

# Islamic Finance and International Financial Regulation

*Emily Sarah Hersh*

The financial crisis has revealed underlying weakness in the current global financial architecture. International financial regulation seeks to promote stability by preventing systemic failure, but the crisis has severely damaged the credibility of the status quo, leading to calls by many to correct its apparent failures before new ones arise. Upon this background, a variety of alternatives are being proposed and seriously considered by those who feel wronged by the current architecture.

Islamic finance is one of these alternatives. At the 2009 World Islamic Economic Forum, “Muslim presidents, prime ministers and princes . . . called on the world to adopt Islamic financial practices to overcome the global crisis and urged Islamic banks to undertake ‘missionary work’ in the west to promote sharia banking.”<sup>1</sup> Proponents view Islamic finance as inherently more stable than conventional finance, bolstered by the fact that Islamic institutions appear to have largely avoided the fallout of the crisis due to lack of exposure to the subprime mortgage market and the absence of complex structured products.<sup>2</sup> The need for change is undeniable, but whether Islamic finance should replace the current system is dubious. What is relevant to policymakers in the current crisis is the experience of Islamic financial regulation in comparison to conventional regulation.

The success of any global movement requires the establishment of a universal framework to regulate and stabilize activities — in the case of Islamic finance, the establishment of an Islamic financial architecture. This paper will briefly explain Islamic finance, and then consider the current regulatory

---

<sup>1</sup> John Aglionby, “Islamic Banks urged to show the west the sharia way forward,” *Financial Times*, London, March 3, 2009, p. 3.

<sup>2</sup> Ibid.

---

*Emily Sarah Hersh received her M.A. from American University’s School of International Service in May 2010, where she studied International Economic Relations with a concentration in Middle East Studies. While at AU, Emily served as Editor in Chief of the Journal of International Service and worked as a research assistant for Dr. Kristin Smith-Diwan on issues including Islamic Finance and Islamic political movements in the Persian Gulf. Upon graduation, she received the Samuel L. Sharp Award for Creative Work in International Relations at the Graduate Level. Emily is currently living in Buenos Aires, Argentina, where she is working as an independent consultant on issues of private equity and start-up building for Exoventure Associates LLC. Emily can be contacted at emilyshersh@gmail.com.*

framework for conventional banks, highlighting the requirements of the Basel II agreement and the proposed changes under the Basel III amendments. It will consider the Islamic Financial Services Board (IFSB), the current Islamic regulatory body, compared to the Basel II agreement, and examine the need for certain countries, specifically Bahrain, to adopt both regulatory systems. It will conclude by considering the ramifications for the future of international financial regulation.

*Background: The Roots and the Practice of Islamic Finance*

The practice of Islamic finance is based on passages of the Qur'an,<sup>3</sup> prohibiting Muslims from engaging in forbidden economic activities, which shaped early Islamic commercial practices. These activities consist most notably of *riba*, closely translated as interest, and *gharar*, closely translated as uncertainty.<sup>4</sup> In March 2008, Islamic financial institutions managed an estimated \$700 billion in assets globally, and predictions suggest asset holding will increase at a rate of 24 percent annually. Additionally, as a whole, the Islamic finance industry's annual growth rate has averaged 23 percent since 1994.<sup>5</sup> While there is debate over whether products should reflect an Islamic *meaning* or be in compliance with Islamic law (*Shari'ah*), in practice, Islamic financial products are Islamic in form rather than substance, and closely mimic conventional counterparts to achieve deeper markets and global competitiveness.

Islamic products are offered by three major categories of banks: banks in countries with fully Islamicized financial systems, fully Islamic banks that operate internationally alongside conventional banks, and conventional banks that offer Islamic products through Islamic windows. Pakistan, Iran, and Sudan have officially fully Islamicized their financial systems; however, these countries are rife with varying degrees of political turmoil, poverty, international indebtedness, war, and informal sectors<sup>6</sup> that stand in the way of strong systems, Islamic or not. Fully Islamic banks operate primarily in the Middle East and Asia. Islamic windows are operated by conventional banks in areas where a significant Muslim population demands these services, including the Middle East, Southeast Asia, the United States, and Western Europe. Appendix 1 shows the distribution of Islamic banks by region in 2002,

---

<sup>3</sup> The Qur'an is the holy text of the Muslim religion. Muslims believe the Qur'an is God's word as revealed to the prophet Muhammad in Mecca (modern-day Saudi Arabia) circa 622 A.D.

<sup>4</sup> For a more detailed treatment of *riba* and *gharar* in the Qur'an, see Mahmoud El-Gamal, *Islamic Finance: Law, Economics, and Practice* (New York: Cambridge University Press, 2006), ch. 3.

<sup>5</sup> Fouad Al-Salem, "The Size and Scope of the Islamic Finance Industry: An Analysis," *International Journal of Management* 25, no. 1 (2008): 124-199.

<sup>6</sup> Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburgh: Edinburgh University Press, 2000), 112-123.

illustrating the industrial dominance in internationally operative banks in the Middle East and Asia.

While Islamic finance is small compared to the global financial system, and concentrated in areas where Islamic products and services are demanded by Muslim clientele, its international nature and rapid growth warrant a strong framework to ensure harmonization and universally accepted standards. Strength of an international system requires institutionalized regulations to promote stability and consistency. In the case of conventional finance, the Basel Committee of the Bank of International Settlements fills this role. Islamic financial products largely mimic their conventional counterparts, making the Basel regulations an appropriate starting point.

*Conventional Financial Architecture: Basel II and III*

The goal of international financial regulation is to increase the stability of a system characterized by risk. The system is vulnerable to bouts of instability capable of causing systemic crises; furthermore, regulation through ongoing supervision is superior to the simple existence of a lender of last resort (LOLR). A LOLR promotes stability by mitigating the effects of crises and preventing panics, yet this stability comes at a cost. The existence of a LOLR creates moral hazard by providing financial institutions with a safety net that mitigates potential losses and guarantees that institutions that take excessive risks will be able to recapitalize. Ongoing supervision can mitigate this moral hazard by identifying potential problems sooner and ensuring early remedial action. Bank failures and the ensuing financial crises generate severe externalities for taxpayers, who are forced to finance costly bailouts.<sup>7</sup> Regulation is justified on the grounds that the risk of systemic failure and cost of potential consequences outweigh the benefits of an unregulated system, and that it can correct market inefficiencies that arise from deposit insurance and the existence of a LOLR.

Until very recently, international financial regulation was dictated by the 2004 Revised Framework on International Convergence of Capital Measurement and Capital Standards, known as the Basel II agreement. The agreement presented a three-pillar approach to defining and monitoring capital adequacy for international banking institutions. Pillar I established minimum capital requirements based on the risk of banks' assets. Pillar II put forth a system of supervisory review to assess a bank's systems, controls, and risk management that can further influence the minimum capital requirement. Pillar III enforced market discipline by increasing information through rules promoting disclosure and transparency.<sup>8</sup> Theoretically, these pillars provided

---

<sup>7</sup> Howard Davies and David Green, *Global Financial Regulation: The Essential Guide* (Malden, MA: Polity Press, 2008), 7–19.

<sup>8</sup> *Ibid.*, 42–44.

architecture for international banking that efficiently maximized societal benefit by minimizing unnecessary risk.

The first pillar defines a bank's minimum capital requirement based on credit risk, operational risk, and market risk. Banks' credit risk, the risk of borrowers not repaying their loans in full and on time, is assessed using either a standardized approach of weighted risk categories or a newer, internal ratings-based (IRB) approach based on banks' self-assessment of the probability and exposure in the event of default, loss, and maturity. Operational risk, the risk of loss in the event of "inadequate or failed internal processes, people and systems or from external events [including] legal risk,"<sup>9</sup> is assessed, quantified, and reflected by a capital charge added to the capital adequacy requirement. Operational risk is quantified using a basic indicator approach, a standardized approach differentiating between eight lines of business, or the advanced measurement approach allowing individual banks' internal operational risk-measurement systems to generate the appropriate charge. Finally, market risk, the risk of an asset depreciating due to market forces, is considered to minimize arbitrage possibilities.<sup>10</sup>

Pillars II and III seek to regulate the environment within which international banks operate. Pillar II specifies the bank's role in self-monitoring and the committee's supervisory power to monitor and enforce capital requirements, to require that banks hold capital above the minimum, and to intervene early to prevent crises. Pillar III enhances market discipline by mitigating informational asymmetries that shield banks from market forces. It requires banks to operate transparently by implementing a formal disclosure policy regarding risky products and operations, especially for banks that opt to use the IRB approach.<sup>11</sup> The three pillars of Basel II attempt to manage risk by addressing its complex array of origins to most accurately stabilize the system.

The Basel Committee established the Basel II agreement to address and correct Basel I's weaknesses in assessing risk. Basel I failed to quantify and subject important risks to capital regulation; most significantly, it did not address operational risk. Since the implementation of Basel I, increased securitization of loans created major regulatory arbitrage opportunities that caused banks' regulatory capital requirements to diverge from their actual exposure to risk. Additionally, as the banking industry as a whole grew in complexity with the development of new products and instruments, banks devised similarly innovative methods to more accurately manage their risk.<sup>12</sup> International regulation exists to stabilize the system by promoting a common

---

<sup>9</sup> The Basel Committee 2004 in Daniel K. Tarullo, *Banking on Basel: The Future of International Financial Regulation* (Washington, DC: The Peterson Institute for International Economics, 2008), 28.

<sup>10</sup> *Ibid.*, 27-28, 124-125.

<sup>11</sup> *Ibid.*, 126.

<sup>12</sup> *Ibid.*, 87-91.

approach to risk management. Basel I was no longer applicable to the evolving, differentiated international banking system.

The Basel II agreement departs most significantly from its predecessor by permitting banks to use an internal ratings-based (IRB) approach to quantify many categories of risk. It provides three approaches to calculating the minimum capital requirement for credit and operational risk: the Standardized Approach, which assigns a minimum percentage based on individual assets' risk categories, the Foundational IRB approach (F-IRB), and the Advanced IRB approach (A-IRB). Banks may elect to use whichever of the three approaches best suits their individual operations and financial market infrastructure.<sup>13</sup> The complexity of Basel II reflects the paradoxical nature of international financial regulation: as international banking evolves in size and complexity, the need for universal standardization and regulation to ensure the stability of the system increases drastically; contrastingly, the possibility of conceiving of and implementing a single set of standards decreases precipitously.

Basel III refers to the package of amendments to the Basel II regime created as a direct response to the 2008 international financial crisis, which was not averted by the existing regulatory framework. Basel III does not change the fundamental architecture of Basel II, but makes a series of adjustments to the calculation components with the effect of increasing the amount of capital banks are required to hold at all times, and imposes constraints on certain banking activities.<sup>14</sup> While at the time of writing, Basel III has not yet come into effect, it is predicted that it will increase the capital charge for derivatives and securities transactions, increase the risk charge for exposures, increase minimum capital levels allowed, change the definitions of capital permitted to count towards meeting minimum levels, increase the leverage ratio, and impact the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR). These increases will not take place immediately; instead, banks will be given until 2023 to implement changes.<sup>15</sup> The purpose of these changes is to increase the quality and transparency of the capital base, to strengthen the risk coverage of all institutions, to reduce the cyclical nature of the Basel II requirements, and to generally increase liquidity and reduce risk.

Although adoption of Basel III is technically voluntary, it is considered a necessary prerequisite for banks to operate internationally; indeed, it has "... effectively set the standard for the world," evidenced by its implementation in at least 100 countries.<sup>16</sup> Yet, as the paradox suggests, wider implementation will exacerbate the difficulty in having one set of regulations. Increasingly diverse institutions will introduce similarly diverse risks that may be specific to

---

<sup>13</sup> Davies and Green 2008, 43–45.

<sup>14</sup> Clifford Chance, "Basel III – The Shape of Banks to Come," October 2010 Briefing Note, [http://www.cliffordchance.com/content/dam/cliffordchance/PDF/Basel\\_III\\_lowres1.pdf](http://www.cliffordchance.com/content/dam/cliffordchance/PDF/Basel_III_lowres1.pdf).

<sup>15</sup> *Ibid.*; see Appendix 3 for a table summarizing the changes from Basel III.

<sup>16</sup> *Ibid.*, 43, 45.

regional circumstances or cultural practices and not fall conveniently within the Basel framework. Universal regulation is desirable, yet what options are available to internationally operative banks that find Basel inadequate or inapplicable? The response of Islamic banks to this question provides an example with proscriptive implications for the future of international financial regulation.

*Islamic Financial Architecture: The Islamic Financial Services Board*

The Islamic Financial Services Board (IFSB) was established with the support of the IMF in 2002 by central banks and the Islamic Development Bank, and tasked with “the provision of prudential standards and guidelines for international application by banking supervisors in the supervision of Islamic banks.”<sup>17</sup> The IFSB addresses challenges faced by supervisors attempting to apply Basel II regulations to Islamic banks, which manage different assets and consequently different risks than conventional banks.<sup>18</sup> Additionally, Islamic noninterest-bearing savings and investment products that resemble collective investment schemes do not have conventional counterparts addressed in Basel II, creating a greater regulatory challenge. The rationales for international capital adequacy regulation – mitigation of systemic risk and the social cost of moral hazard – are salient for Islamic banks. The calculation of appropriate minimum capital requirements presents “technical rather than conceptual differences . . . in the identification, measurement, and mitigation” of the risks faced by Islamic banks.<sup>19</sup> The IFSB seeks to fill the regulatory gap between Islamic banks and conventional regulation by creating a framework to identify risk and quantify minimum capital requirements.

Pillar I of Basel II addresses credit, market, and operational risk. Islamic banks face similar credit risks as their conventional counterparts, with differences resulting from the profit- and loss-sharing or -bearing arrangements under some Islamic products. Islamic banks are exposed to greater market risk from products tied to commodities whose prices are subject to market fluctuations, and additional equity-position risk from stakes in the businesses they finance. They are exposed to less market risk because *Shari’ah* prohibits taking large open/speculative positions in the futures market.<sup>20</sup> These credit

---

<sup>17</sup> Simon Archer and Rifaat Ahmed Abdel Karim, eds., *Islamic Finance: The Regulatory Challenge* (Singapore: John Wiley & Sons, 2007), 3.

<sup>18</sup> See Appendix 2 for a tabular presentation of the major differences between Islamic and conventional banks.

<sup>19</sup> Simon Archer and Rifaat Ahmed Abdel Karim, “Measuring Risk for Capital Adequacy: The Issue of Profit-sharing Investment Accounts,” in Archer and Karim, eds., *Islamic Finance: The Regulatory Challenge* (Singapore: John Wiley & Sons, 2007), 223–235.

<sup>20</sup> Toby Fiennes, “Supervisory Implications of Islamic Banking: A Supervisor’s Perspective,” in Archer and Karim, eds., *Islamic Finance: The Regulatory Challenge* (Singapore: John Wiley & Sons, 2007), 247–249.

and market risk differences present technical differences in quantifying minimum capital requirements, but it is in operational risk that Islamic banks differ most significantly.

Islamic banks face significantly higher operational risks than conventional banks. These operational risks can be divided into two categories – those inherent and unavoidable in Islamic products and those that result from the undeveloped nature of Islamic banking. The current form of Islamic banking has only existed since the mid-1970s, resulting in systems, processes, and products not sufficiently mature to allow the identification and management of the majority of problems and risks. The rapid growth of Islamic finance has strained resources, including the supply of skilled experts in banking and *Shari'ah*. Modern finance relies on advanced technology, yet computer software for Islamic financial services is less tested, less robust, and at times inapplicable to many operations of Islamic institutions.<sup>21</sup> These operational risks will arguably lessen over time and converge with levels similar to conventional banks.

Much of the operational risk that Islamic banks are exposed to is intrinsic to their Islamic products and services, and will remain perpetually present. Islamic products are contract-based, requiring an extra legal step, and have more components than their conventional counterparts.<sup>22</sup> These differences increase vulnerability to documentation error, processing mistakes, and legal risk. Islamic banks hold more physical assets on their balance sheets, and Islamic insurance cannot insure against losses to the extent of conventional insurance. Islamic banks also face a unique *Shari'ah*-compliance risk, because the acceptance of and demand for their products are subject to approval by religious authorities.<sup>23</sup> These risks will always be present in Islamic finance and cause the practice's risk management needs to differ from conventional finance.

Pillars II and III enhance the supervision and transparency through market discipline, respectively, of international banks. Their application to Islamic banks similarly involves difficulties inherent to the Islamic products and services, and difficulties that exist because of their immature status. Supervising Islamic banks requires sufficient expertise in the above risk differences. As some of these risks fade when the industry gains experience and depth, a corresponding portion of need for additional expertise will wane as well. Transparency and market discipline will increase with maturity; nonetheless, sufficient differences between Islamic and conventional banking will persist, and will require the continued existence of a separate Islamic regulatory body.

---

<sup>21</sup> Elisabeth Jackson-Moore, "Measuring Operational Risk," in Archer and Karim, eds., *Islamic Finance: The Regulatory Challenge* (Singapore: John Wiley & Sons, 2007), 237–239.

<sup>22</sup> For a detailed explanation of the mechanics of Islamic products, see chapter 4 of Iqbal and Mirakhor on Financial Instruments, 77–97.

<sup>23</sup> Jackson-Moore 2007, 237–239.

The existence of a separate regulatory framework for Islamic banks does not significantly affect the majority of the international banking system. The members of the Basel Committee<sup>24</sup> are unlikely to see the effects of Islamic regulation in their countries. Similarly, countries with wholly Islamicized systems are unaffected by the existence of conventional regulation. The concern arises for countries with significant Islamic and conventional banking sectors, which must adopt dual regulatory standards to be globally competitive.

*Bahrain: Between the West and the East*

The Kingdom of Bahrain established the Bahrain Monetary Agency (BMA)<sup>25</sup> in 1973 as the country's single monetary financial authority. At the same time, Bahrain undertook decisive action to diversify its economy away from oil by transforming into the dominant financial center in the Gulf. Bahrain's regulatory framework has allowed it to surpass regional competition from Dubai and Qatar and emerge as the Gulf's preeminent financial center.<sup>26</sup> Bahrain's ability to attract conventional finance allows it to compete globally; but to compete regionally, Bahrain played "the Islamic banking card."<sup>27</sup> In order to be a competitive global financial center in the Arabian Gulf, Bahrain caters to both conventional and Islamic banking institutions, necessitating dual adoption of conventional and Islamic internationally approved regulatory systems.

A globally competitive financial sector is essential to Bahrain's economy. Beginning in the 1970s, the BMA took steps to attract conventional Western banks by maintaining a convertible currency fixed to the U.S. dollar, offering advantages to foreign investors, and most importantly, enforcing a high-quality regulatory environment.<sup>28</sup> Currently, Bahrain has the largest community of international banks and financial institutions in the Gulf,<sup>29</sup> and is the Gulf's most mature financial center.<sup>30</sup> By 2006, the financial sector represented 25 percent of GDP, surpassing the previously dominant oil sector,

---

<sup>24</sup> The Basel Committee is made up of the G10 countries plus Luxembourg. For more information, visit the Basel Committee website: <http://www.bis.org/bcbs/history.htm>.

<sup>25</sup> The Bahrain Monetary Authority became the Central Bank of Bahrain in 2006, inheriting the role as the sole regulator of Bahrain's financial sector. For more information on the transition, examine the CBB law of 2006, available at <http://www.cbb.gov.bh/cmsrule/index.jsp?action=article&ID=2065>.

<sup>26</sup> "Bahrain finance: Harboring regional ambitions," Economist Intelligence Unit, New York, May 9, 2006.

<sup>27</sup> Warde 2000, 128.

<sup>28</sup> Philip Molyneux and Munawar Iqbal, *Banking and Financial Systems in the Arab World* (New York: Palgrave Macmillan, 2005), 28–29.

<sup>29</sup> *Ibid.*, 28–29.

<sup>30</sup> Stephen Timewell, "Middle East: Bahrain — Hard work for a leading player — Bahrain faces a difficult task to keep ahead of its rivals as the leading financial center of the Middle East, but the right moves could pay off," *The Banker*, London, May 2008.

which represented 15.5 percent.<sup>31</sup> Bahrain's status as a global financial center is essential to its survival and is contingent on "the strength of its regulatory framework as a critical success factor and key attraction for institutions operating in the region."<sup>32</sup> Bahrain must implement the regulatory framework adopted by the conventional banking world.

Bahrain recognized the need to establish itself as the center for Islamic banking and finance in order to emerge as the dominant center in the Gulf. It implemented a set of regulations for Islamic banks in early 2000, before the establishment of the IFSB, to cover regulatory issues concerning capital adequacy, asset quality, and liquidity management. These regulations gave Bahrain-based Islamic banks a competitive edge by associating them with the globally respected regulatory authority of the BMA. Currently, Bahrain is home to the largest number of Islamic banks, institutions, industry support organizations, and insurance organizations in the world.<sup>33</sup> Bahrain recognized the importance of an internationally accepted regulatory framework, and was influential in the establishment of the IFSB.<sup>34</sup> Islamic finance is a rapidly growing industry and essential to the future of Bahrain's financial sector.

Bahrain's unique position as a global financial center and the dominant center in the Gulf necessitates that it regulate both the conventional and Islamic sectors in accordance with their respective internationally accepted regulatory frameworks. Both sectors are growing continually, evidenced by the 38 new financial institutions, six of which were Islamic, licensed in 2007.<sup>35</sup> Bahrain faces the challenge of dual regulation, or deciding which rules, regulations, and supervisory authorities should apply to each system. When only conventional regulatory standards are implemented, Islamic banks claim discrimination; however, when a dual system is implemented, conventional banks claim that the "special treatment" amounts to discrimination as well. The BMA addressed this dilemma by establishing an internal division to regulate Islamic banking, yet the existence of the need for multiple regulatory systems raises concerns for the future of the internationally harmonized system of financial regulations envisioned by the architects of the Basel II agreement.

*Conclusion: A Fragmented Future?*

International financial regulation is at its core a system of risk management that attempts to identify and quantify risk, and take steps to mitigate risks with the

---

<sup>31</sup> Ibid.

<sup>32</sup> Ibid.

<sup>33</sup> Molyneux and Iqbal 2005, 155-156.

<sup>34</sup> Smith, 176.

<sup>35</sup> Timewell 2008.

potential to cause systemic failure.<sup>36</sup> Basel II was formulated and implemented because its predecessor was seen as weak and insufficient to effectively fill this role. Similarly, countries with Islamic banking sectors established the IFSB because Basel II alone was insufficient to quantify and manage the risk faced by Islamic institutions. In the past, weakness in the current international regulatory systems has provided the impetus for new systems. Presently, the financial crisis has revealed weakness in the current system, once again providing an impetus for change. The question for policymakers is how to proceed, and whether universal agreement on standards that effectively manage the risk of all international banking institutions can be reached.

The Basel II agreement was insufficient to manage the risk of the global financial system partly because it reflects “an out-of-date view of the balance of power.”<sup>37</sup> It lacks representation from clearly relevant international powers – most strikingly, China. It not only fails to reflect an accurate balance of financial power, it lacks representation from culturally, geographically, and ideologically diverse areas of the world that will drive individual governments’ responses to the current crisis. Following the 2009 spring G20 summit, global leaders agreed on the need for greater bank capital, greater cushions in good times, curbs on bankers’ pay, and the establishment of an institution to regulate systemically important hedge funds, yet they failed to agree upon the institutions and regulations to accomplish these goals.<sup>38</sup> The variety of opinions, political environments, and specific financial needs raises the possibility of a fragmented future financial architecture, with regional systems emerging to manage regionally specific banking risks.

The proposed Basel III agreement changes the impact of international regulation on the Islamic regulatory framework, but not as significantly as conventional institutions are impacted. The increase in banks’ capital quality, consistency, and transparency does not affect Islamic banks because the hybrid and Tier III capital that are affected by the changes have not played a significant role in Islamic banks’ capital structures. While the increase in the required level of capital will affect Islamic institutions, the effect will be of the same degree as it is to all other institutions. The newly introduced nonrisk-based leverage ratio is irrelevant to Islamic institutions, as they do not use deposit-type investment accounts, but could be of relevance in the future if certain loaning and deposit practices increase. The Basel III efforts to reduce cyclicity could have the opposite effect on Islamic banks and increase procyclicality; thus, it will be likely that Islamic banks will maintain countercyclical buffers under Pillar II. Regarding Basel II’s new liquidity standards, it

---

<sup>36</sup> Dr. Hilton Root, “Causes of Current Financial Crisis” (lecture, American University, Washington, DC, April 6, 2009).

<sup>37</sup> Davies and Green 2008, 217.

<sup>38</sup> George Parker, Chris Giles, and Edward Luce, “G20 Leaders Hail Crisis Fightback,” *The Financial Times*, London, April 2, 2009, p. 4.

is unlikely that Islamic banks will be able to comply due to lack of funding. The new challenges set out under Basel III are currently being actively addressed by the IFSB to ensure continued operation under globally accepted norms.<sup>39</sup> The new regulatory framework does not adversely impact Islamic institutions, but highlights the stark differences between the Islamic and conventional systems. Even with adaptations and changes, the Basel framework fails to encompass all large financial institutions.

Islamic finance will not provide a “new way forward,” but provides a relevant example of the emergence of a different regulatory system in response to risk created by culturally specific practices. The IFSB has existed successfully alongside the Basel II agreement, yet the very fact that in order to be a global and regional financial center it was *necessary* for Bahrain to adopt both systems carries a warning for the future of international financial regulation. Bahrain competed with its rivals using the number of regulatory systems offered. If the world as a whole does not establish a new system to manage risk following the crisis, various regional institutions will fill the regulatory void, forcing future global centers to adopt pluralistic regulatory systems to remain competitive.

Although the current system’s weakness has been revealed, the rationale for a universal regulatory framework is equally if not more salient in the wake of the crisis. The risk of systemic failure has not abated, nor has the need to mitigate the moral hazard created by the existence of a LOLR, and a fragmented system is unlikely to comprehensively address these palpable dangers. Policymakers should strongly consider the creation of the IFSB in response to the inadequacy of Basel II to accurately manage the risk of Islamic institutions, realizing that failure to represent the current financial balance of power and regional diversity will result in future inadequacies. The failure of the Basel III reforms to correct this representation imbalance suggests that future divergence in the regulatory system is likely. Risk can never be eliminated, but it can be managed, and policymakers must seek to augment the global financial architecture with a new regulatory framework with a wider scope for institutional differentiation.

---

<sup>39</sup> Raed H. Charafeddine, “Capital Management in Islamic Finance: Would conventional regulatory capital requirements be appropriate for Islamic Finance?,” Global Islamic Finance Forum, Islamic Finance: Opportunities for Tomorrow, Kuala Lumpur, October 26, 2010.

Appendix 1: Distribution and assets of Islamic banks by region (2002)

Region	No. of Banks	% of Banks	Assets (US\$ Million)	% of Assets
South & Southeast Asia	18	18.56	6765.00	13.05
Gulf Cooperation Council (GCC)	42	43.30	38,374.50	74.04
Other Middle East	14	14.43	4806.86	9.27
Africa	9	9.28	NA	NA
Rest of the world	14	14.43	1876.68	3.63
Total	97	100	51826.04	100

Source: Islamic Banking Information System (IBIS) in Molyneux and Iqbal (2005)

Appendix 2: Similarities and differences between Islamic and conventional banks

Banking activities	Conventional Bank	Islamic Banks
I. Sources of funds		
Capital and R.E.	Yes	Yes
Deposits; (fixed interest)	Yes	Yes (participating in profit)
Loans and bonds	Yes	No
II. Use of Funds		
Investment in loans	Yes	No
Investment in securities	Yes	Yes (no fixed-interest securities)
Participation in business	Small	Yes (main field of investment)
Investment in foreign currencies	Yes	Yes
III. Services rendered		
Current accounts	Yes	Yes
Credit card	Yes	Yes; no overdraft
Letters of guarantees	Yes	Yes
Bills discounted	Yes	No
Forward rate and arbitrage	Yes	No
Prearranged profit basis	No	Yes
Letter of credit	Yes	Yes (100% down payment)
Credit cards	Yes	Yes with no overdraft
Forward rate and arbitrage	Yes	No

Underwriting in securities	Yes	Equities and Islamic instruments
IV. Cost of Capital		
Expected return on capital	Yes	Yes (stockholders)
Expected return on bonds	Yes	Yes Sukuk and Islamic bonds
Expected return on deposits	No	Yes

Source: Sabri and Jaber, 1985 and 1987 in Sabri (2008)

### Appendix 3: Basel III Capital Requirement Adoption Timeline

Source: Clifford Chance (2010)

Basel III Capital Requirements

	2013	2015	2018	2023
Equity	3.5%	4.5%	7%	7%
Other Tier 1	1.0%	1.5%	1.5%	1.5%
Tier 2	3.5%	2.0%	2.0%	2.0%
Total Requirement	8%	8%	10.5%	10.5%
Capital Deductions	0%	40%	100%	100%
Legacy sub debt	90%	70%	40%	0%
Leverage Ratio	Observed	Disclosed	In force	In force
LCR	Observed	In force	In force	In force
NSFR	Observed	Observed	In force	In force

