

ISLAMIC ECONOMIC STUDIES

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Rajab 1431H-Muharram 1432H (June 2010-January 2011)

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ARTICLES

Solvency of *Takāful* Fund: A Case of Subordinated *Qard*

ABDUSSALAM ISMAIL ONAGUN ¹

There are two elements important in formulating the solvency requirements of a takāful undertaking namely the takāful fund and qard facility. It has been seen in some regulatory frameworks that the regulator puts a requirement on the takāful operators to show that they are providing some financial support towards the solvency of the takāful funds. This paper attempts to explain the measures involved in the takāful operator using their shareholders' funds to provide financial backing to support the solvency of takāful funds through the practices of qard facility, injection of assets into the takāful funds and assignment or allocation of assets in the shareholding to the takāful funds. The paper will focus on the nature of qard and its basis in the primary sources of Sharia'h. Is it acceptable legally to subordinate qard in the case of deficit, deficiency or drawn down of takāful fund? Finally, the paper will analyze the legal ruling related to qard and how it is different to conventional insurance practices.

1. Introduction

Solvency of *takāful* fund and legality of the condition of *qard* facility are significant issues for their impact on the capital requirements for *takāful* undertakings. Sharī'ah rulings and *takāful* regulations differ across different countries. Since the legal and regulatory landscape of the *takāful* industry is still in its infancy, development and harmonization of the prudential regulation and supervision of *takāful* companies at the international level remains a challenge. *Takāful* funds tends to be divided into two schemes namely: General *takāful* and Family *takāful*. This paper briefly examines the nature of tabarru' in *takāful* and the resulting legal effects on the solvency of both kinds of *takāful* funds. The paper only focuses on that part of *takāful* funds which is allocated for coverage of risks and claims (risk funds), not the savings / investment portions of the funds (in family *takāful*) which clearly belong to the individual participants.

2. General *Takāful*

The general *takāful* undertaking is a short-term contract where participants pay contributions and operators undertake to manage risk. The contributions paid by the

¹ Staff member, Islamic Financial Services Board (IFSB). The views expressed in this paper are those of the author and do not necessarily represent the views of Islamic Financial Services Board (IFSB) and its management.

participants are credited into the general *takāful* fund, which is then invested and the profits generated are paid back to the fund.

General *takāful* schemes are basically contracts of joint guarantee on a short-term basis (normally one year), providing mutual compensation in the event of a specified type of loss. The schemes are designed to meet the needs for protection of individuals and corporate bodies in relation to material loss or damage resulting from a catastrophe or disaster inflicted upon real estates, assets or belongings of participants. The *takāful* contribution paid is pooled into the *takāful* fund under the principle of *tabarru'* to match the risk elements of the business that are inherent in its underwriting activities.²

Although investment activities in the general *takāful* pool or fund are secondary to the underwriting activities, they may be important for the solvency of the fund, especially in the case of longer-tailed risks.³

The contributors' payments are divided into management cost, risk management, surplus and Special Security Fund (SSF). Management cost is divided into commission, management cost and establishment cost, which covers bills and other miscellaneous expenses. The commission is meant for staff salaries and is determined by the *takāful* operator, which is deducted from the management cost. Commission can also be paid by the participant through mutual consent and agreement.

A percentage of the participants' contribution also goes to the Participants' Risk Fund (PRF), which backs up the *takāful* fund and handles the risk of insolvency. A certain percentage of a predicted amount is contributed to the Participants' Risk Fund (PRF) as a reserve for bankruptcy. For instance, a company may estimate the probability of bankruptcy for the next 10 years and calculates that it will reserve RM10 million (US\$2.69 million) for back up. The participants then contribute 2% of *takāful* fund, each *takāful* fund to fulfill the reserve requirement of RM10 million (US\$2.69 million), which will be held by the Central Bank. This money cannot be touched by the Central Bank and will not earn or lose any interest. If the *takāful* fund becomes insolvent before the predicted 10 years, say in five years, the Central Bank will return RM5 million (US\$1.35 million) from the reserve to the company. If the company does not become insolvent after 10 years, the reserve remains untouchable. The purpose of this is to protect the benefits and interest of the participants. The regulators will need to ensure that *takāful* operators are prudent in maintaining sufficient reserves to protect themselves and participants against untoward events in their operations. The more risky the *takāful* operator, the more capital it needs to put aside to provide a cushion against things going wrong.⁴

A proposal has been mooted to use the *qard* facility in the SSF mechanism. From the RM10 million (US\$2.69 million) the company reserved in the Central Bank, it will get back RM1 million (US\$269,025) for every year it earns profit. Thus, if the company

² The IFSB-8 (December 2009) Guiding Principles on Governance of *Takāful* (Islamic Insurance) undertakings.

³ See: IFSB-8 (December 2009) Guiding principles on Governance of *takāful* (Islamic insurance) undertakings, p 6.

⁴ See Tobias Frenz & Younes Soualhi (2010) pp 204-209.

earns RM1.5 million (US\$403,509) profit in the first year, the Central Bank will return RM1 million (US\$269,025) to the company. However, if this occurs every year, and the money that is returned is then used or invested, and the company becomes insolvent in the ninth year, there will be insufficient reserved funds left to cover the loss. To avoid these consequences, the returned reserved money could be credited to another company account where it could not be touched, specifically for back-up purposes. The Central Bank would no longer hold the reserve.

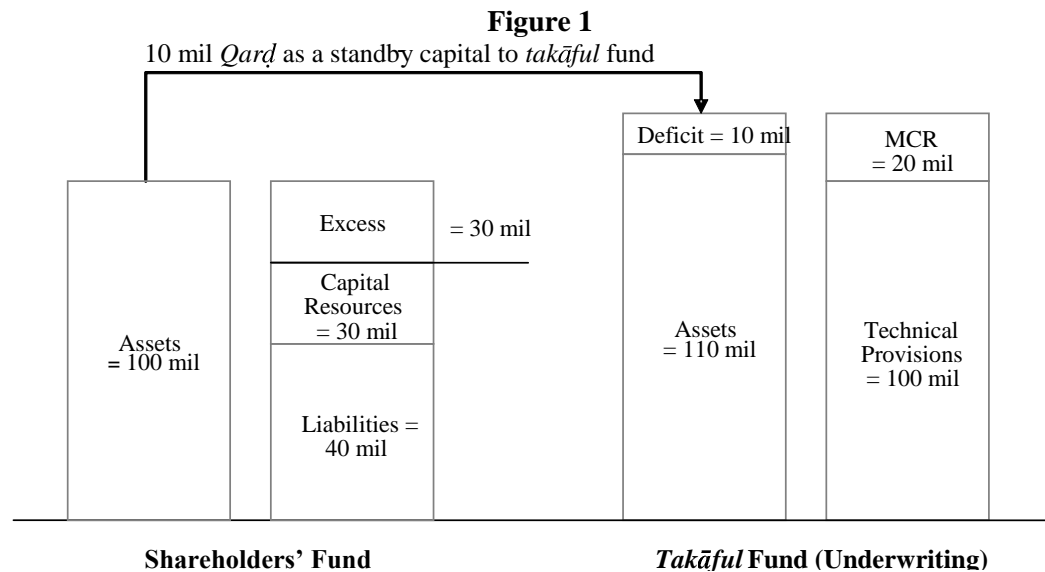
3. Family *Takāful*

Family *takāful*, does not mean insuring one's life, but is a financial protection for the heirs or beneficiaries of the deceased (or insured) against future unexpected financial risk. Family *takāful* deals with the provision of financial relief to the participants and/or their family in the event of misfortunes that relate to the death or disability of the participants. This category of *takāful* normally requires the *takāful* operator to engage in a longer-term relationship over a defined number of years with the *takāful* participants, throughout which the participant is required to make regular instalment payments in consideration for his or her participation in the *takāful* scheme.⁵

In family *takāful*, the paid *takāful* contribution of a participant will usually be divided into two accounts which feed two different funds. The first is the participant's investment fund (PIF), and the aggregate PIFs constitute an investment fund for the purpose of capital formation. The second is the participants' risk fund (PRF) which is a risk or *takāful* fund – i.e. an element of the business that is inherent in the underwriting activities, and the contributions to which are made on the basis of *tabarru'* commitment.

However, one of the key specificities of a *takāful* undertaking is a distinct separation between the *takāful* fund and shareholders' funds as illustrated in the table below:

⁵ For more details see: IFSB-8, pp 5-6.



The segregation of the amounts credited to the PIF and the PRF, respectively, is commonly made based on certain percentages of the *takāful* contributions paid, and this is normally part of the family *takāful* product pricing and design. The *takāful* operator will indicate in the family *takāful* contract the distinction between the two accounts and their relative proportions within the overall contribution, which cannot be unilaterally altered throughout the duration of the *takāful* contract. Family *takāful* consists of two types of funds: participant's risk fund (PRF) and participant's investment fund account (PIF).

The segregation of funds is to facilitate better management of investments activities and risk management. The separation of risk and savings/investment components is deemed necessary to recognize the different ownership, purpose and risks associated with the contributions. Profit is distributed to participants according to their contribution or investment in the family *takāful* fund, based on the terms and conditions applied by the company. The contribution paid by the participants in family *takāful* is allocated for management costs, which comprises commission, management costs and the SSF account. The majority of the contribution paid for family *takāful* is invested in PRF and PIF.

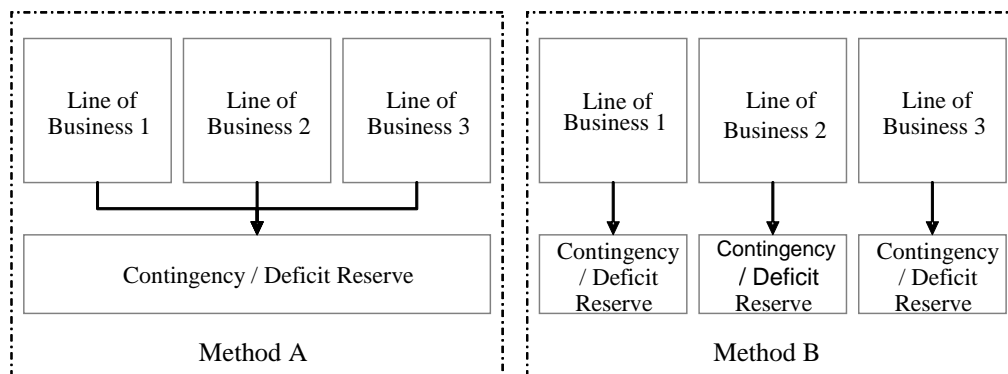
4. Methods of Reserving

The management of reserves is the key element for having adequate capital resources in *takāful* funds. However, the method of reserving may vary and to a certain extent could determine the transferability of these capital resources between the lines of business. The determinants of fund transferability depend on the contractual term or even legal framework that governs the operational aspects of the overall *takāful* undertaking. Some *takāful* products may have so-called ring-fenced structures, where part of the business is segregated from the rest of other operations in a ring-fenced fund. This ring-fenced fund should be understood as a contractual or legal arrangement whereby part of the assets or

eligible surplus of the fund is strictly segregated from the rest of other lines of business and can only be used to meet the *takāful* and *retakāful* obligations with respect to which the ring-fenced fund has been established. As a consequence, the capital resources in the undertaking held within the ring-fenced fund can only absorb the losses stemming from the risks associated with the ring-fenced portfolio and will not be available to meet the other fund obligations and cannot be transferred from the rest of the activity, on a going concern basis

To facilitate the analysis of fund transferability in the reserving method, a simple example is illustrated in Figure 2. In this illustration, there are two methods, namely, Method A and Method B. All reserves from the various lines of business in Method A are pooled into a common reserve fund. These reserves are construed as being available in the sense that the reserves could be withdrawn and transferred to the lines of business in the event of deficiency in one of the business line. However, Method B shows that reserves allocated specifically to one line of business. Potentially Method A could be abused to boost the distribution of underwriting surpluses for a particular line of business. If this is the case, the practice should be prohibited. The objective of having a common pool of reserves is to serve the purpose of providing a solvency buffer for the *takāful* funds.⁶

Figure- 2 Contingency / Deficit Reserves



5. Shari‘ah Regulatory Measures for Solvency of *Takāful* Funds

There are some regulatory measures for solvency of *takāful* fund which Dr. Engku has explained that it has been seen in some regulatory frameworks that the regulator puts a duty on the *takāful* operators to show that they are providing some financial support towards the solvency of the *takāful* funds.⁷

Thus, to provide comfort to both the regulator and the industry generally, some additional measures have been put in place by some *takāful* operators to meet solvency

⁶ See IFSB, (2008) position paper: Solvency requirements for *takāful* operations, p 5.

⁷ Engku Rabia Adawiyah Engku Ali, “Solvency of *Takāful* Fund”, in IFSB, (2011) pp 24-26.

requirements of *takāful* funds. These measures normally involve the *takāful* operators using their shareholders' funds to provide financial backing to support the solvency of *takāful* funds through the practices of:

- *qard* (interest-free loan) to make good any deficit in the *takāful* funds;
- Injection of assets into the *takāful* funds; and
- Allocation of assets in the shareholders' fund to cover any deficit in the *takāful* funds.

However, the *takāful* operators are also bound to consider other factors in their management of solvency of *takāful* funds, such as, fiduciary duties and any possible conflicts of interest, pricing, risk management, business strategies, etc. They must also ensure good governance, especially in terms of segregation of funds and monitoring the role of appointed actuary. In this regard, it may be ideal for the *takāful* operator to allow for participants' representation in their management team, or in the board of directors.

In this sense, it can be said that the regulation of *takāful* seems to combine the features of mutual /cooperative insurance and those of commercial insurance. This approach is considered necessary, based on policy consideration, to cater for the specific features and characteristics of *takāful*.⁸

However, the terms and conditions of *qard* on repayment and timing of the drawdown are unclear and not stipulated. The technical aspect of *qard* that has to be kept in mind is how to maintain fairness between different generations of participants, in particular future generations i.e. *takāful* participants that newly joined a pool in a solvent position (without drawdown of the *qard* facility) will be negatively affected as they might have to pay higher contributions or receive a smaller or no share of the underwriting surplus due to the need to make repayments of the *qard*. There will be an obvious risk that *takāful* participants may decide to leave the fund once the fund is in a deficiency if they are facing higher contributions or cannot expect to receive any underwriting surplus at the end of the *takāful* contract. Hence, it might be difficult to convince any potential *takāful* participants to join a pool that is in a technical deficiency i.e. below the solvency requirements. It is important to point out that according to the Sharī'ah the setting of contribution levels so as to repay a *qard* must not result in a higher fee or other remuneration for the *takāful* operator, as this would defeat the requirement that *qard* be a benevolent or interest free loan.

In short, all the above arrangements involve the *takāful* operators using their own shareholders' capital to support the solvency of *takāful* funds. A relevant question that arises here is: what is the Islamic juristic position on the imposition of a duty on the *takāful* operator to financially support the solvency of *takāful* funds in the above manners? However before getting into the Sharī'ah position on this issue, it is imperative to examine the details of *qard* and its legal basis in Islamic law.

⁸ Ibid, p 26.

6. The Concept of *Qarḍ* Facility

The Sharī'ah law allows *qarḍ* facility as a form of financial services for the shareholders in *takāful* undertaking to help and protect *takāful* participants when the *takāful* fund is in deficit and those who are in need of financial assistance. *qarḍ* in Sharī'ah may be obtained in two ways: (i) *qarḍ* with condition of repayment, and (ii) gratuitous loan without any compensation (*qarḍ hassan*). However, Sharī'ah does not recognize any loan with interest for the benefit of the debtor. It only recognizes gratuitous *qarḍ* or better known as *al-qarḍ al-ḥasan*, but this term is the terminology used in the holy Qur'ān. It is stated in the Holy Qur'ān: "...give regular charity; and loan to Allah a beautiful loan" (*Al-Muzamil*: 30). Therefore, the *qarḍ hassan* is the term used in the holy Qur'ān and such term cannot be used in institutions offering Islamic financial services; which indicate that *qarḍ* is charity not financial assistance.

6.1 Definition of *Qarḍ*

The *qarḍ* has been defined in the IFSB-1 (2005) on Capital adequacy standard as a contract to provide amounts of loan (interest free) to others intended to allow the borrower to use the loaned funds for a period with the understanding that the same amount be repaid at the end of the period.⁹

Al-Zuhaili (1985) also defined *qarḍ* as a specific contract to pay the money (interest free loan) to another that the same amount be repaid at the end of the contract".¹⁰

The AAOIFI has defined *qarḍ* as "the transfer of ownership in fungible wealth to a person on whom it is binding to return wealth similar to it".¹¹

Therefore, *qarḍ* is a kind of gratuitous loan given to the needy people for a fixed period without requiring the payment of interest or profit. The receiver of *qarḍ al-ḥasan* is only required to repay the original amount of the loan.

6.2 Objectives of *Qarḍ* Facility

Sharia'h emphasizes to make brotherhood among the Muslims. The main principle of brotherhood is to care and share each other. *Qarḍ* being a loan (without interest) can help the fellow muslim brothers who need money but do not have it at present. Thus, *qarḍ* facility enhances brotherhood among the Muslims. The main objectives of *qarḍ al-ḥasan* are:

- To establish better relationship between shareholders, *takāful* operators and the *takāful* participants.
- The mobilization of saving from all people in the society.

⁹ See IFSB-2 for more details

¹⁰ See: Al-Zuhaili (1985), Vol-5, p 3785.

¹¹ See: Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), (2010), Sharī'ah Standard for Islamic Financial Institutions No 19, p 347

- To perform a good deed that is encouraged and appreciated by the Almighty Allah and His messenger.
- To strengthen the global *takāful* industry and Islamic finance in general.

6.3 *Qarḍ* in *Qur'ān* and *Sunnah*

In many places of the Holy Qur'ān, Allah has mentioned and encouraged *qarḍ* by assuring better reward in this world and in the Hereafter. In Qur'ān Allah says, "Who is it that will give Allah *qarḍ al ḥasan*, which Allah will double into his credit and multiply many times." [Al-Baqarah: 245]

The Qur'ān says:

"If you give Allah *qarḍ al-ḥasan*. He will double it to your credit and he will grant you forgiveness." (Al-Tagabun: 17)

In the Ḥadīth

The *Sunnah* of the Prophet (peace be upon him) is also very clear on this issue. In Ḥadīth reported by Abu Hurayrah, the Prophet (peace be upon him) said, "Whoever relieves a believer from a difficulty in this world, Allah will relieve him from his difficulty and Allah will facilitate him in this world and world hereafter." [Sahih Muslim, Ḥadīth No 239]

The above Qur'ānic verses and Aḥadīth directly and indirectly encourage giving *qarḍ* in general which includes giving *qarḍ* facility to the *takāful* participants or anybody who is facing financial difficulties. This will add to the credits of a Muslim in manifold and bring forgiveness for him in this life and hereafter.

7. Sharī'ah Ruling of *Qarḍ* Facility in *Takāful* Undertaking

This paper does not intend to give an elaborate examination of these interpretations and arguments on the *qarḍ* facility. Direct reference can be made to the original writings on the matter by those who need more elaboration. What the paper will do is just to highlight the various interpretations as given by the scholars and the effects of each of these interpretations on the issue of ownership of *takāful* funds and responsibility for their solvency. *Qarḍ* facility, being a contract between two parties requires some Sharī'ah rules and principles which are applicable for other Islamic financial transactions. These rules and principles are as follows:

7.1 Both Parties Should Be Legally (Sharī'ah) Capable to Enter Into the Qarḍ Contract.

It is unanimously agreed by the four schools of law that to enter into a contract, parties should be mature (*baligh*), have reason (*'aqil*) and *rashid* (major with sound judgment). In the holy Qur'ān, Allah says:

“Make trial of orphans until they reach the age of marriage; if then you find sound judgment in them, release their property to them” [Al-Nisa: 6].

This verse states that the age of marriage and the sound judgment is the age of maturity. Thus, a matured person is capable to enter into any transaction and the contract or transaction is considered valid.

In Ḥadīth of the prophet, it is states that:

The Prophet (peace be upon him) said, "The pen is raised for three groups (of people) that is, they will not be responsible for their actions: the insane until they become sane, those who are sleeping until they are awoken, and the youth until they reach puberty". (Sahih Muslim, Ḥadīth No 319)

The above Ḥadīth makes it clear that a person who has not attained the age of puberty may not be a responsible party in any contract or any transaction particularly *qarḍ* contract.

7.2 Ijab (offer) and Qabul (acceptance) of the Qarḍ Must be Clearly Made Before Entering into the Loan Contract

All four schools of thoughts agree upon that *ijab* and *qabul* should be clearly indicated in the contract, otherwise, the loan contract may create dispute in future. In the loan agreement, there should have clear expression, collation and conjunction of the *ijab* and *qabul* between the parties.¹²

7.3 The Date of Payment for Qarḍ Facility Must Be Specified

It is also agreed among the Muslim jurists that the date of payment should be mentioned in the *qarḍ* agreement. If no date is specified between the *takāful* operators and *takāful* participants, the transaction may lead to ambiguity and dispute in future among the shareholders and the *takāful* participants.

The basis for the above Sharī'ah ruling means that paying the *qarḍ* facility in time as specified in the contract which cannot be subordinated is that it was based on the *qarḍ* agreement of the Prophet's companions. When the Prophet migrated to Madinah, he was informed that contracts of *salam* were made without stating specified time or amount.

¹² See: Al-Zuhaili (1985), vol-5, pp 3785-3789.

This is the analogy to show that in any contract specification of time is very significant, the prophet said:¹³

“whoever enters into a contract of salam should specify the date of delivery and the amount of subject matter” (Narrated by Bukhari and Muslim)

7.4 *The Qarḍ Contract Should be Written Down*

This ruling is based on a Qur’ānic injunction. As Allah (s.w.t) says; "O you who believe! When you deal with each other in transactions involving future obligations for a fixed period of time reduce them in writing." [Al-Baqarah: 282]

Muslim jurists, however, differ on this condition. Majority of the muslim jurists argue that it is not obligatory but strongly recommended. The reason given by them is that if both parties agree not to write, then it is no longer an obligation upon them to write down. The wisdom behind the writing down is to avoid future dispute. On the contrary, minority of the Muslim jurists like *al-Tabari* are of the opinion that it is obligatory upon the parties to write down the contract. It is submitted that the majority's stand seems more reasonable as they have given the option upon the parties whether to write it down or not.¹⁴

7.5 *Getting Two Witnesses*

The Qura'nic injunction is that there must have two male witnesses, if two men are not available, then one man and two women will have the same effect. As the Qur'an says:

"And get two witnesses out of your own men and if there are not two men, then a man and two women" [Al-Baqarah (2): 282].

It is very essential for the loan contract to be complied with this Qur’ānic requirement to avoid future disputes.

7.6 *Extra Payment*

It is very clear that in the *qarḍ* agreement, there will be no condition for extra payment; otherwise, it will be *ribā*. It is however, advisable for the debtor to give some sort of gift to the creditor as a sign of appreciation of his voluntary deed.

In a Ḥadīth, Jabir bin Abdullah (may Allah be pleased with him) reported that I had the right (of *qarḍ*) on the Messenger of Allah, he had settled it and made additional payment to me. Again Abu Rafi' reported that the Prophet (saw) had borrowed a young female camel from someone and when he received zakat of camels, he ordered me to send a young female camel to the man as settlement of the loan. I said to him, "I could not find among the camels except a female camel which is ready for pregnancy". The Prophet (peace be upon him) said, "give it to him,

¹³ Ibid, p 3789

¹⁴ See: Al-Zuhaili (1985), vol-5, p 3785.

indeed, the good person among you is he who settles *qard* with something better". (Sahih Muslim, Ḥadīth no 231)

This in fact is not regarded as doubt as to its chain of narrators. Moreover, Muslim jurists have various opinions relating to extra payment over *qard*. The Hanafi, the Shafi'e and the Hambali's stand is that every loan with profit is forbidden because of the statement "every *qard* which draws benefit is *ribā*" if the profit is stipulated in the loan agreement, otherwise, the profit is permitted.¹⁵ According to Malikis, the borrower may pay more than the capital quantitatively or qualitatively at the time of the settlement of the *qard* provided that the *qard* was used for commercial purpose. They restricted the extra benefit from the *qard* if it was used for consumption purpose.

7.7 Early Demand to Pay Back

Qard facility is a voluntary act by the creditor. However, it is not encouraged for early demand to pay back the *qard* from the debtor. In the Holy Qur'ān Allah says: O you, who believe, fulfil your contract. [Al-Maidah:1]

The Qur'ānic and the Ḥadīth injunctions indirectly provide that the creditor should not demand the loan amount from the debtor before the agreement matures or lapses. Muslim jurists, however, have given different views on this matter. According to the Shafi'e and the Hambali jurists, the creditor can demand the settlement from the debtor before the expiry period as he wishes. They have given the reason that the loan is voluntary and it cannot compel any party to abide it. The Hanafi and the Maliki jurists, on the contrary, are of the views that the creditor cannot demand the loan amount back until the time for settlement matures.

8. Sharī'ah Views on Case of Subordinated *Qard*

According to the Sharī'ah principles, *takāful* operator is commonly expected to provide a *qard* facility (interest free loan) in case of a deficit in the *takāful* fund and the repayment of *qard* should be from future surplus arising from the *takāful* funds. The most obvious reasons why the *takāful* operator is expected to provide a *qard* are twofold. Firstly, it is hardly practicable to ask each and every individual *takāful* participant to contribute more funds into a fund in deficit. Secondly, as the *takāful* operator being an agent of the pool shares the risk of a deficiency, this falls within the mandate of *takāful* operator. In this case subordinated *qard* is "a process by which a creditor is placed in a lower priority for the collection of its *qard* from its debtor" or "it means that the *qard* providers (shareholders) have subordinate status in relationship to the *qard* facility".¹⁶ However, the Sharī'ah position and juristic views on the case of subordinated *qard* will be summarized in the following

Al Ashqar¹⁷ is of the opinion that it is not permissible for Islamic insurance to undertake to cover deficit in the insurance fund from its shareholders' fund, even by way

¹⁵ See: *ibid*, p 3787.

¹⁶ For more details see: <http://en.wikipedia.org/wiki/Subordination>, visited on 16 March 2012.

¹⁷ See more details: Al-Ashqar, (1998), p 22-23.

of *qard*. But he allows for other means to cover the deficit i.e Islamic insurance reserves. He argued that the *takāful* company is a *muḍārib* in investing the *takāful* funds. Thus, when the company undertakes to give *qard* to the *takāful* funds in the event of deficit, this will amount to stipulating one contract in another contract, i.e., *muḍārabah* and loan; or *muḍārabah* and guarantee.

The argument by Al-Ashqar seems to apply to a situation where the *takāful* company is a *muḍārib*. The same argument may not apply where the *takāful* operators use *wakālah* contract in the management of *takāful* funds, which is the practice by many *takāful* companies.

In contrast, it is stated in the Sharī‘ah standard for Islamic financial institutions No 26 issued by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)¹⁸ that:

When the Islamic insurance assets along with indemnities received from re-insurance fall short of covering the indemnity commitments, the *takāful* operator may cover the deficit from project financing or *qard* (interest free loan) debited to the account of the *takāful* fund. In this regard, the deficits resulting from commitments of the current year may be covered from the surpluses of the succeeding years. The *Takāful* Operator (TO) may also claim settlement of the deficit from *takāful* participants if they undertake to do so in the *takāful* scheme.¹⁹

Dr. Engku Rabiah has explained that a view similar to that of AAOIFI had been expressed by the Shariah Advisory Council (SAC) of the Malaysian Central Bank on this issue. For example, in the 38th Meeting of the SAC, it decided that:

- In the event that the reserves are not sufficient to cover deficits in the Participants’ Special Account (PSA),²⁰ then the *takāful* operator must cover the deficits by giving financial help from the shareholders’ fund by way of *qard ḥasan*.

She said that the SAC had resolved in their 46th Meeting to:

- Approve the Central Bank of Malaysia’s proposal to impose on the *takāful* operators the responsibility for the solvency of *takāful* funds and to secure the benefits and savings of the participants through asset injection from the shareholders’ funds into the *takāful* funds to cover any deficit that occurs based on the reason given. The security and injection of asset may be implemented by the *takāful* operator based on commitment to donate (*iltizam bit tabarru’*), i.e., the operator undertakes to give donation to cover all the claims (liabilities) on the *Takāful* fund in the case of deficit.

¹⁸ See: Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), (2008), Sharī‘ah Standard for Islamic Financial Institutions No 26, p 476

¹⁹ See: AAOIFI, Sharī‘ah Standard on Islamic Insurance, item 10/8

²⁰ Participants’ Special Account (PSA) is the common name used in Malaysia to signify the risk /Tabarru’ account in family *takāful* plans. This account is considered as the “*takāful* fund” to cover for claims.

There are some regulators that are of the view that the *qard* can be subordinated. While a *takāful* firm or *takāful* operator may exclude from its fund liabilities any amounts borrowed from the *takāful* fund so long as the following conditions are met:²¹

- The loans are free loans, established in accordance with Islamic principles, and the Shari‘ah Supervisory Board (SSB) approves the terms and conditions of those loans.
- The loans rank for repayment upon winding up of the *takāful* company only ahead of the ordinary shares of the company and, for the avoidance of doubt, must be subordinated to all participants and other creditor obligations of the *takāful* fund.

It is also explained that the *takāful* undertaking allows for the capital to be contributed to the risk fund in the form of *qard* facility. From the point of view of risk fund, since there is a separation between the *takāful* operator’s fund and the fund as explained earlier, *qard* facility received might be viewed as capital in the risk fund, provided that is appropriately subordinated to the need to meet claims and can only be repaid out of future surplus. To avoid so called “double gearing” using the same capital to cover two different risks, if *qard* facility represented capital in the risk fund it could not also be recorded as an asset in the *takāful* operator’s fund even though it is expected to be repaid.²²

This regulatory position is contradicted with Shari‘ah rules and principles based on the *qard* contract which will be discussed in details below. Sobia Maqbool²³ has already argued her speech that subordinated *qard* is not allowed in Malaysia; as for *takāful* solvency requirements she explained, “The relative priority of claim of *qard* offered by the SHF vis-à-vis other obligations, is also an important rating factor. For instance in Malaysia, *qard* facility is not explicitly subordinated to the interests of policyholders (*takāful* participants). In Pakistan, however, this is not the case as the company is only required to pay *qard* from underwriting surplus. This is considered positively as underwriting surplus is arrived at after taking all claim expenses as well as associated reinsurance costs/benefits into account”.²⁴

Unlike conventional insurance, any surplus generated within the PIF is shared with the participants, which may prevent capital formation. Therefore, policy with respect to creation of surplus equalization reserve is considered important in terms of future assessment of claims paying ability. This reserve would only gradually grow upon time, depending upon the policy adopted by the *takāful* operator and any credit thereof is built accordingly into ratings. In view of the practice of distributing surplus, the claims paying ability strictly from the PIF perspective may actually vary significantly from year-to-year and undertaking a firm-wide capitalization analysis therefore makes more sense. It is also

²¹ See: Central Bank of Bahrain Rulebook, (2005), Capital Adequacy Module, CA-8.4.10 volume 3, 23-25.

²² James Smith, (2009), p. 230-240.

²³ Sobia Maqbool’s opening speech, (2008), Rating Agencies Methodologies for *takāful* and *Re-takāful* Firms, JCR-VIS Credit Rating Company Limited, p 2-4

²⁴ See Tobias Frenz & Younes Soualhi (2010), *Takāful* and *Retakāful*: Advanced Principles and Practices, (Malaysia: Kuala Lumpur IBFIM, 2 edition), pp 204-209.

considers the extent of ring-fencing amongst the surpluses generated by various product lines and the degree to which surplus from one may be used to off-set the losses on others. A more rigid structure may result in a greater need to call for capital from the SHF and may not be viewed positively.

The IFSB-11 has explained that *qard* facility cannot be subordinated in the *takāful* undertakings. This is because the extent to which a *Qard* facility enables a *takāful* undertaking to meet regulatory solvency requirements depends, inter alia, on the terms on which such *qard* facilities are made available by *takāful* operators. This depends in the light of the regulations in a particular jurisdiction, including, in particular, those that determine the status of an outstanding amount of a *qard* facility (that has already been drawn down as a *qard*) in the case where a PRF enters into an insolvent winding-up.²⁵ In such a case, there are two possible scenarios:

- i. Any outstanding *qard* would rank *pari passu* with participants' claims, so that the deficiency would be shared pro rata;
- ii. Participants' claims would rank above any outstanding *qard*

Only in the second case should the *qard* facility be considered to be fully part of regulatory capital. In the first case, it might be considered as making some contribution to regulatory capital.

Therefore, in order to know Sharī'ah position on subordinated *qard* the IFSB-11 further emphasized that in order for a *qard* facility or *qard* to be accepted for solvency purposes, supervisory authorities should satisfy themselves that the following conditions are met:²⁶

- (i) the *qard* facility provided to a PRF cannot be withdrawn by the *takāful* operator before the PRF is considered to meet solvency requirements independently of any *qard* facility;
- (ii) the *takāful* operator has given its consent to the supervisory authority that, in a winding-up situation, it will treat any part of the *qard* facility that has been drawn down as a *qard* as being donated to the PRF to the extent that is necessary in order for participants' claims to be in accordance with regulatory obligations (or some other arrangement to the same effect).

However, Elgari in his paper (2009) "*qard* facility in *takāful* fund" delivered in the IFSB seminar on Sharī'ah issues related to *takāful* undertakings in Madinah stated:

Origin of *takāful* fund above is that this fund belongs to *takāful* participants. Therefore, *takāful* participants have to bear or be responsible for paying back the shareholders this amount. Elgari (2009) explained that what if the deficiency in the *takāful* fund is still continuing which leads to a winding up. According to

²⁵ IFSB-11 (2010), Standard Solvency requirements for *takāful* (Islamic insurance) undertakings, p 2-12.

²⁶ See: IFSB-11 (2010), Standard Solvency requirements for *takāful* (Islamic insurance) undertakings, p 14

him: If this is what happens to this fund, in the event of a continued deficit, the *takāful* operators or shareholders have the right to forgo or donate this *qarḍ* facility for the benefit of *takāful* participants, this will show the meaning of cooperative which is the core principles of *takāful* undertaking. There is no restriction from Sharī‘ah rules and principles, it is permissible.

8. Conclusion

Upon the discussion on the *takāful* fund and the case of subordination *qarḍ* in this paper we have concluded on the following:

1. There are two elements important in formulating the solvency requirements of a *takāful* undertaking namely the *takāful* fund and *qarḍ* facility.
2. Sharī‘ah attempts to establish justice and eliminate exploitation in the society and prevent the accumulation of wealth in the hands of few people. Therefore, Sharī‘ah absolutely prohibits usury (*ribā*) as it is the root of all injustices in the financial transactions. *Qarḍ* facility, on the contrary, being an interest free loan which is among the Sharī‘ah compliant contracts adopted in Islamic finance and *takāful* industry. The Qur‘ān and the *Sunnah* have much appreciated and encouraged giving *qarḍ*.
3. The treatment of the *qarḍ* facility is a fundamental issue. Any draw-down of a *qarḍ* facility into a participants’ risk fund (PRF) should in principle be repaid from future surpluses of the PRF and should not be subordinated as mentioned. The draw-down of the *qarḍ* facility will have been initiated with the intent of enabling the PRF to meet its regulatory obligations.
4. The IFSB-11 stated that *qarḍ* cannot be subordinated and any outstanding *qarḍ* would rank *pari passu* with participants’ claims, so that the deficiency would be shared pro rata; and participants’ claims would rank above any outstanding *qarḍ*.
5. The *qarḍ* facility provided to a PRF cannot be withdrawn by the *takāful* operator before the PRF is considered to meet solvency requirements independently of any *qarḍ* facility;
6. The *takāful* operator has given its consent to the supervisory authority that, in a winding-up situation, it will treat any part of the *qarḍ* facility that has been drawn down as a *qarḍ* as being donated to the PRF to the extent that is necessary in order for participants’ claims to be in accordance with regulatory obligations (or some other arrangement to the same effect).

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The Process of Shari‘ah Assurance in the Product Offering: Some Important Notes for Indonesian and Malaysian Islamic Banking Practice

AGUS TRIYANTA¹ and RUSNI HASSAN²

Shari‘ah compliance is one of the important legal and fiduciary duties of Islamic banks. Its importance is growing in the wake of the challenging business environment and the increasing needs for innovative products and instruments faced by Islamic banks. The present paper seeks to analyze the process and procedures for Shari‘ah assurance in the product offering in Islamic banking sector in Indonesia and Malaysia. Starting with the theoretical overview of the Shari‘ah assurance, the regulatory framework designated to cater such processes and procedures are then mapped and evaluated. Having this at hand, practical implementations are discussed to draw any distinctive features in both jurisdictions. Lastly, suggestions are presented to be proportionally adopted for the purpose of achieving better process and procedures of Shari‘ah assurance in the product offering in Islamic banking sector in both, Indonesia and Malaysia.

1. Introduction

The discussion in this paper is not designated to cover all the aspects of Shari‘ah compliant corporate governance, which may be very broad. As the topic of the article suggests, the discussion is specifically directed to the duty and responsibility of Shari‘ah board³ members pertaining to the process that Shari‘ah compliance is ensured within Islamic banking. As such, the deliberation on Shari‘ah compliance cannot be separated from the discussion on Shari‘ah compliant corporate governance.

Apart from diversity in models of the Shari‘ah board (referred to as Board here in after) across various countries, there are some common methods and procedures that the Board members undertake to examine and ascertain Shari‘ah compliance of the products and operations of Islamic banking. These methods and procedures are called instruments for supervision which, according to Abd al-Hamid al-Ba‘li, are three:⁴

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³ Shari‘ah board is the general term for a certain body which is responsible to advise or supervise the Shari‘ah aspects of Islamic banking. To be specific, there will be some different names in these two countries, like Shari‘ah committee in Malaysian banking industry and Shari‘ah advisory council within Bank Negara Malaysia. While in Indonesia, the Shari‘ah supervisory council within Islamic banking industry and national Shari‘ah council at national level.

⁴ al-Ba‘li, (2003).

- 1) Researching and evaluating the operations of the bank
- 2) Issuing verdicts relating to the products and operations, as and when necessary.
- 3) Withdrawing or cancelling former decisions and operations, which are not in line with Shari'ah principles.

To achieve the effectiveness in Shari'ah supervision, it is utmost necessary for the Board to examine the whole aspects related to the operations of the bank and to ensure that these are according to Shari'ah principles. This supervision is not limited solely in giving opinions or issuing *fatwās* or advices before certain products are launched by the bank, rather it also encompasses reviewing and auditing of the operations after the products have been launched.

For these reasons and irrespective of the method of supervision that may be adopted, pre-launch, on-going, and post-launch supervisions are needed.⁵ Pre-launch supervision means ascertaining Shari'ah compliance through analyzing portfolios and the simulation of the products. On-going supervision means the control along the practical operations of the banking business, such as how various financial contracts are factually undertaken by the parties involved. Post-launch supervision means the rechecking after the bankig business is being undertaken. Thus the compliance to Shari'ah can be assured through the three step procedure.⁶

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), has devised a set of legal framework to ascertain that the products and operations of Islamic banks comply to Shari'ah principles. The Islamic Banks have therefore associated prominent scholars and experts in their Shari'ah boards and assigned them with the responsibility to ascertain compliance to Shari'ah, particularly in the following aspects:⁷

- (a) Planning review procedures for adoption by the Islamic banks and financial institutions.
- (b) Executing review procedures and preparation as well as review of working papers.
- (c) Documenting conclusions and reports after the review has been completed.

In particular reference to the review procedures following steps must be undertaken:⁸

- i) Understanding the management's awareness, its commitment and compliance to control procedures for adherence to the Shari'ah.
- ii) Reviewing contracts, agreements, etc.

⁵ Abu Ghuddah, (2002), p.22.

⁶ In auditing terminology, certifying permissible financial instruments through *fatwās* is called "ex-ante Shari'ah audit", whereas verifying that transactions comply with issued *fatwās* is called "ex-post Shari'ah audit". Wafik Grais and Matteo Pellegrini (2006).

⁷ AAOIFI (1423H-2002), p.16.

⁸ AAOIFI, Governance Standard, p. 16.

- iii) Ascertaining whether transactions are authorized by Shari'ah board.
- iv) Reviewing other information and reports issued.
- v) Consultation/coordination with advisors, such as external auditors.
- vi) Discussing findings with the management of the Bank.

It is clear from the above procedures that the Board members are required to collaborate intensively with other boards or parties relevant to the banking business, including external auditors. It again shows that the assurance of Shari'ah compliance is an inter-divisional responsibility in which the Boards cannot work alone.

To substantiate the procedures of Shari'ah review, the Islamic Financial Service Board (IFSB) recommends an appropriate mechanism in obtaining rulings from Shari'ah scholars, applying fatwās and monitoring Shari'ah compliance in all aspects of the Islamic banking activities. In this regards, two mechanisms are important for assuring Shari'ah compliance:⁹

- Scrutiny of all financial transactions carried out by the Islamic banks, both before (ex ante) and after (ex post) aspects
- Watching the operations of the Islamic bank, including investment policies, disposal of non- Shari'ah compliant income, charitable activities, etc.

It is interesting to note that both AAOIFI and IFSB have focused on similar point as also emphasized by 'Abd al-Hamid al-Bā'li, albeit with slight improvements made by the two relevant authorities.

The common problems faced by the Board members is how to monitor intensively the activities of the bank. It should be understood that the existence of the Board is essentially needed by the bank, despite the fact that it is created merely to fulfill the requirements of obtaining a license. Therefore, the ignorance of Board members towards the issues related to Shari'ah compliance may be deemed as failure of the Board to accomplish its basic mission. On the other hand, it seems difficult for members of the Board to closely understand the practical operations of the Islamic banking business when certain methods of monitoring are not available.

For the purpose of providing efficient supervision in Islamic banking, it is proposed that a permanent office of the Board be established within the premises of the bank that will facilitate the members to check and review all products and related documentations. This will enable the board members, via assistance of an administrative officer as in-charge for the job, to monitor the activities of the bank. In addition, it may be possible to arrange periodical (regular) meetings of the Board with the management of the bank to discuss all the entailing issues and respond to all the queries of practical nature raised by

⁹ Islamic Financial Services Board (IFSB) - Guiding Principles on Corporate Governance For Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (*takāful*) Institutions and Islamic Mutual Funds) 2006, Retrieved May 7, 2007. <http://www.ifsb.org>

the management. This method, however, is more formal, and may put the management in an uncomfortable situation to some extent. Indeed, this highly formal situation also means that the Board members may not obtain the necessary information directly. Another possible method for supervision is that the Board undertakes to check samples of the banking documentations and other relevant issues.¹⁰

In order to identify the parallelism between the theory and practice and also for the purpose of comparison, we discuss the practices followed for assuring Shari'ah compliance in Islamic banking sector, of Malaysia and Indonesia intensively as under:

2. Shari'ah Compliance in Islamic Banking Malaysian Case

The process of assuring Shari'ah compliance in Islamic banking may involve a long chain of activities, which are interconnected. The process involves various parties and covers various activities from the initial formation of the products till such products are launched and marketed. In a nutshell, there are five steps for the Shari'ah compliance process adopted by Islamic banking practitioners in Malaysia. First is to establish measures for the product offered, second is to pinpoint the advisory or supervisory activities. The next step is to obtain a Shari'ah opinion or *fatwā* about the validity of a new product. Fourth is to take necessary action in case of non-compliance towards *fatwās* or decision. The last step is to pass Shari'ah opinions on the annual report of the bank to be presented in the shareholders' general meeting. Deliberation of each step will be presented in the following discussions.

(i). Establishing Specific Measures for Product Offering

The first and most important stage in ascertaining Shari'ah compliance is to define the product. The details of the products in Islamic banking business are not clearly stated in the existing regulations, neither in the Islamic Banking Act 1983 (IBA) nor in the Bank and Financial Institutions Act 1989 (BAFIA). Guidelines for product offering however, have been enumerated in SPTF (Skim Perbankan Tanpa Faedah) or Interest Free Banking Scheme Guidelines,¹¹ which were initially designated for conventional banks offering Islamic banking business.

The absence of a specific legal provision concerning the features of the product for Islamic banks, may be due to the fact that Islamic banks were incorporated under the IBA 1983, in which the Shari'ah Committee (SC) is required to ascertain that any product offered does not infringe Islamic tenets. The Shari'ah Committee (SC) members together with the management of the bank is supposed to be capable of deciding a list of products, which are compliant to Shari'ah principles.

It is observed that the definition of products in Islamic banking business is practically similar to that of conventional banks offering Islamic banking services. This is due to

¹⁰ Bakar, Mohd. Daud, (2002), p.80.

¹¹ Bank Negara Malaysia Guidelines on "Skim Perbankan Tanpa Faedah (SPTF)" for Finance Companies 1993. (Acts and Statutes: Malaysia).

the fact that conventional banks conducting Islamic banking business are under the supervision of the Bank Negara Malaysia, and thus they are also subject to the same advisory body, which is the Shari'ah Advisory Council (SAC). As such, it would be understandable that the list of the products and their definitions does not differ significantly from that of conventional banks conducting Islamic banking business (products listed by SPTF Guidelines 1993).

Considering that the definition may be general in nature, the particular products need for further detailed measures. Setting up clear measures of the products is a step that the bank shall take before the application of the product into a real financial contract. The measures are made in such a way that enables both the bank and the customers understand very clearly the nature of the contract (product) and its legal effects.

Under the guidance of Shari'ah Committee (SC) members, the bank formulates the structures of the products according to the specific measures (terms of product). The terms of the product carry a brief description of every product offered that provides an easy and simple process of execution of the contract. *Bay' Bi Thaman al-Thaman al-ājil* (BBA) financing is a good example to illustrate the point. According to SPTF Guidelines 1993, it is "the sale of goods on deferred payment basis at a price which includes a profit margin agreed by both parties".¹²

Based on the definition, an Islamic bank then redefines it in a way that enables the customers to clearly understand the product. Accordingly, Bank Islam Malaysia Berhad (BIMB) defines this product as follows:

"*Bay' Bi Thaman al-Thaman al-ājil* means deferred payment sale whereby the Bank will finance customers who wish to acquire an asset but to defer the payment for the asset for a specific period or to pay by installment".¹³

This product then, is formulated into a specific applicable term. Accordingly, BIMB provides that the contract of BBA should be executed in-line with specific product terms. The terms provide that: "Under this facility, the Bank shall first purchase the asset concerned. The Bank subsequently sells the relevant asset to the Customer at a selling price which comprises of the actual cost of the asset to the Bank and the Bank's margin at profit".¹⁴

As the terms are initiated by the industry, hence there is non-uniformity in the features of the product terms, as it depends on the Islamic financial institutions themselves. For instance, the Maybank Islamic has adopted a slightly different definition of BBA. It is defined as: "*Bay' Bi Thaman al-Thaman al-ājil* or Deferred Payment Sale refers to the sale of goods on a deferred payment basis at a price that includes a profit margin agreed upon by both the buyer and the seller".¹⁵ Since there is no specific terms

¹² SPTF Guidelines 1993, 4

¹³ Bank Islam Malaysia Berhad at: <<http://www.bankislam.com.my>>, accessed May 7, 2007.

¹⁴ Bank Islam Malaysia Berhad at: <<http://www.bankislam.com.my>>, accessed May 7, 2007.

¹⁵ Maybank at: <<http://www.maybank2u.com.my>> accessed July 17, 2007.

and features given, this definition seems to be sufficient to describe the essential aspects of the product.

There are many terms of a product, as many as the *mu'āmalah* contracts, applied in a particular bank. However, as is apparent from the examples of two banks cited above, the difference in delivering such terms is merely in the wording, while substantially they are similar to one another. The additional features may be given by the banks in their terms of the products, as this is a matter of the banks' policy. However, these must be Sharī'ah compliant any way.

(ii). *Advisory and/or Supervisory Activities*

Basically, there are two kinds of supervisory and/or advisory activities that the Sharī'ah Committee (SC) undertakes; namely the periodical meetings with the board of directors, and ad hoc meetings in resolving critical cases.

Periodical meetings are set out to sustainably evaluate the operations and products of Islamic and conventional banks conducting Islamic banking business. Usually, this mode of activity is conducted through the meeting with the board of directors or management of the bank. Since such meetings are a matter of internal policy, their frequency may be different from bank to bank. However, monthly meetings are as the most common schedules.¹⁶ In these meetings, issues related to Sharī'ah can be resolved by the Committee (SC) members. Although the common agenda pertains to the new products, it is also possible to table the issues pertaining to given *fatwās* that need to be evaluated. Although monthly meetings may be rare, however, the banks usually have an established procedure to resolve critical issues through ad hoc meetings. This needs further explanation.

It is observed that periodically scheduled meetings may not be sufficient to resolve some urgent issues faced by the bank. Therefore, the bank normally will call the Sharī'ah Committee (SC) for ad hoc meetings as and when considered necessary. Certain departments within the bank directly concerned with the issue, either because of launching a new product or some other matter related to operations, have to provide the paperwork explaining the context of the issue and a proposed possible solution. The members of the Sharī'ah Committee (SC) have to examine the case and resolve the issue immediately. This provides the rationale for an ad hoc meeting to be called. Situations like these normally arise in the Product Department, which specifically deals with the product development and innovation. The ad hoc meetings are convened on case to case basis. Anyhow, this is indeed the duty of the Sharī'ah Committee (SC) to resolve such issues immediately.

¹⁶ In this case BIMB has meetings once in every two months, source: Interview with the Head of Sharī'ah Department who is also the secretary of the Sharī'ah Committee in the BIMB, Ustad Nasrudin Yaakub on February 28, 2007. Also, Interview with Dr. Abdul Halim Muhammad, Vice Chairman of the SAC, February 22, 2007

(iii). *Floating Shari'ah Opinion or Fatwā¹⁷ (Why using the word Fatwās? Why not Fatāwā)*

The floating of well-considered opinions (*fatwās*) on matters relating to Islamic banking products is one of the most important roles of the Shari'ah Committee (SC). The procedure can be divided into two stages. First, the revealing of opinions relating to the products or issues while the structure of basic contracts has already been considered by the Shari'ah Advisory Council (SAC). Second, the floating of *fatwās* relating to the products or new issues in which case no previous opinion or resolution of the Shari'ah Advisory Council (SAC) exists.

When a certain department or division of the bank faces certain issues that need to be resolved in light of Shari'ah provisions or intends to launch a new product, the concerned staff prepares a detailed proposal for submission to the Shari'ah department or to the liaison officer of the Shari'ah Committee (SC).¹⁸ The Shari'ah department, pursuant to the proposal forwarded, arranges a meeting of the committee. The said proposal is then presented in the meeting.

The Shari'ah Committee, besides attending to the presentation, may also ask the Shari'ah department to conduct the necessary research regarding various aspects of the proposed product. The committee, after considering the proposal and results of the research if any, analyses the issue and resolves the problem in a clear statement, called the Shari'ah opinion. However, if the Shari'ah Committee doesn't reach any conclusion to resolve the issue, the matter shall be referred to the Shari'ah Advisory Council to obtain a formal approval.¹⁹

The procedure is more relevant when the bank intends to develop or launch a new product. The respective bank requires confirmation and approval from the Shari'ah Advisory Council situated at the Central Bank, of course through the channel of local Shari'ah Committee. This approval is necessary on the grounds that the product may be novel and complicated in nature, and that no well defined standards or precedence may be available to the bank. Anyhow, it is the duty of the Shari'ah Committee to prepare the proposal and provide adequate Shari'ah reasoning to justify the product. The board of directors of the bank together with the Shari'ah committee may then forward the proposal to the Islamic Banking and *takāful* Department of the Bank Negara Malaysia for consideration.

¹⁷ Though scientifically there is no sharp difference between Shari'ah opinion and *fatwā*, as the two are actually similar in nature, technically, a Shari'ah opinion is a specific term to call the opinion given by Shari'ah board within the industry. In contrast, a *fatwā* usually refers to the decision delivered by the higher Shari'ah body, namely SAC in Malaysia or NSC in Indonesia. Interview with the Head of Shari'ah Department, Ustad Nasrudin Yaakub on February 28, 2007 and Prof. Asymuni Abdurrahman, member of National Shari'ah Council Indonesia, February 3, 2007.

¹⁸ Not all the banks conducting Islamic banking business have a Shari'ah department. In this case, Shari'ah board members have to do research themselves. Therefore, according to the opinion of Dato' Md. Hasyim Hj. Yahya, a member of the SAC, there should be such department within the BAFIA-IBS bank (Interview with him on March 7, 2007).

¹⁹ Interview with Head of Shari'ah Department BIMB, Ustad Nasrudin Yaakub, February 28, 2007.

The process of obtaining decisions or opinion (*fatwās*) of the Shari'ah Advisory Council (SAC) about any new product or on any new issues may pass through several stages. It is important to note that prior to the establishment of this council, the Shari'ah Committee could give a decision independently. However, after its establishment, now the decision about a new product is finally given by the council.²⁰

In situations where the Shari'ah Committee of the respective bank is capable of resolving the issue, the only requirement is to send the report to the Shari'ah Advisory Council for obtaining its approval. The council may require the Shari'ah Committee to present the proposal in a meeting if further explanation is needed particularly when the issue is complex. Here, the process of the issuance of *fatwās* or decision taking is completed by the Shari'ah Advisory Council in the manner.²¹

Firstly, When the Shari'ah Committee of the respective bank proposes to resolve a Shari'ah related issue on a new product, the board of directors of the bank shall send an application to the Bank Negara Malaysia requesting for a verdict (*fatwā*). The application is supported by the proposal together with the explanation of the product and its justification according to the Shari'ah.

Secondly, The Islamic Banking and *takāful* Department of the Central Bank, in response to the above application, undertakes necessary research on the problem raised by the proposal. The outcome appears in the form of a draft paper for discussion in the Shari'ah Advisory Council.

Thirdly, the Central Bank invites meeting of the Shari'ah Advisory Council members, the board of directors and the Shari'ah Committee of the respective bank for the purpose of getting *fatwā* pertaining to the product. The proposal forwarded by the respective bank, together with the paperwork or draft is then presented in the meeting. The aim behind involvement of all the relevant parties is to comprehend the problem, to discuss all the aspects, and to ensure that *fatwā* is made with full understanding of the issue at hand.

Fourthly, the process involves resolving the issue. Having reviewed all the aspects of the proposal, the Shari'ah Advisory Council may then resolve the problem and grant the approval accordingly. If considered necessary, the council may conduct another meeting or a series of meetings to deliberate further and analyze the problems relating to the

²⁰ The first Islamic bank in Malaysia was incorporated in 1983 with the inception of BIMB, which comes within the purview of the Islamic Banking Act 1983. At that time, the SAC was not yet established. It is logical to say that the Shari'ah Board of BIMB had to tackle all the responsibilities of doing supervisory work and issuing *fatwās*, relating to Islamic banking. Only after the establishment of SAC pursuant to the amendment of the Central Bank Act (CBA) 1958 on section 16B (which came into effect in 2003), all the responsibilities were shifted to SAC. Initially there was no central body available, and any bank conducting Islamic banking business had to refer to and consult its problems with the SAC working at the Central Bank level.

²¹ This process of the issuance of *fatwās* is based on three interviews: (i). Interview with Mr. Hamzah Kamaruzzaman, Department of Islamic Banking and *takāful* the Bank Negara Malaysia, answers were emailed on December 5, 2007, (ii). Interview with Dr. Abdul Halim Muhammad, Vice Chairman of SAC, February 22, 2007, and (iii). Interview with Dato Md. Hasyim Hj. Yahya, member of SAC, March 7, 2007.

proposal. If members of the council are still not satisfied and thus unable to resolve the issues, they may ask the Islamic Banking and *takāful* Department of the Central Bank to do further research on the relevant aspects and submit its findings.

The Shari'ah Advisory Council (SAC) formulates the final result in the form of a *fatwā* or resolution,²² which is circulated by the Central Bank for information of all concerned, i.e. banks and financial institutions involved in the Islamic banking business and not specifically to the bank from where the case is initiated or Shari'ah issue raised.

Keeping in view different stages that need to be undertaken for the process to complete, it is understandable that the issuance of a *fatwā* or resolution may be delayed. The duration needed for the purpose mostly depends on the complication and intensity of the problem. From the experience of the Shari'ah Advisory Council, the longest time taken to resolve an issue may extend to three months.²³

Ever since the Shari'ah Advisory Council (SAC) was established in 1997, no less than twenty one *fatwās* or resolutions have been passed, ranging from banking to *takāful* issues,²⁴ with the exception of issues relating to Islamic securities, since these are dealt with by the Securities Commission of Malaysia (which came into being under the Securities Commission Act 1993) that has independent Shari'ah committee and own resolutions.²⁵ The resolutions of Shari'ah Advisory Council comprise a wide range, from those pursuant to the applications or requests from the industry to those initiated independently by the Bank Negara Malaysia, particularly by the Department of Islamic Banking and *takāful* relating to Islamic banking and finance.²⁶

(iv). *Enforcement of Fatwās or Decisions* (Why using the word *Fatwās*? Why not *Fatāwā*)

The non-compliance towards issued *fatwās* is perceived as ignorance and infringement towards Islamic tenets. It is reasonable therefore, that specific actions can be taken against the relevant institutions which do not comply with the *fatwās*. In this regard, respective administrative bodies which have the authority, namely the Shari'ah Committee and the Central Bank, shall ensure the enforcement of the *fatwās*.

²² The official term used for such products of the Shari'ah Advisory Council is "decision", for instance see BNM/GPS1 - Guidelines on the Governance of Shari'ah Committee for the Islamic Financial Institutions, December 2004, whereas the term "resolution" is used for the products of the Shari'ah Advisory Council in the Securities Commission, for comparison see Securities Commission, Malaysia (2006), *Resolutions of the Securities Commission Shari'ah Advisory Council*, (Kuala Lumpur, 2006). However in the publication issued by the Central Bank pertaining to the decisions of this council, the terms used is also resolution, see Shari'ah Resolutions in Islamic Finance (Bank Negara Malaysia, Kuala Lumpur: 2007).

²³ Interview with Dr. Abdul Halim Muhammad, a member of the SAC appointed for the tenure 2004-2006 and 2006-2007. Prior to the appointment he was a member of the SAB in various Islamic financial institutions, such as the Malaysian Development Bank, RHB Bank, Bank Rakyat, Bank Muamalat and Bank Bumi. Interview was conducted on February 22 & 27, 2007.

²⁴ Bank Negara Malaysia, (2007), *Shari'ah Resolutions in Islamic Finance*.

²⁵ For the resolutions issued by Shari'ah Committee Securities Commission, see, Securities Commission, Resolutions.

²⁶ Interview with the staff of Shari'ah Unit, Islamic Banking and *Takāful* Department, Bank Negara of Malaysia, Mr. Hamzah Kamaruzzaman. Written answers of the questionnaires was emailed on December 5, 2006.

As has been generally understood, the Shari'ah Committee is basically designated to perform advisory activities in the respective bank. The Committee has no internal auditor towards the implementation of Shari'ah compliance within the bank. To ascertain and monitor such implementation, a dedicated department is established for the purpose in certain banks. For instance, in Bank Islam Malaysia Berhad (BIMB), it is the Department of Audit and Shari'ah Risk that is designated to do the monitoring work. Periodically, a team is appointed to monitor the branches to ensure if there are Shari'ah issues or cases of non-compliance. Normally the audit exercise is conducted once in two months. When the Department finds a Shari'ah issue or case of non-compliance, a report of the findings must then be presented to the Shari'ah Committee (SC) for resolving the issue.²⁷

In the Malaysian structure of financial authority, it is the responsibility of the Central Bank to ensure the enforcement and compliance towards *fatwās*. It is the Supervision Department in the Bank Negara Malaysia which is responsible for any non-compliance and ignorance.²⁸ After passing through certain set procedure, this department will bring any non-compliance cases into the notice of Central Bank, and the Bank will then take necessary actions.²⁹

In the case of non-compliance, the Central Bank may conduct an investigation at any time without prior notice and if the case is found correct, the personnel concerned will be subject to the respective punishment.³⁰ This is part of the authority of the Central Bank to control banks in Malaysia, as the provision below states:

“The Central Bank shall from time to time investigate, under condition of secrecy, the books, accounts and transactions of each Islamic bank and of any branch, agency or office outside Malaysia opened by an Islamic bank”.³¹

It is also stated in BAFIA 1989, that the Central bank holds similar authority over conventional banks conducting Islamic banking business. It is stipulated that the Central Bank shall, from time to time, examine various documents and transactions of the licensed financial institution.³²

In addition to above, it is legally stated that the Central bank, with the directives from the Minister, may conduct special investigation if there is sufficient reason to believe that the Islamic bank is carrying on its business in a manner that contravenes the Act.³³

²⁷ Interview with the Head of Shari'ah Department, BIMB, Ustad Nasrudin Yaakub, Feb 28, 2007.

²⁸ Interview with the staff of Shari'ah Unit, Islamic Banking and *Takāful* Department, Bank Negara Malaysia, Mr. Hamzah Kamaruzzaman. Written answers of the questionnaires were received on December 5, 2006.

²⁹ Islamic Banking Act (IBA) 1983, Section 37 (a), (b) (Malaysia).

³⁰ The punishment ranges from administrative penalties, such as letter of reminder, till petition for winding up the bank. Islamic Banking Act (IBA) 1983, Section 37 (a), (b) (Malaysia).

³¹ IBA Section 31, (Malaysia).

³² Banking and Financial Institution Acts (BAFIA) 1989, Section 69, (Malaysia).

³³ IBA Section 32, (Malaysia).

Thus, the authority of the Central Bank to control the Islamic banks or other commercial banks conducting Islamic banking business is clearly noticeable here.

In the case of infringement towards the standing legal framework, or towards Shari'ah compliance, there are a few types of penalties that shall be imposed on any institution which is proven to infringe the *fatwās*. In short, the penalties range from requesting banks to take certain steps to rectify the infringement as determined by the Ministry of Finance or the Central Bank, like the revocation of the license, and/or presenting a petition to the High Court for termination of the Bank.³⁴ These provisions indicate that compliance to Shari'ah principles by the bank is mandatory.

(v). *Displaying Shari'ah Opinions in the Annual Report*

The annual report is an expression of the responsibility of the institution to the shareholders and to the public. For this reason, a complete performance of the bank and a comprehensive audit should be clearly presented in this annual report. In this regard, Islamic banks, or any banks conducting Islamic banking business, are obliged to provide various presentations that compare their performance with other banks operating under interest system. Besides the presentation on prudential aspects, they shall also present the Shari'ah compliance aspect. Thus, the annual report of Islamic banks and conventional banks conducting Islamic banking business must contain the prudential audit³⁵ as well as Shari'ah audit.

As the prudential aspect is mandatory for corporate governance of the banking industry, Islamic banks are also required to attend to this aspect. In this regards, the Islamic banks are treated equally with conventional banks. Variables which are used to review the prudentiality of conventional bank are also applicable for Islamic banks. Having audited in their prudential aspect, the next component of the annual report is the Shari'ah audit; This is the distinctive feature which differentiates Islamic banking from conventional banking as the Islamic bank has to comply with Shari'ah principles in all operations and products. For the purpose of the annual report, the Shari'ah Committee must conduct a comprehensive audit for a period of one year, and issue the opinion with regards to compliance of the products and operations of the bank with Shari'ah principles. In the annual report, the statement of Shari'ah opinion must be included. An example of such an opinion is as follows:

“.....We, Dr Yosuf bin Ramli and Mohd Bakin bin Mansor, being two of the members of the Shari'ah Supervisory Council BIMB Holding Berhad, do hereby confirm on behalf of the Council, that in our opinion, the operations of the Group and of the Company for the year ending 30 June 2006 have been conducted in conformity with Shari'ah principles”.³⁶

³⁴ IBA section 37 (f), BAFIA, Section 73, (Malaysia).

³⁵ Prudential audit is the audit which is based on measures showing the fitness of financial aspects, such as Capital Adequacy Ratio (CAR) and Non Performed Loan (NPL).

³⁶ Bank Islam Malaysia Berhad, Annual Report 2006, p.84.

Based on the above procedures, the display of Sharī'ah opinion in the annual report is the last stage of the whole process involved in ascertaining Sharī'ah compliance of Islamic banking.

2.1 Issues in Sharī'ah Advisory Process and the way Forward

(a). Problems of Sharī'ah advisory process

Sharī'ah advisory or supervisory is a relatively new profession and hence further effort to enhance this profession is much demanded. This is a new area where Sharī'ah scholars can play a significant role. Being a new area of profession, there exist some problems which need solutions. The authority of the body and its independence are cases in point. In turn, these problems affect the efficiency of the Board members in performing their duties. With specific reference to the operations of Islamic banking in Malaysia, the problems faced in the process are discussed below:

i) Rapid development of the product.

Banking industries are marked with continuous change and development of the products. In addition, product innovation is a main concern of the industry. The new products are sometimes formulated in the form of a mixture between or among the existing products, as well as in a form which is totally new and novel.³⁷ Since the contract principles in Islamic law are well established, therefore, to accommodate a new product and fit it in the Islamic contracts, there is a need for a complicated contractual engineering.

Since most of the members of the Sharī'ah Committee have the technical background of Islamic law of Contract (Sharī'ah or fiqh muamalat) they may find problems and difficulties to fit the new banking products into the Sharī'ah context. The compromise between classical Fiqh and modern financial products is not that much easy.

ii). The conflict of law (ikhtilāf)

It is a well established fact that in many matters pertaining to Fiqh (jurisprudence), there are areas of disagreement (ikhtilaf) among the jurists, especially among different schools of law (*madhahib*). Malaysia, which so far holds onto Shafii madhhab, needs to reconsider its stance. It seems that the Sharī'ah opinions solely based on this madhhab cannot be accepted globally. The application of *bay' al-'inah* is a case in point. In addition to this legal controversy, the problem has become increasingly complicated due to expanding activities of foreign financial institutions in Malaysia. Sometimes, these institutions have to follow the *fatwās* of Sharī'ah boards in their countries of origin, which may be affiliated to a madhhab different from that commonly followed in

³⁷ For instance, the new product may be in the form of "three in one" means three contracts in one product, or "two in one", means two contracts in one product, as has been stated by Dato Md. Hasyim Hj. Yahya, a member of the SAC in the interview on March 7, 2007.

Malaysia. Al-Rajhi Bank is a case in point.³⁸ Hence, the Malaysian practitioners are now considering opinions (*Fatwās*) that are more globally acceptable. To bring about harmony in *Fatwās* based on different schools of law and to find a practicable solution, the role of international agencies such as AAOIFI, IFSB, Majma' al-Fiqh al-Islami, or any other standard Shari'ah boards is very significant.

(b). *The way forward*

For the purpose of addressing the existing problems, some plans and actions may be suggested. As can be seen from the following, some of the problems have been responded to while the rest are still in the process of consideration:

i). *Enhancing the expertise*

In order to overcome the difficulties in resolving cases pertaining to the new product, proper training to members of the Shari'ah Committee is necessary. In addition to this, the composition of the members of the Shari'ah Committee is also a mixture of scholars in Shari'ah and experts in the field of finance.³⁹ Consequently, the appointment of the members who are mostly academicians from well established universities may seem to be a suitable solution for the moment. They are in possession of the ability to do research, an ability which is very essential for doing Shari'ah advisory.

ii). *Converging with the globally acceptable Fatwās*

For the purpose of introducing *Fatwās* which are globally acceptable, various legal opinions from major schools of thought (Madhahib) in the Muslim society need to be considered. The precedence set by the AAOIFI, IFSB, Majma al-Fiqh al-Islami and other standard bodies for Islamic financial business can be considered as reference for the Shari'ah Advisory Council (SAC) in issuing *Fatwās* or resolution. Further, the establishment of some foreign Islamic banks in Malaysia has brought about implications to the *Fatwās* that they follow. In principle, being licensed companies, they have naturally to follow the decisions of Shari'ah Advisory Council. Alternatively they may adopt an operation standard that may be different from the Malaysian standard, with the approval of the SAC within the Central Bank.⁴⁰ This process enhances the standardization of *Fatwās* (Shari'ah opinion), which is globally acceptable.

³⁸ The initiative for globally acceptable *fatwās* conforms to the observation that international boards relating to Islamic banking may significantly play a role in bridging the gap in the Islamic legal aspect. As stated by Thomas, Abdul Kadir, (2007), "this body of 22 scholars represents broadly all members of the Organization of Islamic Conference (OIC), assuring that the Malaysian and other East Asian voices are heard on a peer basis with scholars from West Asia, South Asia and Africa. It is at AAOIFI and the IFSB that the convergence of East and West Asia is slowly but surely being hammered out into proper accounting and governance guidelines".

³⁹ The action has been introduced by BIMB - Interview with the Head of Shari'ah Department of BIMB, Ustad Nasrudin Yaakub, February 28, 2007.

⁴⁰ For instance, Al-Rajhi Bank (Saudi based) is willing to use a scheme under the *musharakah mutanaqishah* in lieu of the *Bay' Bi Thaman al-Thaman al-ʿajil*, and this bank has actually followed the said procedure - Interview with Dr. Abdul Halim Muhammad, Vice Chairman of the SAC, February 27, 2007.

It is observed from the above deliberation that the existing legal framework provides clear duties and responsibilities of all the parties involved in the process of assuring compliance to Shari'ah ruling and so the objective can be attained accordingly. However, in regard to the proposal for creating globally acceptable *Fatwās* and resolution on matters pertaining to Islamic banking business, Malaysia needs a concerted effort to accommodate various opinions from different schools of law (madhahib) without losing their strong hold of the Shafi'i madhhab, which has been in practice for centuries.

3. Shari'ah Compliance in Islamic Banking Indonesian Case

In general, the process of assuring Shari'ah compliance in Islamic banking in Indonesia resembles that of Malaysia. However, slight differences are apparent due to the fact that the Shari'ah Supervisory board in Islamic banking in Indonesia, as the term "supervisory" implies, is designated for supervisory tasks, instead of advisory.⁴¹ The notion of supervision, will appear in the process to imply maintaining the compliance of Shari'ah principles, as the discussion below will cover.

(i). *Establishing Specific Measures for Products Offering*

Bank Indonesia Regulation has adopted various *fatwās* issued by the National Shari'ah Council (NSC) to be enforced to Islamic banks and conventional banks conducting Islamic banking business. The *Fatwās* mostly relate to the types of contract from which Islamic banking products are derived.

In addition to this adoption, the regulation also provides a detailed description in which various contracts discussed in the *fatwās* are formulated into clear points to measure various aspects of compliance towards Shari'ah principles. This spade work has laid down an elementary foundation for further developments towards Shari'ah compliance. The example of how the measures have been developed, can be seen from the minimum requirements laid down for the *Murābaḥah* financial scheme below:⁴²

- "The applicable minimum requirements for financing of funds in the form of *Murābaḥah*-based financing are as follows:
 - a. The Bank shall provide funds for financing on the basis of an agreement for sale and purchase of goods.
 - b. The term for payment of prices for goods by the customer to the Bank shall be based on the terms agreed by the Bank and the customer;
 - c. The Bank may finance all or part of the purchase price for the goods at agreed quality specifications;

⁴¹ Although the standing regulation in Malaysia requires an "advisory" board, not all banks conducting Islamic banking business follow the same convention. In particular, BIMB still maintains the term "supervisory", namely Shari'ah Supervisory Council –for reference see the Annual Report of Bank Islam Malaysia Berhad, (Kuala Lumpur: 2006), 44.

⁴² Bank Indonesia Regulation Number: 7/46/PBI/2005 concerning funds mobilization and financing agreements in conducting business based on Shari'ah Principles, section 9 & 10.

- d. If the Bank delegates the purchase of the goods to the customer as ‘agency’ (*wakālah*), the *Murābahah* agreement must be executed after the goods in principle have become the property of the Bank;
 - e. The Bank may request the customer to make a down payment or *Ñurbun* upon signature of the initial agreement for the customer order for the goods;
 - f. The Bank may request the customer to provide additional collateral other than the goods financed by the Bank;
 - g. Agreed terms on margin must be determined once at the beginning of the Agreement and may not change throughout the duration of the agreement;
 - h. The financing installments must be executed on a pro rata basis throughout the duration of agreement.
- If the Bank requests the customer to make a down payment or *Ñurbun* as referred to in paragraph (1) (e), the following provisions shall apply:
 - a. In the case of down payment, if a customer refused to purchase the goods after making the down payment, the real costs of the Bank must be paid from the down payment and the Bank must return the surplus down payment to the customer. However, if the down payment is insufficient to cover the loss borne by the Bank, the Bank may demand further payment from the customer to cover the remaining loss;
 - b. In the case of *Ñurbun*, if the customer cancels the purchase of goods, the *Ñurbun* previously paid by the customer shall be forfeited to the Bank to a maximum of the loss borne by the Bank as a result of the cancellation, and if the *Ñurbun* is insufficient, the customer shall be required to pay the shortfall.
 - In *Murābahah* financing, the Bank may discount the total payment obligation only for customers who have paid installments promptly and/or customers who have suffered a loss of repayment capacity.
 - The amount of the *Murābahah* discount for the customer may not be promised in the agreement and shall be at the discretion of the Bank policy.”

These guidelines have set out the minimum requirement for a specific contract *Murābahah* in a very clear illustration. Based on these standards, the measures for Shari‘ah compliance in this contract seem to be less complicated. In addition to these requirements, the respective banks may set out the terms of each product that they offer. The content of the terms of product is certain and the steps which must be taken by the parties involved, namely the bank authority and the customers, are clear. To analyze what the terms of product consists of, it is important to consider an example.⁴³ In the terms of products of Bank Muamalat Indonesia (BMI), *Murābahah* for instance, is defined as:

“Financing facility in the form of sale: Bank purchases any Shari‘ah permissible (*Halāl*) asset you need, and resells it to you for deferred payments with the affordable installment. This mode of financing may be utilized to meet the needs

⁴³ Product and services, at Bank Muamalat Indonesia, at <<http://www.bankmuamalat.com>> accessed on May 7, 2007. See also, product simulation, in the respective website. This term is translated by the author from the original term in Bahasa Indonesia.

for enterprise (working capital and investment, purchasing assets such as machineries, tools, etc) as well as personal needs (such as purchasing motor vehicles, houses, etc)”⁴⁴.

Prior to the emergence of Bank Indonesia Regulation Number: 7/46/PBI/2005 concerning funds mobilization and financing agreements conducting business based on Shari‘ah principles, it seems that the terms of products provided by the respective bank were good guidance in the product offering. However, the introduction of the guidelines, as stipulated in section 9 and 10 of the above Regulation seems to be more comprehensive, and provides detailed instructions in the product offering. As such, the respective bank’s terms of products seem to be less important. This is because the measures of the financial contracts, given by the Bank Indonesia Regulation referred to above, seem to be more detailed and exhaustive in deriving the elements of the contract, which must be there while concluding such financial contracts.

An additional stage in the process of assuring Shari‘ah compliance is the implementation of such measures by the board of directors with the advice and supervision of the Shari‘ah Supervisory Board (SSB). Since the measures in product offering are comprehensive, further stages towards Shari‘ah compliance in Islamic banking lies in the hands of members of this board.

(ii). Advisory and/or Supervisory Activities

It is clear from the above description that the enforcement of Shari‘ah compliance measures in Indonesia lies in the hands of both the SSB and the board of directors of the bank. In fulfilling this responsibility, the Board (SSB) members have adopted a method of periodical meetings and ad hoc meetings for the purpose.

Periodical meetings are normally scheduled as manual (operational procedures) in the respective bank.⁴⁵ The Board (SSB) members are obliged to attend the meetings with the board of directors, on a minimum of monthly basis.⁴⁶ The periodical meetings provide a forum in which the board of directors and board of management of the bank may request consultation pertaining to Shari‘ah issues. In view of the Board (SSB) members, they also benefit from the meetings by raising some issues where they need a clarification and explanation by the board of directors, particularly when the issues are related to the company policies.

Although the meetings are generally scheduled on monthly basis, however under specific circumstance where the bank needs advice on certain urgent Shari‘ah issues or when it is preparing to launch a new product, the meetings may be called more than once

⁴⁴ *ibid*, accessed on May 7, 2007.

⁴⁵ Interview with K.H. Ma‘ruf Amin, member of the Shari‘ah Supervisory Board (SSB) of BMI, January 26, 2007.

⁴⁶ Certain banks allow meetings of the Shari‘ah Board (SSB) up to four times in a month, thus it is purely a matter of necessity. However, the minimum requirement is monthly meeting: Interview with Prof. Asymuni Abdurrahman, member of the National Shari‘ah Council Indonesia, February 3, 2007.

in a month. In these cases, the attendance is based on the necessity to resolve the issues at hand, and this is what we call ad hoc meetings.

In ad hoc meetings, the board of directors, pursuant to the requirement from the product department, invites members of the Board (SSB) to give advice (Sharī'ah opinion) concerning the proposal of a new product or an urgent issue. When the problems or cases are forwarded to the SSB liaison officer, the board of directors or the board of management then requests the Board (SSB) members to resolve the issue. The procedure is however somewhat different from the case of Malaysia where the liaison officer or Sharī'ah department is normally responsible for the preparation of proposal and conducting research relating to the issues to be discussed. However, since the intermediation of liaison officer is a new phenomenon,⁴⁷ therefore it is the responsibility of Sharī'ah Supervisory Board (SSB) members themselves to undertake necessary research for the purpose of floating a Sharī'ah opinion.

(iii). *Floating Sharī'ah Opinions or Fatwās*

The outcome of the meetings of the Sharī'ah Supervisory Board (SSB), as mentioned above, is nothing but a concerted opinion. Under the prevailing rules, this opinion is possible only for cases in which the main mu'amalah contracts have been defined by the National Sharī'ah Council (NSC). So far as the case of innovation or a new product is concerned, the Board (SSB) members cannot give any Sharī'ah opinion; instead they have to request the National Sharī'ah Council (NSC) for the verdict (*Fatwā*) and guidance.

Similar to the case of Malaysia, before the establishment of the national level Sharī'ah board in Indonesia, the Sharī'ah board at the industrial unit (bank) was the only body to issue Sharī'ah opinions (*Fatwās*) and its members were working independently without any other superior authoritative body. However, the National Sharī'ah Council (NSC), after its establishment in the year (???), is now the highest authority for not only issuance of *Fatwās* but also to resolve controversies in Sharī'ah matters throughout Indonesia.

As has been obvious from the above deliberation, the Sharī'ah Supervisory Board (SSB) does not possess authority to resolve Sharī'ah related issues in case of new products. In such cases, the bank which is in need of such guidance and verdicts (*Fatwā*) shall prepare a proposal for the purpose. The process starts from the application stage when the said proposal is forwarded by the board of directors of the respective bank together with the comments of its Board (SSB) members to the National Sharī'ah Council (NSC).

⁴⁷ Ibid and interview with Mr. Nurfi & staff of Sharī'ah Division Bank Negara Indonesia (BNI), January 25, 2007. The first liaison officer was appointed in Bank Muallamat Indonesia in 1992, however in other banks conducting Islamic banking, the office has been adopted since 2006.

Consequent upon the receipt of application and the proposal, the National Sharī'ah Council (NSC) arranges a series of meetings as set out in the *Fatwā* procedure. There are four steps in the procedure for the Council (NSC) to react.⁴⁸

First, a general meeting will be held involving all of members of the Council (NSC). The representatives of the concerned bank and the Central Bank of Indonesia will be invited in this meeting. The said bank shall present the proposal of the new product for which the *Fatwā* is sought. The presence of the Central Bank of Indonesia in the meeting is important, being the regulator of Islamic banking business in Indonesia and the sole authority responsible for incorporation of all *Fatwās* into the Bank Indonesia Regulation. At this forum, every related party may raise questions and offer suggestions regarding the issue.

Second, the outcome of the general meeting in the first stage is then brought into an intensive deliberation forum. In this stage, only members of the executive board of the National Sharī'ah Council (NSC) are involved. This meeting is designated to analyze the case independently. It is considered important to have an independent atmosphere and to approach the issue from the point of view of the advantages and disadvantages (*masaleh and mafasid*) without any inconvenience and influence, which may occur if the concerned parties are also present.

Third, the results from the special meeting are then discussed in the second general meeting. The relevant parties are invited to ensure that they fully understand the decision made. However, suggestions from the parties concerned can still be considered in this meeting. The objective of this second general meeting is to review the proposal and to obtain responses and suggestions to enable the National Sharī'ah Council (NSC) to issue a good, relevant and well considered *Fatwā*.

Fourth, suggestions and responses appearing in the second general meeting are then accommodated in the finalizing and drafting of the *Fatwā*. To finalize the process, another special meeting is then called for, with only members of the executive board to participate. This is the final step of the process, and having passed through this step, the *Fatwā* is formally issued. However, the *Fatwā* or verdict so give, is not automatically incorporated into the Bank Indonesia Regulation. It is the Directorate of Sharī'ah Banking at the Central Bank of Indonesia, which holds the authority to do so and also responsible for its adoption, albeit with the advices from members of the meeting.

Apart from the laid down procedures stated above, it is important to note that the proposal or the initiative for the issuance of *Fatwās* may come either from the National Sharī'ah Council (NSC) or the industry. Since this Council (NSC) is an element of the National Ulama Council, which has been recognized as an authoritative body for issuing *Fatwās* in various matters, it has a moral obligation to provide guidance to Muslim public in the country. Due to the unavailability of a regulatory framework in the early stages of

⁴⁸ Interview with Mr. Irfan, the Liaison Officer of Executive Committee of National Sharī'ah Council (NSC), at January 17, 2007. This procedures is resolved in *Ijtima' Sanawi* of National Sharī'ah Council (NSC) in 2006.

Islamic banking in Indonesia, this body initiated to issue *Fatwās*, which were very fundamental for the operations of Islamic banking. *Fatwās* in some basic contracts, such as *wadeeah*, *Murābaḥah*, *ijarah*, and other general products applied in Islamic banking are examples of the early endeavours initiated by the board.⁴⁹

Since the incorporation of the National Sharī'ah Council (NSC), more than 53 *Fatwās* have been issued so far and compiled in *Himpunan Fatwā Dewan Syariah Nasional*, published in collaboration with the Bank Indonesia.⁵⁰ In contrast to Malaysia where a nationally recognized Sharī'ah Advisory Council (SAC) deals solely in Banking and *takāful*, the National Sharī'ah Council (NSC) in Indonesia deals with all aspects of Islamic financial business, which encompasses Islamic banking, insurance, mutual funds, and other businesses. Hence, the above mentioned compilation also comprises *Fatwās* in other aspects besides banking.

(iv). *Enforcement of Fatwās or Decisions*

The non-compliance of Islamic banks or conventional banks conducting Islamic banking business toward Sharī'ah principles, as has been set out by the existing legal and regulatory framework, brings about some legal consequences that vary from case to case depending on the degree of non-compliance. If it is proven that a bank or financial institution has failed to comply with Sharī'ah principles as laid down in *Fatwās*, the Sharī'ah Supervisory Board, the National Sharī'ah Council and the Central Bank shall exercise their rights to audit the business conducted by the bank.

In a case of such a failure or ignorance of the *Fatwās* adopted in the Bank Indonesia Regulation, the Sharī'ah Supervisory Board (SSB) in the respective bank shall take or initiate necessary actions according to rules. Here, the supervisory function means that it is the main responsibility of the board to ensure that the bank complies with Sharī'ah principles. When the issue of non-compliance arises, the board is responsible to resolve it at source. This resolution is usually conducted through successive meetings with the board of directors. However, in severe cases when the act of non-compliance continues, the Supervisory Board (SSB) has to send a report to the Central Bank of Indonesia and National Sharī'ah Council (NSC).⁵¹ Such an action taken by Board (SSB) is based on the provision that the task to ascertain Sharī'ah compliance lies in their hands and the board of directors.⁵²

Pursuant to the above, the Sharī'ah Supervisory Board (SSB) shall then begin with the internal audit, following the procedure laid down in the regulations of Directorate of

⁴⁹ Those *fatwās* can be found in National Sharī'ah Library and Bank Indonesia, *Himpunan Fatwā Dewan Syariah Nasional* (Jakarta, 2006)

⁵⁰ *ibid.*

⁵¹ Interview with Dr. Dadang Muljawan and Dr. Bambang Irawan, Directorate of Sharī'ah Banking, the Central Bank of Indonesia, January 16, 2007.

⁵² This can be seen from the Articles of Association of Bank Muamalat Indonesia (BMI), stating that "The function of the Sharī'ah Supervisory Board is to supervise the operations of the company to be in line with Sharī'ah"- section 17 (1). Also clear from the interview with K.H. Ma'ruf Amin, the member of Sharī'ah Supervisory Board of BMI, January 26, 2007.

Shari'ah Banking, Central Bank of Indonesia. The audit process, according to Circular Letter of Bank Indonesia to all Commercial Banks Conducting Business Based on Shari'ah Principles in Indonesia, is made through the analysis of the elements of contracts in every financial product. The standard auditing measures provided in the above mentioned circular, must be followed by the Supervisory Board (SSB) and shall be reported to the National Shari'ah Council (NSC) and the Central Bank. An example of such measures is given below:⁵³

- "Shari'ah supervision finding report shall contain no less than:
 - a. Supervision findings on the compliance of Bank operations with the *Fatwās* issued by the National Shari'ah Council.
 - b. Shari'ah opinion on operating guidelines and products released by Bank.
 - c. Analysis on new products and services which have not obtained any *Fatwās* in order to request the National Shari'ah Council for *Fatwā*.
 - d. Shari'ah opinion on the whole operation of Bank in the Bank's condensed financial statement."

The measures given above seem to be sufficient to facilitate the audit conducted by the Supervisory Board (SSB), as part and parcel of the steps taken by the National Shari'ah Council (NSC) and the Central Bank of Indonesia to ensure Shari'ah compliance.

Pursuant to the report submitted by the Supervisory Board (SSB), the Directorate of Shari'ah Banking in the Central Bank of Indonesia, in the capacity of regulator, has to investigate the case. Indeed, the National Shari'ah Council (NSC) as the issuer of *Fatwās* and highest authority to resolve Shari'ah-based financial issues also has the responsibility to provide necessary assistance to the investigating team appointed by the Central Bank in the matter.

When the investigation discovers the occurrence of non-compliance to Shari'ah in the reported case, then further action may be taken in accordance with the existing legal framework. There are some administrative penalties that the Central Bank may exercise on the non-compliant banks, which have been clearly stipulated in the Act No. 10 of 1998 on Banking, section 2, and reproduced below:

- | | |
|---|--|
| 1). Compound | 2). Written reminder |
| 3). Degradation of the bank prudential | 4). Banned from clearing |
| 5). Termination of the operation | 6). Disposal of the directors and staffs |
| 7). Blacklisting of the directors, staff and workers in the banking business industries | |

⁵³ Bank Indonesia Circular Letter No. 8/19/DPBS to all Commercial Banks Conducting Business Based on Shari'ah Principles in Indonesia, August 24, 2006, on General Review.

In addition to the above administrative sanctions, there is also a maximum penalty in the form of imprisonment for the persons who have been proven guilty of such non-compliance.⁵⁴ Thus, personally and institutionally, those who are in the position to run the business shall also make the necessary effort to maintain that the bank is always in compliance with Shari'ah.

It is worthy to note that various penalties as cited above seem to be sufficient to ensure that the financial institutions conducting Islamic banking business stick to the objective of compliance towards *Fatwās* as Shari'ah regulations adopted into the Bank Indonesia Regulation.

It is also clear from the above discussion that one of the duties of Supervisory Board (SSB) in Islamic banks is to present periodic reports to the Central Bank and the National Shari'ah Council (NSC). Based on these reports, the Central Bank can evaluate the degree of compliance to Shari'ah principles. In case where the report regarding non-compliance of the bank to Shari'ah is proved, necessary actions can be taken by the Central Bank according to regulations.

(v). *Displaying Shari'ah Opinion in the Annual Report*

The annual report of a bank or any other corporation is considered as the authentic source of information on the whole operations and products of the business. Since the business of the bank is in the area of Islamic financial matters, the general audit must include different aspect of Shari'ah compliance. Basically there are two aspects which must be reflected in the annual report, namely the prudential audit and Shari'ah audit.

In prudential audit, the performance of the bank can be seen through different criteria set out by the Central Bank to evaluate the prudential requirements, such as the Capital Adequacy Ratio (CAR), Non Performed Loans (NPL), and other indicators as specified by the Central Bank.⁵⁵ The auditing exercise for prudential aspect of the bank is normally undertaken by the authorized accountants and legal consultants.

In addition to above, the evaluation process of the bank also includes the Shari'ah audit, which is conducted by the Shari'ah Supervisory Board. The members of this Board (SSB) need to evaluate the whole products and financial transactions conducted by the respective bank during the given period. The conclusions drawn must be clearly stated in the annual reports. The following example of the statement in the form of Shari'ah opinion in one of the Islamic banks in Indonesia will clarify the point:

“ On behalf of the Shari'ah Supervisory Board of Bank Muamalat, we hereby state that the conduct of operations as well as the products and services of Bank Muamalat in the year 2006 fully complied with the *Fatwās* of the National Shari'ah Council, and the rulings of the Shari'ah Supervisory Board.”⁵⁶

⁵⁴ Act no. 10 of 1998 on Banking, Section 46-50 (Indonesia).

⁵⁵ Bank Indonesia Regulation No. 7/35/PBI/2005, Section 36.

⁵⁶ Annual Report of Bank Muamalat Indonesia, 2006, 9, accessed on May 7, 2007 from the website: <<http://www.muamalatbank.com/>>

The audit conducted by this bank (BMI), which is comprehensive and covers all aspects of operation, products and services, seems to be a step forward from the basic requirements of audit provided by the legal framework as stated in Bank Indonesia regulations.⁵⁷

3.1 Issues in Shari'ah Supervisory and the Way Forward

(a) Problems of Shari'ah Supervisory board

The activities pertaining to advice or supervision to ascertain Shari'ah compliance, as may be clearly evident from the above discussion, comprise a process that requires attention not only from members of the Shari'ah Supervisory Board (SSB) but also from the parties involved in the business. Various problems may come to surface during this process, as will be discussed below, and therefore a concerted effort by the parties involved is necessary to ensure Shari'ah compliance.

- 1). The lack of an integrated expertise⁵⁸ Members of the Shari'ah Supervisory Board (SSB) should have integrated expertise in both Shari'ah and Islamic financial matters. Since most members of the Board (SSB) and National Shari'ah Council (NSC) have more theoretical knowledge on Shari'ah matters but lack practical experience, this may prove a hindrance in developing Islamic banking in Indonesia. This is due to the fact that the National Shari'ah Council (NSC) is basically an instrumental organization of the Indonesian Ulama Council that normally deals with religious issues, and therefore, most of its members need enhancement in their expertise or experiences in Islamic finance.

Similarly, most of the Board (SSB) members also face the same problem of lacking expertise and experiences in Islamic finance, since they are also chosen from among the members of the National *Shari'ah* Council (NSC). It seems that short courses and trainings to push up the knowledge of the members in financial and economic matters may be helpful in exposing them to practical issues of Islamic banking and finance. However, this may not be always sufficient, since the Islamic banking business is getting becoming more sophisticated and its complexities and technicalities increasing day by day. As such, these courses and training programs should a regular feature of the Islamic banking industry.

- 2). Inadequacy of regulations in terms of independence of the Board (SSB) members.

As a matter of fact, the members of Shari'ah Supervisory Board (SSB) of one bank also hold similar positions in other banks or Islamic financial institutions, being

⁵⁷ Bank Indonesia Regulation Number: 6/24/PBI/2004 on Commercial Banks Conducting Business Based on Shari'ah Principles as amended by Regulation No. 7/35/PBI/2005 and No. 8/3/PBI/2006 on Conversion of Business of Conventional Commercial Banks to Commercial Banks Conducting Business Based on Shari'ah Principles and Establishment of Bank Offices, are the legal basis for the operation of Islamic banking. As mentioned in these regulations, the banks conducting Islamic banking business shall comply to Shari'ah principles in both product and operation. However, the regulation is silent on the audit of services and operations of the bank.

⁵⁸ Interview with Dr. Dadang Muljawan and Dr. Bambang Irawan, Directorate of Shari'ah Banking, the Central Bank of Indonesia, January 16, 2007.

consultants for financial products. It is true that there is no legal or administrative constraint on an individual to hold various positions at one time in different institutions. However, from ethical point of view, such practice should not be encouraged.⁵⁹ This, to a certain extent, may cause some inconvenience in performing supervisory duties. The issue of objectivity may arise in this context.

3). The conflict of interests between members of the board of directors and SSB

The core duty and responsibility of the members of the Board (SSB) to supervise the industry for Shari'ah compliance has not yet been fully understood by the industry. The board of directors may see that Board (SSB) members are too rigid viz-a-viz more accommodative and have a certain degree of flexibility.⁶⁰ This fact suggests the conflict of interests between the two as if they are rivals.⁶¹ Certainly this behaviour needs harmonization towards an integrated vision between the two parties so as to enable the Board (SSB) members to work optimally.

The above are some of the substantial problems and challenges faced in terms of assuring Shari'ah compliance in Islamic banking sector in Indonesia. As these problems seem to be very crucial, bold steps are needed by the relevant authorities to address the problems and find appropriate remedies so as to enhance the functioning of the Islamic banking sector.

(b). The Way Forward

In response to various problems in the process of assuring Shari'ah compliance in Islamic banking, a few aspects have already been addressed:

1). The establishment of Shari'ah Banking Committee.

The newly established Shari'ah Banking Committee (Komite Perbankan Syariah) pursuant to the Act No. 21 of 2008 on Shari'ah Banking is aimed to resolve the problem of independence and lack of expertise in the area of Islamic finance.⁶² This is supposed to be an independent committee working under the Central Bank. The qualification requirements for appointment of members on the Board (SSB) have to be determined by the Committee. The objective is to enhance the advisory or supervisory function of the Shari'ah Supervisory Board.

2). Special commissioner in the Shari'ah compliance aspect.

For the purpose of enhancement of the advisory or supervisory activities to ensure Shari'ah compliance, it is suggested to create a chair in the board of commissioners

⁵⁹ This is different from the case of Malaysia, which strictly regulates that members of SAC cannot be members of the Shari'ah Board (Shari'ah Committee) in any Islamic Bank or *Takāful* Company. See, BNM/GPS1, Guidelines on the Governance of Shari'ah Committee for the Islamic Financial Institutions, December 2004, 19 (a), (Malaysia).

⁶⁰ Observation in Shari'ah Division, Bank Negara Indonesia, January 16, 2007.

⁶¹ The board of directors (the management of the unit) is required to understand the position of the Shari'ah board within the industry. By mutual understanding, the existing legal framework can be easily implemented. In a case of compliance towards Shari'ah principles, it is hoped that the management will be more lenient in allowing members of Shari'ah board to conveniently conduct Shari'ah audit. Interview with Prof. Didin Hafidhuddin, member of NSC, January 27, 2007.

⁶² Section 26 (4) and (5) of the Act No. 21 of 2008 on Shari'ah Banking, (Indonesia).

(directors) of the bank, which should be filled by a person well acquainted with handling the Shari'ah aspects of the products and operations of the Islamic banking business. The position of a commissioner with sufficient authority will facilitate the process of Shari'ah compliance and make it more meaningful in directing the industry towards the intended objective⁶³ (the board of directors will be under the authority of this commissioner?? How??).

It is evident from the above discussion that the process of assuring Shari'ah compliance in Islamic banking in Indonesia needs further development. Thus, the relevant authority is still in the process of identifying a proper model, which is theoretically and practically acceptable. However, some of the regulations of the Central Bank of Indonesia relating to Shari'ah compliance, which have been published and distributed to the Islamic banking and financial institutions in the recent two years are good attempts in the relevant direction.

4. Conclusion

The discussions in this paper indicate that the process of assuring Shari'ah compliance is one of the substantial aspects in shaping the practice of Islamic banking business to be truly reflective of Islamic norms. It is the process to determine the extent to which compliance to Shari'ah principles is enforced and maintained. In this connection, the advisory and supervisory process supported by an established legal framework, is significant for ascertaining Shari'ah compliance.

Looking at the theoretical discussions on the methods of assuring Shari'ah compliance in the beginning of this paper, it is apparent that Islamic banking practice in Malaysia and Indonesia, to great extent, is parallel with what the theories suggest. However, in terms of the responsibilities of Shari'ah board,, both countries still emphasize more on the products as compared to the operational aspects of the Islamic banking business so far as Shari'ah compliance is concerned. This point should be taken into consideration by both countries in the present established regulations, which exclude the operational aspect as part and parcel of the Shari'ah compliance requirement. The detailed guidelines in terms of Shari'ah Compliant Good Corporate Governance (GCG) are important to be initiated soon. This will support the objective of Shari'ah compliance in the whole operation of the Islamic banking system.

The difference in adoption of the model of Shari'ah board has brought about a difference in the process of ascertaining the bank complies to Shari'ah principles. Indonesia has adopted the "supervisory" model that holds the Shari'ah Supervisory Board (SSB) to be responsible for reporting Shari'ah issues to the Central Bank, and the later treats this report as a preliminary proof for further investigation to be conducted. The case of Malaysia is somewhat different. The Shari'ah board members are not obliged for this responsibility. It is the Bank Negara Malaysia, through the Supervisory Department, which holds the authority to handle such cases of incompliance.

⁶³ Interview with Prof. Asymuni Abdurrahman, member of National Shari'ah Council Indonesia, February 3, 2007.

Malaysia has planned to adopt *fatwās* standard that is internationally recognized. However, Indonesia seems to be focused on domestic needs, as the country is still undergoing the process of strengthening the foundation for the Islamic banking business. Following the plan for globalizing Islamic financial business in Malaysia, the policy to harmonize *fatwās* looks to be sensible as this country is striving to be a future hub for the International Islamic financial business in the region.

The position of the Shari'ah Advisory Council of Malaysia (which draws its authority from the Central Bank) is different from the National Shari'ah Council of Indonesia (which works in the capacity of a non-governmental body. The process for issuing *fatwās* in Indonesia is more complicated, whereby there must be at least two general meetings and two special meetings. This is because many members and many institutions are involved in the process. In contrast, the process is more simple and straight forward in Malaysia, and therefore less time consuming.

Since the regulatory framework in both countries still needs improvement, a reference to the decisions of international regulatory bodies, especially AAOIFI and IFSB, is very important. The problems arising due to deficiency in the legal provisions can temporarily be avoided.

As Shari'ah compliance is part and parcel of the legal framework in the two countries, the non-compliance means an infringement of the existing legal frameworks (namely IBA 1983 and BAFIA 1989 in Malaysia and Act No 10 of 1998 on Banking in Indonesia). Therefore, in cases of non-compliance where found, the Central Bank shall undertake necessary investigation leading to direct actions and punishments. In Malaysia, such investigation is clearly stipulated, while in Indonesia, there is no clear provision in the regulations at present.

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The Effect of Market Power on Stability and Performance of Islamic and Conventional Banks

ALI MIRZAEI¹

Abstract

Bank-level panel data are used to test the effects on risk and returns, of market power, banking and bank-environment activities with respect to a total of 175 Islamic and conventional banks in 12 Middle Eastern countries. By incorporating the traditional SCP and the RMP hypotheses, I assess the relatively high bank returns in Islamic banking system. The results indicate that Islamic banking systems are generally biased toward the RMP hypothesis, but there is evidence that supports the traditional SCP paradigm in conventional banks. I find that interest rate spreads appear to present conventional banks with a trade-off between risk and returns. Off-balance-sheet activities increase bank profitability and stability for both markets. Furthermore, most of other bank-specific and macroeconomic variables such as capital adequacy, liquidity and cost efficiency are significant, although their impact and relation with profits and stability is not always the same for Islamic and conventional banks. Finally, in the extended dynamic model, the results show that profitability persists strongly, suggesting that a departure from a perfectly competitive market structure may be very substantial.

1. Introduction

The purpose of this study is to answer some fundamental questions. Firstly, how do I apply the market power hypothesis to the Islamic banking system? Secondly, why are Islamic banks operated in the Middle Eastern countries recently more profitable than their counterparts? Thirdly, are there any discrepancies in determinants of banks risk and returns between Islamic and conventional banks? If so, to what extent are such discrepancies due to variations in factors under the control of bank management and/or factors relating financial structures? This paper contributes to a new strand of literature that has attempted to answer these questions. I systematically compare market structure and determinants of Islamic bank performance with conventional banks in this region. Since there is interest internationally in the effect of augmented competition and

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deregulation on banking systems, the results of this study may help bank managers determine the key success (or failure) factors of Islamic banks.

Islamic and conventional banking systems are different in many ways. According to Santos (2000), the conventional bank operation is to purchase transactions deposits from the depositors at a low interest rate, then allocate those funds to the households and firms at a higher interest rate, earning an interest spread based on its competitive advantage at gathering information and underwriting risk. Islamic banks, although, behave in the same manner as intermediary function way, they do not receive a pre-determined interest from borrowers and do not pay a predetermined interest to the depositors. In fact, the amount of a bank return is based on the profit sharing agreements with the depositors and also with the borrowers. Thus, Islamic banking considered as a different banking stream as it prohibits interest and replaces with a profit share. Moreover, another principle of an Islamic bank is the avoidance of economic activities involving oppression. However, some recent studies discuss that Islamic banks have shown a tendency to mimic the conventional banking sector (see e.g. Chong and Liu, 2009; Zainol and Kassim, 2010; Beck et al, 2010; and Cevik and Charap, 2011).

The market structure matters for the bank's power irrespective of the nature of banks as it can directly affect bank performance. A positive statistical relationship between measures of market structure, such as concentration or market share, and profitability has been reported by many banking studies (e.g. Berger, 1995). Furthermore, a number of studies have examined the effects of market concentration on competitive conditions and bank risk and returns in developed markets, but limited for Islamic banks.

Previous studies argue that Islamic banks have higher profitability ratios, compared to conventional banks (Samad, 1999; Samad & Hassan, 1999; Iqbal, 2001 and Hassoune, 2002). In support of such an argument, I also analyse my data and find that profitability ratio (return on assets) in Islamic banks increased significantly during the period 1999-2008, and it exceeded the profitability of conventional banks since 2004 (figure 1). Similarly, Bourkhis and Nabi (2011) observe that before 2009, Islamic banks were more profitable than conventional banks. Thus, in this study, I attempt to answer why bank profitability in Islamic banks is higher than those observed recently in conventional markets. Are high profits indicative of high risk premium, which can cause financial instability?

Furthermore, As Turk Ariss (2010) discuss, Islamic banking is relatively underdeveloped (compared to conventional banking) as they are young and hence it is likely that a higher degree of market concentration prevails in the industry, although Weill (2010) finds that there is no significant difference between market power of Islamic banks and their conventional. So, are higher profits observed in Islamic banks (compared to their peers) is due to their market structure which allows them to do command a higher degree of market power or other internal and external factors?

Finally, I examine the extent to which bank behaviour in Islamic banking is similar to that observed for conventional banking. This is important for developing banks in the Middle East to improve their banking environment, so as to enter in international

markets. Thus, I systematically compare the determinants of bank risk and returns in Islamic markets with that of conventional markets, so as to identify the underlying different determinants of profitability and stability.

In a substantial study by Turk Ariss (2010), the author analyses the importance of competitive conditions on bank profitability using the new empirical industrial organization measures of both the Panzar and Rosse H-statistic and the Lerner index. Using a sample of bank across 13 countries over 2000-2006 and distinguishing among Islamic and conventional banks, the author finds that profitability in conventional banks increases with market power, but there is no evidence for such a relationship for Islamic banks. Compared to this study, however, the contribution of my paper is two-fold. Firstly, recent studies find that there is low correlation between traditional measures of market structure such as concentration ratio and new measures of competition such as H-statistic (e.g. see Carbo et al, 2009). As a result, I apply traditional indicators of concentration; since such measures of market structure are more interested for policy makers. Secondly, I investigate the joint effect of market power on bank profitability and stability. This is of importance as market power may enter with a trade-off between profitability and financial stability, an important issue following the recent financial crisis.

To this end, this paper utilizes data from 12 Islamic countries in the Middle East, containing a panel set of 175 Islamic and conventional banks over the period 1999-2008. Tests of market power hypotheses are performed by regressing performance indicators against measures of market power, bank and bank environment activities, and macroeconomic variables. The results indicate that Islamic banking systems are generally biased toward the RMP hypothesis, but there is evidence that supports the traditional SCP paradigm in conventional banks. I find that interest rate spreads appear to present conventional banks with a trade-off between risk and returns. Off-balance-sheet activities increase bank profitability and stability for both markets. Furthermore, most of other bank-specific and macroeconomic variables such as capital adequacy, liquidity and cost efficiency are significant, although their impact and relation with profits and stability is not always the same for Islamic and conventional banks. Finally, in the extended dynamic model, the results show that profitability persists strongly, suggesting that a departure from a perfectly competitive market structure may be very substantial.

One policy implication of these results is that since market concentration has negative impact on bank stability and also does not contribute to the profitability of Islamic banks, banking regulators should take into account the aspect of systemic stability as a further important criterion by removing entry restrictions and discouraging the process of any possible merger and acquisitions within Islamic banks.

The reminder of this paper is structured as follows. Section 2 presents a literature review of related studies. Section 3 contains a description of the methodology used in the empirical analysis. Section 4 details the data for this study and summarises the descriptive statistics. The empirical results are reported in Section 5. Section 6 realizes some robustness tests, and finally Section 7 concludes.

2. Literature Review

This study tests the relevant of banking market structure for Islamic and conventional banks, and further examines other determinants of bank profitability and stability. Thus, in this section, I first review the literature related to the role of market structure and other factors for profitability, and then I present the literature studies the impact of market structure on financial stability.

2.1. Concentration and Profitability

This section studies the theoretical and empirical background of the relationship between market power and bank performance. According to the existing literature, there are three main hypotheses explaining the relationship between market structure and performance. The first one is the traditional structure–conduct–performance (SCP) hypothesis (Bain, 1956). The SCP paradigm assumes that extra profits are the result of higher concentration that enables banks to collude. The second one is the relative-market-power (RMP) paradigm that states earning supernormal profits are due to firms with well-differentiated products that can increase market share and exercise their market power in pricing products. And the last one is the efficient structure hypothesis (Demsetz, 1973) which suggests that earning higher profits is due to higher efficiency that allows banks to obtain both greater profitability and market shares. The efficiency structure hypothesis is usually divided into the X-efficiency and scale efficiency hypotheses (Berger 1995). Furthermore, the empirical studies that explain the profit–structure relationship usually focus mainly on the US and European countries (Goddard et al., 2004 and Vander Venet, 2002 for the European case, and Berger, 1995 for the US, among others).

Most early research into the determinants of the performance of banks such as Bourke (1989) and more recently Mamatzakis and Remoundos (2003) was based on the SCP paradigm. The authors focused on the interpretation of a positive empirical relationship between concentration market and profitability. The SCP hypothesis states that bank performance depends on various elements of market concentration, market structure, number and size of banks, and collusion. The more concentrated the market, the less the degree of competition and higher profitability. Goddard et al (2004a), for example, find a positive relationship between market concentration and profitability. Smirlock (1985), On the other hand, reports that concentration has no significant effect on profitability. However, he argues that market share affects profitability positively, implying that market share has effect on profitability rather than market concentration.

Furthermore, according to Goddard et al. (2004b), if there are a lot of large banks, collusion would not exist. They argue that the existence of high profits among the large banks is ambiguous. However, they point out that such high profits could be the result of a concentrated market structure and collusion, or reduction of costs by management in order to create higher returns. Mamatzakis and Remoundos (2003) found no significant relationship between structure and performance in the market and so refused the SCP hypothesis. By contrast, a positive relationship between concentration and profitability was reported by Demircuc-Kunt and Huizinga (1999), as well as Athanasoglou et al (2006). Molyneux and Thornton (1992) also found a positive and significant relationship

between concentration and return on equity, in consistent with the SCP paradigm and support the studies by Bourke (1989) and Short (1979).

Apart of market structure, researches have also attempted to identify other determinants of bank performance. So far, the impacts of many variables on bank performance have been reported, according to the nature and the purpose of each study. Athanasoglou et al. (2008) point out that the determinants of bank profitability are usually discussed as a function of internal and external variables. The internal variables are a proxy of microeconomics or bank-specific determinants such as size, asset quality, capital adequacy, liquidity ratios, operation ratios, and leverage, while the external determinants reflect macroeconomic indicators such as inflation, GDP, and interest rates (see Rhoades 1985; Bourke 1989; and Demirguc-Kunt and Huizinga 2000; among others).

For the specific case of Islamic banks in the Middle East, a part of Turk Ariss (2010) discussed before, different studies assess the determinants of profitability of Islamic banks and have shed some light on the Islamic bank performance. Haron (1996), for instance, analyses the determinants of profitability for Islamic banks, and finds that competition is positively associated with profitability. Using data for eight Middle Eastern countries over 1993-1998, Bashir (2003) examines the determinants of profitability in Islamic banks. He finds that market structure, capital to asset and loan to asset ratios are significantly associated with profitability. Similarly, Hassan and Bashir (2003) investigate a variety of internal and external banking characteristics as the determinants of Islamic bank profitability. Using bank-level data of 21 countries over the period 1994-2001, they report that capital ratio positively, but loan to assets ratio and size of banks negatively affect Islamic bank profitability. Also, they conclude that GDP per capita and inflation have no impact on profitability in Islamic banks, although growth of GDP affects profits significantly. Ben-Khadiri and Ben-Khadiri (2009) examine the determinants of Islamic bank profitability in the MENA region, during the years 1999-2006. Their results suggest that bank concentration increase bank profitability, and capitalisation and management efficiency enhance bank performance. Also, bank profitability is positively associated with, economic growth, and inflation. Finally, Al Manaseer (2007) measured the determinants of bank profitability in four Arab countries in the Middle East includes Jordan, Bahrain, Egypt, and Saudi Arabia over the 1996-2003 period. They find that determinants of bank profitability are different among traditional and Islamic banks in those countries. Finally, some other studies have attempted to investigate the effects on Islamic performance of other characteristics such as bank ownership (Sufian et al. 2007).

To summarize, the existing studies on market structure and other determinants of bank performance supply the comprehensive account of the effect of internal and external variables on bank profitability in an individual country or panel of countries. However, the effect of market structure on bank performance in Islamic banking is not still adequately dealt with. Particularly, there is no study to analyse the SCP hypothesis for Islamic banks and systematically compares with conventional banks. There is no evidence whether banking structure has significant influence on Islamic profits function or not. Thus, current research attempts to address the above issues.

2.2. *Concentration and Stability*

Regarding the impact of banking market concentration on financial stability, both economic theory and empirical evidence seem to be inconclusive, and there is a current debate in the banking literature. Particularly, there are two conflicting views reflecting contrasting views on the relationship between concentration and stability, namely “concentration-stability” and “concentration-fragility” views. While there is a large literature that concludes that banks rationally choose more risky portfolios when confronted with increased competition (less concentration), new studies find risk-incentive mechanisms that show the opposite direction, meaning banks take on more risk when become more concentrated.

Uhde and Heimeshoff (2009) have classified the existing arguments regarding these two views. According to this classification, proponents of the “concentration-stability” view argue that larger banks in concentrated banking sector reduce financial fragility through at least five channels. First, according to the traditional SCP hypothesis larger banks may increase profits, and hence building high ‘capital buffer’, allowing them to be less prone to liquidity or macroeconomic shocks (Boyd et al., 2004). Second, and similar to the first channel, larger banks may increase their charter value, encouraging bank managers to decrease excessive risk-taking behaviour (Keeley, 1990). Third, larger banks are more subject to stability as few larger banks tend to be easier to monitor, resulting the effective action of supervisory, and consequently reducing the risk of a system-wide contagion (Allen and Gale, 2000). Fourth, larger banks are more subject to providing credit monitoring services (Boot and Thakor, 2000). And finally, due to higher economies of scale and scope larger banks have the potential to diversify loan-portfolio risks more efficiently (Boyd and Prescott, 1986), and also diversify risk geographically through cross border activities (Meon and Will, 2005).

However, advocates of the “concentration-fragility” view argue that larger banks in concentrated market destroy stability through three channels (according to Uhde and Heimeshoff, 2009 classification). First, larger banks are more subject to “too big to fail” institutions which receive guarantee from public, and consequently the moral hazard problem becomes more severe (Mishkin, 1999). Second, larger banks may charge higher loan interest rates because of their market power, resulting taking more risky projects by borrowers to compensate such high rates, which consequently increase borrowers default risks (Boyd and De Nicolo, 2005). Third, managerial efficiency following higher degree of risk diversification may decrease, resulting higher operational risk (Cetorelli et al., 2007).

Regarding the recent empirical studies, Beck et al (2006), using data on 69 countries during the period 1980-1997, provides strong evidence that in more concentrated banking system the financial crises are less likely to occur. They show that less contestable markets are more subject to systemic risks. Similarly, Carletti and Vives (2008) show that market power may have a moderating effect on bank risk-taking incentives. Also, studies by Jimenez et al. (2007) as well as Berger et al. (2009) find a negative association between degree of market power and overall risk exposure for Spanish and 23 developed economies, respectively. In contrast, Boyd et al. (2006) by employing the Z-score acquire

the evidence in which concentration in either deposits or loans correlated with higher probability of increased risk. Molyneux and Nguyen-Linh (2008) also investigate the relationship between competition and bank risk in South East Asian banking and find that competition does not increase bank risk-taking.

Finally, regarding the stability of Islamic banking system, Bourkhis and Nabi (2011) analyse the resistant of Islamic and conventional banks to the recent financial crisis. They find that although Islamic banks were more resilience and stable during the first wave of the crisis, they have been indeed affected when financial crisis pass through the real economy. Comparing conventional and Islamic banks, Beck et al. (2010) find few significant differences in bank performance including stability between Islamic and conventional bank. In these papers, however, they don't examine the influence of market structure on Islamic banking stability.

3. Methodology

In this study, panel data models are considered. I examine Islamic and conventional bank performance through market structure. Market concentration reflects collusive behaviour and suggests that a firm's power to extract higher profits is due to oligopolistic behaviour and collusive arguments. I chose a key aspect of banking system health – bank performance, measured by bank risk and returns – and relied on previous empirical models to specify our own model, with which I investigate the potential influence of market power on these variables. Following Smirlock (1985) and Douglas and Diana (1988) the following model is established:

$$\Pi_{it} = \alpha_0 + \alpha_1 MS_{it} + \alpha_2 CR_{4it} + \sum_{j=1}^J \beta_j X_{jit} + \sum_{m=1}^M \theta_m X_{mit} + \varepsilon_{it} \quad (I)$$

where Π measures bank performance, and market structure refers to either market share (MS) or 4-firm concentration ratio (CR_4). A coefficient combination of $\alpha_1 > 0$ and $\alpha_2 = 0$ implies that firms with a high market share are more efficient than their rivals and earn more. Such coefficients also indicate that there is empirical evidence in support of the RMP theory, in which the key element of market structure is market share. Conversely, $\alpha_1 = 0$ and $\alpha_2 > 0$, suggests that the traditional SCP theory can be verified. For the possible case of $\alpha_1 > 0$ and $\alpha_2 > 0$, I cannot distinguish directly between the SCP and the RMP hypotheses. However, if I observe such a case, it is possible to disentangle the SCP from the RMP theory by using an interaction term. Also, X_j is a vector of bank-specific variables and X_m is a vector of country-specific factors. It is also worth noting that $\varepsilon_{it} = \mu_{it} + \nu_{it}$, the disturbance term, is a one-way error component, and is given by ε_{it} , with μ_{it} being the unobserved individual-specific effect and ν_{it} the reminder disturbance, where $\mu_{it} \sim IIN(0, \sigma_\mu^2)$ and independent of $\nu_{it} \sim IIN(0, \sigma_\nu^2)$.

In order to examine cross-section variations, two empirical models are considered: the fixed effect model and the random effect model. Model 1 is estimated through the fixed effects regressions. The potential for using the fixed effect, rather than the random effects model, can be tested with the Hausman test. If the null hypothesis is rejected at

conventional level, then the fixed effect model is more appropriate. By using this test, I find that the null hypothesis is rejected at 5% and hence I apply the fixed effect model. I estimate several specifications of this equation, highlighting the various different models, such as static and dynamic ones, as well as clustering of the errors at the bank levels.

4. Variables Definitions, Data Sources and Summary Statistics

4.1. Variables Definition

4.1.1 Dependent variables

In the previous research (e.g. Pasiouras and Kosmidou 2007), two important indicator of profitability are usually used; the return on average assets (*ROAA*) and return on average equity (*ROAE*). *ROAA* (*ROAE*) is the net profits expressed as a percentage of average total assets (equity). Furthermore, in order to investigate the effects of market structure on bank stability and following literature (e.g. Levy Yeyati and Micco, 2007), the *Z-score* as a measure of individual bank risk is used. It is defined as $z \equiv \frac{\mu + \text{Cap}}{\sigma_{\mu}}$, where μ is return as a percentage of average assets, *Cap* is equity capital as percentage of assets, and σ_{μ} is standard deviation of return on assets as a proxy for return volatility. A higher the z-score implies a lower probability of insolvency risk. An alternative indicator is the *Sharpe ratio* a measure of the excess return (or risk premium) per unit of risk. It is calculated as $\text{Sharp ratio} = \frac{\text{Cap}}{\sigma_{\text{cap}}}$ where *Cap* is, again, equity capital as percentage of assets, and σ_{cap} is standard deviation of return on equity. A higher the Sharpe ratio implies more stable banking system.

Market structure variable

The first measure of market structure is *market share*, which is a measure of relative market power, calculated as the bank's share of assets to total bank assets. It is expected that market share and bank profitability has a positive relationship. The *concentration ratio*, which provides estimates of the extent to which the largest firms contribute to activity in an industry, is taken as the second measure of market structure. Following Demircuc-Kunt et al. (2004), I measure bank-market concentration as the fraction of bank assets held by the four largest banks in a country. The degree of concentration of a market is expected to exert a negative influence on the degree of competition in the market.

Bank-specific variables

Eight bank-specific variables used in this study are interest rate spread, bank size, capital adequacy, cost efficiency, liquidity, Overheads, off-balance-sheet activities, and market growth.

Interest rate spread: The difference between the average yields a bank receives from loans and other interest-accruing activities and the average rate it pays on deposits and borrowings. The net interest rate spread is a key determinant of a bank's profitability. The

greater the spread, the more profitable the financial institution is likely to be. Since return on assets, as an indicator of profitability, is the ratio between net income and total assets, and further since interest spread is a major part of net income, we expect a positive association between interest spread and profitability. However, since for Islamic banks the term interest is not used, we use the profit-and-loss sharing accounts to measure the approximate interest spread as we calculate for conventional bank. Thus, the spread is the difference between the rates charged on loans (measured as the ratio between interests received and loans) and rates paid on deposits (measured as the ratio between interests paid and deposits).

Size: According to Goddard et al. (2004b), for several reasons size of a bank can affect the profit positively. First, banks with higher assets benefit from scale and scope economies. Secondly, larger banks may benefit from their market powers. Finally, a positive relationship between size and profit may be a consequence of abnormal profits through market power in wholesales. We measure bank size as the natural log of total assets.

Capital adequacy: Capital adequacy measured as the ratio of equity to total assets is also employed. This variable is an indicator of bank capital strength. Since well-capitalized banks face lower costs of funding and consequently lower risk of bankruptcy, I expect a negative relationship between the equity to assets ratio and bankruptcy risk and a positive association with profitability. Furthermore, as Pasiouras and Kosmidou (2007) note, in the event of bankruptcy or liquidation banks with high equity to assets tend to be relatively safer.

Cost efficiency: following Pasiouras and Kosmidou (2007), I use the cost to income ratio as an efficiency measure and shows how cost is changing compared to changes in income. Higher profits (or fewer risks) are achieved when expenses are minimized.

Liquidity: The ratio of liquid assets to total assets is employed to capture liquidity. This ratio indicates the percentage of deposit and short term funds that could be met if they were withdrawn suddenly. One important policy of banks refers to their liquidity management. Hence, a negative (positive) relationship between this variable and profitability (or stability) is expected (Bourke, 1989).

Overheads: Moreover, a negative correlation between overhead expenses and profitability (or stability) is expected. Overheads account for the bank's entire overhead associated with all of its activities. Hence, following Demircuc-Kunt and Huizinga (1999) we employ the ratio between overhead costs and total assets.

Off-balance-sheet activities: I also apply off-balance sheet activities to total assets, this variable is applied as a proxy of any assets, debts or financing activities which are not on the bank's balance sheets. In order to analyse the output of banks the role of off-balance sheet activities should be taken into account, otherwise the results would lead to biased conclusions. Since the off-balance sheet activities is an indicator of bank diversification we expect a positive effect on bank profitability and stability.

Market growth: Finally, growth of total assets is employed to capture the impact of yearly growth of total assets on bank profitability. One would expect that banks which grow faster would be able to generate greater profits and at the same time face more risk. Nonetheless, an increasing amount of assets could lead to higher profits if and only if banks are able to convert assets to earning ones. It may also depend on the credit quality of those assets. Thus, the impact of this variable is indeterminate and has to be tested empirically.

4.1.2 External variables

In addition to internal variables, three external determinants (financial development, inflation and GDP growth) are used to examine the impact of environment on bank's performance.

Bank development: Domestic credit to the private sector which refers to financial resources provided to the private sector as percentage of GDP is used in most studies (Cetorelli and Gamberra, 2001) investigating finance-grow nexus. This variable is used as a proxy for a country's banking sector development, and can influence bank performance.

Inflation: Including the inflation rate in our analysis allows us to see whether monetary policy affects bank profitability and stability. Inflation may affect both the costs and revenues of any organization including the banks. Short (1979) states the relationship between inflation and profitability is positively significant. We also expect a negative association between bank stability and inflation rate.

GDP growth: Finally, according to Demircuc-Kunt and Huizinga (1999); Bikker and Hu (2002) and Athanasoglou et al. (2008), *GDP growth* has a positive effect on banks profitability, possibly due to increases in lending rates. Hence, we include the real GDP growth of each country into the model.

4.2. Data Sources

By driving data for Islamic and conventional banks over the period 1999-2008, this paper examines what factors affect bank profitability and stability. The bank-level and market structure data are derived from financial statements such as income statements and balance sheets as available from the BankScope database compiled by Fitch IBCA. I use the BankScope database which is considered as one of the most comprehensive databases that widely used in banking research. I should note that for selecting banks I impose several criteria. Firstly, banks must be active as indicated by the BankScope. Secondly, in order to remove very small banks, they have to have minimum total assets of a billion USD. And finally, I remove central banks and other non-banking financial institutions. The above procedure yielded unbalanced panel data sets of 175 banks over the period 1999-2008, consisting of 320 and 1430 observations for Islamic and conventional banks, respectively. The data is an unbalanced panel and covers all 12 Middle Eastern countries. Furthermore, the country level data and data of macroeconomic variables such as inflation, GDP per capita and credit provided to the private sector are retrieved from the IMF Financial Statistics (IFS) and World Bank

Databases. These databases have high quality national and international statistics. Finally, I should emphasise that since the number of observations for Islamic banks are less than that for their commercial counterparts, the comparisons must be interpreted with some caution.

Table 1 shows the aforementioned variables with their notations, expected effect on profitability and stability and sources. It also reports countries included in the sample.

4.3. Summary Statistics

Appendix A demonstrates the degree of correlation between the explanatory variables used in the multivariate regression analysis. The matrix shows that in general, the correlation between the profitability determinants is not strong, thus suggesting that multicollinearity problems are either not severe or non-existent. The maximum correlation (0.6171) is found between market structure ratios, i.e. the 4-firm concentration ratio and the market share. Furthermore, Table 2 summarizes the dataset used in this analysis by country. It also reports sample means (calculated for bank-year observations), for all variables. Comparing the summary statistics across countries, I see significant variations in market structure, bank activity, and macroeconomic variables. In order to distinguish between such differences across bank types, Appendix B demonstrates the descriptive statistics by bank type. I also test the mean equality for all variables. The t-values show that there are significant differences between variable means for Islamic and conventional banks, although I observe a distinct closeness of mean values for some explanatory variables.

Table-1
Definitions, Units, Expected Effect

Variables	Units	Expected effect on profitability	Expected effect on performance	Source
Profitability and Stability Indicators				
Return on average assets before tax (ROAA)	Ratio	--	--	BankScope
Return on average equity before taxes (ROAE)	Ratio	--	--	BankScope
Z-score	Ratio	--	--	BankScope
Sharpe ratio	Ratio	--	--	BankScope
Market Structure				
Market share	Ratio	Positive	Positive	BankScope
4-firm concentration ratio	Ratio	Positive	Positive	BankScope
Bank-specific Characteristics				
Interest rate spread	Percentage	Positive	Positive	BankScope
Size of bank	Logarithm	?	?	BankScope
Equity to total assets	Ratio	Positive	Positive	BankScope
Cost to income ratio	Ratio	Negative	Negative	BankScope
Liquid assets to total assets	Ratio	?	Positive	BankScope
Overheads to total assets	Ratio	Negative	Negative	BankScope
Off-balance-sheet activity to total assets	Ratio	?	?	BankScope
Market growth (total assets)	Ratio	?	?	BankScope
Macroeconomic Variables				
Domestic credit provided by banking system (% of GDP)	Ratio	?	?	World Bank
Inflation	Percentage	?	?	World Bank
GDP growth	Percentage	?	?	World Bank
Countries Included Bahrain, Egypt, Iran, Jordan, Kuwait, Lebanon, Oman, Qatar, Saudi, Syria, Turkey, and UAE				

Table-2
Descriptive Statistics of Dataset by Country Averages over 1999–2008

Country	No. of observations			Bank Performance				Bank Concentration			Bank-specific Variables						Macroeconomics			
	IB	CB	Tot	ROAA	ROAE	Z-score	Sharpe ratio	Market Share	4 Firms Concentration	Interest Spread	Log (size)	Equity to Total Assets	Cost to Income	Liquid Assets to Total Assets	Overheads to Total Assets	Off-balance-sheet activities	Market Growth	Domestic Credit	Inflation	GDP Growth
Bahrain	50	100	150	1.63	14.52	1.92	2.20	8.47	82.75	6.83	15.06	0.11	46.00	0.25	0.02	0.169	23.82	60.27	1.81	5.99
Egypt	20	220	240	0.86	9.37	0.83	1.12	4.52	66.29	7.75	14.53	0.08	50.65	0.31	0.02	0.178	15.16	99.94	4.64	4.88
Iran	60	90	150	1.57	13.79	1.27	2.29	8.77	77.68	8.73	15.20	0.07	49.20	0.21	0.02	0.315	37.65	47.33	-	5.78
Jordan	10	80	90	1.22	11.34	2.09	1.83	11.11	91.56	6.36	14.88	0.10	51.61	0.43	0.02	0.274	12.35	97.29	2.78	6.02
Kuwait	40	100	140	2.28	16.12	3.47	2.41	11.11	80.00	7.42	15.43	0.12	35.06	0.32	0.02	0.181	17.71	78.03	2.51	2.62
Lebanon	20	160	180	0.83	12.55	2.71	2.51	7.41	59.35	5.93	14.91	0.07	57.24	0.36	0.01	0.078	11.77	180.57	-	-
Oman	20	60	80	2.24	14.90	3.38	3.12	14.08	83.52	4.47	14.21	0.13	45.93	0.21	0.02	0.346	16.68	39.02	1.55	3.72
Qatar	10	60	70	2.38	19.51	4.20	3.90	16.95	93.25	6.97	14.86	0.13	34.31	0.30	0.01	0.411	28.26	41.48	3.35	5.60
Saudi Arabia	20	90	110	2.33	18.61	3.57	2.90	10.10	66.00	4.08	16.38	0.11	38.82	0.31	0.02	0.231	15.05	58.15	2.58	3.42
Syria	10	40	50	0.38	7.51	0.16	3.92	20.83	99.38	7.09	14.50	0.07	46.57	0.71	0.01	0.350	24.76	33.98	4.04	3.89
Turkey	30	200	230	1.79	16.16	1.29	1.87	8.69	79.48	3.23	15.66	0.11	56.82	0.28	0.04	0.352	21.28	45.94	8.78	6.05
UAE	30	230	260	2.43	14.49	2.39	2.27	4.95	61.97	3.55	14.76	0.14	36.67	0.27	0.02	0.461	25.25	51.13	-	-
Middle Eastern banks																				
Mean	27	119	146	1.55	13.36	2.13	2.25	8.66	74.40	5.96	15.09	0.10	47.76	0.30	0.02	0.27	18.86	77.54	3.08	4.91
No. of observation	320	1430	1750	1350	1305	1860	1860	1690	1792	1056	1448	1241	1394	1448	1424	1302	1299	1662	865	1226

Note: This table shows summary statistics of the main variables in different countries. ROAA is return on average assets, which is defined as profit before tax as a percentage of total assets of a bank. ROAE is return on average equity, which is defined as profit before tax as a percentage of equity of a bank. Z-score is defined as $[(ROAA+CAR)/SROAA]$, where ROAA is return on average assets, CAR represents capital assets ratio, and SROAA stands for standard deviation of return on assets. Shape ratio constructed as $(ROAE/SROAE)$, where ROAE is return on average equity and SROAE represents standard deviation of return on equity. Market share is the share of a bank's assets to total assets in the national market. 4-firm market concentration is the fraction of assets held by the four largest banks in each country. Interest rate spread is the difference between lending and deposit rates. Log (total assets) is the natural logarithm of total assets in US dollars. Equity to total assets is the capital to asset ratio, which is defined as equity as a percentage of total assets. Cost to income is the ratio of total costs to total income as a proxy of efficiency. Liquid asset to total assets is a ratio defined as liquid assets as a percentage of total assets. Overheads is defined as total overhead costs as a share of total assets. Off-balance-sheet activities are assets or debts that do not appear on a company's balance sheet as a percentage of total assets. Market growth is the inflation-adjusted growth rate of bank assets. The data for these bank level variables are obtained from BankScope database. Domestic credit is domestic credit provided by banking sector as a percentage of GDP. Inflation is the inflation rate based on consumer prices. GDP growth is the inflation-adjusted growth rate of gross domestic product of the country. All these macroeconomic variables are from World Development Indicators of the World Bank.

Figure 1 shows trend of return on assets for both Islamic and conventional banking during 1999-2008. As it can be seen, ROAA in Islamic banks increased significantly from around 0.80 to 2.20 per cent during this period, but for the case of conventional banks it remains approximately at 1.5 per cent. Surprisingly, level of ROAA in Islamic banks accelerated that observed for conventional banks during 2003-2008. Furthermore, Figure 2 indicates that market share of both bank types decreased significantly during the period under consideration, although the rate for Islamic banks is greater than conventional banks. Also, Figure 3 shows that market concentration of all considered countries went out significantly, reached to around 66 per cent. Appendix C demonstrates the average returns and concentration ratio across Middle Eastern countries.

Figure-1
Trend of Return on Assets in Middle Eastern Banks during 1999-2008
Islamic Banking vs Conventional Banking

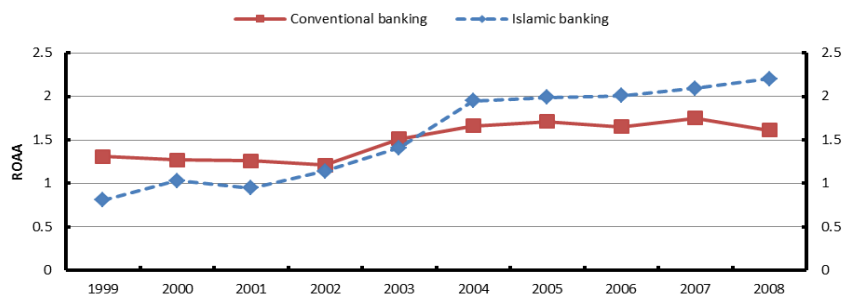


Figure-2
Trend of Market Share in Middle Eastern Banks during 1999-2008
Islamic Banking vs Conventional Banking

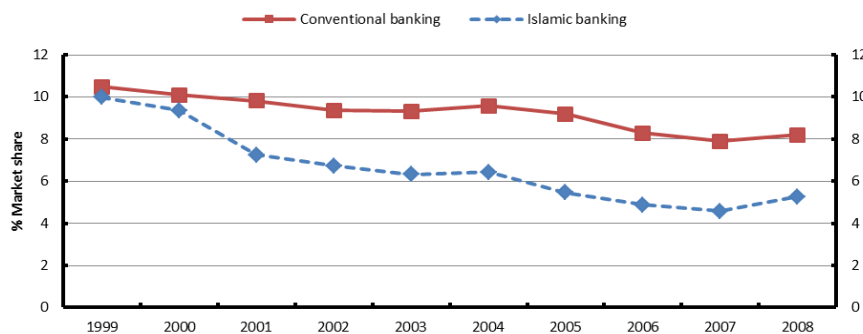
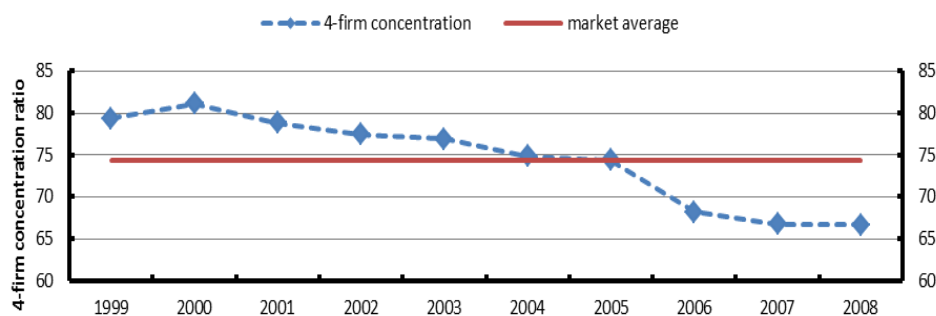


Figure-3
Trend of Concentration Ratio in Middle Eastern Banks during 1999-2008



Finally, Table 3 ranks countries in descending order of market structure and bank profitability and stability indicators, according to various different measurements. The rankings vary considerably and it is difficult to assess the extent to which they correspond with one another. The distance between any two given ranks has no cardinal value. According to Table 3, Iran, Qatar and UAE, with 37.65, 28.26 and 25.25 percent respectively, have the highest market growth in their region for the period 1999-2008. By contrast, Saudi (15.05%), Jordan (12.35%) and Lebanon (11.77%) experienced the lowest market growth. Moreover, differences in market structure, which refers to the number and distribution of firms in the market, are as follows. Syria, with a 99.38% 4-firm concentration ratio and Jordan with a 0.25% Herfindahl ratio, seem to have the most concentrated markets in the Middle East. Finally, Qatar (with approximately high ROAA, ROAE, Z-score, and Sharpe ratio), has more profitable and stable banking systems than other banks located in the region.

Table-3
Mean Values and Ranks of Market Structure and Bank Performance for the Middle East over 1999–2008

Market growth is the inflation-adjusted growth rate of bank assets. Market share is the share of a bank's assets to total assets in the national market. 4-firm market concentration is the fraction of assets held by the four largest banks in each country. ROAA is return on average assets, which is defined as profit before tax as a percentage of total assets of a bank. Normal Herfindahl index is a concentration ratio measured as sum of square of market share. ROAE is return on average equity, which is defined as profit before tax as a percentage of equity a bank. Z-score is defined as $[(ROAA+CAR)/SROAA]$, where ROAA is return on average assets, CAR represents capital assets ratio, and SROAA stands for standard deviation of return on assets. Shape ratio constructed as $(ROAE/SROAE)$, where ROAE is return on average equity and SROAE represents standard deviation of return on equity.

Rank	Market Growth – Total Assets (%)	Market Share (%)	4-Firm Concentration (%)	Normal Herfindahl Index	ROAA	ROAE	Z-score	Sharpe ratio
1	Iran (37.65)	Syria (20.83)	Syria (99.38)	Jordan (0.25)	UAE (2.43)	Qatar (19.51)	Qatar (4.20)	Syria (3.92)
2	Qatar (28.26)	Qatar (16.95)	Qatar (93.25)	Qatar (0.23)	Qatar (2.38)	Saudi (18.61)	Saudi (3.57)	Qatar (3.90)
3	UAE (25.25)	Oman (14.08)	Jordan (91.56) Oman (83.52)	Turkey (0.21)	Saudi (2.33)	Turkey (16.16)	Kuwait (3.47)	Oman (3.12)
4	Syria (24.76)	Jordan (11.11)		Bahrain (0.16)	Kuwait (2.28)	Kuwait (16.12)	Oman (3.38)	Saudi (2.90)
5	Bahrain (23.82)	Kuwait (11.11)	Bahrain (82.75)	Kuwait (0.15)	Oman (2.24)	Oman (14.90)	Lebanon (2.71)	Lebanon (2.51)
6	Turkey (21.28)	Saudi (10.10)	Kuwait (80.00) Turkey (79.48)	Iran (0.14)	Turkey (1.79)	Bahrain (14.52)	UAE (2.39)	Kuwait (2.41)
7	Kuwait (17.71)	Iran (8.77)		Oman (0.12)	Bahrain (1.63)	UAE (14.49)	Jordan (2.09)	Iran (2.29)
8	Oman (16.68)	Turkey (8.69)	Iran (77.68)	Egypt (0.1)	Iran (1.57)	Iran (13.79)	Bahrain (1.92)	UAE (2.27)
9	Egypt (15.16)	Bahrain (8.47)	Egypt (66.29) Saudi (66.00)	UAE (0.08)	Jordan (1.22)	Lebanon (12.55)	Turkey (1.29)	Bahrain (2.20)
10	Saudi (15.05)	Lebanon (7.41)		Lebanon (0.06)	Egypt (0.86)	Jordan (11.34)	Iran (1.27)	Turkey (1.87)
11	Jordan (12.35)	UAE (4.95)	UAE (61.97)	Saudi (0.05)	Lebanon (0.83)	Egypt (9.37)	Egypt (0.83)	Jordan (1.83)
12	Lebanon (11.77)	Egypt (4.52)	Lebanon (59.35)	-	Syria (0.38)	Syria (7.51)	Syria (0.16)	Egypt (1.12)

-Not available.

Note: Ratios are calculated for each bank in each country and then averaged over the country's sample period.

Source: Authors' calculations based on data from the BankScope database of the IBCA.

5. Results

5.1. Evaluation of Bank Returns and Market Structure

This section presents the results of regressions that explain variation in bank returns through a range of relevant bank and bank-environment variables. Table 4 reports the empirical estimations of Equation (1) for a bank's ROAA in panel A and bank's ROAE in panel B, in which profitability (Π) is regressed on market structure, bank-specific characteristics, and macroeconomic variables. Panel B is fully analogous to the regressions of Panel A. Table 4 contains the regression results for both Islamic and conventional banking systems in the Middle East separately, and uses individual bank-year observations. The regressions include bank and year fixed effects and clustering of the errors at the bank level. The explanatory power of the model is much higher for Islamic banks (R^2 equal to

0.472 and 0.413 when ROAA and ROAE are dependent variable respectively for the case of Islamic banks compared to 0.264 and 0.271 for conventional banks), while the F-statistic for all models is significant at the 1% level. These results imply that additional factors may influence profitability of commercial banks.

For all regressions, the market share coefficients are positive, but statistically significant at the 10% level only for Islamic banking system. Also, the coefficients of market concentration (4-firm concentration) are again positive for all regressions, but statistically highly significant at the 1% level only for commercial banks. Based on these results, it is clear that, although a bias is evident in favour of relative-market-power (RMP), rather than the traditional structure-conduct-performance (SCP) hypothesis, the high profitability indicators for Islamic banks cannot be explained by market structure. By contrast, a positive and highly significant relationship between returns and market concentration is found for conventional banking system, supporting the traditional SCP paradigm in this market. The results also indicate that in Islamic banking systems, market share dominates market concentration, and that the RMP applies, while in commercial banks, market concentration dominates market share and supports the traditional SCP hypothesis.

Turning to bank-specific characteristics, all the coefficients are significant, with the exception of off-balance-sheet activities and market growth, with respect to Islamic markets and size with respect to commercial markets. The main finding is that the effect of interest rate spread (lending rate minus deposit rate) on both profitability indicators (ROAA and ROAE) is positive for Islamic banks and negative for conventional banks. It seems that banks operating under Islamic law tend to adjust their lending and deposit rates in the sense of raising profits, without losing their customers. One possible reason for the negative impact of spread on profitability for conventional banks might be that profitability in conventional banks are very elastic to interest rates setting on loans, indicating that banks may lose their customers as Islamic banks are potential rivals in this region. Among the controls, the assets variable enters with a negative and significant coefficient for Islamic banks and a positive and insignificant coefficient for commercial banks. This suggests that larger banks have lower rates of return for Islamic banking and larger rates of return for their conventional counterparts. These results support the studies that reported either economies of scale and scope for smaller banks, or diseconomies for larger financial institutions, although the theory provides conflicting predictions about optimal bank asset structures. In addition, the negative effect of bank size on Islamic bank's profitability is in line with Turk Ariss (2010) who found evidence of a negative relationship between size and profitability, although the effect is statistically insignificant. Using data for a sample of Islamic banks from 17 countries, Weill (2010), however, found different results.

Table-4
Determinants of the Return on Assets and Equity (Islamic Banks vs Conventional Banks)

Variable	Panel A: ROAA		Panel B: ROAE	
	Islamic banks	Conventional banks	Islamic banks	Conventional banks
Market Structure				
Market share	0.0721* (1.81)	0.0089 (0.93)	0.3232* (1.88)	0.2551 (1.49)
4-firm concentration	0.0038 (0.53)	0.0015*** (4.97)	0.0477 (1.57)	0.0145*** (2.65)
Bank-Specific Variables				
Interest rate spread	0.0171** (2.08)	-0.0155** (-2.28)	0.1478*** (4.84)	-0.0777*** (-13.01)
Log(total assets)	-0.3980*** (-3.58)	0.241 (1.29)	-0.366*** (-3.50)	0.1206 (1.42)
Equity to total assets	0.8874*** (10.62)	0.4622*** (14.46)	-0.9489*** (-4.05)	-0.4346*** (-3.77)
Cost to income	-0.7323*** (-11.15)	-0.3087*** (-27.67)	-0.9827*** (-24.25)	-0.5456*** (-26.04)
Liquid assets to total assets	-0.4345* (-1.66)	-0.2099** (-6.00)	0.2756*** (4.44)	0.1265* (1.80)
Overheads to total assets	-0.1983** (-2.42)	-0.2980*** (-4.33)	-0.3581*** (-3.33)	-0.2732*** (-5.08)
Off-balance-sheet activities to total assets	0.0028 (0.95)	0.0075*** (3.58)	0.0034 (1.11)	0.0112*** (3.75)
Market growth (assets)	0.0008 (0.43)	0.0012*** (8.83)	0.0124 (1.18)	0.0115*** (4.77)
Macroeconomics				
Domestic credit provide by banking	-0.0134*** (-5.15)	0.0001*** (5.01)	-0.0642*** (-5.59)	0.0275*** (8.91)
Inflation	0.0243** (2.06)	-0.0256*** (-6.01)	0.3083*** (10.96)	-0.3502*** (-4.56)
GDP growth	0.3188*** (4.70)	0.1089*** (5.47)	0.3012*** (3.92)	0.1989*** (6.98)
Bank dummies	Yes	Yes	Yes	Yes
Year dummies	Yes	Yes	Yes	Yes
No. of bank	35	151	35	151
No. of observation	270	1420	270	1420
R ² -overall	0.472	0.264	0.413	0.271
Clustering level	Bank	Bank	Bank	Bank

Note: The dependent variable in panel A is return on average assets, which is defined as profit before tax as a percentage of total assets of a bank. The dependent variable in panel B is return on average equity, which is defined as profit before tax as a percentage of equity a bank. Market share is the share of a bank's assets to total assets in the national market. 4-firm market concentration is the fraction of assets held by the four largest banks in each country. Interest rate spread is the difference between lending and deposit rates. Log (total assets) is the natural logarithm of total assets in US dollars. Equity to total loans is the capital to loan ratio, which is defined as equity as a percentage of total loans. Cost to income is the ratio of total costs to total income as a proxy of efficiency. Liquid asset to total assets is a ratio defined as liquid assets as a percentage of total assets. Overheads is defined as total overhead costs as a share of total assets. Off-balance-sheet activities are assets or debts that do not appear on a company's balance sheet. Market growth is the inflation-adjusted growth rate of bank assets. The data for these bank level variables are obtained from BankScope database. Domestic credit is domestic credit provided by banking sector. Inflation is the inflation rate based on consumer prices. GDP growth is the inflation-adjusted growth rate of gross domestic product of the country. All these macroeconomic variables are from World Development Indicators of the World Bank. We estimate all regressions using country and time fixed effects and clustering at bank level. T-values are in parentheses. *, **, *** denote significance at 10%, 5%, and 1%, respectively.

One possible explanation for such negative effect might be that small banks may have a local market and hence they can impose their power to earn more, but larger banks have commercial rivals that do not allow them to benefit from their power.

Next, capital strength, expense efficiency and liquidity appear to be the most significant determinants of bank profitability in all cases, as the relatively high and significant coefficients of equity to loans, cost to income, liquid assets to total assets, and overheads to total assets demonstrate. Capital adequacy, measured as equity to total assets, is positively related to ROAA and negatively related to ROAE, when I examine banks in both Islamic and non-Islamic banking sectors. These findings are consistent with previous studies (Bourke (1989), Demircuc-Kunt and Huizinga (1999), Goddard et al. (2004b), Kosmidou et al. (2005), Athanasoglou et al. (2006), and Pasiouras and Kosmidou (2007).

Consistent with our expectations, the cost to income ratio appears to be another important determinant of profitability for both banking systems. Its coefficient is negative and statistically highly significant at the 1% level for both. This result meets the expectation that the more efficient a bank, the greater its profitability. Smirlock (1985) found that firm-specific efficiency seems to be the dominant variable explaining profitability in studies of the US banking industry and this is also the case in the current study. The difference in the coefficient between Islamic and conventional banking system implies that an increase (decrease) in expenses reduces (increases) profits to a greater extent in Islamic banks, compared to those operating under conventional rule. Furthermore, liquidity, measured by the ratio of liquid assets to total assets, is estimated to have a negative and statistically significant impact on ROAA for both markets, indicating a negative relationship between bank profitability and the level of liquid assets. However, when ROAE is the explained variable, I observe a positive association between profitability and liquidity. The relationship between overheads, measured by overhead expenses divided by total assets, and bank profitability, is negative for both markets.

On the whole, controlling for all other relevant factors, off-balance-sheet activities appear to be associated with greater return, although the effect is statistically significant only for the commercial banking system. Using data for 1,334 banks in 101 countries over the 1995-2007 periods, Demircuc-Kunt and Huizinga (2010) found similar results. They report that expansion into fee income (non-interest income) increases the rate of return on assets, and it could offer some risk diversification benefits. Moreover, market growth, measured as real growth of assets in the bank's markets, is another important determinant only for commercial banks. The association with asset growth is positive, although the effect is no longer significant for the Islamic markets banking system. This implies that fast-growing commercial banks tend to have higher returns, while banks operating under Islamic law markets tend to lose the potential to increase their assets in terms of operating income.

Turning to financial structure and macroeconomic variables, the impacts are mixed. While there is a highly significant relationship between domestic credit provided by the banking sector and profitability, the coefficient signs are opposite of the negative and positive for both markets. One possible explanation of this difference would be that in emerging economies, providing credit to the private sector may be influenced by government policies, and that banks are under pressure to provide credit even for unprofitable proposals. Finally, the effects of inflation and GDP growth on bank profitability are positive and statistically significant for both markets, with the exception that inflation has a negative impact on profitability for commercial banks. GDP growth is generally assumed to influence banks through many factors related to the supply and demand of loans and deposits. Therefore, high inflation and high GDP growth are associated with higher returns for banks in emerging economies, while low inflation and high GDP growth tend to increase bank returns in advanced economies.

5.2. *Evaluation of Bank Stability and Market Structure*

I next consider how a bank's Z-score, defined as the pre-tax return on average assets plus capital to asset ratio, divided by the standard deviation of the return on average assets, as an index of bank risk, is related to the market structure and other determinants of bank performance. I also investigate how an alternative measure of bank return, the Sharpe ratio, defined as the pre-tax profits relative to equity, divided by the standard deviation of the return on equity, is associated with the market structure. Table 5 presents the regressions of the Z-score and the Sharpe ratio, for both Islamic and conventional banking systems. Specifically, in panel A, I relate an overall Z-score (computed using yearly mean data of the country) to the yearly mean value of explanatory variables for the country. In panel B, I show the Sharpe ratio (again computed using yearly mean data for the country) to the yearly mean of the explanatory variables for the country. All explanatory variables in both panel regressions are analogous to the rate of return regressions in Table 4. The estimation is by ordinary least squares (OLS) with a clustering of the errors at the bank level. According to the regression results, the same bank variables that tend to give rise to higher bank returns also lead to greater stability, with few differences.

Table-5
Determinants of the Z-score and Sharpe Ratio (Islamic Banks vs Conventional Banks)

Variable	Panel A: Z-score		Panel B: Sharpe ratio	
	Islamic banks	Conventional banks	Islamic banks	Conventional banks
Market Structure				
Market share	0.0412*** (3.87)	0.0339*** (6.17)	0.1402*** (7.17)	0.0576** (2.35)
4-firm concentration	-0.0023 (-0.37)	-0.0041* (-1.82)	-0.0095*** (-4.90)	-0.0120*** (-3.17)
Bank-Specific Variables				
Interest rate spread	0.0514*** (3.51)	0.0026* (1.97)	0.0672** (2.47)	-0.0305 (-1.35)
Log(total assets)	-0.0584 (-0.81)	-0.0087*** (-9.05)	-0.2940** (-2.10)	-0.1033 (-0.39)
Equity to total assets	0.6165*** (3.89)	0.3800*** (4.22)	0.4210** (1.96)	0.2637** (2.46)
Cost to income	-0.0280*** (-4.60)	-0.0008 (-0.08)	-0.0458*** (-4.24)	-0.0121* (-1.81)
Liquid assets to total assets	0.1159*** (4.34)	0.0068 (1.54)	0.2477* (1.71)	0.1503 (0.28)
Overheads to total assets	-0.5811*** (-3.59)	-0.3502*** (-5.69)	-0.2197*** (-2.90)	-0.1659*** (-3.61)
Off-balance-sheet activities to total assets	0.0211** (1.97)	0.0033*** (2.99)	0.1082*** (4.04)	0.0110*** (2.06)
Market growth (assets)	0.0279*** (5.52)	0.0167** (2.51)	0.0239*** (2.66)	0.0124* (1.66)
Macroeconomics				
Domestic credit provide by banking	-0.0067*** (-3.08)	-0.0024 (-1.61)	-0.0042 (-1.07)	-0.0050*** (-3.08)
Inflation	0.0068 (0.13)	-0.0592 (-1.29)	0.0610 (1.37)	-0.1062** (-2.19)
GDP growth	0.0210 (1.14)	0.1273*** (4.67)	0.0843** (1.98)	0.1907*** (5.91)
Bank dummies	No	No	No	No
Year dummies	No	No	No	No
No. of Country	35	151	35	151
No. of observation	270	1420	270	1420
R ² -overall	0.351	0.251	0.394	0.302
Clustering level	Banks	Banks	Banks	Banks

Note: The dependent variable in panel A is the Z-score, which is defined as $[(ROAA+CAR)/SROAA]$, where ROAA is return on average assets, CAR represents capital assets ratio, and SROAA stands for standard deviation of return on assets. The dependent variable in panel B is the Shape ratio constructed as $(ROAE/SROAE)$, where ROAE is return on average equity and SROAE represents standard deviation of return on equity. Market share is the share of a bank's assets to total assets in the national market. 4-firm market concentration is the fraction of assets held by the four largest banks in each country. Interest rate spread is the difference between lending and deposit rates. Log (total assets) is the natural logarithm of total assets in US dollars. Equity to total loans is the capital to loan ratio, which is defined as equity as a percentage of total assets. Cost to income is the ratio of total costs to total income as a proxy of efficiency. Liquid asset to total assets is a ratio defined as liquid assets as a percentage of total assets. Overheads is defined as total overhead costs as a share of total assets. Off-balance-sheet activities are assets or debts that do not appear on a company's balance sheet. Market growth is the inflation-adjusted growth rate of bank assets. The data for these bank level variables are obtained from BankScope database. Domestic credit is domestic credit provided by banking sector. Inflation is the inflation rate based on consumer prices. GDP growth is the inflation-adjusted growth rate of gross domestic product of the country. All these macroeconomic variables are from World Development Indicators of the World Bank. We estimate all regressions with mean data for every year and clustering at bank level. T-values are in parentheses. *, **, *** denote significance at 10%, 5%, and 1%, respectively.

Both the Z-score and the Sharpe ratio are positively and significantly related to market share. This suggests that a greater market share increases bank stability. By contrast, the effect of market concentration on bank stability is negative, meaning that concentrated markets are more risky for both markets. Furthermore, the Z-score and the Sharpe ratio are related to bank-characteristics in a statistically significant manner. For a start, banks operating in both markets are found to be more stable when bank charge higher prices, interest rates. This finding indicates a trade off between risk and return and price, and is inconsistent with the negative relationship between the interest rate spread and the rate of returns on assets and equity for commercial banks in the analogous regression of Table 5. Bank size is found to be negatively related to bank stability for both markets. Since from Table 5, I find a positive impact of size on returns in commercial banks, this new finding, again, indicates that bank size appears to present banks with a trade-off between risk and return. In all regressions, higher cost efficiency and higher overheads are also negatively and significantly related to bank stability for both markets, meaning that banks with higher costs to income ratios and overheads are further estimated to be less stable. However, as expected, banks with more capital and liquidity appear to be more stable. Firms with a focus on generating profits through off-balance-sheet activities tend to have a higher rate of returns and lower risk. Furthermore, the Z-score and the Sharpe ratio are further estimated as higher when the market grows more rapidly. The regression results also suggest that old banks are more stable, as the positive coefficients of bank age indicate, although this impact is statistically significant only for commercial banks.

Turning to the financial structure and macroeconomic variables, domestic credit provided by the banking system enters with negative coefficients. This suggests that as domestic credit increases, the bank risk rises, no matter under which law they operate. Finally, a country's bank risks decline when the country has high GDP growth in an inflationary period, for Islamic, but in deflationary periods for commercial banks.

5.3. Dynamic Evaluation of Bank Returns and Market Structure

Another approach followed by previous studies is based on dynamic panel analysis. Goddard et al. (2004b), for example, analyze the profitability of 665 banks from six European countries (Denmark, France, Germany, Italy, Spain and the UK) during the 1990s, using different models compared to other studies. Their study represents one of the few attempts to account for dynamic panel analysis in banking. The empirical results suggest that there is a significant persistence of profits from one year to the next, despite high competition in the European banking system. More recently, Athanasoglou et al. (2008) examined the effect of bank-specific, industry-specific and macroeconomic determinants of bank profitability in Greek banks over the period 1985-2001. By applying the GMM technique, their main finding is a positive and statistically significant relationship between a one year lag of profits and current profits, which indicates the persistence of

profitability in the Greek banking sector. They find no support for the SCP hypothesis and also no size-profitability relationship.

Thus, in order to account for profit persistence, I apply the GMM technique to a panel of emerging and advanced market banks. Table 6 shows the empirical estimations, using ROAA and ROAE as the profitability variables. I applied the GMM estimator and used a lag of dependent and independent variables as instruments, and the Sargan test for over-identification restrictions in our dynamic model estimation. I cluster the errors at the bank level, and analogous sets of regressions of returns are reported in panels A and B. The model, having fairly stable coefficients, seems to fit the panel data reasonably well. The results confirm the dynamic character of the model specification, as there are highly significant coefficients of ROAA (t-1) and ROAE (t-1) at the 1% level for both markets. In addition, the smaller coefficients in the case of Islamic banking system imply more competition in the financial market in this market. However, since the coefficients takes a value of 0.4011 and 0.0.3953 when returns on assets and equity behave as dependent variables, respectively, for the case of Islamic banking, and 0.2174 and 0.2277 for the case of commercial banks, no perfectly competitive structure for both markets is found, at least for the period under consideration.

Furthermore, the regression results again show that the market structure-profitability relationship supports the relative-market-power (RMP) hypothesis for Islamic market banking systems, and suggests the structure-conduct-performance (SCP) hypothesis for conventional market banking systems. Also, just like static results presented in Table 7, while there is a positive association between bank profitability and interest rate spread in Islamic banks I find a reverse relationship in commercial banks. Overall, the results demonstrate that there is no substantial difference between the static and dynamic characteristic of profitability, although the regression coefficients in some cases do differ across both markets. For example, for commercial economics, the effects of off-balance-sheet activities and domestic credit are no longer positive, and no GDP growth-profitability relationship is found.

6. Robustness Tests

In order to test the sensitivity of our results, I conduct a set¹ of robustness tests in this section. The dependent and independent variables in this section are analogous to those reported in main results (Table 4 and 5). However, to preserve space, I just report the two main interested variables i.e. market share and concentration ratio to distinguish the SCP and the RMP hypotheses, and the reminder variables, although included into the model, not reported and available on request.

¹ Apart of these set of robustness tests, the findings from the regressions remained also robust including a one-period lag of explanatory variables, and net interest margin instead of ROAA and ROAE. None of the results yielded significant changes.

Table-6
Determinants of the Return on Assets and Equity (Islamic Banks vs Conventional Banks) - GMM Estimation

Variable	Panel A: ROAA		Panel B: ROAE	
	Islamic banks	Conventional banks	Islamic banks	Conventional banks
ROAA (t-1)	0.4011*** (13.09)	0.2174*** (7.52)		
ROAE (t-1)			0.3953*** (11.77)	0.2277*** (6.23)
Market Structure				
Market share	0.0488*** (3.67)	0.0017 (1.20)	0.0411*** (5.43)	0.0001 (1.16)
4-firm concentration	0.0144 (1.11)	0.0009* (1.70)	0.0077* (1.88)	0.0011** (2.31)
Bank-Specific Variables				
Interest rate spread	0.0015** (2.30)	-0.0216*** (-3.14)	0.0022*** (4.60)	-0.0102** (-2.27)
Log(total assets)	-0.1051 (-0.73)	-0.1563** (-2.31)	-0.5731 (-0.28)	-0.2601** (-1.99)
Equity to total assets	0.3931*** (5.21)	0.8611*** (4.68)	-0.6801*** (-8.99)	-0.4221*** (-6.73)
Cost to income	-0.0501*** (-7.73)	-0.0097*** (-6.40)	-0.0871*** (-27.54)	-0.0147*** (-6.53)
Liquid assets to total assets	-0.8680* (-1.85)	-0.4272*** (-3.49)	-0.1031*** (-6.40)	-0.9301*** (-3.77)
Overheads to total assets	-0.2791* (-1.81)	-0.1433*** (-3.07)	-0.7130*** (-7.37)	0.2275*** (5.23)
Off-balance-sheet activities to total assets	0.5711*** (3.33)	0.0294 (0.41)	0.3232*** (5.34)	0.0652 (1.54)
Market growth (assets)	-0.001 (-0.71)	0.0046** (2.03)	-0.0021* (-1.94)	0.0011* (1.75)
Bank age	0.0275* (1.79)	0.0055 (0.96)	0.0177 (0.83)	0.0011 (0.72)
Macroeconomics				
Domestic credit provide by banking	-0.0111* (-1.76)	-0.0011* (-1.72)	-0.0189** (-1.96)	-0.0023* (-1.83)
Inflation	0.0081 (1.47)	0.0195** (2.47)	0.0079 (1.11)	0.0321*** (4.21)
GDP growth	-0.0061 (-0.73)	0.0037 (1.17)	-0.0011 (-0.60)	0.0073 (1.10)
Bank dummies	Yes	Yes	Yes	Yes
Year dummies	Yes	Yes	Yes	Yes
No. of bank	35	151	35	151
No. of observation	195	1380	195	1380
R ² -overall	0.170	0.114	0.201	0.163
Clustering level	Bank	Bank	Bank	Bank

Note: The dependent variable in panel A is return on average assets, which is defined as profit before tax as a percentage of total assets of a bank. The dependent variable in panel B is return on average equity, which is defined as profit before tax as a percentage of equity a bank. ROAA (t-1) is one lag period of ROAA. ROAE (t-1) is one lag period of ROAE. Market share is the share of a bank's assets to total assets in the national market. 4-firm market concentration is the fraction of assets held by the four largest banks in each country. Interest rate spread is the difference between lending and deposit rates. Log (total assets) is the natural logarithm of total assets in US dollars. Equity to total loans is the capital to loan ratio, which is defined as equity as a percentage of total loans. Cost to income is the ratio of total costs to total income as a proxy of efficiency. Liquid asset to total assets is a ratio defined as liquid assets as a percentage of total assets. Overheads is defined as total overhead costs as a share of total assets. Off-balance-sheet activities are assets or debts that do not appear on a company's balance sheet. Market growth is the inflation-adjusted growth rate of bank assets. The data for these bank level variables

are obtained from BankScope database. Domestic credit is domestic credit provided by banking sector. Inflation is the inflation rate based on consumer prices. GDP growth is the inflation-adjusted growth rate of gross domestic product of the country. All these macroeconomic variables are from World Development Indicators of the World Bank. We estimate all regressions using country and time fixed effects and clustering at bank level. T-values are in parentheses. *, **, *** denote significance at 10%, 5%, and 1%, respectively.

I first start by using a different sample period. In the basic test, I used the time period 1999-2008, the period which include recent financial crisis. It might be argued that the ongoing financial crisis may influence the performance of banking sector. Although such effect on Middle Eastern banks is not substantial, still I use a different period covers 1999-2006 and test whether there is a difference between determinant of risk and return before crisis. Using the same regressions as before, the results using the 1999-2006 data are reported in Table 7.

The results are very similar to those observed so far, indicating, again, that in Islamic banking systems, market share dominates market concentration, and that the RMP applies, while in commercial banks, market concentration dominates market share and supports the traditional SCP hypothesis.

As a subsequent robustness test, I next investigate whether the results is robust if I use an alternative indicator of market concentration. So far, I have used an indicator of market concentration i.e. 4-firm concentration ratio. Since this indicator does not take into account the number of banks in each country, I also use the alternative indicator, the Herfindahl-Hirschman index, which is measured as the sum of the square of the market shares of all the banks in the market. This allows us to check whether our previous findings are robust or they are sensitive to the use of different indicators of market concentration.

Table 8 presents these results. Again, the previous results are maintained that is the use of an alternative indicator of bank concentration does not affect the significances of the coefficients.

Table-7
Determinants of Risk and Returns on Assets and Equity over 1999-2006
(Islamic Banks vs Conventional Banks)

Variable	Model 1: bank profitability		Panel B: ROAE	
	Panel A: ROAA		Islamic banks	Conventional banks
	Islamic banks	Conventional banks	Islamic banks	Conventional banks
<i>Market Structure</i>				
Market share	0.0833** (1.99)	0.0061 (1.02)	0.4011* (1.79)	0.1082 (1.33)
4-firms concentration	0.0024 (0.79)	0.0129*** (5.02)	0.0211 (0.97)	0.0331*** (3.70)
Bank dummies	Yes	Yes	Yes	Yes
Year dummies	Yes	Yes	Yes	Yes
No. of bank	35	151	35	151
No. of observation	216	1136	216	1136
R ² -overall	0.399	0.233	0.402	0.260
Clustering level	Bank	Bank	Bank	Bank
<i>Model 2: bank stability</i>				
Variable	Panel A: Z-score		Panel B: Sharpe ratio	
	Islamic banks	Conventional banks	Islamic banks	Conventional banks
<i>Market Structure</i>				
Market share	0.0378*** (4.01)	0.0419*** (5.73)	0.2102*** (6.91)	0.0443*** (3.44)
4-firms concentration	-0.0011* (-1.81)	-0.0125** (-1.95)	-0.0071*** (-7.21)	-0.0314** (-2.24)
Bank dummies	Yes	Yes	Yes	Yes
Year dummies	Yes	Yes	Yes	Yes
No. of bank	35	151	35	151
No. of observation	216	1136	216	1136
R ² -overall	0.481	0.255	0.427	0.268
Clustering level	Bank	Bank	Bank	Bank

Note: In model 1, the dependent variable in panel A is return on average assets, which is defined as profit before tax as a percentage of total assets of a bank. The dependent variable in panel B is return on average equity, which is defined as profit before tax as a percentage of equity of a bank. In model 2: the dependent variable in panel A is the Z-score, which is defined as $[(ROAA+CAR)/SROAA]$, where ROAA is return on average assets, CAR represents capital assets ratio, and SROAA stands for standard deviation of return on assets. The dependent variable in panel B is the Shape ratio constructed as $(ROAE/SROAE)$, where ROAE is return on average equity and SROAE represents standard deviation of return on equity. Market share is the share of a bank's assets to total assets in the national market. 4-firm market concentration is the fraction of assets held by the four largest banks in each country. Other explanatory variables (not reported) are as follow: Interest rate spread is the difference between lending and deposit rates. Log (total assets) is the natural logarithm of total assets in US dollars. Equity to total loans is the capital to loan ratio, which is defined as equity as a percentage of total assets. Cost to income is the ratio of total costs to total income as a proxy of efficiency. Liquid asset to total assets is a ratio defined as liquid assets as a percentage of total assets. Overheads is defined as total overhead costs as a share of total assets. Off-balance-sheet activities are assets or debts that do not appear on a company's balance sheet. Market growth is the inflation-adjusted growth rate of bank assets. The data for these bank level variables are obtained from BankScope database. Domestic credit is domestic credit provided by banking sector. Inflation is the inflation rate based on consumer prices. GDP growth is the inflation-adjusted growth rate of gross domestic product of the country. All these macroeconomic variables are from World Development Indicators of the World Bank. We estimate all regressions with mean data for every year and clustering at bank level. T-values are in parentheses. *, **, *** denote significance at 10%, 5%, and 1%, respectively.

Table-8
Determinants of Risk and Returns on Assets and Equity
(Islamic Banks vs Conventional banks)

Variable	Model 1: bank profitability		Panel B: ROAE	
	Panel A: ROAA		Islamic banks	Conventional banks
	Islamic banks	Conventional banks	Islamic banks	Conventional banks
<i>Market Structure</i>				
Market share	0.0601** (2.02)	0.0053 (1.16)	0.2909* (1.79)	0.3018 (0.89)
4-firms concentration	0.0113 (0.14)	0.0024*** (3.13)	0.0505 (0.79)	0.0315*** (3.01)
Bank dummies	Yes	Yes	Yes	Yes
Year dummies	Yes	Yes	Yes	Yes
No. of bank	35	151	35	151
No. of observation	270	1420	270	1420
R ² -overall	0.399	0.301	0.402	0.398
Clustering level	Bank	Bank	Bank	Bank
Model 2: bank stability				
Variable	Panel A: Z-score		Panel B: Sharpe ratio	
	Islamic banks	Conventional banks	Islamic banks	Conventional banks
<i>Market Structure</i>				
Market share	0.0407*** (4.03)	0.0377*** (5.73)	0.2013*** (6.36)	0.0604*** (3.12)
4-firms concentration	-0.0036* (-1.88)	-0.0121* (-1.92)	-0.0077** (-2.13)	-0.0107*** (-2.99)
Bank dummies	Yes	Yes	Yes	Yes
Year dummies	Yes	Yes	Yes	Yes
No. of bank	35	151	35	151
No. of observation	270	1420	270	1420
R ² -overall	0.403	0.291	0.415	0.302
Clustering level	Bank	Bank	Bank	Bank

Note: In model 1, the dependent variable in panel A is return on average assets, which is defined as profit before tax as a percentage of total assets of a bank. The dependent variable in panel B is return on average equity, which is defined as profit before tax as a percentage of equity of a bank. In model 2: the dependent variable in panel A is the Z-score, which is defined as $[(ROAA+CAR)/SROAA]$, where ROAA is return on average assets, CAR represents capital assets ratio, and SROAA stands for standard deviation of return on assets. The dependent variable in panel B is the Shape ratio constructed as $(ROAE/SROAE)$, where ROAE is return on average equity and SROAE represents standard deviation of return on equity. Market share is the share of a bank's assets to total assets in the national market. Herfindahl-Hirschman index is the sum of square fractions of assets held banks in each country. Other explanatory variables (not reported) are as follow: Interest rate spread is the difference between lending and deposit rates. Log (total assets) is the natural logarithm of total assets in US dollars. Equity to total loans is the capital to loan ratio, which is defined as equity as a percentage of total assets. Cost to income is the ratio of total costs to total income as a proxy of efficiency. Liquid asset to total assets is a ratio defined as liquid assets as a percentage of total assets. Overheads is defined as total overhead costs as a share of total assets. Off-balance-sheet activities are assets or debts that do not appear on a company's balance sheet. Market growth is the inflation-adjusted growth rate of bank assets. The data for these bank level variables are obtained from BankScope database. Domestic credit is domestic credit provided by banking sector. Inflation is the inflation rate based on consumer prices. GDP growth is the inflation-adjusted growth rate of gross domestic product of the country. All these macroeconomic variables are from World Development Indicators of the World Bank. We estimate all regressions with mean data for every year and clustering at bank level. T-values are in parentheses. *, **, *** denote significance at 10%, 5%, and 1%, respectively.

In a subsequent set of regressions, I test whether the results thus far could be affected by the period 2004-2008, the period in which Islamic banks shown a

positive trend on profitability and exceeded the rate of their conventional counterparts. In fact, I test whether the determinants of risk and returns for Islamic banks have recently changed. With this objective, Table 9 shows the results. I, again, confirm the previous results in which the market structure of Islamic banks support the RMP hypothesis, while conventional banking market structure is in favour of traditional market structure theory (the SCP hypothesis).

In a subsequent and last set of regressions, I test whether the results, especially for Islamic banks, maintain when we exclude Iranian banks. It is argued that Iran's system of Islamic Finance is different from Islamic Finance practiced in the rest of the Middle Eastern countries. Particularly, banking sector does not necessarily apply the strict considerations relating to interest. As a result, most Islamic banks in Iran operate in a very similar nature to conventional banks rather than Islamic one. Hence, Table 10 presents the results where we exclude Iranian banks. The results show that although the coefficients of interested variables change, to some extent, in magnitude, they do not change in terms of statistical significant.

Table-9
Determinants of Risk and Returns on Assets and Equity over 2004-2008
(Islamic Banks vs Conventional Banks)

Variable	Model 1: bank profitability		Panel B: ROAE	
	Panel A: ROAA		Islamic banks	Conventional banks
	Islamic banks	Conventional banks		
<i>Market Structure</i>				
Market share	0.0217*** (3.23)	0.0079 (1.15)	0.2218** (2.11)	0.1993 (0.93)
4-firms concentration	0.0014 (0.67)	0.0014** (2.03)	0.0231 (1.05)	0.0127*** (3.01)
Bank dummies	Yes	Yes	Yes	Yes
Year dummies	Yes	Yes	Yes	Yes
No. of bank	35	151	35	151
No. of observation	135	710	135	710
R ² -overall	0.370	0.229	0.389	0.231
Clustering level	Bank	Bank	Bank	Bank
	Model 2: bank stability		Panel B: Sharpe ratio	
	Panel A: Z-score			
	Islamic banks	Conventional banks	Islamic banks	Conventional banks
<i>Market Structure</i>				
Market share	0.0171** (2.27)	0.0310*** (4.23)	0.1319*** (6.80)	0.0411*** (3.14)
4-firms concentration	-0.0096** (-2.30)	-0.0017 (-0.89)	-0.0016** (2.43)	-0.0210*** (-4.22)
Bank dummies	Yes	Yes	Yes	Yes
Year dummies	Yes	Yes	Yes	Yes
No. of bank	35	151	35	151
No. of observation	135	710	135	710
R ² -overall	0.321	0.240	0.368	0.298
Clustering level	Bank	Bank	Bank	Bank

Note: In model 1, the dependent variable in panel A is return on average assets, which is defined as profit before tax as a percentage of total assets of a bank. The dependent variable in panel B is return on average equity, which is defined as profit before tax as a percentage of equity a bank. In model 2:

the dependent variable in panel A is the Z-score, which is defined as $[(ROAA+CAR)/SROAA]$, where ROAA is return on average assets, CAR represents capital assets ratio, and SROAA stands for standard deviation of return on assets. The dependent variable in panel B is the Shape ratio constructed as $(ROAE/SROAE)$, where ROAE is return on average equity and SROAE represents standard deviation of return on equity. Market share is the share of a bank's assets to total assets in the national market. 4-firm market concentration is the fraction of assets held by the four largest banks in each country. Other explanatory variables (not reported) are as follow: Interest rate spread is the difference between lending and deposit rates. Log (total assets) is the natural logarithm of total assets in US dollars. Equity to total loans is the capital to loan ratio, which is defined as equity as a percentage of total assets. Cost to income is the ratio of total costs to total income as a proxy of efficiency. Liquid asset to total assets is a ratio defined as liquid assets as a percentage of total assets. Overheads is defined as total overhead costs as a share of total assets. Off-balance-sheet activities are assets or debts that do not appear on a company's balance sheet. Market growth is the inflation-adjusted growth rate of bank assets. The data for these bank level variables are obtained from BankScope database. Domestic credit is domestic credit provided by banking sector. Inflation is the inflation rate based on consumer prices. GDP growth is the inflation-adjusted growth rate of gross domestic product of the country. All these macroeconomic variables are from World Development Indicators of the World Bank. We estimate all regressions with mean data for every year and clustering at bank level. T-values are in parentheses. *, **, *** denote significance at 10%, 5%, and 1%, respectively.

Table-10
Determinants of Risk and Returns on Assets and Equity over 1998-2008
(Islamic Banks vs Conventional Banks) – excluding Iranian Banks

Variable	Model 1: bank profitability		Panel B: ROAE	
	Panel A: ROAA		Islamic banks	Conventional banks
	Islamic banks	Conventional banks	Islamic banks	Conventional banks
<i>Market Structure</i>				
Market share	0.0128** (2.43)	0.0105 (1.08)	0.1928** (2.30)	0.2012 (1.40)
4-firms concentration	0.0034 (0.91)	0.0011*** (3.09)	0.1078 (0.94)	0.1057*** (3.85)
Bank dummies	Yes	Yes	Yes	Yes
Year dummies	Yes	Yes	Yes	Yes
No. of bank	29	142	29	142
No. of observation	220	1440	220	1440
R ² -overall	0.380	0.291	0.385	0.280
Clustering level	Bank	Bank	Bank	Bank
Model 2: bank stability				
Variable	Panel A: Z-score		Panel B: Sharpe ratio	
	Islamic banks	Conventional banks	Islamic banks	Conventional banks
<i>Market Structure</i>				
Market share	0.0146** (2.38)	0.0610*** (5.04)	0.1099*** (5.76)	0.0571*** (4.34)
4-firms concentration	-0.0172** (-2.44)	0.0055* (1.78)	-0.0107** (2.30)	-0.0340*** (-3.27)
Bank dummies	Yes	Yes	Yes	Yes
Year dummies	Yes	Yes	Yes	Yes
No. of bank	29	142	29	142
No. of observation	220	1440	220	1440
R ² -overall	0.370	0.273	0.382	0.281
Clustering level	Bank	Bank	Bank	Bank

Note: In model 1, the dependent variable in panel A is return on average assets, which is defined as profit before tax as a percentage of total assets of a bank. The dependent variable in panel B is return on average equity, which is defined as profit before tax as a percentage of equity a bank. In model 2: the dependent variable in panel A is

the Z-score, which is defined as $[(ROAA+CAR)/SROAA]$, where ROAA is return on average assets, CAR represents capital assets ratio, and SROAA stands for standard deviation of return on assets. The dependent variable in panel B is the Shape ratio constructed as $(ROAE/SROAE)$, where ROAE is return on average equity and SROAE represents standard deviation of return on equity. Market share is the share of a bank's assets to total assets in the national market. 4-firm market concentration is the fraction of assets held by the four largest banks in each country. Other explanatory variables (not reported) are as follow: Interest rate spread is the difference between lending and deposit rates. Log (total assets) is the natural logarithm of total assets in US dollars. Equity to total loans is the capital to loan ratio, which is defined as equity as a percentage of total assets. Cost to income is the ratio of total costs to total income as a proxy of efficiency. Liquid asset to total assets is a ratio defined as liquid assets as a percentage of total assets. Overheads is defined as total overhead costs as a share of total assets. Off-balance-sheet activities are assets or debts that do not appear on a company's balance sheet. Market growth is the inflation-adjusted growth rate of bank assets. The data for these bank level variables are obtained from BankScope database. Domestic credit is domestic credit provided by banking sector. Inflation is the inflation rate based on consumer prices. GDP growth is the inflation-adjusted growth rate of gross domestic product of the country. All these macroeconomic variables are from World Development Indicators of the World Bank. We estimate all regressions with mean data for every year and clustering at bank level. T-values are in parentheses. *, **, *** denote significance at 10%, 5%, and 1%, respectively

7. Conclusions and Policy Implications

Emerging banks enjoyed very high profits during the period 1999-2008, before they were affected by the current crisis. This paper investigates the effects of market structure, bank-specific characteristics and overall macroeconomics on profitability and stability of 32 Islamic banks and 143 commercial banks in the Middle East during this period. In particular, I assessed the extent to which the relatively high profitability in Islamic banking systems can be attributed to non-competitive market conditions and or pricing behaviour. Novel features of our study are the analysis of the effect of market structure on bank risk and returns in Middle East banking systems, and providing a systematic comparative analysis between Islamic and conventional banking systems.

The results show clearly that there are large differences in profitability among the banks in our sample and that a significant amount of this variation can be explained by the factors included in our analysis. I find that market concentration has no significant impact on bank profitability in Islamic banks, providing no evidence in support of the SCP hypothesis. Rather the results support the RMP hypothesis. In contrast, I find evidence to support the SCP hypothesis in commercial banks. Individual bank characteristics also explain a substantial part of the within-country variation in bank profitability. For the case of Islamic banks, I find that both a bank's rate of return and its stability increase with its interest rate spread, but for conventional bank suggest trade-offs. However, off-balance-sheet activities increase both bank returns and stability for both markets. High profitability tends to be associated with banks that hold a relatively high amount of capital, have lower cost to income and liquidity ratios, and small overhead expenses. The results reveal that the coefficient of size is negative for almost all regressions. I find that domestic credit provided by the banking sector have a negative effect on bank profitability. Finally, in an inflationary environment, Islamic market banking systems (or commercial banking system in a deflationary

environment), and countries with high GDP growth, similarly tend to achieve a high rate of return on assets.

One policy implication of these results is that since market concentration has negative impact on bank stability and also does not contribute to the profitability of Islamic banks, banking regulators should take into account the aspect of systemic stability as a further important criterion by removing entry restrictions and discouraging the process of any possible merger and acquisitions within Islamic banks. However, for conventional banks policy makers should bear in their mind a possible trade-off between profitability and stability.

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Appendix-A

Correlation Probability	ROAA	ROAE	Z-score	Sharpe ratio	Market share	4-firm concentra- tion	Interest rate spread	Log(total assets)	Equity to total assets	Cost to income	Liquid assets to total assets	Overhead s to total assets	Off- balance- sheet activity	Market growth (assets)	Domestic credit	Inflation
Market share	0.3421***	0.3174***	0.3869***	0.4004***												
4-firm concentration	0.4519***	0.3313***	0.4566***	0.4941***	0.6171***											
Interest rate spread	0.1448***	0.2023***	-0.0360**	0.0400*	0.1880***	-0.0369***										
Log(total assets)	0.1276***	0.2079***	0.0951***	0.1291***	0.3428***	0.1071***	-0.0947***									
Equity to total assets	0.4361***	0.2293***	0.2096***	0.2172***	0.1500***	0.2386***	0.5623***	-0.0075								
Cost to income	-0.5516***	0.4832***	-0.3159***	-0.3454***	-0.2456***	-0.2763***	-0.0148	0.2185***	0.2642***							
Liquid assets to total assets	0.1701***	0.2331***	0.1227***	0.1413***	0.1669***	0.1575***	0.5189***	0.0357**	0.5826***	0.0822***						
Overheads to total assets	0.1015***	-0.0197	-0.0326**	-0.0241*	-0.0283**	0.0347**	0.1611***	0.2823***	0.0485***	0.2930***	0.1709***					
Off-balance- sheet activity	0.4328***	0.3279***	0.3277***	0.3845***	0.2723***	0.4213***	0.0019	0.1525***	0.2854***	0.3044***	0.1827***	0.0163				
Market growth (assets)	0.2648***	0.2384***	0.1586***	0.2201***	0.0929***	0.1842***	-0.0119	0.0597***	0.0739***	0.1204***	0.0955***	-0.0362**	0.1139***			
Domestic credit	-0.4040***	0.3113***	-0.3866***	-0.3749***	-0.4821***	-0.4273***	-0.0610***	0.0389***	0.2347***	0.1563***	0.2207***	-0.1281***	0.2415***	0.1222***		
Inflation	0.3249***	0.2655***	0.1584***	0.2429***	0.2454***	0.3475***	0.0551***	0.1768***	0.1758***	0.1538***	0.1687***	0.0659***	0.2533***	0.1854***	0.3423***	
GDP growth	0.3857***	0.3746***	0.3924***	0.5303***	0.3423***	0.4306***	0.0594***	0.1032***	0.2463***	0.2428***	0.2089***	-0.0393***	0.3135***	0.1943***	0.4368***	0.2860***

Correlation matrix for variables for all banks.

This table shows the correlations between the main variables. ROAA is return on average assets, which is defined as profit before tax as a percentage of total assets of a bank. ROAE is return on average equity, which is defined as profit before tax as a percentage of equity of a bank. Z-score is defined as $[(ROAA+CAR)/SROAA]$, where ROAA is return on average assets, CAR represents capital assets ratio, and SROAA stands for standard deviation of return on assets. Shape ratio constructed as $(ROAE/SROAE)$, where ROAE is return on average equity and SROAE represents standard deviation of return on equity. Market share is the share of a bank's assets to total assets in the market. 4-firm market concentration is the share of 4 largest bank assets to total assets in the market. Interest rate spread is the difference between lending and deposit rates. Log (total assets) is the natural logarithm of total assets in US dollars. Equity to total asset is the capital to asset ratio, which is defined as equity as a percentage of total assets. Cost to income is the ratio of total costs to total income as a proxy of efficiency. Liquid asset to total assets is a ratio defined as liquid assets as a percentage of total assets. Overheads is defined as total overhead costs as a share of total assets. Off-balance-sheet activities are assets or debts that do not appear on a company's balance sheet as a percentage of total assets. Market growth is the inflation-adjusted growth rate of bank assets. The data for these bank level variables are obtained from BankScope database. Domestic credit is domestic credit provided by banking sector as a percentage of GDP. Inflation is the inflation rate based on consumer prices. GDP growth is the inflation-adjusted growth rate of gross domestic product of the country. All these macroeconomic variables are from World Development Indicators of the World Bank. *, **, *** denote significance at 10%, 5%, and 1%, respectively.

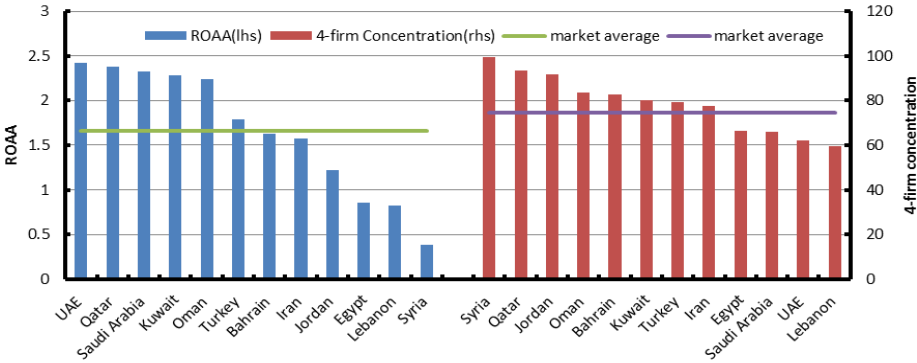
Appendix-B

	Banks in Emerging Economies (No. of Obs. 3080)				Islamic banks vs. Conventional banks
Variable	Islamic Banks (No. of Obs. 2460)		Conventional Banks (No. of Obs. 620)		Tests of means (t-statistics)
	Mean	St. Dev.	Mean	St. Dev.	
Bank Performance					
ROAA	1.85	1.29	1.41	1.35	4.89***
ROAE	16.01	8.52	12.15	8.24	6.11***
Z-score	2.13	1.32	2.11	1.45	5.50***
Sharpe ratio	2.23	1.05	2.25	1.18	4.91***
Banking Concentration					
Market share	6.11	7.13	9.13	11.69	0.61
4-firms concentration	78.15	12.44	74.99	12.44	-
Bank-Specific Variables					
Interest rate spread	15.15	5.15	13.10	13.36	0.93
Log(size)	15.03	1.35	15.11	4.92	0.88
Equity to total assets	0.09	0.05	0.09	1.41	5.39***
Cost to income	51.68	18.84	47.03	0.04	0.33
Liquid assets to size	0.21	0.14	0.31	17.24	0.27
Overheads to size	0.03	0.01	0.02	0.01	6.10***
Off-balance-sheet activities	0.22	0.21	0.28	0.17	9.22***
Market growth	30.96	20.78	16.78	0.21	8.33***
Macroeconomics					
Domestic Credit	59.78	18.95	59.78	18.95	-
Inflation	3.15	2.36	3.15	2.36	-
GDP Growth	5.23	2.39	5.23	2.39	-

Descriptive statistics of dataset by bank types (Islamic banks vs. conventional banks)

This table reports summary statistics of the main variables in different economies for different bank types. ROAA is return on average assets, which is defined as profit before tax as a percentage of total assets of a bank. ROAE is return on average equity, which is defined as profit before tax as a percentage of equity a bank. Z-score is defined as $[(ROAA+CAR)/SROAA]$, where ROAA is return on average assets, CAR represents capital assets ratio, and SROAA stands for standard deviation of return on assets. Shape ratio constructed as $(ROAE/SROAE)$, where ROAE is return on average equity and SROAE represents standard deviation of return on equity. Market share is the share of a bank's assets to total assets in the national market. 4-firm market concentration is the fraction of assets held by the four largest banks in each country. Interest rate spread is the difference between lending and deposit rates. Log (total assets) is the natural logarithm of total assets in US dollars. Equity to asset is the capital to asset ratio, which is defined as equity as a percentage of total assets. Cost to income is the ratio of total costs to total income as a proxy of efficiency. Liquid asset to total assets is a ratio defined as liquid assets as a percentage of total assets. Overheads is defined as total overhead costs as a share of total assets. Off-balance-sheet activities are assets or debts that do not appear on a company's balance sheet as a percentage of total assets. Market growth is the inflation-adjusted growth rate of bank assets. The data for these bank level variables are obtained from BankScope database. Domestic credit is domestic credit provided by banking sector as a percentage of GDP. Inflation is the inflation rate based on consumer prices. GDP growth is the inflation-adjusted growth rate of gross domestic product of the country. All these macroeconomic variables are from World Development Indicators of the World Bank. *, **, *** denote significance at 10%, 5%, and 1%, respectively. Emerging economies included East European and Middle Eastern countries. Advanced economies included West European countries.

Appendix-C
Average Return on Assets and 4-Firm Concentration Ratio in Middle Eastern Banks



EVENTS AND REPORTS

Report 5th IDB Global Forum on Islamic Finance, Baku, Azerbaijan

The 5th IDB Global Forum on Islamic Finance is a continuation of the series of IFSD Forums that were initiated by IRTI in 2006, with close cooperation of various other organisations, including the different departments within IDB. It is an annual event held in conjunction with IDB Annual Meetings. The objectives of these forums are to provide a platform for strategic policy dialogue for sharing country and institutional experiences with regard to developing the various segments of the IFS industry; identifying key challenges of the industry's different segments in an integrated manner and promoting cooperation, knowledge sharing and partnership in alleviating the challenges, thus, facilitating the industry's orderly development, competitiveness and stability.

The aim of the 5th IDB Global Forum, held in Baku, Azerbaijan on 21st June 2010, was to highlight the need for, and discuss ways of, assessing the level of development and stability of the Islamic financial sector. It also aimed at addressing challenges and opportunities of Islamic micro-finance in various regions of the world. The theme of the Forum was "Toward Global Resilience and Inclusiveness". The Programme of the Forum consisted of five sessions:

1. Keynote Speech on Ethics and Finance:

The Keynote speech highlighted that the Islamic financial system is based on an ethical framework. It promotes justice, fairness and stability at the global level. The recent financial crisis has revealed the systemic instability of the contemporary global financial system. It also provided opportunity for Islamic finance industry to learn from experience in order to develop itself into a resilient and more inclusive financial sector.

2. Towards Developing a Template for Islamic Financial Sector Assessment Programme (iFSAP):

Periodic assessments of the developmental needs and stability concerns of the Islamic financial sector are important for devising supportive policies for its growth in the world. The main results of a study entitled "Towards Developing a Template to Assess Islamic Financial Services Industry (IFSI) in the World Bank – IMF Financial Sector Assessment Programme (FSAP)" was presented in the Forum. It was commissioned by Islamic Development Bank to see how, within the current design of FSAP methodology, a template for assessment of Islamic Financial Services Industry can be developed and what are the challenges and gaps in doing so. The study was part of ongoing efforts by the IDB Group to widen the role and enhance the resilience of Islamic finance. The

panelists offered their insights on how to address the various gaps identified in developing an assessment template (iFSAP) for Islamic financial services institutions.

3. Launching the Islamic Banks Information System (IBIS):

IRTI has developed an online portal “Islamic Banks Information System” (IBIS) which is rapidly becoming a leading provider of information and knowledge services on Islamic finance. IBIS is designed to serve the needs of academic community, researchers and industry professionals interested in Islamic finance. It contains a specialized collection of articles, research papers and books on Islamic economics and banking literature, news events, glossary of Islamic economics terms, and Fiqh opinions of distinguished Shari‘ah scholars on Islamic banking and finance, as well as Who’s Who Database. IBIS is also helping to increase awareness, promote products, and direct the development of Islamic finance. In this session the IBIS was formally launched. Detailed introduction of the capabilities of this system and a demonstration on how to use IBIS online (www.ibisonline.net) were also given.

4. Islamic Microfinance:

The IDB-Microfinance Development Programme (IDB-MDP) intends to promote Islamic microfinance and to provide assistance in member countries through delivery of Shari‘ah-compliant microfinance to the poor and ultra-poor. In this session, presentations were made by four pilot programmes (one each from Bangladesh, Indonesia, Sudan and Senegal) highlighting their experiences of successes and challenges in micro-financing. The issues include investment and co-financing of such institutions, licensing issues, provision of technical assistance, legal issues faced in provision of Shari‘ah compliant microfinance, as well as operational issues.

5. Towards Global Report on Islamic Finance:

With the rapid growth of Islamic finance in many parts of the world, there is now a dire need to measure the progress and development of this sector in a consolidated way at global level. This task will require coordinated efforts of various Islamic financial infrastructure institutions. This session served as a brainstorming and a consultative session among the stakeholders on the possible format of a Global Report on Islamic Finance that is proposed to be regularly issued jointly by Islamic finance infrastructure institutions.

IDB Prize Laureate Lecture

Scarcity, Self-interest and Maximization from an Islamic Angle

Zubair Hassan

(IDB Prize Winner in Islamic Economics, 1430H)

This lecture clarifies some misinterpretations of three foundational concepts in mainstream economics from Islamic viewpoint. These are scarcity of resources, pursuit of self-interest and maximizing behaviour of economic agents. It argues that stocks of resources that God has provided are inexhaustible. But important is the availability of resources out of stocks to mankind. Availability is a function of human effort and the state of knowledge about resources over time and space. In that sense resources are scarce in relation to multiplicity of human wants for Islamic economics as well. Self-interest must be distinguished from selfishness. The motive operates on both ends of human existence: mundane and spiritual. Its pursuit does not preclude altruism from human life. Counter interests keep balance in society and promote civility. Islam recognizes the motive as valid. Maximization relates to quantifiable ex-ante variables. Uncertainty of future outcomes of actions makes maximization a heuristic but useful analytical tool.

The concept is value neutral. What is maximized, how and to what end alone give rise to moral issues. Modified in the light of Sharī'ah requirements the three concepts can provide a firmer definition for Islamic economics centred on the notion of *falāḥ*.

**ANNOTATED LIST OF IRTI'S
RECENT PUBLICATIONS**

Ayyash, Mohammed Saleh, *The Nature and Importance of Social Responsibility of Islamic Banks*, (Jeddah: IRTI, Islamic Development Bank, 1431H, 2010)

Despite the growth of Islamic banks and the expansion and diversification of their banking services and investment activities, their impact on the socio-economic development of communities is rather limited.

Islamic banks, at most, extend their social role by facilitating the collection of zakah, granting of financial aids, or providing interest-free loans. The increasing social challenges within Muslim communities, such as poverty, lack of education, unemployment, and weak provision of health care, necessitate Islamic banks to concretely address these problems.

The book, hence, attempts to analyse the essential aspects of social responsibility of Islamic Banks and the means to achieving them. Apart from encapsulating the Sharī'ah formulation of the social responsibility and its relation to the objectives of Sharī'ah, the book also addresses the linkage between social responsibility and the economic and social development of Muslim communities. Furthermore, it demonstrates the impact of the nature of social and developmental role which should be undertaken by Islamic banks, not only for achieving socio-economic development but also for making the earth inhabitable and prosperous.

Chapra, M. Umer, *The Islamic Vision of Development in the Light of Maqāṣid Al-Sharī'ah*, (Jeddah: IRTI, Islamic Development Bank, 1429H, 2008)

This paper asserts that comprehensive vision of human well-being cannot be realised by just a rise in income and wealth through development that is necessary for the fulfilment of basic needs or by the realization of equitable distribution of income and wealth. It is also necessary to satisfy spiritual as well as non-material needs, not only to ensure true well-being but also to sustain economic development over the longer term.

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 The occasional paper studies the role of <i>zakat</i> and <i>awqāf</i> in mitigating poverty in Muslim communities. The study addresses the issue by studying the institutional set-up and mechanisms of using <i>zakat</i> and <i>awqāf</i> for poverty alleviation. It discusses how these institutions can be implemented successfully to achieve the results in contemporary times using theoretical arguments and empirical support.</p> | Price \$ 5.0 |
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 The paper will serve to increase the understanding in developments and challenges of the new products for Islamic financial markets. The ideas explored in it will help expand the size and depth of these markets.</p> | Price \$ 5.0 |

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<i>Sami Al-Suwailem</i>
The book outlines an Islamic approach to hedging, with detailed discussions of derivatives, <i>gharar</i> and financial engineering. It accordingly suggests several instruments for hedging that are consistent with Shari'ah principles. | Price \$ 5.0 |
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The book proposes a two-pronged strategy to poverty alleviation through micro-enterprise development based on the dichotomy between livelihood and growth enterprises. With a focus on provision of Shari'ah-compliant financial services for micro-enterprises, it reviews thematic issues and draws valuable lessons in the light of case studies from three IsDB member countries – Bangladesh, Indonesia, and Turkey. | Price \$ 5.0 |
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<i>Sami Ibrahim al-Suwailem</i>
This research paper (book/occasional paper) discusses the possible use of recent advances in complexity theory and agent-based simulation for research in Islamic economics and finance | |
| □ | ISLAMIC MICROFINANCE DEVELOPMENT: INITIATIVES AND CHALLENGES (Dialogue Paper No. 2), (2008), pp. 81.
<i>Mohammed Obaidullah and Tariqullah Khan</i>
This paper highlights the importance of microfinance as a tool to fight poverty. It presents the “best practices” models of microfinance and the consensus principles of microfinance industry. | |

Lectures

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<i>Maurice Allais</i>
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Documents occasionnels

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| <input type="checkbox"/> | <p>DEFIS AU SYSTEME BANCAIRE ISLAMIQUE, (1998), 90 pages</p> <p><i>Munawar Iqbal, Ausaf Ahmad et Tariquallah Khan</i></p> <p>Le but de ce document occasionnel est que les théoriciens et praticiens dans le domaine bancaire islamique doivent explorer les voies et moyens permettant au système bancaire islamique de soutenir son rythme de progrès au moment où il entre dans le 21ème siècle.</p> | <p>Prix \$ 5.0</p> |
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TRANSLITERATION TABLE

Arabic Consonants

- Initial, unexpressed medial and final:

ء '	د d	ض ḍ	ك k
ب b	ذ dh	ط ṭ	ل l
ت t	ر r	ظ ṣ	م m
ث th	ز z	ع ʿ	ن n
ج j	س s	غ gh	ه h
ح ḥ	ش sh	ف f	و w
خ kh	ص ṣ	ق q	ي y

- Vowels, diphthongs, etc.

Short	اَ	a	يَ	i	وَ	u
Long	أَ	ā	يَ	ī	وَ	ū
Diphthongs	أَ	aw	أَ	ay		

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9. Articles: Al-Qari, Mohamed Ali (1993), "Towards an Islamic Stock Market", *Islamic Economic Studies*, Vol. 1, No. 1; Books: Khan, A. R. (1993), *Financial Intermediation*, New York: Springer Publishers. Page references to works referred to in the text should take the following form: Al-Qari (1993:17). Citations within the text should follow Harvard APA style.
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Islamic Development Bank (IDB)

Establishment

The Islamic Development Bank is an international financial institution established in pursuance of the Declaration of Intent issued by the Conference of Finance Ministers of Muslim Countries held in Jeddah in Dhul Qa'dah 1393H (December, 1973). The inaugural Meeting of the Board of Governors took place in Rajab 1395H (July 1975) and the Bank was formally opened on 15 Shawwal 1395H (20 October, 1975).

Vision

By the year 1440H Hijrah, IDB shall have become a world-class development bank, inspired by Islamic principles that have helped significantly transform the landscape of comprehensive human development in the Muslim world and help restore its dignity.

Mission

The mission of IDB is to promote comprehensive human development, with a focus on the priority areas of alleviating poverty, improving health, promoting education, improving governance and prospering the people.

Membership

The present membership of the Bank consists of 56 countries. The basic condition for membership is that the prospective member country should be a member of the Organization of Islamic Cooperation (OIC), pay its contribution to the capital of the Bank and be willing to accept such terms and conditions as may be decided upon by the IDB Board of Governors.

Capital

As of the month of Rajab 1431H, the Authorized Capital of the Bank was ID 30 Billion, and the Issued Capital was ID 18 Billion, of which ID 17.474 Billion was subscribed with ID 4.031 Billion Paid-Up.

Group

At present the IDB Group is made up of Islamic Research and Training Institute (IRTI), International Islamic Trade Finance Corporation (ITFC), The Islamic Corporation for Insurance of Investments and Export Credit (ICIEC) and The Islamic Corporation for the Development of the Private Sector (ICD).

Headquarters and Regional Offices

The Bank's headquarters is in Jeddah in the Kingdom of Saudi Arabia. Four regional offices were opened in Rabat, Morocco (1994), Kuala Lumpur, Malaysia (1994), Almaty, Kazakhstan (1997) and Dakar, Senegal (2008).

Financial Year

The Bank's financial year is the lunar Hijra year.

Accounting Unit

The accounting unit of the IDB is the Islamic Dinar (ID), which is equivalent to one SDR – Special Drawing Right of the International Monetary Fund.

Languages

The official language of the Bank is Arabic, but English and French are also used as working languages.