A REGULATORY FRAMEWORK FOR ISLAMIC BANKS

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Abstract

This paper seeks to provide a framework for addressing regulatory issues which impact operations and institutional development of Islamic banks. Arguing against universal regulation or creating separate specialized regulations, the approach in this paper uses the regulatory dialectic principle to highlight the need to regulate Islamic banks and focuses on the area of regulations that need to be covered and regulated. The area of regulations can be classified into seven broad categories, i.e. regulations on bank activities, bank entry, capital adequacy, deposit insurance, monitoring, government ownership and supervision. The area of regulations providing stability in a financial system context cannot develop without a conducive legal and regulatory environment. Finally, we will introduce the CAMEL rating to measure the soundness of Islamic banks.

Keywords: Islamic banks, Regulation, Legal requirement, Capital structure

INTRODUCTION

Bank Negara Malaysia (BNM) as the regulator and supervisor of the financial institutions, as stated in the Central Bank of Malaya Ordinance (CBO) 1958, is responsible in achieving various objectives, namely to issue currency and keep reserves safeguarding the value of the currency; to promote monetary stability and a sound financial structure; and influence the credit situation to the advantage of the country. Therefore, in order to meet these objectives, BNM is vested with comprehensive legal power to regulate and supervise the financial system including the Banking and Financial Institutions Act 1989 and Islamic Banking Act 1983.

Furthermore, BNM is the main institution that is responsible in implementing the monetary policy. Two important variables, i.e., money supply and bank credit act as the intermediate targets of the monetary policy to achieve the final target of economic growth. Therefore the financial intermediaries including the banking institutions and non-bank financial institutions play an important role to the economic growth. Hence, we need a regulation that is able to monitor the orderly development of the financial intermediaries and also to encourage and promote a vibrant and healthy financial market. In addition, this regulation also produces the confidence of investors in the financial market by offering instruments and modes of investment that are acceptable to, and in compliance with the shariah.

Therefore, the main objective of this paper is to provide a framework in addressing regulatory issues which impact Islamic banks operations and institutional development in Malaysia. The paper could be useful in developing guidelines to establish a regulatory environment that permits Islamic banks to progressively evolve into institutions capable of wider outreach and achieving critical mass in operations.

The rest of the paper is organized in the following way: the next section explains the need to regulate the Islamic Banking System; the area of regulations including the bank entry, capital adequacy and deposit insurance are outlined in the third section; the legal and regulation environment in Malaysia are examined in the fourth section. Section 5 produce the estimation of bank surveillance monitoring system; and the sixth section summarizes the conclusions.

WHY DO WE NEED TO REGULATE THE ISLAMIC BANKING SYSTEM?

The basic idea in regulatory dialectic principle is aimed to solve the conflicting objectives of different agents. The safety and stability on one hand and efficient banking structure on the other hand. Think of *safety* in terms of protecting depositors and the deposit insurance funds or customer protection. *Stability* is protecting the economy from the vibrations of the financial systems or ensuring a safe and secure banking system (e.g., financial panic or contagion in the form of deposit runs). This objective focuses on systemic risk, or fear of collapse of the financial system. In contrast, *structure* focuses on promoting competition (protecting bank customer from the monopoly power of bank) and achieving efficiency.

Safety and Stability

The objective of safety is to reduce the risk associated with bank liabilities (i.e., protecting bank from deposit runs and liquidity crises). Today the safety objective is partly under the guise (and subsidy) of deposit insurance. The *domino* theory of bank failure dominates regulatory thinking of this objective. According to this theory, bank failures are contagious and therefore must be contained to prevent the system from collapsing.

The stability and safety objectives are built on some fundamental microeconomic and macroeconomic ideas. One of the tasks of macroeconomic stabilization policy is to protect the money supply from rapid shrinkage through open market operation and access to the money market to attempt to control "ruinous competition". However, after a decade, the disintermediation savers still exist through credit token and pawn broking business.

The overall goal of bank regulation and deposit insurance is to maintain public confidence in the banking system. Building confidence at the microeconomic level focuses on limiting the risk exposure of individual banks (unsystemic risk) and at the microeconomic level, isolating bank failures, the banking authorities try to see that each bank is operated in a safe and sound manner. By pursuing the microeconomic goal of (limited) failure prevention, the banking authorities are expected to maintain public confidence in the banking system.

Promoting Competition and Efficiency through Banking Structure

The objective of structure is best viewed in terms of the degree of competitiveness and efficiency in the banking industry. The linkage between structure and competition is provided by the IO (industrial organization) model, because this model links structure with conduct and then with performance. It is also referred to as the structure-conduct-performance model. The IO model postulates the following linkages with the basics of supply and demand, i.e., structure-conduct-performance.

*Structur*e refers to the number of banks in the market, *conduct* to the behavior of the bank in the market, and *performance* to the quantity and quality of products and services by banks in the market. The conclusion of the model is the more banks exist in the market, the smaller the chances of anticompetitive behavior and the greater the chances high-quality products and services being provided at the competitive prices, defined as the business of gathering deposits and making loans, competitive prices for customers, mean low mark-up rates and high deposits returns.

Basis for the Monetary Policy

It is important for central bank to maintain a sound and stable financial system. The main objective of monetary policy is to establish an optimum level of money supply in the economy. The overall effectiveness of monetary policy, however, will depend on the extent of its contribution to the attainment of full employment, to the prevention of high inflation and a rise in the economic growth rate. Central bank usually employs three primary methods or instruments that have a similar effect on the quantity of money and credit in the economy.

Open market operation involves the purchases and sales of securities by the central bank. This is the most frequently used instrument because of its convenience and flexibility. Financial institutions are normally required to deposit funds, based on a fixed percentage of deposit liabilities at the central bank. This deposit is known as the statutory reserve deposits. Movement in the percentage of this reserve will affect the quantity of money and credit in the economy. An increase in reserve requirement's percentage reduces the quantity of money and credit in the economy and vice versa. Loans by central bank to financial institutions are another instrument of monetary policy. These

loans are referred to as inter-bank funds and the rate paid is agreed upon between central bank and bank.

AREA OF REGULATIONS

The rapid expansions of the financial system are actively promoted through deregulation reforms that may give an incentive to foster the development of financial intermediaries and markets. In this section, we will explore the area of regulations that needs to be covered.

Regulation On Bank Activities And Banking-Commerce Links

There are five main reasons for restricting the degree to which banks can engage in securities, insurance, and real estate activities or their own nonfinancial firms. Indeed, it is these types of regulations that help define what observes mean by the term "bank". First, conflicts of interest may arise when banks engage in such diverse activities as securities underwriting and real estate investment. Banks, for example may attempt to "dump" securities on or shift the risk to ill-informed investors so as to assist firms with outstanding loans.

Second, to the extent that moral hazard encourages riskier behavior by bank, they will have more opportunities to increase risk if allowed to engage in a broader range of activities. Third, broad financial activities and the mixing of banking and commerce may lead to the formation of extremely large and complex entities that are extraordinarily difficult to monitor. Fourth, large institutions may become so politically and economically powerful that they become "too big to discipline". Finally, large financial conglomerates may reduce competition and hence efficiency in the financial sector. Based on these arguments, the government can ease market failures and thereby enhance bank performance and stability by means of restricting its activities.

However, there are alternative theoretical reasons for permitting banks to engage in a broad range of activities. First, fewer regulatory restrictions on the activities of banks permit the exploitation of economies of scale and scope in gathering and processing information about firms, managing different types of risk for customers, advertising and distributing financial services, enforcing contracts, and building reputation with clients.

Second, fewer regulatory restriction may increase the franchise value of banks and thereby augment incentives for banks to behave prudently. Third, broader activities may diversify income streams and thereby create more stable banks. Finally, government do not restrict bank activities to ease market failure. So, regulatory restrictions promote government power, create a bigger role for corruption through the granting of exceptions to the rules, and ultimately hinder bank performance and stability.

Regulations On Domestic And Foreign Bank Entry

Petersen and Rajan (1995) demonstrate that banks with monopolistic power have stronger incentives to incur the necessary costs associated with overcoming informational barriers, which then facilitates the flow of credit to more worthy enterprises. Furthermore, banks with monopolistic power may possess considerable franchise value, which enhances prudent risk-taking behavior [Keeley (1990)]. Thus, there may be a 'helping-hand' role for the government in limiting destabilizing competition. The approach to regulations provides a quite different perspective on regulating entry. While there may exist valid economic reasons for regulating entry, this view stresses the impact of such limits on facilitating corruption and impeding economic efficiency. Politicians and regulators use entry restrictions to reward friendly constituents, extract campaign support, and collect bribes [Djankov, La Porta, Lopez-de-Silanes, and Shleifer (2001)]. Furthermore, an open, competitive banking sector may be less likely to produce powerful institutions that unduly influence policymakers in ways that adversely affect bank performance and stability. The impact of competition may depend on the degree of regulatory restrictions on bank activities and the mixing of banking and commerce, the quantity and quality of bank supervision, the features of any deposit insurance scheme, capital adequacy requirements, the degree of equity market development, and the extent to which government-owned banks play a dominant role in the banking sector.

Regulations On Capital Adequacy

Traditional approaches to bank regulation emphasize the positive features of capital adequacy requirements. Capital, or net worth, serves as a buffer against losses and hence failure. Furthermore, with limited liability, the privilege for bank owners to shift toward higher risk activities decreases with the amount

of capital at risk relative to assets. With deposit insurance (implicit or explicit), official capital adequacy regulations play a crucial role in aligning the incentives of bank owners with depositors and other creditors [Berger, Herring and Szego (1995), Kaufman (1991), Stevens (2000), Furlong and Keeley (1989) and Keeley and Furlong (1990)]. Researchers, however, disagree over whether the imposition of capital requirements actually reduces risk-taking incentives. Moreover, it is extraordinarily difficult - if not impossible - for regulators and supervisors to set capital standards that mimic those that would be demanded by well informed, undistorted private-market participants.

For instance, Kahane (1977), Koehn and Santomero (1980), Lam and Chen (1985), Kim and Santomero (1988), Flannery (1989), Genotte and Pyle (1991), Rochet (1992), Besanko and Katanas (1996), Blum (1999), and Alexander and Baptista (2001) note that actual capital requirements may increase risk-taking behavior. In a more-guarded assessment, Thakor (1996) demonstrates the conditions under which risk-based capital requirements increase credit rationing, with negative implications on the economic growth. Also, Thakor and Wilson (1995) argue that higher capital requirements may induce borrowers to shift to capital markets and in the process impair capital allocation, while Gorton and Winton (1999) show that a process in raising capital requirements can increase the cost of capital. Thus, theory provides conflicting predictions on whether capital requirements curtail or promote bank performance and stability.

Deposit Insurance Design

Countries often adopt deposit insurance schemes to provide protection for unsophisticated and small depositors, who face coordination and free-rider problems. If too many depositors attempt to withdraw their funds at once, an illiquid but solvent bank can fail. Moreover, monitoring banks is expensive and there is an externality associated with monitoring to curtail risk-taking behavior. Therefore, depositors will have a tendency to free ride, so that there is a socially sub optimal level of monitoring. To ameliorate these problems, a proponent of official intervention would favor deposit insurance to protect payment and credit systems from contagious bank runs *plus* tight official oversight to augment private sector monitoring of banks. However, potential gains from a deposit insurance scheme come at a cost. There are concerns

that deposit insurance would encourage excessive risk-taking behavior [Barth (1991)].

The moral hazard problem, which is aggravated by deposit insurance, continues to be a concern today. Thus, even those subscribing to the 'helping-hand' view may argue that the adverse-incentive costs of deposit insurance outweigh the benefits. Yet, many believe that official regulation and supervision can control the moral-hazard problem, including an appropriately designed insurance system that encompasses coverage limits, scope of coverage (or the extent of uninsured liabilities), coinsurance, funding, premia structure (flat fee or risk-based), who manages the funds and how they are motivated, and membership requirements.

Supervision

The advantages of powerful official regulators and supervisors are as follows: First, banks are costly to monitor. Private agents may not have the ability or incentive to supervise banks and will attempt to free ride. Thus, there will be too little monitoring of banks, which implies sub-optimal performance and stability. Official supervisors can ameliorate this market failure. Second, because of informational asymmetries, some argue that banks are prone to contagious and socially costly bank runs. According to the 'helping-hand' view, government supervision in such a situation can serve a socially efficient role. Third, since many countries have chosen to adopt a deposit insurance scheme, this situation: (1) creates incentives for excessive risk-taking behavior by banks, and (2) reduces the incentives for depositors to monitor banks. Thus, strong, official supervision will help prevent banks from engaging in excessive risk-taking behavior and consequently improve bank performance and stability. Alternatively, powerful government regulators and supervisors may exert a negative influence. Governments with powerful supervisory agencies may use this power to benefit favored constituents, attract campaign donations, and extract bribes. Powerful regulators/supervisors, according to this view, will be less focused on overcoming market failures and be more concerned with carrying political support and implementing their own narrow objectives. According to this so-called 'grabbing-hand' view, powerful supervision and regulation will be positively related to corruption and will not improve either bank performance or stability.

Regulations On Easing Private Sector Monitoring Of Banks

Many supervisory agencies encourage private monitoring of banks. For instance, supervisory agencies may require banks to obtain certified audits and/or ratings from international-rating agencies. Some countries make bank directors legally liable if information is erroneous or misleading. Some supervisory agencies compel banks to produce accurate, comprehensive and consolidated information on the full range of bank activities and risk-management procedures. Furthermore, some countries credibly impose a "no deposit insurance" policy to stimulate private monitoring of banks.

Some economists have advocated greater reliance on the private sector and have expressed misgivings with official supervision of banks. For instance, Shleifer and Vishny (1993) "grabbing-hand" view of government regulations holds that banks will pressure politicians who, in turn, can unduly influence supervisors and regulators. Furthermore, in some countries, supervisors are not well compensated and hence quickly move into banking, resulting in a situation in which supervisors may face mixed incentives when it comes to strict adherence to the rules. Also, since supervisors do not have their own wealth invested in banks, they have different incentives than private creditors when it comes to monitoring and disciplining banks.

However, question placing excessive trust in private-sector monitoring, especially in countries with poorly-developed capital markets, accounting standards, and legal systems. Countries with weak institutional environments will benefit more from official supervisors and regulators containing excessive risk-taking behavior of banks and thereby instilling more confidence in depositors than would exist with private sector monitoring. This view argues that, in weak institutional settings, increased reliance on private monitoring leads to exploitation of small savers and hence much less bank development.

Government Ownership Of Banks

Economists hold sharply different views about the impact of government ownership of bank on financial and economic developments [LaPorta, Lopez-de-Silanes, and Shleifer (2001)]. The statist or socialist view argues that government ownership of banks facilitates the mobilization of savings and the allocation of those savings toward strategic projects with long-term beneficial effects on an economy. According to this view, governments have adequate information and sufficient incentives to ensure socially desirable investments.

Consequently, government ownership of banks helps economies overcome private capital-market failures, exploit externalities, and invest in strategic sectors. Myrdal (1968), and Gerschenkron (1962) specifically advocate government ownership of banks to promote economic and financial development, especially in underdeveloped countries.

In contrast, Shleifer and Vishny (1993) argue that governments do not have sufficient incentives to ensure socially desirable investments. Government ownership tends to politicize resource allocation, soften budget constraints, and otherwise hinder economic efficiency. Thus, government ownership of banks facilitates the financing of politically attractive projects, but not necessarily economically efficient projects.

In an influential study, LaPorta, Lopez-de-Silanes, and Shleifer (2001) piece together data on government ownership of banks from an assortment of sources. They find that countries with higher initial levels of government ownership of banks tend to have both slower subsequent rates of financial system development and slower economic growth. In a related paper, Barth, Caprio, and Levine (2001) find that the greater government ownership is generally associated with less efficient and less well developed financial systems.

THE LEGAL AND REGULATORY FRAMEWORK IN MALAYSIA

Both the legal and regulatory frameworks are essential to the expansions of the financial system. These frameworks, as mentioned by Abd Ghafar and Ismail (2003) and Abd. Ghafar and Ismail (2004), induce banks to operate in a safe and prudent manner, and follow the shariah principle. In addition, the regulatory framework can counteract the distortions introduced by public sector guarantees. These frameworks have been formalized by a set of legal requirement and bank regulatory surveillance system. The following sub-section will further explore these elements.

The Legal Framework

In Malaysia, for example, the Islamic Banking Act 1983 was passed by Parliament prior to the establishment of the Bank Islam Malaysia Berhad in 1983 and this law applies to all Islamic banking institutions wishing to operate

in Malaysia. This law contains sixty sections that can be categorized into seven parts as follows:

Part I: PRELIMINARY (Sections 1 & 2)
(Short title, commencement, application and interpretation)

Part II: LICENSING OF ISLAMIC BANKS (Sections 3 to 13)
(Islamic banking business to be transacted only by a licensed Islamic bank, Minister may vary or revoke condition of license, license not to be granted in certain cases, foreign owned banks, opening a new branches, Islamic bank may establish correspondent banking relationship with bank outside Malaysia, license fee, restriction of the use of certain words in an Islamic bank's name, revocation of license, effect of revocation of license, and publication of list of Islamic banks).

Part III: FINANCIAL REQUIREMENT AND DUTIES OF ISLAMIC BANKS (Sections 14 to 20)
(Maintenance of capital funds, maintenance of reserve funds, percentage of liquid assets, auditor and auditor's report, audited balance sheet, statistics to be furnished, and information of foreign branches).

Part IV: OWNERSHIP, CONTROL AND MANAGEMENT OF ISLAMIC BANKS (Sections 21 to 23)
(Information on change in control of Islamic banks, sanction for reconstruction of bank required, and disqualification of directors and employees of banks).

Part V: RESTRICTIONS ON BUSINESS (Sections 24 to 30)
(Restrictions on payment of dividends and grant of advances and loans, prohibition of loans to directors, officers and employees, restriction on grant of loan, advances or credit facility to directors, officers and employees, restriction of credit to customer, disclosure of interests by directors, limitation on credit facility for purpose of financing the purchase or holding of shares, and proof of compliance to all restrictions and prohibitions).

Part VI: POWERS OF SUPERVISION AND CONTROL OVER ISLAMIC BANKS (Sections 31 to 43)

(Investigation of banks, special investigation of banks, production of bank's books and documents, banking secrecy, action to be taken if advances are against interest of depositors, banks unable to meet obligations to inform Central Bank, action by Central bank if bank unable to meet obligations of conducting business to the detriment of depositors and managers, offences by companies and by servants and agents, prohibition on receipt of commission by staff, general penalty, power of Governor to compound, consent of the Public Prosecutor, regulations, bank holidays, application of other laws, and **exemption**).

Part VII: CONSEQUENTIAL AMENDMENTS (Sections 57 to 60)

(Amendment of Banking Act 1973, amendment of companies Act 1965, amendment of Central Bank of Malaysia Ordinance 1958, and amendment of Finance Companies Act 1969).

The above provisions are very similar to the provisions of another Malaysian law called the Banking and Financial Institution Act (1989), which regulates the conventional banking system in Malaysia.

Bank Regulatory Surveillance System

Management of operational risk in Islamic banks could usefully be addressed through an appropriate CAMEL (refer to capital, asset quality, management, earnings and liquidity) rating framework. CAMEL rating is a measure of a relative soundness of a bank and is calculated on a 1-5 scale with one being the strongest performance. The standard CAMEL rating system would need to be appropriately adapted to an Islamic banking environment as discussed below:

Capital

In a standard CAMEL rating, capital adequacy is evaluated (through 1 to 5) according to: (1) the volume of risk assets, (2) the volume of marginal and inferior assets, (3) bank growth experience, (4) the strength of management in relation to all the above factors. In addition, consideration is given to a bank's capital ratios relative to its peer group.

The bulk of the assets of bank operating according to a paradigm version of Islamic banking is represented by PLS transactions, that is mostly uncollateralized equity financing. These assets are far riskier than the ones represented by non-PLS transactions, which are collateralized by commercial or retail financing operations. PLS transactions are at the core of Islamic banking, while non-PLS modes are at the margin. The ratio of riskier assets to total assets can be higher in an Islamic bank than it is in a conventional bank. An appropriate assessment of the capital adequacy ratio in an Islamic environment should address on two issues: the level of the capital adequacy ratio and the risk–weighting methodology for its calculation.

The Level of Capital Adequacy Ratio

According to the Basle Committee on Banking Supervisions bank, risk-weighted capital adequacy ratio should be at least at 8 percent. However, while the Basle Committee's minimum level of eight percent may be an acceptable floor given the operational environment of banks in OECD country, it should be somewhat higher in an Islamic environment. This is because of specific reasons inherent to the operation of Islamic banking, as well as more general reasons as part of the high-risk environment in which most Islamic bank operates. The specific reasons are following: (1) Mudaraba contracts put depositor's funds at risk, but allow a portion of profits to accrue to bank's owners. This creates a potentially strong incentive for risk taking and for operating financial institutions without suitable capital. Hence, to help reduce moral hazard, it would be important for the bankers to have substantial amounts of his own capital at risk; (2) the ratio of riskier assets to total assets can be higher in an Islamic bank than it is in a conventional bank; (3) the lack of control on investment project in Mudaraba transactions. Some of the factors contributing to the high risk environment of most developing and emerging market countries in which Islamic bank operate are: (1) a relatively weak legal infrastructure supporting bank lending supporting bank lending operations; (2) an underdeveloped financial market; (3) a volatile economic environment, contributing to an uncertain financial condition in the enterprises sector, and (4) a less diversified of the economy.

Therefore, while it can be reasonable argued that the minimum capital adequacy ratio for Islamic banks should be somewhat higher than the Basle

Committee's minimum level of 8 percent, it is more difficult to envisage a precise figure which may make sense for and reflect the particular situations of so many countries.

Risk-Weighting Methodology

The Basle Committee's reference risk weights are 100 percent for current facilities to customers, 100 percent for net investments and 50 percent for mortgage loans on residential properties. Islamic bank's assets side includes all transaction carried out under the permissible Islamic modes of financing. So, it is possible to reconcile with three conventional broad categories of assets as mentioned above, while recognizing inevitably involves some approximation. For example, Islamic bank may have transactions on their balance sheet that are the results of a mix of different permissible Islamic modes of financing. Moreover, very different Islamic modes, such as Mudaraba and non-PLS modes that are not secured by mortgage (e.g, installment finance) fulfill the same economic functions of *current facilities to customers*. Mudaraba contract may be considered as *current facilities to customers*; Musharaka and direct investment as *net investments*. Depending on the specificities of each transaction-notably, the existence or not of a mortgage, non-PLS modes may be considered as *mortgage loans*, i.e, the least risky transaction, or *current facilities to customers*.

Islamic modes of financing also involve different degrees of riskiness. All categories of off balance sheet commitments must be converted to credit risk equivalents by multiplying the nominal principal amounts by a credit conversion factor; the resulting amounts are then weighted according to the nature of the counterpart. Depending on the specific cases, off balance sheet commitments should carry a credit risk conversion factor ranging from 100 percent (general guarantees, bank acceptable guarantees and stand by letters of credit) to zero (short term commitments that can be unconditionally canceled at any time).

Assets

In a standard CAMEL rating, assets quality is rated (1 through 5) according to: (1) the level, distribution, and severity of classified assets; (2) the level and composition of non accrual and reduced rate assets; (3) the adequacy of valuation reserves, and (4) the demonstrated ability to administer and collect problem credits.

With regard to factors (1) to (2), it should be recognized that, in an Islamic environment, assets represented by Mudaraba transactions cannot be classified until the relative contracts expire. Until that moment, there is no recognizable default with the exception of the proved negligence or mismanagement on the part of the agent entrepreneur. " Default" of PLS contracts means that the investment project has failed to deliver what is expected, that is a lower or no profit, or a loss. Nevertheless, PLS assets that deliver lower or no profit should be considered as reduced rate assets until the expiration of the relative contracts.

The ability of Islamic banks to reduce the capital value of investment deposits in case of a loss should not be viewed as tantamount to an automatic setting aside of a provisions against loan loss. Indeed, this situation can hardly be compared with sound loan loss provisioning practices aimed at preserving the solvency and the viability of an Islamic bank as an ongoing operation. Moreover, it introduces strong incentives for moral hazard that could result in systemic risk. Hence, to help prevent the corrosive effect of problem assets on the level of capital, the adequacy of valuation reserves should also remain a key factor in an Islamic environment.

With regard to factor (4), the ability of an Islamic bank to administer and collect problem credits should be evaluated not only in cases where PLS contracts default before expiration because of negligence or mismanagement on the part of the entrepreneur but also in all cases of defaulted non PLS transaction.

Management

In a standard CAMEL rating, management is evaluated (1 through 5) according to: (1) technical competence, leadership, and administrative ability, (2) compliance with bank regulation and statutes; (3) ability to plan and respond to changing circumstances; (4) adequacy of and compliance with internal policies; (5) depth and successions; (6) tendencies toward self dealing; and (7) demonstrated willingness to serve the legitimate needs of the community. All these factors are applicable in an Islamic banking environment too.

Earnings

In a standard CAMEL rating, earnings are rated (1 through 5) according to: (1) the ability to cover losses and provide for adequate capital; (2) earnings trends; (3) per group comparisons; and (4) quality and composition of net income. Earning rated 1 is sufficient to make full provision for the absorption of losses and the accretion of capital when due consideration is given to assets quality and bank growth. Bank so rated typically have earnings well above per group averages. Banks whose earnings are rated 5 are typically experiencing losses.

The above criteria are generally applicable to Islamic banks. Nevertheless, it should be reminded that in Islamic banking, economic losses would first result in a depreciation of the value of the depositor's wealth and then in a decline in the Islamic bank's profitability, particularly when the bank has also used its own resources (for example through a Musharaka arrangement) to finance the loss making investment projects.

Liquidity

In a standard CAMEL rating, liquidity is rated (1 through 5) according to: volatility of deposits; reliance on interest-sensitive funds; technical competence relative to structure of liabilities; availability of assets readily convertible into cash; and access to inter bank markets or other sources of cash, including lender of last resort (LoLR) facilities at the central bank.

Islamic banks cannot obtain funds through LoLR facilities, as well as overdraft or other credit facilities operated by central bank. This is because all the above facilities require the payment of interest. In an Islamic environment, reserve requirements (RR) can be viewed as a particular case of liquidity ratios. Indeed, to help reduce the possibility of assets – liability mismatch when Islamic banks operate according to a two-tier Mudaraba arrangement, the RR ratio applied on demand deposit withdrawals. In principles, a RR ratio on demand deposits of 100 percent would rule out the problem, as is the case in the two windows arrangement. This however would excessively limit Islamic bank's ability to engage in maturity transformation, which is at the core of every bank's activity, and add an element of complexity to the transaction and payment functions that demand deposits are meant to perform. Therefore, the preferred alternative solution especially if the ratio of

demand deposits to total deposits is relatively low- is to mandate specific RR on all deposits held in bank operating according to a two tier Mudaraba arrangement. However, if applied to total deposits, RR may represent an excessive burden for the banking systems given the fact that, in an Islamic framework, RR may be remunerated.

ESTIMATING THE CAEL RATING

In 1980s, BNM adopted the uniform rating system as a common way to rate the financial condition of banks. The system helps identify banks whose condition warrants special supervisory attention. Under this system, each bank receives a uniform rating based upon evaluation of financial performance, condition, operational soundness, and regulatory compliance.

The rating of a bank is based upon on-site evaluation of five important variables of performance-capital adequacy, asset quality, management, earnings, and liquidity; hence the acronym CAMEL, which consequently has become the popularized name of this rating system[1].

Therefore, in this study, each component is assigned to a rating on a scale of 1 to 5 descending order of performance:

1. strong performance
2. satisfactory performance
3. performance that is flawed to some degree
4. marginal performance that is significantly below average
5. unsatisfactory performance that is critically deficient and in need of immediate remedial action.

Once the five component ratings have been determined, the composite CAEL rating is assigned as a summary measure and as the primary indicator of financial condition. Composite ratings are assigned on a scale of 1 to 5; 1 indicates that an institution is of the least supervisory concern, and 5 indicate that an institution is of the most supervisory concern. The five composite rating levels are set forth as follows:

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[1] Further discussion on this rating can be found in Abd. Ghafar and Mohd. Azlan (2002)

1. an institution that is basically sound in every respect
2. an institution that is fundamentally sound, but with modest weaknesses
3. an institution with financial, operational, or compliance weaknesses that give cause for supervisory concern
4. an institution with serious financial weaknesses that could impair future viability
5. an institution with critical financial weaknesses that render the probability of failure extremely high in the near term.

In this study, the analysis is structured around five financial ratios computed from financial statement for 1999 and 2002. The four ratios-capital (C), non-performing loan (A), earning (E) and liquidity (L)- are the variables of a primary surveillance screen for CAEL. The description of each variable is presented in Table 1. These variables, then, are converted to a percentile ranking and later, be given a rating[2]. Banks with scores in the 1st-20th percentiles are classified as 1 and banks with in the 81th-100th percentiles are classified as 5-rated; banks in intervening percentile ranges receive the corresponding ratings.

Table 1: Variables for the Rating Model

Variable	Description
Capital (C)	Total capital base minus deduction divided by total risk-weighted assets
Assets (A)	Closing balance of non-performing loans divided by assets
Earning assets (E)	Interest income minus interest expense divided by total assets
Liquidity (L)	Loans divided by deposits

[2] Institutions with the highest rankings are placed on the exception list for additional off-site analysis and potentially, for supervisory action. A surveillance screen uses a set of financial ration values to identify, or screen, institutions whose condition warrants special supervisory attention.

The ratings are summed to form a bank's composite score, with each rating receiving different weight in the summation.[3] These composite percentile rankings served as the basis of the primary surveillance screen.[4]

Table 2 produces the classification results from yearly estimates based upon the financial statement for 1999 and 2002. The results show that foreign banks produce much better ranking than domestic banks. While, the Islamic banks are classified as unsatisfactory.

Table 2: CAEL Ratings

	1999	Capital	Assets	Earning	Liquidity	Average
	Foreign Bank					
1	ABN Amro Bank Bhd.	2	1	2	5	2
2	Bangkok Bank Bhd.	2	5	5	2	4
3	Bank of America M'sia Bhd.	2	1	2	5	2
4	Bank of Tokyo-Mitsubishi (M)	2	1	1	3	1
5	Citibank Bhd.	2	2	1	1	2
6	Deutsche Bank (M) Bhd.	3	2	1	4	2
7	Hongkong Bank M'sia Bhd.	5	3	3	1	3
8	OCBC Bank (M) Bhd.	4	3	3	2	3
9	Oriental Bank Bhd.	5	5	5	4	5
10	Overseas Union Bank	3	2	3	5	3
11	The Bank of Nova Scotia Bhd.	1	1	3	5	2
12	The Chase Manhattan Bank (M)	1	1	1	3	1
13	Standard Chartered Bank M'sia	3	2	2	2	2
14	The Pacific Bank Bhd.	4	3	4	1	3

[3] Avg.w and Avg.s refer to the average ratings with different weight. The first variable uses 20% (capital), 40% (assets), 30% (earning) and 10% (liquidity) as the weighted percentage. While, the second variable uses 20% (capital), 30% (assets), 20% (earning), 10% (liquidity) and 20% risk as the weighted percentage.

[4] Institutions with the highest composite percentile rankings are also placed on an "exception list". Institutions on this list are subjected to more in-depth, off-site analysis by central bank.

	Domestic Bank					
1	Arab-Malaysian Bank Bhd.	5	5	5	5	5
2	Ban Hin Lee Bank Bhd.	3	4	4	1	4
3	Bank Islam Malaysia Bhd.	2	3	4	4	3
5	Bank Utama (M) Bhd.	1	4	4	3	3
6	BSN Comm. Bank (M) Bhd.	5	5	5	4	5
7	EON Bank Bhd.	2	5	5	4	4
8	Hock Hua Bank Bhd.	1	4	2	2	3
10	International Bank Malaysia	4	4	1	1	3
12	Multi-Purpose Bank	5	3	3	3	3
13	Perwira Affin Bank	4	4	4	3	4
14	Public Bank Bhd.	5	1	4	1	3
17	Southern Bank Bhd.	1	3	2	4	2
18	Wah Tat Bank Bhd.	4	2	5	2	3
	2002	**Capital**	**Assets**	**Earning**	**Liquidity**	**Average**
	Foreign Bank					
1	ABN Amro Bank Bhd.	2	1	3	4	2
2	Bangkok Bank Bhd.	3	5	5	1	4
3	Bank of America Malaysia Bhd.	1	1	1	4	1
4	Bank of Tokyo-Mitsubishi (M)	1	1	1	4	1
5	Citibank Bhd.	4	1	1	2	2
6	Deutsche Bank (M) Bhd.	2	3	3	1	3
7	Hongkong Bank Malaysia Bhd.	5	5	3	3	4
8	OCBC Bank (M) Bhd.	4	3	2	3	3
9	Overseas Union Bank	4	4	2	5	4
10	Phileo Allied Bank	5	5	4	2	4
11	Standard Chartered Bank M'sia	4	2	1	4	2
12	The Bank of Nova Scotia Bhd.	1	1	2	5	2
13	The Chase Manhattan Bank (M)	1	2	1	1	1
14	The Pacific Bank Bhd.	4	4	5	3	4
	Domestic Bank					
1	Arab-Malaysian Bank Bhd.	5	5	5	5	5
2	Bank Islam Malaysia Bhd.	2	3	4	4	3

3	Bank Utama (M) Bhd.	3	5	5	3	4
4	EON Bank Bhd.	3	4	4	5	4
5	Perwira Affin Bank	5	4	5	3	4
6	Public Bank Bhd.	3	1	4	1	2
7	Southern Bank Bhd.	2	3	2	5	3

Then, as shown in Table 3, we divide banks into two broad groups- those that are satisfactory and those that are unsatisfactory. In defining satisfactory, we label banks with CAEL ratings of 1 or 2 as satisfactory and banks with ratings of 3, 4, and 5 as unsatisfactory. In 2002, the CAEL rating system identifies 13 banks as unsatisfactory (61.90%) and 8 banks as satisfactory (38.10%). Specifically, in 2002, of the 21 banks included in the sample, 4.8% received a CAEL rating of 5, 38.1% received a CAEL rating of 4 and 19.0% received a CAEL rating of 3.

Table 3: Estimated CAEL Ratings

Actual Rating	**1999**	**2002**
1		
No. of banks	2	3
Percentage	7.4	14.3
2		
No. of banks	7	5
Percentage	25.9	23.8
3		
No. of banks	11	4
Percentage	40.7	19.0
4		
No.of banks	4	8
Percentage	14.8	38.1
5		
No.of banks	3	1
Percentage	11.1	4.8
Total no. of banks	27	21
Percentage	100.0	100.0

CONCLUSIONS

The aim of this paper is to provide a framework for addressing regulatory issues which impact Islamic banks operations and institutional development in Malaysia. These regulatory issues are combined into several related questions, i.e., why do we need to regulate the Islamic banks and what are the area of regulations that need to be covered? The examination of regulation in Malaysia shows that: first, the provisions under Islamic banking acts are very similar to the provisions of another Malaysian law called the Banking and Financial Institution Act (1989), which regulates the conventional banking system in Malaysia. Second, the revised version of CAMEL rating is introduced to measure the relative soundness of Islamic banks. This rating provides a timely measure of financial condition. The rating for an individual bank can also be calculated as soon as the bank sends its monthly financial statement rather than later, when enough yearly financial statement is available to calculate meaningful averages. Hence, the revised system can identify deterioration or improvement in the banking industry within peer groups and system-wide. Therefore, the CAMEL rating can be used as a guidance to monitor the condition of banks more accurately and thoroughly after their unpleasant performances during the recent banking crisis.

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