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Paper Abstracts & Tentative Program

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PAPER ABSTRACTS

Sensitivity of the Islamic Banks to Interest Rate Changes in a Dual Financial System: The Case of Malaysia

There seems to be a general belief that since the Islamic banks only deal with interest-free instruments, they are therefore shielded from the risks associated with interest rate fluctuations. Focusing on the Malaysian data covering the period from January 1999 to December 2006, the study tests of this proposition. It attempts to determine the sensitivity of the Islamic banks by analyzing the impact of interest rate changes on the banks' loans and deposits. The study uses autoregressive distributed lag (ARDL), the vector error correction (VECM), impulse response functions and variance decomposition analysis based on the vector auto-regression (VAR) methodology. The study finds that the Islamic banks' balance sheet items are relatively more sensitive to monetary policy changes, while the conventional banks' balance sheet items, particularly the conventional loans are insensitive to interest rate changes. This implies that the impact of monetary policy is more de-stabilizing on the Islamic banks than the conventional banks. The results of this study have important implications for the risk management practices of the Islamic banks, particularly in a dual banking system such as in Malaysia.

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Sharia Issues in Liquidity Risk Management

Islamic banks need to establish sound liquidity risk management as a standard practice in modern banking to guarantee safe banking operation and maintain their business. Considering the bank's characteristics and risk profile, Shariah provides Islamic banks with Shariah approaches and techniques to conduct liquidity risk management taking into account its challenges. Practically, to mitigate liquidity risk, Islamic banks prepare internal investment approach and liquid instruments from Islamic financial market or regulators to work out regular and irregular liquidity needs.

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Measuring the Efficiency of Islamic Banks in Indonesia and Malaysia using Parametric and Nonparametric Approaches

This study measures and compares the efficiency of Islamic banks in Malaysia and Indonesia using parametric stochastic frontier approach (SFA) and distribution free approach (DFA), as well as nonparametric approach data envelopment analysis (DEA). The results using parametric SFA and DFA show that Islamic banking in Malaysia has been improving and has become as efficient as Islamic banking in Indonesia in 2006. Meanwhile, the results using non-parametric DEA show that Islamic banking in Indonesia is slightly more efficient than Islamic banking in Malaysia, especially due to better technical efficiency. Funding (deposits) and human resource (labor) are the sources of inefficiency in Malaysia as well as in Indonesia. Therefore, Islamic banks should redirect their marketing and communication strategies to focus more on targeting floating customers, while the shortage in human resource should be given serious attention with short term and long term strategies.

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Risk Identification of the Islamic Banks in Indonesia: A VAR Modeling Approach

Islamic banking is a nascent industry in Indonesia, with impressive total asset growth of approximately 50 per cent per annum but small proportion of the total banking industry's market share. Amid the aggressive efforts to accelerate growth of the industry within the realm of stable financial environment, there is an urgent need to identify and critically evaluate the risks faced by the Islamic banking institutions. In view of this, the main objective of this study is to identify the types of risks facing the Islamic banking in Indonesia by focusing on the latest available data from March 2000 to August 2007. The study employs rigorous investigation techniques by adopting the Impulse Response Functions and Variance Decomposition Analysis based on Vector Autoregressive (VAR) methodology. The study found that, in addition to the conventional banks' risks, the Islamic banks are exposed to unique risks namely the benchmark risk, rate of return risk, displaced commercial risk, withdrawal risk, and Shariah compliant risk. These risks, if not properly managed, could be significant obstacles in developing the Islamic banking industry and achieving the Islamic financial system stability. Ultimately, effective risk management frameworks are paramount for better risk management practices and growth of Islamic banking institutions in Indonesia and also worldwide.

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Gharar and Jahl revisited - New impulses on how to distinguish permissible risk taking from forbidden speculation: A comparative study of Qualified-Investor-Concept-provisions in Luxemburg, Switzerland and Germany and their impact to Shariah issues

With a vibrant fund market, Continental European banking centers like Luxemburg, Frankfurt and Zurich claim a significant share of the market worldwide. These centers have always adhered to investor protection for the sake of market functionality. During 1428-1429AH/2007-2008AD ´Qualified Investor Concepts´ are channeled into Continental European reform projects thus reconciliating investor protection and flexible risk models by implementation of a differential treatment for different groups of investors. The balance between permissible risk taking and forbidden speculation has for a long time been an important issue under the precepts of Gharar and Jahl - though from a much broader perspective. The paper provides insights into the guiding principles of these ´Qualified Investor´-approaches and the practice of their implementation. Similarly, the prescriptions of Gharar and Jahl are examined. This will open the stage for a comparative view of both systems. The unusual approach delivers evidence how the systems can learn from each other.

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Duration Gaps and Net Worth Risk for Islamic and Conventional Banks: A Comparative Cross Country Analysis

This paper undertakes a comparative analysis of the Duration gap and Net worth (NW) risk of Islamic Commercial Banks (ICBs) and Conventional Commercial Banks (CCBs). Though Islamic banks work on interest free principles, the vast majority of the world's ICBs operate within dual banking systems. The inevitable flow of funds between the two banking systems and the common customer base implies that ICBs would have the same exposures as CCBs. Our sample consists of a total 60 commercial banks from nine Islamic countries. These were made up of 30 ICBs and 30 CCBs. Each ICB had a CCB pair of approximately equal asset size in US $ terms. The analysis is based on year end 2006 financial data. We test for significant difference in rate risk between ICBs and CCBs using both a parametric and nonparametric test. Our results show ICBs to have higher duration gaps and Net worth risk than CCBs. We do however find substantial country specific difference in risk profile. Malaysian ICBs had significantly higher Duration gaps and Net worth risk compared to both the other ICBs and CCBs in our sample.

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Cross-Border Interbank Exposures and Financial Contagion

Integrated financial (interbank) markets provide opportunities for expansion and improved risk sharing on one hand, but pose threats of contagion risk through cross-border interbank exposures on the other. This paper examines cross-border interbank contagion risk for available seventeen countries over the period 1999-2005. To that purpose we use aggregate cross-border interbank exposures of reporting countries in the Consolidated Banking Statistics. We find that contagion risk increases over time. Particularly, the US banks, through their cross-border exposures with non-US banks, mainly trigger international financial contagion. The failure of British or German banking system is also a serious concern for global financial stability. We also observe that the "speed of propagation of contagion" has increased in recent years resulting into an increasing number of directly exposed banking systems. Contagion risk is also found in bank level analysis under certain assumptions and robust to alternative representations of country risk transfer in BIS consolidated banking statistics.

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Volatility Spillover Effects for Jakarta Islamic Index, LQ45 and Jakarta Composite Index

The paper attempts to analyze two investment benchmarks namely, ethical investment and non-ethical investment for Indonesian stock markets. The study employs volatility approach to measure to what extent shocks persistency from the previous period affect the volatility in the current period for each type of investment. Jakarta
Islamic Index (JII) is used to represent the ethical investment type, while non-ethical investment type is represented by Jakarta Composite Index (JCI) and LQ45. Univariate and Multivariate Conditional volatility models are employed to achieve the objective. Univariate models of GARCH(1,1) and AGARCH (1,1) will be used to analyze shock persistency for each market. Moreover, multivariate conditional models of VAR(1)-GARCH(1,1) and VAR(1)- AGARCH(1,1) will be used to investigate how volatility spillover runs among these three markets. The result shows that in general JII and JCI are better modeled by GARCH(1,1) while LQ45 is better by GJR(1,1). Furthermore, there is
spillover effects among the markets in which JII tends to be superior with higher persistency of shock. This result implies to a better understanding for investors in making prediction of the stocks in order to select the optimal portfolios.

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Regulating Islamic Finance in Secular Countries: A Case Study of India

Indian Muslims have always been trying to manage their economic affairs within the framework of Shariah. Their struggle against usury practices has been both religious and financial struggle. This paper aims to highlight the attempts made by Indian Muslims in this regard and how some of the recent developments since opening of Banking and financial sectors and FDI cap from 74% to 100% in various categories of banking and provides opportunity and poses regulatory challenge in establishing Islamic Finance and Sharia compliant-products affecting their functioning. The paper focuses on opportunities, events and regulatory changes facilitate and pose new and additional challenges to new entrants. It examines the potential segments including NBFCs, FII, Micro Finance and Mutual Funds as new source of proliferation in India and the regulatory mechanism existing and requisite for functioning at large scale. The paper also relates the causes of failures in past by the depressed economic scenario in early 1990s and the highly changing regulatory environment in the late 1990s. Some prominent Islamic NBFCs and new initiatives by UTI and others in India are taken for detailed case studies to identify the future aspects in the topic of the paper.

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Cost, Revenue, and Profit Efficiency of Islamic versus Conventional Banks: International Evidence Using Data Envelopment Analysis

This paper measures and compares the cost, revenue, and profit efficiency of 43 Islamic and 37 conventional banks over the period 1990-2005 in 21 countries using Data Envelopment Analysis. In addition, it assesses the efficiency of those banks based on their size, age, and region. The findings suggest that there are no significant differences between the overall efficiency results of conventional versus Islamic banks. However, there is substantial room for improvement in cost minimisation and revenue and profit maximisation in both banking systems. Furthermore, the findings show no significance difference in average efficiency scores between big versus small and new versus old banks in both banking streams. This implies that size and age did not affect the performance of those groups significantly in this sample. However, geographical location explains the significant differences in revenue and profit efficiency between both streams of banks. Overall, the results in this paper are favourable with the 'new' banking system.

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Unique Risks of Islamic Modes of Finance: Systemic, Credit and Market Risks

This paper examines the unique attributes of systemic risks (the possibility of financial system or institution to collapse or fall down), credit risks (bad loans), and market risks (currency fluctuation) of Islamic modes of finance, as these issues are considered as contemporary concerns for the global financial industry. In addition, as types and sources of risk in finance are interrelated and encompass diversity of risks, other types of financial risks which are associated with systemic, credit and market risks, such as the operational and liquidity risk, will be explored and discussed accordingly. Furthermore, the paper argues that implementing Al Shariah compliant guidelines and procedures devised from the principle of Islamic finance would be an effective instrument in controlling these risks.

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Issues and Challenges in Implementing Strengthened Supervisory Standards for Islamic Banks: the Role of Investment Account Management as a Risk Mitigant in Islamic Finance

The paper highlights some of the key issues and gaps in the supervision of Islamic Banks, and in particular, addresses the supervisory implications of the role of investment account management. One of the key issues in Islamic banking is how to measure and manage the sharing of returns and risks between shareholders and investment account holders (IAH), so that such risk sharing can become an effective tool of risk management in Islamic finance. A methodology for estimating such risk sharing is developed so that the extent of risks shifted ("displaced") from IAH to shareholders, also referred to as "Displaced Commercial Risk" (DCR), can be measured. Drawing on the recent work on linking the DCR with the "Alpha", which is the share of risk weighted assets funded by IAH that should be included in the denominator of Capital Adequacy formula for Islamic banks(as recommended in the new IFSB Capital Adequacy standard), the paper presents and illustrates an empirical approach for the supervisory assessment of "Alpha".

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Regulation and Supervision of Islamic Banks and Financial Institutions: Bangladesh Perspective

This paper presents an explanation of the role of Bangladesh Bank (Central Bank of Bangladesh) in accomplishing the above task. There are six full-fledged Islamic banks, one non-bank Islamic financial institution and 22 Islamic banking branches of ten conventional banks operating in Bangladesh in tandem in line with the glorious Islamic Shariah. Alongside, one Islamic mutual fund, Government Islamic Investment Bond and Islami Bank Mudaraba Perpetual Bond is also playing important role in mobilizing the financial resources on Islamic line in the stock exchanges of the country. The rules, provisions etc, of the above instruments have been discussed. Above all, role of Bangladesh Bank has been critically examined relating to the regulation and supervision of the Islamic banking system of the country and some suggestions have been proposed for enhancement of the capacity of the central bank in achieving its objectives.

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Challenges in Implementing Basel II Pillar 1 to Islamic Banks

Throughout the past thirty years or so, the practice of Islamic banking has proved to be a viable alternative and is growing at an estimated annual rate of 15%. However, many challenges still lie ahead for Islamic banks to be able to comply with international standards and guidelines. A key issue relates to the implementation of Pillar 1 of the Basel II accord, or capital adequacy requirements that were originally set to capture different types of risks faced by conventional banks, and which do not cater for the risk specificities of Islamic banks. The objective of this paper is to provide an empirical fieldwork to study the implications of applying Pillar 1 to a major Islamic bank following recent IFSB guidelines for risk management and capital adequacy. We specifically raise serious issues related to the nature of risks arising from the uses of funds of Islamic financial institutions and their implication on the banking book of the Islamic financial institution. Still other challenges lie ahead of international regulatory bodies in order to cater for other types of risks that are unique to Islamic financial institutions.

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The Responsibility and Independence of Shari'ah Supervisory Boards of the Indonesian Islamic Banks

Despite the present guidelines developed by National Shari'ah Council-Indonesian Ulama Council (NSC-IUC) and Bank Indonesia, there is a lack of sufficient guidelines related to the existence of Shari'ah Supervisors (SSs) in Islamic Banks (IBs) in Indonesia. Therefore, this study is designed to examine the perceptions of managers and SSs of IBs in Indonesia on the responsibility and independence of SSs. The study utilizes questionnaires to obtain the perceptions of IB managers while it uses interview to obtain the perceptions of SSs of IBs. The study shows that the respondents perceived that the SSs are responsible for ensuring that the products, contracts and transactions of IBs are in compliance with Shari'ah principles. In order to improve the independence of SSs, the respondents viewed that the SSs should be prohibited from becoming consultants and majority shareholders of the IBs for the same IBs in which they act as SSs.

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Performance Evaluation of Islamic Commercial Banks in Indonesia after the Financial Crisis

This study evaluates intertemporal and interbank performance of Islamic commercial banks from 1999-2006 or after the financial crisis vis-à-vis interest based conventional banks in Indonesia focusing on profitability, liquidity, solvency risk and their contribution to small and medium enterprises. Financial ratios are employed to measure their performance. Meanwhile, t-test and F-test are applied to determine their level of significance. The Islamic interbank study found that Bank Muamalat Indonesia performed better in terms of profitability and liquidity. Meanwhile there is no significant difference in performance between Islamic commercial banks and conventional banks in Indonesia. However the contribution of Islamic and conventional banks in financing small and medium enterprises showed significant differences. It is found that Islamic commercial banks performed relatively better than conventional banks.

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Assets Liabilities Management In Islamic Banking

The paper studies assets and liabilities management (ALM) structure and instrument in Islamic banking. Since in Islamic banking depositors take partnership in benefits of bank so Islamic banking follows to maximizing benefits of beneficiaries and among them depositors. Therefore, there are dissimilarities between ALM approaches in Islamic banking and conventional banking. First, this dissimilarity comes from differences on accounting system in Islamic banking in comparison to conventional banking. Secondly, usury illegalness and its related jurisprudence specifications indicate that time is not the solely the effective factor on increasing equity (deposited capital) return; but profit and loss sharing resulted from investment in real economy sector is the essential base in monetary transactions. These two important factors are considerable factors in Islamic ALM. In this paper we consider influence specifications of these factors in two banking approaches for creating economic value added (EVA). Comparison of financial indices for the two type of banking leads us that Islamic banking is more efficient than conventional banking.

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DEA/C&R: DEA with classification and regression tree: A case of banking efficiency

Data Envelopment Analysis (DEA) is a non-parametric technique for measuring efficiency and productivity of decision making units (DMUs) (Charnes, Cooper, Rhodes, 1978). On the other hand data mining techniques allow DMUs to explore and discover meaningful, previously hidden information from huge organizational databases. Classifications and regression (C&R) is the commonly used decision tree in data mining that was developed by Breiman, et al. (1984) and further improved by Ripley (1996). The results shows that on average banks located in UAE and Kuwait seem to be more efficient while banks located in Bahrain seem to be less efficient. The Conventional banks are more efficient than Islamic banks; on other hand price book value is the most important variable in determining the most efficient banks, price earning index and country are the second and third important variables. The number of branches and the operation style seem to be less important in the classification of the efficient banks.

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Capital and Risk Adjustments under Risk-Based Capital regulations and Diversification Loss

In the last two decades, regulators have focused on the enforcement of minimum capital requirements on banks. Excessive risk-taking might otherwise have been encouraged by the principle of limited liability and by the availability of deposit insurance. Strengthened capital regulation has resulted in improved capital ratios for banks, and a more stable financial system. However, the changes to the regulatory system have been criticized on the grounds that an increased regulatory capital standard may encourage an increase in leverage and portfolio risk. Both the theoretical literature and the empirical literature on the impact of capital regulation have produced heterogeneous results concerning the capital and risk adjustment behavior of banks. This study uses a cross-sectional time-series data set on commercial banks that is longer and more recent than in most other studies. We estimate the effect of changes in portfolio risk on the capital adjustment and of risk-based capital regulation on portfolio risk adjustment, using a simultaneous equations model. We find support for the capital buffer theory, which suggests that banks increase their capital holdings in response to an increase in portfolio risk, in order to avoid regulatory penalties. We also find evidence that banks increase their loan portfolio concentration in order to increase their regulatory capital ratios, suggesting that improvements in capital ratios are achieved at a cost in terms of the degree of diversification of the banks' portfolios.

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Measuring Service Quality of Malaysian Banking Industry: A Comparison between Islamic and Conventional banks

This study aims to develop the SERVQUAL model to access the customers' satisfaction in Malaysia banking sector. Further, the dominance analysis technique is used to examine the relative importance of different service quality dimensions as extracted from the factor analysis. Finally, it compares the conventional bank with that of Islamic bank in terms of each service quality dimension and measures their relative importance in bridging the overall gap between expectation and perception. The application of factor analysis is able to detect only four dimensions – Tangibility, Reliability, Competence and Convenience. The results reveal that there are significant differences between the respondents' expectation and their perceptions. It is found that the expectation on Competence and Convenience are significantly different between Conventional banks and Islamic banks, whereas, the perception on Tangibility and Convenience are found to be significantly different between the above two types of banks. The application of dominance analysis to predict the SERVQUAL gap indicates that the difference between the two types of banks is in terms of degree and not in terms of pattern. The Competence and Convenience are found to be the relatively more dominating dimensions in both types of banks. These two dimensions together can help to reduce the overall service quality gap to an extent of 72% in the case of Conventional bank and 85% in the case of Islamic banks. The Malaysian banking sector needs to take initiative to become more competent by being more responsive and fulfilling the assurance of the customers and providing the banking facilities more conveniently.

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Risk Management Assessment Systems: An Application To Islamic Banks

Risk management is central in operations of financial institutions, both from business and regulatory perspectives. Risk management is not only about identifying and mitigating risks, but involves a strong risk management system that includes establishing appropriate risk management environment, maintaining an appropriate risk management process, and instituting adequate internal controls. This paper provides a measurable tool to assess the risk management framework in Islamic banks. The structured assessment methodology provides indices that gives a quantitative assessment of not only the overall risk management system of a financial institution, but also indicates the strengths and weaknesses of various aspects of this system. The assessment process can be used by Islamic banks and regulatory authorities to identify the weaknesses and improve upon the risk management framework. The paper provides examples of how the assessment method outlined can be used to estimate the status of risk management system for two Islamic banks.

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Financial Stability and Early Warning Systems: Implications for Islamic Finance

This paper overviews early warning systems (EWS) and analyzes their implications for Islamic finance. The main purpose of early warning systems is to generate ex-ante warnings of potential problems that may emerge or develop in the future on account of the current risk profile of a financial institution. There are various approaches to model prediction of financial risks. Three approaches of signal extraction, limited-dependent variable and contingency claim are explained in detail. The paper will also analyze limitations of these early warning systems for Islamic finance. To sustain its long-term growth, Islamic finance needs regular risk assessment. In this regard, development of suitable early warning systems for Islamic finance is necessary. It is claimed that a comprehensive early warning system for Islamic financial system has to take into consideration all qualitative and quantitative risk factors. Many of these risk factors have well known indicators and can be constructed for individual Islamic financial institutions and aggregated for the whole system. However, many of other qualitative risk factors including institutional and Shariah compliance factors are yet to be constructed and incorporated into the early warning system.

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Neutralizing Disincentives for holding Profit Sharing Instruments: The role of regulators and the capital adequacy ratio

Recent calls by prominent Islamic scholars to shift the focus of Islamic Finance away from bond-like sukuk have been met with great unease by bankers in the industry. Islamic Financial Institutions (IFIs), which hold the majority of all sukuk issued, face deposit side constraints on the types of returns they distribute, due to a need to match returns to market based deposit interest rates. Hence, it is in their interest to hold assets that provide stable benchmark based returns. This study proposes that regulators require banks to include a greater proportion of risk weighted assets funded by unrestricted investment account holders (UIAH) in the denominator of their capital adequacy ratio, based on the extent to which the particular bank engages in smoothing returns to investment depositors. Providing true returns to UIAH will consequently minimize incentives for IFIs to hold assets that return benchmark interest rates and allow them to hold assets that provide for variable returns.

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Exploring Corporate Social Responsibility Disclosure of Islamic Banks With Special Reference to Disclosure Practices Under the AAOIFI Standard

Corporate social responsibility (CSR) is an issue of growing interest and many multinational companies and banks are voluntarily disclosing information regarding their CSR activities. For Islamic banks, one of the avenues to demonstrate their acceptability and commitment to serving the needs of the Muslim community, and society in general, is via disclosure of relevant and reliable information in their annual reports. In this study, we explore whether any discrepancy exists between the corporate social activities disclosed in the annual reports of the Islamic banks and CSR information deemed to be vital, based on the Islamic business ethics framework. Using content analysis and disclosure measured by an index score, our longitudinal survey results indicate the overall mean CSR disclosure index of only one Islamic bank out of seven surveyed to be above average. The CSR disclosure of the remaining six Islamic banks falls significantly short of our expectations. It is also found that the largest inconsistency in reporting to be related to four CSR dimensions: commitment to community development, disclosure of clear cut ethical behavior, stakeholders' engagement and customer relation; research, development and training; and corporate governance related to top management. The results have important implications for Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in developing a CSR reporting/disclosure standard if Islamic banks are to enhance their image and reputation globally, as well as to remain competitive.

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Efficiency of Islamic Banks in Selected Member Countries in the Organization of Islamic Conference (OIC) Region

This study investigates the relative efficiency of 25 Islamic banks in selected 14 OIC member countries during 2002 to 2006. These countries are classified into three groups: least-developed member countries (LDCs) medium-developed member countries (MDCs) and energy-exporting member countries (FECs). The study employs Data Envelopment Analysis (DEA) method by using the intermediation approach. The inputs used are total deposit, overhead expenses and fixed assets, while the outputs are total loans, other operating incomes, and total earning assets. Additionally, regression method is used to find the correlation between the efficiency scores and some of the banks' performance indicators. The result shows that during 2002-2006, Islamic banks in the LDCs were more efficient than Islamic banks in the other two groups. Lastly, the efficiency level of Islamic banks in the study was significantly and positively influenced by Earnings to Total Assets Ratio, Return on Average Assets, and Loan to Deposit Ratio. In contrast, efficiency score is negatively related to Operating Expense to Operating Income.

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Impact of Capital Regulations on Capital Ratios and Risk Taking of Islamic Banks

Effectiveness of regulation in enhancing capital adequacy ratios of weakly capitalized banks has been the subject of current research and the results generally suggest successes. This study uses the same methodologies to the BankScope dataset of 67 Islamic banks in 11 countries. The results suggest that Islamic banks' capital ratios have not been enhanced during the 1999-2004 period and these banks generally have taken imprudent capital risks. The policy implication is that regulators have to be concerned with capital adequacy ratios in Islamic banks, particularly, in response to the requirements of adopting Basel II.

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Capital Adequacy Requirements for Sukuk Securitisations and Real Estate Investments

The Exposure Draft (ED) of Capital Adequacy Requirements for Sukuk Securitisations and Real Estate Investment deals with aspects of regulatory capital requirements for institutions offering Islamic financial services (IIFS) in respect of Sukuk that are not covered in IFSB-2 (Capital Adequacy Standard). These include capital requirements for IIFS in relation to Sukuk and securitisations process. In respect to real estate investment, the ED deals primarily with capital requirements for an IIFS that invests in real estate investment activities..

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Guiding Principles on Governance of Islamic Collective Investment Schemes

The Exposure Draft (ED) of Guiding Principles on Governance for Islamic Collective Investment Schemes aims to complement IFSB-3 (Corporate Governance) and other internationally recognised governance Standards, by reinforcing international best practices while addressing the specificities in the governance of Islamic Collective Investment Schemes (ICIS). The ED covers approach to general governance, transparency and disclosure, compliance with Shari'ah rules and principles, and additional protection for ICIS investors.

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