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## **RISK SHARING IN ISLAMIC BANKING**

**May 2019**



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## **RISK SHARING IN ISLAMIC BANKING**

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**May 2019**

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## ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which involves, among others, the issuance of exposure drafts, holding of workshops and, where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

For more information about the IFSB, please visit **[www.ifsb.org](http://www.ifsb.org)**.

## ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
CMT	Commodity <i>murābahah</i> transactions
CPIFR	<i>Core Principles for Islamic Finance Regulation</i>
DCR	Displaced commercial risk
FAS	Financial accounting standard
GN	Guidance note
HQLA	High-quality liquid assets
IADI	International Association of Deposit Insurers
IAH	Investment account holder
IFRS	International financial reporting standards
IFSA	Islamic Financial Services Act
IFSB	Islamic Financial Services Board
IMF	International Monetary Fund
IRR	Investment risk reserve
NPSIA	Non-profit-sharing investment account
PER	Profit equalisation reserve
PIDM	Perbadanan Insurans Deposit Malaysia
PSIA	Profit-sharing investment account
PSIFIs	Prudential and Structural Islamic Financial Indicators
RPSIA	Restricted investment account
RSAs	Regulatory and supervisory authorities
RWA	Risk-weighted assets
UPSIA	Unrestricted profit-sharing investment account

## GLOSSARY

Diminishing <i>mushārah</i>	A form of partnership in which one of the partners promises to buy the equity share of the other partner over a period of time until the title to the equity is completely transferred to the buying partner. The transaction starts with the formation of a partnership, after which buying and selling of the other partner's equity takes place at market value or at the price agreed upon at the time of entering into the contract. The "buying and selling" is independent of the partnership contract and should not be stipulated in the partnership contract, since the buying partner is only allowed to promise to buy. It is also not permitted that one contract be entered into as a condition for concluding the other.
<i>Fiqh</i>	Knowledge of the legal rulings pertaining to conduct, which have been derived from specific evidence.
<i>Hibah</i>	The payment of money or transfer of an asset to another party without a consideration.
<i>Ijārah</i>	A contract made to lease the usufruct of a specified asset for an agreed period against a specified rental. It could be preceded by a unilateral binding promise from one of the contracting parties. The <i>ijārah</i> contract is binding on both contracting parties.
Islamic window	That part of a conventional financial institution (which may be a branch or a dedicated unit of that institution) that provides both fund management (investment accounts) and financing and investment that are Sharī'ah -compliant – that is, with separate funds. It could also provide <i>takāful</i> or <i>retakāful</i> services.
<i>Muḍārabah</i>	A partnership contract between the capital provider ( <i>rabb al-māl</i> ) and an entrepreneur ( <i>muḍārib</i> ) whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur. Profits generated by that enterprise or activity are shared in accordance with the percentage specified in the contract, while losses are to be borne solely by the capital provider unless the losses are due to misconduct, negligence or breach of contracted terms.
<i>Murābaḥah</i>	A sale contract whereby the institution offering Islamic financial services sells to a customer a specified kind of asset that is already in its possession, whereby the selling price is the sum of the original price and an agreed profit margin.
<i>Mushārah</i>	A contract between the institution offering Islamic financial services and a customer whereby both would contribute capital to an enterprise, whether existing or new, or to ownership of real estate or a movable asset, on either a temporary or a permanent basis. Profits generated by that enterprise or real estate/asset are shared in accordance with the terms of the <i>mushārah</i> agreement, while losses are shared in proportion to each partner's share of capital.
Sharī'ah	The practical divine law deduced from its legitimate sources: the Qur'ān, Sunnah, consensus ( <i>ijmā'</i> ), analogy ( <i>qiyās</i> ) and other approved sources of the Sharī'ah.
Sharī'ah board	An independent body set up or engaged by the institution offering Islamic financial services to supervise its Sharī'ah compliance and governance system.
Sharī'ah non-compliance risk	An operational risk resulting from non-compliance of the institution with the rules and principles of Sharī'ah in its products and services.
<i>Ṣukūk</i>	Certificates that represent a proportional undivided ownership right in tangible assets, or a pool of tangible assets and other types of assets.

	These assets could be in a specific project or specific investment activity that is Sharī'ah-compliant.
<i>Takāful</i>	A mutual guarantee in return for the commitment to donate an amount in the form of a specified contribution to the participants' risk fund, whereby a group of participants agree among themselves to support one another jointly for the losses arising from specified risks.
<i>Tawarruq</i> or commodity <i>murābaḥah</i>	A <i>murābaḥah</i> transaction based on the purchase of a commodity from a seller or a broker and its resale to the customer on the basis of deferred <i>murābaḥah</i> , followed by the sale of the commodity by the customer for a spot price to a third party for the purpose of obtaining liquidity, provided that there are no links between the two contracts.

## Abstract

As a prelude to another IFSB working paper<sup>1</sup> on related issues that is based on empirical cross-country analysis, this working paper is basically both exploratory and cross-sectional in nature. It describes the views of both Islamic banks and regulatory and supervisory authorities (RSAs) on the practices of Islamic banks in IFSB jurisdictions. This is in relation to the governance rights of unrestricted profit-sharing investment account (UPSIA) holders, as well as likely reasons that may account for the limited usage of equity-based contracts especially on the asset side of the balance sheet of Islamic banks. The findings reveal that the capital treatment of the UPSIA in general varies across different jurisdictions and Islamic banking type; and that in most of the jurisdictions sampled, UPSIAs are considered to be “investments” exposed to losses, rather than “deposits” with capital certainty. The Islamic banks sampled comply mostly with the disclosure requirements and, except in a few jurisdictions, engage in smoothing both of investment returns and of losses. UPSIA holders’ lack of governance rights is well noted by both the participating RSAs and Islamic banks, but neither consider “vicarious monitoring” by shareholders sufficient to attenuate the lack of governance rights of the UPSIA holders. The high regulatory risk weights required on *muḍārabah* and *mushārah* assets (excluding diminishing *mushārah* for home purchase finance) discourage Islamic banks from placing funds in such assets. Other reasons include the agency and transactions costs attaching to such assets. Specifically in this regard, the operational risks associated with the lack of human resources with the requisite knowledge and understanding of the specificities of risk-sharing contracts are noted.

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<sup>1</sup> The views of UPSIA holders are not covered in this paper. Also, interpretation of the results is based on a generic view whereas jurisdictional peculiarities may offer plausible reasons for some of the findings obtained. From a regulatory point of view, the impeding effect of high risk weights on the use of risk-sharing contracts, though highlighted, did not give account of the actual risk weights used in various jurisdictions are not highlighted. An account of the risk management practices used by Islamic banks in this regard, as well as of possible Shari’ah matters arising from the innovative risk-sharing practices in various jurisdictions, is also not provided. These and other related issues will be addressed in another IFSB working paper on profit-sharing investment account: cross country analysis.



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## SECTION 1: INTRODUCTION

### 1.1 Background

The foundational principles upon which Islamic banking is built and which differentiate it from the conventional banking system can be viewed from both theoretical and practical perspectives. In Islamic business ethics, risk sharing is an important principle: it is not considered ethical to act as a *rentier* by earning income from providing financing without assuming the risk of what is being financed. The avoidance of interest-bearing loans is in accordance with this principle. Risk sharing is considered by some authorities to be a fundamental principle that underlies the potential of Islamic banking to ensure financial stability, strengthening the link between the real and financial sectors, and promoting shared prosperity among the various stakeholders based on allocative efficiency and equity.<sup>2</sup>

The implication of risk-sharing contracts for financial stability hinges on the fact that funds mobilised on the liabilities side are by nature real savings that are channelled towards wealth-creating and real economic activities on the asset side of the balance sheet so as to generate future economic returns. The probable and future state-dependent nature of the risks and returns of risk-sharing contracts may thus be considered to promote more mutuality in prudence, accountability and responsibility on the part of both investors and Islamic banks as partners, especially given the inherent attribute of the inseparability of a right to profit on the one hand from exposure to losses of capital or efforts or both on the other hand depending on the underlying risk-sharing contract.

In practice, Islamic financial institutions follow *fiqh al-mu'amalat* (Islamic commercial jurisprudence) which, among other things, incorporates a number of commercial contracts (the so-called nominate contracts) which provide methods of financing that avoid interest, but most of which do not share risk except in the limited sense of being asset-based. These are the so-called exchange-based contracts, which involve the sale (e.g. *murabahah*) or leasing (*ijarah*) of the asset by the financier to the customer, as well as working capital financing by means of advance purchasing or progress payments (*salam* and *istiṣnā'*). Risk-sharing or equity-based contracts are forms of partnership, either *musharakah* (similar to a conventional partnership) or *muḍārabah* (a “partnership between work and capital”, where the capital provider is a sleeping partner while the managing partner provides the work).<sup>3</sup>

On the liability side of an Islamic bank's balance sheet, risk- and reward-sharing contracts, usually in the form of “profit-sharing investment accounts”, are typically used to mobilise funds.<sup>4</sup> Most jurisdictions show an increasing trend in the use of such

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<sup>2</sup> Maghrebi and Mirakhor (2015), p. 88.

<sup>3</sup> Mirzet, Alaa and Masih (2016), p. 54.

<sup>4</sup> In Malaysia, for instance, the *Islamic Financial Services Act* (IFSA) makes a clear distinction between Islamic deposits and investment accounts as sources of funding to Islamic banks. While the former is risk-free and with a guaranteed principal, the latter is treated as risk bearing and with no guarantee of the principal amount invested.

investment accounts.<sup>5</sup> For instance, they represent more than 72% of total funding in Bangladesh and 69% in Indonesia (PSIFIs 2Q18). An exception is Malaysia, where it is about 11% (PSIFIs 2Q18).<sup>6</sup> In most Islamic banks, investment account contracts are structured on the basis of *muḍārabah*.<sup>7</sup> The *muḍārabah* contract may not necessarily be, and in the case of unrestricted profit-sharing investment accounts (see below) generally is not, a time-limited investment as it may continue for as long as the contractual terms are favourable to the *muḍārib* (Islamic bank) and the *rabb al-māl* (investment account holder) who may also opt to voluntarily retain his funds in the investment.

In a *muḍārabah* contract for profit-sharing investment accounts (PSIAs), the bank as *muḍārib* shares the profits with the profit-sharing investment account holders (PSIAH) as *rabb al-māl*, while in the absence of misconduct and negligence on the part of the bank, losses on the investment have to be borne by the latter alone.<sup>8</sup> Profit-sharing investment accounts can be either restricted or unrestricted. The restricted profit-sharing investment account (RPSIA) imposes a number of restrictions on both the investor and the Islamic bank. For instance, while an investor is restricted from withdrawing funds invested prior to the maturity period, an Islamic bank has to manage the investment based on a specific investment mandate given by an investor. RPSIA funds are typically not commingled with either the shareholders' funds or any other funds mobilised by an Islamic bank and, as such, are treated as an off-balance sheet item but with disclosure in the notes to the financial statements.

On the other hand, where the contract allows an Islamic bank as *muḍārib* to manage the funds at its discretion, this type of investment account is generally referred to as an unrestricted profit-sharing investment account (UPSIA).<sup>9</sup> Unlike the RPSIA, it vests in the Islamic bank an unqualified mandate to invest the funds in Sharī'ah-compliant assets. If the funds mobilised via the UPSIA are commingled with other funds on the Islamic bank's balance sheet, they are treated as on-balance sheet items for financial reporting purposes.<sup>10</sup> This is the treatment set out in the standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the internationally recognised standard setter for Islamic financial institutions.<sup>11</sup>

Islamic banks book UPSIA funds on the liabilities side of their balance sheet. The AAOIFI standard introduces a distinct balance sheet category for unrestricted

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<sup>5</sup> This depends on the extant regulations by central banks and statutory authorities across jurisdictions regarding operationalisation of the profit-sharing investment accounts – for instance, on risk transfer to investment account holders, deposit insurance coverage, etc.

<sup>6</sup> This trend is especially noticeable since the introduction of the Investment Accounts Platform (IAP) in 2015 under the IFSA in Malaysia, which specifically distinguishes deposits from investments. In fact, as at 4Q18, the IAP constitutes only about 0.2% of the total amount of investment accounts in Malaysia.

<sup>7</sup> Other types of Sharī'ah contracts adopted in Malaysia, for instance, are the *mushārah* and *wakālah* contracts. In Pakistan, running *mushārah* is also used as a risk-sharing product for financing working capital.

<sup>8</sup> See Sapuan (2016), p. 350–4, for the views of both classical and contemporary Islamic scholars on this matter.

<sup>9</sup> For a brief distinction between UPSIA and RPSIA, see Archer and Karim (2009), p. 302.

<sup>10</sup> There is an exception to this practice in Malaysia, in which case the funds of the UPSIA holders are not commingled with other funds. Rather, UPSIA funds are tagged to specific assets bounded by the investment objective and strategies disclosed to the UPSIA holders.

<sup>11</sup> This attribute makes these accounts look more like the typical private banking investment accounts in conventional investment banking, with the difference that the funds in the latter are not commingled with other funds. Another key difference is that the UPSIA holders are usually risk-averse and seek only modest returns, in contrast to the risk appetite of the high-net-worth investors that patronise private banking investment accounts seeking high returns.

investment accounts between customers' current accounts and shareholders' equity. While UPSIAs are used by Islamic banks in place of conventional interest-bearing deposits, unlike the latter they are not "capital certain" as the bank has no contractual obligation to guarantee the principal amount in case of investment losses, and in fact the *muḍārabah* contract excludes the giving of any such guarantee.<sup>12</sup>

In addition, there are also concerns about the use of UPSIAs in some cases with capital impairment risks, or governance and regulatory issues. Though the funds of UPSIA holders are in some, if not most, cases commingled with those of shareholders, the former do not have equal governance rights when it comes to matters relating to how the invested funds are allocated; nor is their risk preference necessarily considered in fund allocation, whereas they are typically more risk-averse than shareholders.<sup>13</sup>

The conceptual loss-bearing quality of investment accounts has been taken as an argument for special treatment with respect to regulatory capital requirements. UPSIAs do not qualify for treatment as equity, according to international financial reporting standards (IFRS), or as "own capital" for regulatory purposes. For these purposes, the treatment proposed by the Islamic Financial Services Board (IFSB) consists of the total or partial exclusion of assets financed by PSIA funds from an Islamic bank's total risk-weighted assets (RWAs) when calculating its regulatory capital requirements under Basel standards.<sup>14</sup>

While Islamic banks make considerable use of risk-sharing contracts (usually *muḍārabah*) on the liability side to mobilise funds, risk-sharing contracts are little used on the asset side. A trend analysis based on the IFSB's PSIFIs data indicates a limited use of risk-sharing financing contracts in Islamic banking across jurisdictions.<sup>15</sup> As shown in Figure 1.1, data from the Islamic banking industry indicate that only a little over 5% of total financing by Sharī'ah-compliant contracts is based on *muḍārabah* and *mushārah* contracts.<sup>16</sup> A number of reasons have been advanced as accounting for this trend.<sup>17</sup>

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<sup>12</sup> This loss-bearing feature is emphasised by calling investment account holder (IAH) funds "equity of profit-sharing investment accounts" (as per the AAIOFI standard), but this terminology should be interpreted with caution. "IAHs' equity" is different from "shareholders' equity" in substantial respects: IAH funds are not with the bank in permanence but can be withdrawn by the account holders at short notice, and IAH do not have any governance rights such as those of common shareholders. *Muḍārabah* contracts factually shift the commercial power of control from the owner of funds (*rabb al-māl*) to the fund manager (*muḍārib*) – that is, from the IAH to the bank. The *rabb al-māl* are "sleeping partners" and have no right to interfere in or control the business managed by the *muḍārib* (except in the case of misconduct and negligence). The *muḍārib*, having no financial capital invested in the subject-matter of the contract, is thus not exposed to losses (absent misconduct and negligence).

<sup>13</sup> See Archer and Karim (2009), p. 2.

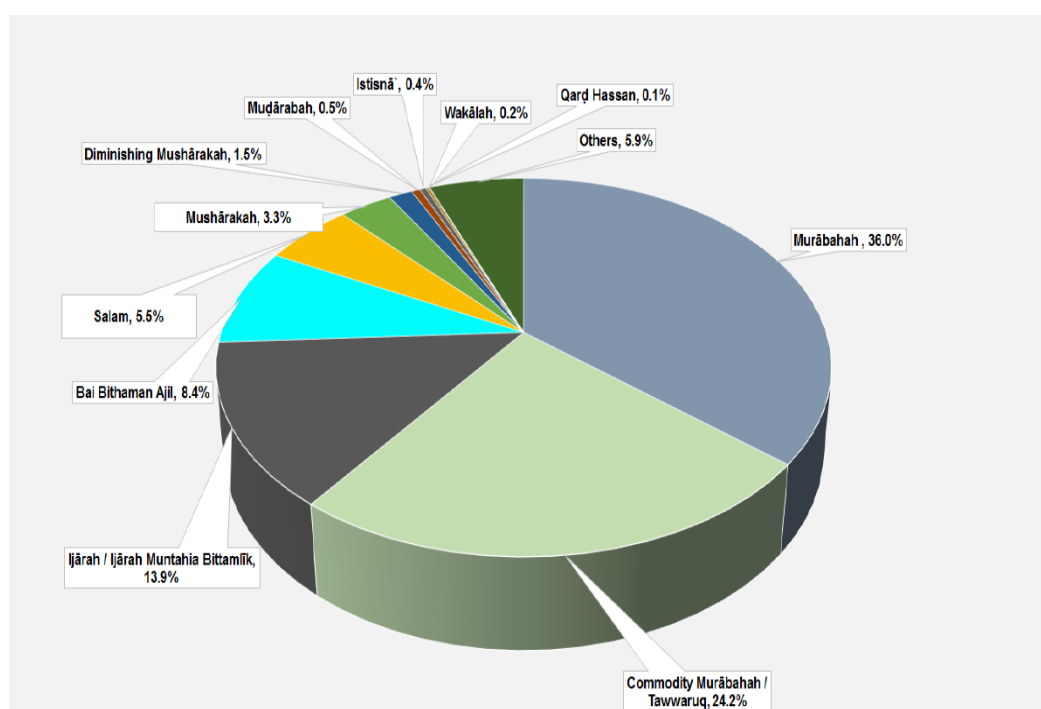
<sup>14</sup> This treatment of an UPSIA presumes it is an investment. However, in some other jurisdictions where UPSIAs are considered as a deposit, their loss-bearing attribute may be attenuated by the coverage provided through deposit insurance. In these cases, the justification for discounting the RWAs for on-balance-sheet assets funded by the UPSIA is questionable. The IFSB standard for calculating the Basel capital adequacy ratio incorporates a parameter '*alpha*' which reflects the treatment of the UPSIA with respect to lack of profits or to losses. This parameter is discussed in subsection 4.3 below.

<sup>15</sup> IFSB, *Islamic Financial Services Industry Stability Report 2018*.

<sup>16</sup> A further decomposition indicates that *muḍārabah* accounted for less than 1% of the total financing contracts in the Islamic banking industry as per PSIFIs 2Q18 data.

<sup>17</sup> Some of these reasons are discussed in Section 3 of this paper.

Figure 1.1 Financing by Type of Sharī'ah-Compliant Contract, 2Q18



Source: PSIFIs key exhibits.

Islamic banks' preference for exchange-based contracts, rather than equity-based contracts, in providing financing to customers may be explained by the onerous requirements of risk management for exposures to the latter, which are aggravated by the fact that the funds used for such financing may be largely the funds of UPSIA holders. These risks include those of capital impairment, together with information asymmetry<sup>18</sup> and limited possibilities of monitoring and control, which could lead to adverse selection and a concentration of bad risks for the Islamic banks. These risks impose heavy transactions and agency costs on an Islamic bank that provides financing using equity-based contracts, which do not arise in the use of exchange-based contracts.<sup>19</sup> Managing such risks calls for the skills and risk appetite of venture capital providers or managers of private equity funds, rather than those of Islamic commercial bankers managing UPSIA funds. Moreover, for the purpose of capital adequacy requirements and for the stability of the Islamic banking sector, regulators consider equity-based financing assets as involving high-risk exposures, implying a high capital charge. In a regulatory system with risk-weighted capital requirements, this discourages banks from using equity-based modes of financing.<sup>20</sup>

If, in a competitive environment, an Islamic bank were to pass on any investment losses directly and unbuffered to the UPSIA holders, it might experience significant reputational risks which could trigger withdrawals of UPSIA funds (so-called withdrawal risk). Even in less dramatic situations with no loss, but with profit pay-outs to UPSIA holders that fall substantially short of their expectations (which are probably based on

<sup>18</sup> See Sapuan (2016), p. 350.

<sup>19</sup> Archer, Karim and Al-Deehani (1998), p. 161.

<sup>20</sup> Islamic banks may be exposed to credit or capital impairment risks due to information asymmetry when entrepreneurial activities are financed using equity-based contracts. While these risks may be mitigated by close monitoring, this is very costly.

prevailing market rates), similar fund-shifting effects might emerge. As a consequence, Islamic banks may resort to various mechanisms to avoid passing some or all of the effects of poor financial results on to their UPSIA holders. These mechanisms are described in subsection 3.5 below. Use of such mechanisms may give rise to so-called displaced commercial risk (DCR) – namely, the transfer or displacement of variability in profits from the UPSIA holders to shareholders. Islamic banks may also use a so-called investment risk reserve (IRR) to cover losses on investments of UPSIA funds.

The danger from withdrawal risk is considerable, given that the majority of the assets financed by UPSIA funds have substantially longer maturities than the latter. In normal circumstances, this is not a problem as UPSIA holders tend to behave like typical retail depositors and provide fairly stable funding. But if withdrawal risk is triggered, the maturity mismatch could cause serious liquidity problems and reputational damage for an Islamic bank. Sharī'ah scholars have allowed the application of profit-smoothing techniques, but they generally still oppose guarantees of the principal by the bank. Nevertheless, banks have several options to cushion investment losses if they are not too large, and for worst-case scenarios different types of Sharī'ah-compliant (third-party) investment account guarantee schemes have been implemented in a number of jurisdictions.<sup>21</sup>

As a prelude to another working paper on related issues but based on empirical cross-country analysis, this working paper is basically exploratory in nature. Based on the views of both Islamic banks and RSAs, this working paper describes the practices of Islamic banks in relation to governance rights of UPSIA holders as well as reasons that may account for the limited usage of equity-based contracts on the asset side of the balance sheet of Islamic banks.

## 1.2 Objectives

This working paper provides some initial exploratory findings on risk-sharing practices in the Islamic banking industry.<sup>22</sup> Issues of interest in this research to a large extent relate to the five specific principles relating to Islamic banks in the *Core Principles for Islamic Finance Regulation* (CPIFR) for banking developed by the IFSB and adopted by the International Monetary Fund (IMF) in 2018.<sup>23</sup> Elicited by myriad governance issues and the treatment of PSIA holders, and the declining use of risk-sharing contracts on the asset side, this study has the following aims:

- a. To investigate the existing practices and regulations with regard to risk-sharing practices in Islamic banking. Specifically, the paper investigates the:

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<sup>21</sup> In a particular jurisdiction, it was indicated that the aftermath of a previously encountered financial crisis makes such investment guarantee schemes essential for building people's confidence in participating in PSiAs, stating that in the absence of such a guarantee scheme withdrawal risk is very high. While no such investment guarantee scheme is permitted in Malaysia, in Bahrain and Kuwait UPSIA only is covered. This is in contrast to the practice in Indonesia, where both the UPSIA and RPSIA are non-risk absorbent (considered as deposit) and as such are covered by the country's deposit insurance scheme.

<sup>22</sup> Another working paper focusing on cross-country analysis of the practice of PSIA includes the analysis on risk management practices, regulation and Sharī'ah governance.

<sup>23</sup> The IMF on 28 May 2018 issued a press release to the effect that it is adopting the *Core Principles for Islamic Finance Regulation* (CPIFR) for banking developed by the IFSB. The five principles are: treatment of PSIA/IAH (CPIFR 14), Sharī'ah governance framework (CPIFR 16), equity investment risk (CPIFR 24), rate-of-return risk (CPIFR 26), and Islamic windows' operation (CPIFR 32).

- i. regulatory and capital treatment of PSIAs in Islamic banking
  - ii. protection of the rights and investment funds of UPSIA holders
  - iii. disclosure practices relating to UPSIAs in Islamic banking
  - iv. “smoothing” practices among Islamic banks in relation to UPSIA.
- b. To probe the factors that impede the use of risk-sharing financing contracts among Islamic banks in various IFSB member jurisdictions. Specifically, the following themes based on the literature review are explored:
  - i. regulatory issues
  - ii. rate-of-return risk
  - iii. liquidity management
  - iv. operating structure
  - v. agency costs and transaction monitoring costs
  - vi. customers’ preferences for financing modes.
- c. To provide suggestions, on areas which are considered important for related future policy and developmental work undertaken by IFSB and its stakeholders.

### 1.3 Scope of the Paper

This working paper is an exploratory cross-sectional study on the risk-sharing practices in Islamic banking, especially in relation to the governance rights of UPSIA holders<sup>24</sup> on the liability side and the limited use of equity-based contracts on the asset side.<sup>25</sup> It focuses on IFSB members in various jurisdictions, including Islamic banks and RSAs.

### 1.4 Structure of the Paper

This paper is divided into five sections. Section 2 provides a brief description of the methodology. Analysis of the survey report follows. Section 3 focuses on funding- or liability-side issues, particularly the existing practices with respect to UPSIAs in Islamic banks across jurisdictions. This section explores further the regulatory treatment of PSIAs, as well as other general practices relating to the protection of the interest and investment of UPSIA holders. Section 4 focuses on asset-side issues; in particular, the limited use of equity-based (profit-sharing) financing contracts in the Islamic banking industry is investigated. Questions have been grouped based on common themes from the literature reviewed. The final section presents the conclusions.

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<sup>24</sup> The focus of this paper on the UPSIA is not prejudicial to the relative importance of the RPSIA. Rather, it hinges on the extant literature’s documentation of the higher susceptibility of UPSIA holders to lack of governance rights and inadequate disclosure practices by Islamic banks.

<sup>25</sup> The focus in this paper is on the use of the venture mode risk-sharing contracts of *muḍārabah* and *mushārahah*. The risk profiles of these contracts reflect pure venture intents, which significantly differ from, for instance, *mushārahah mutanāqishah* which, although it is risk sharing in nature, may resemble a sales-based financing contract in some respect.

## SECTION 2: METHODOLOGY

The data used in this study were collected via two sets of questionnaire surveys addressed to Islamic banks and RSAs in various jurisdictions covered by the IFSB between September and October 2018. The survey was based on online distribution and comprised mainly closed-ended questions with codes to indicate the appropriate option a respondent wished to select. In some other instances, open-ended questions were also included for the respondents to freely express their opinion on related matters beyond the closed-ended options provided.

The cooperation of the RSAs and Islamic banks was sought especially in terms of ensuring that the responding officer was the person with the relevant responsibilities to do so, and that the permission of relevant superiors or authorities was obtained where necessary, as the responses provided by an institution would be assumed to reflect its perspectives on the issues raised. The respondents were assured of the confidentiality of the responses obtained. An access link to the online survey was provided in the email invitation, as well as the due date for submitting the completed survey.

Owing to the exploratory nature of the research, data elicited from Islamic banks from 68 countries (shown in Table 2.1) and RSAs from 14 jurisdictions<sup>26</sup> were subjected to descriptive data analysis only, mainly based on simple percentage, frequency and, in a few instances, weighted mean scores to show relative importance.<sup>27</sup>

Table 2.1 Respondent Islamic Banks by Region and Country

Region	Countries where respondent Islamic bank is based	Number of respondent Islamic banks
GCC and Middle East	Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, UAE, Iraq	19
South-East Asia	Brunei Darussalam, Indonesia, Malaysia	26
West, Central and South Asia	Kazakhstan, Maldives, Pakistan	18
Africa	Tanzania, Mauritius	2
Europe	Turkey	3
	<b>16 countries</b>	<b>68 Islamic banks</b>

## SECTION 3: FUNDING SIDE ISSUES

### 3.1 Nature of Islamic Banking Operations

The practice of Islamic banking does not appear to require a fundamentally new prudential architecture. However, Malaysia recently decided to make a significant change in its regulatory framework for PSiAs.<sup>28</sup> As the new law became effective only

<sup>26</sup> The list of the RSAs that responded to the survey is provided in the appendix.

<sup>27</sup> The analysis is based on pooled data which may mask jurisdictional peculiarities. This concern is addressed in some instances in this paper in cases where such a peculiarity is considered material and relevant information is available.

<sup>28</sup> Malaysia issued the *Islamic Financial Services Act* in 2013.



recently, it is much too early for a definitive evaluation of the implications for how investment accounts transactions are carried out in Malaysia.<sup>29</sup>

More generally, anecdotal evidence suggests that the practice of Islamic banks is changing, but not always towards what some people would consider to be the ideal of more risk and return sharing. Some large banks have developed new types of Shari'ah-compliant accounts that resemble even more conventional deposits with predetermined returns (e.g. on a commodity *murābahah* basis).<sup>30</sup> Nonetheless, the use of profit-sharing and risk-bearing *muḍārabah*-based investment accounts on the liability side is still very prominent across jurisdictions, accounting for a sizeable amount of funding for the Islamic banks in most jurisdictions.

For instance, in Indonesia and Pakistan, while Islamic deposits account for over 80% of funding, over 60% of such funding is based on a *muḍārabah* time deposit structure.<sup>31</sup> Exceptions to this are noticed in Kuwait, where the proportion of PSIA funding is very small, probably due to the fact that most financing provided is for real estate, personal loans and interbank lending. In Malaysia, a declining trend in PSIA funding is noted and may be explained by the introduction of the IFSA 2013 and its regulatory requirements which distinguish Islamic deposits from investment accounts. The fact that neither return nor principal is guaranteed for these investment accounts perhaps explains the significant decline in the share of the PSIA in total funding from about 41% in 2013 to 13% by the end of 2015.<sup>32</sup>

In addition to jurisdictional peculiarities, another factor that needs to be considered regarding the nature of an Islamic bank's operations and practices with respect to PSIAs is whether it operates as a full-fledged Islamic bank or an Islamic window of a conventional bank. This distribution is important because it may have implications for each Islamic banking type's PSIA practices.<sup>33</sup> The first question in the survey is therefore: "What is the nature of your Islamic banking undertaking?" Based on the survey report, as shown in Figure 3.1, 72% of the respondents are full-fledged Islamic banks, while the remaining 28% are Islamic banking windows.<sup>34</sup>

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<sup>29</sup> Some preliminary details can be found from: <https://islamicbankers.files.wordpress.com/2015/08/investment-account-august-2017-ibrc.pdf>

<sup>30</sup> Alhammadi, Archer, Karim, Padgett (2017), p. 3.

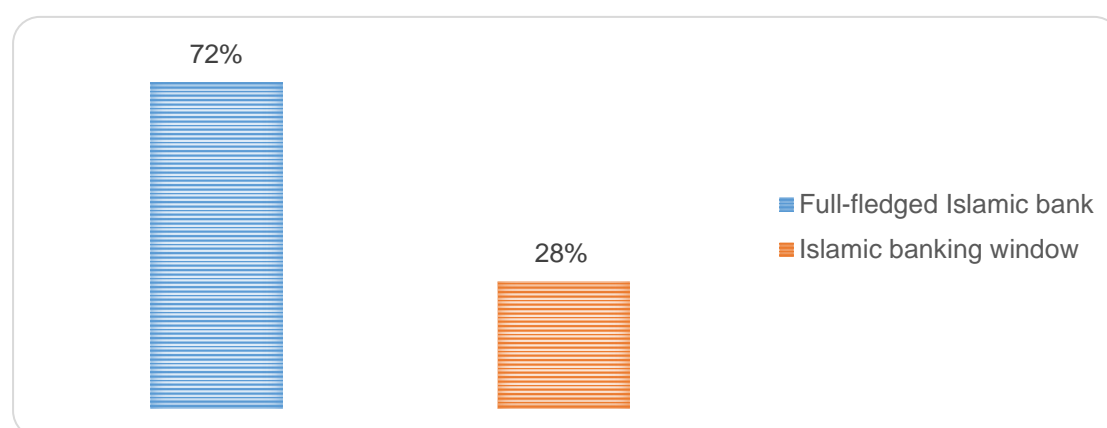
<sup>31</sup> The proportion of funding raised from the PSIA is also quite significant in jurisdictions such as Nigeria, Kenya and Djibouti with a nascent Islamic finance industry and in which, on average, PSIAs account for about 40% of total funding (IMF Country Report No. 17/145).

<sup>32</sup> See IMF Staff Report No. 17/145, p. 56.

<sup>33</sup> Song and Oosthuizen (2014), p. 12.

<sup>34</sup> This distribution is not too different from the 58% and 42% recorded in the IMF survey on Islamic banking by Song and Oosthuizen (2014), p. 11.

Figure 3.1 Nature of Islamic Banking Undertaking



In an IMF survey, respondent RSAs gave a number of reasons why they allowed the operation of Islamic banking windows in their respective jurisdictions. Nonetheless, a plethora of counter-arguments were also offered by other RSAs which were also reiterated in the IMF CPIFR document approved in 2018. Emphasis was placed especially on the issue of the commingling of investment funds, regulatory arbitrage and other Shari'ah governance issues that are peculiar to the practice of Islamic banks in general and the Islamic banking windows offering PSIA in particular.<sup>35</sup>

The research for this working paper further probed into how investment accounts are viewed in the various jurisdictions, by asking the question: "Based on the banking law in your jurisdiction, how are PSIA legally viewed?" Based on responses regarding RPSIAs, 26% consider that they are similar to deposits, while the remaining 74% view RPSIAs as investments. It is somewhat surprising that RPSIAs may be considered as deposits rather than investments, as the funds are placed with a specified asset allocation and maturity. Quite expectedly, the converse is noted in the case of the UPSIAs, where 57% of respondents consider them as being similar to deposit accounts while the remaining 43% indicate otherwise.

A likely implication is that while the RPSIAs are usually placed in specific investments, with a fixed tenure and in which the risk appetite of the investors is matched to the risk of the assets to which the funds are channelled,<sup>36</sup> the UPSIAs are more "deposit-like", being usually general investments with flexible tenure, easy exit and redemption, and often in a commingled asset portfolio.<sup>37</sup> Thus, since UPSIAs reflect more of the attributes of deposits, this may explain why more respondents view them as such.

The survey results also indicate that the Islamic banking windows are more likely than the full-fledged Islamic banks to treat UPSIAs as deposits. Therefore, it is likely that in jurisdictions with a small Islamic finance presence and where Islamic banking windows operations seem very prevalent, there may not be specific provision for the treatment

<sup>35</sup> See Box 3 in Song and Oosthuizen (2014), p. 12, for highlights of arguments for and against the operations of Islamic banking windows.

<sup>36</sup> Other attributes include penalty on exit and redemption, single user utilisation, etc. (see Islamic Bankers Resource Centre, 2017), <http://islamicbankers.me>

<sup>37</sup> Ibid.

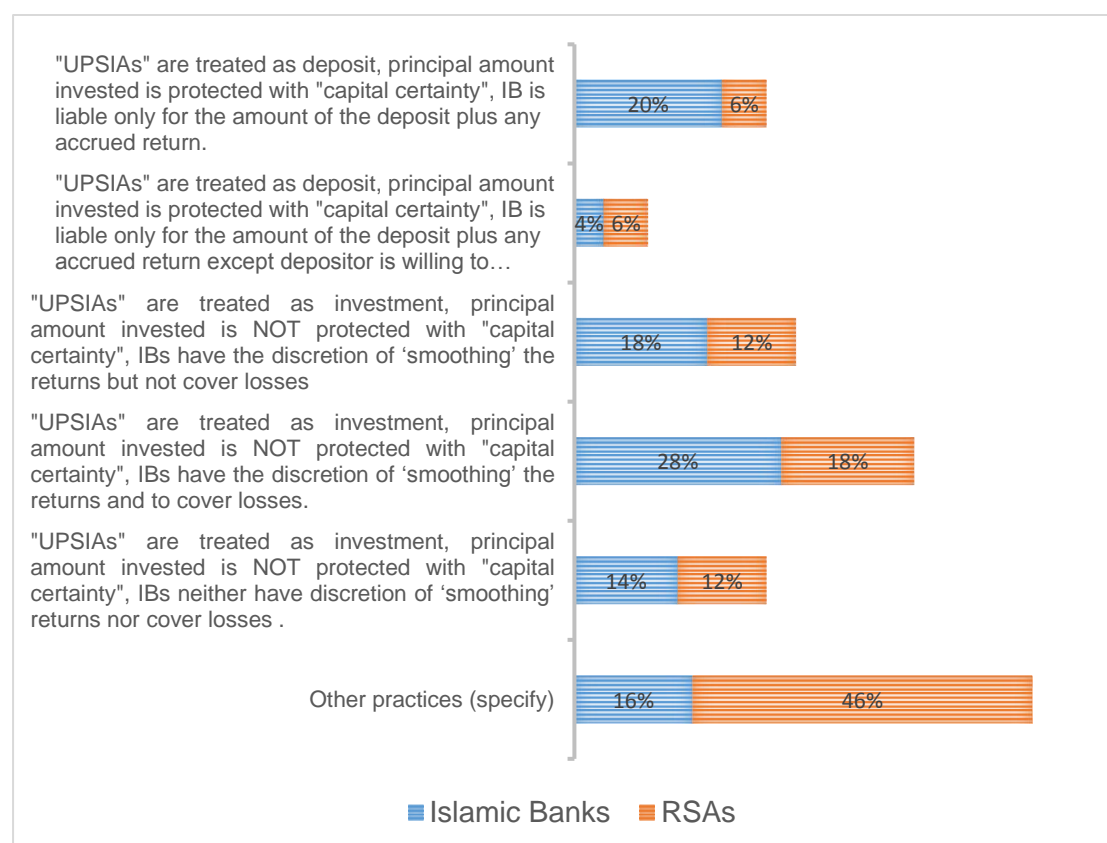
of PSIA funds.<sup>38</sup> The potential for commingling of funds and regulatory arbitrage is higher, which may pose additional supervisory and Shari‘ah compliance issues.<sup>39</sup>

The distribution of the responses by the RSAs differs slightly in terms of how PSIAs are legally viewed in the various jurisdictions. In terms of further decomposition, although the distribution is almost equally represented between RPSIAs and UPSIAs, a narrow majority of the RSAs viewed both the RPSIAs and the UPSIAs as being more “investments” than “deposits”. Specifically, 58% and 54% of the RSAs view RPSIAs and UPSIAs as investments, respectively. This suggests there is a “regulatory-operational” variance between the juristic views of the RSAs and the Islamic banks as far as RPSIAs and UPSIAs are concerned.<sup>40</sup>

### 3.2 Capital Treatment of UPSIA Funds

The next question in the survey asked Islamic banks about the treatment of UPSIA funds, especially in relation to the “capital certainty” of the amount invested or deposited, and the discretion to “smooth” returns and losses. The responses obtained indicate a fairly balanced view among the respondent Islamic banks, as shown in Figure 3.2.

Figure 3.2 Capital Treatment of UPSIAs



<sup>38</sup> In such jurisdictions, it is likely that the same licensing requirements are applied to both the Islamic and the conventional banks. In turn, this may potentially not require separation of UPSIA funds from the other funds under the control of an Islamic bank/Islamic banking window.

<sup>39</sup> See CPIFR 32 of IFSB-17: *Core Principles for Islamic Finance Regulation (Banking Segment)*.

<sup>40</sup> A quick cross-tabulation between the nature of the Islamic bank (full-fledged or window of conventional) vs. the legal view of PSIA (RPSIAs or UPSIAs) reveals that Islamic windows are more likely to view the PSIA as a deposit rather than an investment.

Almost 60% and 42% of the respondent Islamic banks and RSAs, respectively, indicated that, for regulation and capital treatment purposes, UPSIAs are treated as investments with no “capital certainty” but with varying application or otherwise of the PER and IRR for the smoothing of investment return and losses, respectively. A further breakdown indicates that overall, slightly more than a quarter (28%) of the respondent Islamic banks and 18% of the respondent RSAs view UPSIAs as investments, as well as considering such investments as not “capital certain”. The respondents stated, however, that Islamic banks have the discretion of “smoothing” the returns through PER and, in the event of losses, through the use of IRR or similar mechanisms.<sup>41</sup>

Two other modified views are also offered. In the first, 18% of the respondent Islamic banks’ and 12% of the respondent RSAs’ responses indicate that in their treatment of UPSIAs there is no “capital certainty” on investments. However, the Islamic banks have the discretion to use only the PER for the smoothing of returns. In the event of losses on the underlying investments, the UPSIA holder bears the incidence except where the negligence or misconduct of the Islamic bank as the *mudārib* is established. The other group, represented by 14% of the Islamic banks and 12% of the RSAs, differs only by the fact that the regulation in their jurisdiction does not give Islamic banks any discretion to apply smoothing practices through either PER or IRR.<sup>42</sup>

About a quarter (24%) and 12% of the respondent Islamic banks and RSAs, respectively, treat UPSIAs as deposits.<sup>43</sup> A further breakdown of the responses across both groups indicates that about 20% of the respondent Islamic banks compared to only 4% of the respondent RSAs view UPSIAs as deposit accounts with “capital certainty” contingent on the solvency of the Islamic bank. According to this view, in the event of losses, the Islamic bank is liable for the deposited amount plus any return accrued to the depositor. Another 4% of the Islamic banks and 6% of the RSAs share a similar view, but with an additional provision that the liability of the Islamic bank in the event of a loss may be waived at the discretion of the depositor.<sup>44</sup>

Viewed against the main feature of profit sharing and loss bearing of the PSIA, the fact that about a quarter of the respondents indicated treating it as a deposit and one-fifth providing capital certainty may raise some Sharī‘ah compliance concerns, with attendant reputational risk. An Islamic bank respondent noted that a massive withdrawal risk might be triggered in its jurisdiction if the capital certainty element were removed. However, it is not clear that providing an investment amount with guaranteed principal in order to stimulate investors’ confidence following their bad experience of losing colossal sums of deposits in a previous local financial crisis is really required. This is because in another jurisdiction, a clear distinction is made by law between Islamic deposit and investment accounts, and the implication of choosing either reflects investors’ risk profile.

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<sup>41</sup> Smoothing, profit equalisation reserves and investment risk reserves are discussed in more detail in the section 3.5 on smoothing practices.

<sup>42</sup> This is the practice in Malaysia since the introduction of the *Islamic Financial Service Act* (IFSA) in 2013. See: Alhammadi, Archer, Karim and Padgett (2017), p. 3.

<sup>43</sup> This distribution indicates the consistency of the responses obtained, as it is similar to an earlier distribution on how the UPSIA is viewed.

<sup>44</sup> See Archer and Karim (2009), p. 303.

Respondents for whom the options provided did not accurately describe the regulation and capital treatment of UPSIAs in their jurisdiction offered some open-ended responses to clarify or explain their opinion on the question.<sup>45</sup> For instance, a respondent Islamic bank indicates that UPSIAs are treated as investments, and there is no “capital certainty”; however, if the need arises, Islamic banks in its jurisdiction are given the discretion of smoothing returns. Another respondent indicates that UPSIAs are treated either as investments without “capital certainty” or as deposits with “capital certainty”. In either case, and similarly to another respondent, it is indicated that the Islamic bank is liable only for the principal amount of the deposits in the event of loss.

Over 40% of the RSAs selected the “other” option, indicating perhaps that there are other practices in their jurisdiction not captured in the options provided. A review of the comments provided by respondent Islamic banks offered some other insights. In one jurisdiction, for instance, there are other classifications provided such as restricted non-profit-sharing investment accounts (RNPSIAs) and unrestricted non-profit-sharing investment accounts (UNPSIAs).<sup>46</sup>

In some jurisdictions, it is indicated that the Islamic banks would only be liable for the amount invested if it is proven that a loss incurred on an investment can be linked to the Islamic bank’s negligence or misconduct. This is in fact a normal provision of a *muḍārabah* contract. In some cases, no specific legal regulation for Islamic banking is in place in the jurisdiction, so treatment similar to what would be applied to a conventional bank is adopted.

In another jurisdiction, in compliance with the directives of the RSA, the Islamic banks follow AAOIFI standards in the treatment of UPSIAs, which considers them as on-balance sheet items given that investment losses are fully borne by the UPSIA holders except in the case of negligence or misconduct. Finally, two jurisdictions indicate that UPSIAs are viewed as deposits. In one of the two jurisdictions, there is a cap to deposit protection of about USD 17,100 and the Islamic banks can engage in smoothing through PER and IRR. In the other jurisdiction, eligible accounts are also protected to the tune of USD 14,500 by the deposit insurance scheme.<sup>47</sup>

### 3.3 Protection of the Rights and Investments of UPSIA Funds

The fact that the UPSIA funds appear on the balance sheet may imply a likelihood of their being commingled with other funds managed by the Islamic bank.<sup>48</sup> Unless they are “capital certain”, UPSIAs are a form of equity investment and UPSIA holders are residual claimants. In fact, in terms of liquidation, the UPSIA holders rank first before the shareholders in most jurisdictions, especially where UPSIAs are treated as

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<sup>45</sup> Quite a few respondents indicated that they do not offer UPSIAs in their Islamic banks. Respondents from Brunei Darussalam, for instance, indicate that the *Islamic Banking Order 2008* and other regulations in their jurisdiction do not provide for UPSIAs. In Indonesia, there is no UPSIA as they apply revenue-sharing accounts with an income smoothing mechanism. A bank in Malaysia also indicated that it only offers RPSIAs. Finally, a respondent indicated that UPSIAs are treated as deposits in their balance sheet even though their attributes are closer to being those of investments.

<sup>46</sup> No further details were given on how these accounts differ from the PSIA except that they are non-profit sharing in nature. This will be further explored in detail in the cross-country analysis working paper.

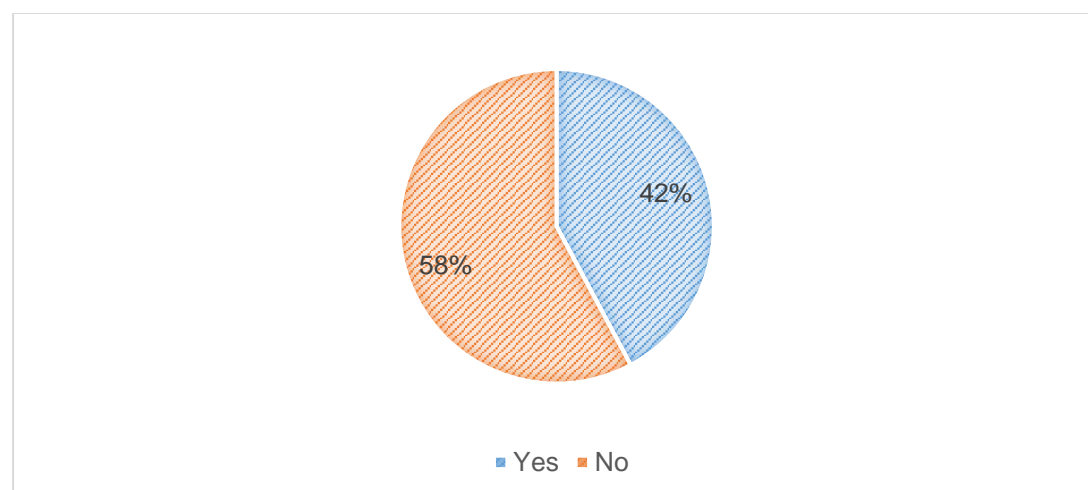
<sup>47</sup> USD exchange rates used are the average of the last 90 days since the survey was conducted.

<sup>48</sup> This could also be due to the prevailing accounting practices in a jurisdiction. For instance, in Bahrain, though the UPSIA funds are maintained separately from the other funds, they may be pooled together to finance the same asset.

deposits.<sup>49</sup> As such, the UPSIA holders would normally be entitled to some rights of governance similar (but not necessarily equal) to those of shareholders. This issue is addressed by the IFSB in its standard IFSB-3. A number of studies, however, have documented the fact that, in practice, UPSIA holders have no governance rights and have pointed out the arguably unfair treatment of UPSIA holders by Islamic banks compared to the treatment given to the shareholders.<sup>50</sup>

A related question asked in the survey is: “Given that the UPSIA holders’ funds are ‘on-balance sheet’ and may be commingled with other funds, would you consider the interests of your Islamic bank’s shareholders to be significantly different from those of your UPSIA holders?” Figure 3.3 shows the responses obtained from the respondent Islamic banks, most of which (58%) indicate that they do not consider the rights of the UPSIA holders as regards fiduciary responsibility to be different from those of shareholders. These rights are not the same as governance rights, but the absence of the latter may tend to have a negative effect on the former.

Figure 3.3 Is the Fiduciary Responsibility of Islamic Banks to UPSIA Holders Different from that to Shareholders?



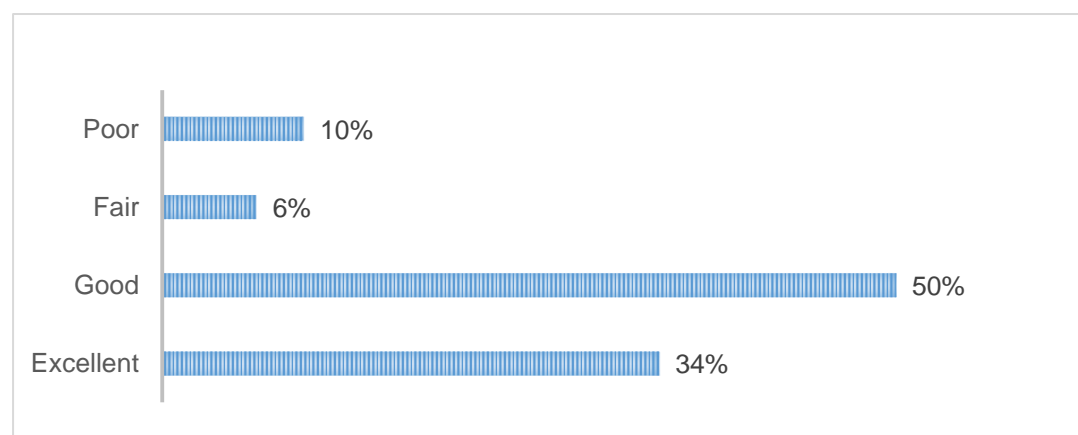
As shown in Figure 3.4, this distribution is complemented by the response of over 80% of the Islamic banks that consider their fiduciary responsibility to the UPSIA holders vis-à-vis the shareholders to be at least “good”.<sup>51</sup> This distribution is in response to the question: “How would you describe your Islamic bank’s conduct of its fiduciary duties towards the UPSIA holders compared to the shareholders who in addition to their statutory rights also have the right to appoint members of the Board of Directors?”

<sup>49</sup> The converse is also true in a particular jurisdiction that treats the UPSIA as an investment.

<sup>50</sup> Archer and Karim (2009), pp. 322–3, noted that the Islamic banks tend to favour the shareholders over the UPSIA holders in terms of quality of assets into which each type of fund is invested. The authors refer to this investment discrimination as “cherry picking”, while also noting the UPSIA holders’ lack of rights of control on the management. See also Alhammadi, Archer, Karim and Padgett (2017) for a detailed analysis of the arguably unfair treatment of UPSIA holders by a substantial proportion of Islamic banks.

<sup>51</sup> In fact, 34% of respondent Islamic banks consider that they rate as “excellent” in their fiduciary responsibility to UPSIA holders.

Figure 3.4 Islamic Banks' Perception of their Fulfilment of their Fiduciary Responsibility to UPSIA Holders vis-à-vis that to Shareholders



This position seems not to reflect the view in most extant empirical and conceptual literature, as already mentioned, that the UPSIA holders generally lack governance rights and that this weakens their position vis-à-vis the shareholders.<sup>52</sup> Perhaps the effect of the UPSIA holders not having governance rights may be considered to be mitigated in some ways. For instance, it may be argued that since the shareholders' funds and the UPSIA funds may be commingled and exposed to the same investment risks, the latter should enjoy some protection by leveraging on the former's governance rights to monitor investments, thus providing "vicarious monitoring".<sup>53</sup> However, this assumes that there is no significant difference in the investment preferences and risk appetites between the two groups of investors, whereas UPSIA holders are typically more risk averse than shareholders.<sup>54</sup>

In the assessment of whether the respondent Islamic banks and RSAs consider the effect of the "vicarious monitoring" important for the protection of the governance rights of UPSIA holders, conflicting views are noted between the two groups. A related question asked in the survey is: "Do you consider the presence of 'concentrated shareholders' – a large block of shareholders – as important and sufficient for the purpose of monitoring the management of your Islamic banks on behalf of the UPSIA holders?" As shown in Figure 3.5 over 80% of the respondent RSAs do not consider the presence of a concentrated or large block of shareholders as important or sufficient to monitor the activities of the Islamic banks on behalf of the UPSIA holders. Over 60% of the respondent Islamic banks, however, indicate otherwise, as shown in Figure 3.5. It may be that while the RSAs' view from an external and supervisory standpoint reflects their expected role to protect the interests of the PSIA holders, one may not expect the view of the Islamic banks to be particularly self-critical.<sup>55</sup>

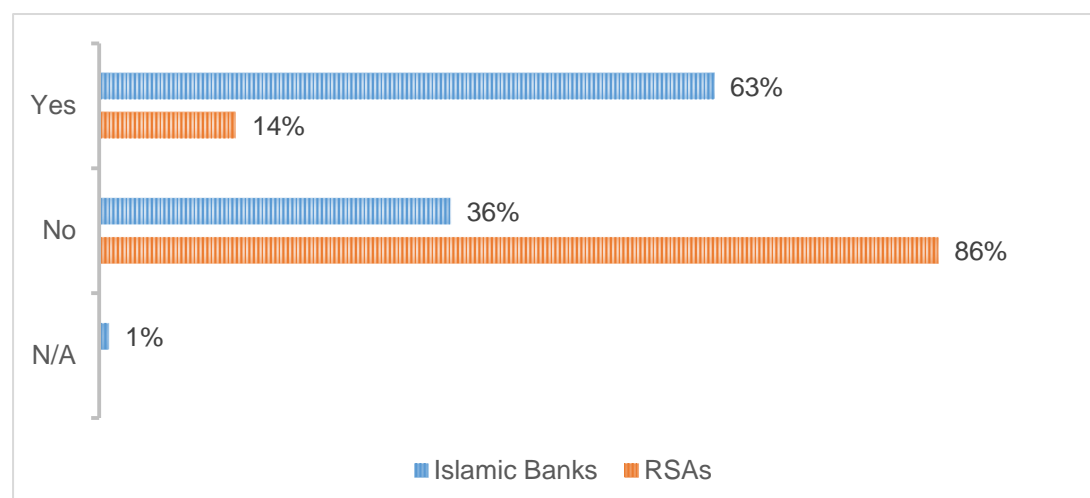
<sup>52</sup> See Archer and Karim (2009); Alhammadi, Archer, I Karim and Padgett (2017); Van Greuning and Iqbal (2008); Hamza (2015); Lopez-Mejia et al. (2014); Kammer et al. (2015), etc.

<sup>53</sup> Archer and Karim (2009), p. 320, referred to this monitoring role of the shareholders on behalf of the UPSIA as "vicarious monitoring". However, they questioned the efficacy of such vicarious monitoring, and stated that the right of UPSIA holders to "vote with their feet" by withdrawing their funds is likely to be more effective.

<sup>54</sup> Archer, Karim and Sundararajan (2010), p. 11.

<sup>55</sup> Customers are not included in the survey.

Figure 3.5 Islamic Banks and RSAs' Views on the Relevance of Shareholder "Vicarious Monitoring"



The IFSB, as part of its role to promote market discipline in the Islamic financial services industry, provides a number of recommendations in its IFSB-3.<sup>56</sup> One of such recommendations is the establishment of a governance committee as part of a financial institution that is responsible for safeguarding the interests of the UPSIA holders. In the survey, the Islamic banks were asked: "As per the recommendation in IFSB-3, does your Islamic bank have a governance committee that forms part of its institution and is responsible for safeguarding the interests of the UPSIA holders?"

Based on the responses from the Islamic banks shown in Figure 3.6, 73% indicate compliance with the governance committee recommendations of IFSB-3. However, the responses from the RSAs indicate otherwise, with less than half (43%) responding in the affirmative. Possible reasons could be that the Islamic banks are taking a looser view of compliance with IFSB-3 (i.e. compliance in substance), while the RSAs are taking a stricter view with particular reference to the governance committee.<sup>57</sup>

Without any intent of drawing inferences and without prejudice to the responses obtained from the Islamic banks that participated in the survey, the view of the RSAs may be considered as being compositely more reflective of the jurisdictional distributions. It is likely that while the UPSIA holders' governance rights are not necessarily protected by the presence of concentrated shareholders, internal governance mechanisms in the Islamic banks such as a governance committee also seem to be inadequate if not absent in many cases.<sup>58</sup>

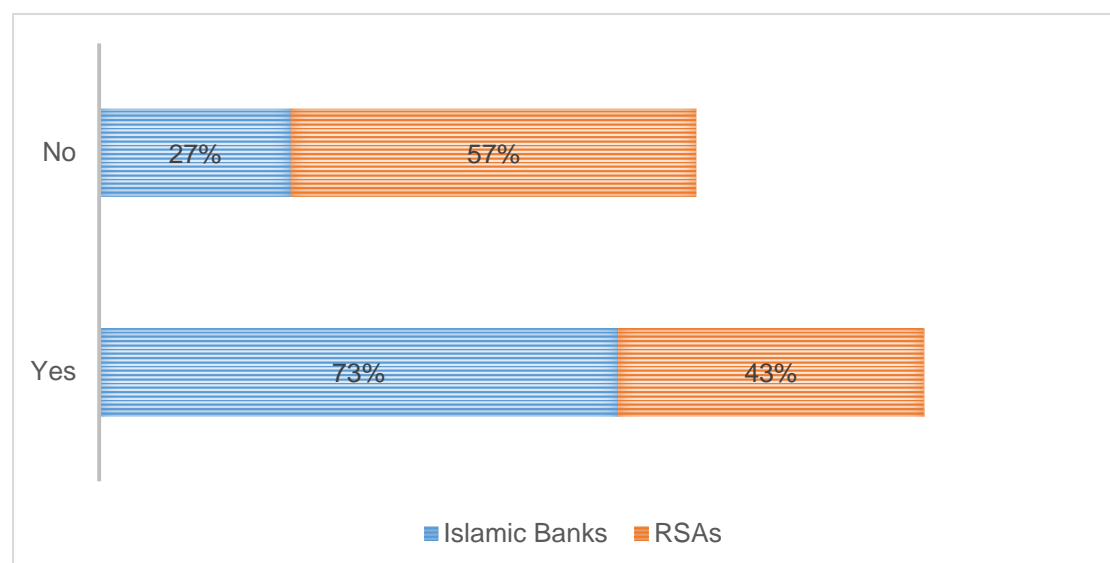
<sup>56</sup> *Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services [Excluding Islamic Insurance (Takâful) Institutions and Islamic Mutual Funds]*.

<sup>57</sup> In most jurisdictions, there are no independent governance committees set up to protect the interests of the investment account holders. In one jurisdiction, it was indicated that, in compliance with jurisdictional regulatory requirements, an investment oversight committee is set up at both the management and board levels. In another jurisdiction, Islamic banks are permitted to appoint independent board directors solely to cater for the interests of PSIA holders. In Bahrain, Islamic banks are urged further to have one of the Shar'ah supervisory board members on the corporate governance committee to protect the interests of PSIA holders.

<sup>58</sup> Most respondents also indicated that there are no external credit assessment institutions in their jurisdiction that serve as alternative means available to the PSIA holders to assess the performance of Islamic banks.



Figure 3.6 Islamic Banks and RSAs' Views on Compliance with IFSB-3 on Establishing a Governance Committee to Protect UPSIA Holders' Rights



In terms of availability and usage of deposit guarantee schemes to protect the UPSIA funds, the responses obtained are fairly consistent across the RSAs and Islamic banks. The practice seems prevalent in only a few jurisdictions, and Islamic banks do not generally view it as a factor that may encourage the use of risk-sharing financing contracts.

In the few jurisdictions where such Shari'ah-compliant deposit guarantee schemes exist, it is indicated that the coverage includes the UPSIA. This aligns with the findings reported in the IMF survey on Islamic banking regulation and supervision, wherein it is stated that in some jurisdictions where a single deposit protection scheme exists it covers all banks.<sup>59</sup> In some jurisdictions, there are separate deposit protection schemes specifically established for Islamic banks.<sup>60</sup> For instance, in Malaysia only Islamic deposits are covered by the Perbadanan Insurans Deposit Malaysia (PIDM), whereas no distinction is made between the coverage for deposit and investment accounts in, for instance, Turkey.

### 3.4 Disclosure, Transparency and Monitoring Practices

As per IFSB-4 and FAS 11 of AAOIFI,<sup>61</sup> a number of recommendations as analysed below are offered to improve transparency and enhance market discipline<sup>62</sup> through disclosure with the intent of enhancing customer protection.<sup>63</sup> Good disclosure practices have a number of economic benefits in addition to helping an Islamic bank avoid regulatory sanctions. They also help users of the disclosed information to make accurate and correct investment decisions based on an Islamic bank's actual financial position, business performance, risk profile and risk management practices. A respondent Islamic bank indicated that, as an essential feature of its investment

<sup>59</sup> For example, Bahrain, Indonesia, Kenya, Lebanon and Turkey.

<sup>60</sup> The IFSB and the IADI are presently working on an Islamic deposit insurance standard.

<sup>61</sup> In jurisdictions where there is no Shari'ah law in place, the IFRS and the national accounting standards are used instead.

<sup>62</sup> Zaheer (2013), p.19.

<sup>63</sup> Song and Oosthuizen (2014).

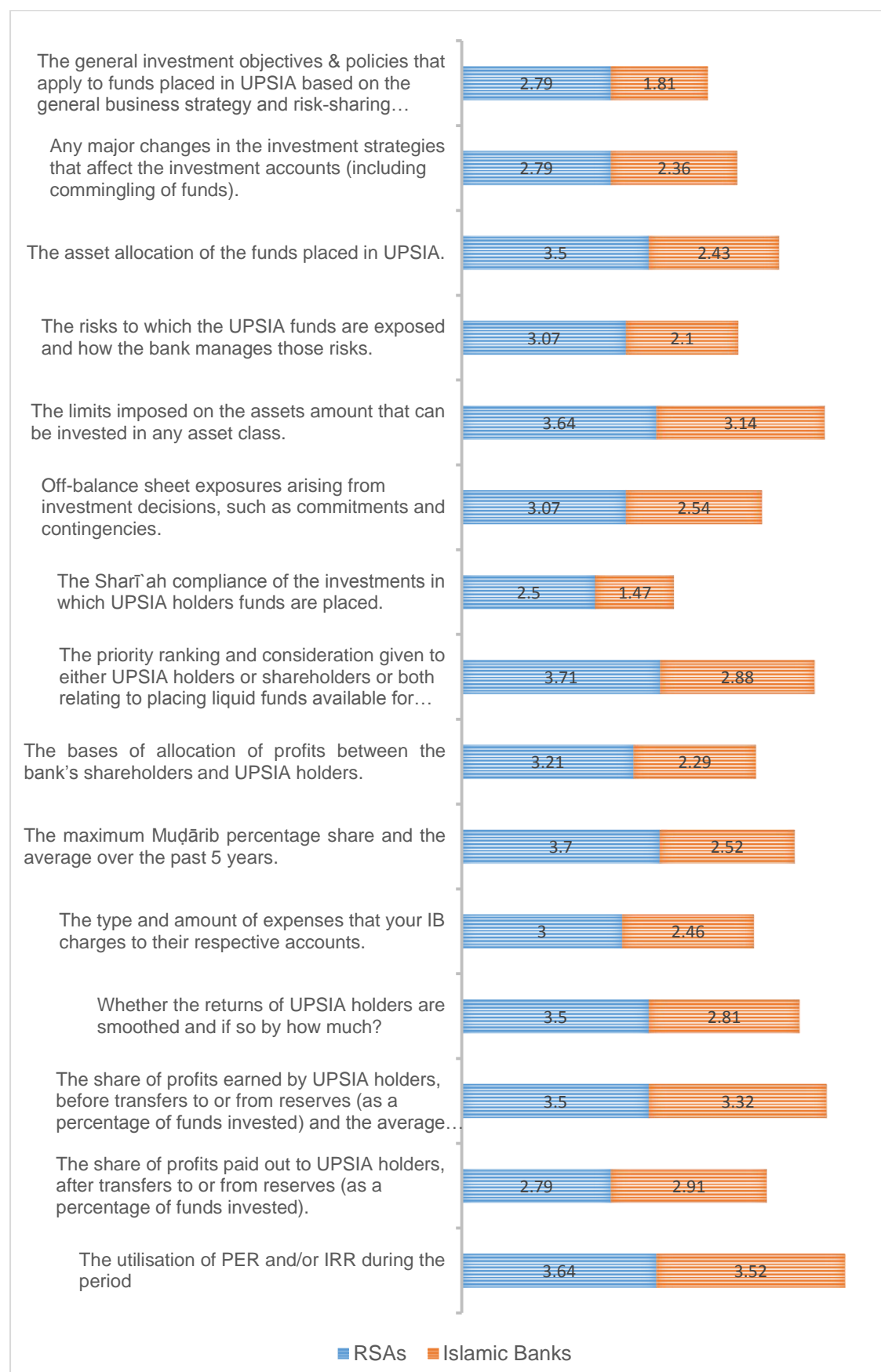
accounts product, it publishes a fund performance report every quarter. In fact, non-disclosure by an Islamic bank to UPSIA holders on its investment account activities is viewed as being at variance with the ethical business conduct that is considered an important tenet regarding economic transactions in Islam.<sup>64</sup>

In the survey, the Islamic banks were asked: “As per IFSB-4 and FAS 11 of AAOIFI, a number of recommendations (15 items) as indicated are offered to improve transparency and enhance market discipline. Kindly indicate the frequency of your Islamic bank’s compliance with these recommendations in its dealings with the UPSIA holders.” Responses were also elicited from the RSAs to indicate the frequency of compliance of Islamic banks in their jurisdiction with these 15 recommendations.

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<sup>64</sup> Alhammadi (2016).

**Figure 3.7 Islamic Banks and RSAs' Views on Islamic Banks' Compliance with IFSB-4 and FAS 11 of AAOIFI to Improve Transparency in their Jurisdiction**



Based on the responses obtained from the RSAs and the Islamic banks, the level of compliance with the 15 specified items in the questionnaire is above average in most instances, where the mean score obtained on a scale of 1 to 5 is greater than the median score of 3. However, scores indicated in Figure 3.7 for RSAs and Islamic banks are weighted to show the relative importance of each item.<sup>65</sup>

Specifically, from the point of view of the RSAs, the aspect that they consider the Islamic banks comply with most is the disclosure requirement relating to the utilisation of PER and/or IRR during the period. The disclosure for this item is also high from the Islamic banks' point of view. In particular, the Islamic banks also consider the bases of allocation of profits between the Islamic banks' shareholders and UPSIA holders, including the maximum *muḍārib* percentage share and the average over the past five years, to be very important as they always disclose it. Most of the other items have similar statistical distributions.

From the perspective of both the Islamic banks and the RSAs, the least disclosed item relates to the Shari'ah compliance of the investments in which UPSIA funds are placed. This may suggest that there is the need to have mechanisms at both the operational and regulatory levels to ensure that the existing Shari'ah governance framework works effectively. Studies have documented the effect of Shari'ah non-compliance to be potentially very serious, as it can trigger reputational risks which may result in loss of business and withdrawal of funds from the Islamic banks.<sup>66</sup> To underscore the importance of Shari'ah compliance, it is stated that in some jurisdictions an annual report with a set of financial statement may not be published if it does not contain an attestation by the Shari'ah board as to whether the Islamic bank's operations are Shari'ah-compliant.<sup>67</sup> Possibly for that reason, many Islamic banks may not consider it necessary to make a specific disclosure on Shari'ah compliance – their Shari'ah board does it for them.

A further probe into the responses obtained on an item-by-item basis, however, revealed that the composite distribution described above may not be revealing the complete story. For instance, as shown in Figure 3.7, the disclosure on the utilisation of PER and IRR during the period had the next-to-highest weighted mean score (3.64), suggesting that the related information is frequently disclosed. However, Figure 3.8 indicates that half of the Islamic banking respondents never do so. In fact, only 26% always disclose and another 5% often do so.<sup>68</sup>

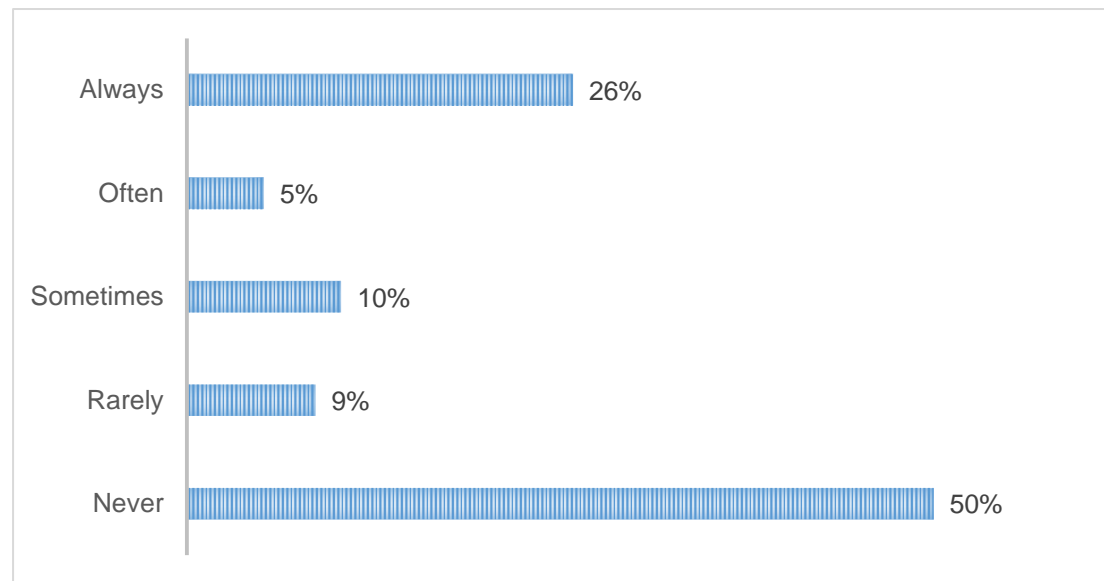
<sup>65</sup> The data from the questionnaire in relation to this section were generated on a scale of 1 to 5. In isolation and at varying percentages, responses to all the 15 items were indicated as either "Always" or "Often", except in a few instances when the "Sometimes" option was indicated. Explaining each item would require many tables to indicate what percentage is "Always = 5", "Often = 4", "Sometimes = 3", "Rarely = 2", or "Never = 1". However, the interpretation reflected in Figure 3.7 is based on weighted scores. The figures are absolute and are interpreted based on their degree. Each item is given an equal weight of 1, then multiplied by responses obtained from each RSA and Islamic bank respondent. The graph shows a weighted score based on total respondent scores for each question. In this case, an item with 1.02, albeit marginal, is considered more important than an item with 1.00, though both items are considered important in isolation.

<sup>66</sup> IMF, CPIFR 2018. Al-Sadah (2007), however, found no effect of Shari'ah non-compliance, suggesting that such effect may depend on how serious it is in a specific Islamic bank.

<sup>67</sup> Examples are Malaysia, Kuwait, Lebanon, Pakistan, Kuwait, Qatar and Sudan. See Song and Oosthuizen (2014), p 33.

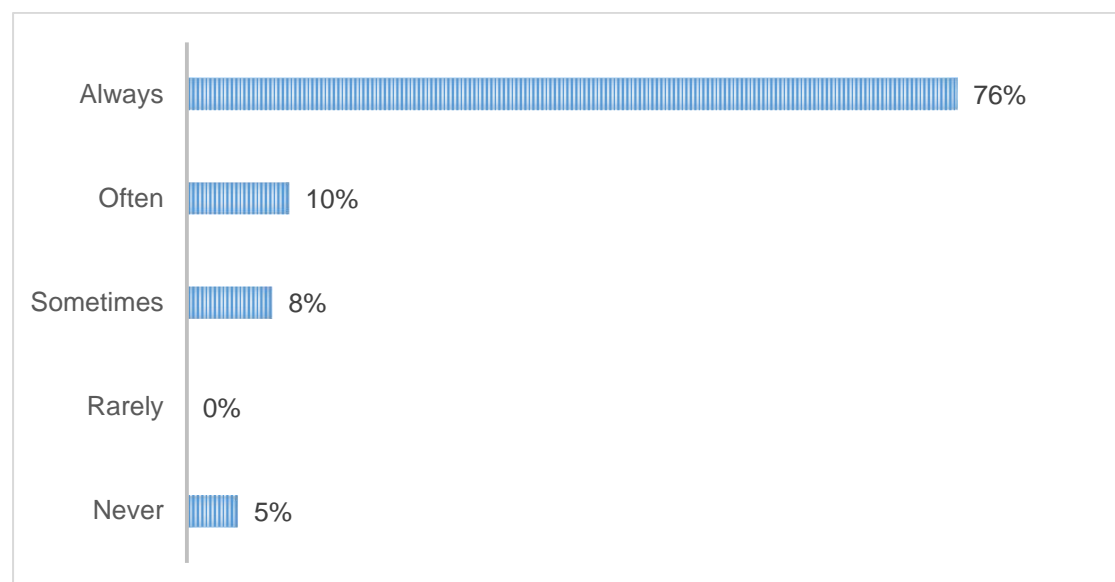
<sup>68</sup> In both Figures 3.8 and 3.9, given that the analysis is on an item-by-item basis, a scale of 1–5 is used to generate the percentage of frequency scores that reflect the proportion of respondents that selected a particular option against each item in the survey. In this case, the coding used is: "Always = 5", "Often = 4", "Sometimes = 3", "Rarely = 2", and "Never = 1".

Figure 3.8 Frequency of Islamic Banks' Disclosure of Utilisation of PER and IRR during the Period



A similar probe was made for the disclosure on the Sharī'ah compliance of the investments in which UPSIA funds are placed. Notwithstanding this item having relatively low weighted mean scores (2.5 and 1.47) from the Islamic banks and the RSAs, respectively (see Figure 3.7), a further probe into its isolated analysis indicated otherwise, as shown in Figure 3.9. At least 76% of the respondents state that they always fulfil the Sharī'ah compliance disclosure requirements as per the IFSB-4 and FAS 11 of AAOIFI.

Figure 3.9 Frequency of Disclosure of Sharī'ah Compliance of Investments in which UPSIA Funds are Placed.



The result indicates that 76% and 10% of the responding Islamic banks surveyed always or often, respectively, disclose the Sharī'ah compliance of investments in which UPSIA funds are placed. However, when considered in aggregate with other aspects

recommended in IFSB-4, the performance of the specific disclosure of Shari‘ah compliance may not reflect the relative importance attached to it.<sup>69</sup>

### 3.5 “Smoothing” Practices in Islamic Banking

This section relates to the “smoothing” practices among Islamic banks. In jurisdictions where such practices are allowed,<sup>70</sup> there are essentially two ways in which “smoothing” is conducted: profit equalisation reserves (PER) and investment risk reserves (IRR).<sup>71</sup> It is stated that while the practice of PER serves as a buffer against possible future low income distribution to UPSIA holders and consequent withdrawal risk, it also creates a number of issues.<sup>72</sup> Limited disclosure of related information about such reserves not only causes unease to investors, but may also not align with the preference of some investors who prefer an immediate distribution of income to its retention to cover possible future poor results or losses. In addition, the lack of governance rights removes any influence the UPSIA holders might have in determining how such funds are used.<sup>73</sup>

A related question asked in the survey states: “Kindly indicate the likelihood of the use of the following smoothing techniques by your Islamic bank in its dealings with the UPSIA holders.” Figure 3.10 provides the distribution of the responses obtained. The scores shown are the weighted mean<sup>74</sup> scores computed based on the frequency of usage of the various smoothing techniques on a scale of 1 to 5 where “1” represents “never” and “5” represents “always”.

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<sup>69</sup> Perhaps an importance–performance matrix analysis on a jurisdictional basis could give richer insights.

<sup>70</sup> Most jurisdictions in the survey allow for “smoothing” of returns practices. An exception in this regard is Malaysia, where such a practice has been discontinued since the introduction of investment account guidelines in 2015.

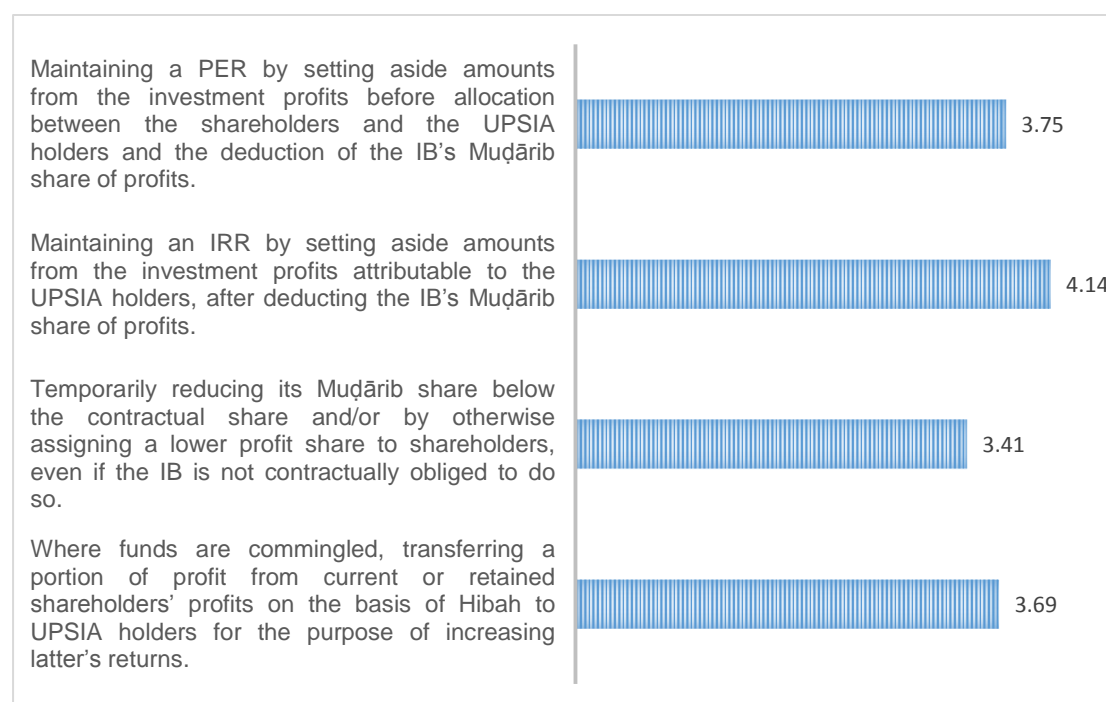
<sup>71</sup> PER comprises amounts appropriated out of the gross income from the *muḍārabah* to be available for smoothing returns paid to the IAH and the shareholders, and consists of a PSIA portion and a shareholders’ portion. See IFSB-15: *Revised Capital Adequacy Standard for Institutions offering Islamic Financial Services [Excluding Islamic Insurance (Takāful) Institutions and Islamic Collective Investment Schemes]*. IRR comprises amounts appropriated out of the income of IAH, after deduction of the *muḍārib* share of income, to meet any future losses on the investments financed by the PSIA. See IFSB-15 (2015).

<sup>72</sup> In fact, according to responses to a question in this survey, 86% of the respondents indicated that “it is not possible for UPSIA holders in Islamic banks who withdraw their funds from their investment account, to get back their contribution to buffers (PER and IRR) used to smooth returns and protect capital”. See Kammer et al. (2015), p. 21.

<sup>73</sup> Van Greuning and Iqbal (2008), p.193–6.

<sup>74</sup> See footnote 66.

Figure 3.10 Frequency of Usage of Smoothing Mechanisms in Islamic Banking



Based on the four different possible uses of the techniques indicated in the survey, the option with the highest weighted mean score of 4.14 is that relating to maintaining an IRR by setting aside amounts from the investment profits attributable to the UPSIA holders, after deducting the Islamic bank's *muḍārib* share of profits. This is followed by the option with a mean score of 3.75 and which relates to maintaining a PER by setting aside amounts from the investment profits before allocation between the shareholders and the UPSIA holders and the deduction of the Islamic bank's *muḍārib* share of profits. This distribution is expected given that these are the two approaches mentioned by the IFSB's GN-3.<sup>75</sup>

The other two options in the survey are less common in practice and have been found only in the literature as possible smoothing mechanisms used in a few jurisdictions. With a mean score of 3.69 is the option relating to instances where funds are commingled – namely, transferring a portion of profit from current or retained shareholders' profits to UPSIA holders for the purpose of increasing the latter's profit pay-outs. The least-used option (which nevertheless had a score of 3.41) is that in which an Islamic bank engages in a temporary reduction in its *muḍārib* share below the contractual share (which tends, in practice, to be set at a maximum level) and/or by otherwise assigning a lower profit share to shareholders, even if the Islamic bank is not contractually obliged to do so.<sup>76</sup> With the exception of the IRR, the use of these various “smoothing” mechanisms leads to varying degrees of displaced commercial risk – that is, the displacement of the effects of poor financial results from the UPSIA holders to the shareholders. The use of PER, however, may be viewed as a means of

<sup>75</sup> Guidance Note on the Practice of Smoothing the Profits Pay-out to Investment Account Holders.

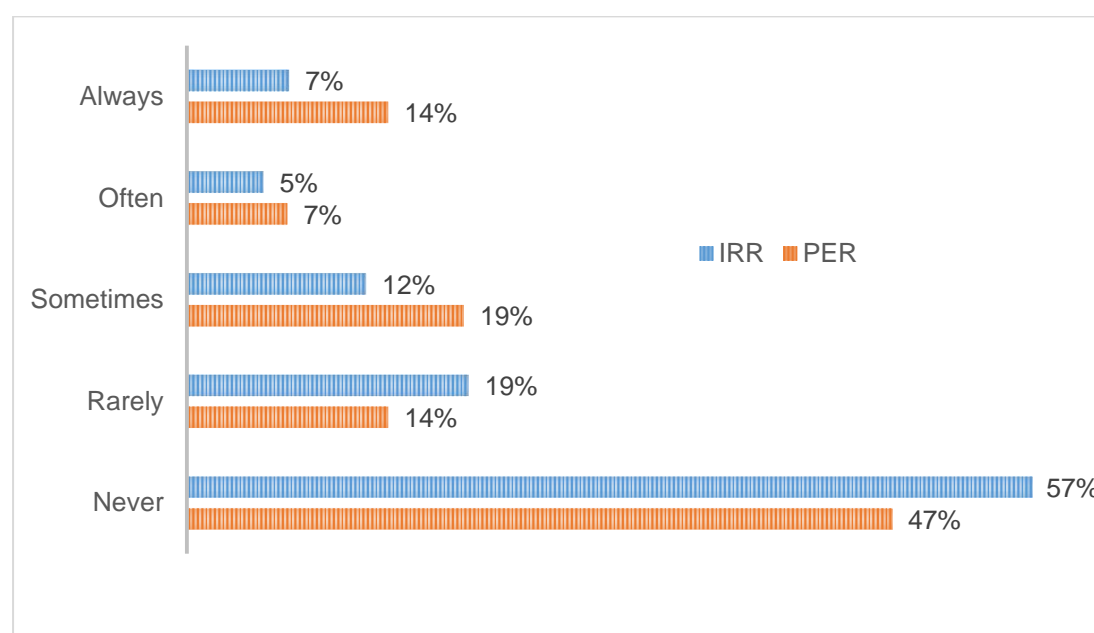
<sup>76</sup> See Archer and Karim (2009), p. 2.

reducing DCR by allowing the avoidance of reducing the *muḍārib* share or transferring a share of profit from shareholders to UPSIA holders via *hibah*.

The highest weighted mean score of 4.14, as shown in Figure 3.10, thus indicates that where smoothing practices are carried out, it is most likely to be IRR or, often, PER. The other two options are used less frequently.

A further breakdown of the analysis on an option-by-option basis reveals that, notwithstanding its high mean score, almost 60% of the respondents indicated they never used the IRR as a smoothing mechanism, while 19% rarely used it, and 12% sometimes used it. Only 12% of the respondent Islamic banks frequently used the IRR. This could imply that the high weighted mean score obtained relative to other mechanisms does not mean that the use of the IRR is widespread after all. It is worth noting, however, that an IRR would actually be used only if it were needed to “smooth” (i.e. cover) losses incurred on investments funded by UPSIA. Moreover, the use of IRR in practice (based on Figure 3.11) seems likely to be quite less concentrated in particular jurisdictions, given that most respondents indicated they never used it. A similar trend is also observed for the PER, as shown in Figure 3.11, except that the frequency of usage is relatively high compared to IRR. Perhaps the Islamic banks understand that even though the profit-sharing and loss-bearing nature of the UPSIA may be clear to the holders, offering them lower returns compared to benchmark rates may trigger withdrawal risks.

Figure 3.11 Frequency of Usage of Both PER and IRR as a Smoothing Technique by Islamic Banks





## SECTION 4: ASSET-SIDE ISSUES

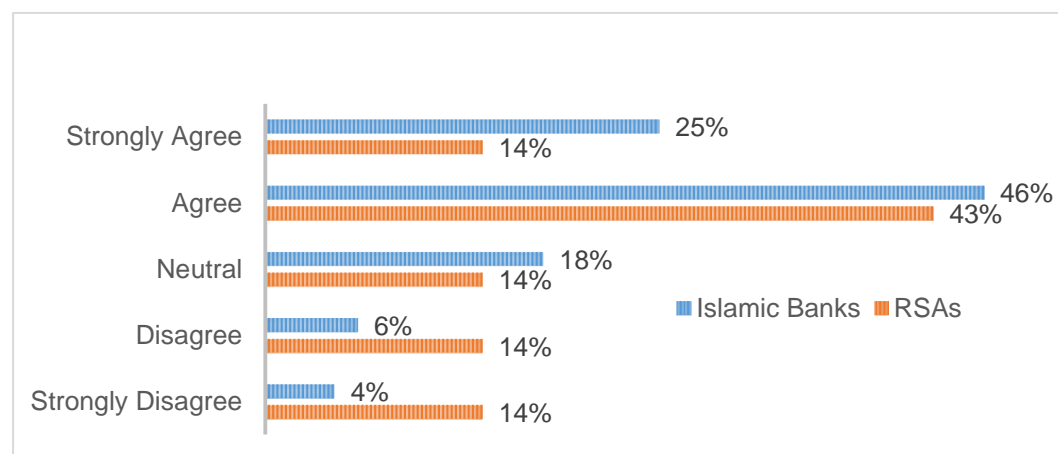
### 4.1 Introduction

Based on the literature review and an assessment of the commonality of the various items under the headings where they appear, an assessment is presented of the various reasons why there is a very limited use of risk sharing – that is, profit-sharing and loss-bearing (*muḍārabah*) or profit- and loss-sharing (*mushārah*) financing contracts in Islamic banking. The various reasons have been grouped under six headings: regulatory issues, rate of return risk, liquidity risk management, agency costs and monitoring, operating structure, and customers' preferences regarding modes of financing.

### 4.2 Regulatory Issues

The need for consistency in the application of IFSB-15 across jurisdictions has been highlighted, especially in relation to the loss absorbency of the UPSIA and the treatment of PER and IRR in regulatory capital and the risk weighting of assets.<sup>77</sup> This is because one of the reasons cited in the literature as limiting the use of the risk-sharing modes of financing is the high risk weights. The perceptions of the Islamic banks and the RSAs seem to be aligned in this regard, as far as the effect of regulatory requirements on the willingness of the Islamic banks to offer risk-sharing financing contracts is concerned. Figure 4.1 indicates that more than half of the respondents agreed with the statement that a regulatory capital requirement of high risk weights on the assets (RWA) of risk-sharing financing modes impedes the placing of funds in such assets by Islamic banks.<sup>78</sup> Seventy-one per cent of the RSAs generally agree, out of which 25% indicate strong agreement with this statement. Only about 10% have some degree of disagreement with this view.

Figure 4.1 Effect of a Regulatory Requirement of High Asset Risk Weights on Restricting the Use of Risk-Sharing Financing Modes by Islamic Banks



<sup>77</sup> IMF Country Report 17/145, p. 11. In the jurisdictions that have complied with the Capital Adequacy Standard (IFSB-15), both the PER and IRR are not allowed in the calculation of alpha. An exception is Indonesia, where the IFSB-15 is not followed in this regard. In this case, the UPSIA are not loss-absorbing and the risk-weighted assets depend on the rating of the end-user of the financing, or a 100% risk weight if the end-user is unrated. This practice results in a lower risk weight compared to the IFSB recommendation.

<sup>78</sup> See Askari et al. (2012); El-Tiby (2011); Ioannis and Kumar (2008); and Van Greuning and Iqbal (2008).

The distribution of the responses obtained from the Islamic banks generally shows a similar trend with slight differences. For instance, about 57% of the respondent Islamic banks generally agreed with the statement on the effect of high asset risk weights as a regulatory challenge impeding the use of risk-sharing modes of financing by Islamic banks. Specifically, 14% of the respondent Islamic banks indicate strong agreement, while about 28% disagree. It is worth noting that while diminishing *mushārah* as a form of home purchase financing product falls into the “risk-sharing” category, it is not significantly more risky for the Islamic bank than alternative home purchase financing products. In fact, in terms of the bank’s exposure to rate-of-return risk, it is less risky than most alternatives.

The responses obtained seem to provide a good reflection of the view that Islamic banks appear to be well-capitalised, especially in view of the high level of the component of common equity in their Tier 1 capital composition.<sup>79</sup> The use of risk-sharing financing based on structures like *muḍārah* or *mushārah* (excluding diminishing *mushārah* for home purchase finance) is considered to be highly risky from a regulatory perspective, which requires that more capital be provided by Islamic banks against the risk exposures than is required for exchange-based financing. This implies that Islamic banks offering risk-sharing financing would need to hold additional capital to meet their capital adequacy requirement as per Basel III. One possible way of raising additional capital to meet such a requirement could be the issuance of *sūkuk*.<sup>80</sup>

Furthermore, capital requirements for Islamic banks differ from those of the conventional banks, depending on factors such as availability of collateral and the structure of a financing facility. Thus, financing based on *muḍārah* or *mushārah* structures may attract a capital requirement of up to 400% – in sharp contrast to a requirement as low as 50% for some home financing structures secured by property. The cost of profit-sharing financing to an Islamic bank, therefore, is two-pronged: first, the high capital charge on account of the high risk weights, which may dilute the return on equity or require the issuance of *sūkuk* to provide additional capital; and second, the “opportunity cost”, since the funds raised cannot be deployed to some other potential profit-earning ventures while being held as capital.<sup>81</sup>

Increased regulation may not necessarily be viewed as absolutely impeding the risk-sharing engagements of the Islamic banks. In fact, based on a theoretical model developed within a profit maximisation framework, increased capital requirements under Basel III and IFSB-15 make Islamic banking appear better capitalised, while from the bank’s point of view UPSIAs are preferable to interest-based deposits in a dual banking system due to the former’s loss-absorbency feature.<sup>82</sup> Furthermore, in some countries where exposures to losses on assets funded by PSIAs are not considered in the computation of the capital adequacy ratio, there has been a consequential need for banks to hold lower reserves.<sup>83</sup> In a particular jurisdiction, for example, an investment account platform is established. This platform is envisaged to enhance the flexibility

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<sup>79</sup> Kammer et al. (2015), p. 22.

<sup>80</sup> Dr. Daud Bakar’s blogpost: <https://www.facebook.com/ShariahMinds/posts/why-profit-and-loss-sharing-does-not-fit-modern-islamic-bankshope-this-is-useful/1903179866630896/>.

<sup>81</sup> Ibid.

<sup>82</sup> Spinassou and Wardhana (2018), p. 15.

<sup>83</sup> Kammer et al. (2015), p. 22.

and remove the restriction due to the size of an Islamic banks' balance sheet in terms of undertaking of risk-sharing contracts. In addition, the assets funded by the investment accounts carry a zero capital charge, given that both credit and market risk-weighted assets funded by it are not included in the computation of the capital adequacy ratio.<sup>84</sup> However, the issue of the Islamic banks' fiduciary duty to their UPSIA holders, as discussed below, needs to be borne in mind.

### 4.3 Rate-of-Return Risk and Fiduciary Duty to UPSIA Holders

The risky nature of profit-sharing equity-based assets, particularly the exposure to loss of the principal, is problematic in terms of Islamic banks' fiduciary duty to their UPSIA holders. The latter expect a modest but secure rate of return, which is not at all what one can expect from profit-sharing assets. Not merely do the latter offer risky returns, but the recipient of the financing has no contractual obligation to maintain the principal amount invested intact. While an Islamic bank also has no such obligation towards its UPSIA holders, it does have an obligation to manage their funds prudently. As already noted, UPSIA holders are typically risk-averse retail depositors seeking safe, modest Shari'ah-compliant returns, not high-net-worth investors seeking high returns with a risk appetite to match. Investing UPSIA funds in risk-sharing assets would be likely to expose an Islamic bank not merely to fiduciary risk, but also to a form of rate-of-return risk (a discrepancy between the rate of return expected by UPSIA holders and the rate of return that the bank is able to pay them), and hence also to DCR and withdrawal risk as discussed further below.

Theoretically, exposure to rate-of-return risk may be considered to have more impact on the liability side of the Islamic banks' balance sheets. For instance, UPSIAs may result in more exposure to rate-of-return risk than, say, 90-day deposits based on commodity *murābahah* transactions (CMTs). On the asset side, it is nevertheless likely that the Islamic banks' exposure to DCR<sup>85</sup> may dis-incentivise them from engaging in risk-sharing financing activities. Rather, they are incentivised to invest UPSIA funds in assets which have predictable yields and no exposure of capital to losses (except in insolvency), such as *murābahah* and *ijārah* financing or *ijārah*-based *ṣukūk*.<sup>86</sup>

Islamic banks that provide financing on a risk-sharing basis are thus exposed to both profit rate risk and equity risk, which may explain their declining patronage of assets based on the *muḍārabah* structure. Profit rate risk arises from the capital-uncertainty attributes of a *muḍārabah* contract, which may have an implication for the return on assets funded by UPSIA funds.<sup>87</sup> Such a risk exposure is also possible, albeit to a lesser extent, in the case of a *mushārahah mutanāqishah* financing contract, in which case its fixed payment plan may create exposure to an Islamic bank with reference to the contracting price vis-à-vis the changes in property prices and in the level of property rents. Equity risks,<sup>88</sup> on the other hand, may increase the exposure of an Islamic bank if it engages in participating financing such as the stock market or private equity.<sup>89</sup>

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<sup>84</sup> CIBAFI (2016), p. 106.

<sup>85</sup> See Sundararajan (2011), pp. 8–10, for an explanation of DCR.

<sup>86</sup> Farook and Farooq (2011), p. 11.

<sup>87</sup> According to Song and Oosthuizen (2014), p. 27, the UPSIA holders may very much expect a modest return, whereas the actual return on a profit-sharing asset can only be determined at the end of the investment period.

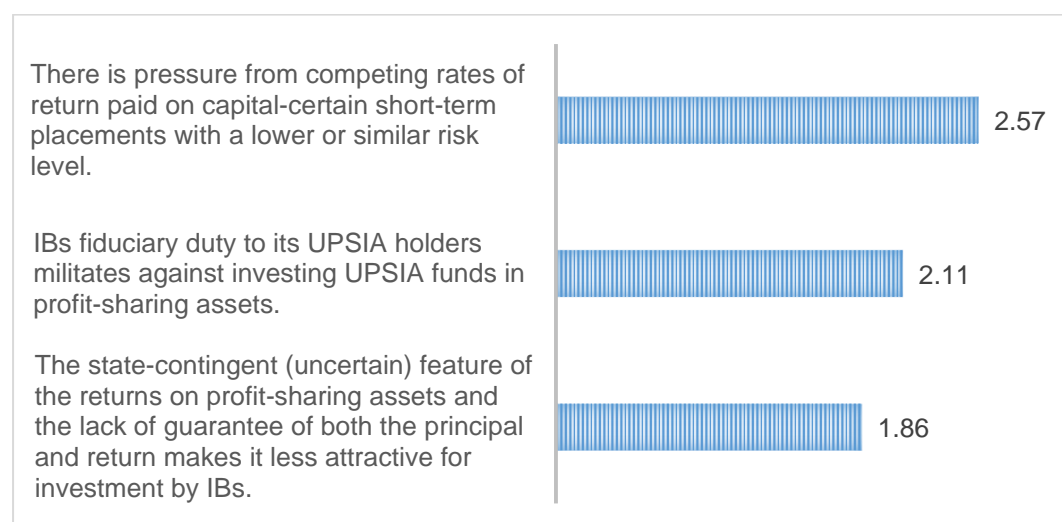
<sup>88</sup> Financial risks incurred by the Islamic banks through holding an equity stake in another investment.

<sup>89</sup> Van Greuning and Iqbal (2008), p.160.

In the survey questionnaire for this paper, three items relate to how issues regarding rates-of-return risk may explain the low usage of risk-sharing financing modes by Islamic banks. The first item sought to determine if the state-contingent (uncertain) feature of the return on risk-sharing assets and the lack of guarantee of both the principal and return make them less attractive for investment by Islamic banks. Another item relates to how Islamic banks' fiduciary duty to their UPSIA holders impedes their investing UPSIA funds in risk-sharing assets. The third question investigates whether there is pressure from competing rates of return paid on capital-certain short-term placements with a lower risk level.

Based on a mean score of between 1 and 3, Figure 4.2, showing the Islamic banks' responses, indicates that they are faced with the pressure to offer a competitive rate of return. In principle, to be competitive, returns on risk-sharing assets are expected to exceed those on less risky investments. This is reflected in the highest weighted mean score of 2.57. Based on the degree of the mean score, the next ranking item with a weighted mean score of 2.11 is the consideration for the fiduciary duty of Islamic banks to the UPSIA holders, followed by an item relating to the state-contingent nature of the return on invested funds with a weighted mean score of 1.86 in that order.

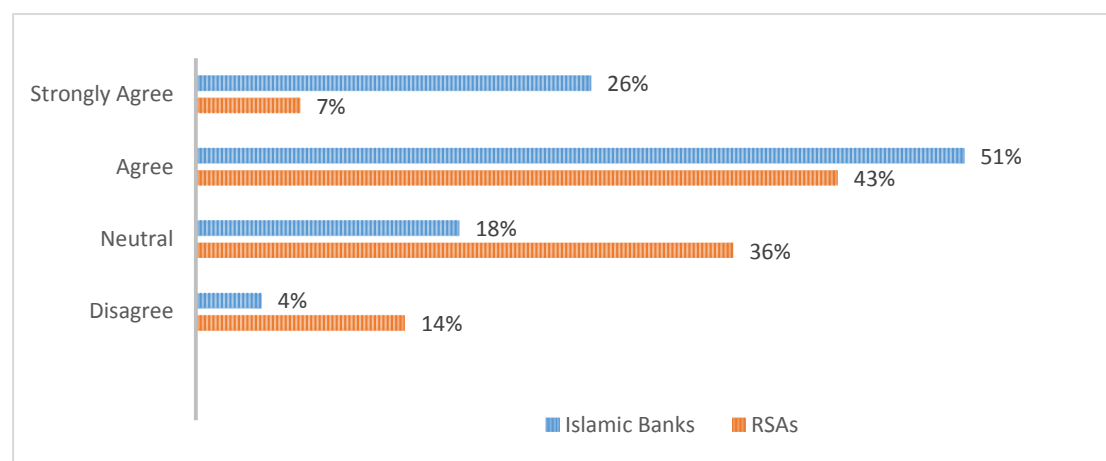
Figure 4.2 Rates of Return and Usage of a Risk-Sharing Financing Mode



A further breakdown of the analysis indicates that 77% of the Islamic banks and 50% of the RSAs either strongly agree or agree with the view that the tendency to use risk-sharing modes of financing is reduced by the need to offer a competitive return, taking the level of risk into account. It may be that the Islamic banks consider it a fiduciary duty not to increase unnecessarily the exposure of their UPSIA holders' funds to risk-sharing assets. There is a possibility of a high risk profile mismatch, as the UPSIA holders as fund providers typically have a low risk appetite. This is notwithstanding the fact that the Islamic banks would also like to offer a competitive, but not necessarily state-contingent, rate of return<sup>90</sup> (see Figure 4.3).

<sup>90</sup> About half of the respondent RSAs agree with this view, compared to about 65% of the Islamic banks.

Figure 4.3 Rate-of-Return Risk has the Effect of Reducing the Use of Risk-Sharing Assets for Financing



It is not Sharī'ah compliant for a *muḍārib* to absorb an overall loss incurred on the *rabb al-māl's* investment. A loss may be absorbed by PER only to the extent that it is the reason for a very low or overall profit (but not an overall loss) which is increased by a transfer from the PER to which the *muḍārib* contributes, or by reduction of the *muḍārib* share or by *hibah*. Overall losses may be covered by use of an IRR to which the *muḍārib* does not contribute.

Without going into detail, it is apparent that Islamic banks do not always (or even only as a last resort) take recourse to the contractual right to pass on investment losses to the UPSIA holders. Instead, competition generally forces the Islamic banks to absorb at least part of such losses themselves, or at least use an IRR to do so. They may also feel the need to “smooth” away poor results by transferring variability of profits from UPSIA holders to shareholders. This has been characterised as “displaced commercial risk” by the IFSB. If Islamic banks take on DCR, a capital buffer for this risk is needed,<sup>91</sup> and the assets financed by investment account funds cannot in that case be totally excluded from the calculation of the total risk-weighted assets which determines the required regulatory capital. The magnitude of this capital buffer depends on the extent of DCR, which may be captured by a parameter called “alpha” proposed by the IFSB.

The IFSB has proposed a formula for the calculation of the regulatory capital adequacy requirement – that is, the capital adequacy ratio (CAR), in which a parameter “ $\alpha$ ” (alpha) reflects an Islamic bank's level of exposure to DCR given its use of the profit-smoothing and loss-absorbing practices of Islamic banks. If investment losses are passed through unbuffered,  $\alpha$  is equal to 0.<sup>92</sup> If profit smoothing and loss avoidance are at a maximum,  $\alpha$  is equal to 1. Ideally, the regulatory authorities should set an “ $\alpha$ ” (identical for all Islamic banks) that reasonably reflects the average practices in their respective jurisdictions.<sup>93</sup> However, it is very difficult to calculate an alpha that is deemed reasonable for all banks (which may have different investment strategies and histories, as well as different approaches regarding loss avoidance). Any  $\alpha < 1$  means

<sup>91</sup> IMF, CPIFR (2018).

<sup>92</sup> This is the current practice in Malaysia since the introduction of the Investment Account Guide in 2015.

<sup>93</sup> Various values of alpha are used in different jurisdictions of the IFSB. For instance, it is 0.3 in Bahrain, 0.35 in Kazakhstan, 0.5 in Kuwait and 0.7 in Turkey.

that the bank in question does not have to provide a full capital charge in respect of assets financed by UPSIA funds. To that extent, UPSIAs are more advantageous than the alternative of CMT-based deposits, which require a full capital charge in respect of the assets that they finance. The higher  $\alpha$  is set, the lower is this advantage.<sup>94</sup>

#### 4.4 Liquidity Risk Management

The rationale for liquidity management is grounded in the various macroeconomic and macroprudential policies aimed at ensuring financial stability and soundness.<sup>95</sup> Islamic banks have been identified as facing some particular challenges as regards liquidity risk management, owing largely to the fact that compared to conventional banks there are relatively few Sharī'ah-compliant liquidity risk management options available to Islamic banks.<sup>96</sup>

In this survey, the implications of liquidity risk management for the limited engagement of Islamic banks in risk-sharing financing structures such as *muḍārabah* and *mushārakah* are assessed based on three related postulations. The first of these postulates that, compared to conventional banks, Islamic banks have limited long-term liabilities, since a large portion of their deposits (including UPSIAs) have short maturities, which inhibits their ability to finance long-term risk-sharing investments. This is likely to be particularly the case if an increase in the benchmark return is anticipated, as UPSIA holders will expect to be remunerated at the increased rate but the Islamic banks typically cannot expect a correspondingly increased rate from the long-term risk-sharing investments, the returns on which are state-contingent and not based on the benchmark rate.<sup>97</sup> While only 10% and 7%, respectively, among the responding Islamic banks and RSAs generally disagreed with this statement, 69% and 72%, respectively, generally agreed. These distributions for both the Islamic banks and the RSAs are shown in Figure 4.4.

This finding reflects concerns in the literature that Islamic banks, in a bid to avoid balance sheet mismatch exposure, would prefer shorter-term Sharī'ah-compliant financing such as commodity *murābahah*-based term credits with tenors reflecting the short-term nature of UPSIAs, which typically can be withdrawn at short notice but, at least in the case of retail UPSIAs, are normally fairly stable.<sup>98</sup> In addition, the small size of the existing liquid market for Sharī'ah-compliant high-quality liquid assets (HQLA), as well as the lack of Islamic deposit insurance schemes in many jurisdictions to protect Islamic banks against unexpected liquidity shortfalls, may likely explain why Islamic banks hold large amounts of cash to comply with regulatory requirements such as the liquidity coverage ratio of Basel III.

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<sup>94</sup> See Sundararajan (2011), pp. 10–13.

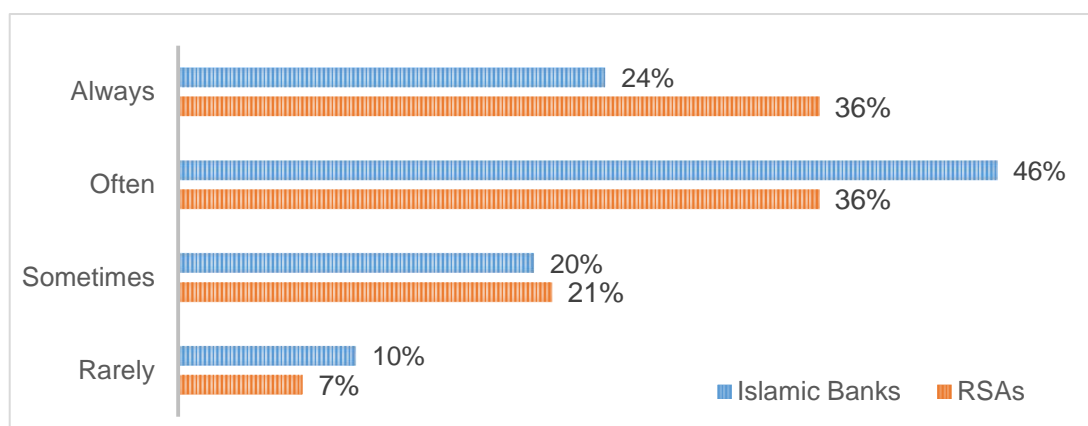
<sup>95</sup> IFSB, *Stability Report 2018*.

<sup>96</sup> Mohd Ariffin and Kassim (2014), p. 34.

<sup>97</sup> Interestingly, one of the respondent Islamic banks indicated that there were instances where its UPSIA holders roll over their short-term funds without a break and over a long time, due to attractive returns generated on their funds relative to conventional deposits. However, retail UPSIA may also be expected to offer stability of funding similar to that of conventional retail deposits.

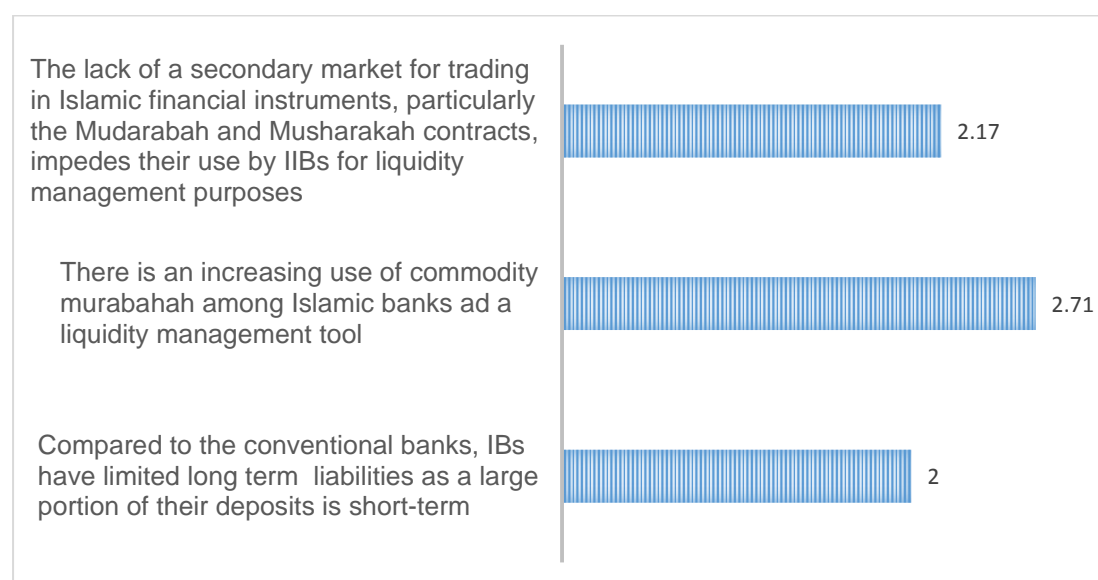
<sup>98</sup> Kammer et al. (2015), p. 22. See also the IFSB PSIFs key exhibits and the stability rating of retail UPSIAs in IFSB's GN-3.

Figure 4.4 Short-term Nature of UPSIA Funding Does Not Suit the Long-term Nature of Risk-Sharing Financing



The implications of the above distributions are somewhat reflected in the responses to the next question in the survey relating to liquidity risk management tools used by Islamic banks. There is an increasing use of commodity *murābahah* among Islamic banks as a short-term financing tool rather than as a liquidity risk management tool.<sup>99</sup> As shown in Figure 4.5, among the three items indicated, responses obtained from the Islamic banks show that the use of commodity *murābahah* as a short-term financing instrument recorded the highest weighted mean score of 2.71. This may imply that, from a financing point of view, the Islamic banks' preference for using commodity *murābahah* to manage their liquidity risk is a reflection of the short-term nature of the funds mobilised through UPSIAs.

Figure 4.5 Liquidity Risk Management Tools Used by Islamic Banks

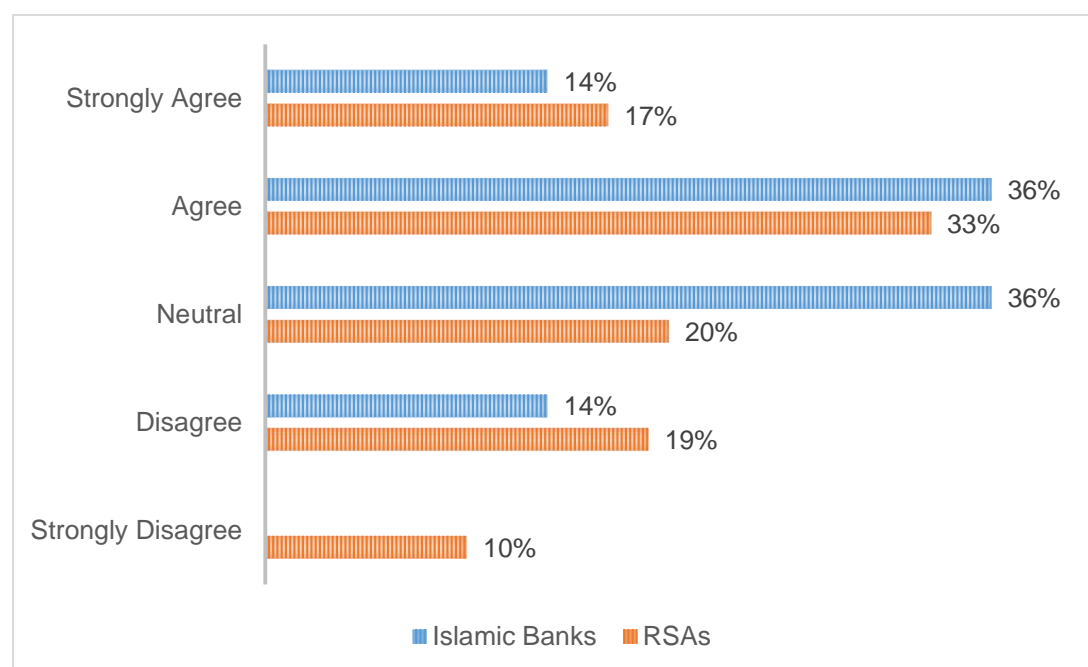


A further probe is made into the distribution of responses to obtain the view of the Islamic banks and RSAs on the use of commodity *murābahah* as a short-term financing instrument. Results indicate that 50% of both the RSAs and the Islamic banks generally

<sup>99</sup>As a liquidity risk management tool, CMT-based *Murābahah* may be used on the funding (liability) side and/or on the asset side to place short-term funds. See IFSB's GN-2.

agreed with the proposition that commodity *murābahah* transactions are indeed gaining traction as a short-term financing alternative rather than just being a liquidity risk management tool, as shown in Figure 4.6. Possible reasons could be that, in recent times, some RSAs, as part of their liquidity risk management framework for Islamic banking, have created standing facilities based on *tawarruq*. In some countries, there are efforts to develop collateralised *murābahah* instruments for interbank financing and lending activities.<sup>100</sup>

Figure 4.6 Islamic Banks and RSAs' Views on Use of Commodity *Murābahah* Transactions for Short-term Financing



The last item under the liquidity risk management issue concerning the limited use of risk-sharing instruments relates to how the lack of a secondary market for trading in Islamic financial instruments, specifically the *muḍārabah* and *mushārah* contracts, impedes their use by Islamic banks for liquidity management purposes. Based on the responses obtained, 80% of the RSAs agreed with this proposition, while 50% of the respondent Islamic banks held similar views. These distributions, as shown in Figure 4.7 for Islamic banks<sup>101</sup> and RSAs, reflect the findings in related studies that reiterated the indispensability of having a functional Islamic money market.<sup>102</sup>

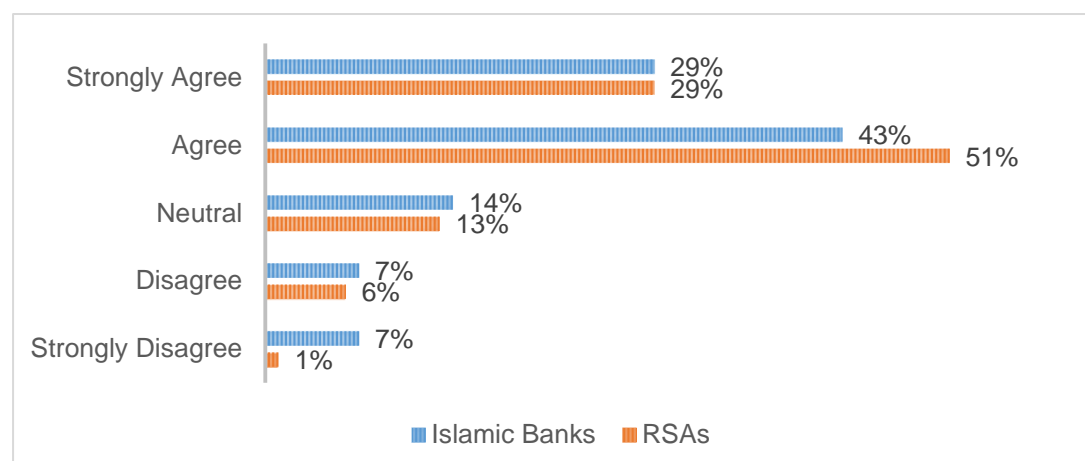
<sup>100</sup> Kammer et al. (2015), p. 29.

<sup>101</sup> A respondent Islamic bank, however, indicated that some Islamic financial institutions have been able to successfully offload their equity holdings on the Investment Account Platform on the market as a proof of the existence of secondary markets for risk-sharing contracts.

<sup>102</sup> Ben Jedidia and Hamza (2015), p. 2; Ma'aji, Ali and Hadi (2014), p. 2; and Oubdi and Elouali (2016), p. 168.



Figure 4.7 Lack of a Secondary Market for Trading Impedes the Use of Islamic Profit-Sharing Financing Instruments



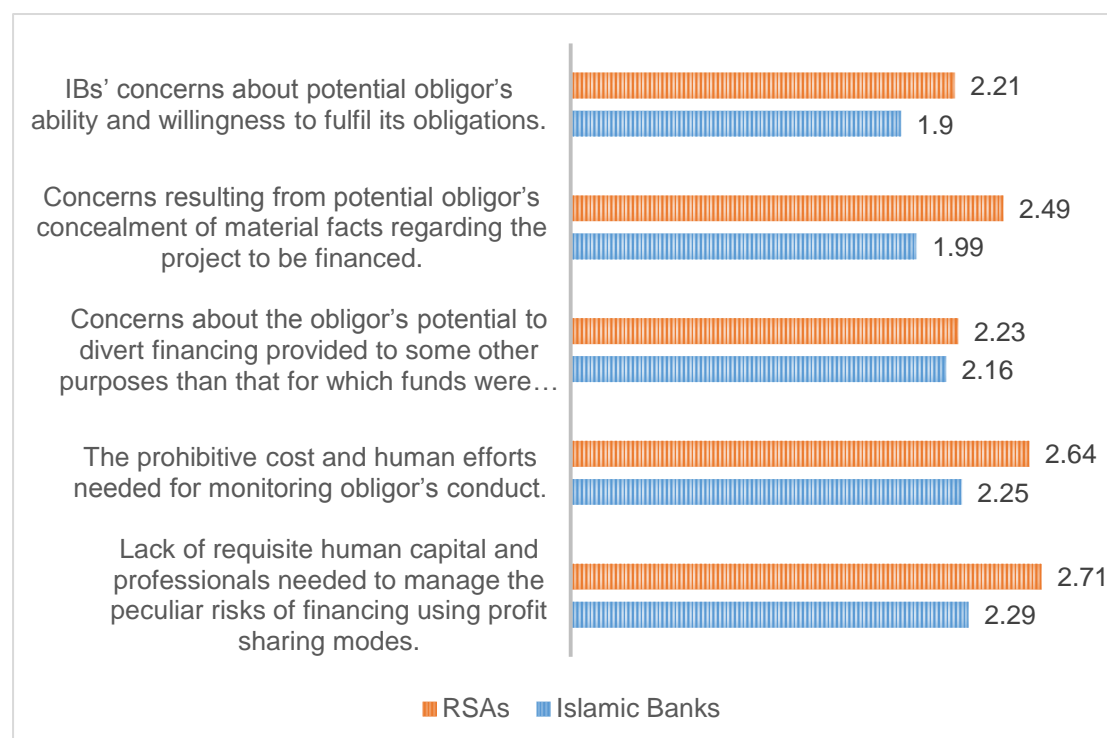
#### 4.5 Agency Costs and Monitoring

The most prominent among the likely reasons for the declining use of the risk-sharing modes of financing by the Islamic banks relates to the well-known agency and transactions costs, moral hazard and monitoring issues due to information asymmetry. Much has been written in this regard to underscore the fact that the need for the holder of a risk-sharing asset to monitor the performance of the investee, and the cost and difficulties of doing so,<sup>103</sup> may not have operational and financial justification from the perspective of an Islamic bank.<sup>104</sup> The high risk of such assets is reflected in the high RWA that regulators place on them.

Based on the responses obtained, an issue that recorded a high weighted mean score relates to the monitoring costs involved in risk-sharing financing contracts apparently due to the issue of information asymmetry. Figure 4.8 indicates that, across the RSAs and the Islamic banks, the weighted mean scores are similarly distributed.

<sup>103</sup> See, for instance, Alhammadi (2016), p. 49.

Figure 4.8 Islamic Banks and RSAs' Views on Limited Use of Profit-Sharing Contracts Due to Agency and Monitoring Costs



The responses obtained from both the RSAs and the Islamic banks also suggest that Islamic banks have some concerns regarding the obligors' moral hazard and adverse selection. In particular, these concerns are reflected in an obligor's potential to divert financing provided to some other purposes than that for which funds were made available and the concerns resulting from a potential obligor's concealment of material facts regarding the project to be financed.<sup>105</sup>

Furthermore, a couple of questions relating to operational risks<sup>106</sup> manifested in the lack of requisite human capital – that is, professionals who have the particular understanding and knowledge relating to risk-sharing financing contracts,<sup>107</sup> agency costs, information asymmetry and moral hazard – are asked in the survey. Based on the responses obtained, with a highest weighted mean score of 2.71 and 2.29 for the RSAs and Islamic banks, respectively, human resource issues are considered to be very fundamental to the handling of risk-sharing financing contracts. Lack of the requisite human capital and professionals needed to manage the peculiar risks of financing using risk-sharing modes seems very prevalent in the industry.<sup>108</sup> Plausible reasons could be the fact that such financing contracts present particular risk attributes significantly different from those of exchange-based arrangements and of the debt-based arrangements that the Islamic banks' management are used to right from their initial experience in conventional banks.<sup>109</sup> Such specificities of Islamic banking

<sup>105</sup> Alhammadi (2016), p. 50; Zaheer (2013), p. 19; and Jouaber and Mehri (2017), HAS (2012) p. 3.

<sup>106</sup> Operational risks in this context may be viewed as deriving from inadequate internal processes within an Islamic bank that infringe on its operational efficiency to tackle peculiar matters such as the risk management of risk-sharing contracts.

<sup>107</sup> See (2016).

<sup>108</sup> Van Greuning and Iqbal (2008) also highlighted this issue.

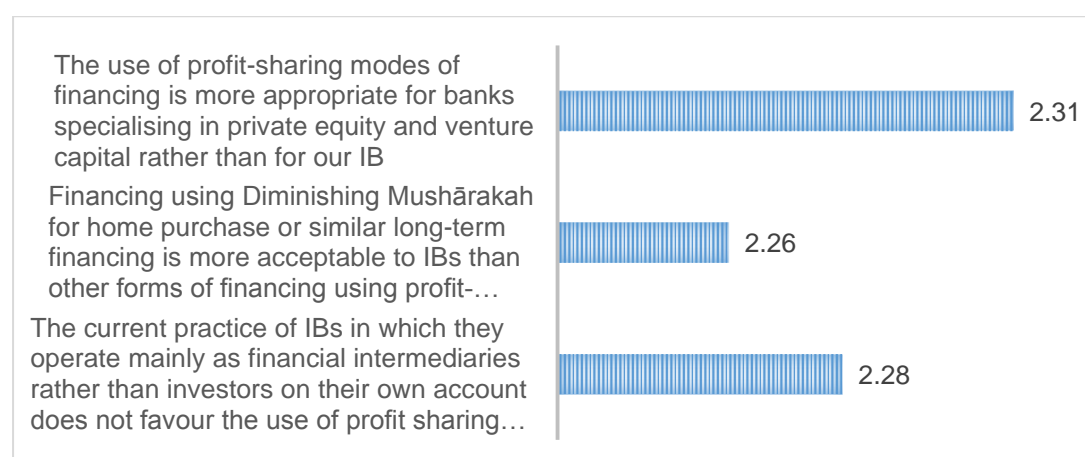
<sup>109</sup> Ibid.

operations may also limit the applicability of existing technology developed to cater for conventional banking and risk management practices.

## 4.6 Operating Structure

The current practice of Islamic banks operating mainly as financial intermediaries rather than investors on their own account seems not to favour the use of risk-sharing modes for financing purposes.<sup>110</sup> That is, the risks of placing UPSIA holders' funds using risk-sharing modes do not match the UPSIA holders' risk appetite.<sup>111</sup> Agreement with this proposition among the Islamic banks is indicated in Figure 4.9. The figure clearly shows strong agreement relative to the other two questions on the operating structure of Islamic banks and how it impedes the offering of risk-sharing modes of financing. Responses to this statement recorded the highest weighted mean score of 2.31. UPSIAs typically constitute the bulk of the on-balance sheet funds that Islamic banks have available for financing purposes.

Figure 4.9 Islamic Banks' Operating Structure and the Use of Risk-Sharing Financing



A further probe, as shown in Figure 4.10, shows that both the RSAs and the Islamic banks offer somewhat similar answers. While 78% of the RSAs agree with the proposition that the current intermediating structure of the Islamic banks does not favour the use of risk-sharing modes for financing purposes, 60% of the Islamic banks share similar views.

<sup>110</sup> There is no evidence that the Islamic banks would have done otherwise if they were investing on their own account.

<sup>111</sup> Archer and Karim (2009) p.302.

A horizontal bar chart comparing responses to Islamic Banks (blue) and RSAs (orange) across five levels of agreement: Strongly Agree, Agree, Neutral, Disagree, and Strongly Disagree. The chart shows that while more respondents agree with Islamic Banks (35%) than with RSAs (57%), a significantly higher percentage of respondents agree with RSAs (57%) compared to Islamic Banks (35%).

Response	Islamic Banks (%)	RSAs (%)
Strongly Agree	25%	21%
Agree	35%	57%
Neutral	27%	22%
Disagree	10%	0%
Strongly Disagree	3%	0%

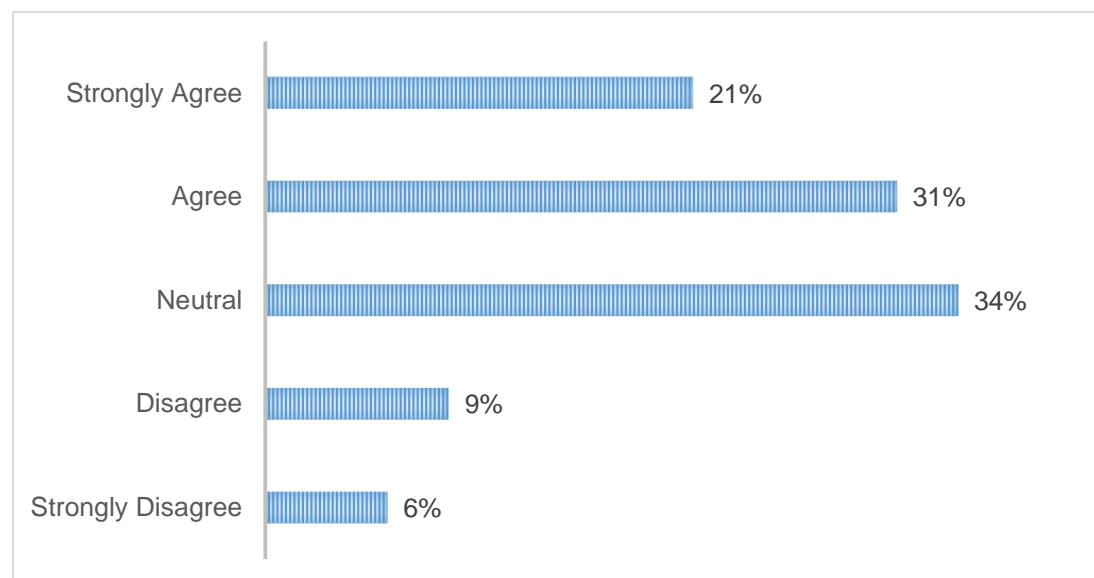
#### 4.7 Customers' Preferences Regarding Modes of Financing

In the survey, respondents' opinions are solicited on the statement: "Potential clients prefer to avoid the accounting and associated monitoring arrangements required with risk-sharing modes of financing." Based on the responses indicated in Figure 4.11,

<sup>113</sup> Though this section relates to customers' disposition towards risk-sharing financing modes, data elicited reflects the views of the Islamic banks.

34% of the respondents among the Islamic banks indicated neutrality. However, 52% generally agreed with the statement, with 21% indicating strong agreement.

Figure 4.11 Islamic Bank Potential Customers' Preference for Risk-Sharing Financing



However desirable it might be that Islamic banks should offer risk-sharing financing to their customers, doing so would be fruitless if potentially qualified customers did not seek such financing, as seems to be generally the case. In the circumstances, it is not clear how a greater use of such modes of financing could be successfully promoted.

## SECTION 5: CONCLUSION AND RECOMMENDATION

This study, a prelude to a cross-country analysis study, focuses on the risk-sharing practices in the Islamic banking industry. One main issue that it addresses relates to exploring the practices of the Islamic banks in mobilising funds using UPSIAs. Cognisance is given to the various governance issues raised by the status of UPSIA holders as a type of equity investor, sharing profits and being exposed to the risk of losses. The other main issue investigated in this study concerns the various reasons based on the extant literature that may account for the limited use of risk-sharing modes of financing, as reflected in the trend analysis of the relevant data culled from the IFSB's PSIFIs database. Primary data elicited from both the RSAs and the Islamic banks in the various IFSB jurisdictions were subjected to mainly descriptive analysis given the exploratory nature of the study.

The findings reveal that the capital treatment of the UPSIA in general varies across different jurisdictions and Islamic banking type. In most of the jurisdictions, UPSIAs are considered to be "investments" exposed to losses, rather than "deposits" with capital certainty. The key distinctions include those made among three different capital treatments: (1) UPSIAs as "pure investments" with no profit "smoothing" and no capital

certainty; (2) UPSIAs with varying degrees of profit “smoothing” (whether called “investments” or “deposits”) but no capital certainty; and (3) UPSIAs with “smoothing” and capital certainty. The second category is the most prevalent. It was noted that Islamic banking windows, and Islamic banks in jurisdictions with a small presence of Islamic banking, especially in those that are yet to adopt various IFSB standards, are more likely to consider UPSIAs to be “deposits” rather than “investments”.

The capital treatment of UPSIAs also varies across jurisdictions. In most cases, they are treated as investments with no capital certainty but with the provision that returns and losses may be “smoothed” via PER and IRR, respectively. Some other varying practices across various jurisdictions are also noted. For instance, while a jurisdiction has what it referred to as a “non-profit-sharing investment account” (NPSIA), some others indicated they have a cap on the amount of “capital considered certain”. One jurisdiction does not allow any form of smoothing whatsoever, and requires UPSIA holders as *rabb al-māl* to absorb all losses on assets financed by their funds, in the absence of misconduct and/or negligence on the part of the Islamic bank as *muḍārib*.. A few jurisdictions also indicated they have an Islamic deposit guarantee scheme and that the coverage extends to the UPSIA.

In most jurisdictions, the UPSIA holders’ lack of governance rights is well-noted by both the RSAs and the Islamic banks. The commingling of the UPSIA funds with the the shareholders’ funds exposes both to similar investment risks, and this might be considered to create an incentive for the latter to act in the interests of the former. However, the respondents do not consider such “vicarious monitoring” sufficient to mitigate the lack of governance rights that the UPSIA holders face. The key issue here is the difference in risk appetite between UPSIA holders who are typically risk-averse and seek modest but safe returns, and shareholders who are prepared to face risk in seeking higher returns.

Another issue that was investigated relates to disclosure, transparency and monitoring. The findings reveal that Islamic banks comply mostly with the disclosure requirements relating to the utilisation of PER and/or IRR during the period. Also, Islamic banks consider the basis of allocation of profits between the Islamic banks’ shareholders and UPSIA holders, including the maximum *muḍārib* percentage share and the average over the past five years, as being very important, as they state that they invariably disclose all these. However, the extent of compliance with the disclosure of the Shari’ah compliance of the investments into which UPSIA funds are placed is generally weak relative to other disclosure requirements. As stated earlier, this could be due to the fact that there is a requirement in various jurisdictions that financial reports contain a Shari’ah board’s attestation as to whether the Islamic banking operations are Shari’ah-compliant in their entirety. Both the PER and IRR are often used as smoothing techniques in most of the jurisdictions surveyed and where they are allowed.

A number of likely reasons extracted from the literature review that account for the limited usage of the risk-sharing modes of financing are grouped into six dimensions for ease of analysis. The first dimension is on regulatory challenges. In this respect, the findings show that the high regulatory risk weights required on *muḍārabah* and *mushārah* assets (excluding diminishing *mushārah* for home purchase finance)

discourage Islamic banks from placing funds in such assets. The rate-of-return risk, liquidity risk management practices and operating structure of an Islamic bank in which it functions as an intermediary also inhibit the use of such assets by Islamic banks.

Other reasons include the agency and transactions costs attaching to such assets. Specifically in this regard, the operational risks reflected in the lack of human resources with the requisite knowledge and understanding of the specificities of risk-sharing contracts are noted. The Islamic banks also believe that their aversion to incurring the costs of monitoring such assets is also shared by potential customers who are averse to the accounting and related requirements involved. As pointed out in the conclusion to subsection 4.7 above, however desirable it may be thought to be for Islamic banks to offer risk-sharing financing to their customers, their doing so would be fruitless if potentially qualified customers do not seek such financing.

A follow-up research on a cross-country basis is planned by the IFSB to complement and offer richer insights into all the issues arising from this exploratory study, taking cognisance of jurisdictional peculiarities. It is suggested that this planned study's scope should cover the views of both the RPSIA and UPSIA holders, so as to have a balanced perspective on pertinent matters.

Specifically, the proposed paper should look into best practices from various jurisdictions on matters relating to the capital treatment, smoothing practices, transparency and disclosure relating to PSIAs. In addition, focus should be on best practices relating to granting and preserving of governance rights of both the RPSIA and UPSIA holders,<sup>114</sup> as well as risk management practices peculiar to the structure of the risk-sharing contracts that underlie the investment accounts. There are also practices in various jurisdictions that require further elucidation. For example, existing practices like running *mushārah*<sup>115</sup> and the proposed risk-sharing financial intermediation model<sup>116</sup>.

Furthermore, due consideration should be given to the internal policies and practices relating to the prospects and challenges of risk-sharing contracts on both sides of the balance sheet of an Islamic bank. In this regard, it suggested that the theorised link between strengthening capital regulation as per Basel III and the incentives to Islamic banks operating risk-sharing accounts on the liability side due to benefits like higher losses absorption capacity and lower capital requirements can be verified.<sup>117</sup> Specifically, there should be investigation into likely operational incentives that can promote the use of risk-sharing contracts in Islamic banking especially for financing purpose.

From a regulatory point of view, the proposed paper, in addition to reviewing the implications of high risk weights for the limited use of risk-sharing contracts for financing purposes, should delve further to elicit responses on actual risk weights used

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<sup>114</sup> Governance rights of the Restricted Profit-Sharing Investment Account Holders (RPSIAH) would also be considered.

<sup>115</sup> See Ahmed, Farook and Arsalan (2016) for an overview and illustration of the modus operandi.

<sup>116</sup> See Lajis (2017) for a detailed explanation, illustration and simulation of the proposed model. A compilation of various discussions among Shari'ah scholars, professionals, academicians, and researchers etc. on 'Running *mushārah*' on the platform of the Islamic Economic Forum can be found at: <http://www.iefpedia.com/english/wp-content/uploads/2017/05/Running-Musharakah-IEF.pdf>

<sup>117</sup> Spinassou and Wardhana (2018), p.15.

in various jurisdictions, the extent of implementation of the FSB-15 recommendations and practices regarding supervisory slotting.

In addition, the proposed paper should provide a detailed account of the legal impediments to implementing risk-sharing regimes for Islamic banking, which often times hinder treating PSIAs as true risk-sharing products in some secular regimes. Specifically, due consideration should be given to the sufficiency of the laws adopted by different jurisdictions to cater for the nature of PSIAs, particularly under the Shari'ah.

An investigation is also suggested into how various jurisdictions are addressing the issue of lack of human resources with the specific risk-management skills needed to address the various peculiar risks involved in financing based on risk-sharing modes. In this regard, the possibility of deploying technology via regulatory sandboxes for instance can be further explored.



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## **Appendix**

### **List of Islamic Banks Participating in the Survey**

1. Abu Dhabi Islamic Bank – **UAE**
2. Affin Islamic Bank Berhad – **Malaysia**
3. Agrobank – **Malaysia**
4. Al Hilal Bank – **UAE**
5. Al Salam Bank Bahrain – **Bahrain**
6. Al-Arabiya Islamic Bank – **Iraq**
7. Albaraka Türk – **Turkey**
8. Alliance Islamic Bank Berhad – **Malaysia**
9. Al-Qabedh Islamic Finance and Investment Bank – **Iraq**
10. Amana Bank Limited – **Tanzania**
11. AmBank Islamic Berhad – **Malaysia**
12. Askari Bank Limited – Ikhlas Islamic Bank – **Pakistan**
13. Bahrain Islamic Bank – **Bahrain**
14. Bank Aceh Syariah – **Indonesia**
15. Bank AL Habib Limited – **Pakistan**
16. Bank Danamon Indonesia, TBK-UUS – **Indonesia**
17. Bank Islam Brunei Darussalam – **Brunei Darussalam**
18. Bank Kerjasama Rakyat Malaysia Berhad – **Malaysia**
19. Bank Mega Syariah – **Indonesia**
20. Bank Victoria Syariah – **Indonesia**
21. BankIslami Pakistan Limited – **Pakistan**
22. BCA Syariah – **Indonesia**
23. BNI Syariah – **Indonesia**
24. BRIsyariah TBK – **Indonesia**
25. BTPN Syariah – **Indonesia**
26. Century Banking Corporation Limited – **Mauritius**
27. Citibank Malaysia – **Malaysia**
28. Dubai Islamic Bank Pakistan Limited – **Pakistan**
29. Faysal Bank Limited – **Pakistan**
30. GFH financial Group – **Bahrain**
31. Global Banking Corporation B.S.C. (c) – **Bahrain**
32. Habib Bank Limited – **Pakistan**
33. Habib Metropolitan Bank – **Pakistan**
34. Hong Leong Islamic Bank Berhad – **Malaysia**
35. HSBC Amanah Bank Malaysia – **Malaysia**
36. Investment Dar Bank – **Bahrain**
37. Islamic Bank “Zaman Bank” JSC – **Kazakhstan**
38. Ithmaar Bank B.S.C – **Bahrain**
39. Khaleeji Commercial Bank – **Bahrain**
40. Kuwait Finance House – **Kuwait**
41. Kuwait Turkish Participation Bank – **Turkey**
42. Liquidity Management Centre B.S.C – **Bahrain**
43. Masraf Al Rayan – **Qatar**
44. Maybank Syariah Indonesia – **Indonesia**
45. MCB Islamic Bank Limited – **Pakistan**
46. Meezan Bank Limited – **Pakistan**
47. National Bank of Pakistan – **Pakistan**
48. OCBC Al-Amin Bank Berhad – **Malaysia**

49. Oman Arab Bank – **Oman**
50. PT Bank BJB Syariah – **Indonesia**
51. PT Bank Muamalat – **Indonesia**
52. PT Bank Syariah Bukopin – **Indonesia**
53. PT Permata Bank – **Indonesia**
54. Public Islamic Bank – **Malaysia**
55. Qatar First Bank LLC (Public) – **Qatar**
56. Qatar International Islamic Bank – **Qatar**
57. Qatar Islamic Bank – **Qatar**
58. RHB Islamic Bank Berhad – **Malaysia**
59. Sindh Bank Limited – **Pakistan**
60. Soneri Bank Limited Mustaqeem – **Pakistan**
61. Standard Chartered Bank Pakistan Limited – **Pakistan**
62. Standard Chartered Saadiq Berhad – **Malaysia**
63. The Bank of Khyber – **Pakistan**
64. The Bank of Punjab – Taqwa Islamic Banking – **Pakistan**
65. United Bank Limited – **Pakistan**
66. Venture Capital Bank – **Bahrain**
67. Zarai Taraqati Bank Limited – **Pakistan**
68. Ziraat Katilim Bankasi – **Turkey**

#### **List of Regulatory and Supervisory Authorities Participating in the Survey**

1. Astana Financial Services Authority (AFSA)
2. Bank Negara Malaysia
3. Bank of Mauritius
4. Bank of Tanzania
5. Banking Regulation and Supervision Agency, Turkey
6. Central Bank of Bahrain
7. Central Bank of Iraq
8. Da Afghanistan Bank
9. Maldives Monetary Authority
10. National Bank of Kazakhstan
11. Otoritas Jasa Keuangan
12. Palestine Monetary Authority
13. Qatar Financial Centre Regulatory Authority
14. State Bank of Pakistan.