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The New Governing Dynamics: *Regulating Islamic Banks in the Global Political Economy*

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Abstract

This thesis seeks to examine the connection between international bank supervision and Islamic banking, specifically, the question of how to supervise and regulate an Islamic bank in a conventional banking environment. I argue that because Islamic banking differs from conventional banking, and because a hard law supervisory approach would frustrate attempts to level the playing field, the way forward lies within the Basel Committee on Banking Supervision. The BCBS is premised on a decentralized approach to cross border bank supervision. Managed effectively, the BCBS can serve as a model for trans-national cooperation in both formal and informal settings, making regulation of Islamic banks an obvious candidate. However, at present, the BCBS does not regulate Islamic banks. The proposed recommendation involves the BCBS as facilitator and promoter of supervisory guidelines for Islamic banking. This requires the creation of a semi autonomous body (Islamic Banking Supervisory Committee) within the BCBS developing a supervisory programme that recognizes the differences and fosters an environment of competition and fair market practices.

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Glossary of Arabic Terms

Amana (Demand deposits)
Deposits held at the bank for safekeeping purpose and day to day banking services. They are guaranteed in capital value, and earn no return.

Bay mu'ajal (Pre-delivery, deferred payment)
The seller can sell a product based on a deferred payment, in instalments or in a lump sum. The price of the product is agreed upon between the buyer and the seller at the time of the sale, and cannot include any charges for deferring payment.

Bay Salaam (Pre-payment, deferred delivery)
The buyer pays the seller the full-negotiated price of a product that the seller promises to deliver at a future date.

Fiqh (Islamic jurisprudence)
Fiqh refers to the whole corpus of Islamic jurisprudence. In contrast with conventional law, Fiqh covers all aspects of life, be it religious, political, social, commercial or economic. The whole corpus of Fiqh is based on the Qur'an and interpretations thereof and the Sunnah (sayings and deeds of the prophet and his family). While the Qur'an and the Sunnah are immutable, Fiqhi pronouncements may change due to changing circumstances.

Gharar
Literally, it means deception, danger, risk and uncertainty. Technically, it means exposing oneself to excessive risks and danger in a business transaction as a result of uncertainty about the price, the quality and the quantity of the counter-value, the date of delivery, the ability of either the buyer or the seller to fulfil his commitment, or ambiguity of the terms of the deal; thereby, exposing either of the two parties to unnecessary risks.

Ijara
(Lease, lease purchase) A party leases a particular product for a specific sum and a specific period. In the case of a lease purchase, each payment includes a portion that goes toward the final purchase and transfer of ownership of the product. It has also been defined as leasing or the sale of the usufruct of an asset. The lessor retains the ownership of the asset, together with all the rights and the responsibilities that go with ownership.

Ijtihad
Refers to the form of analytical reasoning employed in the analysis of problems not covered precisely in either the Qur'an or the Hadith. Within the Muslim scholarly community, it was originally conceived that every trained and authorized jurist had the right to exercise independent juristic reasoning; however, as a consequent to the increase in schools of jurisprudence, Sunni authorities began to curtail the application of the principal, claiming that a large number of legal issues were already settled. This has begun to change. Shi'ite Muslims, on the other hand, have always recognized and encouraged the development of Ijtihad as an important part of jurisprudence and continue to employ it as part of their legal tradition.

Istisna- Deferred payment, deferred delivery
Refers to a contract whereby a manufacturer (or contractor) agrees to produce (or construct) and deliver, at a given price on a given date in the future, a well-described good (or building) according to specifications. As against salaam, in istisna the price need not be paid in advance. It may be paid in instalments, similar to progress payment as agreed by the parties, or partly up front, with the balance being paid later.

Ju'ala (Service charge)
A party pays another a specified amount of money as a fee for rendering a specific service in accordance to the terms of the contract stipulated between the two parties. This mode usually applies to transactions such as consultations and professional services, fund placements and trust services.

Kifala
It is a pledge given to a creditor that the debtor will pay the debt, fine or liability. A third party becomes surety for the payment of the debt if unpaid by the person originally liable.

Mudarabah (Trustee finance contract)
Rabb -ul- mal (capital's owner) provides the entire capital needed to finance a project while the entrepreneur offers their labour and expertise. Profits are shared between them at a certain fixed ratio, whereas financial losses are exclusively borne by rabb -ul- mal. The liability of the entrepreneur is limited only to their time, effort, reputation and opportunity cost.

Murabahah: Mark-Up Financing
It is generally defined as a sale with a pre-determined profit margin. The term, however, is now used to refer to a sale agreement whereby the seller purchases the goods desired by the buyer and sells them at an agreed marked-up price, the payment being settled within an agreed period, either in instalments or in a lump sum. The seller bears the risks associated with the goods in possession until they are delivered to the buyer. Murabahah is also referred to as bay mu'ajjal.

Musharaka (Equity participation)
A contract of partnership somewhat similar to a mudarabah contract, but partners who provide the capital may participate in the management (although the management may be left to one of the partners) and share in the profit and loss. Profits are distributed between the partners in accordance with the ratios initially set, whereas loss is distributed in proportion to each one's share in the capital

Qard Hassan (Beneficence loans)
These are zero – return loans that the Qur'an encourages Muslims to make to the needy. Banks are allowed to charge borrowers a service fee to cover the administrative expenses of handling the loan. The fee should not be related to the loan amount or maturity.

Riba
Literally, it means increase or addition or growth. Technically, it refers to the 'premium' that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or an extension in its maturity. Interest as commonly known today is regarded by a predominant majority of fuqaha' to be equivalent to Riba.

Shariah (Islamic Law)
Shari'ah is defined as the corpus of Islamic law. The term itself means "way" or "path"; it is also defined as the legal framework within which public and to a limited degree, private aspects of life are regulated. The Shari'ah deals with many aspects of day-to-day life, including politics, economics, banking, business law, contract law, sexuality, and social issues. The Shia model of jurisprudence is centralized and horizontally ordered with its major centers of study and jurisprudence in Qum, Iran and Najaf, Iraq. The Shia Model is best known for its emphasis on Ijtihad. Though the Sunni model of jurisprudence is more decentralized, Sunni jurists have traditionally associated with Cairo, Egypt; Karachi, Pakistan and Saudi Arabia.

Some scholars in both the Shia and Sunni schools of thought are willing to accept Shari'ah as the corpus of precedent and legal theory established before the 19th century, whereas other scholars view Shari'ah as changing to reflect current modalities. As a result, there is not a strictly codified and uniform set of laws pertaining to Shari'ah across the Muslim world. In its place, there are a number of different interpretations of the Shari'ah applicable to those adherents who choose to follow.

Sukuk
Plural of 'Sakk', which refers to a financial paper showing entitlement of the holder to the amount of money shown on it. The English word "cheque" has been derived from it. Technically, Sukuk are financial instruments entitling their holders to some financial claims.

Takaful-Mutual Assurance
An equivalent to the contemporary insurance contract whereby a group of persons agree to share a certain risk (for example, damage by fire) by collecting a specified sum from each. In case of loss to any one of the group, the loss is met from the collected funds. It is the Arabic name for insurance based on Shari'ah rules. An Islamic Insurance is a collective protection scheme. It literally means solidarity. Takaful reflects solidarity and is akin to mutual insurance.

Wakala
An agency contract, in which one person appoints someone else to perform a certain task on their behalf, usually against a fixed fee. It may include in its terms a fee for the agent. The same contract can also be used to give a power of attorney to someone to represent another's interests.

Waqf
Appropriation or tying up a property in perpetuity for specific purposes. No property rights can be exercised over the corpus. Only the usufruct is applied towards the objectives (usually charitable) of the Waqf.

Zakat
Is a religiously oriented alms tax prescribed in the Qur'an representing the amount payable by a Muslim on their net worth as part of religious obligations, for the benefit of the poor and the needy. Paying Zakat is an obligatory duty for every adult Muslim whose wealth exceeds a certain threshold.

Sources: Archer and Ahmed (2003), Chapra and Ahmed (2002) and Errico and Farrahbaksh (1998)

List of Abbreviations

AAOIFI Accounting and Auditing Organization for Islamic Financial Institutions
ABS Asset-backed Securitization
ADB Asian Development Bank
ARCIFI Arbitration and Reconciliation Centre for Islamic Financial Institutions
BCBS Basel Committee for Banking Supervision
BCPs Basel Core Principles
CIBAFI (General) Council for Islamic Banks and Financial Institutions
DJIMI Dow Jones Islamic Market Index
FATF Financial Action Task Force
FSA Financial Services Authority
FSAP Financial Sector Assessment Programme
GCC Gulf Cooperation Council
IAH Investment Account Holders
IAIS International Association of Insurance Supervisors
ICM Islamic Capital Market
ICR Insolvency and Creditor Rights
IsDB Islamic Development Bank
IFAI Islamic Financial Architecture and Infrastructure
IFS Islamic Financial Services
IFSB Islamic Financial Services Board
IFSI Islamic Financial Services Industry
IIFM International Islamic Financial Market
IIFS Institutions Offering Islamic Financial Services
IIIIs Islamic International Infrastructure Institutions
IIRA International Islamic Rating Agency
IMF International Monetary Fund
INBMFIs Islamic non-bank and Microfinance Institutions
IOSCO International Organization of Securities Commissions
IRTI Islamic Research and Training Institute
JFFC Joint Forum on Financial Conglomerates
LLR Lender of Last Resort
LMC Liquidity Management Centre
MBS Mortgage–backed Securitization
NAV Net Asset Value
NBMFIs Non-bank and Microfinance Institutions
OECD Organization for Economic Co-operation and Development
OIC Organization of Islamic Conference
REITs Real Estate Investment Trusts
SCM Securities Commission of Malaysia
SGC Shari'ah Governance System
SRI Socially Responsible Investing
TFC Term Finance Certificates
WTO World Trade Organization

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Introductory Remarks

Comprising more than 25% of the global population coupled with rapid growth on a constant basis, Muslims worldwide constitute the second largest population on earth (CIA, 2006). Though heavily concentrated in the Middle East, Africa, and the Indian Subcontinent, Muslims make up significant populations in both Europe and North America. As the migration continues, confirmation of Muslim participation in the greater society is evident with their involvement in domestic law making, commercial endeavour and civic life.

Guidance issued on subjects such as diet, education, attire, finance and the environment are numerous in modern Islamic thought. As it relates to implementation, all but banking and finance have been effectively put into place. I argue that one of the reasons for the lack of growth in this area directly relates to the regulatory obstacles that stand in the way of Islamic finance. The reasons for these obstacles are not without reason; however, they may not accurately reflect the dynamism of the international financial system. Financial Services such as banking, insurance and securities constitute the engine of the modern economy making access to its services important to all participants. As with other areas of daily living, according to the *Qur'an*[1] and *Sunnah*[2], there are restrictions on the concept of money and its use. Islamic finance, as it has come to be known, entails four basic characteristics;

[1] The Qur'an literally means "the reading" and is the central text of Islam. Muslims believe the Qur'an to be the divinely revealed book of guidance and direction for humanity. Muslims also consider the text in its original Arabic, to be the literal word of God revealed to Muhammad (pbuh) over a period of twenty-three years and view the Qur'an as God's final revelation to humanity.

[2] Sunnah literally means "the trodden path", and in relation to Islam the Sunnah of the prophet means "the way of the prophet". The word 'Sunnah' in Sunni jurisprudence refers to those religious actions that were enacted by Muhammad during the revelation period of 23 years as well as through consensus of companions of Muhammad. In Shia Islam, the word 'Sunnah' is expanded based on Shia doctrine to refer to the deeds, sayings and approvals of Muhammad and the twelve divinely appointment Imams to succeed the Prophet and to lead humanity upon his passing.

1. A strict prohibition on the use of interest (*Riba*) coupled by an expansive definition thereof[3];
2. Limitations on the nature of the business venture engaged;
3. Restrictions on the level of incalculable risk and/or uncertainty associated with a transaction;
4. A re-structuring of the relationship between contractual participants[4].

This stands in contradistinction to the underlying premises upon which the conventional banking system rests, and that which billions worldwide have become accustomed to. However, for 1.6 billion Muslims worldwide, Qur'anic injunctions prohibiting the use of interest and excessive uncertainty are quite clear, making the need to address this topic all the more germane. In a domestic context, the 2001 Canadian Census reported that Muslims accounted for nearly 600,000 citizens[5], more than doubling their population from the last decade. The connection between seeking alternatives, Islamic banking, and an increasing Muslim population relates directly to the aforementioned prohibitions which ultimately limit the scope of financial services of which adherents may avail themselves.

The importance of this in the Canadian context relates to the increasing Muslim population who require financial services that comply with their religious tenets. Supporting this claim are three factors. Under the current banking structure, it is entirely possible to formally include Islamic banking in the regulatory framework. In relation to the growing Muslim community in Canada, expanding the banking sector to include Islamic finance would undoubtedly improve relations. More important to perceived improvement in relations

[3] O ye who believe! Devour not usury, doubling and quadrupling (the sum lent). Observe your duty to Allah, that ye may be successful. (The Holy Qur'an Ch 3: 130)

[4] Ali (regarded by the Shia to be the successor to the Prophet pbuh) while guiding the Governor designate, said, "Prevent them (businessmen) from hoarding; for the prophet of God had prohibited it. See to it trade is carried on with the utmost ease that the scales are evenly held and that prices are so fixed that neither the seller nor the buyer is put to a loss. (Alhabshi, 1993: p.1)

[5] This number is exclusive of the temporary and permanent workers, international students, and those who have yet to be granted citizenship and do reside within Canada making the potential number substantially higher in respect to Muslims within the territory of Canada.

would be the formal exemplification of reasonable accommodation for minorities under the current reception of multiculturalism. As it relates to the banking sector, with a growing market base for specialized financial services, it makes sense to research the potential of developing niche markets within the Canadian banking sector. The potential outcome of establishing an Islamic financial services industry within Canada has numerous benefits in terms of the increased employment opportunities, new wealth creation and greater competition which ultimately increase the available choice for the Canadian multicultural public.

Thesis Statement

This thesis explores the connection between international bank supervision and Islamic banking, specifically, the question of how to supervise and regulate an Islamic bank in the conventional banking environment. The appropriate response to the question of unified Islamic bank supervision will recognize that precisely because Islamic banking differs in pith and substance from conventional banking, and because a supervisory approach premised on a hard law framework has the potential of frustrating the intent of domestic bank supervisors to provide a level playing field, I propose that the way forward lies within the existing supervisory framework of the Basel Committee on Banking Supervision (BCBS). The BCBS framework is premised on a decentralized approach to joint oversight on matters of cross border bank supervision.

It is my contention that if the BCBS is managed effectively, it can serve as a model for trans-national cooperation in both formal and informal settings, making regulation of Islamic banks an obvious candidate. However, at present, the BCBS does not explicitly regulate

Islamic banks. This thesis will advance the idea that Islamic bank supervision necessarily involves the BCBS because of the role it has played in the international community as a facilitator of informational exchanges and promoter of supervisory guidelines and best practices for conventional banking internationally.

I argue that in order for this to happen, the creation of a semi autonomous body (Islamic Banking Supervisory Committee) within the BCBS framework will be required. The IBSC will be mandated to develop a supervisory programme that recognizes the inherent differences between Islamic and conventional banking and to foster an environment of competition and fair market practices.

Thesis Structure

This thesis is divided into three main chapters followed by the fourth chapter designed to recap the major arguments and provide a list of suggestions as to the way forward. Chapter One examines the fundamental tenets associated with Islamic banking followed by a comparative analysis between Islamic and conventional banking. The aim of this chapter is to clarify the salient differences between both models of financial services provision and highlight the potential areas of divergence that financial sector supervisors would need to account for when contemplating an appropriate regulatory response.

Chapter Two explores the theoretical framework relevant to Islamic bank supervision. The Chapter conceptualizes governance within the emergence of Global Administrative Law (GAL) as the ideal lens to scrutinize the process of incorporating Islamic banking into the larger supervisory framework. GAL, governance and legalization are directly related to this

endeavour insofar as the potential approach to regulating Islamic banks, as I will propose, constitutes a governance-oriented approach incorporating features of a rules-based framework with greater emphasis placed on softer norms.

Chapter Three examines financial stability as an underlying principle of effective financial sector supervision and the current efforts of Islamic bankers to ensure its maintenance. As part of this process, the Basel Committee on Banking Supervision has emerged as the leading supervisory body in the international community. Efforts to manage the international banking system have led to the publication of three seminal guidelines for bank supervisors that will be introduced in this thesis. In contemplating the addition of alternative banking models into the larger framework, it is important to consider the impact on financial stability and whether the introduction of Islamic banking and its pursuant supervision will negatively impact the pursuit of this objective. In order to re-frame the issue of Islamic bank supervision, the balance of Chapter Three will examine the current attempts within the Islamic financial services industry to assuage concerns held by national regulators and international supervisors as to the compatibility of Islamic banking vis-à-vis its conventional counterpart.

Chapter Four focuses on the suggestions that address the concerns of supervisors while ensuring that Islamic banking is not unduly hindered in its market entry phase. Ultimately the goal of this research is to introduce the idea of a new organization that will oversee Islamic banking and the supervision thereof under the auspices of the Basel Committee on Banking Supervision (BCBS).

The Islamic Banking Supervisory Committee (IBSC), according to the proposal in Chapter Four, will operate within the existing framework of the Basel Committee on Banking Supervision. The mandate of the IBSC will extend to Islamic banks operating worldwide. Financial sector supervisors will have, at their disposal, a consolidated set of supervisory practices that have been created to supplement the existing BCBS best practices ensuring that Islamic banks are accurately assessed for soundness and liquidity. This has been the flashpoint of discussions surrounding the way forward for internationally supervised Islamic banking.

Chapter One- Islamic Banking and the Global Political Economy

The history of Islamic finance dates back to the very origins of Islam itself. Yet it is only in recent times that a resurgence has become evident. As an industry, whether local or international, Islamic finance is still in its nascent stage, yet to complete developing internal guidelines and the scope of its financial endeavors. This indicates that any regulation must account for this relative infancy, and any prescriptions designed to regulate and/or supervise it must not be so rigid such that the industry itself is stifled and innovation ceases. At the same time, effective bank supervision[6] is necessary in creating regimes that protect depositors, provide investors with current and accurate information and allow banks the flexibility to seek out entrepreneurs with investment needs. An increased range of assets and instruments available to Muslim clients makes efficient mobilization of surplus funds easier and consequently assists in streaming new wealth into the international monetary system.

This Chapter introduces Islamic finance as a competing vision to the conventional banking system with the intent of setting the foundation for a discussion of regulatory solution(s) which will be introduced in the final chapter. From a cursory perusal of the available literature[7], it is evident that Islamic finance at present is not part of the international push for consolidated supervision spearheaded by the Basel Committee on Bank Supervision (hereinafter BCBS). The question as to why has been raised by depositors, investors, and

[6] Bank Supervision as it concerns this thesis refers to permanency in both assessment and monitoring of a bank's financial performance and position. Oversight takes place under the guise of an effective regulatory framework premised on reinforcing market discipline, internal governance policies and consequently the operating environment(s) of banks.

[7] For a further discussion of the lack of regulatory options and supervisory oversight for Islamic banking worldwide, refer to following. Iqbal, Z. & Mirakhor A. (2002). Development of Islamic Financial Institutions and Challenges Ahead., in Archer S. & Abdel Karim, R. (eds.) Islamic Finance: Growth and Innovation, Euromoney Books, London: UK; Iqbal, Z & Mirakhor A. (1987) Islamic Banking. IMF Occasional Paper 49. Washington: International Monetary Fund; Islamic Financial Services Board. (2005) Capital Adequacy Standard for Institutions (other than Insurance Institutions) offering only Islamic Financial Services. Kuala Lumpur: Author; Islamic Financial Services Board.(2005).Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds) Kuala Lumpur: Author; Islamic Financial Services Board. (2005).Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) offering only Islamic Financial Services. Kuala Lumpur: Author; Llewellyn, D. (2001) A regulatory regime for conventional and Islamic banks. Jeddah: Islamic Development Bank

regulators alike. Transnational oversight, by design, contributes to international financial stability, eases transactions and provides predictability to the marketplace. This being the case, it begs the question as to why Islamic finance would not fall under the auspices of the BCBS. Upon careful review of the competing bank models, it is apparent that major differences in operating principles have a direct impact on the applicable form of regulation. This Chapter outlines the substance of Islamic finance and the major differences between the conventional and Islamic models, and concludes with an examination of differences in accounting practices. The chapter provides reasonable grounds as to why alternative regulation should be pursued. In doing so, it must be acknowledged that alternative regulation should not preclude the application of relevant BCBS supervisory principles.

The Islamic financial industry has, over the past 30 years, rapidly extended its scope world wide. The industry opened with the savings association(s) of Egypt in the early to mid 1960's which were considered the origin (Chapra & Khan, 2000: p.4). As of 2004, there were approximately 200 Islamic financial institutions globally with assets in excess of $200 billion (El-Hawary, Grais & Iqbal, 2004: p.2). In brief terms, Islamic finance provides borrowers with increased[8] contractual maneuverability as it concerns risk and liability allocation. Lenders are required to take a more active role in the venture for which funds are lent out. Underpinning this growth is the strict prohibition of any interest in finance. Profitability requires participation and most importantly the sharing of risk. The logic behind this concerns *leveling the playing field* between lender and borrower. By transforming lending for profit into a venture capital style arrangement, both borrower and lender have an ongoing interest in the well being of the venture.

[8] Relative statement comparing Islamic finance to conventional terms and conditions found in contracts of adhesion employed within the finance sector.

Sources of Religious Guidance

Underscoring this is the expansive definition of what constitutes illegitimate gain in an Islamic economy. The prohibition against usury (interest) as it was referred to in the *Qur'an* occurs on a number of occasions. The frequency of this theme provides insight evidencing the serious nature of the offence. Chapter 2, verse 275 of the *Holy Qur'an* states unequivocally that,

> Those who devour usury will not stand except as stands one whom the Evil one by his touch hath driven to madness. That is because they say: "Trade is like usury but Allah hath permitted trade and forbidden usury. Those who after receiving direction from their Lord desist shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (the offence) are companions of the fire: they will abide therein (The *Holy Qur'an*, Trans: Yusufali: 2: 275).

Riba, within the Islamic context is viewed as a source of unjustified enrichment as money is not regarded as a profit generating asset (Zaheer & Hassan, 2001: p.2). The role of money is limited to being a medium of exchange and a store of value in an asset oriented economy (El-Gamal, 2000: p.4). *Riba* can be defined in two main ways: *Riba an Nasiah* and *Riba Al Fadl. Riba an Nasiah* refers to the excess amount a creditor settles to receive or recover from the debtor in consideration of giving time to the debtor for re-payment of the loan (Obaidullah, 2005: p.24) whereas *riba al-fadl* is described as an unlawful excess to fair market pricing in commodity based exchange, such as barter (El-Gamal 2000: p.4).

Referring to the aforementioned definition, time, being the basis upon which interest is premised, does not provide an adequate justification for levying a fee for the use of money. In a conventional bank, the time value of money is based on the concept that a dollar today is more valuable relative to the expectation of a dollar in the future (McCracken, 2005). Money held today is worth more because it can be invested to earn return (McCracken,

2005). However, time in the Islamic context is not within the influence of individuals and consequently cannot be used to determine price increases on the use of money or by deferring payment in situations where the financier does not possess the good but intermediates the transaction (Saad'Allah, 1994: p.5).

Riba al-fadl, as the second classification, is described as an unlawful excess in the exchange of two counter-values where the excess is measurable through weight or measure (Saleh 1986; 94-95). The applicability of this prohibition is limited in the modern economy as this would have applied in the context of a barter transaction. However, as a point of discussion, it further illustrates the constraints imposed upon both buyers' and sellers as to how commercial transactions are to be conducted. The prohibition originates in two *Hadith*[9] of the Holy Prophet.

> If you give gold, then receive back the same gold: the same weight and the same quality; and if you give silver, then receive back the same silver: the same weight and the same quality, because the one who gives more or expects more, then [he should know that] that is exactly Riba. (Muslim 0261; 211).

In another context, the tradition cited emphasizes the inherent inequality between participants to the transactions as valuation between the bartered goods may result in trade not reflective of the current market price but of the interaction.

> If you will sell gold for silver then there is a danger of interest in it. Likewise, if you will sell wheat for wheat, barley for barley and dates for dates, the result would be no different; except that the exchange be spot'. (Muslim 0261; 208).

[9] Hadith, in English academic usage, are traditions relating to the sayings and doings of the Prophet Muhammad and his Family.

The aforementioned transaction occurs in the context of a barter transaction and as such can be interpreted as an initial move away from barter to currency based transactions in an effort to limit the abuse of unscrupulous sellers.

Uncertainties and circumstances not amenable to fair dealing and full disclosure colored the pre-Islamic economy of Makkah (El-Gamal, 2000: v). The banking sector reforms ushered in by the Prophet, coupled with a duty to disclose pertinent information, had the cumulative effect of curtailing barter trade which was then replaced by currency as the primary form of exchange (Mirakhor & Khan, 1992: p.14). As a general principle then, the *raison d'etre* for the prohibition of interest in an Islamic economy stems from what is characterized as an *unbalanced equation.* Consider the context of a commercial loan: the interest earned, on one hand, and the opportunity cost, on the other. The bank's interest charge is certain whereas the result from the loan is not. (Sarkar, 2003: p.2) It is this inconsistency between the outcomes, the guaranteed income on one hand and the potential loss on the other hand that constitutes the basis for prohibition (Obaidullah, 2005: p.44)

Risk, as a standard element of a transaction having been acknowledged, is shared equally or to a pre-determined ratio not contravening Shariatic law within the lender-borrower relationship. One cannot shield itself from loss to the detriment of the other. Finance made available for trade and production is premised on risk and profit and loss sharing as a return on investment (Gainor, 1999). The lender who advances money for trade can include provisions to receive a ratio of the profit. In effect, the lender becomes an *angel investor*[10] in the venture, sharing in the risk of the enterprise, and consequently cannot be categorized as a

[10] An angel investor is a person who invests in a business venture, providing capital for start-up or expansion. These individuals are looking for a higher rate of return than would be given by more traditional investments (typically 25 percent or more).

creditor. The definition of illegitimate gain based upon Quranic injunction and prophetic traditions require companies holding themselves out as Islamic financial services providers to offer products and services that represent both in letter and spirit the prohibition of *riba* and *gharar*[11].

Primary Intent of Banking in Society

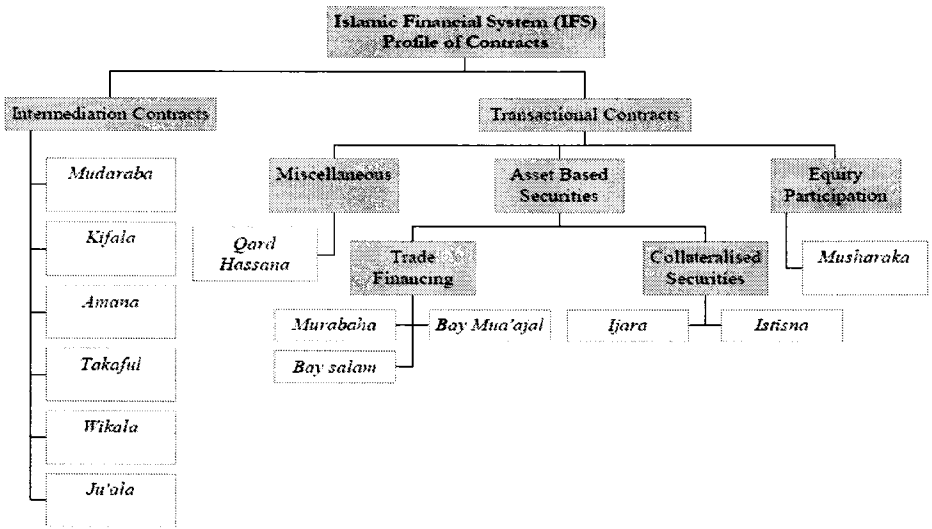
From a societal perspective, financial intermediaries are the root institution in the savings-investment process. (Gorton & Winton, 2002: p.5). As recipients of capital with the mandate to re-invest and redistribute, banks play a key role regulating the behaviour of firms and the creation of new sources of wealth through their financing activities (Gorton & Winton, 2002). This is accomplished in a number of ways: through individual investment deposited as savings and special investments; from institutional investors who manage corporate pension and mutual funds; and finally through government issued certificates and savings bonds (Gorton & Winton, 2002: p.7). The difference in the Islamic context, concerns the objective of redistributing wealth in society. This objective is premised on the fair and efficient capital allocation not only to low risk borrowers who are willing to repay at a premium, but to where capital will most effectively and efficiently be used to promote behavior that is beneficial to society (IJIFS, 2001: p.15)

In order to carry out such activities, Islamic banks enter into legal relations based on contract, which can be further sub-divided into two categories: intermediary and transaction-based (Chapra & Khan, 2000: p.85). Figure 1, below, charts out in greater detail the thrust of Islamic financial endeavors classified under the banner heads of either intermediary or

[11] Gharar is the sale of probable items whose existence or characteristics are not certain, due to the risky nature which makes the trade similar to gambling.

transaction-based arrangements. As a point of reference it also should be noted that hybrid contracts have become increasingly popular over time in areas of financial engineering and active asset/liability management.

Figure 1



Source: El-Hawary & Grais: 2004

The primary modes of finance are intermediary in nature and include, but are not limited to, *mudaraba, amana*[12] *and takaful*[13]. M*udaraba*, being one of the primary forms of investment, begins through the development of a partnership between the investor and entrepreneur (El-Hawary, Grais & Iqbal, 2004: p.6). The investor provides capital while the entrepreneur has particular expertise in a given industry providing the subtext for an agreement to share the profits working with the financial intermediary (Chapra & Khan, 2000: p.85). As a consequence of the type of enterprise, the investor's rights to recoup funds in the event of losses are curtailed unless demonstrable evidence is available indicating that negligence and/or malfeasance has occurred. Losses in some form or another are borne by all parties, as the entrepreneur has sacrificed time, opportunity cost, personal effort as well as

[12] Amanah generally translates to trust, and in the banking context, refers to items held in trust and made available upon request. It takes the form of daily chequing accounts on one hand and safety deposit services on the other.
[13] Takaful in Arabic, means joint guarantee. Thus it can be visualized as a pact among a group of members or participants who agree to jointly guarantee among themselves against loss or damage that may inflict upon any of them as defined in the pact

reputational risk with other banks for future investments. Thus, loss is borne by all parties in a relatively equal manner though the manner in which loss is suffered by design is different based on the specialized contribution (El-Hawary, Grais & Iqbal, 2004: p.24). This is premised on available and efficient relaying of relevant financial information relating to the particular investment.

On the other end of the spectrum are transactional contracts, which are geared towards trade arrangements like *murabaha*[14], *salam*[15] and *mua'jal*[16], generating new opportunities for trade via efficient capital mobilization. The funds provided to borrowers are used for durable consumer goods on one end of the continuum and capital goods on the other making their application relevant to the day to day operations of companies and citizens alike (El-Hawary, Grais & Iqbal, 2004). Though these finance vehicles can be likened to asset based lending in the conventional sense, differences can be attributed to the scope of a potential claim. Islamic instruments are limited to individual assets, whereas their conventional counterparts are linked to an aggregate of assets (El-Hawary, Grais & Iqbal, 2004: p.8), thus creating a financial claim against an asset which is characterized by a short-term maturity and low risk (El-Hawary, Grais & Iqbal, 2004: p.8).

Averting moral hazard and creating transparent institutions are primary goals undergirding success and long term viability to Islamic financial industry and therefore need to be clearly defined with appropriate regulatory safeguards in place (IJIFS, 2001: p.4). Though profit and

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[14] Murabaha involves three parties - the buyer, the seller and the bank. Under this arrangement, the bank acts as an intermediary trader between the buyer and the seller

[15] Salam is a term used to define a sale in which the buyer makes advance payment, but the delivery is delayed until some time in the future. Usually the seller is an individual or business and the buyer is the bank.

[16] Bay Muajjal is defined as a sale for which payment is made at a future fixed date or within a fixed period. In short, it is a sale on credit.

its pursuit link both conventional and Islamic banks, there are fundamental differences in the manner in which profits are generated in an Islamic financial institution vis-à-vis conventional banks. Replacing interest based lending, characterized by guaranteed income, with cost plus financing and partnership(s) associated with risk by design, would limit the profit margin available to Islamic financial institutions. At the same time, the offering of these specialized financial services fills a void in the international economy creating new pools of wealth and sources of funding.

Bank Structure

Open and transparent[17] procedures are a prerequisite for a successful banking system whether Islamically or conventionally oriented. However, with reference to Islamic banking and its unique structure, depositor monitoring processes and investor supervision are actively encouraged as cornerstones of the idyllic Islamic economy (Obaidullah, 2005: p.5). As a working model, Islamic banks have to date operated in either one of two banking configurations; *Two-Windows or Two-Tiered structure* (Sundararajan & Errico, 2002: p.4).

The two-window approach emphasizes clearly defined deposit classification and therefore is divided into two sections: one for chequing and the other for investments with the option being left to the client (Errico & Farahbaksh, 1998: p.9). Current deposits are guaranteed by the bank, being held in trust and are repayable in full on demand. This type of deposit earns no revenue by virtue of its availability (Sundararajan & Errico, 2002: p.25). The relation

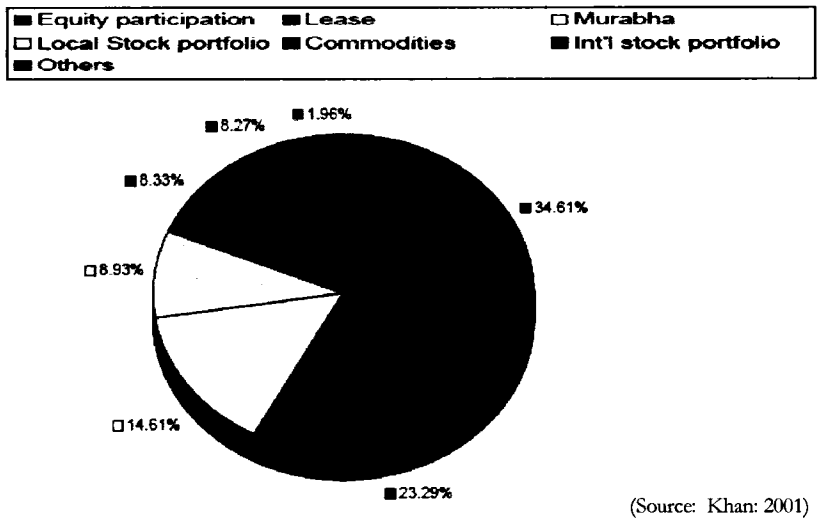
[17] The Merriam-Webster dictionary (http://www.m-w.com/) provides several definitions of transparency; those applicable in a financial context include: easily understood or detected; guileless; open. Transparency is understood as fully revealing the true financial picture of a financial institution. Transparency insures that reported financial data reflects reality. If there is a change in the financial status of a reporting entity, full transparency requires that that change be reflected accordingly and instantaneously to all concerned. Fons, J.S. (1998). Improving Transparency in Asian Banking Systems. Chicago. Moody's Investors Service

binding the bank and the depositor is based on the principle of amanah and not *mudharaba* relegating it to the *teller-services* side of the bank. Deposit provisions are clearly delineated, protecting clients whose main objective is safe keeping and daily chequing functions. To the contrary, investment deposits, those not deposited in trust are used to underwrite risk-bearing investment projects with the depositor's full awareness of the potential risk involved in the transaction (Sundararajan & Errico, 2002: p.24). An Islamic bank operating on the two windows approach offers various forms of deposit, investment and safekeeping options for clients.

With reference to the two windows approach, short term investment deposits that are asset backed are available ranging from one month and upwards and are redeemable on condition that formal notice is provided to the bank (El-Hawary, Grais & Iqbal, 2004: p.8). Consumer and trade finance are the primary activities of Islamic banks holding large pools of unused investment wealth. The advantage of this is minimized operational risk and loss provisioning (credit) as risk is mitigated through collateralized lending practices. The returns are distributed between depositors and the bank according to a predetermined ratio. Referring to joint enterprise:

> All partners contribute financially and share the profit as per pre agreed upon ratios, while the loss is shared according to the ratios of financial contribution of each partner. *Musharakah* is an ideal alternate to replace interest based lending with far reaching effects on both production and distribution of capital (Faysal Bank, 2005).

The majority of assets consist of investment accounts that are flexible liabilities. These take the form of equity investment, generally based on the principle of *mudaraba.* (Khan, 2001: p.4).



(Source: Khan: 2001)

The above chart is characteristic of the asset allocation of a two windows -Islamic bank involved in a variety of commercial activities. Though the single largest allocation is towards equity participation, leasing[18] financing comes in a close second indicating a balancing of risks in order to provide institutional stability. In addition, the *two windows* approach promotes a banking structure that, in some respects, is akin to conventional banking insofar as it offers a number of different forms of investment deposits, reserve ratio and safety deposit services. Alternately, the two tier approach offers a wider array of investment options with the intent to attract customer whose main objective is growth and income options.

The two-tier approach, upon careful examination, can be likened to specialized investment firms and wealth management consultancies offering expertise and investment vehicles to mobilize surplus funds. The two-tier approach, in essence, resembles an investment house dedicated to connecting depositors and borrowers under the guise of enterprise. As a

[18] The term Ijarah relates to usufructs of assets and properties, and means 'to transfer the usufruct of a particular property to another person in exchange for a rent claimed from another.

corollary, enterprise between lender and borrower is then classified as limited partnership insofar as the right to direct the enterprise and one-sided capital loss are curtailed. Common practice has led to a general rule where Islamic banks do not participate in an equalized capacity. *Mudharaba* relationships are designed so that those with surplus capital intent on financial growth can invest in certain projects and/or ongoing enterprises. However, there is no direct relation between the investor and the entrepreneur as the banks intermediate the allocation of capital (El-Hawary, Grais & Iqbal, 2004: p.8). The structure of the relationship involves two separate but connected legal relations. The first is between the investor and the bank, where investors act as supplier of funds to the bank on their behalf; the investors share in the profits earned by the business ventures tied to the investments (Obaidullah, 2005: p.57).

As intermediary, the banks offer detailed prospectus of the companies, and in some instances, the projects for which companies require finance. The investors, upon review of the various companies, make the decision to invest using the data provided by the bank. As such, a duty arises for which the bank must be fully confident of the financial information that they have provided as this is the primary basis upon which customers are making investments decisions. The entrepreneur, as a consequence, bears a responsibility to the financial institution for the information that is provided to them. As a disciplinary measure, the bank has the option to cut relations with entrepreneurs that provide inaccurate and misleading information. This ability to impose consumer sovereignty is also held by the investor over the bank. This is premised on the fact that everyone succeeds when cooperation occurs and the disciplinary measures available are capable of restoring confidence in the industry. As an individual institution, banks operating under the two-tier

approach are limited in their overall scope, due to the fact that a significant number of clients may not have the risk tolerance to withstand significant market downturn or poor performance. As such, the long term scope of these particular institutions will be limited in favor of a full service institution offering a wider range of services inclusive of current accounts for those simply requiring daily chequing and safekeeping.

Although the two investment methods appear similar, differences concerning how funds are invested and mobilized to capital deficit groups will have far-reaching consequences in the event of insolvency. While insolvency is not contemplated as an operating standard, every effort must be made to ensure that funds placed in *amanah* are kept under such conditions (Timberg, 2004: p.10).

Concerning the banks classification of deposits, if deposits are classified solely as equity investments without any depositor protection, in the event of downturn, the banks have the option to distribute the losses amongst the equity investors, in effect reducing the bank's losses at the expense of its investors (Bank Muamalat, 1998). In addition, the relationship structure is such that though clearly delineated rights and obligations between investor and the bank, and between the bank and borrower exist, there is no direct relationship between the investor and the borrower (Sarkar, 2003: p.6). In the conventional context, this is not a concern as the bank guarantees the principal and interest regardless of the financial position of the bank (CSI, 1999: s5 ss9); whereas in the Islamic context, risk by necessity is shared among all parties who stand to make a profit.

Comparing Conventional and Islamic Banking

As a starting premise, the most obvious difference between conventional and Islamic banking is the prohibition of interest as a legitimate source of revenue. In the Islamic context, it is recognized that risk cannot be avoided and consequently guarantees to income and revenue from extending credit cannot logically follow (Mirakhor & Khan, 1992: p.17). As a result of the prohibition, depositors are not creditors but investors when depositing funds with intent to make capital gains. This is a fundamental difference between an *investor* in the Islamic context and a *creditor* in the conventional context[19]. An investor, by definition is one of the financiers of the enterprise, liable for its debts to the extent of the investment, and receives a dividend if and only if profit(s) is (are) generated (CSI, 1999: s1 ss10).

Alternatively, the creditor, as a debenture holder, lends money without the risk of owning and/or operating the capital goods and claims profit regardless of the outcome of the venture (CSI, 1999: s5 ss1). Solvency of the borrower, and not failure of the venture, constitutes the major risk taken on by a creditor. Consequently, under the terms of a typical Islamic partnership arrangement, the relationship between borrower, lender and intermediary are rooted in cooperation and enterprise:

> Musharakah or shirkah can be defined as a form of partnership where two or more persons combine either their capital or labour together, to share the profits, enjoying similar rights and liabilities. Shirkah al-milk implies co-ownership without having entered into a formal partnership agreement. Shirkah al-uqood can, however, be considered a true partnership because the parties willingly enter into contractual agreements for joint investment and the sharing of profits and risks. (Haraan, 1995: p.6)

[19] As it relates to national taxation, gains and/or losses resulting from the investment of funds into an Islamic banking institution would likely be calculated according to capital gains/losses practices prevailing in the jurisdiction.

In both the context of *Mudaraba*[20] and *Musharakah*, access to information which is both current and accurate is paramount to the long term success of the industry. Moral hazard[21] can have severe consequences on the monetary well-being of financial institutions and investors alike (Gorton & Wilson, 2002: p.89). The corollary would naturally represent a loss of confidence not only to institutions, but for the industry as a whole. In order to avoid this, proactive steps need to be taken to provide investors with adequate means of review and supervision of the institutions and entrepreneurs alike (IFSB, 2001: p.8).

Though there are limitations to direct involvement of an investor in the context of a *mudaraba* contract, there are no proscribed limits on an investor's right to know the financial position of both bank and business. This brings to light issues of cost in pursuing full-disclosure, as institutions would be required to finance the cost of such a mechanism in its initial phase. Short-run costs are high and may not be evenly distributed but as a long term measure, transactional costs are reduced and information becomes readily accessible as regulatory bodies begin to take part on a more active scale. This will be addressed in more detail in the final chapter when a comprehensive plan to regulate Islamic finance is introduced.

Under the principle of *Mudaraba*, an investor bears the risk of losing the capital invested by the Islamic Bank, which means the investment risk is similar to that of the shareholders of a conventional bank who bear the risk of losing their capital as equity owners of the corporation (IFSB, 2001: s.85). A duty arises out of this relationship such that the bank must

[20] Rabb -ul- mal (capital's owner) provides the entire capital needed to finance a project while the entrepreneur offers their labor and expertise. Profits are shared between them at a certain fixed ratio, whereas financial losses are exclusively borne by rabb -ul- mal. The liability of the entrepreneur is limited only to their time, effort, reputation and opportunity cost.

[21] Moral hazard is the name given to the increased risk of problematical (immoral) behavior, and thus a negative outcome ("hazard"), because the person who caused the problem doesn't suffer the full (or any) consequences, or may actually benefit.

defer to management, investors and shareholders alike in the decision making process. Islamic banks, as part of open and transparent operating procedures, concede the investors' right to monitor the performance of their investments and the associated risks, and are required to provide adequate means to ensure that these rights are observed and exercised. This is premised on the fact that effective market discipline presumes relevant information is available to the market, as well as the ability of market participants to implement disciplinary measures (IFSB, 2001: p.31).

According investors the right to monitor their investments gives due recognition to the investor's interest and ownership of the funds (IFSB, 2001: p.91). Conceptualizing 'investor ownership' is central to corporate governance; it is the disjointing of ownership from managerial control that produces a situation where the interests of owner and its fund manager ultimately deviate, making supervision and oversight paramount to actualizing any reliable model of corporate governance (Grais & Maglione-Piromallo, 2001: p.8). In order to achieve this, efficiency in relaying financial information facilitates the achievement of the common objectives that have been pursued by regulators: market development, financial stability and inclusion (CSI, 1999: s1 ss4 & ss5). Accessibility of information and full disclosure in the context of an Islamic bank promotes financial and social inclusion as investors are able to review and monitor the ongoing decisions made by the fund manager(s). By providing investors with the necessary information and the forum within which concerns may be voiced, actions taken by fund manager(s) can be challenged, reviewed and ultimately tailored more specifically to the interests of the investors.

As part of an ongoing economic program, market development and financial stability are designed to create conditions where high rates of employment, lower costs of living and increasing incomes for citizens are realizable (Timberg, 2004: p.8). In order to realize these three aforementioned objectives, stability within the financial system is a basic requirement and is achieved alongside established and secure financial institutions operating with high consumer confidence premised on transparency. Hence the reason for an alternative regulatory regime as oversight body to the Islamic banking sector in order to secure stability and development. This development is indicative of a shift towards increased reliance on investor participation, market development, performance monitoring and the exercise of both consumer sovereignty and market discipline (Grais & Maglione-Piromallo, 2001: p.5). This new trend in market involvement has signaled a move away from the current regulatory direction (centralization), towards an emphasis on specialized risk management focusing on functions as opposed to organizations and an increased reliance on market participation as a complement to official supervision (Chapra & Khan, 2000: p.65). Financial intermediation in the Islamic context as described above involves changes in which equity, debt, and ultimately profits and losses are distributed, resulting in a need to re-examine the accounting practices employed in day-to-day banking.

Differences in Accounting Practices

In recent times, there has been a push to standardize international accounting practices under one banner in order that efficiency, compatibility and clarity result in a highly globalized economic environment (Hoesseini, 2006). While such an effort, in theory, brings forth many advantages concerning international trade and investment, it does not account for the differences in economic thought between Islamic and Western economies (Chapra &

Khan, 2000: p.65). The impact of Islamic finance, and as a by-product, Islamic economics, is still in its developmental stage such that the full breadth of its impact on international finance is not known (Sundararajan & Errico, 2002: p.10).

The exclusion of interest in banking coupled with the import of specifically Islamically-oriented "taxes" such as *Zakat*[22] and *Khums*[23] requires that banks engaging in Islamic finance would necessarily have different reporting requirements vis-à-vis conventional accounting. It should be borne in mind that the collection of these taxes outside of an Islamic state would not eliminate the obligations of citizens to the state of any tax remittances and are generally classified as charitable donations. One of the most striking differences between conventional and Islamic banking concerns the classification of corporate identity. In the Islamic context, a *proprietary theory* to enterprise is applied where the proprietor/owner is the primary point of interest (Troberg & Ekholm, 1995: p.2). The balance sheet formula is stated as follows: Assets minus Liabilities are equal to proprietorship (Troberg & Ekholm, 1995: p.2). The assets are assumed to be owned by the proprietor, and as such any liabilities are obligations of the proprietor, unless otherwise stated (Troberg & Ekholm, 1995: p.2).

As a consequence, revenues are classified as increases to the proprietary value and expenses conversely decrease the overall value, and as such net income accrues directly to the owners. The proprietorship then is considered to be the net value of the business to the owners (Hendriksen, 1982: p.453). In the conventional context, an *entity theory* to financial institutions

[22] Zakat is the third of the Five Pillars of Islam in Sunni Islam and one of the Branches of Religion in Shi'a Islam. Zakat refers to spending a fixed portion of one's wealth for the poor and needy in the society. Its literal meaning is 'to grow (in goodness)' or 'increase', 'purifying', or 'making pure'

[23] Khums is an article of faith that refers to a one-fifth tax, which all adult Muslims who are financially secure and have surplus savings income are required to pay annually on savings, net commercial profits, and all moveable and immovable property which is not commensurable with the needs and status of the person.

is applied which states that the firm is considered to have a separate existence and legal personality of its own. The *entity theory* is premised upon the fact that assets are equal to equities (Troberg & Ekholm, 1995: p.3). The main difference between the liabilities and owner's equities is that the valuation of rights of the creditors can be determined independently of other valuations if the firm is solvent, while the rights of the stockholders are measured by the valuation of assets originally invested plus the valuation of reinvested earnings and subsequent revaluations (Troberg & Ekholm, 1995: p.3). Furthermore, any right to receive dividends and share in net assets upon winding up are rights as equity holders, rather than rights ascribed to specific assets (Hendriksen, 1982: p.453). Relating to asset and liability management, Islamic banks rely first on the balance sheet and then the income statement and are required to follow *current value accounting* which by design is concerned primarily with the increase or decrease in the cost of specific assets (Hoesseini, 2006: p.11). Income is not considered to be earned until the corporation has maintained its capital in current value terms (Hoesseini, 2006: p.11). Assets are valued at what they could be sold for, less administrative costs.

The primary focus of a conventional banking model is on the income statement followed by the balance sheet. The classification of assets and liabilities are related to the going-concern assumption, which views the value of a company as an ongoing enterprise (Lamar, 2002: p.6). As such, its value differs from the value of a company's assets if liquidated. By doing so, the ongoing operation has the ability to continue to earn profit, while a wound up company cannot (IFAC, 2000: p.6). Undergirding the going-concern principle is the role of conservatism in accounting. Its pervasiveness in accounting as the premier model of asset and liability valuation is such that Sterling concluded conservatism to be the single most

important principle of valuation in accounting (Fan & Zhang, 2005: p.1). This was further bolstered by Basu (1997) who argued that conservatism, while pervasive in the modern economy, has influenced accounting practice for over five hundred years (Fan & Zhang, 2005: p.3).

Conclusion

In the context of Islamic finance, a relatively young industry steadily increasing, what level of participation by Islamic banks in consolidated bank supervision is desirable at the present time? The differences in accounting practice arguably are enough to justify alternative regulatory measures to supervise Islamic banks alongside the current efforts spearheaded by the U.S Securities Exchange Commission (Archer & Karim, 1997: p.110). Through this chapter, the foundation(s) of Islamic finance has been outlined leading to a discussion as to where divergence between conventional and Islamic banking exists, the result of which is that both form and structure differ between the two and this has a direct impact on how effective existing regulatory efforts will be in this particular context. The intent of this has been to illustrate the point that where fundamental dissimilarity exists, a single form of oversight may not be prudent for the long term prospects of a newly developing industry. Simultaneously, the role of regulation for Islamic finance is still developing and further improvements to bank supervision are required to ensure both investor and depositor are protected from institutional mismanagement. Leading into a discussion of current supervisory practices, the following chapter(s) will outline in greater detail, the present position of the BCBS relating to international bank regulation. It should be noted that the BCBS has also taken steps to account for the differences between conventional and Islamic banks, which too will be explored.

Chapter Two – Governance, Legalization and the Emergence of Global Administrative Law

In the first chapter, I explored the role of Islamic finance as an alternative to the conventional interest based banking system. In this respect, both conventional and Islamic banks were discussed on a micro level without of any reference to an overarching regulatory body. Islamic finance, as demonstrated in the preceding Chapter, is based on an interest free framework. Further to that, risk sharing as an operating norm requires that participants take an active role in the wealth creation process (Chapra & Khan, 2000: p.4). Opposite to that is conventional banking, which is premised on the existence of a time value of money irrespective of effort. In place of participation, a fixed principle of borrowing costs is in practice (CSI: 1999; s5 ss9). Characterized thus, both systems stand at opposite extremes of one another making the notion of unified oversight difficult to fathom. However, the role of oversight need not resemble policing but rather a mix of self regulation and intergovernmental oversight. In the context of Islamic finance, the objective is to facilitate meaningful entrance into the global finance sector. In order that appropriate supervision can occur, this study explores the importance of introducing regulatory options that reflect the current banking environment. In this respect, the proposed framework for this activity should be governance-based and in particular looking towards a global administrative construction. As such, this chapter explores the potential for Islamic banking to be regulated by way of governance that incorporates both hard and soft law along a rules-based continuum. The starting point of unified oversight should be premised on convergence, moving from similarities to areas of divergence.

The primary intent of this chapter is to describe the concept of governance and its emergent role in the international banking sector specifically. In respect to governance, the emergence of Global Administrative Law (hereinafter GAL) will be explored, indicative of the formation of international administrative bodies governing global economic transactions. In the international economic context, global finance has progressively moved towards an integrated system premised on the easy movement of capital, knowledge and goods. In order to facilitate such a transition, efforts have been made to induce countries to adopt similar banking and commercial practices in order to smooth the process of global integration. This has taken form in two main ways, and a range in between: through non-binding declarations issued jointly between like minded nations on one side, and through the creation of rules based systems advancing compliance through obligation on the other.

The thrust of this chapter is the need to create a more expansive governance structure for international bank supervision that addresses the salient differences between Islamic and conventional banking. The focus initially will concern governance generally, and in particular, global administrative law (GAL) as a manifestation of the emerging means of supervising international economic relations. The connection between governance and GAL can be understood in terms of the application of administrative action: rulemaking, administrative adjudication between competing interests, and other forms of regulatory and administrative oversight prevalent in the international economic system (Kingsbury, Krisch & Stewart, 2005: p.17). The emergence of GAL as a recent development is indicative of new patterns of governance shaped by day-to-day consensus building activities at the international level. The importance of GAL in the context of international bank supervision can be understood as engaging regulators in dialogue concerning the need for a more

inclusive approach geared towards a rules-oriented framework reliant on soft norms to govern the financial sector.

The section following the general discussion of governance and GAL will outline the salient features of *legalization* in its application to international legal relations. Within a larger context of governance, legalization focuses on the variety of options (Hard Law vs. Soft Law) at the disposal of lawmakers along a rules-based continuum when negotiating treaties and agreements. For purposes of this work, conceptualizing legalization will assist in the final determination of a regulatory framework for addressing the concerns of Islamic banking in a conventional banking system.

Governance and the Emergence of Global Administrative Law

Governance, as an overarching theme in current international relations dialogue, has led to cutting edge research on the application of governance theories to the global political economy. Part of this research has focused on defining the fundamental elements of governance. Governance has been associated with "governing," or with political authority, institutions, and, ultimately, control (Rosenau, 1999: p.298). Governance in this particular sense, denotes formal political institutions that aim to coordinate and control interdependent social relations and with the ability to enforce decisions (Rosenau, 1999: p.298). James Rosenau has used governance to denote the regulation of interdependent relations in the absence of overarching political authority, such as in the international system (Rosenau, 1999: p.298). Keohane and Nye have defined governance as referring to the emergence and recognition of

> principles, norms, rules, and procedures that both provide standards of acceptable public behavior and that are followed sufficiently to produce behavioral regularities. Governance, thus defined, need not be conducted by governments – international organizations, private firms, associations of firms, NGOs, and associations of NGOs all engage in it (Keohane & Nye, 2000: p.10).

It has been further argued that governance and its primary focus concern the ability of groups with differing interests to come together in resolution of conflicting issues. Kohler-Koch defined governance in terms of inclusiveness and as "concerning the ways and means in which the divergent choices of citizens are translated into effective policy choices, about how the plurality of societal interests are transformed into unitary action and the compliance of social actors is achieved" (Kohler-Koch, 1999: p.14). Weiss and Thakur have defined governance as;

> the complex of formal and informal institutions, mechanisms, relationships, and processes between and among states, markets, citizens and organizations, both inter- and non-governmental, through which collective interests on the global plane are articulated, rights and obligations are established, and differences are mediated.(Weiss & Thakur, forthcoming).

Re-framing the debate on governance, Anne Marie Slaughter argues that governance needs to be viewed in light of the rapid growth of transnational regulatory networks insofar as these transnational regulatory networks "offer a new vision of global governance: horizontal rather than vertical, decentralized rather than centralized, and composed of national government officials rather than a supranational bureaucracy"(Slaughter, 2002: p.193). In developing her thesis, Slaughter further argues that precisely because of the horizontally oriented, decentralized approach, "they are potentially both more effective and more accountable than traditional international institutions, at least for some purposes" (Slaughter,

2002: p.193)[24]. The definitions above reference the interface between citizens, government, corporations, non-Governmental organizations and intergovernmental organizations (hereinafter NGO's and IGO's respectively) as primary participants in governing, working both in concert and opposition towards various ends. This represents a paradigmatic shift in thinking from the current system to that envisaged as ideal. The present system of international relations is primarily geared towards state to state interaction, with private actors and citizens holding secondary and tertiary positions. Further to that, the system also places primacy on the territorial boundaries of nation-states. As indicated, this model of international relations represents a past vision of the global community which has been replaced by a move towards decentralization in the context of global governance[25].

In expanding the scope of governance, we can further break down governance in two ways: relations-based and rules-based (Davidson 2006: p.2). Relations-based governance represents an informal approach to international relations placing greater influence on the relationship between the parties in the context of the negotiations, whereas rules-based governance relies on formal third party institutions to "enforce" arrangements. The following section seeks to clarify the salient differences between the two.

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[24] For a detailed discussion on the expansion of transnational regulatory and government networks, refer to Slaughter, A.M. (2002) Governing through Government Networks., in Held, D. & McGrew, A. (eds.) The Global Transformations Reader. Cambridge: Polity Press.

[25] This point should not be confused with arguments intimating the total collapse of the Westphalian system of international relations as Keohane rightfully argues that, "neither states nor transnational relations will replace one another; for sovereignty neither remains intact under existing forms of complex interdependence nor is it wholly eroded" (Held & McGrew, 2002: p.123). Keohane further argues that sovereignty understood in Westphalian terms has undergone substantive changes "as it has become less a territorially defined barrier and more a bargaining resource for a politics characterized by complex transnational networks" (Held & McGrew, 2002: p.123).

Relations-Based Governance

Davidson defines relations-based governance as reliant

> on the personal relationship of the actors to establish the parameters of their cooperation. Agreements are based on the mutual relations of the actors, and depend on knowledge of and familiarity with each other. Formality is avoided, and the maintenance of good relations is relied on for the 'enforcement' of commitments. (Davidson 2006: p.2)

Good relations then form the basis for present compliance and future cooperation. The relationship itself is premised on the potential for mutual benefit through state interaction. Each and every transaction between states helps to further solidify relations, clarify standards and promote consistency, ensuring smooth and uninterrupted interaction, adding to the efficiency and ultimately profitability of the relationship. If however, relations begin to sour, the role of good relations as enforcement mechanism diminishes forcing recompense to be sought through other means. The informality of the relations based model becomes evident in the event of dispute between participants. In many instances, an independent dispute settlement mechanism has not been created, as the intent of the participants is not to resort to formalized legal relations. Predictability in cases of dispute resolution also poses a concern because the calculability of outcomes does not translate in situations where defined processes do not exist.

The relations of East Asian states have focused on engagement and dialogue amongst one another seeking to enhance cooperation and solidify their relations (Goldstein *et al.,* 2000: p.3). This can take many forms; however, the relation will always be based on trust, indicating the primacy of character in the negotiator. In place of rigid, inflexible systems, a collegial approach to international relations is pursued. It was recognized early on that

unanimity of opinion would prove difficult to achieve as the outcomes generated for each member state could not be comparable to one another. This is attributed to the numerous issue linkages and policy spillover between states. Decisions made by one state on a given subject matter are likely to resonate with policy makers elsewhere, influencing outcomes of seemingly unrelated issues.

Rules-Based Governance

On the other hand, in the context of a rules-based system, the peculiarities associated with individual relations are eliminated, and in their place, rules and regulations, defining in clear and distinct language the extent to which obligations exist and between whom and how redress is to occur are presented leaving little room for doubt. In defining the extent to which rules-based governance impacts states, Davidson goes on to state that:

> 'Rules-based' governance relies more on structures and their functions. 'Rules-based' governance is more formal and involves the negotiation of detailed binding rules to govern the cooperation among the actors, and the establishment of dispute settlement mechanisms to resolve disputes in accordance with the rules. (Davidson 2006: p.2)

With reference to the aforementioned definition, the aim of rules-based governance entails increased predictability and efficiency within the given framework. Ultimately, the objective is to create an economic environment conducive to increased trade whose outcomes are generally knowable and continually seek to improve the transaction process (Davidson, 2005). States recognizing the importance of this in relation to their own domestic wellbeing endeavor to clearly define the extent of legal relations. As part of the process, definitions and boundaries are clearly delineated during the initial negotiation process with the intention of providing patent direction concerning the extent of enforceability of decisions. In doing so,

questions of commitment, accountability and enforcement that require clarification are suitably vetted prior to any dealings. Compliance is further enhanced though the establishment of dispute settlement bodies that are endowed with recognized authority and political influence, which assist in the day-to-day functions and enhance the perceived legitimacy of the body. The driving force behind the surge in popularity of rules-based governance in the present era stems from a desire expressed within the regulatory and business community for greater stability, predictability and consistency within the expanding international economic system. As trade expands and the significance of borders diminishes, there is a recognized need to create a governing framework at the international level that will effectively manage the increase in global economic output.

Though both relations; and rules-based systems are able to coexist side by side, changes in the course of the global political economy, ranging from expansion of international trade and investment as well as the rapid economic growth at the domestic level could impede sustainable co-existence (Dixit, 2002: p.11). Li cites three main factors to the detriment of relations-based governance approaches beyond a smaller contingent of states. First, non-transparency between states, second, the lack of verifiability of information provided, and finally the relational-specificity between states (Shuhe Li, 2000: p.18). In the context of an expanded set of negotiators, Li further states that it is "very costly to establish cross-country governance mechanisms among economies with relation-based governance and between economies with relation-based governance and economies with rule-based governance"[26] (Shuhe Li, 2000: p.18). Accordingly, it is likely that this mix of rules, and relations-based

[26] For a detailed discussion concerning relations vs. rules based governance, refer to Shuhe Li, J. (2000) The Benefits and Costs of Relation-based Governance: An Explanation of the East Asian Miracle and Crisis, in Governance Working Papers 209, East Asian Bureau of Economic Research.

governance mechanisms will begin to diminish moving towards a rule-based system emphasising the ongoing generation of norms as well as reliable forms of enforcement (Davidson, 2006: p.3)

Global Administrative Law

Manifested by an increased desire for a substantive governing framework at the international level which is not premised on a state-oriented model, international law-makers and political actors alike are looking towards administrative law as a source of guidance, opening the "possibility for the emergence of private, non-state based, or non-state legitimated authority" (Biersteker & Hall 2002: p.5). This has culminated in the "idea that authority does not necessarily have to be associated with government institutions" (Biersteker & Hall 2002: p.5). Though in past times, administrative law has been the sole jurisdiction of states, it has begun to change. The recognition of the emergence of private influence in the international system has prompted research concerning the re-organization and materialization of legitimate authority in the governance of the global political economy. Global administrative law as an analytical framework draws on the individual practices associated with different forms of administrative action, having recognized the common thread linking them to one another pointing towards a growing trend in the use of administrative-law type mechanisms for holding global regulatory governance accountable.(Kingsbury & Krisch 2006: p.3) Couched in the language of a *New Governing Order* is the idea that states no longer occupy the central role in negotiation and that the centrality of states in the international system is altogether called into question.

In place of state to state interaction is the notion that a decentralized international system premised on the interplay between private and public bodies ultimately represents the best strategy to address changes (intended or otherwise) brought about through the ongoing globalization process. In conceptualizing the boundaries of global administrative law, Kingsbury and Krisch argue that the majority of what is understood as global governance finds its roots in administration (Kingsbury & Krisch 2006: p.3). Furthermore, they argue that such administration is often organized and shaped by principles of a domestically defined administrative character. Coinciding with the expansion of global governance, many of these domestically defined administrative and regulatory functions are now performed in the global context (Kingsbury & Krisch 2006: p.3)

To that end, Global Administrative Law is emerging as the predominant model by which these changes can be effectively managed and contained. Kingsbury, Krisch and Stewart define global administrative law as "comprising the mechanisms, principles, practices, and supporting social understandings that promote or otherwise affect the accountability of global administrative bodies" (Kingsbury & Krisch 2006: p.3). Transparency, participation, reasoned decision, legality, and effective review of the rules and decisions all form the basis of GAL (Kingsbury, Krisch & Stewart 2006: p.3). The critical link between the shift to rules-based governance and the emergence of Global Administrative Law is understood as a further expansion of the boundaries of rules-based governance. As the theoretical component, rules-based governance is premised on rule creation, application and compliance. However its applicability is limited insofar as governance represents a broadly construed set of ideals. Global Administrative Law, in the alternate, represents a concerted effort to effectively manage the global political economy in a robust manner. Further to that,

it also represents a cutting-edge model concerning the expansion of private/public authority in the international economic system that reflects the particularities of the present globalism.

The relevance of Global Administrative Law to this thesis stems from the recognition that banking, whether domestic or international, is a complex affair involving numerous forms of regulation and supervisory oversight. The addition of Islamic banking into the regulatory fold undoubtedly will further complicate the situation. Islamic banking as has been demonstrated in Chapter 1, starts from a different operating premise than conventional banking which is manifested in a different set of legal relationships between banker, client and shareholder. How then can the two competing visions of banking be effectively regulated under the guise of one oversight body? As part of an overall strategy that I intend to explore and develop in the course of this thesis, Global Administrative Law can and does already play an important role in international bank supervision. I also argue that in order for Islamic banking to grow and develop in an enabling international environment, Global Administrative Law needs to play a more central role in that process.

Global Administrative Law, as a field of inquiry, is still in its infancy; however, its relevance should not be undervalued. The relevance of GAL can be best understood in relation to a shift towards global political and economic integration. The role of Global Administrative Law, as a manifestation of the highly legalized nature of international economic relations, is rooted in the growth of a global administrative space (Kingsbury, Krisch & Stewart, 2005: p.19). Recognition by states of emerging forms of private authority in the international system, then manifested by a measured increase in transnational cooperation between

governments, has been of pivotal importance in expanding administrative spaces. The emergence of this is understood as a place

> in which the strict dichotomy between domestic and international has largely broken down, in which administrative functions are performed in often complex interplays between officials and institutions on different levels, and in which regulation may be highly effective despite its predominantly non-binding forms (Krisch & Kingsbury, 2006: p.14).

Assuming that the necessary safeguards are in place allowing for notice and comment procedures and other forms of administrative oversight[27], the scope of GAL is expanding as this administrative area develops. Kingsbury, Stewart and Krisch, in defining the scope of Global Administrative Law, characterize regulation in one of five ways: (Kingsbury, Stewart & Krisch, 2005: p.20)

1. Administration by formal international organizations such as the UN Security Council, the International Criminal Court or the Financial Action Task Force.

2. Administration based on collective action by transnational networks of cooperative arrangements between national regulatory officials best described in the mandate of the Basel Committee on Banking Supervision.[28]

3. Distributed administration conducted by national regulators under treaty, network, or other cooperative regimes for which the Appellate body of the WTO stands out as an example.

4. Administration by hybrid intergovernmental–private arrangements such as the Internet Corporation for Assigned Names and Numbers (ICANN), which was established as a non-governmental body.[29]

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[27] Notice and Comment procedures (a process central to Global Administrative Law insofar as enhancing participation, transparency and accountability is concerned) describe an interactive process that seeks to include the wide array of opinions from stakeholders associated with a proposed change to policy, procedure and/ practices. Its use is common in administrative law where various groups are informed of proposed rules before they take effect and are afforded an opportunity to comment on the proposed rules and provide additional data to the organization issuing the notice and comment. As part of open, transparent and accountable practices, stakeholders are also able to access the record as part of their analytical process. In turn, the issuing agency analyzes and responds to any comments and thereafter creates a permanent record of the process. The actions of the organization may also be subject to review to ensure the validity of the process

[28] This form of administrative action entails the absence of a binding formal decision making structure dominated in large part by informal cooperation among state regulators, and in the context of Islamic bank supervision, will constitute the general view towards financial sector integration.

5. Administration by private institutions with regulatory functions can be understood by way of the example of the SWIFT system for letters of credit (Society for Worldwide Interstate Financial Telecommunications).

The relevance of the aforementioned scope of regulation to the present discussion is understood in reference to the multiplicity of options that can be incorporated into a governing framework. The second option exemplified by the Basel Committee on Banking Supervision is of direct relevance to the discussion based on the decentralized and informal manner in which the BCBS operates. This will be further developed in the pages ahead.

In looking at the current international system as moving away from a rigid state to state structure and refocusing on the expansion of a global space[30], what becomes apparent is that the growth of a global administrative legal regime capable of facilitating international economic transactions efficiently is on the horizon. Its success will be contingent on the majority of stakeholders standing in approval of these measures expanding the scope of its legitimacy.

Global Administrative Law provides the potential for a more diverse group of stakeholders to be included in the governing process. GAL also represents a clarification of the boundaries of governance in its application in the global political economy. Enhancing this process is the ability of a large variety of public and private actors and agents to provide feedback by way of notice and comment provisions associated with resolutions and

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[29] ICANN as an organization has undergone many changes in its constitution. Though originally modeled as an NGO, the groups "has come to include government representatives who have gained considerable powers, often via service on ICANN's Governmental Advisory Committee, since the 2002 reforms"(Kingsbury, Stewart & Krisch, 2005: p.22).

[30] The Global Space referred to here intimates the notion that as state-based authority continues to erode and private actors engage in rule-making and decisioning, locations wherein private authority is exercised is increasing. For detailed discussion, refer to Biersteker, T.J. & Hall, R.B. (2002) The Emergence of Private Authority in the International System., in Biersteker, T.J. & Hall (eds.), The Emergence of Private Authority in Global Governance. Cambridge: Cambridge University Press.

recommendations. In the context of the Basel Committee on Banking Supervision, the coming section will focus on GAL in action, and will explore the incorporation of informal, transnational networks as reflected by Kingsbury *et al.* in the designation of administration based on collective action.

The Basel Committee on Banking Supervision as an Example of Global Administrative Law

One of the best examples of GAL in general, and transgovernmental regulatory networks in particular, is the Basel Committee on Banking Supervision. Slaughter argues that this form[31] of transgovernmental interaction is more highly developed in the financial regulatory area than in any other and furthermore, that the Basel Committee's processes exemplify the distinctive nature of transgovernmental regulatory cooperation in the international community (Slaughter 2000: p.181). The primary nature of the Committee is based on collective action characterized by informal networks, and it is acknowledged that "the development of close personal contacts (facilitated by the BCBS) between supervisors in different countries has facilitated the resolution of problems affecting individual banks" (BCBS, 1995: p.14). It is also recognized that the evolution of the group as a recognized leader in the realm of international banking has not gone without challenges[32] (Zaring, 2005: p.9). The Basel Committee on Banking Supervision is an institution that meets under the auspices of the Bank for International Settlements (BIS) located in Basel, Switzerland (BIS, 2006: p.1). The composition of the Committee is reflective of the modern industrialized economies representing the distribution of international power post World War II. The members include the U.S, Canada, Japan, France, Germany, Italy, Spain, the United

[31] Administration based on collective action by transnational networks of cooperative arrangements between national regulatory officials best described in the mandate of the Basel Committee on Banking Supervision

[32]Originally conceived of as a tight-knit group of like-minded central bankers, claims pointing to the lack of transparency and participation haunted the group and ultimately the legitimacy of its pronouncements.

Kingdom, Belgium, the Netherlands, Luxembourg, Sweden and finally Switzerland (Zaring, 2005: p.7). Originally conceived of as the panacea to the failure of Germany's Herstatt Bank[33], the "Club" as it came to be known, embarked on a campaign to coordinate and harmonize cross border banking practices in an effort to avoid other international banking crises similar to that of 1974 (BIS, 2006: p.1). The role of the BCBS was later extended in light of the BCCI scandal[34] which occurred in 1991. The events of 1991 catalyzed the committee to expand its mandate to include functions and powers allocated to the oversight of international banking conglomerates in respect to money laundering and terrorist financing (Kapstein, 1994).

As it relates to transparency of decision-making, the BCBS, as indicated above, is comprised of central bankers and national regulators who are outside the conventional domain of public scrutiny (Zaring 2005: p.8). Barr and Miller envisage the committee as "perhaps the most important example of a transgovernmental regulatory network that exercises vast powers, seemingly without any form of democratic accountability" (Krisch & Kingsbury, 2006: p.8). Yet, they go on to state, that within the Basel process lay a "structure of global administrative law… that could be a model for international rule-making with greater accountability and legitimacy" (Krisch & Kingsbury, 2006: p.8). These perspectives confirm some basic assumptions: Basel as an oversight mechanism is flexible, accommodating

[33] One of the most famous examples of settlement risk in the foreign exchange markets, occurring in 1974; Herstatt bank in the course of its daily banking activities had accepted all its currency receipts from its European market, however was yet to make any of its US dollar payments when German bank supervisory officials closed down the bank at the end of the business day. Unsecured counterparties were left without any form of recourse.

[34] The BCCI or the Bank of Credit and Commerce International was one of the premiere international banks founded by Agha Hasan Abedi and his assistant, Swaleh Naqvi in 1972 in Pakistan. In its prime, the bank owned well over 400 branches holding assets in excess of $25 billion operating in 78 countries. The focus on BCCI began in 1991 in what had been called one of the world's worst financial scandals involving the misappropriation of $20 billion. John Kerry in a report to the Committee on Foreign Relations of the United States Senate indicated that "unlike any ordinary bank, BCCI was from its earliest days made up of multiplying layers of entities, related to one another through an impenetrable series of holding companies, affiliates, subsidiaries, banks-within-banks, insider dealings and nominee relationships. BCCI was able to evade ordinary legal restrictions on the movement of capital and goods as a matter of daily practice and routine

changes to the financial and economic realities. The ability to quickly react to current market trends and re-position the global financial system to better withstand externalities has been a hallmark claim of the committee. The flexibility referred to concerns the lack of formal impediments to action (Zaring, 2004: p.8). This flexibility is also related to the fact that the drafters used simple and accessible language in formulating policies, deliberately avoiding the use of legalese to maintain the presence of informality (Slaughter 2000: p.183). The informal nature of the group, the outcomes declared, and the wide arrays of opinions sought from within the industry are indicative of a wider trend towards decentralized governance and as Slaughter correctly points out, precisely because of the informality associated with BCBS, and "unlike most treaties or other legal agreements, the 1988 Accord (Basel I) has been subject to frequent amendments since its promulgation and is intended to evolve over time" (Slaughter 2000: p.183).

This trend towards the increased prevalence of transgovernmental regulatory organizations, however, can have lasting consequences on the perceived legitimacy of these transgovernmental regulatory organizations vis-à-vis the public domain. As Kingsbury and Krisch argue, the informality associated with the Basel process may "serve to diminish transparency and may increase the potential for capture[35] by special interests, particularly the largest, internationally active financial institutions" (Krisch & Kingsbury, 2006: p.5).

However, the flexibility of the process allows for industry representatives, the public and interested parties to participate more effectively in domestic rule-making. The reasons for

[35] In this context, capture refers to the "phenomenon in which a government regulatory agency becomes dominated by the interests of the industry it oversees" (Laffont and Tirole, 1991; Levine and Forrence, 1990).

this relate to continuing access to the ongoing work of the committee as well as the involvement of domestic actors whose positions are more amenable to broad-based national interests. Miller and Barr argue that this informality coupled with continued efforts to make more transparent the inner workings of the BCBS "made it easier for competing interests to assess whether regulatory positions taken reflected capture by important industry players" (Barr & Miller, 2006: p.31). The ability of external groups to pinpoint instances of regulatory capture is an important part of the self-regulatory function embedded in the Basel process. More significant than the ability to merely pinpoint areas of concern is the capability to enact meaningful steps to correct actions and/or processes determined to be detrimental to the long term success of harmonized banking supervision. This is possible by way of the notice and comment procedures available to members and non-members alike where the introduction of best practices, policy and procedures are contemplated, the result of which allows for a malleable form of administrative action taken at the global level with the intent to harmonize the supervisory practices of central bankers and regulators alike.

In spite of concerns relating to capture, I argue that the current model of the BCBS provides the rudiments of a framework that would best exemplify the role of transgovernmental regulatory organizations in Global Administrative Law. This is due in part "because the Basel Committee develops standards that are intended to harmonize national rules, rather than standards that bind nations directly" (Barr & Miller, 2006: p.31), the result of which allows "each participant in the Basel Committee to choose how to implement the new accord domestically" (Barr & Miller, 2006: p.31)[36].

[36] Although this is considered both a blessing and a curse for many opponents of the Basel model (as it implies the option of differential application by states limiting the long term effectiveness of the mandate), in the context of Islamic finance, wholesale differences between Islamic and conventional banking systems and the ensuing difficulties of regulating such institutions are sufficient to warrant the possibility of differential application.

The following section introduces the concept of legalization and explores in greater depth the hard law/soft law continuum developed by Abbott, Keohane, Slaughter *et al.* In reviewing the current direction of the international legal system, Abbott, Keohane, Slaughter *et al.* have framed legalization as a form of institutionalization that categorizes along a continuum, the varying degree of obligation, precision and delegation available to states when formulating international agreements. Like any continuum, the purpose of identifying the full range of possibilities stems from the need to review all available options prior to deciding. In relation to the international legal system, the continuum takes on a norms-based character, and seeks to clarify the variety of possibilities available to regulators as well as charting the differing policy choices available to public and private bodies. Its relevance, as will be demonstrated, relates to the current discussion of governance and Global Administrative Law insofar as the flexibility offered through the legalization taxonomy provides the basis for a number of options to successfully incorporate Islamic banking into the international banking system. I argue that the nexus between Global Administrative Law and the concept of legalization can be understood in relation to the changes in the global political economy and the emergence of private authority in public spaces. Insofar as GAL clarified the broader conceptions of governance, legalization is the direct result of concerted efforts by academics and policy makers to re-frame international relations and represents a new nomenclature identifying and categorizing the various ways in which international actors can interact[37].

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[37] In the final chapter of this thesis, the Islamic Banking Supervisory Committee (IBSC) will be introduced as the ideal body to provide regulatory and supervisory guidance as it relates to Islamic banking. The concept of legalization which is about to be introduced will directly influence the form and substance of the IBSC as a sub-committee of the Basel Committee on Banking Supervision.

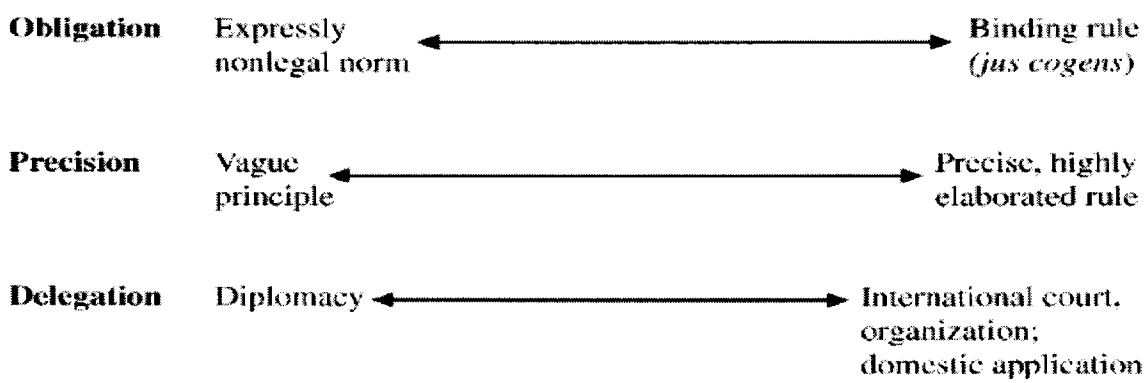
The Concept of Legalization

The thrust of this section is premised on the recognition of the increasing legalization of relations in the international legal system based on the expansion of the global economy and the emergence of GAL, which has expanded the involvement of various stakeholders representative of public and private interest. As will be demonstrated, legalization can take a variety of forms with differing degrees of enforcement, commitment and precision. For the purposes of our discussion, legalization in the context of international relations, applies not only to state-to-state interaction, but as well to private and public actors, agents and organizations.

Current international relations literature focuses on the characteristics of international law in the global context which, according to Abbot *et al.*[38] can be understood via a spectrum: soft law in a more flexible form on one end, and the more rigid examples of hard law on the other. To further clarify the spectrum, they have categorized the degree of legalization along three lines: obligation, precision, and delegation. Obligations can be defined to include both binding and non-binding provisions: meaning that arrangements can take on a range of forms from non-binding declarations to binding treaties (Abbott *et al.* 2000: 401). Precision relates to the degree of specificity and exactitude in delineating rules to define conduct they authorize, require, or proscribe (Abbott *et al.* 2000: 401). Finally, delegation refers to the degree to which third parties are granted authority to implement, interpret, and apply the rules such that a dispute resolution mechanism and an amendment process exist (Abbott *et*

[38] See, e.g., Abbott KW. (2000) Hard and Soft Law in International Governance. International Organization vol. 3-54 p. 421. Goldstein J, Kahler M, Keohane R.O. Slaughter A-M. (2000) Introduction: Legalization and World Politics. International Organization, vol. 3-54. Abbott KW. 2005. Toward a Richer Institutionalism for International Law and Policy. Journal of International Law & International Relations, vol. 1-8. Abbott KW, Keohane RO, Moravcsik A, Slaughter A-M, Snidal D. (2000) The Concept of Legalization. International Organization, vol. 3-54 p. 401. Helleiner, E. (1992) States and the Re-Emergence of Global Finance .New York: Cornell University Press

al. 2000: 401). This is further illustrated through graphic representation indicating the varying spectrums comprising the definition of legalization. (Abbott *et al.* 2000: 404)



By providing three separate spectra, the continuum(s) convey the variety of hard and soft law combinations available to states in the process of aligning foreign and domestic policies. Various combinations of governance and supervision can be categorized according to the basic elements. The WTO in the context of the aforementioned definition of legalization, represents "hard law" entailing binding obligation, precise meaning and provisions for adjudication by way of its dispute settlement mechanism (Abbott *et al.*, 2000: p.405). Conversely, the G20 nations represent "soft law" encompassing relative vagueness in its principles, limitations on its jurisdiction to impose extra-legal action and principles, premised on a non-binding, non self-executing model. For the purposes of this paper, the Basel Committee on Bank Supervision can be viewed as an administrative approach focusing on multi-state declarations, best practices and discussion papers in place of strict obligation, and as such, possesses no legal authority to bind members to its principles (Zaring 2005: p.9). Its sway is closely linked with that of G8 nations, which, although not an institution capable of issuing binding mandates, does exercise considerable authority in global economic issues. Although the sphere of influence held by the G8 nations is enormous, influential and to a large degree, representative of western political thought, the G8 nations do not possess

extra-legal powers as a group. Opposite of that would be an institution such as the International Criminal Court (hereinafter ICC) which, by definition, is a clear example of hard law. Treaty members are required to submit to the exercise of the ICC's jurisdiction (Abbott *et al.*, 2000: p.405). The decisions that are reached are precise and exacting insofar as punishment and compensation is concerned. In reference to delegation, assuming the court has custody, it has the power upon conviction to execute punishment in accordance with the decision[39].

The following sections will explore in brief the concepts of hard and soft law as they relate to the legalization process taking place in the international legal system. The intent of these sections is to introduce with clarity the positive and negative points associated with pursuing either form of rule making

Hard Law Defined

On the legalization spectrum, accord can be reached in a number of ways that include both soft and hard provisions. In respect to hard law, some basic assumptions are as follows: hard law by its nature obliges parties to adhere to the principles agreed to. Further to that, hard law as understood in relation to international law, entails the use of precise terms and conditions (Abbott & Snidal, 2000: p. 425). Finally, as hard law relies heavily on adherence, it employs third party investigation and dispute settlement mechanisms to ensure compliance (Abbott & Snidal, 2000: p. 421).

[39] Though the ICC has yet to hand down a decision, the principles upon which the Rome statute was formulated reflect a legal process that is based in hard law.

Regarding the efficacy of hard law as the primary source of rule-making and adjudication, the working premise guiding this research considers sole reliance on hard law as insufficient to regulate the changing structure of the global political economy. In past times, the reliance on hard law as regulator of state-to-state interface sufficed regarding the nature of international relations (Abbott & Snidal, 2000: p. 421). However, difficulties in the present time relating to changes in the global political economy require a re-thinking of some of the basic assumptions of international law. Agreements characterized as hard law, taking the forms of treaties on the one hand, and customary law, on the other, have made it difficult to effectively regulate new and dynamic industries because of the rigidity of hard law during the negotiation process. (Abbott & Snidal, 2000: p. 427) Processes change and emergent technologies continually reshape the nature of commerce, and as such, the procedural course of action often employed by which binding agreements are arranged, slows down the enactment process limiting the effectiveness of its mandate (Trubek, Cottrell & Nance, 2005). Viewed from a longer-term perspective, hard law, when incorporated into the legal milieu of states, poses a great difficulty when parties try to re-write legislation to better meet the needs of a changing society (Trubek, Cottrell & Nance, 2005: p. 32).

Further to that are other key concerns associated with the drafting of treaties that relate to the process by which rights, responsibilities and obligations are negotiated. Hard law pre-supposes clarity of thought and precision of obligation supported by active consent and on-going participation premised on a recognized form of enforcement. Achieving consensus in the international legal system on the meaning and extent of particular obligations has always proved difficult as differing states can submit memoranda of understanding, ultimately diminishing the efficacy of agreements.

In response to the problems listed above the direction which internationally oriented economic agreements should (and presently do) take would incorporate an admixture of both hard and soft law in a rules based framework. This does not mean the sole reliance on imprecise, non-self executing understandings, but achieving consensus based on the import of softer forms of regulatory oversight. The following section will highlight both opposing and supporting points of the introduction of soft law into the global political milieu.

Soft Law and its Scope

Soft law as it relates to this thesis, is described along the continuums introduced earlier by Abbott *et al.* In that respect, the defining characteristics of the continuum included the extent to which obligation existed within agreements followed by the degree of precision incorporated into the agreement and finally the inclusion of third party enforcement, oversight and adjudicatory bodies (Abbott *et al.*, 2000: p.405). Soft law then can be characterized by the lack of these three characteristics in its most liberal form. Soft law is also characterized by a participatory approach, which encompasses processes and procedures with the addition of greater contributor oversight. It involves governmental organizations, private institutions, trade organizations, unions, NGOs and IGOs (Hillgenberg, 1999). In opposition to hard law, soft law can be described as referring to a variety of processes for which the commonality rests with the fact that although they hold normative character, soft law(s) do not constitute binding legal relations (Trubek, Cottrell & Nance 2005: p. 5).

Kirton and Trebilcock define soft law as referring to regimes that are designed to rely primarily on both the resources and participation by nongovernmental actors in the

construction, operation and implementation of a governance arrangement (Kirton & Trebilcock 2005: p.9). As part of their analysis, the defining features of soft law by John Ikenberry are included, which characterize soft law as based on four attributes; a lack of formal authority, voluntary participation, consensus-based decision making and the absence of a coercive enforcement mechanism (Kirton & Trebilcock 2005: p.9).

Incorporating the legalization spectrum(s) by Abbott *et al.*, the scope of soft law relative to issues of monitoring and enforcement takes on a different character vis-à-vis hard law. Issues of enforcement, compliance and adherence, like many other aspects of soft law have the potential of flexibility not possible within a hard law oriented, rules-based framework. For example, the use of trade organizations can be employed allowing sanctions related to membership of a trade organization to be dealt with internally. This is important to the discussion concerning regulatory options available to central bankers and financial sector supervisors for the incorporation of Islamic financial institutions into the larger regulatory fold. The expansive scope of action available on the soft law continuum, as mentioned above, affords regulators the ability to initiate additional regulatory oversight activities concerning Islamic finance requiring minimal institution-building and the capacity for regulatory bodies to internally discipline members whose actions are outside the boundaries of the organization.

The following sections will outline in brief some of the more salient arguments in opposition and support of implementing soft law in the global political economy. In respect to its opposition, two main charges have been levelled against the application of soft law in international relations: the lack of accountability and the lack of a binding nature.

It has been argued that the fact that soft law bypasses the normal protocols of accountability assists in undermining any legitimacy precisely because it avoids public scrutiny from the onset (Trubek, Cottrell & Nance 2005: p.6). Where democratic accountability is alleged to be missing, questions of legitimacy are often raised. In financial governance, this perceived lack of accountability relates to the lack of a direct relation between the central banker and local citizen. The opacity of the deliberative process and the environment in which IGO's operate highlight some of the serious concerns about democratic accountability primarily because these groups are often able to conduct their actions while being insulated from broader public scrutiny (Zaring, 2004: p.41).

The impacts of arrangements made at the global level employed through softer forms of legalization do not afford local citizens, action groups and other concerned members of society a direct voice of appeal to the agreements made. This is problematic, as its mandate does not allow excluded stakeholders a forum to raise issues relevant to the local outcomes of global process. In relation to the present discussion, the lack of accountability in soft law regimes is indeed a major worry. However, as Kingsbury and Krisch note, although the increased exercise of public power in the global administrative field has raised serious concerns about legitimacy and accountability, these have prompted patterns of responses to those concerns in many areas of global governance (Kingsbury & Krisch 2006: p.2).

In the context of GAL, accountability problems are being addressed through increased transparency, through the use of notice-and-comment procedures, and through the development of new avenues of judicial and administrative review, all of which is occurring

in a variety of contexts such as banking, the Security Council, the administration of refugees and through the domestic regulation of transboundary environmental issues. (Kingsbury & Krisch 2006: p.3). Specifically with regards to the BCBS, the external oversight function coupled with the notice and comment provisions associated with the committee are allowing for effective dialogue and exchange to meaningfully occur.

With reference to commitment, the fact that soft law, by design does not bind has prompted criticism as to its advantage in regulating relations on the global plane (Kirton & Trebilcock 2005: p.13). Part of this criticism relates to the lack of both clarity and precision associated with soft norms and the fact that precision of thought is needed to provide a reliable and predictable framework to effectively govern economic activity (Trubek, Cottrell & Nance 2005: p.10). The lack of linguistic formality associated with soft law pronouncements and consequently, the wider range of implementation options available to domestic lawmakers may result in a situation where the individual application of soft norms differs markedly from their originating principles. The consensus achieved is generally hortatory in nature with the final details resolved domestically and as a corollary, the application of the general principles is also susceptible to divergent applications between states. This is further complicated when collectives of nations entering into such compacts do so knowing that they can ignore, withdraw or frustrate the process[40] precisely because the outcomes achieved are limited insofar as obligation, precision and delegation are concerned.

[40] In contrast, hard law through its reliance on high degrees of precision, obligation and delegation carries material consequences for breaches that can have far-reaching effects on the relationships between states in the international community.

Tied in with a recognized lack of binding authority and linguistic informality, is the idea that soft law agreements designed without a coercive mechanism impressing the importance of compliance on contracting parties would have limited success in ensuring compliance in the short-term and thereby contributing to an increased level of uncertainty in the marketplace in the longer-term. It can be further argued that as a by-product of the application of softer norms with minimal emphasis on enforcement, adherence to the originating principles of an agreement would diminish.

However, I argue that this claim, limited to soft law, does not reflect the practical implications associated with international relations insofar as compliance in the context of treaty law has proved just as difficult. In recent times, the international community has witnessed clear examples where signatories have engaged in behaviour that clearly goes against both the spirit and letter of those agreements[41]. Starting from the premise that the expectation of modifying behaviour and compliance cannot be obtained within hard law treaties, applying this expectation only to soft law appears to be arbitrary as examples exist where compliance to and adherence of obligatory principles remains a concern.

In contrast to the traditional sources of international law, emphasizing strict obligation that is precisely defined, soft law has developed in recent times catering for a global community that is more progress-oriented premised on rapid advancement (Trubek, Cottrell & Nance 2005: p.15). The role of technology is of major importance in the movement towards flexible

[41]With reference to the softwood lumber dispute between Canada and the US, the WTO through its Dispute Settlement Body ruled in August 2001 that the export restraints were not considered a financial contribution and were not countervailable subsidies as the US had contended and attempts at imposing levies to counteract the Canadian lumber flow were tantamount to a breach of the originating agreement. However, the US authorities continued to act in contravention of their obligations.

regimes premised on non-binding commitments. The flow of information has increased exponentially with increased access to the internet, cellular devices and other telecommunications devices (Trubek, Cottrell & Nance 2005: p.15). These flows of information, when fully harnessed, facilitate increases in knowledge, which can greatly influence the direction of a given decision as risks can be better calculated, and gains better clarified. In the context of states negotiating with one another over key domestic and foreign policy objectives, the employ of soft law as part of a larger regulatory framework allows for changes in the global political economy to be better addressed and responded to.

The fact that soft law promotes dialogue in pursuing consensus without aiming to bind parties to strict obligation (Trubek, Cottrell & Nance 2005: p. 15), is central to the success of multilateral arrangements, where soft law plays a key role in facilitating trade and relations between states, multinationals and citizens alike (Trubek, Cottrell & Nance 2005: p. 15). Financial sector supervision at the international level has relied primarily on softer forms of cooperation, restricting the imposition of obligation in order to promote solutions premised on convergence (Trubek, Cottrell & Nance 2005: p.16).

In support for the broader implementation of soft law in the global political economy, the argument is that soft law, because of its natural flexibility and relative imprecision, can more rapidly address current problems while maintaining adaptability. The reliance on best practices and guidelines in place of rigid treaties allows national legislators the freedom to tailor the solution to local concerns while remaining true to the intent of the agreement (Abbott & Snidal, 2000: p. 445).

There are additional reasons to pursue a soft law approach in place of binding obligation, especially the contracting and sovereignty costs associated with pursuing harder forms of law (Trubek, Cottrell & Nance 2005: p.16). The creation of any agreement requires negotiations, which have associated costs. These can be high in politically sensitive or hotly contested situations requiring additional measures to ensure cooperation. As a result, when these costs increase beyond expectations, soft law becomes more appropriate precisely because non-binding agreements lower the commitments for relevant stakeholders making conformity to best practices and guidelines an initial step towards fomenting binding obligations between states (Trubek, Cottrell & Nance 2005: p.15). Initially, when considering binding treaty agreements, it is appropriate to account for costs incurred by states starting with differences in outcomes between participants, the loss of decision making authority in certain issue areas, and as an ongoing concern the diminution of state sovereignty (Trubek, Cottrell & Nance 2005: p.15). In events where such outcomes can be envisaged, soft law is better equipped to promote cooperation while preserving sovereignty. It can be used to move past stalemates in negotiations where political and economic disparities make binding agreements impossible (Trubek, Cottrell & Nance 2005: p.15).

In further support for soft law, issues of national interest often polarize states. In this case, negotiations between states can be lengthy, limiting the overall success of projects that require international cooperation. As such, states in past times, have pursued non binding declaratory regimes as opposed to well defined and precise treaties outlining legal rights and responsibilities in order to begin the process with meaningful results. In this respect, the creation of flexible and evolving legislative regimes in conjunction with accepted practices provides sufficient room to grow without undue hindrance while allowing international

negotiators the time to work through the difficult tasks of legalizing established customs and practices.

In relating this back to the BCBS, the role and importance of soft law is understood through the success of the BCBS insofar as the international harmonization of banking supervision is concerned. Despite the lack of a formal mandate and authority divested by way of treaty, the BCBS process has emerged as an example of the benefits of employing soft law by way of transnational regulatory networks in the global political economy. Chapter Three introduces a detailed and expansive discussion on the BCBS, its major publications and its contribution to global financial stability.

Recapping Governance, GAL and Legalization

This Chapter discussed ideas of governance, and in particular, the emergence of GAL with reference to the Basel Committee on Banking Supervision. The BCBS, as discussed, is the premiere bank supervisory organization. It also is an excellent example of GAL representing the cooperative efforts between transnational networks on an international scale. As part of the main argument of this thesis, the BCBS provides an ideal environment for the development of an Islamic banking secretariat whose mandate would extend to Islamic banks worldwide.

To recap, governance is understood as regulation and administration; governance also describes both formal and informal interactions between states, markets, citizens and organizations and it includes both inter- and non-governmental groups. The convergence of the public and private and the emergence of global administrative law within an

administrative space can be understood as a response to the question of how best to supervise and manage the growth of global regulatory bodies. In the context of legalization, this Chapter explored the notion that international agreements can and do take on a variety of forms that incorporate varying degrees of obligation, precision and delegation.

As it relates to Islamic banking, the ideal regulatory framework will necessarily contain both hard and soft provisions. In the final Chapter, I will introduce the Islamic Banking Supervisory Committee as a sub-committee within the existing Basel Committee on Banking Supervision. The group does not exist. However, as I argue, there is a need to introduce such an organization within the BCBS that is dedicated to Islamic banking. I intend to argue that an effective body will incorporate into its mandate, organizational structure and governance model the concepts of governance, GAL and legalization discussed in this Chapter.

The BCBS provides an ideal governing structure through its use of informal transnational networks as well as its reliance on consensus building. The flexibility offered through the concept of legalization and its application to the international economic system will assist in the formulation of the organizational structure and mandate of the IBSC. Flexibility with reference to legalization refers to the ability to fashion an organization that has varying degrees of obligation, precision and delegation as described by Abbott *et al.* The importance of developing a regulatory framework reflective of the dynamism associated with Islamic finance is crucial to its long-term success. The way forward does not contemplate any one form of regulatory oversight whether hard of soft, but instead the form of regulatory oversight contemplated, associated with integrating Islamic banking, considers the framework developed by the BCBS and the role of Global Administrative Law in providing

administrative oversight and managerial supervision as an underlying premise to the future success of Islamic bank supervision.

The following Chapter introduces the overarching concept of global financial stability. As the primary intent of regulators and financial sector supervisors alike, financial stability and the maintenance thereof, require that any attempts to introduce newer and/or alternative banking models initially require careful assessment. As part of the assessment process, the Basel Committee has put forth a number of seminal publications addressing greater financial stability. In particular, three are of direct relevance to this thesis. In order to address the work of the BCBS vis-à-vis financial stability, the Core Principles on Banking Supervision, Basel 1 and Basel 2 will be introduced. The final section of Chapter 3 will examine in detail the endogenous regulatory developments emerging from within the Islamic financial services industry to ensure that greater financial stability is maintained while creating an enabling environment for Islamic banks to flourish.

Chapter Three – Maintaining Financial Stability in the Islamic Financial System

Chapters One and Two explored the basic principles of Islamic finance and issues of governance within the international bank supervision architecture. Chapter One detailed the origins of Islamic finance as well as the religious impetus for its existence. In addition to a historical exploration, Chapter One also discussed the current approaches under which Islamic banks operate and thereafter compared Islamic banking to conventional banking. Chapter Two explored the concept of governance and specifically, the importance of rules-based governance in the international system. Chapter 2 also detailed the expansion of a global administrative space allowing for the re-allocation of regulatory authority to institutions not directly associated with states. This has manifested itself in the emergence of Global Administrative Law (hereinafter GAL).

Global Administrative Law was defined as "comprising the mechanisms, principles, practices intended to promote the accountability of global administrative bodies" (Kingsbury & Krisch 2006: p.3). Underlying the emergence of global administrative law is the vast increase in the reach and forms of transgovernmental regulation and administration designed to address the consequences of globalized interdependence (Kingsbury, Krisch & Stewart 2006: p.20). Organized supervision takes on a variety of masks including formal intergovernmental regulatory bodies, informal intergovernmental regulatory networks, international intergovernmental regimes, hybrid regulatory bodies, and several private organizations(Kingsbury, Krisch & Stewart 2006: p.10).

Thereafter I introduced *Legalization* as an analytical framework for the evaluation of the various forms of interaction at the international level. The framework was originally developed by Abbott *et al.* and categorized international interactions along three continuums: Obligation; Precision; Delegation. Their intent was to provide a clear framework of analysis in respect to the growth of international organizations and the legal effect of their mandates. The connection between legalization as an analytical framework and Islamic banking is understood in terms of the regulatory strategies that can be developed using the legalization methodology. This will be dealt with at length in Chapter Four in reference to the development of a specialized agency within the BCBS catering to Islamic bank supervision. Islamic banks, as discussed earlier, have special risks relative to the structure of the international financial system. Salient differences between conventional and Islamic banking requires careful consideration when contemplating the creation of a multi-faceted supervisory regime. Chapter 3 is intended to highlight some of these associated risks in an effort to suggest a way forward.

At present, the relevant international financial institutions such as the BIS[42], IMF[43] and World Bank[44] are developing effective regulatory strategies alongside the Islamic financial services industry to address the needs of Islamic finance. However, the BCBS does not play an active role in the development of Islamic finance in concert with the relevant international financial institutions. Although, as noted in the previous chapter, the BCBS occupies an office of immense importance vis-à-vis international bank supervision by

[42]Aziz, Z.A. (2004) Ensuring Stability in the Islamic Financial System. Delivered at 3rd annual Islamic Finance Summit. www.bis.org/review/r040121c.pdf

[43] The IMF is not itself directly involved with private financial institutions. To date, the role that the IMF has played is one of external research and analysis done in conjunction with the World Bank.

[44] Though the World Bank is not directly involved in the day-to-day operations of Islamic finance, it is an associate member of the Islamic Financial Services Board (IFSB). The Bank participates in working groups set up by the IFSB on issues of governance, supervision and transparency, for Islamic financial services providers. Its involvement is generally limited to research and analysis of existing institutions and regulators.

providing its 'good offices' to central bankers and national regulators to make international bank supervision increasingly more stable, the current directives of the BCBS have not formally recognized Islamic finance as either an area of opportunity, or even of concern. I argue that as a consequence, regulatory attempts may have a hindering effect on the growth and stability within the industry and impede the wealth creation process.

Chapter Three explores the regulatory considerations associated with international bank supervision in three sections. These sections respectively, will outline the underlying principle of financial stability, the role and works of the BCBS, and the efforts of the Islamic financial services industry to effectively regulate Islamic banks. Section I reviews and defines the salient features of financial stability and the core objectives of financial sector supervision. The importance of understanding the *bigger picture* is to aid in the discussion to follow of how best to incorporate Islamic bank regulation into the larger supervisory scope. Section II details the present efforts by the Basel Committee on Banking Supervision (BCBS) under the auspices of the Bank of International Settlements (BIS) to ensure global financial stability. To date, the BCBS has emerged as the premiere bank regulator in the global context. In that respect, seminal publications such as the Core Principles, Basel 1 and Basel 2 have shaped the present direction of international banking. However, concerns surrounding the lack of effective regulatory policies for Islamic banks and banking within developing countries have persisted. Section III will detail the development of a regulatory strategy based upon the emerging policy recommendations within the Islamic banking industry. The Islamic Financial Services Board (IFSB), Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and finally the Liquidity Management Centre (LMC) are emerging as pivotal actors in the growth of Islamic banking.

The Big Picture (The International Financial Economy) - Financial Stability Defined

Financial stability is at stake in the global economy. Though there exists a number of different financial systems linked to sovereign states, there is a high degree of interdependence between them. As the global economy progressively moves towards further integration, the need to ensure stability across international borders becomes even more imperative. In this respect, the Financial Stability Forum has stepped forth with the intent of ensuring financial stability[45].

Broadly construed, financial stability encompasses different aspects of finance which include the infrastructure, governing institutions, and the marketplace for financial services. More specifically, Houben *et al.*, define financial stability as a situation in which the financial system is capable of: (1) allocating resources efficiently between activities and across time; (2) assessing and managing financial risks, and (3) absorbing shocks. (Houben, Kakes & Schinasi 2004: p.12). They then go on to state that "financial stability not only implies that finance adequately and efficiently allocates resources and risks" (Houben, Kakes & Schinasi 2004: p.12) but that it also allows for an efficient system that mobilizes savings thereby facilitating the process of wealth accumulation (Houben, Kakes & Schinasi 2004: p.10).

Financial stability also implies that the payment system functions smoothly. This is premised on the concept of financial stability relating not only to the absence of financial crises but

[45] The Financial Stability Forum (FSF) was convened in April 1999 to promote international financial stability through information exchange and international co-operation in financial supervision and surveillance. The Financial Stability Forum (FSF) brings together senior representatives of national financial authorities (e.g. central banks, supervisory authorities and treasury departments), international financial institutions, international regulatory and supervisory groupings, committees of central bank experts and the European Central Bank. The FSF by its own mandate seeks to co-ordinate the efforts of these various bodies in order to promote international financial stability, improve the functioning of markets, and reduce systemic risk. (FSI, 2007: websource)

also to the ability to limit, contain, and deal with imbalances before they become economic threats (Schinasi, 2005: p. 13-15). Financial stability entails both preventive action and curative response. In the wider context, financial stability should be understood in relation to its potential consequences on the real economy (Tsatsaronis 2005: p.4). Any efforts designed to enhance the effectiveness of regulation should view financial stability along a continuum, as finance, by design, involves risk and uncertainty, and is composed of many interlinked and evolutionary elements requiring that the definition of stability be flexible enough to account for newer developments (Schinasi, 2005: p.20). That which represents financial stability today, may not be appropriate in the future depending on other aspects of the economic system—such as technological, political, and social developments. Moreover, financial stability should be seen in the various combinations of its constituent parts, such as the soundness of financial institutions, conditions in the financial marketplace, and the overall effectiveness of the various components of the banking network (Schinasi, 2005: p.20).

Financial stability is not merely an academic concept studied in an intellectual vacuum but a real concern to both the domestic and international financial system. Charged with the duty of overseeing the domestic financial system, bank supervisors are in a unique position to ensure greater financial stability. Bearing this in mind, in order that supervisors carry out their assigned tasks effectively, supervisors must have operational independence, the means and powers to gather information and the authority to enforce their decisions (BCBS, 1997: p.9). Supervisors are mandated to regulate risks within the industry, and as such, must have a thorough understanding of the nature of banking activities undertaken and further ensure that the risks incurred by banks are being adequately managed. Effective banking supervision requires that the risk profile of individual banks be assessed and supervisory resources

allocated accordingly (BCBS, 1997: p.10). Supervisors must also ensure that banks have resources appropriate to undertake risks, including adequate capital, sound management, and effective control systems and accounting records (BCBS, 1997: p.10).

The emerging global economy is connected to, and related by way of a number of different actors. At the centre of this is the financial sector. As such, the need to establish closer cooperation with other supervisors in different states is essential to the well being of the global financial system. This is particularly true where the operations of banking organizations cross national boundaries and the potential for contagion across borders is a possibility. In respect to financial stability, the International Organization of Securities Commissions (hereinafter IOSCO) introduced three core objectives that are directly related to the regulation of financial markets: *investor protections, fair market practices and the reduction of systemic risk.* (IOSCO, 1998: p.6).

Investor Protections

The financial market place, interlinked in nature, involves the transfer of capital among billions of participants. A large majority of these transfers are comprised of individuals and families investing today's earnings for tomorrow's purchasing. Because of their stature relative to the larger institutional investors, individuals, by their limited size and influence, also tend to be the most vulnerable within the financial economy. As such, a key to successful oversight requires that investors be protected from practices that mislead or manipulate insofar as informational asymmetries are concerned (IOSCO, 1998: p.6). Further to that, activities such as insider trading and the misuse of client assets have been cited as areas of concern for regulators within the securities industry (IOSCO, 1998: p.6). Also

relevant is the timely disclosure of information that is material to investors and the direction taken insofar as investments are concerned. As part of preventive action, the timely disclosure of relevant information has been identified as one of the most important means for ensuring investor protection (IOSCO, 1998: p.6). Afforded these safeguards, investors are in a better position to assess the risks and rewards of their investments allowing the investor to better protect their own interests. Thus, as a key requirement of transparent investment practices, accounting and auditing standards of a high and internationally accepted nature need to be in place (IOSCO, 1998: p.6).

Ensuring Fair Market Practices

Working towards greater financial stability, fairness within the marketplace is recognized as an important area of review for regulators. As a basic economic principle, an efficient market allows for and facilitates, the dissemination of relevant information in a timely and widespread manner, which is then reflected in the price formation process making the promotion of market efficiency a pressing concern (IOSCO, 1998: p.7). Efficiency in the market is best achieved when non-beneficial practices are curbed right from the onset. Though the impact is most pronounced for the individual investor, the positive benefits have a far-reaching effect on the economy as a whole. Thus, ensuring the fairness of market practices is of major import and is linked directly to the protection of investors, leading IOSCO to state that "market structures should not unduly favour some market users over others and regulation should detect, deter and penalize market manipulation and other unfair trading practices" (IOSCO, 1998: p.7).

Reducing Systemic Risk

The third core objective of financial sector supervision concerns the financial system as a whole and in particular, focuses on the prevention of financial sector failure. It would be imprudent to expect that regulators, are in a position to prevent such failures. Within the purview of financial sector regulators however, is the ability to monitor the ongoing activities of these institutions. Barring the effectiveness of preventative measures, authorities "should seek to reduce the impact of that failure, and, in particular, attempt to isolate the risk to the failing institution" (IOSCO, 1998: p.8). Isolation of the inherent risks associated with bank failures should not be overlooked as the risk of contagion across territorial boundaries can occur at a rapid pace, "so regulator's responses to market disruptions should seek to facilitate stability domestically and globally through cooperation and information sharing" (IOSCO, 1998: p.8).

These three core objectives contribute to an overall strategy to increase the level of stability within the global financial economy. The protection of the investor is central to this process. Ensuring fair market practices plays into the previous objective of investor protection. As part of this approach, the reduction of systemic risk needs to be factored into the final formulation. Though it is recognized that regulators can only limit or reduce the level of system risk, the importance of this aspect has far reaching consequences if neglected. This fits into the larger discussion of global financial stability insofar as proactive steps taken in this respect are designed to protect the most vulnerable class of investors while ensuring that the financial system operates in an efficient manner. As an overarching principle, market efficiency is essential in order to keep pace with the wealth creation process. More

importantly, market efficiency[46] insofar as capital and risk allocation is concerned is paramount to maintaining the levels of growth in the international economy that has been witnessed in the last 10 years (Lusinyan, 2002: p.4).

The interests of financial stability and economic growth must be balanced. The following section details the current direction of banking supervision on an international scale to achieve that goal. The Basel Committee on Banking Supervision, as discussed in the previous chapters, has emerged as an important institution in the field of international bank regulation[47].

Basel Committee on Banking Supervision (BCBS)

As discussed in the previous Chapter, the Basel Committee on Banking Supervision developed in response to the first major financial crisis, which ended just over 30 years ago. The Basel Committee was established by the Central Bank Governors of the Group of ten countries that regularly meet four times a year (BCBS, 2007: p.1). Since its establishment, the committee has developed a number of key publications providing concrete guidance to home and host country regulators as to banking supervision and oversight. As indicated in the previous Chapter, members of the BCBS include Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, United Kingdom and United States. The unexpected failure of the Herstatt bank in 1974 signalled a new direction in which bank supervisors would need to move if they were to prevent banking

[46] In the context of this thesis, market efficiency is defined broadly as the degree to which the present price of a given asset is accurately reflected in the available information in the marketplace.
[47] Even though important, it should be noted that there is some criticism of the BCBS. Basel II specifically has come under attack from emerging market supervisors recognizing that the developments associated with internal ratings boards involve a level of complexity and sophistication limited to the larger internationally active banks resulting in a palpable advantage to a limited number of internationally active banks.

collapses that moved seamlessly across international borders. Rational fears of contagion within the international banking community were sufficient to promote a new form of coordination. In 1991, the BCCI scandal began to unfold indicating the disparaging situation that characterized international bank oversight. Though the scandal directly implicated the BCCI, it indicated the level of corruption in the international financial system by a variety of global actors whose participation was required in order for the BCCI to achieve the levels of illegality in which it had engaged. As such, the focus of the committee expanded and they set their sights on the BCCI[48]. The outcome has led the Committee's work "to close gaps in international supervisory coverage in pursuit of two basic principles: that no foreign banking establishment should escape supervision; and that supervision should be adequate" (BCBS, 2007: p.3)

In spite of such lofty goals, "the Committee does not possess any formal supranational supervisory authority, and its conclusions do not, and were never intended to, have legal force" (BCBS, 2007: p.3). This stands in contrast to the normative framework of international law, which is premised on binding obligation. However, as demonstrated in Chapter Two, the varieties of regulatory frameworks are numerous when taken in the context of a hard law/soft law continuum. In place of restrictive covenants, the Committee "formulates broad supervisory standards and guidelines and recommends statements of best practice in the expectation that individual authorities will take steps to implement them" at the national level (BCBS, 2007: p.3). As part of its mandate, the Committee sought to

[48] Herstatt represented the first instance where a bank had accepted all its currency receipts from its European market however was yet to make any of its US dollar payments at day's end whereas the BCCI (Bank of Credit and Commerce International) involved the criminal misappropriation of $20 billion. Both issues represented the potential for financial instability on an unprecedented global scale

introduce an internationally applicable capital measurement system which commonly was referred to as the Basel Capital Accord, introduced to counter credit risk.

In addition to the work solely aimed at financial institutions, the Committee has broadened its regulatory scope to include developments within the insurance and securities industries. In this respect, they have been "working closely with securities and insurance supervisors to study the challenges presented by the development of diversified financial conglomerates" (BCBS, 2007: p.4). Anticipating changes in the operational structures of the broader financial services sector and as the market for global financial services expands, the full scope of banking, insurance and securities services will be better understood allowing for a broader supervisory regime. In November 2006, the Committee released Basel II which will be discussed further in the coming sections.

Its main intent was to build upon the framework initially established in 1988, and to close regulatory gaps that were not originally anticipated. Its main purpose has been a revision of capital adequacy requirements and risk management techniques. The following will detail the pith and substance of the Core Principles, Basel I and Basel II in an effort to outline the present state of international bank supervision. The objective of this exploration will assist when in the third section regulatory developments within the Islamic banking industry are introduced for comparative purposes.

Core Principles of Effective Bank Supervision

The Core Principles of Effective Bank Supervision (hereinafter Core Principles), prepared in consultation with both the BCBS members along with non-G10 supervisory authorities, were intended to provide a basic reference for supervisory authorities internationally. The twenty-five basic principles have come to be recognized as best practices for international bank supervision. The Core Principles cover a wide array of banking related activities providing a road map to supervisory authorities insofar as domestic banking is concerned and are categorized into seven main groupings[49].

Concerns shared by both home and host country supervisors have been addressed making cross border supervision easier to undertake. Since its original release in 1997, the BCBS has revised the Core principles, however, not with "the intention to radically rewrite the Core Principles but rather to focus on those areas where adjustments to the existing framework were required to ensure their continued relevance" (BCBS, 2006: p.6). Insofar as revisions to the original text are concerned, the changes as evidenced by the Committee itself were minimal, focusing their attention on refinement in opposition to re-formulating the principles themselves (BCBS, 2006: p.6).

[49]"Objectives, independence, powers, transparency and cooperation (principle 1); Licensing and structure (principles 2 to 5); Prudential regulation and requirements (principles 6 to 18); Methods of ongoing banking supervision (principles 19 to 21); Accounting and disclosure (principle 22); Corrective and remedial powers of supervisors (principle 23); Consolidated and cross-border banking supervision (principles 24 and 25)". (http://www.bis.org/publ/bcbs129.pdf)

Basel I- The International Convergence of Capital Measurement and Capital Standards

Released in 1988 and thereafter mandated to be in effect in all G10 countries by 1992, the Basel Capital Accord was designed to provide a working definition for capital that could be internationally applied. Looking back on both the Herstatt and BCCI mishaps, and looking forward to an emerging financial economy, the Committee saw fit to publish guidelines that are now the benchmark of the international banking industry. They defined capital as an "adequate level of reserve that all banks were required to maintain in relation to outstanding loans" (BCBS, 1998: p.3). After much deliberation, the target was set at 8% which was to be in place by all member states by 1992 (BCBS, 1998: p.13). Second to a working definition of capital, the accord also addressed the need to standardize the risk management techniques including credit and operational risks for domestic and internationally active banks. The primary aim of classifying risk management, as the Committee has, is to ensure that banks across international borders would be easily comparable with one another (BCBS, 1998: p.8). In this respect, the success of the accord is reflected best in its adoption by nearly 100 non-members.

Basel II - The International Convergence of Capital Measurement and Capital Standards - A Revised Framework

The International Convergence of Capital Measurement and Capital Standards - A Revised Framework – also called Basel II represents recommendations by bank supervisors and central bankers from the 13 BCBS member countries to revise the international standards for measuring the adequacy of a bank's capital (BCBS, 2006: p.15). The process of revising the capital accord began in 2001 with member-level discussions culminating in its official launch in late 2004. The primary aim of the revised frameworks was to address areas where

effective supervision lacked, and where future developments could be anticipated. In this respect, the Committee devised a framework that approached bank oversight in three interrelated ways (BCBS, 2006: p.15). The 3 pillars, as they have been termed, include regulation, supervision and market discipline addressing issues of capital adequacy and risk management. Pillar 1 included newly developed calculations designed to clarify the banks position vis-à-vis the risks it was taking (BCBS, 2006: p.26). Basel II has expanded the use of mathematical and statistical modeling relative to its predecessor and increased its attention to risk management techniques that are being internationally applied. Part of the background debate leading up to the Accords release has been the balancing of interests between flexibility on the one hand and comparability on the other (BCBS, 2006: p.15). Pillar 2 represents the Committee's attempt to assuage both sides by allowing flexibility at the local supervisory level (BCBS, 2006: p.218). The final pillar is reliant on the market to discipline institutions whose actions and/or offerings do not resonate positively with the public (BCBS, 2006: p.240). Transparency of policy and prudence of decision will ultimately determine the long term profitability of institutions (BCBS, 2006: p.240). Bearing this in mind, banks, in the ideal situation will act in a manner that will keep consumer sentiment at bay by limiting high risk credit deals. The limitations of risk-based pricing become evident when considered in relation to negative impacts that market-oriented disciplinary actions can have.

Endogenous Regulatory Developments for Islamic Banking

The previous section explored the role of the BCBS in the international banking sector as well as standards set through their work. In that respect, the Basel capital accords have provided direction and guidance for financial institutions and regulators alike. However, the

pronouncements have not addressed the emergence of Islamic banking in the international banking sector. The reasons for which Islamic finance have not been explicitly included within the two respective accords are outside the scope of this inquiry. However, it remains important to bear in mind that the popularity of Islamic finance within the global financial community continues to grow. Also, without repeating too much, it must be recalled that the prohibition on interest within Islamic banking has a direct impact on their operating structures. Insofar as interest and the use of fractional reserve lending are concerned, there is no Islamic equivalent *per se*, making the use of the Basel capital adequacy standard(s) limited insofar as effective bank supervision is concerned.

The question then arises that since the newest Basel accord does not address Islamic finance, and since efforts to regulate Islamic finance using conventional banking precepts will pose regulatory challenges to officials, how can Islamic banks be effectively regulated under the current conventional banking framework? To answer this seminal question, the following section will review endogenous regulatory developments within the Islamic banking industry that are helping to shape the direction in which Islamic banking is moving. More important is the role that these developments are having in bridging the gaps between the work of the BCBS and the Islamic financial services sector.

Regulating in a Dual Banking Environment

In a dual banking environment where Islamic banks operate side-by-side with conventional institutions, it remains important to harmonize the regulatory infrastructure with the intent of providing a level playing field for both the Islamic and conventional financial services industry (BNM, 2007). The challenge lies in the development of a rigorous regulatory

framework as well as a legal and tax structure that will not position any of the financial players at a disadvantage (BNM, 2007). Of equal importance is the need to ensure that opportunities for regulatory arbitrage in banking practices are limited to avoid making one system more attractive than the other in terms of offerings and pricing (BNM, 2007). As part of the process of incorporating Islamic banking into the mainstream, policy choices will be made which will impact the way in which these new banks will develop. This will occur within the early stages of the newly forming bank's operations. This period of adjustment is of vital importance if Islamic banks are to have a beneficial impact on the international financial system. The fear in this instance is that in an effort to minimize disruption in the market place through the expanded presence of Islamic institutions, financial sector regulators will take a heavy handed approach to regulating these banks. In so doing, the potential for Islamic banks to integrate into the mainstream with competitive offerings and alternative solutions will be severely limited. I therefore propose that the solution to incorporate Islamic financial institutions into the international supervisory framework should balance the interests of Islamic banks vis-à-vis their clients religious requirements against the interests of the greater financial community for ensuring global financial stability.

As the industry develops, Islamic bankers and regulators are meeting regularly, with the intent of consolidating their supervisory approaches in order to facilitate further integration between different jurisdictions. The Islamic Financial Services Board (hereinafter IFSB), the Accounting and Auditing Organization for Islamic Financial Institutions (hereinafter AAOIFI) and the Liquidity management Centre (hereinafter LMC) are emerging as a competitive alternative for Islamic financial institutions seeking guidance over the pronouncements associated with Basel II. These regulatory bodies are being designed

specifically to accommodate the differences associated with Islamic finance. Furthermore, they are being developed in concert with a number of countries who are working to incorporate Islamic finance into their domestic banking systems. This prevalence lends to the overall credibility of allowing Islamic banks to be regulated in the international banking system outside of the Basel II structure but still within the BCBS. A regulatory solution allowing for differential rules between Islamic and conventional banks will be introduced in the fourth chapter and discussed at length. The following section outlines the evolution of the IFSB. Thereafter, the AAOIFI will be introduced in reference to accounting considerations. As part of central bank operations, lender of last resort facilities available to accommodate temporary shortfalls and ease periods of market insolvency is being filled by the Liquidity Management Centre (LMC) which will be introduced in the final sub-section of this chapter.

IFSB - Capital Adequacy, Risk Management and Corporate Governance Standards Designed with the Islamic Bank in Mind

Comprising 110 members ranging from sovereign states to supervisory/regulatory bodies, the IFSB has emerged as an international standard setting organization whose primary mandate is to develop regulatory guidelines for Islamic banks (IFSB, 2007). The Islamic Financial Services Board (IFSB), based in Kuala Lumpur, was established in 2002 and serves as an association of central banks, monetary authorities and other institutions that are responsible for the regulation and supervision of the Islamic financial services industry (IFSB, 2007). Like the Basel Committee, the IFSB is another example of the growth of Global Administrative Law insofar as the mandate of the IFSB is modelled on transnational regulatory networks. In its short history, the group has focused its attention on the risks inherent to Islamic banking and has provided a number of declarations and best practices

providing guidance to institutions on prudential matters (IFSB, 2007). As part of its mandate, "the IFSB promotes the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing international standards consistent with Islamic Shari'ah principles, and recommends them for adoption" (IFSB, 2007). Being part of the international regulatory community, the developments of the IFSB are designed primarily to work alongside the Basel Committee on Banking Supervision, International Organization of Securities Commissions and the International Association of Insurance Supervisors (IFSB, 2007).

The publication of two documents in recent months has elevated the status of the IFSB to one of the newly emerging regulatory advisory group for Islamic institutions. The documents are entitled the Guiding Principles of Risk Management[50] and Capital Adequacy Standard for Islamic Financial Services[51]. Both publications focus on key areas to Islamic bank regulation addressing many of the concerns echoed by national regulators. As indicated above, December 2005 marked the release of a regulatory strategy for the Islamic financial services industry on issues ranging from a suitable capital adequacy formula catering to the risks associated with the PLS mode of finance to the suitable legal framework governing relations between investor, intermediary and entrepreneur. Moreover, these standards address the identification, classification, measurement and reporting of the risks for Islamic financial institutions (IOSCO Islamic Cap Mkt comm., 2004: p.45). The implications of these

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[50] Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (IIFS). http://www.ifsb.org

[51] Capital Adequacy Standard for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (IIFS). http://www.ifsb.org

publications are yet to be known. However, it does signal a shift in direction for providers of Islamic financial services writ large.

The IFSB consists of 17 council members representing states from the Middle East, Asia, Africa, and the UK. The importance of this relates to the level of cooperation between states and the forefront role that developing nations are playing in its evolution. The IFSB is expected to play a significant role in developing international prudential and supervisory standards and best practices for Islamic financial institutions on an international scale. (IOSCO Islamic Cap Mkt comm., 2004: p.45) The following two sections will detail the pith and substance of the aforementioned publications of the IFSB.

Capital Adequacy Standard for Institutions Offering only Islamic Financial Services

The recently released capital adequacy standard by the IFSB was initially designed to complement the existing international capital convergence standards developed by the BCBS. The main aim of the additional capital adequacy standard (hereinafter CAS) was to address specific differences that have already been reviewed concerning the divergence between conventional and Islamic banks. The objectives of the standard as set out by the IFSB are two-fold. The first objective seeks to provide Islamic banks with a viable regulatory alternative when calculating acceptable levels of capital within banks (IFSB, 2005: p8). The second objective is directed at the industry insofar as uniformity is concerned (IFSB, 2005: p8). Thus far, the evolution of Islamic banking has occurred in a piecemeal fashion lacking uniformity and standardization. Recognizing this as a serious deficiency to the long term success of Islamic banking, the IFSB has also directed its attention inwards at the industry. In that respect, the second objective seeks to standardize the risk assessment and

management techniques used by individual institutions in an effort to create a more level playing field within the industry itself.

The objectives of the Standard are to:

- Address the specific structure and contents of the Shari'ah compliant products and services offered by the IIFS that are not specifically addressed by the currently adopted and proposed international capital adequacy standards, and Shari'ah-compliant mitigation; (IFSB, 2005: p.8)

- Standardize the approach in identifying and measuring risks in Shari'ah compliant products and services and in assigning risk weights (RW) thereto, thereby, creating a level playing field amongst the IIFS, in adopting and developing risk identification and measurement practices that meet internationally acceptable prudential standards. (IFSB, 2005: p.8)

In developing the standard, the IFSB has approached the task by accounting for the work already undertaken by the BCBS. As it relates to international bank supervision, the BCBS remains in the forefront due to the large and ongoing contributions it makes to the supervisory community. Having set the tone, the first section of the CAS addresses the main risks to capital adequacy that are faced by Islamic institutions in their day to day operations such as credit risk (p8), market risk (p18), operational risks (p25) and specific concerns faced though the use of investment accounts (p29). The balance of the CAS looks to outlining each other major line of business in which an Islamic bank will generally engage[52] (p6). As this thesis focuses primarily on regulatory considerations and not on technical aspects of Islamic bank regulation, specific data concerning the capital adequacy requirements will not be addressed in any detail.[53]

[52] Murābahah and Murābahah for the Purchase Orderer; Salam and Parallel Salam; Istisnā`and Parallel Istisnā; Ijārah and Ijārah Muntahia Bittamleek; Mushārakah and Diminishing Mushārakah; Muḍārabah; and Sukūk held as investment (in the "banking book").

[53] For further information refer directly to the IFSB website: www.ifsb.org

In general, the capital adequacy requirements for Islamic banks as envisioned by the IFSB amount to a total of 8% of the bank's total capital (tier 1+tier 2) which on its surface parallels that which was originally prescribed with Basel I (IFSB, 2005: p18). However, the difference in calculating available capital from the banks perspective is where the importance of this standard comes into play. Though arriving at a similar reserve percentage for Islamic banks, the nature of the businesses that Islamic banks engage in has been addressed accordingly. The result is the formation of an adequacy standard that accounts for these salient differences in operational structure bridging the gap between conventional and Islamic bank regulation.

Guiding Principles of Risk Management for Institutions Offering Only Islamic Financial Services

At the same time the CAS was introduced, a second publication addressing another key component of effective bank supervision was also released. The Guiding Principles of Risk Management directly addresses issues of risk management that the capital adequacy standard only sought to introduce. Where the CAS introduced credit, market and operational risk, the Guiding Principles address in further detail equity investment risk (IFSB, 2005: p.12), liquidity risk (IFSB, 2005: p19) and finally rate of return risk (IFSB, 2005: p26). The roles and responsibilities of the board of directors are also addressed insofar as due diligence and effective oversight is concerned. This is further enhanced through the introduction of additional responsibilities for the supervisors assigned to regulate Islamic banks (IFSB, 2005: p.29). In this respect, the document sets forth 15 principles concerning effective risk management techniques within the purview of the Shariah (IFSB, 2005: p29). This is an important point to consider as risk mitigation techniques used in the conventional context may not be applicable in the Islamic context based primarily on the parameters of Islamic

banking, namely the use of interest bearing instruments and the lack of risk sharing associated with conventional finance.

According to the IFSB, the primary aim of releasing its risk management standard stems from the recognition that although "certain issues are of equal concern to all financial institutions" (IFSB, 2005: p.8) some risks are localized to Islamic banks and as such, these principles "serve to complement the BCBS guidelines in order to cater to the specificities of Islamic banks" (IFSB, 2005: p.9). As with the CAS, the guiding principles will also help to consolidate practices creating a level playing field within the Islamic banking sector. The long-term benefit of institutional comparability within the industry will help to enhance the stability of the industry vis-à-vis conventional banking, creating an alternative banking model with competitive offerings and effective oversight (IFSB, 2005: p.9). In addressing the various forms of risk that Islamic banks are exposed to, the guiding principles set forth the methodologies required in order to balance concerns between both the internationally agreed standards of the BCBS and Shariah compliance issues that are fundamental to the operation of these specialized institutions.

AAOIFI - Statement on the Purpose and Calculation of the Capital Adequacy Ratio for Islamic Banks

Recognizing the inadequacy of the existing international accounting standards in use vis-à-vis Islamic banking, the formation of an advisory group became of great importance in bridging the gap between financial reporting practices employed by Islamic banks and conventional accounting (AAOIFI, 2007). This led to the establishment of the Accounting and Auditing Organization for Islamic Financial Institutions (hereinafter the AAOIFI) in 1991 as an autonomous, and internationally recognized corporate body (AAOIFI, 2007). The primary

aim of the group was to develop accounting, auditing, governance, and Shari'ah standards for Islamic financial institutions.

As indicated, the relevance of the group to modern Islamic finance relates to the need to develop accounting standards that adequately reflect the nature of Islamic banks and the activities they engage in (AAOIFI, 2007). As Islamic banks begin to emerge alongside conventional institutions, there is a recognized need to develop accounting standards that will parallel as far as possible the rules and regulations developed for conventional banks to the extent that these rules do not contravene Shariatic principles (AAOIFI, 2007). Since its inception in 1991, the AAOIFI has published 56 documents that range from regulatory concerns to financial accounting considerations and finally to matters of ethics (IOSCO Islamic Capital Market commission., 2004: p.45).

Furthermore, the creation of the group was viewed by some as an important first step in enhancing the reliability, consistency and clarity of financial reporting by Islamic financial institutions. The anticipated by-product would assist in enhancing investor confidence in Islamic finance. (IOSCO Islamic Capital Market commission., 2004: p.46) Premised on those considerations, there are instances where an Islamic bank runs into difficulties insofar as accounting practices developed by the International Accounting Standards Board (IASB) and listed in the Generally Accepted Accounting Principles (GAAP) have been developed based on conventional banking whose institutions, product offerings and/ or practices are insufficient to accurately reflect the nature of Islamic financial transactions (IOSCO Islamic Capital Market commission., 2004: p.40). *Shariah* compliant transactions may not have parallels in conventional financing and therefore, there may be significant accounting

implications making the objective of a well developed and widely-used set of accounting practices germane to Islamic banks all the more relevant

LMC – Liquidity Management in an Islamic Environment

In describing the evolution of endogenous developments in the Islamic financial services industry, the role of liquidity and the management thereof is of importance insofar as the ultimate goal of financial stability is concerned(IOSCO Islamic Capital Market commission., 2004: p.42). As discussed earlier, the role of banks is primarily that of intermediation and in specific, the transfer of capital from areas of excess to those of shortage. The issue as it relates to financial stability concerns those instances where depositors require ready access to the funds entrusted to financial institutions that have been previously allocated. In the context of banking, liquidity is normally understood as the banks ability to meet its obligations when they come due without incurring unacceptable losses (IOSCO Islamic Capital Market commission., 2004: p.42) On a day to day basis, banks are required to manage issues of liquidity by constantly monitoring and projecting cash flows so as to ensure sufficient liquidity within the banks is always maintained (IOSCO Islamic Capital Market commission., 2004: p.41)

Notwithstanding instances where clients forgo ready access to funds in the hopes of a larger return as in the case of certificates of deposit, guaranteed investment certificates and other interest bearing instruments, banks are generally under a duty to provide those funds upon demand. This situation poses a serious problem where there does not exist a double coincidence of wants between borrowers repaying funds and depositors accessing funds. Barring this double coincidence of wants, banks in the conventional context have options

available for generating liquidity, such as borrowing from other banks or by borrowing from the central bank itself. This stands above and beyond the reserve requirements that are mandated by the financial sector regulator for all institutions holding themselves out as banks.

In the context of Islamic banks, this is problematic for a number of reasons, primarily based on the fact that all these solutions are premised on the use of interest bearing instruments making them unavailable to an Islamic bank. This fact does not exempt Islamic banks from attaining a safety net or creating the necessary infrastructure to deal with these concerns as they arise. Recognizing this as a serious impediment to the growth of a stable and well founded Islamic financial services industry, steps are being taken to create a lender of last resort facility, with the main difference being that funds made available would be on the basis of sukuk[54] and not on an interest basis. This has culminated in the establishment of the Liquidity Management Centre (LMC) in 2002, which is considered to be the opening stages for a larger, efficient and reliable interbank money market.

> The LMC is based in Bahrain and is part of a larger project to create an International Islamic Financial Market (IIFM). LMC was established to facilitate the creation of an Islamic interbank money market that would enable Islamic financial institutions to manage their liquidity effectively. (IOSCO Islamic Capital Market commission., 2004: p.42)

The importance of this in relation to financial stability is that by creating a centre such as the LMC, issues of short-term liquidity crunches can be better managed. The availability of Shari'ah compliant instruments that are available to Islamic banks writ large will further

[54] Sukuk are asset-backed, stable income, tradable and Shari'ah compatible trust certificates of which the primary condition of issuance is the existence of assets on the balance sheet of the issuer. Further to that, Shari'ah considerations dictate that the pool of assets should not solely be comprised of debts from Islamic financial contracts

strengthen confidence in the sector as it develops. Because of these developments, investors are in a better position vis-à-vis their investments with the knowledge that situations of short-term illiquidity and systemic risk can be overseen and effectively managed before they unfold into larger problems.

Conclusion

The thrust of this Chapter has been one of comparison in light of the overarching goal of financial stability. To recap, financial stability encompasses different aspects of finance, which include the infrastructure, governing institutions, and the marketplace for financial services. The importance of financial stability in the global environment has been examined in both the conventional and Islamic banking environments and it has been established that in both contexts, financial stability remains the primary goal. Financial sector supervisors however are required to approach financial stability differently based on the inherent differences between the two banking systems.

From the conventional banking standpoint, the BCBS remains the premiere organization wherein supervisory best practices are emerging. With more than 30 years of experience, the BCBS has formulated a supervisory framework for effective bank supervision on an international scale that has been adopted by more than 100 states, a majority of which are BCBS non-members. It has also been evidenced that although the BCBS has been so influential in the conventional banking industry, they have yet to adequately address questions of regulation and oversight for Islamic banks. In order that the Islamic financial services industry flourishes, it has been recognized that adequate supervisory guidance and regulatory oversight are needed.

In order to complement the work of the BCBS, and more importantly, to address fundamental issues like fair market practices, managing systemic risk and investor protections, groups such as the IFSB, the AAOIFI and the LMC have been developed to offer substantive direction to institutions offering Islamic financial services. Standardization of financial reporting as developed by the AAOIFI will level the playing field between Islamic banks that will ultimately benefit the consumer of Islamic financial products addressing issues of investor protection and fair market practices. The development of a capital adequacy standard and risk management techniques will allow Islamic banks to develop products in a Shari'ah friendly environment, which is of fundamental importance to the industry as a whole. At the same time, this will also fulfil the requirement of limiting and/or better managing system risk. Finally, the creation of institutions such as the LMC which are able to provide liquidity management services to Islamic financial institutions directly impact systemic risk by affording Islamic banks options when faced with short term liquidity concerns. In the final analysis, the endogenous developments of the Islamic financial services industry are effectively filling the gaps that the BCBS has not addressed creating an enabling environment for the development of the industry as a whole.

In relation to the previous chapters, Chapter Three focused on the current situation in the international banking community as well as the emergent Islamic banking community. The stated thrust of the chapter detailed financial stability as the objective, the BCBS as one of its instruments and the Islamic bankers as fulfilling the mandate of economic constancy. In the context of Chapter One, which detailed the differences between Islamic and conventional banks, the possibility of successful incorporation of Islamic banks into the larger regulatory

apparatus is all the more evident when taken alongside the efforts emerging from within the Islamic banking industry. The ongoing developments within the Islamic financial services industry as illustrated by the release of substantive materials such as the Capital Adequacy Standard and the Guiding Principles of Risk Management by the IFSB make evident the fact that as Islamic banks develop, they are accounting for greater financial stability within the international economy. The AAOIFI, in releasing an alternate set of capital adequacy standards along with a standalone financial reporting protocol, are further developing the argument that Islamic banking officials are taking proactive steps to ensure that greater financial stability is maintained as Islamic financial institutions enter the international marketplace. As part of an overall strategy to ensure systemic risks are effectively managed, the development of the LMC is contributing to the availability of Shar'iah compliant liquidity instruments for commercial banks operating under Islamic finance principles. The net-result is a situation characterized by increasing market confidence, investor protections and adequate oversight to ensure greater financial stability. In relation to Chapter Two which focused on Global Administrative Law and legalization, the steps taken individually by the IFSB, AAOIFI and LMC to effectively advance supervisory resolutions that fulfill the concerns of national regulators exemplifies global administrative law as it relates to "collective action by transnational networks of cooperative arrangements between national regulatory officials" (Kingsbury, Stewart & Krisch, 2005: p.20).

All of the recent developments have succeeded in addressing two fundamental concerns: Whether it is possible to create an effective internationally-based supervisory body overseeing the day-to-day operations of Islamic banks and whether there are the necessary safeguards in place that will at minimum maintain and optimally improve Global stability

within the international banking system? More important than simply addressing these objectives is the belief that Islamic bank supervisors should ensure that in the process of enacting these changes, a clash between the two objectives does not occur rendering these efforts ineffectual. I argue that developments within the Islamic financial services industry introduced in this chapter are clear examples of the balance-positive solutions to internationally sensitive issues that are being developed to ensure that financial stability is not only maintained but improved where possible. There is, however, the issue of centralizing the process that still needs to be addressed.

In the final Chapter of this thesis, the way forward will be examined entertaining the notion of centralizing the process of Islamic bank integration into the larger regulatory apparatus. Islamic banking as an international industry is emerging as an alternative for more then 1.3 billion people worldwide and as such it is imperative that a regulatory framework governing their operations is created. The thrust of the argument recommends the import of the endogenous regulatory developments evidenced in this chapter to work within a BCBS framework. The envisioned solutions calls for the creation of a semi-autonomous organization mandated by the BCBS to produce supervisory best practices and guidelines that reflect the nature of Islamic banking while ensuring that the overarching goal of maintaining financial stability is achieved while creating the necessary infrastructure for alternative banking models to develop unhindered.

Chapter Four - Conclusions and Recommendations

The thrust of this thesis is how Islamic banking can be effectively incorporated into the larger supervisory framework under the auspices of the Basel Committee on Bank Supervision (BCBS). Over the course of this thesis, this question has been broached by looking to Global Administrative Law as a supervisory mechanism based in administrative law wherein the development of softer forms of regulatory oversight can be developed and applied. Furthermore, it has been evidenced that internal regulatory developments emerging from the Islamic banking industry are proving to be a viable way forward vis-à-vis Basel 1 and 2. The primary reason for this relates to the fact that these internal developments are designed specifically to address issues that Islamic banks will face. Insofar as an adequate regulatory response is being developed, it is occurring in light of ongoing developments at the BCBS. These developments are not intended to supersede the best practices issued by the Basel Committee but are designed to supplement the existing supervisory framework by ensuring that Islamic banks are supervised according to their unique structures and transactions.

This final chapter brings together the arguments canvassed in this thesis. The reason for re-framing the discussion herein is to draw attention to the variety of institutional approaches (emerging as a response to the issue of how to supervise and legitimate 'softer institutions') which are available to financial sector supervisors when contemplating Islamic bank supervision. This Chapter is organized in two sections with concluding remarks. The first section reviews the findings of each of the preceding three Chapters. The second section introduces the structure for Islamic bank supervision within the larger banking supervision framework of the BCBS.

Recapping the Main Arguments

Chapter One introduced Islamic finance as a competing vision to the conventional banking system. Islamic finance provides participants with an alternate financial structure that equitably re-allocates risk and liability. Financiers undertake a dynamic role in the venture to ensure its profitability. Underpinning this relationship is the strict prohibition of interest in any transactions. Profitability requires participation and risk sharing. The Islamic financial industry has, over the past 30 years extended its scope worldwide. At present, there are approximately 200 Islamic financial institutions globally with assets in excess of $200 to 500 billion USD (El-Hawary, Grais & Iqbal, 2004: p.2). The full breadth of Islamic banking worldwide is yet to be known. However, its popularity is continually growing. This leads to the conclusion that effective supervision and oversight will be required to maintain consumer confidence in the Islamic financial system. Despite growing popularity, the current regulatory framework for international bank supervision (under the auspices of the Basel Committee on Banking Supervision) does not expressly address Islamic institutions.

In order to address the issue of effective supervision for Islamic banks, Chapter Two introduced governance, GAL and the concept of legalization as an analytical framework describing contemporary international relations. The emergence of an administrative space in the global political economy is allowing for regulation, supervision and oversight to occur through non-traditional forms of authority. Global Administrative Law (GAL), in the context of this thesis, is understood as a recognized shift away from a rigid international legal order that is characterized by reliance on state-to-state interaction towards political and economic integration on an international scale.

Directly related to the emergence of an integrative international relations model is the recognition that issue spillover between states cannot be adequately addressed at the national level in isolation of the global perspective. This recognition is largely related to the level of integration between states on issues of high and low politics forcing interdependent actors to consult with one another outside the general confines of international law. The thrust of the argument is that within this space, an alternative approach to regulating Islamic finance will be found. The current supervisory framework for international bank supervision (BCBS) falls within the purview of global administrative law under the heading of "administration based on collective action by trans-national networks of cooperative arrangements between national regulatory officials (Kingsbury, Stewart & Krisch, 2005: p.20).

As the BCBS remains the single most important advisory body on bank supervision, its pronouncements have a major impact on the international banking community yet it does not issue any binding declarations nor does it enforce any of its pronouncements. It is precisely because the BCBS does not bind central bankers and supervisors that it naturally has popular appeal over binding and restrictive approaches reminiscent of an older international paradigm. The BCBS has opted for a softer approach to international agreement by employing harmonization as opposed to obligation as the objective of its supervisory mandate. The form of international legal relations under which the BCBS operates is premised on a decentralized international order that is characterized by the degree of obligation, precision and delegation manifested[55]. It is for the aforementioned reasons

[55] Discussed in chapter 2.

(Global Integration and BCBS Prominence) that a unified approach to Islamic bank supervision is sought under the auspices of the BCBS.

As an overarching mandate of the BCBS, maintaining financial stability within the global political economy is understood as the primary aim of banking, insurance and securities supervision. The importance of maintaining stability within the global financial system cannot be emphasized enough as the livelihoods of billions are at stake. As an underlying premise to maintaining financial stability, prudence of action and consideration of consequences require that the banking industry as a whole needs to be carefully scrutinized on an ongoing basis to ensure that risks, systemic or otherwise are being effectively managed. This directly impacts all new organizations seeking entrance into the financial services industry and in the context of Islamic banking requires that the necessary safeguards, reflective of its precise operating structure and constraints are in place to manage these institutions.

Chapter Three introduced the importance of maintaining global financial stability as well as the current steps initiated within the Islamic financial services industry to address these concerns. In that respect, capital adequacy, risk management, accounting standards and corporate governance were addressed and solutions to supervise Islamic banks were introduced. As part of the creation of these standards the IFSB, AAOIFI and the LMC, acting separately, have each engaged in direct and indirect consultations with the BIS, BCBS, World Bank, FSI and IMF to ensure that the guidelines produced can be applied within the existing international bank supervision framework. The next step involves the consolidation of these efforts towards the creation of a unified strategy to Islamic bank supervision.

Islamic Bank Regulation: The Way Forward

In this final section, the aim is directed towards developing a strategy that effectively addresses the concerns of financial sector supervisors and ensures that supervision will benefit the Islamic financial services industry. This requires a transformation of the current bank supervisory apparatus. Transforming the system of international bank supervision will require sufficient flexibility insofar as accommodating the requirements of alternative financial institutions is concerned. Over the course of this thesis, two primary goals have been outlined that directly influence this required flexibility.

> 1) The creation of an effective internationally based supervisory body overseeing the day-to-day operations of Islamic banks.
>
> 2) The maintenance of Global financial stability within the international banking system.

The question then arises whether these two aims are compatible with one another. Premised on the compatibility of both, a second question arises; while pursuing these objectives individually, will a situation arise where one goal is achieved at the expense of the other. As a precursor to any changes in the international banking supervisory framework, issues of compatibility must be adequately addressed resulting in a situation where, at least at the theoretical level, these concerns are resolved. Chapter Three addressed these concerns recognizing the validity of the question and more importantly, the need to resolve these fundamental issues before changes are suggested. From the evidence provided in Chapter Three, the question of compatibility and the potential clash of objectives have been answered. Islamic banking does not pose a threat to the international banking structure and incorporating it into the larger supervisory framework will not expose the financial system to shocks directly associated with an Islamic bank's operations.

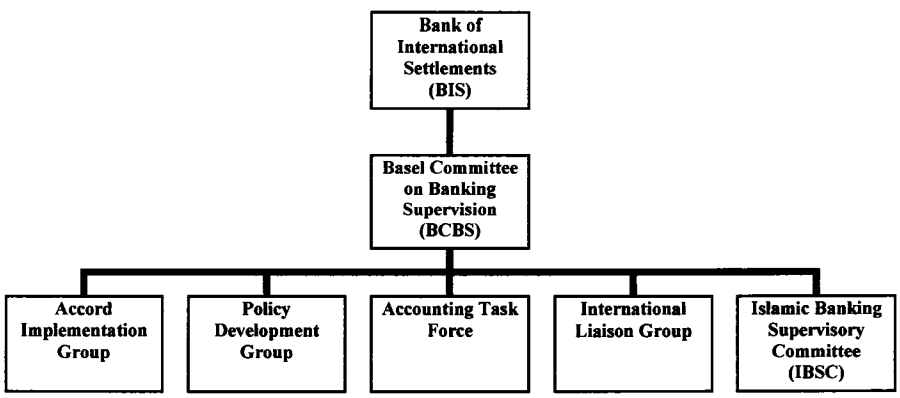
The intent of Chapter Three was to establish that the incorporation of Islamic banking into the international banking system does not directly threaten the financial stability of the system. It was shown that the Islamic banking industry is taking the necessary steps to address these concerns through the creation of best practices, model codes and guiding principles concerning the three key areas of bank supervision (Capital Adequacy, Risk Management and Corporate Governance). In all three cases, the creation of supplemental guidance specific to Islamic banking has been designed to work with the larger supervisory objectives of the BCBS. The next consideration concerns how Islamic banking will be effectively regulated and as a natural progression to these developments, I argue that the ideal regulatory strategy for Islamic bank integration necessarily involves the BCBS.

As part of the overall strategy, I propose that the BCBS should continue in the same capacity it has in terms of its role as facilitator between national regulators and as informational intermediary. The international banking system undoubtedly benefits from the work that the BCBS engages in, making any alteration (that seeks to minimize their role) counterintuitive. As opposed to any wholesale changes to its mandate, the BCBS should continue to play an active role in the integration of Islamic banking on an international scale.

The Islamic Banking Supervisory Committee (IBSC)

In order to facilitate this integrative process with minimal disruption, the solution I propose calls for the creation of a specialized advisory group catering to the specificities of Islamic banking operating within the BCBS legal framework. I argue that the creation of this group is within the existing mandate of the BCBS and more importantly is representative of the

proactive history of the Committee. As part of its larger objective, the BCBS is continually pursuing "supervisory cooperation through support for regional supervisory committees" (BCBS, 2007) and in that respect, sponsors an international conference every two years (BCBS, 2007). As it relates to governance and GAL, Kingsbury, Krisch and Stewart have categorized the BCBS as an example of Global Administrative Law manifested through the use of transnational networks of cooperative arrangements between national regulatory officials (Kingsbury, Stewart & Krisch, 2005: p.20). Including the concerns of central bank supervisors who are directly affected and have a stake in the outcome of Islamic bank supervision would not only enhance the supervisory regime but also provide further evidence as to the changing dynamics in the international community of states. The creation of a specialized agency designed to address Islamic banking would be a natural extension to the mandate of the BCBS and the global administrative paradigm it was founded upon. By design, the group would be responsible to the BCBS and ultimately to the BIS. The organizational chart shown below conceptualizes the location of the advisory group within the BCBS framework. For the purposes of this thesis, the group will, hereinafter be referred to as the Islamic Banking Supervisory Committee (IBSC).



The IBSC, as the name implies, would act as a supervisory group for Islamic banks under the auspices of the BCBS. Its creation is necessary due to the lack of existing supervisory guidance for Islamic banks and the fact that Islamic banks are markedly different from the conventional banks presently supervised under the BCBS. The role the IBSC would play and the guidance it would provide are designed to work in concert with the existing supervisory framework of the BCBS such that international bank supervision would encompass Islamic and conventional banks under one banner head[56]. Furthermore, the IBSC would intermediate the concerns of national regulators by providing guidance and clarifying questions of operational structure and the related risks. This is an important point of consideration for national regulators who are not fully acquainted with the specificities of Islamic finance and are required to supervise their operations. With the creation of a unified body issuing guidance to the regulatory community on technical issues, the ability to clear up misconceptions and present a singular vision on the direction of Islamic bank supervision will result, furthering the overarching objective of maintaining global financial stability.

The Mandate of the Proposed IBSC

The creation of the IBSC within the supervisory framework of the BCBS is premised on the ongoing role that the BCBS has played in international banking supervision generally and specifically, the fact that the "Committee maintains links with supervisors not directly participating in the committee with a view to strengthening prudential supervisory standards in all the major markets" (BCBS, 2007). This has manifested itself in recent years through

[56] In Chapter Two, governance was defined as actions taken by institutions that aim to coordinate and control interdependent social, political and economic relations ensuring that the concerns held by relevant stakeholders are addressed and ultimately incorporated into the end product. The proposal I am making in respect to the formation of the IBSC within the BCBS falls within the purview of governance and in particular, GAL as it relates to the authority vested in the group. The formation of the IBSC would represent a meaningful attempt to include central bank supervisors who until recently have been left outside the Basel process. The inclusion of new supervisors has the potential of improving the perception of the Committee from an exclusive club to an international organization.

the proactive pursuit of supervisory cooperation through support for regional supervisory committees and sponsorship of international conferences (BCBS, 2007). As it relates to the framework of the BCBS, there is sufficient flexibility based on the unique history of the Committee and the authority allocated to it by its membership, which as discussed in Chapters Two and Three, seeks cooperation as opposed to binding obligation when issuing supervisory guidelines. I argue that in order for Islamic banking to be effectively supervised, the mandate of the IBSC naturally would only extend to institutions holding themselves out as Islamic financial services providers. As part of that mandate, the IBSC would be involved in the formulation of a cross border strategy to regulate Islamic banks alongside national regulators and industry experts. The aim is to create a set of best practices and supervisory guidelines that are applicable to all institutions holding themselves out as Islamic financial services providers. In order to facilitate effective supervision, the first step for the group will be to consolidate the various best practices and guiding principles developed by the IFSB, AAOIFI and the LMC. It should be recognized that although there are differences with the final formulation of the capital adequacy and risk management standards proposed by both the IFSB and AAOIFI, both sets of publications share common values and ideas making the consolidation process easier to complete. The desired result would be an internationally acceptable set of standards for capital adequacy, risk management, corporate governance and accounting standards that reflects both the letter and spirit of principles for Islamic finance.

The Make-up of the IBSC

Directly related to the need to develop a consolidated supervisory approach is the make up of the IBSC itself. It is important to note that Islamic banking is not confined to any one state, making the need to develop guidelines that are reflective of all the participating states germane. With reference to the international nature of Islamic banking and the diffusion of Islamic banks throughout the world, the need to create a representative and inclusive regulatory model is imperative.

As it relates to Islamic finance, there are a number of countries preparing their domestic banking systems for the entrance of Islamic financial services providers, beginning in the early 1970's in Egypt. By the late 1970's, Iran under the newly formed Islamic Republic, introduced legislation banning interest based transactions and since then has promoted Islamic principles of economics and finance. Bahrain and Malaysia stand out as potential centres for an Islamic inter-bank money market and more importantly as international centres for Islamic finance. Pakistan and Nigeria are yet other examples of states moving towards the development of an Islamic financial services industry. Beyond these states, numerous Gulf States, the UK and the US have stepped forth expressing an interest in introducing Islamic banks into their domestic banking systems. This indicates that pursuing Islamic banking is not limited to a few states but has larger appeal in the international context. For that reason, the members of the IBSC would necessarily include members of the BCBS but also many more members not officially part of the BCBS. Countries like the UAE, Bahrain, Malaysia and Iran, have taken major steps to develop Islamic banking both in domestic and international contexts making their presence in the IBSC, and ultimately the BCBS, a necessity. The experience that each state will bring with it to the discussions, and

ultimately the development of a unified and consolidated strategy, will be of major benefit to the long-term success of Islamic finance on a global scale. Embedded within discussions of the various industry players is recognition of the doctrinal differences between *Shia* and *Sunni Ulema*[57]. The result of differing perspectives on jurisprudential matters may affect the nature, structure and product offerings of an Islamic financial services provider. As such, it is imperative to consider these concerns when formulating best practices, supervisory guidelines, and the mandate of the Shari'ah supervisory boards that the individual financial institutions rely on.

Concluding Statement

In the final analysis, the appropriate response to the question of unified Islamic bank supervision that I propose recognizes two main considerations that directly impact the nature of regulation and supervision. First, Islamic banking differs in pith and substance from conventional banks. Throughout this thesis, I have demonstrated that Islamic banking, by its very nature, is significantly different from conventional banking insofar as the clear and unequivocal ban on any form of interest is concerned. Furthermore, the construction of relationships between banker, investor and entrepreneur does not correspond directly with those associated with conventional banking and finally, there are tangible differences in accounting treatment between conventional and Islamic banks.

Second, a supervisory approach premised on hard law would frustrate the intent of financial sector supervisors to provide a level playing field for all participants insofar as the banking industry has demonstrated itself to be dynamic and innovative. This recognized dynamism

[57] Refers to an educated class of Muslim scholars who are known as arbiters of Shariah law; In addition to questions relating to the Shariah, the ulema are also versed in other sciences, such as philosophy, dialectical theology or Quranic hermeneutics.

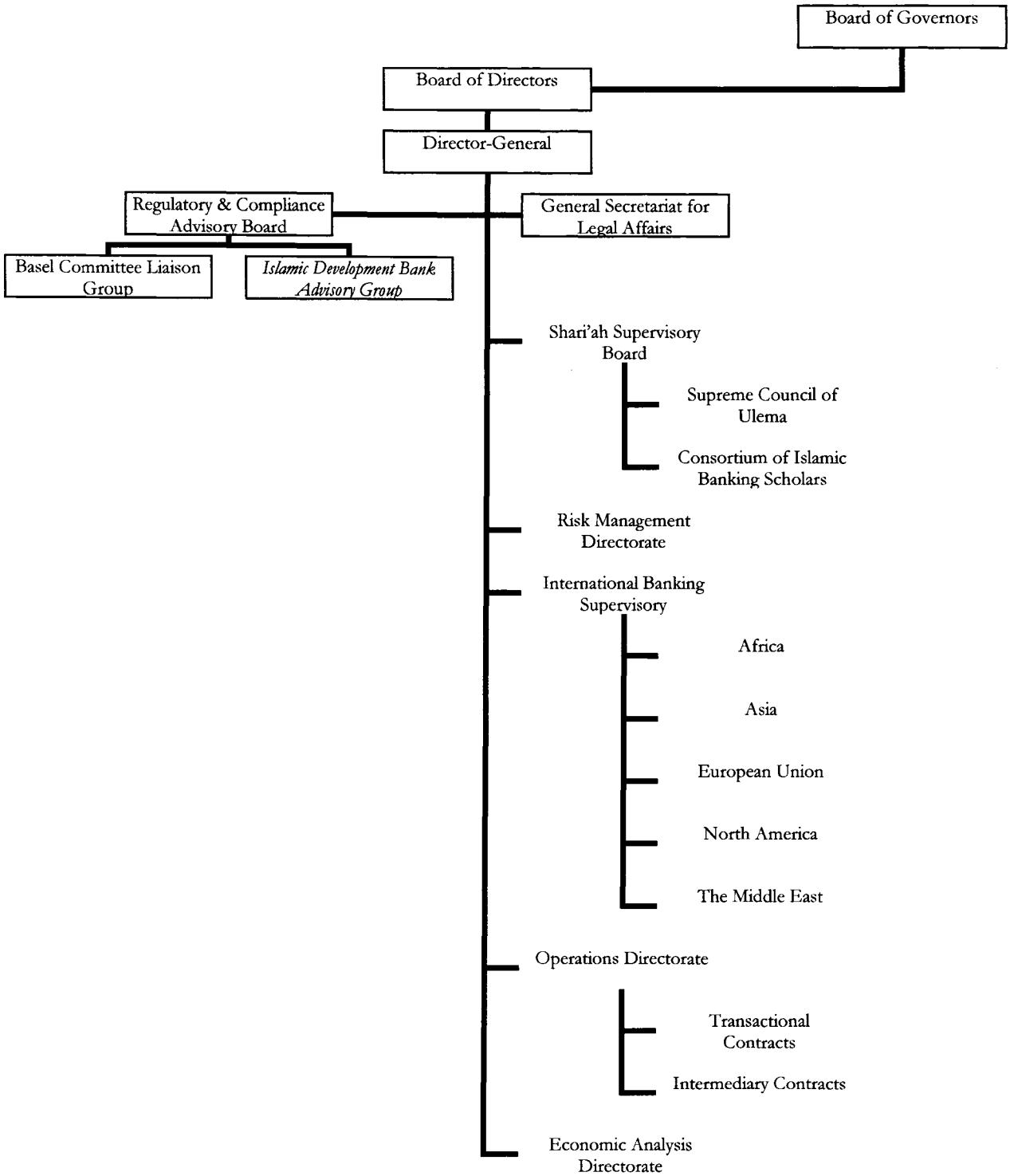
strikes at the core of the debate concerning the efficacy of hard law to regulate Islamic banks specifically and the banking industry in general. As new technologies develop and novel approaches to financial engineering continue to emerge, strictly enforced and precisely construed obligations will inevitably become difficult to apply and even more problematic to revise due to obsolescence. The ability to successfully negotiate treaty obligations between states in the field of international trade and commerce as discussed in Chapter Two has posed many difficulties relating to the ability to negotiate lasting solutions, costs associated with state sovereignty, issues of enforcement and other costs associated with maintaining a fully independent third party dispute resolution process.

Recognizing these difficulties as it relates to commercial supervision, the trend has been towards implementing agreements that are softer in nature meaning that they do not necessarily bind parties to specific processes and that the decision as to how to implement mutually acceptable solutions ultimately rests with the parties themselves. Included in this calculus, the role that governance and Global administrative law plays in furtherance of a strategy aiming at harmonizing Islamic bank supervision is pivotal to long-term success of the Islamic financial servicies industry. In respect to supervising Islamic financial institutions, the proposed solution should be no different then the approach of the BCBS as it has proven to be a viable resolution to an evolving challenge.

In furtherance of these considerations and those presented in this thesis, the way forward for regulating Islamic banking lies within the existing supervisory framework of the BCBS. The BCBS framework is premised on a decentralized approach to joint oversight on matters of cross border bank supervision. Managed effectively, the BCBS can serve as a model for

trans-national cooperation in both formal and informal settings making regulation of Islamic banks an obvious candidate. However, at present, the BCBS does not explicitly regulate Islamic banks. The proposed recommendation for Islamic bank supervision that I suggest necessarily involves the BCBS as facilitator of informational exchanges and promoter of supervisory guidelines and best practices for Islamic banking internationally. This requires the creation of a semi autonomous body (IBSC) within the BCBS framework mandated to develop a supervisory programme that recognizes the inherent differences between Islamic and conventional banking and fosters an environment of competition and fair market practices.

Organizational Structure of the Islamic Banking Supervisory Committee



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