Editor’s Note

The world is now reeling in financial crisis. It started in the US and is now engulfing the entire world, and will affect financial markets for several years. The current crisis resulted from three sources of excessive risk taking: credit crisis in the subprime housing market in the US, leverage effect from speculation in the housing market by both households and financial institutions, and liquidity crisis at the end. Each of this crisis could have been managed, but their combination and interplay produced financial nightmare worldwide. Speculative activities in the housing market and lax regulation created a parallel banking which is about 40 Percent of the regulated banking sector (JP Morgan, 2008). In this game, everyone is to blame for the regulation, the homebuyers, the mortgage industry, the investment banker and the providers of liquidity and providers of insurance policies. The policymakers are infusing capital in the capital market with the hope that it will bring confidence in the credit market and will let the ailing financial institutions start lending again. The regulators are also providing other measures to bring confidence in the market such as extending deposit insurance coverage to depositors and short-term debt market. Islamic financial world was relatively immune from this crisis, as Islamic finance forbids lending money for money, speculation, creating debt excessively. Forbidden also in Islam are all toxic securities such as credit default swaps (CDS) and collateralized debt obligations (CDOs). Hopefully, the world will learn a few things from Islamic financial system. Innovation is beneficial as long as it does not violate the basic principles of good sense. Islam is a natural religion which is very compatible with the modern financial system. A call for an alternative financial structure is on the horizon. Both Muslims and non-Muslim thinkers are seriously thinking of creating a new financial structure which will make the world financial market more stable and less crisis-prone.

We have five papers in this issue analyzing various aspects of Islamic finance and banking industry. The first paper “Issues in Managing Profit Equalization Reserves and Investment Risk Reserves in Islamic Banks,” by Dr. V. Sundararajan examines the corporate governance issues of investment account holders who deposit their savings into bank as a Rabbul-Mal. Dr. Sundararajan argues in this paper that the use of investment risk reserve (IRR) is key to covering potential losses on assets invested with investment account holders (IAH) funds, and profit equalization reserve (PER) is needed to smooth the returns, so that a desired return to IAH can be provided in the face of volatility in asset returns, and thereby help manage the level of displaced commercial risk (DCR); but the relationship between PER/IRR and DCR is complex. Certain minimum amounts are needed to ensure that a targeted risk return combination can be provided to the IAH with a high probability, even if on some rare occasions asset return may turn negative, requiring the use of IRR to offset the losses, and some PER to ensure a market related return to IAH. Since a variety of
combinations of PER and IRR can yield a specific targeted return, the appropriate combination will have to be decided by IIFS management based on the expectations of the likely usage of these reserves in the future. This requires regulatory supervision and transparent accounting process where PER and IRR are properly maintained. Unfortunately, the Islamic finance industry is not up to the mark, but hopefully, it will gradually improve to international standard.

In the second article “Islamic Banking: Policy and Institutional Challenges,” Dr. Wafik Grais argues that the potential of Islamic finance has caught the eyes of international market players and the national authorities and market participants need to seize the opportunities by developing a clear legal and regulatory framework, enabling adequate availability of market information and, an nurturing broad institutional infrastructure. Dr. Grais argues that there must be clarity of the legal and regulatory framework that should govern Islamic financial services. The AAOIFI, IFSB and IIFM could play a significant role in organizing the development of best practice benchmarks. The legal and regulatory regime to govern Islamic finance needs to ensure a level playing field with conventional finance. It should foster financial stability as well as competition and market vibrancy. The second pillar should ensure transparency and availability of information to market players. Dr. Grais argues that given the growth of the industry, the diversity of its products and its wide geographical presence, an international cooperative approach and regional focuses are likely to be required and such an effort needs to be institutionalized, adequately funded and sustained. The third pillar should develop a broader institutional infrastructure that enables market development. Dr. Grais argues that financial authorities need to convey clearly the laws that would govern Islamic finance and the available dispute resolution mechanisms.

The third paper “Whether Islamic Banks Choose to Adjust their Assets Due to Capital Adequacy Requirements,” by Dr. Abdul Ghafar Isamail and Ahmad Azam Sulaiman empirically examine the impact of capital adequacy requirement on the portfolio choice of Islamic banks. They find the behavior of Islamic banks are consistent with conventional banks and are consistent with theoretical prediction of portfolio choice models of capital adequacy and risk and return combination. By utilizing a panel of data from 15 Islamic banks’ balance sheet and income statements for financial year 1994-2006, the estimate the empirical relationship between growth of various classes of the Islamic bank’s assets and the bank’s capital ratio. Their results show that the bank capital has statistically highly significantly and negatively affect asset, loan and government bond. The implication is that given higher capital requirement, Islamic banks take on more risk and these

The fourth article “Corporate Governance of Islamic Financial Services Industry in Brunei Darussalam” is by Dr. Abul Hassan and Dr. AbdelKader Chachi. In this empirical paper, the authors analyzed contents of annual financial statements to
ascertain the level of Shariah compliance by a group of Islamic banks and insurance companies in Brunei Darrusalam. It is of utmost importance that Islamic financial institutions comply with Islamic Shariah to satisfy customers and keep them under their fold. Specifically, they examine the role of Shariah Supervisory Boards (SBB) and their value addition to the Board of Directors (BOD) of Islamic financial institutions. The authors add to the literature by examining this corporate governance issue in the context of Brunei Darrusalam. The empirical results shows that overall compliance rate of four issues of corporate governance of IFIs in Brunei Darussalam are above 90%.

The final article of this issue is by Sayd Farook on “Social Responsibility for Islamic Financial Institutions: Laying Down a Framework,”. The author debates the cardinal issue whether Islamic financial institutions are merely profit-making entities or they also have simultaneous responsibility of social welfare through recognizable activities. He provides a basis for both mandatory and recommended institutional social responsibilities (ISR) for Islamic financial institutions. Many IFIs are following simply the form but not the spirit of Islamic teachings. He makes a case for standard setting bodies such as AAOIFI and others to develop ISR which can be flexible and at the same time shairah –based and can be adopted by Muslim countries within their unique economic and social conditions. The author is basically arguing for transparency for ISR of Islamic financial institutions so that the gaps that may now exist will be eliminated to bring them in true compliance with the spirit of Islamic Shariah.

I hope the current issue of the Journal will bring many insights and information to our readers.

M. Kabir Hassan, Editor
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