discussed further in the next section.

B. Strengthening the International Financial Architecture

Recurring financial failures have made international financial institutions, standards-setters, national regulators and policy-makers, the industry and the academic world all conscious of the need to avert and to manage them effectively. As a result, they have initiated ongoing consultations, debates and reforms, broadly known as the international financial architecture. Close cooperation and coordination between these bodies is of prime importance. Institutions, standards, guidelines, systems and procedures all need to be strengthened. Systems and procedures gaps need to be identified both for crisis prevention and for crisis resolution. These challenges can all be classified into three key areas, namely: enhancing transparency and accountability, strengthening domestic financial systems and managing international financial crises.[ii]

Transparency in releasing accurate and timely information by both the public and private sector institutions is essential. The collapse of Enron and a leading auditing firm in the process emphasize the critical role of transparency in financial accounting and auditing within this financial architecture. Indeed, by strengthening institutions' regulations and supervision, by implementing international standards, by enhancing market discipline and by minimizing public sector influence similar outcomes can be avoided.

However, risk-sharing mechanisms underlying financial systems are more significant. The key to managing international financial failures lies with better risk management. It involves financial intermediation by efficient

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risk-sharing schemes and making the private sector at least partially responsible for crisis management. The first recommendation of the Working Group on International Financial Crises was to "encourage the governments of emerging markets to explore the possibility of developing and using contractual arrangements that contain a degree of risk-sharing between debtors and creditors and that provides additional liquidity during periods of market volatility."[iii]

III. Islamic Financial Architecture: An Update

Interest-based lending is prohibited in Islam as well as in the original scripts of Christianity, Judaism and Hinduism. The Islamic financial industry evolved as a result of the response of Muslim scholars to the prohibition of interest in the *shari*[c]*a*.

A. Salient Features of Islamic Finance

The salient features of Islamic banking and finance can be summarized as follows.

- Interest-based lending as well as financing of gambling forms of transactions, and unethical goods and services are all prohibited in Islam.
- Deposits can either be based on *qard* (interest-free but principal protected loans) or profit-and-loss sharing (PLS).
- Equity participation, temporary equities, credit sale, leasing and other suitably designed modes replace interest-based finance.
- Financial engineering of new products and instruments must comply with *shari*[c]*a* requirements.
- Debt cannot be traded, rescheduled or discounted for interest. However, debt can be swapped for goods and services.
- Private property and free markets are basic to the economic system.

B. Features of Islamic Finance That May Enhance Stability

Efficiency of a financial system cannot be sustained without stability. A number of features of the Islamic financial industry, on both the liability and asset side, contribute to the stability of financial markets.

Islamic financial institutions primarily raise money on the PLS basis. A bank's positive performance on its assets side can be shared by PLS depositors on its liability side. As a result, depositors help share the bank's losses allowing it to overcome financial difficulties. Due to this responsibility, depositors are expected to remain vigilant about the performance of banks. Academic and policy circles view such vigilance as a way of contributing to financial stability.

Debt creation in Islamic finance is not possible without the backing of goods and services. So, debt instruments are not readily tradable unless re-enforced with specific goods and services. Therefore, little room exists for a sudden mass movement of funds as compared to the flexibility available in interest-based short-term funds. Hence the effects of destabilizing speculation would be significantly curtailed. Monetary flows through Islamic financial modes would all be tied directly to commodities and services. In other words, the dichotomy between financial and real activities is removed. Here, finance is automatically earmarked for specific uses on goods and services leaving little room for excessive credit expansion.

Interest-based lending has no doubt created debt pyramids from which many indebted countries discover no way to honor contractual obligations. It is not uncommon to find that borrowers' servicing payments are many times the original principal borrowed. Despite continuous efforts to seek relief, debtor developing countries and institutions face unending debt problems.

Islamic asset-based finance has certain characteristics due to which debt crises are less likely to arise. In particular, the total value of debt, which includes the spot value of commodities purchased on credit as well as an implicit mark-up, is set from the very beginning. The total value of debt can be paid in installments, without increasing its total value, as there is no compounded interest to pay on the outstanding balance. When debtors face unavoidable circumstances that would make them insolvent, they are often granted grace periods to assist them to bring their finances back into order. No penalty interest can be levied in this case. In other words, debt rescheduling is granted at no extra cost to borrowers. Islamic asset-based finance is created through the finance of acquiring goods and services on credit, and the loan is thus used from the very beginning for its prescribed and asset-based purpose. Default resulting from improper use of borrowed funds is therefore most unlikely. Asset-based finance directly contributes to the ability of the economy to meet its internal and external financial obligations.

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C. Major Institutions Comprising the Islamic Financial Architecture

A timeline of the evolution of Islamic financial architecture is given in Table 2 below. The Islamic financial industry has come a long way during its short history. Its future, however, will depend on how it copes with the rapidly changing financial world. One major factor will be how well its institutions can manage the risks generated in providing such Islamic financial services. Islamic financial institutions need to equip themselves with up-to-date management skills and operational systems to deal with the changing environment. The establishment of a number of supporting institutions is also needed to bring the infrastructure of the Islamic financial industry, if not at par, at least closer to the infrastructure of the traditional industry—quantitatively and qualitatively.

The Islamic Development Bank (IDB) has been playing a leading role in establishing several supporting institutions which includes the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the International Islamic Rating Agency (IIRA), the Islamic Financial Services Board (IFSB), the International Islamic Financial Market (IIFM), the Liquidity Management Center (LMC) and the General Council of Islamic Banks and Financial Institutions (GCIBFI).

TABLE 2: EVOLUTION OF THE ISLAMIC FINANCIAL ARCHITECTURE: A TIME LINE

6th century CE	▪ Prohibition of commercial lending in the Qur'an.	
1890s	▪ Commercial banking is initiated in the Muslim world.	▪ Critique of bank interest as *riba* starts, particularly in Egypt.
Early 1900s	▪ The critique spreads to other Arab regions, and particularly to South Asia.	▪ Majority of scholars subscribe to the view that interest in all its forms constitutes *riba*.
1930s	▪ A critique of interest from an Islamic perspective provided by a professional economist.	▪ Islamic scholars argue that bank interest falls under the purview of prohibited *riba.*
1950s	▪ Islamic scholars and Muslim economists start to offer theoretical models of organizing banking and financing as a substitute to interest-based banking.	▪ Models of interest-free banking based on two-tier *mudaraba* are proposed.
1960s	▪ Practice of Islamic principles of finance starts. ▪ Operational mechanisms for Islamic financial institutions begin to be proposed.	▪ Rise and fall of Mitghamr Egypt Saving Associations during 1961-64. ▪ Establishment of Tabung Hajji Malaysia in 1966.
1970s	▪ Establishment of Islamic banks and non-banking financial institutions. ▪ Organization of academic activities. ▪ Establishing academic institutions. ▪ Development of the financial *murabaha* mechanism. ▪ First International Conference on Islamic Economics, Mecca 1976.	▪ Publications of a number of books on Islamic banking based on profit-and-loss sharing, *murabaha*, and leasing. ▪ Dubai Islamic Bank 1971. ▪ Islamic Development Bank 1975. ▪ Center for Research in Islamic Economics Jeddah.
1980s	▪ Public sector policy interests. ▪ More private banks. ▪ Islamic banking product diversification. ▪ Interests in the Western academic and financial circles increase. ▪ Some conventional banks start Islamic windows. ▪ More research, teaching and training programs initiated.	▪ Pakistan, Iran, Sudan, Malaysia and other countries try transforming overall systems or patronize the Islamic system. ▪ IMF publishes working papers, articles on Islamic banking. ▪ PhDs, research, publications on Islamic banking increase in West. ▪ OIC *Fiqh* Academy and other *fiqh* boards established.
1990s	▪ Rise of Islamic Index and Mutual Funds. ▪ Spread of Islamic windows.	▪ Establishment of Islamic mutual funds globally. ▪ Establishment of the Dow Jones and

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2000 and beyond	▪ Progress in Islamic asset-based instruments.
	▪ Recognition of systemic importance of Islamic banks and financial institutions.
	
	▪ Continuous growth and maturity but rising challenges.
	▪ Advancement of the Islamic financial architecture.
	▪ Need for economic size, mergers.
		Financial Times Islamic Indices.
		▪ Regulation and supervision get momentum.
		▪ AAOIFI standards issued
		▪ Work on building supporting institutions start.
		▪ Concern with risk management, and corporate governance.
		▪ Establishment of:
		  ▪ Asset-based security markets.
		  ▪ Islamic Financial Services Supervisory Office.

1. *The Accounting and Auditing Organization for Islamic Financial Institutions*. Shareholders, depositors, investors and regulators all utilize information provided in financial statements. Where statements are prepared on the basis of uniform standards, objective comparison between different financial institutions can be made, enabling market discipline to work more effectively. In this regard, the Accounting and Auditing Organization for the Islamic Financial Institutions (AAOIFI) succeeded in adopting international standards to suit Islamic financial institutions. AAOIFI standards were first introduced in 1993. Since then an increasing number of Islamic financial institutions have embraced these standards.

2. Shari^{c}a *Supervision*. *Shari*^{c}*a* supervision is one of the most important pillars of the Islamic financial architecture. Almost all main market participants including central banks have constituted their own *shari*^{c}*a* supervisory boards. As the raison d'être of Islamic banking and finance is compliance with the *shari*^{c}*a*, Islamic financial institutions carry vital fiduciary responsibilities. Non-compliance can prompt excessive deposit withdrawals and cause even a financially sound institution to fail. Hence, client confidence in financial institutions is extremely important to financial stability. A dynamic financial services industry has to constantly upgrade its product designs and structures to meet *shari*^{c}*a* compliance. AAOIFI is also working on standardizing some of its basic rules for *shari*^{c}*a* supervision.

3. *The International Islamic Rating Agency (IIRA)*. Market discipline is important for an efficient and stable financial system. In this regard, external rating systems and accounting standards play vital roles in improving the availability of information to depositors, bankers and regulators. Existing conventional rating systems are primarily concerned with the financial strength of counter-parties and not that of compliance with *shari*^{c}*a* requirements. Since non-compliance of even a financially sound Islamic bank with the *shari*^{c}*a* can be a cause of serious systemic instability, the need for an Islamic rating agency has always been felt. Keeping this in view, the establishment of the IIRA has been under active consideration by the IDB as well as other Islamic financial institutions for some time. The Agency is presently undergoing registration procedures in Bahrain.

   Once operational, the IIRA will also scrutinize *shari*^{c}*a* aspects of financial institutions and their products. As a basis for its operations, the agency will use AAOIFI accounting standards, which will therefore contribute toward the goal of ushering in a sound and strong Islamic financial system. The agency's activities and global appeal will be of major importance to the Islamic financial industry. As a specialized rating agency, the IIRA should complement existing agencies, adding value to the market. In no way will it compete with conventional agencies, as its objectives are different. Its scope of work will distinguish it from other conventional rating agencies in at least four aspects:

   - It will provide independent assessment of the likelihood of default by determining fiduciary risk of the issuer.
   - It will assess compliance with the principles of *shari*^{c}*a*.
   - Applicable accounting standards will be those of Accounting and Auditing Organization for Islamic Financial Institutions (AAIOFI).
   - It will scrutinize *shari*^{c}*a* transparency for new financial instruments and their issuers.

   By assessing the fiduciary relationship and the credit risk inherent in any instrument or issuer, the IIRA will help create a higher degree of confidence and acceptability of products among the players in the industry. Therefore, IIRA operations will be broader than those of conventional rating agencies.

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The target market of the IIRA will include international financial institutions incorporated or operating in IDB member countries. It will also focus on securities issues targeted for the Islamic market/investors, issuer/corporate credit ratings and foreign currency funds raised by sovereign/companies/financial institutions from IDB member countries.

4. *The Islamic Financial Services Board (IFSB)*. Proper regulation and supervision of banks and financial institutions are also important for financial efficiency and stability. Due to *shari^c^a* requirements, some risks faced by the Islamic financial industry are unique. Bank supervisors utilizing conventional standards cannot assess such risks. Hence, the need for special guidelines for the regulation and supervision of Islamic banks has long been felt. Some regulatory authorities have already introduced guidelines for Islamic banking supervision in their respective jurisdictions. Through an active involvement of the International Monetary Fund (IMF), the IDB, the Bahrain Monetary Agency (BMA), Bank Negara Malaysia (BNM) and other central banks, an initiative has been taken to establish the IFSB. This institution is expected to be operational in Malaysia by 2002.

5. *International Islamic Financial Market (IIFM).* At present, the Islamic financial services industry faces greater liquidity risk due to the absence of a secondary market for Islamic financial instruments. The non-existence of an interbank Islamic money market makes liquidity management a challenging task. The Islamic banks are thus under a constraint to maintain liquidity that is higher than what conventional banks do. This adversely affects the Islamic banks' competitiveness. The establishment of an IIFM is thus one solution to this problem, making it an important building block in the Islamic financial services infrastructure.

   To this end a Working Group was constituted, comprising of the Labuan Offshore Financial Services Authority (LOFSA), the Bahrain Monetary Agency (BMA), the Bank of Sudan, the Bank of Indonesia, and the IDB. Its objective is the establishment of a more structured global financial market based on *shari^c^a* principles and to enhance the cooperative framework among Islamic countries and financial institutions.

   The agreement to establishing the IIFM Board was signed in Paris on 13 November 2001. The IDB has the role of chairing the Board. Though currently dealing with the organization's set-up, the IIFM Board is specifically tasked with determining broad directions and setting major policies and determining standards, fostering promotion and development of Islamic financial instruments, necessary prerequisites for the success of the market.

   Ultimately, the market will be functional and operational only if a critical mass of players is achieved. To this end, strong support from central banks and governments is required. The market aims to set high standards of integrity, by allowing only authorized institutions to act as arrangers, managers and/or underwriters, effectively protecting investors and participants.

   In order to effectively deal with *shari^c^a* issues, IIFM will have its own *Shari^c^a* Supervisory Board (SSB) comprising of internationally recognized experts in the *shari^c^a* from various parts of the world. The SSB is of paramount importance to the success of the IIFM for the global financial market. The SSB will effectively bridge gaps and differences in opinions among the different schools of thought. The SSB will approve financial instruments and harmonize the application of *shari^c^a* among the *shari^c^a* boards.

6. *Liquidity Management Center (LMC)*. As mentioned above, one of the most acute problems facing the Islamic banking industry is the lack of short-term liquidity instruments and the lack of such a market. It is estimated that the total liquid funds available to the Islamic financial institutions for short-term investments are between $20-30 billion. Thereby the need of a money market for efficient managing of short-term liquidity is evident. The LMC as an operating arm of the IIFM Board is under establishment. Founding shareholders are invited to subscribe to its share capital.

   There are two important constraints on the Islamic financial markets that result in the need for the LMC. These are the lack of quality assets and the lack of secondary markets. The envisioned LMC will among other things help to overcome a number of problems. Such problems include the lack of *shari^c^a* credibility and acceptance of existing liquidity programs, insufficient generation of funds, lack of treasury instruments with different tenors, lack of product and geographic diversification and the absence of secondary markets. It is also expected that returns on instruments offered in the LMC should have better risk-return profiles than returns available from ad-hoc alternatives, usually commodity *murabaha*, which are below LIBOR.

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The liquidity management center will operate via securitizing tangible long-term assets acquired from a variety of sources. The *sukuk*s (certificates) will be issued against the pool of assets. Due to the tangible nature of the asset pool, these certificates will offer enhanced *shari*ᶜ*a* credibility. In addition, the LMC will create opportunities for buyers to finance long-term projects that can be liquidated at their discretion.

The LMC will also create a secondary, over-the-counter market for its products by establishing a consortium of liquidity providers. Therefore, asset and liquidity risks, from the *sukuk* holders' point of view, will be diversified across multiple assets and institutions. The LMC will bridge the needs of asset rich conventional institutions with that of Islamic financial organizations holding surplus liquidity through a Special Purpose Vehicle (SPV). The SPV will structure, securitize and ensure *shari*ᶜ*a* compliance of conventional institutions' assets and thereby channel the liquidity flows via SPVs. Therefore, LMC is envisioned as a mechanism of pivotal importance under the new global Islamic finance architecture. It will add value toward standardization and unification of Islamic financial markets. In return, this will promote growth in the industry, making it more attractive and significant to both conventional and Islamic investors.

7. *The General Council of Islamic Banks and Financial Institutions (GCIBFI)*. The understanding of Islamic banking and finance has grown rapidly during the past three decades. Nevertheless, being relatively new, it is important for the industry to develop strategic alliances and partnerships with others to remove misconceptions and to pool together resources to confront challenges. The GCIBFI, with its headquarters in Bahrain, was been established with such a background and objective in mind.

IV. THE WAY AHEAD

As discussed above, the central premise of Islamic finance is risk sharing, asset-based nature of finance and the control of gambling-like and unethical transactions. The Islamic financial industry has been using these contracts with success during the last two decades. Since then, their use continuously grows worldwide. Such expansion is beneficial to strengthening financial institutions and promoting financial stability. Since the development of the Islamic financial architecture is a significant task, several challenges and opportunities can be forecast. The most pertinent are mentioned here briefly.

A. Consolidation of the Emerging Islamic Financial Architecture

Considerable expansion of the Islamic financial industry has taken place during the last three decades, both in terms of number of institutions, as well as institutions supporting the industry as an infrastructure. It can be predicted that the next stage may be the consolidation of both types of institutions.

Consolidation in the financial institutions may take the form of size consolidation and functional consolidation. With respect to the former, Islamic financial institutions are generally small in size. It is in the interest of the industry for institutions to workout cooperative mergers of viable economic sizes in order to operate on competitive grounds. The establishment of Al-Shamil Bank has already set the trend of mergers.

In the latter, there is a need for functional consolidation within the various segments of the Islamic financial industry. Namely, there is a need for cooperative mergers among banks, insurance companies and other functional entities. This trend enlarges the platform of universal banking, which is considered to be much closer to the philosophy of Islamic banking. This trend may actually be necessitated by size consolidation as well. It is important to note that such mergers will require effective supervision and clearer capital adequacy requirements for the various functional entities of a consolidated group.

The need to consolidate supporting institutions is even more important as most of these institutions are still in their inception phase. Once fully operational, they can be strengthened by consolidating their activities. For instance, all institutions should comply with the AAOIFI standards and adopt international special risk standards set by the IFSB. The Islamic Rating Agency, for example, has to rely on the standards of IFSB and AAOIFI for its own work. All these institutions have to comply with the *shari*ᶜ*a*. The usefulness of the Islamic financial architecture depends on the complete consolidation of operations of these institutions.

B. Application of International Standards to Islamic Banks

There are a number of channels through which the stabilizing effects of Islamic banking and finance can be transmitted to the global markets. Those countries that have adopted the Islamic system are in the process of consolidating their respective experiences. Their successes in doing so can contribute to stability of their respective economies and can have favorable implications for financial stability in their respective regions. Countries that have

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allowed the establishment of Islamic financial institutions side by side with their conventional banks have in fact liberalized their financial markets. If Islamic financial institutions prove to be more stable due to their inherent characteristics, this will have positive implications in their respective countries further adding to financial stability. This will also encourage the transformation of conventional banks in line with Islamic principles as well as establish new Islamic banks. Similarly, conventional banks, which offer Islamic banking products, may benefit from the stabilizing features of Islamic principles, and hence contribute to financial stability of the markets at large.

1. *Application of international standards*. The positive effects of Islamic banking and finance depend on the strength of Islamic financial institutions in actual practice. Such strength rests on them being properly regulated and supervised by internationally acceptable standards. No disagreement exists on the need for Islamic financial institutions to meet such required international standards on risk management systems. However, it is important to note that a number of the risks faced by Islamic banks differ from those of conventional banks. Some international standards meant for conventional banks need to be adapted to make them relevant and effective to Islamic banks. Hence, effective supervision of Islamic banks requires proper study of their unique risks as well as formulating suitable guidelines. In this regard IFSB will play a vital role.

2. *Preconditions for effective Islamic banking supervision.* As far as the Basel Committee's Core Principles for effective banking supervision, disclosure and transparency requirements are concerned, these are equally relevant to Islamic banks. Due to the risk sharing nature of Islamic banks, these banks need an even more effective system of supervision and transparency. In addition to the preconditions for effective banking supervision set in the Core Principles document, there are a number of other preconditions specific for effective Islamic banking supervision. One set of these preconditions has to be fulfilled by bank regulators and supervisors. These include providing a level playing field for competition, licensing facilities, lender of last resort facilities acceptable to the mandate of Islamic banks, proper legal framework, proper *shari^ca* supervision, etc. The other set of preconditions has to be met by the Islamic banks themselves. These include: effective corporate governance, development of interbank market and instruments, resolution of a number of unresolved *fiqh*-related issues, and development of proper internal control and risk management systems. The consolidation of the initiatives discussed above is expected to play an important role in strengthening the infrastructure of the Islamic financial industry.

3. *Capital adequacy standards.* The Basel capital adequacy standards are applied to Islamic banks in addition to the risk absorbing features of their investment accounts. Islamic banks are in fact better capitalized. However, due to the diverse nature of the Islamic modes of finance and their unique risks, there is a difficulty in applying the risk weighting methodology of the 1988 Basel Accord. This difficulty equally applies to those conventional modes of finance, which are more complex and which couldn't be appropriately put into the five buckets required by the standards. Indeed, one of the fundamental considerations of the proposed new Basel accord is to overcome this limitation as in the 1988 Accord by offering the internal ratings based (IRB) approach for credit risk-weighting of assets. The IRB approach allows mapping the risk profile of each asset individually. Since the Islamic modes of finance are diverse, the IRB approach suits these modes more than the old approach. Moreover, the IRB approach aligns the actual risk exposure of banks with their capital requirements. This is consistent with the nature of Islamic banks. Furthermore, the IRB approach is expected to encourage and motivate banks to develop a risk management culture and thereby reduce the risks in the banking industry and enhance stability and efficiency. For these and a number of other reasons, Islamic banks are expected to benefit from the IRB approach in the long run. Again, IFSB's important role in this approach is evident.

4. *Off-site and on-site supervision.* Most Islamic banks are located in IDB member countries. A growing number of these countries are in the process of adopting and effectively implementing international standards, namely, the Core Principles, minimum risk-weighted capital requirements, and the international accounting standards. Some countries are undertaking financial sector reform programs. Strengthening the capital of banks is an important part of these programs. Since most Islamic banks are very small, some countries have announced a program of mandatory merger of Islamic banks to strengthen their capital base. An increasing number of countries, where Islamic banks are located, are putting in place both off-site and on-site supervisory systems. The well-known on-site supervisory risk assessment system, CAMELS, is also being used in some countries. Islamic banks are generally being supervised within the framework of the

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prevailing international commercial banking supervisory systems. In this manner, capital adequacy requirements, international accounting standards, best practices of transparency and disclosures and other standards are equally applied to Islamic banks as to conventional banks.

C. Strengthening National Regulatory and Supervisory Capacities

Strengthening national financial institutions is of primary importance for sustained economic growth and social welfare. Islamic financial institutions can also be strengthened like their conventional counterparts by adopting best practices in corporate governance, in internal control systems, in risk management, and in disclosure and transparency standards. The application of international acceptable standards to Islamic financial institutions can be ensured only with proper regulation and supervision. It hence can be visualized that adoption and supervision of international standards for Islamic banks are going to be among the most important challenges for the Islamic financial industry in the near future.

D. Liaison with International Standard Setters

Achieving financial stability is a common concern for all constituents of the international financial architecture. Islamic finance is one part of this overall financial system. There is therefore a need for greater interaction between the above-mentioned emerging Islamic institutions and their relevant international counterparts such as the Basel Committee, the International Accounting Standards Committee, the International Organization of Securities Commissioners, the International Association of Insurance Supervisors and relevant national institutions. Such interaction will be in the interest of the entire international financial architecture, helping to achieve sustained financial stability.

V. Conclusion

The Islamic banking and financial system is based on three main ingredients:

- Replacement of the interest mechanism with a system of real asset-based finance.
- Putting controls on gambling like transactions and on financing of unethical goods and services.
- Having a greater reliance on risk-sharing types of contractual relations wherever possible.

The practices of Islamic financial institutions show that reforms are feasible to implement and will not cause any undesirable disruption to the financial markets and institutions. The past three decades' theoretical, practical and policy-oriented works in the area demonstrate that significant progress has been made. Yet, considerable challenges and opportunities can still be visualized ahead. If the policies of Islamic finance are combined with the implementation of international standards of best practices, a more efficient, stable and equitable financial system could be established. The IDB in cooperation with interested national, regional and international organizations will continue to enhance the role of the Islamic financial industry in achieving financial stability.

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[i] VF Garcia et al.
[ii] See Reports of Working Groups on the International Financial Architecture, available on the Web site of the Bank for International Settlements: http://www.bis.org/publ/other.html/FinArch
[iii] Ibid. p. 40.

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