The Impact and Challenges of Basel III Implementation in Saudi Arabia

A Thesis Submitted for the Degree of Doctor of Philosophy of law

By

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January 2018

Acknowledgements

The journey of completing this thesis has been long and challenging, yet fruitful at the same time. I have not been alone. First and foremost, all praise and thanks be to Allah, the Almighty God, who has given me the capability, power and determination to pursue my passion.

I am greatly indebted to my supervisor, Dr Akalemwa Ngenda, for his continuous support and dedication and his indispensable ideas, supervision and advice throughout this PhD journey. My words are inadequate to express how thankful I am to him.

I am also grateful to Dr Mohammed Alshalhoub and Dr Maryam Alotaibi for their willingness to share their insights and valuable knowledge with me during the time I spent writing, and supporting me during the course of this research.

Last but not least, I owe genuine gratitude to my family. I would like to thank my mother and father, to whom I am greatly indebted for all their support, prayers and love, which have helped me achieve my goals in life. I would like to thank my brothers and my sisters for their encouragement and support. I am most grateful to my loving wife, Jawaher and my daughter Sidra, who have supported me and waited so patiently and keenly for this thesis to be completed.

Declaration of Originality

This thesis, submitted for the Degree of Doctor of Philosophy, is an original work of my own and has not been submitted before for any other degree.

List of Abbreviations

AAOIFI: Accounting and Auditing Organisation for Islamic Financial Institutions

BCBS: Basel Committee on Banking Supervision

BCL: Banking Control Law

BNM: Bank Negara Malaysia

CAR: Capital Adequacy Ratio

EWS: Early Warning System

FSB: Financial Stability Board

GDP: Gross Domestic Product

IFRS: International Financial Reporting Standards

IFSB: Islamic Financial Services Board

IMF: International Monetary Fund

IRB: Internal Ratings Based Approach

LCR: Liquidity Coverage Ratio

LDR: Loan to Deposit Ratio

LTV: Loan to Value

NPL: Non-performing Loan

NSFR: Net Stable Funding Ratio

PLS: Profit and Loss Sharing

PSIA: Profit Sharing Investment Account

SA: Standardised Approach

SAC: Shariah Advisory Board

SAMA: Saudi Arabian Monetary Authority

Glossary

Aqd: A contract.

Bai al-Arbun: A deposit which is lost if the contract is revoked

Bai al-Muajjal: A sale for which payment is made at a future fixed date or within a fixed period.

Bai al-Salam: A deferred delivery sale whereby delivery of a specified sale item is deferred for a fixed period

Bai` Bithaman Ajil: A sale and purchase transaction used to finance of assets on a deferred and an instalment basis. The sale price will include a profit margin.

Bai` al-`Istisna: A contract for the making of an asset in the future.

Fatwa: A religious opinion concerning Islamic law.

Gharar: Deception or uncertainty relating to a sale contract, for instance when the price or conditions are unknown or uncertain.

Haram: An action which is forbidden by Islam.

Ijārah: A contract for the transfer of the benefits of an object with payment agreed between the parties.

Istisna`: A purchase order contract of assets whereby a buyer will place an order to purchase an asset that will be delivered in the future.

Mubādalah: A swap contract.

Mudarabah: A Mudarabah contract is a profit sharing contract in which the capital provider agrees to share the profits between themselves and the entrepreneur at an agreed ratio or percentage.

Muḍārib: The labour provider.

Maslahah: Public interest.

Maysir: Gambling or uncertainty.

Murabahah: The cost plus sale.

Riba: Interest

Salam: An agreement to purchase, at a pre-determined price. The underlying asset may or may not be traded over the counter or on an exchange.

Sukuk: Islamic bonds issued as certificates, each of which assigns the holder with proportionate ownership in underlying asset and all rights and obligations therein.

Wakālah: An agency contract where the customer (principal) appoints the institution a contract with the bank offering Islamic financial services as an agent to invest or carry out transactions on their behalf.

Legislation

Banking Control Law (Royal Decree No M/5, 11/6/1966)

Basic Law of Governance (Royal Decree No/90, 27/8/1412 AH)

Capital Market Law (Royal Decree No M/30 dated 2/6/1424H (2003))

Central Bank of Malaysia Act 2009

Charter of the Saudi Arabian Monetary Agency (Royal Decree No 23, 15/12/1957)

Companies Law (Royal Decree No M/6 of 1385H as amended)

Currency Regulation (Royal Decree No M/6, 31/12/1959)

Federal Constitution of Malaysia (31 August 1957, last amended 1/11/2010)

Foreign Capital Investment Law (Royal Decree No M/4 date 2/2/1399 AH, 31/12/1978)

Foreign Investment Law (Royal Decree No M/1 dated 5/1/1421 AH, 10/4/2000)

Glass-Steagall Act 48 Stat 162 (1933)

Implementing Regulations of the Finance Companies Control Law

Law of the Board of Grievances (Royal Decree Number M/78 of 18 Ramadan 1428H, 1/10/2007)

Law on Supervision of Finance Companies (Saudi Royal Decree Number M/51 dated 13/8/1433AH (2/7/2012)

Laws of Malaysia Act 519, Central Bank of Malaysia Act 1958 (revised, amended and repealed in part in 1994 and 2009)

Laws of Malaysia Act 618, Development of Financial Institutions Act 2002

Laws of Malaysia Act 701, Central Bank of Malaysia Act 2009

Laws of Malaysia Act 758, The Financial Services Act 2013

Laws of Malaysia Act 759, Financial Services Act 2013

Limited Liability Partnerships Act 2000

Limited Partnership Act 1907

Malaysia Deposit Insurance Corporation Act 2005

Saudi Foreign Investment Law Resolution No 1 (5/1/1421 AH)

Saudi Banking Control Law

Saudi Companies Law (Royal Decree No M/6 dated 22/3/1385 AH (22/7/1965))

Saudi Companies Law 2015

Saudi Shura Council Law 1992

Cases

Beximco Pharmaceuticals Ltd and Ors v Shamil Bank of Bahrain EC [2004] EWCA Civ 19

Investment Company of the Gulf (IICG) v Symphony Gems NV & Ors [2008] EWCA Civ 389

Islamic Investment Co of the Gulf (Bahamas) Ltd v Symphony Gems NV and others [2008] EWCA Civ 389

Kingdom of Saudi Arabia v ARAMCO (1963) 27 ILR 117

Lloyds Bank plc v Rosset [1991] 1 AC 107

Lochner v New York 198 US 45

Abstract

This thesis is devoted to examining the legal framework for, and efficacy of, the implementation of the Basel III framework that governs capital, liquidity and market disclosure standards. It is set against the backdrop of the 2007 to 2008 financial crisis and attempts to unpack the myriad challenges associated with current efforts to harmonise international risk regulation standards in the context of legal diversity. These challenges are sharply illustrated in the context of Saudi Arabia's Islamic legal system and its uneasy relationship with the government's ongoing attempts to subject Saudi banks to the Basel III authored market and risk regulation disciplines. Paralleling the growth of Islamic (equity driven) finance markets worldwide, Islamic banks in Saudi Arabia now compete in the global market for conventional (debt centred) banking products. The growth of, and demand for, conventional financial services in Saudi Arabia highlights the duality of the Saudi legal system and its banking sector, despite apparent divergences between conventional and Islamic finance models, legally and normatively. These divergences manifest themselves, both in the differential treatment of Islamic and conventional banking customs and norms in the context of the overall Saudi legal system, and in respect of the general suitability of the conventional basis of the Basel regulatory model as applied to Islamic finance contexts and instruments. The thesis will challenge the convention that Islamic financial practices are self-evidently less risk averse, or more ethical, than their conventional alternatives. In a second step, this thesis will consider whether the national implementation of Basel III standards provides Saudi banks with sufficient protection against future threats to the stability of the country's Saudi market-economy in periods of economic volatility. These aims will be synthesised to provide an overarching analysis of the 'gaps' in Saudi banking institutions and applicable law. Comparing the Saudi banking regime with the dual banking sector in Malaysia, this thesis will conclude with a defence of strengthened corporate governance regulation, transparency and 'rule of law' reforms in Saudi Arabia's legal system. These recommendations should be further accompanied by concrete efforts to formulate, and, more effectively, reconcile, local and Islamic disclosure and accountability related standards with Basel III-approved technical measures on risk-mitigation and measurement.

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Chapter I: Introduction

1.1 Introduction

This thesis examines the legal framework for and efficacy of the implementation of Basel III standards in Saudi Arabia. Basel III is a comprehensive set of international reform measures promulgated by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision, and risk management of the banking sector worldwide with the purpose of enhancing financial stability.[1] These standards were agreed in 2010 to 2011 and developed in response to deficiencies in financial regulations as revealed by the global financial crisis of 2007 to 2008. They have the aim of establishing an international voluntary regulatory framework on bank capital adequacy, stress testing, and market liquidity risk. The idea behind this regulatory framework is to strengthen the resilience of the global financial system and to improve the regulation and supervision of financial market participants. The government of Saudi Arabia has committed and undertaken to implement Basel III within its jurisdiction under the auspices of the Saudi Monetary Agency (SAMA) in order to shore up the resilience of local banks.

This research will, accordingly, outline the key features of Saudi Arabia's legal system and banking law regulations and it will highlight the dualistic character of Saudi Arabia's banking system.[2] Saudi Arabia is nominally an Islamic country and, therefore, bound to observe the rules of Shariah as a matter of constitutional law. However, an informal sector in non-Shariah compliant or conventional banking has a firm basis in Saudi Arabia, but this generates uncertainty about the rules applicable, in the context of Islamic versus conventional financial institutions, instruments, and products. The result has been the creation of a differentiated legal regime for Islamic and conventional banks. The dualistic nature of the Saudi legal system suffers from other 'gaps' which have the potential to destabilise expectations around regulatory and commercial outcomes. Objective banking standards, effective enforcement mechanisms, transparent risk disclosure practices, and sound corporate governance related accountability mechanisms are all integral elements of a well-functioning banking system.[3] In

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[1] Basel Committee on Banking Supervision (BCBS), *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (Bank for International Settlements 2011) 49-56.

[2] Saudi Arabian Monetary Agency (SAMA), 'History' <http://www.sama.gov.sa/ABOUTSAMA/Pages/SAMAHistory.aspx/≥ accessed 18 November 2016.

[3] ibid.

the proceeding analysis, this research will demonstrate that it is in these areas where the Saudi legal system is most lacking. Without such protections, there is no way of ensuring that Saudi financial operators can report their losses and reduce their risks both transparently and with accountability.[4]

This research will contend that 'gaps' in Saudi Arabia's legislation cannot be remedied by the direct transposition of Basel standards into its national legal system, since the Basel Committee provides only marginal independent criteria by which to evaluate state practices on these critical issues of corporate governance, rights protection, and rule of law reform. Moreover, it is not entirely obvious that the standards developed under Basel III are entirely suited to the risk exposures of Islamic financial institutions. By utilising comparative analysis, the regulatory relationship between Islamic and conventional banks in Saudi Arabia will be critically examined.[5] This will prepare the groundwork for a more focused discussion on the unique risk profiles of Islamic banking. These risks are not, it can be argued, adequately accounted for or addressed under the Basel framework on banking supervision. By pursuing this line of enquiry further, the thesis will seek to shed light on challenges surrounding the development of consistent 'standards and principles' that are used in both conventional and Islamic models of banking, each being founded upon radically opposed assumptions, values and functions. [6]

Finally, by first drawing attention to the limitations of banking regulations in Saudi Arabia,[7] the thesis will draw on the experience of Malaysia as a model for Saudi reform. It will argue that Malaysia has been relatively successful in reducing its risk exposures while opening its market to a vibrant sector in Islamic finance: it has a system which operates in parallel with the market in conventional banking services. Malaysian banking authorities have pioneered standards that bring together elements of the Basel framework that are most effective at mitigating risk in both the Islamic and conventional segments of its financial industry. In

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[4] Thea Vinnicombe and David Park, 'The Implications of Islamic Jurisprudence for the International Harmonization of Accounting Standards' (2007) 6 Financial Reporting, Regulation & Governance 1.

[5] Monzer Kahf, 'Basel II: Implications for Islamic Banks' (6th International Conference on Islamic Economics and Finance, Jakarta, November 2005) 1, 10.

[6] Fitch Ratings, 'Fitch: Islamic Banking is Dominant in Saudi Arabia' (*Fitch Ratings*, 2 February 2016) <https://www.fitchratings.com/site/pressrelease?id=998856/> accessed 22 May 2016; Hesham Al Homoud, 'Banking Overview in Saudi Arabia' (*Al Tamimi & Co.*, 2011) <http://www.tamimi.com/en/magazine/law-update/section-7/october-november-1/banking-overview-in-saudi-arabia.html/> accessed 20 August 2016.

[7] Ahamed *Kameel* Mydin Meera and Dzuljastri Abdul Razak, 'Islamic Home Financing Through Musharakah h Mutanaqisah and al-Bai Bithaman Ajil Contracts: Comparative Analysis' (2005) 9(7) Journal of the International Association for Islamic Economics 15.

doing so, the Malaysian legal framework attempts to reconcile the increasing demand for global best practices on risk regulation with a respect for the ethical and pragmatic benefits of Islamic modes of financing.[8]

In the final analysis, this study is inspired by the need to promote mutual learning and accommodation between Islamic and conventional banking systems, based on the assumption that each has its own limitations and advantages. The regulatory measures adopted by Malaysia offer considerable potential for 'mutual learning' between Saudi regulatory authorities, such as the Saudi Arabian Monetary Authority (SAMA) and the Capital Market Authority (CMA). This thesis looks to conceptualise 'differences' not merely in terms of the structure and processes of risk regulation in Saudi Arabia relative to other legal jurisdictions, but in terms of the potential impact of these on the growth and profitability of their respective markets, and it goes further to assess the normative and jurisprudential perspectives that inform these differences. In so doing, the author attempts to bring critical depth to the analysis developed and the reform solutions proposed.

1.2 Research Context and Background

Widely touted as the most catastrophic economic event since the Great Depression, the global sub-prime mortgage crisis of 2007/2008 sent shockwaves through global markets. The global financial crisis originated from the actions of the US investment bank, Lehman Brothers Holdings.[9] Credit providing institutions such as these were deeply implicated in the sub-prime mortgage crisis because they were responsible for issuing non-viable mortgage securities. The widespread practice of double leveraging and the unsustainable growth of secondary markets in credit derivatives triggered a series of events leading to the collapse of major financial institutions, and this had far reaching implications for public and private finances.

In the aftermath of the global sub-prime mortgage crisis, law makers were once again forced to consider the function of law in correcting market failures and mitigating risks. Set against the backdrop of the world's increasingly mobile global financial and capital markets, debates about the appropriate scope, level and instruments of risk regulation re-emerged, with a

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[8] Saiful Rosly, *Critical Issues on Islamic Banking and Financial Markets* (AuthorHouse 2005) 29-33.
[9] Markus Brunnermeier, 'Deciphering the Liquidity and Credit Crunch 2007-2008' (2009) 23(1) Journal of Economic Perspectives 77.

renewed urgency.[10] Questions over 'how much' regulation is desirable remain contentious, prompting deeper controversies over the ultimate aims and purposes of market regulation (i.e. the optimality of market outcomes, the allocation of 'public goods', and the redistribution of wealth etc.).[11] If we put these conflicts aside, it is now widely recognised that financial institutions that do not manage risk, or plan for future losses, are more vulnerable to loss risks. As recent experiences have made abundantly clear, the collapse of major institutions can fundamentally threaten the stability of other banks, financial institutions, and even economies. As global finance and capital markets become more integrated, market failures experienced in one sector will often have a 'systemic' impact on the stable functioning of financial markets and institutions across the world.[12] This thesis will, according, explore the interface between local banking regulations and global finance markets, focusing on how each has the potential to reinforce the mutual (risk) vulnerabilities of the other.

In the above regard, this thesis will focus centrally on the work of the Basel Committee on Banking Supervision (BCBS) and the liquidity, capital, and disclosure requirements introduced under the umbrella of Basel III reforms.[13] These reforms were proposed and adopted in response to the global financial crisis. In the pre-financial crisis era, Western economies underwent a series of reforms aimed at the comprehensive liberalisation, privatisation, and deregulation of global capital and finance markets. Counter to these trends, the Basel framework represents an attempt to re-regulate financial entities and services at an international level, in this case by encouraging financial institutions and national regulatory authorities to harmonise their laws and approaches to risk management and supervision. The effect is to establish a regulatory floor on the capital requirements which all banks must meet, regardless of whether the financial laws of the host state are strictly applied and interventionist, or permissive and reinforcing of market freedoms. In this sense, the Basel III proposals were devised as a corrective to 'gaps' in state regulations,[14] and indeed, the failures

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[10] Michael S Barr and Geoffrey P Miller, 'Global Administrative Law: The View from Basel' (2006) 17 European Journal of International Law 15, 18.

[11] See, eg, Reza Dibadj, 'Beyond Facile Assumptions and Radical Assertions: A Case for "Critical Legal Economics"' (2003) Utah Law Review 1155; See also Owen M Fiss, 'The Autonomy of Law' (2001) 26 Yale Journal of International Law 517, 518.

[12] Prudential Regulation Authority, 'Strengthening Capital Standards: Implementing CRD IV, Feedback and Final Rules' (PRA Policy Statement PS7/13, December 2013); Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (2013) OJ L176/1 (EU Framework CRD IV Directive) arts 25-91, arts 465-520.

[13] BCBS (n 1).

[14] BCBS, *Consultative Document: Strengthening the Resilience of the Banking Sector* (BIS 2009) 13.

of previous Basel standards which did not prevent the crisis or predict its far-reaching consequences.[15]

This thesis will offer an investigation of the reasons as to why financial institutions in Islamic countries such as Saudi Arabia remained well capitalised at the high point of the global credit crash, rendering them better able to withstand the debt fuelled 'contagion' effects of the US originating sub-prime mortgage crisis. No bank in Saudi Arabia failed during the crisis or even suffered substantial losses in the way that many other banking sectors across Europe, Far East Asia, and the Americas did.[16]

It is commonly assumed that Saudi Arabia, as with many other gulf countries, survived the worst impact of the crisis for at least two reasons. The first is that regulators in Saudi Arabia, most notably the Saudi Arabian Monetary Agency, restrict lending and borrowing. Under current Saudi banking and investment regulations, banks only provide finance, both commercial and personal, to borrowers when strict criteria on deposit requirements are met.[17]

A second reason concerns the Islamic finance model on which Saudi Arabian banking is ostensibly based. Islamic finance models are primarily equity driven, and this is in contrast with the financial portfolios of conventional financial institutions which tend to rely more heavily on debt-based instruments and assets.[18] It should be emphasised here that the supply of cheap and fast credit to borrowers was a key structural cause of the ensuing crisis. Irresponsible lending by major banks resulted in the accumulation of institutional debts and counter party defaults. Due to religious restrictions, Saudi Arabian banks are, in principle, prevented from taking up short positions on trading markets and from leveraging their debts.[19] Accordingly, trade and investment activities in Saudi Arabia are typically focused on

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[15] Bank for International Settlements (BIS), 'Instruments Eligible for Inclusion in Tier 1 Capital' (Press Release, 27 October 1998) <http://www.bis.org/press/p981027.htm/> accessed 17 October 2017; BIS, 'International Convergence of Capital Measurement and Capital Standards of the Basel Committee on Banking Supervision' (June 2006) 2 <http://www.bis.org/publ/bcbs128.htm/> accessed 17 October 2017; BIS, *Revisions to the Basel II Market Risk Framework* (BIS 2009).

[16] Kahf (n 5).

[17] Suleman Muhammad Ali, 'The Subprime Crisis and the Lessons for the Islamic Finance Industry' (2013) 30(2) Journal of Islamic Banking and Finance 11, 15.

[18] BCBS (n 1) 4; Alexei Vassiliev, *The History of Saudi Arabia* (Saqi 2013) 157; AE Tschoegl, *Foreign Banks in Saudi Arabia: A Brief History* (Transnational Corporations 2002) 123, 124.

[19] Beck Thorsten, Asil Demirguc-Kunt and Vojislav Maksimovic, 'Financing Patterns around the World: The Role of Institutions' (World Bank Policy Research Working Paper 2905, 2002) 23-24. See also, Nadhem Al-Saleh, 'Decisions on Capital Structure in a Zakat Environment with Prohibition of Riba: The Case of Saudi Arabia' (2009) 10(5) Journal of Risk Finance 460.

the sale and exchange of cash-value goods. Speculative trading, including the use of future contracts or options, is also discouraged under Islamic financial models.[20] As a result, Saudi Arabia does not hold much sovereign debt and financial institutions generally retain capital in excess of international and national regulatory minimums.

The economic outlook in Saudi Arabia has, however, changed dramatically in the last five years. A downturn in global crude prices since 2015 has had an impact on national oil and gas sectors in the Gulf Cooperation Council (GCC), the majority of which are highly dependent on the revenues generated from oil exports. Oil export revenues account for 90% of Saudi Arabia's, 'central government fiscal revenues and around 85% of export revenues.'[21] This budgetary reliance on oil revenues is similarly replicated in the economies of other GCC countries such as Yemen, Oman, and Qatar. With the fall in oil prices, GCC countries have found themselves in unchartered territory.[22] In the years 2002 to 2011, Gulf countries maintained a budgetary surplus of around 12.2% of their total revenue. GCC countries are now experiencing historic levels of sovereign debt, having racked up a combined annual budgetary deficit of around USD SR840 billion in 2015.[23]

Of the GCC countries, Saudi Arabia has been the most dramatically affected by the decline in oil exports. The country's budgetary deficit is now estimated to be in the region of USD 98 billion in 2015 and USD 79 billion in 2016.[24] National salaries have depreciated significantly over the last decade, and national growth rates are projected to slow to 0.4% by the end of 2017. Currently, the government is financing its public debts from its substantial foreign reserves, last estimated to account for around USD 770 billion.[25] The future economic outlook of the Kingdom may not be gloomy as forecasts suggest. The country's sovereign

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[20] Munawar Iqbal and Philip Molyneux, *Thirty Years of Islamic Banking: History, Performance and Prospects* (Palgrave Macmillan 2005) 86.

[21] International Monetary Fund, 'Saudi Arabia: Selected Issues' (IMF Country Report No 15/286, October 2015) 5 <https://www.imf.org/external/pubs/ft/scr/2015/cr15286.pdf/≥ accessed 12 September 2017.

[22] International Monetary Fund, 'Economic Diversification in Oil-Exporting Arab Countries' (Annual Meeting of Arab Ministers of Finance, April 2016) 13 ≤https://www.imf.org/external/np/pp/eng/2016/042916.pdf/> accessed 17 October 2017.

[23] Jadwa Investment, 'Saudi Arabia's 2017 Fiscal Budget' (Financial Note, 25 December 2016) <http://www.jadwa.com/en/researchsection/research/economic-research/budget-reports> accessed 12 September 2017.

[24] KPMG, 'Saudi Arabia's Vision 2030: The Kingdom's Plan for Life after Oil' (KPMG Consultation Document, February 2017) 2 ≤https://home.kpmg.com/content/dam/kpmg/uk/pdf/2017/03/saudi-vision-2030 life-after-oil-kpmg-corporate-intelligence.pdf/> accessed 12 September 2017.

[25] John Welman, 'Saudi Risk Score Plummets' (*Euromoney*, 16 December 2014) <http://www.euromoney.com/Article/3410818/Saudi-risk-score-plummets-as-oil-shock-intensifies.html?copyrightInfo=true/> accessed 15 May 2015.

debt accounts for 16 percent of GDP, compared with a median of 26.3% for A-rated countries.[26] However, volatility in exchange markets has meant that Saudi Arabia's foreign reserves have also depreciated in value, resulting in a drop of around USD 200 billion since August 2014.[27] One harbinger of Saudi Arabia's increased exposure to sovereign debt risk is the relatively weak performance of public sector investments, many of which are financed through the Islamic equivalent of corporate bonds known as 'sukuks'. Take the example of public stocks in the Saudi Electricity Company. This company benefits from a high degree of state support and is by far the best proxy for Saudi sovereign risk in the Eurobond market. Yet, only eight months after they went on sale, the value of stocks in Saudi Electricity dropped one hundred and three base points since their opening price, to 3.18%.[28]

If the above statement of the Saudi economic situation is not challenging enough, the Kingdom now faces rapid shortages in home ownership properties foreshadowing the very conditions that led to the sub-prime mortgage crisis in the United States.[29] Tellingly, Saudi Arabia's credit institutions now face major credit risk exposure. In another major setback, international rating agencies have downgraded the Kingdom's international credit rating. Saudi banks are set to take the biggest hits, with early figures suggesting that the number of non-performing loans issued by Saudi banks remains relatively high. International indicators on loan to value (LTV) ratios suggest that Saudi Arabian banks yield returns on loans issued, of around 70% of the underlying value of the asset, compared with countries such as India, where loans values reach the 80% mark, and developed markets such as the UK which run at around 90 to 95%.[30] The personal finances of Saudi borrowers and savers have also been affected by stagnation in Saudi investments and asset portfolios. A survey conducted by Asli Demirgüç-Kunt and Leora Klapper for instance, tends towards the conclusion that savings accounts are generally underperforming, with savers gaining little or no return on their

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[26] Intelligence Unit, 'Saudi Arabia Country Risk' (The Economist Intelligence Unit, May 2015).
[27] KPMG (n 24).
[28] Bloomberg News, 'Saudi Electricity Co's Islamic Debt Sparkles' (*The National*, 18 December 2012) <http://www.thenational.ae/business/markets/saudi-electricity-cos-islamic-debt-sparkles/> accessed 29 March 2017.
[29] Camilla Turner, 'House Prices Rise to Ten Times Average Salary' (*The Telegraph*, 17 June 2014) <http://www.telegraph.co.uk/finance/property/house-prices/10905333/House-prices-rise-to-ten-times-average-salary.html/> accessed 29 March 2017.
[30] Citigroup, '2008 Annual Report' 9; Royal Bank of Scotland, 'Annual Report and Accounts 2008' 2; Samba Financial Group, 'Consolidated Financial Statements and Auditors Reports for the Year Ended 31 December 2008' 13.

deposits.[31] The above described risk exposures, if not adequately addressed through robust regulation and effective risk management techniques, may further destabilise and undermine not merely the functioning and viability of certain Saudi institutions, but the health and growth of the Saudi economy, in general.[32]

Given these seismic changes, it is necessary to re-evaluate the effectiveness and utility of Basel standards in reducing risk exposure for Saudi Arabia's fledgling banking sector.[33] This requires a renewed enquiry into whether Saudi regulators have taken the necessary steps to ensure effective supervision and regulation of its banking sector, to ensure consistency with Basel-approved best practices and baselines. What has yet to be considered is whether the national implementation of Basel standards for liquidity and capital adequacy baselines are sufficiently flexible to accommodate 'differences' in national regulatory approaches and institutional risk profiles. In seeking to answer this question, this thesis will assess whether the authors of the Basel III regulations were adequately responsive to the risk exposures of Islamic banks, and more particularly, Islamic banks in Saudi Arabia.

1.3 Objectives of the Study

This thesis offers an assessment of the legal and financial impact of the measures and guidelines adopted under Basel III.[34] The Kingdom is well on its way to meeting its obligations under the next Basel III implementation phase.[35] No banks have failed in Saudi Arabia, and the risk-to-capital ratios of Saudi banks generally comply with, or otherwise, substantially exceed, Basel regulatory thresholds. Saudi regulators have already integrated Basel recommendations into the relevant banking and capital market laws. Domestic and foreign banks subject to Saudi commercial laws are made to comply with a plethora of regulatory measures aimed at mitigating credit default risks. Considering these restrictions, one might pose the question: why does Saudi Arabia need reform if it is already compliant

[31] Asli Demirgüç-Kunt and Leora Klapper, 'Measuring Financial Inclusion: The Global Financial Index' (World Bank Policy Research Working Paper 6025, 2012).

[32] Mohamad Shamsher, Taufiq Hassan, Mohamed Khaled and Mohamed Khaled I Bader, 'Efficiency of Conventional Versus Islamic Banks: International Evidence Using the Stochastic Frontier Approach (SFA)' (2008) 4(2) Journal of Islamic Economics, Banking and Finance 107.

[33] Musa Essayyad and Haider Madani, 'Investigating Bank Structure of an Open Petroleum Economy: The Case of Saudi Arabia' (2003) 29(11) Managerial Finance 73.

[33] Fitch Ratings (n 6).

[33] Thorsten, Kunt and Maksimovic (n 19); Al-Saleh (n 19).

[34] Law on Supervision of Finance Companies (Saudi Royal Decree Number M/51 dated 13/8/1433AH (2 July 2012).

[35] ibid.

with Basel III? Put differently, if the Basel III reform proposals are designed to temper the worst excesses of conventional banking, one might also conclude that Saudi Arabia is already in step with the emerging international consensus on prudential risk management and banking supervision.

In providing an answer to the above question, this thesis will first consider the impact of external markets and the political pressures that have been placed on the Saudi banking sector since the crisis. Volatility in export and foreign exchange markets have brought increased scrutiny of the region's regulatory and economic models. This scrutiny extends to Saudi Arabia's presumed enforcement of Islamic concepts of law and finance, as discussed below. The proceeding analysis will take each issue by turn.

In a first line of enquiry, this thesis will consider and critique the role and effectiveness of Basel standards for mitigating or managing the risk exposure for the Saudi banking sector. To this end, the Saudi banking sector will be assessed against the specific risk indicators identified under the existing Basel framework. It is generally understood that Saudi Arabian banks have performed better than conventional banking institutions because they have maintained sufficient levels of institutional liquidity to offset liquidity, market and credit loss risks; the very risks that Basel III is designed to minimise and eliminate.

The global economic outlook has changed substantially since the 2008 sub-prime crisis which, at the time, mainly affected Western conventional banking systems in Europe and the United States.[36] In early 2016, King Salman approved Saudi Arabia's Vision 2030 which sets out a comprehensive plan for the wholesale structural transformation of its economic strategy, to smooth the country's transition to the 'post-oil' era. In this vision, it is acknowledged that without continuous foreign direct investment, Saudi banks will not be able to rely on adequate sources of stable funding to meet their financial obligations, nor service the consumer credit demand in the rapidly exploding home finance, commercial real estate, and construction sectors. This study will, more particularly, examine whether Saudi Arabia

[36] HE Chakib Khelil and others, 'The Impact of Falling Oil Prices on the Future of the Middle East' (Middle East Institute Panel Discussion, Washington DC, 24 February 2015). Jean Francois Seznec highlighted Saudi Arabia's economic and political strategies for enduring a period of low oil prices. The country is set to have a $180 billion budget deficit in 2015, he said, but with access to nearly $1 trillion in cash reserves, it can sustain this course for up to five years. Politically, however, it needs to balance its policy against the interests of Iran and Russia, whose co-operation it seeks in addressing other regional issues like Yemen and ISIS in Iraq and Syria.

has implemented the reforms needed to ensure the stability and viability of its banking sector, while reducing risk exposures by issuing relevant capital adequacy, supervision and market disclosure rules.

Any study of Saudi Arabia's application of Basel III norms, and its risk-limiting potentialities, cannot be isolated from a broader enquiry into the nature and operation of Saudi Arabia's banking and finance laws. Taking the above as a starting point, a second line of enquiry will consider the strengths and limitations of Saudi Arabia's framework of finance laws, and their governance will be explored and critically assessed. Having sustained a fiscal surplus over the past decades, the Saudi government has had little impetus to implement substantial market reforms, or update its financial regulations. The state-centralised model of financial planning and governance adopted by Saudi Arabia over the past three decades has been slow to reform, prompting criticisms of the country's regulatory and economic policies. As one Saudi banking official put it, the decline in oil prices has 'swung the door open' to a new era of prudential government and the liberalisation of Saudi banking, competition, foreign investment laws.[37] This study will investigate the key limitations of Saudi Arabia's finance laws and regulations. The inconsistent application of Islamic finance standards to banking regulation and dispute settlement; ineffectual corporate governance laws and poor enforcement of disclosure and auditing practices across the banking sector will be identified as areas of much needed reform.[38]

This brings us to the narrow focus of the Basel III reforms, which are not programmatic or substantive in scope, but have instead emphasised the more procedural aspects of risk regulation. While guidelines issued under Basel II and Basel III have called upon national authorities to enhance supervision of banks and strengthen market disclosure rules, wider issues the concern the structural reform of global financial architecture, including the endemic culture of risk taking which has infected the burgeoning securities and derivatives markets, has been left off the table. In a missed opportunity, the growing demand for socially responsible, inclusive, transparent forms of corporate governance is, lamentably, placed outside the scope of the Basel Committee's reform agenda and has been conceptualised instead as a matter exclusively reserved for national law and sovereignty. From these

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[37] KPMG (n 24).
[38] Abdulrahman Baamir, 'Saudi Law and Judicial Practice in Commercial and Banking Arbitration' (Doctoral dissertation, Brunel University, 2009).

premises, it will be suggested that the Committee's preoccupation with narrower questions of risk computation and measurement may function to further obscure, rather than mitigate, the most problematic aspects of corporate culture in financial institutions today.[39]

The above issues are intimately related to the efficacy of Saudi Arabia's banking laws and regulations, both before and after the Basel III regulations are implemented. As will be argued in this thesis, the wider challenges now posed to the future stability of Saudi Arabia's banking sector cannot be addressed by capital risk regulation alone. What is required is a comprehensive reform of the relevant laws and governance structures, both at an institutional and state level. The inconsistent application of Islamic finance standards to banking regulation and dispute settlement and the ineffectual corporate governance laws and poor enforcement of disclosure and auditing practices across the banking sector will be identified as areas where reform is much needed.[40]

There is another reason why this thesis eschews a more technical analysis of Basel III reforms and their implementation processes. It is suggested that there are current efforts to harmonise risk regulation and endlessly replicate the model of banking law and governance more usually associated with Western legal systems and economies. For ease of reference, these models will be described as 'conventional banking systems'. At the heart of Basel III harmonisation lies a paradox: the Basel framework on risk regulation represents an attempt to 'universalise' conventional approaches to market regulation, and associated theories of market function. At the same time, the Basel III reforms are a response to the cyclical nature of financial crises apparent in the conditions of late capitalism.[41] The conceptual dependence of the Basel framework on neo-liberal models of governance and market function will be explored in a bid to assess the invariable legitimacy relating challenges that accompany any attempt to 'universalise' a contingent model of banking to the exclusion of all other alternatives. This research considers the tension which exists between international harmonisation efforts and the diversity of local laws and traditions.

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[39] BIS, 'Instruments Eligible for Inclusion in Tier 1 Capital' (Press Release, 27 October 1998) <http://www.bis.org/press/p981027.htm/> accessed 17 October 2017; BIS (2006) (n 15) 2.

[40] Baamir (n 38).

[41] Daniel Tarullo, *Banking on Basel: The Future of International Financial Regulation* (Peterson Institute for International Economics 2008) 131-133.

In a third line of enquiry, this thesis aims to identify the foundational underpinnings of the Islamic banking model, taking into consideration the wider societal and economic goals that a Shariah compliant banking system aims to accomplish, and the evolution of the contemporary banking model utilised within Saudi Arabia.

Saudi Arabia operates an Islamic legal system. By extension, Saudi banks which are classed as Islamic are typically structured by rules of a distinctive nature. Rooted in the principles of equity and risk-sharing, Islamic financial seem to stand in sharp contrast to the excessive risk taking and 'profit all costs' approach to corporate culture that many regard is an endemic feature of conventional banking structures in the West.[42] Only by understanding the structure of Islamic financial models and the ideals which underpin it, can one understand not only how this model differs from traditional banking systems used outside Islamic society, but why some believe this model to be more desirable than its alternatives.

It is estimated that Saudi Arabia's share in the global market of Islamic finance products accounts is around 13%.[43] Due to the 'Saudisation' of rules on corporate ownership and shareholdings, banks established in Saudi Arabia are subject to strict licensing laws.[44] Those banks that meet strict standards for licensing and capital deposit requirements are designated Islamic and/or Shariah compliant by default.[45] Though the actual ratio of Islamic to conventional banking assets held in Saudi banks is under-reported, possibly to avoid religiously sensitive issues around Shariah compliance, it is widely acknowledged that conventional banks do have a strong commercial presence on the Saudi stock exchange and on foreign exchange markets.

It is taken for granted that every financial institution will be exposed to unique risks. Yet, it is equally evident that the Basel 'stress testing' models are based on market pressures more commonly associated with conventional banking systems. Islamic banks do not always suffer from these same pressures.[46] Moreover, they may face risk exposures that are trivialised or inadequately addressed under the current Basel framework. Islamic banks are, for instance,

[42] Fitch Ratings (n 6); Homoud (n 6).
[43] Jammaz Al-Suhaimi, 'Consolidation, Competition, Foreign Presence and Systemic Stability in the Saudi Banking Industry' (BIS Papers No 4, 2001) 129.
[44] Timur Kuran, 'The Logic of Financial Westernization in the Middle East' (2005) 56 Journal of Economic Behavior & Organisation 593, 595.
[45] Al-Suhaimi (n 43).
[46] Kahf (n 5).

bound by religious and other regulatory restrictions which are not applicable to the debt-based model of conventional finance and finance regulation. This does not mean, however, that Islamic banks are too 'ethical' to fail. Framed in these terms, this study goes beyond a doctrinal assessment of the legal and regulatory measures that will be implemented by Saudi Arabia to bring its national laws into compliance with Basel III, in order to assess whether these standards are suitably tailored to the risk exposure of Islamic financial institutions within the Kingdom.

There is no doubt that Basel III significantly reduces bank risk exposures by establishing a floor on the minimal capital a bank can hold to remain operational and absorb losses.[47] It would, however, be short-sighted to assume that mere compliance with capital thresholds provides sufficient protection against market shocks or failure.[48] Therefore, it is necessary to consider whether Basel III standards are effective at mitigating the risk exposure of Saudi banks, specifically Islamic banks or those with equity-heavy portfolios.[49]

1.4 Literature Review

The Basel I and II Accords were deemed defective for many reasons.[50] The emphasis on institutional compliance with non-differentiated capital adequacy requirements was the most prominent reason owing to the fact that little emphasis was placed on the mutually destabilising effects of institutionalised risk-taking in the ever-integrating global finance and capital markets.[51] The architects of the Basel consensus to a certain extent underestimated the

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[47] BS Alrawashdeh and NB Rahman, 'To What Extent are Saudi Banks Committed to the Decisions of the Basel II Committee' (2013) 1(5) Merit Research Journal of Art, Social Science and Humanities 67.

[48] BCBS, *Regulatory Consistency Assessment Programme (RCAP) Report: Assessment of Basel III Risk-based Capital Regulations – Saudi Arabia* (BIS 2015) 2-10; for an internal report by SAMA, see 'Annual Report No. 46' (2010) 1-8.

[49] Ioannia Akkizidis and Sunil Kumar, *Financial Risk Management for Islamic Banking and Finance* (Palgrave Macmillan 2008) 87-89.

[50] Some of the reasons include the cost of implementation and compliance borne by banks and national supervisors; capital decisions were largely left to banks, so they were allowed to develop models for quantifying their respective capital requirements; and risk-weights and broad risk categories were used incorrectly because all assets within each category were deemed to be equally risky, thereby encouraging banks to invest in riskier assets within the category. See L Jacobo Rodriguez, 'International Banking Regulation: Where's the Market Discipline in Basel II?' (2002) Policy Analysis 3, 9; Richard Herring, 'Implementing Basel II: Is the Game Worth the Candle?' (2005) 14(5) Financial Markets, Institutions and Instruments 267, 267-287; Norman S Posner, 'Why the SEC Failed: Regulators against Regulation' (2008) 3 Brook Journal of Corporate Finance and Commercial Law 289, 289; John F Rosato, 'Down the Road to Perdition: How the Flaws of Basel II Led to the Collapse of Bear Stearns and Lehman Brothers' (2011) 17(2) Connecticut Insurance Law Journal 475, 475.

[51] See Imad A Moosa, *Quantification of Operational Risk under Basel II: The Good, the Bad, and the Ugly* (Palgrave Macmillan 2008) 49-51; Paul JJ Welfens 'The Transatlantic Banking Crisis: Lessons, EU Reforms

systemic impact of the widespread trend in double leveraging, on the stability of interconnected national banking sectors.[52] Thus, when systemically important banks endured sustained pressure on their cash flows during a bank run, they were unable to absorb losses by relying on more stable and liquid sources of funding.[53] The newly formulated Basel III Accord therefore introduces stricter and more transparent levels of capital management and responsibility in banking institutions for all countries that choose to implement the proposals.[54] It lays greater emphasis on key definitions of capital and capital risk measurement, which include general loan-loss reserves, including raising the amount of capital finance institutions should have so as to be able to withstand market pressures and other risks affecting their institutional liquidity.[55]

Riccio notes that the focus on capital risk measurement is to improve the ability of the banking sector to handle economic phases of stress and strengthen transparency by linking the calculation of regulatory capital by individual banks to macroprudential factors in the financial system.[56] Siqiwen also argues that this reduces the incentive of financial institutions to understate reported risk and facilitates regulation by enabling the regulator to easily set the capital adequacy charge.[57] A question that crops up is whether these changes were necessary for Islamic banks. The new risk computations, buffers, solvency and leverage ratios, higher quality Tier 1 capital introduced by Basel III[58] were more suited to conventional banks, many

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and G20 Issues' in Paul JJ Welfens and Cillian Ryan (eds), *Financial Market Integration and Growth: Structural Change and Economic Dynamics in the European Union* (Springer 2011) 51.

[52] Michael B Gordy, Erik A Heitfield and Jason J Wu, 'Risk-based Regulatory Capital and the Basel Accords' in Allen N Berger, Phillip Molyneux and John OS Wilson (eds), *The Oxford Handbook of Banking* (2nd edn, Oxford University Press 2015) 560-562.

[53] For other shortcomings of the Basel I and II Accords, see See Karim Pakravan, 'Bank Capital: The Case against Basel' (2014) 22(3) Journal of Financial Regulation and Compliance 208, 209; John Farrar, 'Improving the Governance of Financial Institutions' in Mohammed Ariff, John Farrar and Ahmed M Khalid (eds), *Regulatory Failure and the Global Financial Crisis: An Australian Perspective* (Edward Elgar 2012) 133-134.

[54] See Niamh Moloney, *EU Securities and Financial Markets Regulation* (3rd edn, Oxford University Press 2014) 380-381

[55] See Sepil Kuzucu and Narman Kuzucu, 'Enhancing the Risk Management Functions in Banking: Capital Allocation and Banking Regulations' in Hasan Dincer and Umit Hacioglu (eds), *Risk Management, Strategic Thinking and Leadership in the Financial Services Industry* (Springer 2017) 79-83.

[56] Gianluca Riccio, 'Considerations on Developing and Validating Expected Loss (EL) Methodologies' in Kern Alexander and Rahul Dhumale (eds), *Research Handbook on International Financial Regulation* (Edward Elgar 2012) 90.

[57] Li Siqiwen, *Emerging Trends in Smart Banking: Risk Management under Basel II and III* (IGI Global 2014) 109.

[58] For an overview, see Walter E Eubanks, The Status of the Basel III Capital Adequacy Accord (Congressional Research Service 2010) 1-12.

of which did not have sufficiently high-quality capital to cope during stress periods.[59] Regarding Islamic banks that are fully Shariah-compliant on the other hand, Archer and Karim note that their capital structures are generally dominated by higher quality Tier 1 capital in common equity form.[60] Also, their capital adequacy ratios are comparatively much higher than those of conventional banks.[61] This may be explained by the lack of subordinated debt and hybrid and callable capital structures due to the prohibition of conditionality, speculation and uncertainty. Thus, it is difficult to raise alternative and lower quality forms of capital in Islamic markets. Also, Louati and others examined 12 countries in the Middle East and South East Asia in which Islamic and conventional banks operated and found that although capital adequacy requirements have a major impact on the credit behaviour of Islamic and conventional banks, Islamic banks are less sensitive to market competitiveness.[62]

The above notwithstanding, Basel III may be said to be the product of an emerging international consensus based on an understanding that global risk regulation standards had failed to prevent, or predict, the global financial crisis of 2007/2009.[63] However, two years after the Basel III report was published, Sinclair pointed out that many studies failed to underscore the fact that the global financial architecture that was wrecked by the financial crisis underpins the conventional banking system, and the latter is in some sense, an artifice, albeit one that has been accepted as a social 'fact'.[64] This is still the case, six years after Sinclair's concern was published. I believe this concern is related to the observation by Salem and Baldredrin that the countries that were worst affected by the global financial crisis were those that had adopted the most conventional (Western) models of banking and finance.[65]

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[59] See Larry D Wall, 'Post-Crisis Changes in US Bank Prudential Regulation' in Esa Jokivuolle and Radu Tunaru (eds), *Preparing for the Next Financial Crisis: Policies, Tools and Models* (Cambridge University Press 2017) 38-44. See also, Daniel Aronoff, *The Financial Crisis Reconsidered: The Mercantilist Origin of Secular Stagnation and Boom-Bust Cycles* (Palgrave Macmillan 2016) 229-230.
[60] Simon Archer and Rifaat AA Karim, *Islamic Capital Markets and Products: Managing Capital and Liquidity Requirements under Basel III* (Wiley 2018) 20-21.
[61] Ibid.
[62] Salma Louati and others, 'Capital Adequacy Implications on Islamic and Non-Islamic Banks' Behaviour: Does Market Power Matter?' (2015) 15(3) Borsa Istanbul Review 192, 192-204.
[63] See Lamia B Boulifa and Dalenda R Khouaja, 'Could Basel III Capital and Liquidity Requirements Avoid Bank Failure?' (2016) 10(4) The International Journal of Business and Finance Research 63, 63; Ranjit Lall, 'From Failure to Failure: The Politics of International Banking Regulation' (2012) 19(4) Review of International Political Economy 609, 609-610.
[64] Timothy J Sinclair, 'Institutional Failure and the Global Financial Crisis' in Wyn Grant and Graham K Wilson (eds), *The Consequences of the Global Financial Crisis: The Rhetoric and Reform and Regulation* (Oxford University Press 2012) 142.
[65] See Rania A Salem and Ahmed M Badredlin, 'Assessing the Resilience of Islamic Banks: An Empirical Analysis' in Habib Ahmed, Mehmet Asutay and Rodney Wilson (eds), *Islamic Banking and Financial Crisis: Reputation, Stability and Risks* (Edinburgh University Press 2014) 41.

Hence, questions about the essential functions of markets and when it is appropriate to intervene in markets which do not function as they *ought* to,[66] should be addressed in different ways in systems (or social contexts) that are different from the conventional system. It follows that it is important to determine whether the Basel regulatory architecture was developed from a harmonised system of international banking regulations. However, is the system sufficiently flexible to accommodate diversity across states and institutional and social contexts? In other words, are the standards developed under Basel III entirely suited to the risk exposures of Islamic financial institutions? These are pertinent questions that are yet to be given in-depth consideration. The bulk of the studies in the literature examine the impact of Basel III on Islamic banking or the opportunities and challenges for Islamic banks,[67] without addressing the basic questions of whether it is justified for Basel III to change the capital adequacy standard for Islamic banks. Also, although the central banks of some influential Islamic countries such as Malaysia and Saudi Arabia have adopted Basel Accords with some success,[68] it remains uncertain whether Basel III reconciles the increasing demand for global best practices on risk regulation with a respect for the ethical and pragmatic benefits of Islamic modes of financing. Addressing this issue involves determining in a first instance whether liberalism that provides the theoretical foundation of Basel III may be effectively used as a measure of a different system such as the Islamic banking system.

1.4.1 Should Liberalism Serve as the Measure of Islamic Finance?

The revival of classical liberalism has enjoyed unprecedented success in many Western states with the sweeping endorsement of the idea that private ordering should remain both outside the law (through legislative oversight and judicial control) and within it (chiefly through its

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[66] See for example, Stephen Orvis and Carrol Ann Drogus, *Introducing Comparative Politics: Concepts and Cases in Context* (3rd edn, Sage 2015) 201-202; Edward Soule, *Morality and Markets: The Ethics of Government Regulation* (Rowan & Littlefield 2003) 3.

[67] See for example, Canan Ozkan and Zamir Iqbal, 'Implications of Basel III for Islamic Baking: Opportunities and Challenges' (2015) World Bank Policy Research Working Paper 1; Mohammad Bitar, Sami B Naceur, Rym Ayadi and Thomas Walker, 'Best Compliance and Financial Stability: Evidence from Islamic Banks' (2017) IMF Working Paper WP/17/161; Omar Masood, Mondher Bellalah and Shahid Ghauri, 'Basel III Implementation Outcome in Islamic Banks' (2017) 19(S1) Journal of Risk < https://ssrn.com/abstract=2956307> .

[68] See Rozaimah Zainudin R, Chan Sok-Gee and Aidil Rizal Shahrin, *The Malaysian Banking Industry: Policies and Practices after the Asian Financial Crisis* (Routledge 2019) chapters 1 and 3; Siti Zaleha et al, *Weathering the Global Crisis: Can the Traits of Islamic Banking System Make a Difference?* (Patridge 2014) 37-38; BCBS, *Assessment of Basel III Risk-Based Capital Regulations: Saudi Arabia* (BCBS 2015); BCBS, *Regulatory Consistency Assessment Programme (RCAP): Assessment of Basel III Liquidity Coverage Ration Regulations – Saudi Arabia* (BCBS 2015).

enforcement through private law doctrines).[69] Thus, governmental intervention is shunned because it has the effect of disturbing the spontaneous (supply and demand) equilibrium of the market place, reducing the autonomy of informed and rational consumers, while rendering market institutions vulnerable to competition-impeding interest group capture, rent seeking, and monopolies.[70] However, Deepak Lal, a professor of international development studies who has advised many governments in both Muslim and non-Muslim countries, argues with some degree of cogency that the revival of liberalism involves changes in material beliefs, whereby new attitudes generated by capitalism are substituted for religious precepts or attitudes of a pre-industrial agrarian society.[71] Deepak Lal notes further the contrast between both attitudes is reflected in the contrast between the following:

> the conception of society as a community of unequal classes with varying functions, organized for a common end, and that which regards it as a mechanism adjusting itself through the play of economic motives to the supply of economic needs; between the idea that a man must not take advantage of his neighbour's necessity, and the doctrine that 'man's self-love is God's providence'; between the attitude which appeals to a religious standard to repress economic appetites, and that which regards expediency as the final criterion.[72]

Lal then concluded that those who question the moral basis of capitalism (which he believes is akin to market economy and liberalism) largely rely on the above atavistic pre-industrial attitudes.[73] Deepak Lall's perspective contrasts with that of many international business scholars, led by John Dunning, who have argued that global capitalism desperately needs a new moral ecology that should seek to mitigate the negative side-effects of capitalism.[74] In the same vein, Buckley and Casson observed that 'Late twentieth-century Western culture is

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[69] See chapter 2.
[70] Ibid.
[71] Deepak Lal, *Reviving the Invisible Hand: The Case for Classical Liberalism in the Twenty-First Century* (Princeton University Press 2008) 7.
[72] Ibid.
[73] Ibid, chapter 6.
[74] See John H Dunning (ed), *Making Globalization Good: The Moral Challenges of Global Capitalism* (Oxford University Press 2033); John H Dunning, 'The Eclectic (OLI) Paradigm of International Production: Past, Present and Future' (2001) (2001) 8(2) International Journal of the Economics of Business 173.

secular and atomistic: it has fostered a low-trust form of capitalism, based on a selfish, individualistic and competitive concept of the entrepreneur.'[75]

However, the discussion in chapter 2 clearly demonstrates that capitalism, as well as liberalism, whether classical liberalism or neo-liberalism, comes in several guises. Thus, there is a guise that meets the ethical needs of Islamic banking. Equally, although there is general scepticism about the state's role in managing the market, different schools of thought advocate for varying levels of intervention given the limitations of private and self-regulation and the existence of interstitial worlds of finance and commerce in the shadow of legislative and judicial oversight. As such, the cause championed by advocates of liberalism such as Deepak Lal is actually that of extreme liberalisation rather than liberalism.

Liberalisation is an institutional change or a political process of legitimating the innovation of institutions. Gallarotti noted that the legitimation in this context refers 'to the voluntary acceptance of political authority on the part of those who are ruled.'[76] Schuman also noted that it refers to a 'generalized perception or assumption that the actions of an entity are desirable, proper or appropriate within some socially constructed system of norms, values, beliefs, and definitions.'[77] Thus, the institutional change is effective when it changes the beliefs of agents regarding the way in which a game is played.[78] The generative mechanism of institutional change may be injustice or inefficiency.

As such, the change will be considered legitimate only where it is aimed at addressing identifiable issues of injustice or inefficiency. Any institutional innovation that is not dictated by justice and efficiency considerations would therefore not be legitimate regardless of whether it is based on a mechanism adjusting itself through the play of economic motives to the supply of economic needs, as well as the prioritisation of man's self-love or expediency. On the contrary, an institutional change in a religious setting such as in a Muslim country is more likely to be legitimate where it is based on the conception of society as a community of unequal classes organised for a common end, and the contentions that it is wrong for one man to take advantage of his neighbour's necessity and entrepreneurs must appeal to religious

[75] Peter J Buckley and Mark Casson, 'The Moral Basis of Global Capitalism: Beyond the Eclectic Theory' (2001) 8(2) International Journal of the Economics of Business 303, 303.
[76] Giulio Gallarotti, 'Legitimacy as a Capital Asset of the State' (1989) 63 Public choice 43, 44.
[77] Mark C Schuman, 'Managing Legitimacy: Strategic and Institutional Approaches' (1995) 20(3) The Academic of Management Review 571, 574.
[78] Masahiko Aoki, *Toward a Comparative Institutional Analysis* (MIT Press 2001) 231.

standards in order to repress their economic appetites. The latter ideas reflect the economic and social realities of these countries and translate an ideological consistency. They are desirable, proper or appropriate within this specific socially constructed system of values, norms, and beliefs.[79]

This thesis therefore shows that the conception of liberalism, as posited by scholars such as Deepak Lal or the late twentieth-century capitalism as described by Buckley and Casson, explains why Islamic governments and even scholars do not advocate for liberalism. Such a conception may not serve as a measure of Islamic finance. Furthermore, Deepak Lal is arguably incorrect to suggest that the resistance to liberalism is because of anchored religious precepts or attitudes of a pre-industrial agrarian society.[80] Moreover, he patronises Islamic scholars and legislators by contending that the opposition of Islamic countries to globalisation (with a liberal bias) is 'based on the erroneous belief that adopting Western capitalism will also mean adopting Western ways of living, particularly in the domestic domain.'[81] Such contentions only seek to highlight Islam's apparent inherent unsophistication and support for ideas that are positively medieval. It is noted above that liberalism shuns governmental intervention because it has the effect of disturbing the spontaneous (supply and demand) equilibrium of the market place, reducing the autonomy of informed and rational consumers, while rendering market institutions vulnerable to competition-impeding interest group capture, rent seeking, and monopolies. However, Islam is favourable to free market and prohibits rent seeking, the exploitation of the poor and society as a whole, and creation of monopolies. It is noted above that liberalisation is an institutional change, and any institutional change that is not dictated by justice and efficiency considerations would not be legitimate.

Also, it is important to note that minarchist libertarians argue that Islamic law developed in opposition to the idea that the state is the prominent scholarly authority.[82] They note that the state must safeguard the plurality of the fiqh positions through the non-endorsement of any

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[79] For a critique of liberalism and a discussion of the importance of communitarianism in Islamic society, see Filippo Dionigi, *Hezbollah, Islamist Politics, and International Society* (Palgrave Macmillan 2014) 65-81.
[80] Deepak Lal (n 71) 7.
[81] Ibid, 8.
[82] Gerhard Bowering (ed), *The Princeton Encyclopaedia of Islamic Political Thought* (Princeton University Press 2013) 317.

specific interpretation or doctrine.[83] They therefore hold that the Qur'an is liberal and prohibits the imposition of Islam (Sura 2, v. 256), promotes private property (Sura 2, v. 188), requires promises to be kept (Sura 2, v. 177), and proposes several rules of commercial law (Sura 2, v. 282-283). The endorsement of the interpretations and doctrines of specific schools, such as the Saudi government's endorsement of the interpretations of the Hanbali school may be explained by the inclination towards statism whereby the Islamic state was required to codify Islamic law. Hence, it may be difficult to contend that a system setup by Islamic law may apply Basel III standards which are based on capitalism. As such, this thesis argues that Basel III requires states, including Muslim states to achieve specific results and does not dictate the means of achieving the results. Jones and Zeitz conducted a regression analysis and showed that Basel III standards require substantial modification before they can be fully implemented, and countries that pursue high levels of implementation are those in which large international banks operate.[84] The standards therefore require modification before they can be applied in Muslim countries despite the fact that Muslim liberalism has a strong resonance with Islamic tradition. As such, the Islamic economic system inspired by the Qur'an is not antithetical to capitalism.[85]

Hence, unlike conventional finance, it is not appropriate for liberalism to serve as a measure of Islamic finance, unless there are hermeneutic innovations that facilitate the institutionalisation of novel ideas about how liberalism can foster Islamic finance as a moral project of social change.[86] It may for example be argued that the liberalisation of capital movements and the consequent global integration of financial markets have facilitated the expansion of Islamic finance as well as ethical modes of investment and reduced the level of exploitation in business transactions. This contention is premised on the assumption that there is a causal link between the expansion of Islamic finance and the increasing emphasis on socially and ethically responsible investment. This link has been demonstrated by Anas and

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[83] Francois Facchini, 'Economic Freedom in Muslim Countries: An Explanation Using the Theory of Institutional Path Dependency' (2011) 15 Documents de Travail du Centre d'Economie de la Sorbonne 1, 16.
[84] Emily Jones and Alexandra O Zeitz, 'The Limits of Globalizing Basel Banking Standards' (2017) 3(1) Journal of Financial Regulation 89, 122.
[85] See Mohamed Aslam Haneef and Hafas Furqan, 'Developing the Ethical Foundations of Islamic Economics: Benefitting from Toshihiko Izutsu' (2009) 17(2) Intellectual Discourse 173, 176.
[86] See for example, Daromir Rudnyckyi, 'Assembling Islam and Liberalism: Market Freedom and the Moral Project of Islamic Finance' in Darmir Rudnycki (ed), *Religion and the Morality of the Market* (Cambridge University Press 2017) 160-176.

Mounira and Sorensen.[87] The emphasis on the efficiency considerations in the Islamic society reflects the institutionalist perspective discussed in chapter 2.

Hence, although the effectiveness of an institution is identified as a key metric of its success, effectiveness does not merely denote desirable market outcomes. Institutionalist theories as shown in chapter 2 tend to prioritise the responsiveness of a given institution, as evidenced by its capacity to react to dynamic market conditions and adjust its practices to reflect new social expectations and demands. This thesis shows that this is a more cogent approach to the use of liberalism as a measure of Islamic finance, and consequently the use of informal standards and corporate codes of practice of global public institutions, such as the Basel Committee, to assess Islamic financial institutions.

Previous studies have demonstrated that the Basel Accords are largely based on the neoliberal beliefs of self-regulation in free markets.[88] Sine Just for example notes that 'Basel III is, like its predecessors, caught in rhetorically charged performation struggles in which neoliberal principles continue to hold sway, and may, at best, be seen as postliberalism in the making.'[89] In a similar vein, Baud and Chapielo drew on Foucault's analyses of neoliberalism and concluded that 'the presence of disciplinary aspects in [the Basel Accord's] risk-based regulation should not necessarily be regarded as a "pathological drift" or a "subversion" from its initial neoliberal program, but rather as both neoliberalism's other face and its very condition.'[90] Thus, liberalism logically provides the theoretical framework within which the Basel Accords may be used to assess a system or financial institutions. However, it is shown in this thesis that the Basel framework is not based on assumptions which are value neutral. This raises the question of the appropriateness of the 'Basel solution' to the Islamic financial market. It is important that some Islamic practices or ideals should be adopted if Islamic finance has to be integrated into the centrally regulated economy of an Islamic State and

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[87] Elmeki Anas and Ben Arab Mounira, 'Ethical Investment and the Social Responsibility of Islamic Banks' (2009) 2(2) International Business Research 123, 123, 125; Bjorn Sorenson, 'Ethical Money: Financial Growth in the Muslim World' (2007) 23(4) American University International Law Review 647, 648-651.
[88] Henk Overbreek and Bastiaan van Apeldoorn, *Neoliberalism in Crisis* (Palgrave Macmillan 2012) 121;.
[89] Sine Norholm Just, 'The Negotiation of Basel III' (2015) 8(1) Journal of Cultural Economy 25, 25-41.
[90] Celine Baud and Eve Chiapello, 'Understanding the Disciplinary Aspects of Neoliberal Regulations: The Case of Credit-Risk Regulation under the Basel Accords' (2017) 46 Critical Perspectives on Accounting 3, 3. See also, Vanessa Redak, 'Risks, Ratings and Regulation: Toward a Reorganization of Credit via Basel II' in Peter Mooslechner, Helene Schuberth and Beat Weber (ed), *The Political Economy of Financial Market Regulation: The Dynamics of Inclusion and Exclusion* (Edward Elgar 2006) 208.

regulated in light of the Basel standards.[91] In order to achieve this, it is foremost necessary to ascertain the Islamic perspective on the causes of the global financial crisis that motivated the development of the comprehensive set of reform measures that became the third instalment of the Basel Accords. Previous studies do not provide a vivid picture of the Islamic perspective.

1.4.2 The Islamic Perspective

The literature on the causes of the global financial crisis focuses on the conventional model of banking.[92] Thus, in summary, it may be said that the crisis was caused by reckless mortgage financing whereby substantial lines of credit were issued to borrowers who were at a high risk of defaulting on their repayments; the inordinate appetite for assets at a grossly inflated market value; exposure to the moral hazard of under-pricing lending risks, which entailed the even greater risk of multiple defaults across a chain of borrowers; extraordinarily high liquidity that facilitated the deployment of new financial instruments such as Collateralised Debt Obligations (CDOs) in order to conceal their losses or risk exposure; financial institutions leveraging risk against yet more risk, by issuing Credit Default Swaps as insurance against collateralised debt obligations; and finance ministries and regulatory bodies being largely unaware of levels of debt accumulated in the increasingly saturated market because financial entities were not required to disclose these assets on their balance sheets under the relevant legislation.[93]

Kayed and Hassan have argued that such a crisis could not have originated in an Islamic State because most, if not all, of the factors that contributed to the development or spread of the crisis are prohibited by the principles of the Shariah.[94] This aligns with the above argument that the capital adequacy ratios of Islamic banks are comparatively much higher than those of conventional banks because of the lack of subordinated debt and hybrid and callable capital structures in Islamic markets.[95] Hence, with the prohibition of interest-based mechanisms and the securitisation of nominal assets that seek to transfer rather than share risks, and the requirement that nominal transactions should be backed by real transactions, Islamic financial

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[91] Robert R Bianchi, *Islamic Globalization: Pilgrimage, Capitalism, Democracy and Diplomacy* (World Scientific Publishing Co 2013) 77-78.
[92] See Chapter 2
[93] A critical examination of these causes in the literature is carried out in chapter 2.
[94] Rasem N Kayed and M Kabir Hassan, 'The Global Financial Crisis and Islamic Finance' (2011) 53(5) International Business Review 551, 551-552.
[95] See (n 60) and (n 62).

institutions are less likely to induce a crisis.[96] This is supported by the fact that some studies show that Islamic banks performed better than conventional banks during the crisis. Akhtar and Jahromi for example sought to determine the impact of the global financial crisis on Islamic and conventional stock and bond indices in eleven countries and concluded that Islamic stocks performed better in the early stage of the crisis because the Shariah prohibits the holding of sub-prime mortgage securities and derivatives.[97] However, the benefits became less significant as the crisis became global. Nonetheless, their findings may be interpreted to the effect that recommendations for regulations in the banking industry such as the Basel Accords should not apply to Islamic banks given that the Islamic model is better structured to deal with unexpected losses.[98]

Notwithstanding, the above studies do not show that Islamic banks are entirely immune to the effects of a global financial crisis. Banks in different countries and regions can be connected by financial obligations and claims. Thus, defaults of international conventional banks may lead to defaults or failures of Islamic banks that are connected to the former. This explains why the housing market and banking system of Dubai were adversely affected by the global financial crisis.[99] Hence, it may be submitted that the impact of the financial crisis in Muslim-majority countries was proportionate to the connectedness of the countries' banks to international financial systems.[100] That is why banks in Bahrain for example were more adversely affected by the global financial crisis than banks in Oman or Saudi Arabia.[101]

Also, some studies have shown that many Islamic banks were adversely affected by the global crisis. Solaiman et al for example assessed the productivity, scale and technical efficiency of eleven commercial banks from the Saudi banking sector during the 2007/2009 global financial crisis and found that only one, out of the eleven banks, was efficient during

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[96] Muhammad Ashfaq, 'Impact of Global Financial Crises on Global Financial Stability and Need for an Alternative Financial System' (2016) 2 Poslovna Izvrsnost Zagreb 109, 113-115; Nauman Ejaz and Hayat Khan, 'The Underlying Cause of the Global Financial Crisis: An Islamic Perspective' (2014) 33(1) Economic Papers 45, 45-46.

[97] Shum Akhtar and Maria Jahromi, 'Impact of the Global Financial Crisis on Islamic and Conventional Stocks and Bonds' (2017) 57(3) Accounting & Finance 623, 623.

[98] Elisabetta Montanaro, 'Islamic Banking: A Challenge for the Basel Capital Accord' in Fahim Khan and Mario Porzio (eds), *Islamic Banking and Finance in the European Union: A Challenge* (Edward Elgar 2010) 112-113, 123.

[99] Filip Zembowicz, 'Remodeling Dubai' (2009) 30(4) Harvard International Review 12, 12-13.

[100] See Juliane Brach and Markus Loewe, 'The Global Financial Crisis and the Arab World: Impact, Reactions and Consequences' (2010) 15(1) Mediterranean Politics 45, 51.

[101] See May Y Khamis, Abdullah Al-Hassan and Nada Ouidi, The GCC Banking Sector: Topography and Analysis (IMF 2010) 6.

that time.[102] They then concluded that their findings reveal that the banks are not immune to a global crisis.[103] Singh et al also investigated the impact of the global financial crisis on the efficiency of the top 49 banks in the Arab world as per Forbes' list of top 100 companies.[104] The study reveals that the banks were largely technically inefficient during the crisis due to their close ties with the international financial system.[105]

As such, a causal link may be established between financial crises and speculation and monetary expansion, inefficient regulation, and the rise and sudden fall of asset prices. In this light, recommendations for regulations in the banking industry such as the Basel Accords should apply to Islamic banks since they may be adversely affected by inefficient regulation and the rise and sharp fall of asset prices. It must be noted that a financial crisis is not only induced by predatory lending, charging of excessive interests, and speculative derivative trading as was the case of the 2007/2009 global financial crisis. Although the banking sector of a country such as Saudi Arabia was largely unaffected by the global crisis,[106] the Kingdom's stock market collapsed in 2006, with its main index, the TASI, losing about 65 per cent of its value and market capitalisation falling by half.[107] Data published by SAMA revealed that prior to the crash of 2006, retail traders who were involved in two-thirds of the trading volume on the stock exchange, the Tadawul, were buying on margin. As a result, personal debt levels increased significantly between 2002 and 2006; interest-free loans for purposes other than real estate or durable goods rose five times between 2002 and 2005; and many middle-class investors with very little experiences liquidated their life savings to buy stocks in the bull market.[108]

Furthermore, prior to the crash, a study conducted by the Saudi Chamber of Commerce[109] revealed that the stock market was not efficient because information influencing the value of listed companies was not reflected in the price of their stock, noncompliance with disclosure

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[102] Golam Solaiman et al, 'Bank Efficiency in Saudi Arabia: Examining the Impact of the Global Financial Crisis' (2017) 1(4) Central European Review of Economics and Management 69, 84.
[103] Ibid.
[104] Baljeet Singh et al, 'Impact of Financial Crisis on Banking Sector Efficiency in the Arab World' (2017) 7(1) International Journal of Development and Conflict 49, 49.
[105] Ibid.
[106] Mohammed M Ramady, *The Saudi Arabian Economy: Policies, Achievements, and Challenges* (2nd edn, Springer 2010) 111.
[107] Josh Lerner, Ann Leamon and Steve Dew, *The CMA and the Saudi Stock Market Crash of 2006* (CMA 2017) 11.
[108] Ibid, 13-14.
[109] Saudi Chamber of Commerce, *The Extent of the Efficiency of the Local Stock Market and its Role in Supporting the National Economy* (Chamber of Commerce 2005) 24.

rules was not severely punished making it difficult for potential investors to access information about listed companies, and traders were able to influence stock prices because of the small stock floats for the listed companies.[110] Following calls for an increase in the number of brokerage and analysts firms and the reduction of government-owned listed companies, the CMA adopted the International Financial Reporting Standards (IFRS) in 2012 that serve as global guidance for publicly-traded companies. It follows that Islamic institutions generally face similar supervisory and regulatory challenges as conventional institutions and require effective prudential regulation.

Thus, this thesis argues on the one hand that recommendations for regulations in the banking industry such as the Basel Accords should apply to Islamic banks, and then seeks to determine on the other hand whether the gaps in Saudi Arabia's legislation can be remedied by the direct transposition of Basel standards into its national legal system. The main regulatory challenge in Saudi Arabia, like many other Muslim countries, involves determining the severity of risks that are related to the modes of financing and instruments used by banks, as well as assessing the correlation between the products of banks and their capacity to identify and mitigate risks.[111] The objective here is therefore to determine whether the Basel Accords have helped banks in Saudi Arabia to overcome this challenge; what is the impact of the capital, liquidity and leverage ratios of Basel III on the stability of banks in Saudi Arabia. Sami Naceur and Magda Kandil examined the link between the implementation of Basel I and lending activities in five Middle Eastern countries (not including Saudi Arabia) between 1989 and 2004 and found that there was a significant increase in credit growth following the implementation.[112] Akhtar and others however argue that the liquidity risk requirements of Basel III will adversely affect Islamic banks because they cannot transfer their surplus liquidity to conventional banks or those that are Shariah-noncompliant.[113] Furthermore, Beck and others hold that Basel III is counterproductive for

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[110] See also, Abdullah I Ashikh, 'Testing the Weak-Form of Efficient Market Hypothesis and the Day-Of-The-Week Effect in Saudi Stock Exchange: Linear Approach' (2012) 8 International Review of Business Research Papers 27, 8; Batool Kasim Asiri and Hamad Alzeera, 'Is the Saudi Stock Market Efficient? A Case of Weak-Form Efficiency' (2013) 4 Research Journal of Finance & Accounting 35, 41.

[111] See Abdulaziz Sharbarly, Risk Regulation in Islamic Banking: Does Saudi Arabia Need to Adopt the Risk Regulation Practices of Basel (Unpublished Thesis, University of Westminster 2016) 131; Simon Archer and Abdullah Haron, 'Operational Risk Exposures of Islamic Banks' in Simon Archer and Rifaat AA Karim (eds), Islamic Finance: The Regulatory Challenge (John Wiley & Sons 2007) 52.

[112] Sami Ben Naceur and Magda Kandil, 'Has the Basel Capital Requirement Caused Credit Crunch in the MENA Region?' (2013) 5(2) Middle East Development Journal 1, 30-31.

[113] Mohamad F Akhtar, Ali K and Sadaqat S, 'Factors Influencing the Profitability of Islamic Banks of Pakistan' (2011) 66 International Research Journal of Finance and Economics 125, 130.

Islamic banks because of the limited access to liquidity during crises owing to the constraints on the selling of debt imposed by the Shariah.[114] The liquid assets of Islamic banks may only be equity, and in most Muslim countries, there is a shortage of liquid assets that are equity-based. Thus, it is important to determine whether the findings of the above studies are true regarding the implementation of Basel III in Saudi Arabia.

1.5 Significance of the Contribution

This thesis aims to evaluate the resilience of Saudi Arabia's model of finance regulation in the aftermath of the global financial crisis, specifically by comparing how Islamic and conventional banks perform under the same pressures. While these propositions have been addressed to some extent in the existing research, the predominant focus has been on financial and economic perspectives. This research adopts a regulatory perspective and approach to understanding the normative and operational aspects of both Islamic and conventional banking systems and it considers how such differences contribute to their ultimate sustainability.

The central armature of this thesis is that economic policies cannot be effectively implemented without sound laws and governance. This research will aim to demonstrate that Saudi regulatory authorities have yet to follow the lead of other advanced Islamic finance economies such as Malaysia. This comparative angle invariably draws the reader's attention to the hybrid nature of Saudi Arabia's finance system and regulatory elements. In the Saudi context, norms and standards borrowed from international organisations such as Basel sit alongside Islamic finance standards, techniques and instruments. The latter of these include, for instance, the decisions of so called Shariah advisory boards in Saudi banks, and standards developed and advanced by the Islamic Financial Services Board (IFSB), or the growing market in Saudi Arabia for Shariah compliant bonds, known as Sukuks.

The relationship between Islamic and international finance instruments and norms is an uneasy one. Since the paradigmatic model of banking in the West is based on the relationship between an interest taking lender and the interest paying lender, it is sharply apparent that there are fundamental differences between Islamic concepts of banking and their

[114] Thorsten Beck and others, 'Islamic vs. Conventional Banking: Business Model, Efficiency and Stability' (2013) 37 Journal of Banking & Finance 433, 445.

conventional counterparts.[115] This thesis will, however, seek to scrutinise and problematise the claim that Saudi Arabian banking institutions are always compliant with Shariah governed principles of Islamic law, and even if all banks in Saudi were fully compliant with Shariah principles then this would automatically render them more efficient, or ethical, than conventional banking systems in the West.[116]

Islamic banks are not immune to risk, and it would be misleading to suggest, though it is often implied, that Islamic banks do not fail. Poor risk management has not caused a failure in the Saudi banking system so far, when it is liquid, because of oil revenues. However, the Saudi government cannot afford to be complacent, or it may find itself in a similar position to Dubai, should its oil revenues run out.[117] The effects of the real estate crisis in Dubai is pertinent; the accumulation of debts with Dubai banks, and the resulting liabilities, were ultimately passed to savers, who suffered a loss of around 25% to funds held in depositors' accounts. Dubai was rescued from a major liquidity crisis and sovereign default only because of a capital injection from one of its shareholders, the Abu Dhabi Islamic Bank.[118]

Leaving aside the merits and deficiencies of Islamic banking, as judged by its efficacy or legitimacy, the Islamic influence on the Saudi banking sector raises challenges of a more systemic kind. At the same time, it is arguable that 'gaps' in governance, at the level of national law or in specific institutions, are not always best addressed with one size fits all solution. Banking regulations might be perceived as legitimate and effective if the measures applied are appropriately tailored to the specific asset and risk profiles of specific banks, be it Islamic or conventional. Just as the risky lending practices of a handful of banks can trigger a global banking crisis, then ineffective, excessive, or poorly designed state-regulation can stifle innovation, competition, and efficiency in local and national banking sectors.[119] From a

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[115] Yusuf Karbhari, Kamal Naser, and Zerrin Shahim, 'Problems and Challenges Facing the Islamic Banking System in the West: The Case of the UK' (2004) 46(5) Thunderbird International Business Review 521, 523-524.

[116] M Mansoor Khan and M Ishaq Bhatti, 'Development in Islamic Banking: A Financial Risk-Allocation Approach' (2008) 9(1) Journal of Risk Finance 40; Abdullah Saeed, *Islamic Banking and Interest: A Study of the Prohibition of Riba and its Contemporary Interpretation* (Brill 2008) ch 1.

[117] Candemir Baltali and Joseph Tanega, 'Basel III: Dehybridization of Capital' (2011) 8(1) New York University Journal of Law & Business 1.

[118] Dato' Sri Zukri Samat, *Islamic Banking: The Lessons and Challenges in Malaysia & Beyond* (Association of Islamic Banking Institutions Malaysia 2010) 21.

[119] Hania Abou Shamat, 'Openness and Rigidity of Islamic Law: Jurists' Motives for Change within the Islamic Legal System' (15th Annual Conference of the International Society for New Institutional Economics, Stanford, 18 June 2011) 5-7.

legal pluralist standpoint,[120] an attempt to transpose unifying standards to diverse legal and normative contexts will invariably have to be balanced against respect for the autonomy of national laws, cultures, and traditions. How then can the (value orientated) assumptions underlying the Basel framework on risk regulation be reconciled with the unique features and risk profiles of Saudi Arabia's market and Islamic finance?

1.6 Research Questions

In light of the above identified problems and 'gaps' in research, this thesis will propose to answer the following questions:

1. How successfully has Saudi Arabia implemented the Basel standards within its legal framework on banking and risk regulation?
2. How can Saudi Arabia Reconcile Shariah and Basel Standards to strengthen the resilience of is banking sector?

This thesis will employ critical and comparative analysis, and will draw on relevant theories to provide support and justification for the claims described.

1.7 Methodology

An attempt to examine banking regulation within the confines of the legal system of Saudi Arabia is invariably a herculean task. A further complicating factor is that Saudi Arabia plays host to a dual banking system from within, wherein Islamic and conventional banking institutions compete, though not always on a level playing field. A comprehensive and comparative analysis of the regulatory models and objectives of each distinct model will be undertaken, and an assessment made of the relative performance of Islamic and traditional banks in Saudi Arabia. This analysis will focus on the risk mitigating effects of Basel III implementation in this regard. In the final analysis, this study is future facing in that it is chiefly concerned with proposing specific legislative and institutional reforms to the existing banking and corporate governance framework in Saudi Arabia.

[120] For a general discussion see Sherman A Jackson, 'Legal Pluralism between Islam and the Nation-State: Romantic Medievalism or Pragmatic Modernity?' 2006 30(1) Fordham International Law Journal 158, 163-165.

The study will conclude by defending wider reforms of the Saudi Arabia legal system and the Islamic finance market model, highlighting the need, and growing demand, for strengthened transparency, predictability, and generality of rules and standards across all aspects of finance law and governance. If these reforms are implemented, Saudi Arabia may well emerge as a leader in the region, paving the way for further integration between Basel and Islamic finance standards. The future sustainability and resilience of Saudi banks in a changing economy will, it is argued, be greatly strengthened by these reforms.

These above claims and propositions will be supported and demonstrated through use of various methodologies as follows: doctrinal analysis, institutional theory and comparative analysis.

Firstly, this research engages a doctrinal analysis of the laws and regulations applicable to financial institutions operating in Saudi Arabia, encompassing a textual legislative interpretation of the relevant laws and measures as well their application over time.[121] A doctrinal analysis is applied to the specific questions identified in this thesis, for the purposes of identifying the strengths and weaknesses of the Saudi Arabian banking sector. The study will offer an assessment of whether national Basel implementation measures are likely to minimise, mask, or even deepen the 'gaps' between Saudi financial legislation and its judicial enforcement. This information can is then use to discover what regulatory reform proposals can be implemented to improve risk management policies in the future.

This thesis will consider the effectiveness of the Basel implementation processes in Saudi Arabia. This enquiry raises questions of a practical nature, such as: do Saudi banks comply with Basel norms because of Saudi judicially enforceable domestic law? Questions about the formality or binding nature of international financial norms are of practical importance to those with an interest in a stable and increased globalised financial system. But the stability and soundness of the financial system often implicate issues of a more normative nature. Indeed, a preoccupation with the 'effectiveness' of a particular banking regime, national or international, can divert focus away from the justice of outcomes. It is in this respect that this thesis aims to assess the legitimacy of the current regulatory framework in Saudi Arabia, as well as its effectiveness.

[121] Terry Hutchinson, 'The Doctrinal Method: Incorporating Interdisciplinary Methods in Reforming the Law' (2015) 3 Erasmus Law Review 130.

Drawing on the diverse strands of new institutional and governance theories, including the growing influence of theories on regulatory pluralism and harmonisation, this thesis will consider the ideals and assumptions underpinning conventional and Islamic banking systems and will situate these within wider theories on law and market regulation. More importantly, it is only by systematically deconstructing the value assumptions underpinning these regulations, and their underpinning models, that we can acquire a more nuanced insight into the relationship between the objective goals of these respective systems and the internal workings of financial institutions at the level of practice.[122] These broader debates provide the necessary context in which to examine the rules and purposes of each distinct model, both Islamic and conventional: where one stresses ethics, the latter is assumed to emphasise the lean and mean values of the marketplace, such as efficiency, effectiveness, and economy. The actual practice of Islamic banks is less clear cut. In the global market place, moreover, Islamic banks need to be efficient too.[123]

In addition to the doctrinal textual and critical conceptual analyses, this study will utilise a comparative methodology to assess how Saudi Arabia's banking regime and Basel implementation processes compare with equivalent laws and processes in Malaysia. Through this analysis, the study will reflect on the comparative success of the Malaysian Islamic banking system and will contrast this with the legal experience in Saudi Arabia. In justification of this claim, Malaysian approaches will be contrasted with aspects of Saudi Arabia's banking law, including the Basel implementation processes. The Malaysian Islamic finance banking sector will be examined with a view to assessing the efficacy of its implementation of Basel related capital adequacy standards and ratios. The relative strengths of Malaysia's approach to risk management, vis-a-vis its Saudi equivalents will, accordingly, be discussed and scrutinized.

Malaysia has been selected as the regime for comparison for several reasons. The first relates to the pioneering role it has played in harmonising Basel and Islamic financial standards. In this regard, Malaysia is the first South-East Asian country to establish a Shariah compliant

[122] Terry Hutchinson and Vale Bunny Watson, 'Law Librarian, Law Libraries and Legal Research in the Post-Internet Era' (2014) 106(4) Law Library Journal 579, 584.
[123] Dennis Charles Pearce, Enid Mona Campbell and Douglas Edison Harding, *Australian Law Schools: A Discipline Assessment for the Commonwealth Tertiary Education Commission* (Australian Government Publishing Service 1987) 312.

legal and financial framework in which Islamic banks can flourish and compete.[124] The comparative sections of this thesis will seek to demonstrate that, unlike Malaysia, Saudi Arabia currently lacks a framework dedicated to the standardisation of Islamic banking regulations and supervision practices.

Secondly, the comparative study will seek to demonstrate that the Malaysian banking and risk regulatory regime has generally been more effective in addressing and overcoming the implementation and enforcement challenges identified in the Saudi system. Malaysian markets have benefited from higher levels of stable growth, in large part because they are structured by regulatory processes which are more fully embedded in a well-defined and transparent legal and institutional framework.[125] Saudi Arabian banks have yet to fully internalise corporate governance related discourses. A related problem is that the Saudi capital market and banking regulators have generally underused their oversight and enforcement powers in the above regard.[126]

A third reason for selecting Malaysia relates to the performance of its banking sector. Malaysian banks, both Islamic and conventional, have remained competitive and have proved adaptive to market shocks and pressures. One reason given in support of the apparently more developed nature of Malaysian markets are the similarities its shares with conventional banking models and systems. Malaysian banks tend to demonstrate higher levels of compliance with professional standards relating to prudential risk and supervision. The economic policy of the Malaysian government is generally based on the free-market principles of openness, privatisation, and competition. The comparative discussion will, therefore, reflect on the close relationship that exists between the consistent enforcement of banking and corporate governance laws and the stability of markets.[127]

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[124] BNM, ‘Reports on Financial Reporting and Corporate Governance Related Requirements’ (BNM/RH/CP 032-2, 31 October 2014) 6, 24 <http://www.bnm.gov.my/guidelines/01_banking/02_financial_reporting/Financial%20Reporting.pdf/> accessed 2 October 2016.

[125] Howard Davies, ‘Islamic Finance and the UK Financial Services Authority’ (Conference on Islamic Banking and Finance, Bahrain, 2 March 2003) 104, 104-105. It should be noted that the FSA has been dissolved and no longer exists.

[126] H Fathiyah, ‘Capital Structure and Performance of Islamic banks and IBS Commercial Banks in Malaysia’ (National Seminar on Islamic Banking and Finance, KUIM, 29-30 August 2006).

[127] Zuriah Abdul Rahman, Rosylin Mohd Yusof and M Shabri Abd Majid, ‘The Role of Goods, Money and Securities Markets in Promoting Family Takaful in Malaysia’ (2009) 2 International Journal of Monetary Economics and Finance 317, 318-321.

Drawing on the interdisciplinary aspects of studies in this area to date, the above observations are supplemented by quantitative and qualitative statistical data derived from economic surveys and reports charting the performance of finance sectors before and after the global financial crisis. Crucially, these observations enable us to make certain predictions of how certain pressures are likely to affect the performance and stability of banks and banking sectors. These insights prove illustrative when considering the vulnerabilities and exposures of Saudi banks in the years to come.

Combined, the above methodologies are applied to the analysis as a basis from which to recommend actionable legislative reform proposals that can be implemented at the level of international and national (banking) in order to improve risk management practices.

1.8 Theoretical Framework

As fleshed out in Chapter 2, the overarching theme or aim of this thesis is to examine the values or 'logic' underpinning these different regulatory models. Viewed and interpreted through this lens, this thesis will seek to problematise two prevailing assumptions. The first is that, because Saudi Arabia continues to comply with Basel standards and has taken efforts to implement Basel by implementing national legislation, it is does not face significant risk exposure. The second claim this thesis seeks to problematise is the uncritical assumption that Islamic banks are 'too ethical to fail'.

By foregrounding its analysis in a wider discussion of the theories of market and market regulation, this thesis will reflect on the extent to which the dual banking system in Saudi Arabia has helped to further the goal of legal certainty, while protecting the rights of market participants. Regulatory certainty and clarity has played a significant role in the growth and stability of the Malaysian banking sector, which is more firmly embedded in constitutional and hierarchical laws, rights protections, the separation of powers, and judicial precedent and oversight. Consumers and banks benefit from regulation under a system which has more effectively balanced the Islamic principle of distributive justice with liberal 'free-market' principles. Of course, the Malaysian banking sector is not without its limitations and challenges, and these issues will be discussed in the comparative sections. In the final analysis, it will be argued that Saudi Arabia has the potential to become a hub of foreign investment and Islamic banking, should it implement the necessary reforms. This thesis will propose recommendations, focusing on the rights of different stakeholders in the Saudi

banking sector, on the one hand, and the responsibilities of financial institutions and their regulators, on the other.[128]

1.9 Limitations of Study

One significant limitation of the research undertaken was the availability of updated and comprehensive data on Saudi banks or on the Basel implementation processes. Moreover, Saudi banking and dispute settlement authorities do not widely publish their decisions. A system of judicial precedent has not been established in Saudi Arabia, and case law is scant. Furthermore, one substantive issue addressed by the thesis is the failure to standardise Islamic finance rules, or rules on auditing and disclosure. Saudi banks, therefore, are not under a strict obligation to disclose their finance statements. Accounting rules are similarly variable from one bank to another, despite attempts to develop common Shariah compliant standards. Malaysia was therefore selected due to the availability of data on regulation, risk management, and accounting practices from 1997 to 2016.

Based on an analysis of the history and development of the regulated market on Shariah compliant finance in Malaysia, it is suggested that the Malaysian models of risk regulation are, in fact, broadly comparable to those applied under Basel, and those currently being implemented in Western markets. However, there are clear differences between conventional banking models and the structure of Islamic financial products. By linking theory to a practical analysis of laws which govern subjects in Malaysia, compared with those which operate in Saudi Arabia, this thesis will explain the differences between conventional and Islamic banking schemes with reference to Islamic finance principles that govern the latter's operation and enforcement.[129]

1.10 Structure of Thesis

This thesis will be structured as follows.

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[128] Swedish Export Credits Guarantee Board, 'Saudi Arabia – Country Risk Report' (*EKN*, 14 May 2013) 1, 4-5 <http://www.ekn.se/Global/Landriskanalyser/Mellan%C3%B6stern/Engelska/Saudiarabien2013EngExtern.pdf/> accessed 14 May 2013.

[129] S Nazim Ali, 'Islamic Finance and Economics as Reflected in Research and Publications' (2008) 12 Review of Islamic Economics 151, 152.

Chapter Two will present a doctrinal and institutional analysis of Saudi Arabia's banking laws and associated laws, in a wider historical and theoretical context. This chapter will explore the reasons why market mechanisms failed in the run up to the global credit crisis, and why these events prompted the Basel Committee to introduce stricter capital and liquidity standards under the revised Basel III framework. By drawing on (neo-liberal and utilitarian) theories of market regulation and neo-liberal models of governance, this chapter will proceed to examine the intellectual and normative foundations of the modern systems of global finance and banking law, which find their origin in classic and neo-classical perspectives about the boundaries between public regulation and private order. These ideas are also implicitly reinforced and 'universalised' through harmonisation and other commercial customs of which the Basel framework is a prime example. These will then be compared with the theories and models that underpin Islamic models of finance and finance regulation, which purport to offer an 'ethical' alternative to the utilitarian logic of global financial architecture. By applying critical analysis, this chapter will proceed to identify key the limitations of Islamic and conventional banking models, to prepare the ground for a discussion of the gaps in Saudi legislation, focusing on the necessary relationship between stable markets and legal certainty vis-a-vis the 'rule of law' and sound corporate governance. In this regard, Chapter Two serves as a literature review and presents a theoretical framework.

Chapter Three is a foundational chapter in that it assesses the pertinent features of the Saudi legal system, and its relevant instruments for financial and banking regulation. Building on this discussion, the chapter assess the 'common law' and the influence of Shariah law on current banking practices and dispute settlement procedures. This chapter will reflect on the duality of the Saudi legal system and banking sector, placing emphasis on how capital markets and banking authorities approach conventional banking practices which are not strictly compliant with Shariah principles and precepts. The later sections will present an empirical and statistical analysis. The composition of the Saudi banking sector will be explored with the purpose of illustrating the ratio of Islamic to conventional banking assets and institutions, as well as the short-term performance of respective sectors in Saudi Arabia. This chapter will conclude by noting the challenges surrounding the inconsistent application of Shariah related principles and the legal compliance risks this creates for conventional banking institutions, products and instruments. The chapter also establishes the groundwork

for a discussion of the more unique aspects of Islamic finance instruments and the associated risks.

Chapter Four expands on the idea that Islamic finance institutions are vulnerable to capital loss risks, due to their dependence on equity based assets. This chapter offers an introductory discussion of the core instruments and principles of Islamic finance. Many of these instruments are championed because of their basis in profit and loss sharing arrangements, thereby ensuring that risk is distributed equitably and responsibly among all profiting partners. Islamic finance institutions, instruments, and products are vulnerable to risks which may be different, in degree and nature, from those experienced in conventional banking settings. Investors in Islamic finance arrangements may be particularly exposed to equity loss risks, while Islamic banks are susceptible to losses stemming from existing investor risks as well as counterparty default risks, among others. At the crux of this chapter is an attempt to demystify Islamic finance concepts, while also debunking the claim that Islamic finance institutions are more 'ethical', or, at the very least, as ethical in practice as they required to be under Shariah law. This discussion provides the groundwork for a discussion on how the specific ways in which the Basel banking supervision and risk regulation framework is not ideally suited to Islamic finance risk exposures.

Chapter Five offers a detailed discussion of the Basel framework, focusing on successive phases of revision to the original Basel Accords (Basel I) through the most recent changes adopted under Basel III, in the wake of the financial crisis. The technical aspects of the Basel framework will be detailed, including the increase in capital and liquidity baselines. The analysis will show that Islamic finance institutions and banks have generally met, or even exceeded, Basel technical requirements. While Islamic finance institutions have, because of religious restrictions, largely escaped the sorts of credit risks that conventional banks were exposed to (due to the exploitation of leverage and under-regulation of the securities market), then mere compliance with technical risk ratios and capital measurement requirements is not sufficient to guarantee that an Islamic bank will not suffer similar losses or, even, failure. Pursuing this line of enquiry further, this thesis will argue that the Basel III framework, whilst a necessary step, suffers from certain deficiencies which are likely to disproportionately impact Islamic banks in Saudi Arabia. The first is, as mentioned previously, that Basel III is modelled on risks associated with debt based banking, which does not take account equity imbalance in the asset portfolios of Islamic banks. The second

deficiency, which ties into a discussion about the 'gaps' in Saudi banking, finance law, and regulation, reflects on a narrow procedural approach adopted by the Basel Committee on wider issues of corporate governance and social responsibility. Transparency in market disclosure and its related procedural disciplines are part of the Basel framework on banking supervision, but these issues are not addressed in a holistic way. This bears relevance to the Saudi legal system, since the stability and viability of local finance markets and institutions can only be achieved through corporate governance and related reforms.

Chapter Six will examine the strengths of the Malaysian sector and highlight how the Malaysian authorities have attempted to develop standards that integrate harmonised international banking regulation standards with the local norms of Islamic finance authorities and standard setting bodies. This chapter provides a general overview of the relative strengths of Malaysian banking law regime and a dual banking sector, which will be contrasted with the notable deficiencies in the Saudi Basel implementation processes.

Chapter Seven takes the form of a discussion. Blending insights from previous chapters, this chapter settles on the conclusion that the Basel standards cannot be effectively implemented or risk mitigated, in the absence of wider private and public law reform. This chapter will focus in more detail on the specific ways in which Saudi Arabia might experience systemic risks, in part because of its failure to standardise disclosure and auditing rules for all Saudi banks, or introduce greater oversight and rights protection for those affected by the decisions of bank managers and directors.

Chapter Eight presents the conclusion. This chapter outlines recommendations for the future reform of the Saudi banking sector, focusing on three main issues: measures aimed at enhancing the application of Shariah to conventional and Islamic banking practices, with the aim of introducing a more transparent culture of corporate accountability and the development of country-wide standards which allow for the adaption and implementation of Basel III standards in Saudi Arabia in a manner that best reflects its dualistic legal systems and changing economy.

Chapter II: Theorising Banking: A Theoretical Framework

2.1 Introduction

As suggested in the previous chapter, this thesis is devoted, primarily, to an investigation of the efficacy of Saudi Arabia's implementation of Basel III and its impact on Saudi Arabia's mixed banking sector, in which Islamic and conventional financial institutions operate alongside each other with varying degrees of success. Before we can examine the efficacy of Saudi Arabia's finance architecture and its implementation of global banking norms under the Basel III framework, it is important to first foreground and provides a background to these questions touching on wider theoretical debates surrounding the legitimate purposes of the market economy and the proper boundaries of its regulation. Set against the backdrop of the forces of globalisation, liberalisation and privatisation, this chapter examines the explicit, or implicit, assumptions that underpin theories on the role and function of law (and the state) in constraining market institutions and correcting market failures. Two seemingly opposed theories on the role of law in market regulation will be contrasted and critically questioned: the neo-liberal model of governance and the Islamic socio-economic model of market regulation.

If we take neo-liberal concept of market function as our starting point, we can say that the free-market system is fundamentally oriented to the utilitarian philosophy of unlimited consumption. By the same token, the contemporary defence of free markets find their roots in the theories of classic liberalism and the state/market boundaries on which such theories depend. In the classic liberal's worldview, a sharp boundary separates the public and private spheres. In this concept, a 'naturalised' economic sphere floats free of the political realm constituted by governments. The Islamic economic system, by opposition, is assumed to be highly integrative. In accordance with Islamic legal philosophy, no boundaries are assumed to exist between the state, the market and the individual, since all are governed under a common system of rules and regulations.

This analysis will throw critical light on the above assumptions, by exploring the causes of the financial crisis, the regulatory response to this crisis as embodied by the Basel framework

on risk regulation, and the conflict between neo-liberal assumptions on which the Basel model is based, as compared with its Islamic alternative.

2.2 The Causes of the Global Financial Crisis

Basel III was the product of an emerging international consensus based on an understanding that global risk regulation standards had failed to prevent, or predict, the global financial crisis of 2007/2008.[130] It almost seems hard to believe that the actions of a handful of market actors operating within a specialised segment of the market in mortgage financing, and governed under the laws and jurisdictional control of the United States, catalysed a financial crisis of global dimensions, but this is the truth and the events have to be explained.

One of the reasons of the financial crisis was represented by the imbalances at macro levels which had increased rapidly in the last ten years and the financial market advances and new instruments that were influenced by the imbalances.

Countries in East Asia that exported oil, such as Japan, China and other emerging developing nations in that region had accumulated a current account surplus. At the opposite side of the spectrum, countries such as the USA, UK and Spain had experienced significant current account deficits.

In a global world, marked by trans-national flows of trade, people, capital and investment, financial institutions are highly interdependent. Financial entities will purchase shares in other companies, and acquire portfolio investments in stock exchanges in markets around the world. Through these and other investments, they will own stakes in the future performance and losses of companies and in global trading markets. Financial interdependence is both the engine and lubricant of global money markets.[131] The global distribution of trade, wealth, and investment across state borders has produced miraculous results, disrupting and subverting old economic hierarchies between the developed and developing world, and between producers and exporting countries

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[130] See Emily Lee, 'Basel III: Post-Financial Crisis International Financial Regulatory Reform' (2015) 28(11) Journal of International Banking Law and Regulation 433, 433; Ranjit Lall, 'From Failure to Failure: The Politics of International Baking Regulation' (2012) 19(4) Review of International Political Economy 609, 625-626; Stefan Schwerter, 'Basel III's Ability to Mitigate Systemic Risk' (2011) 19(4) Journal of Financial Regulation and Compliance 337, 337.

[131] See, eg, Financial Services Authority, 'The Turner Review: A Regulatory Response to the Global Banking Crisis' (March 2009) 3.

There is, of course, a clear downside to financial integration. In this respect, the term 'global' can signal something 'important' about the consequences of market behaviour on the regulatory power and authority of nation states.[132] The localised actions of a few market actors, in other words, can penetrate deeply within the nation state to affect its economic and social policies, as well as impact the lives and livelihoods of its citizens. Under the dual banking systems of Western political economies such as the US, state-chartered banks are governed by state banking law, while being regulated at a sector level by a national banking regulatory agency. Finance lawyers are keenly aware of the challenges associated with these developments. The first is the general trend from 'command and control' governance, which entails direct oversight by state legislatures and courts, to a more deregulated approach towards the finance sector.[133] The second is the equally challenging trend from centralised or 'universal' models of banking regulation, towards introducing a more decentralised (or fragmented) model of governance, in which an authority is pooled or 'fragmented' within a multiplicity of financial and banking bodies. Yet, this development too has the potential to destabilise the project of sound global financial governance.

Since financial policies are intimately connected with 'macro-prudential' market stability regulations,[134] the move towards sector fragmentation appears to be especially problematic.[135] Peter J Wallison reaches the conclusion that overlapping jurisdictions where regulatory agencies assert authority over the regulation of hybrid products, including the complexly regulated field of derivatives and securities, "will create great distractions for the regulators and chaotic regulatory policies for the financial services industry."[136] Moreover, regulators will articulate fragmented, even conflicting policies, opening the door to, "regulatory arbitrage-that is, products will be designed to avoid regulation."[137] With these transformations (noted by several commentators) the aspirations embodied by the 'Welfare

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[132] Joint Statement of the Shadow Financial Regulatory Committees of Asia, Australia, New Zealand, Europe, Japan, Latin America, and the US, 'Making Securitization Work for Financial Stability and Economic Growth' (17 August 2009) <http://www.aei.org/docLib/081709%/20Joint°/020Statement%20-/ 20Chile.pdf/> accessed 21 November 2009.

[133] Richard S Camel, Jonathan R Macey and Geoffrey P Miller, *The Law of Banking and Financial Institutions* (4th edn, Aspen 2009) 539-43.

[134] United States Department of the Treasury, 'The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure ('Bush Treasury Blueprint')' (March 2008) T146-58, 39.

[135] See Donato Masciandaro, 'Divide et Impera: Financial Supervision Unification and Central Market Fragmentation Effect' (2007) 23 European Journal of Political Economy 285.

[136] Peter J Wallison, 'Thinking Ahead: Treasury Prepares to Lay Down a Marker for the Future (Part I)' (AEI Financial Services Outlook, October 2007) 2.

[137] ibid.

State' whereby– state institutions aim to 'tame' economic behaviour by structuring free markets so that they might serve the public good, now seem more than ever to be a doomed project.[138]

A reason for the imbalances at macro levels in some developing countries such as China was the high savings rates that allowed it to have significant domestic investment and to accumulate claims on the rest of the world. Because China wanted a fixed exchange rate, the claims took the shape of central bank reserves. The reserves were not invested in equity, property or fixed income assets, as they were used to buy government bonds or government guaranteed bonds that carried almost no risk to speak of.[139]

As a consequence of this, the risk-free rates of interest fell to historically low levels. If in 1990 in the UK or the US the yield to maturity for risk-free government bonds was above 3% real, in the years before the crisis it has been less than 2% or even as low as 1%.

The increased liquidity available in the market had an influence in significantly lowering the interest rates. The reduced interest rates had two implications. Firstly, they caused a rapid growth of available credit that was used especially for residential mortgages. The growth was accompanied by a degradation of credit standards, as increases in property values made the lower credit standards appear of little importance and this was not the case as it was shown. Secondly, they cultivated among investors a search for yield, as they wanted to gain as much as possible over the riskless rate that was low. Twenty years ago, an insurance company could invest at 3.5% real to maturity and in the years before the crisis it became only 1.5%. Any financial products that added some basis points to that yield without adding significant risk, were highly evaluated.[140]

The demand for an increased yield together with imbalances at the macro level has been the cause of the introduction of new financial instruments that were centred on the origination, packaging and trading of securitised credit investments. Starting with the 1990s, securitised credit has registered a significant increase in scale and complexity. It was a visible evolution,

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[138] Masciandaro (n 70); See also Hal S Scott, *International Finance: Transactions, Policy, and Regulation* (16th edn, Foundation 2009) 168-71.

[139] FSA (n 66).

[140] Ibid, 14.

because of the growth in the value of the stock of credit securities and the increase in the volume of credit derivatives, allowing investors to create synthetic credit exposures.

By the end of 2006, Alan Greenspan, under the chairmanship of the Federal Reserve, would increase interest rates setting into motion a series of events with cascading effects.[141] The increase in interest rates had the purpose of counteracting inflation and did not stop the mortgage flows, as it came after a long period of low interest rates. Wall Street was the main source of mortgage money and not the thrifts, as mortgages were packaged in securitised assets.

As securitisation grew in importance, its development was lauded as a way to reduce banking risks and cut the costs of credit intermediation, with credit risk being transferred to end investors, reducing the volume of required bank capital. A regional bank in the US could replace holding undiversified credit exposures in its own region with securitisation, as this allowed loans to be packaged and sold to a diversified set of end investors. It was believed that securitised credit intermediation could reduce risks for the entire banking system.

Starting with 2006, the housing property boom was about to come crashing down.[142] First, there was a downturn in housing prices, and borrowers, could not afford to make their repayments. This led to widespread defaulting. Unable to recover the lost value of overpriced loans, lenders all along the transaction chain began to record significant losses.[143] Money markets across the globe reacted with panic, and this had a destabilising effect. Market institutions essentially reversed their lending policies by refusing loans to borrowers

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[141] Charles AE Goodhart, 'The Background to the 2007 Financial Crisis' (2008) 4 International Economics & Economic Policy 331. Discussing the US Federal Reserve's damaging policy lowering liquidity thresholds and interest rates in boom times, Goodhart says, 'In many respects, this crisis was foreseen in advance. Almost every central bank which published a Financial Stability Review, and international financial institutions, such as the BIS and IMF, which did the same, had been pointing for some time prior to the middle of 2007 to a serious under pricing of risk. This was characterised by very low risk spreads, with differentials between risky assets and safe assets, having declined to historically low levels. Volatility was unusually low. Leverage was high, as financial institutions sought to add to yield, in the face of very low interest rates. Those same institutions were apparently prepared to move into increasingly risky assets in order to do so, often leveraging them several times in pursuit of that objective.'

[142] See, eg, Robert J Shiller, *The Subprime Solution: How Today's Global Financial Crisis Happened and What to Do About It* (Princeton 2008) 29-32.

[143] Dirk Bezemer, 'Lending Must Support the Real Economy' (Financial Times, 5 November 2009) <http://www.ft.com/cms/s/0/547d2fd8-c977-1lde-aO71-OO144feabdcO.html/> accessed 3 October 2017.

regardless of their creditworthiness. This policy change would now precipitate a global credit crunch.[144]

As the crisis appeared it became obvious that the diversification of risk holding had not been achieved. The majority of securitised credit and the corresponding losses were not in the books of the end investors, but in the books of highly leveraged banks. In a greater extent securitised credit was not simply sold to an end investor, but bought by the propriety trading desk of another bank, sold with a part of the risk still remaining because of credit derivatives ad incorporated in complex and opaque instruments such as collateralized debt obligations.

There were banks that approached securitisation by originating and distributing, but other banks were acquiring and 'arbitraging' securitised credit. The new approach left the majority of the risk on the balance sheets of the bank, but in a more complex and much less transparent shape.

The sub-prime mortgage crisis unfolded over the period of April 2, 2007 to February 28, 2008 and was first seen in the United States.[145] Major US financial institutions, involving, primarily, investment and commercial banks, insurance operators, and credit providers, provided billions of dollars in loans to finance 'so called' sub-prime mortgages.[146] Mortgage financing of this type proved in retrospect to be highly irresponsible. Substantial lines of credit were issued to borrowers who were at a high risk of defaulting on their repayments, including those with low or no income, unstable or no employment, or to individuals with poor creditworthiness.[147] By 2004, when US interest rates had fallen to historically low levels, the value of loans issued against sub-prime mortgages (so called double leveraging) has risen dramatically. Individuals and banks were now greedily purchasing assets at a grossly inflated market value. At the same time, financial institutions were encouraged to increase profits in order to remain competitive in an overcrowded marketplace. This, in turn,

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[144] George G Kaufman, 'Bank Failures, Systemic Risk and Bank Regulation' (1996) 16 Cato Journal 17.
[145] For a chronological account of the key drivers of the financial crisis, see Claudio Barrio, 'The Financial Turmoil of 2007: A Preliminary Assessment and Some Policy Considerations' (BIS Working Paper, March 2008) 251, 262.
[146] Thorsten Beck and others, 'Bank Concentration, Competition, and Crises: First Results,' (2006) 30(5) Journal of Banking and Finance 1581.
[147] The events leading up to the financial crisis have been documented extensively in a swathe of literature, including: Yuliya Demyanyk and Otto Van Hemert, 'Understanding the Subprime Mortgage Crisis' (2009) 24(6) The Review of Financial Studies 1848; For a factual analysis of events, see International Monetary Fund, *Global Financial Stability Report: Financial Stress and Deleveraging, Micro Financial Implications and Policy* (IMF 2008) 17, 67.

exposed banks to the moral hazard of under-pricing lending risks, which entailed the even greater risk of multiple defaults across a 'chain of borrowers' (i.e. from credit lenders who provide external financing to banks, to the retail bank itself, ending with the borrower who had taken out the mortgage with the bank).

As Wood and others have detailed, credit default risks exposure that can result in a 'borrow-short, lend-long strategy'. This exemplifies the interconnectedness of the global financial architecture. Banking institutions and subsidiaries are linked by payment systems and they borrow heavily from other institutions in interbank deposit markets.[148] The term 'counter-party risk' is often employed to describe, for instance, the situation in which one bank has a credit balance with another bank (the counter-party), or has otherwise entered into a credit default swap agreement with that counter-party.[149] Should that counter-party become insolvent, the first bank is likely to experience a loss, triggering a cycle of capital loss risks with global reach and impact.

The situation in the UK also has to be presented because it is the home country of a number of leading global banks. The UK was influenced by the increase in securitised credit and shadow banking activities and was vulnerable to their collapse.[150]

Several of the largest banks in the UK were carrying out a strategy of acquire and arbitrage of credit intermediation. The leverage of those banks increased as trading books expanded, and they were relying on liquidity through marketability, as they were involved in the intricate mechanism of assets, liabilities and new financial instruments. UK banks were as exposed as the US banks to the loss of confidence and fall of asset prices which were the especially noticeable after the collapse of Lehmans in September 2008.

In the UK, as in the US, the decade before the crisis was a period of rapid credit growth in the household sector, as house prices grew rapidly with strong demand for houses relative to their physical supply. Total mortgage debt to GDP increased from 50% to over 80%, the income leverage also increased and an increased amount of mortgages was available as banks estimated that debt burdens were likely to fall as household assets continued to appreciate in

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[148] Philip R Wood, *Regulation of International Finance* (Sweet & Maxwell 2007) 1-015, 1-019.
[149] ibid.
[150] FSA (n 66).

value. It was not similar in scale with the US subprime market, but mortgage credit was extended to social categories which previously did not have this possibility.

An important characteristic of the UK banking system in the period before the crisis was the rapid growth of a number of banks such as Northern Rock, Bradford & Bingley and Alliance and Leicester, which were reliant on interbank funding and the activity of securitising and selling large credit assets, especially in the mortgage sector. The failure of these banks did not only cause solvency and credit quality problems, but also the reduced demand for securitised credit assets and wholesale funding availability. As credit problems started to appear, the financial crisis continued with credit capacity constraints and economic slowdown.

Not only the banks in the UK, but also those in Germany, France, Denmark, Iceland and Spain were rocked by the crisis, perhaps even more so than in the US.[151] Even if assessed in accordance, the Basel I risk-weighted approach contrasted with a pure leverage ratio, in which bank assets are not risk-weighted, and European banks were far more leveraged than the US banks, who were relatively conservative in their attitudes to leveraging practices. Indeed, the emphasis on the US origin of the sub-prime crash has largely been obscured by the fact that the structural factors which contributed to the credit crisis of 2008 were much the same in Europe as in the US.[152] The largest European banks were estimated to hold an average debt to shareholder equity ratio (of the bank's total assets) of 35, compared with the largest US banks whose total debt-to-equity asset ratios was less than 20.[153]

Understanding the financial crisis requires examining how US financial markets have changed in fundamental ways in the decade before.

As late as the 1990s, US banking consisted of thousands of modest-sized banks that interacted mostly with local communities. Since 1990, the number of regional banks and thrifts shrunk from over 15,000 to approximately 8,000 by 2009 and in the same time 13,000

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[151] Karel Lannoo, 'Concrete Steps Towards More Integrated Financial Oversight: The EU's Policy Response to the Crisis' (Centre For European Policy Studies Task Force Report, December 2008) 10, 11.

[152] Elijah Brewer III, George G Kaufman and Larry D Wall, 'Bank Capital Ratios across Countries: Why Do they Vag?' (Paolo Baffi Centre Research Paper, Series No 2008-28, 2008).

[153] Daniel Gros and Stefano Micossi (eds), 'Gros and Micossi: The Beginning of the End Game' in Andrew Felton and Carmen M Reinhart, 'The First Global Financial Crisis of the 21st Century: Part II' (*VoxEU*, 2009) 317, 319 <http://www.voxeu.org/reports/reinhart feltonvol2/FirstGlobalCrisisVol2.pdf/> accessed 15 September 2017.

regional and local credit unions have been reduced to 7,500.[154] The approach meant that when a bank suffered losses, the government could easily close its doors, protect the depositors and prevent important damage to the banking system and the economy.

In the 1990s, the United States implemented substantial changes to the banking industry, some of which relaxed the banking rules, others that imposed new regulations and other that encouraged riskier behaviour. In 1994, Congress explicitly authorized interstate banking, which allowed banks to open branches across the nation easier than before.[155] In 1999, Congress repealed the Glass-Steagall Act of 1933, which had required banks, securities companies and insurance companies to operate separately.[156] The repeal allowed banks to openly combine their operations.[157]

In 2000, Congress enacted the Commodity Futures Modernization Act which barred federal regulation of swaps and swap markets and this allowed banks, brokers and other financial institutions to develop, market and trade these financial products.[158]

These and other steps allowed a small number of US banks to become giant financial conglomerates involved in collecting deposits, trading equities and issuing debt instruments, derivatives and insurance policies. As these institutions grew in size and complexity and played an increasingly large role in the economy, policymakers began to examine the possibility of the failure of one of these financial institutions damaging the US financial system and the US economy as a whole.

At the end of 2005, in the United States there were 8,800 federally insured banks and 8,700 federally insured credit unions, many of them that issued home loans.[159] These financial institutions were supervised by five agencies: the Federal Reserve which oversaw state and foreign banks, the Office of the Comptroller of the Currency (OCC) which oversaw banks with national charters, the Office of Thrift Supervision (OTS) which oversaw federal thrifts, the National Credit Union Administration which oversaw federal credit unions and the

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[154] U.S. Census Bureau, 'Statistical Abstract of the United States' (2011) 735 <http://www.census.gov/compendia/statab/2011/tables/11s1175.pdf> accessed 23 July 2018.
[155] Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, P. L. 103-328.
[156] Glass-Steagall Act of 1933 also known as the Banking Act, P. L. 73-66.
[157] Gramm-Leach-Bliley Act of 1999, also known as the Financial Services Modernization Act, P. L. 106-102.
[158] The 2000 Commodity Futures Modernization Act (CFMA) was enacted as a title of the Consolidated Appropriations Act of 2001, P. L. 106-554.
[159] FDIC Quarterly Banking Profile (2005) 1.

Federal Deposit Insurance Corporation (FDIC) which oversaw financial institutions that have federal deposit insurance.[160]

The biggest responsibility of these supervising authorities was to ensure the safety and viability of the financial institutions they oversaw. In order to do so, they conducted examinations on a periodic basis of the companies within their jurisdiction and included the results in an annual Report of Examination given to the Board of Directors at each entity. The largest financial institutions were an ongoing concern and examinations were carried out during the year with the results stated in the annual report of examination.

If a supervising authority was concerned about the safety of a financial institution, it had a range of informal and formal actions that could be used to require operational changes. The informal actions were asking the financial institution to issue a safety and soundness plan or a memorandum of understanding. The formal actions included issuing a cease and desist order requiring the financial institution to stop an unsafe practice or correct identified problems, imposing a civil monetary penalty and suspending or removing personnel from the financial institution.

To make home loans more profitable, banks started to use the mechanism of securitization. It is an activity carried out by a bank that bundles a large number of home loans in a loan pool and computes the mortgage payments that will be paid in that pool by the borrowers. The bank then forms a shell corporation or trust to contain the loan pool and uses the mortgage revenues to make coupon payments to investors. The bonds are registered with the Security and Exchange Commission and are called residential mortgage-based securities (RMBS) that are sold through a public offering to investors.

The widespread use of increasingly complex and opaque financial instruments played an integral part in the crisis. Many sub-prime mortgages were bought by specialised financial institutions for the sole purpose of creating new financial instruments, including Collateralised Debt Obligations (CDOs).[161]

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[160] The Dodd-Frank act has removed one of these agencies, the Office of Thrift Supervision, and assigned its duties to the OCC.

[161] Photis Lysandrou and Anastasia Nesvetailova, 'The Shadow Banking System and The Financial Crisis: A Securities Production Function View' (FESSUD Working Paper Series No 5, 2010) 5, 10-12.

These CDOs were a type of structured finance product whose securities received credit ratings and were sold to investors. These were a complex financial product that contributed to the crisis as they had a substantial amount of risk and they made the balance sheet more opaque so it was more difficult to identify the negative aspects of those products. A CDO could contain BBB rated securities from 100 different RMBS securitizations. It could also contain other types of assets, such as commercial mortgage backed securities, corporate bonds or other CDO securities. These assets were often called cash CDOs, as they received cash revenues from the underlying RMBS titles and other assets. The senior tranches could receive AAA ratings, even if all the underlying assets had BBB ratings.

There were banks that created synthetic CDOs that were similar to the cash version but did not contain actual mortgages or other assets that produced income. The product simply referenced existing assets and allowed investors to use credit default swaps to bet on the performance of the referenced assets.

Among the most troubling aspects of an increasing recourse to use these instruments, was that financial institutions could deploy them precisely in order conceal their losses or risk exposures.[162] They could do so because financial entities were not required to disclose these assets on their balance sheets under previous US legislation (and international risk regulation under the previous Basel I and II Accords).[163] The 'domino effects' of financial institutions that had 'run amok' had already begun to infect other global markets.[164] Later, the interventions of central banks and finance ministries, not to mention key international professional bodies, most notably Basel-established international institutions, such as the Financial Stability Forum (renamed the Financial Stability Board in 2009) and the Basel Committee on Banking Supervision itself would, as a result, come too late. Some of the most influential banking institutions bought into highly sophisticated and technically opaque securities 'usually without doing their own investigation and analysis and almost certainly

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[162] See, eg, Theodor Baums and Eddy Wymeersch (eds), *Asset-Backed Securitisation in Europe* (Kluwer 1996) 3-7.

[163] Glass-Steagall Act 48 Stat 162 (1933); See Peter J Wallison, 'Deregulation and the Financial Crisis: Another Urban Myth 3' (2009) <http://www.aei.org/docLib/10- FSO-October-g.pdf/> accessed 1 October 2016; On the limitations of previous Basel I and II Accords, see Rym Ayadi, 'Basel II Implementation in the Midst of Turbulence' (Centre for European Policy Studies, Task Force Report 17, June 2008) Table 1.

[164] For a discussion of the credit losses suffered by markets outside of subprime securities, see Committee on Capital Markets Regulation (CCMR), 'The Global Financial Crisis: A Plan for Regulatory Reform' (26 May 2009) 7-11.

without adequate due diligence.'[165] They did so, as Dam argues, because, "like many US purchasers, they sought higher returns than elsewhere available."[166] Unable to keep pace with the rapid diversification and sophistication of these and other types of financial products, finance ministries and international regulatory bodies were largely unaware of levels of debt accumulated in the increasingly saturated market of sub-prime mortgages. Financial institutions were leveraging risk against yet more risk, this time by issuing Credit Default Swaps as insurance against CDOs.

Investors, instead of selling their RMBS or CDO securities, could purchase insurance against a loss by buying a Credit Default Swap that could pay off if the security registered losses or other negative credit events. In the years before the crisis, investment banks had standardised CDS contracts for RMBS and CDO securities, making it a practical alternative. This product had contributed to the crisis by increasing the volume of assets that relied on mortgage backed securities.

There were a lot of financial institutions that wanted mortgage backed securities in order to register a quick profit from securitisation fees that contrasted with mortgage loans that were held on the balance sheets of the banks for a long period. It was a perception that caused lenders to issue mortgages not only to qualified borrowers, but also to higher risk borrowers. These higher risk borrowers were called subprime borrowers and were separate from the creditworthy prime borrowers who qualified for home loans.

There was not a commonly accepted definition for subprime borrowers, but in 2001, federal banking authorities identified them as having the following characteristics: two or more 30-day delinquencies in the last year or one or more 60-day delinquencies in the last two years, a judgement or foreclosure in the last two years, a bankruptcy in the last five years, a credit score below 660 on the FICO scale or a debt service-to-income ratio of 50% or more.[167] There were also financial institutions that identified subprime borrowers only if they had a credit score below 660 or even 620 on the FICO scale and there were other institutions that did not implement a definition at all.[168] The credit score was a useful instrument that

[165] Kenneth W Dam, 'The Subprime Crisis and Financial Regulation: International and Comparative Perspectives' (2010) Chicago Journal of International Law 581.
[166] ibid.
[167] Adam Ashcraft and Til Schuermann, 'Understanding the Securitization of Subprime Mortgage Credit' (2008) Federal Reserve Bank of New York Staff Report No. 318 at 14.
[168] SEC vs. Mozilo (2009) Case No. CV09-03994.

estimated the probability that a debt will be repaid by a specific borrower, but it was not wise for a financial institution to rely only on it, as there were several indicators that had to be considered.

There was an increased use of high risk loans that supported mortgage related securities, but this did not impede credit rating agencies to give AAA ratings to them, indicating they were safe investments. The credit ratings gave a sense of security to investors and institutions such as pension funds, insurance companies and municipalities that were required to have safe investments in order to continue to buy mortgage related securities.

Credit rating agencies issued credit ratings and were officially designated by the SEC. There were ten registered credit rating agencies in the US, but the market was composed mostly by three institutions: Moody's Investors Service, Inc. (Moody's), Standard & Poor's Financial Services LLC (S&P) and Fitch Ratings Ltd. (Fitch).[169] Those companies issued around 98% of the total credit ratings and collected 90% of the credit rating revenue.[170]

In the period before the crisis, Moody's and S&P issued a record number of ratings and received a record amount of revenues. S&P issued, from 2004 to 2007, more than 5,500 RMBS ratings and more than 835 mortgage related CDO ratings.[171] Moody's issued, from 2004 to 2007, over 4,000 RMBS ratings and over 870 CDO ratings.[172]

Credit rating agencies obtain their revenue from issuers wanting rating for the products they sell. In this situation there can easily appear conflicts of interest, because credit rating agencies can be required to give a high rating, as issuers and investment banks bring them business and they want a suitable rating. Issuers and investment banks can go ratings shopping, by choosing the credit rating agency that offers the highest ratings and this weakens the standards of credit rating agencies. The SEC reported in 2003 that the conflicts of interest noticeable in credit rating agencies have increased, especially because credit rating

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[169] SEC, 'Credit Rating Agencies - NRSROs' (2008) <http://www.sec.gov/answers/nrsro.htm> accessed 23 July 2018.

[170] Congressional Research Service, 'Credit Rating Agencies and their Regulation' (2009) Report No. R40613.

[171] Compliance letter from S&P to SEC (2008) SEC_OCIE_CRA_011218-59 at 20.

[172] Compliance letter from Moody's to SEC (2008) SEC_OCIE_CRA_011212.

agencies have also started to have an advisory role for their clients and they continue to rise in importance.[173]

The credit ratings assigned to RMBS and CDO securities are intended to last the lifetime of the securities. It is also possible for the situation to change, so credit rating agencies survey each rated financial instrument to evaluate if the rating is still valid or it should be upgraded or downgraded. Starting with July 2007, Moody's and S&P issued hundreds and then thousands of downgrades to RMBS and CDO rating, the first mass downgrades in US history.

Moody's and S&P began to downgrade RMBS and CDO instruments in late 2006, when there were signs that the residential mortgage delinquency rates were increasing. In July 2007, S&P placed on credit watch the ratings of 612 subprime RMBS with a value of $7.35 billion. It then downgraded 498 of the ratings placed on credit watch.

In October 2007, Moody's started to downgrade CDOs daily, downgrading about 270 CDO securities valued at $10 billion. After two months, it downgraded another $14 billion in CDOs and placed $105 billion on credit watch. Moody's stated that in 2007 it downgraded 8725 ratings from 2116 deals and upgraded 1954 ratings from 732 deals, so this means that it downgraded four times more ratings then it had upgraded.[174]

The downgrades caused turmoil in the market, as investors were required to sell assets that had lost their investment grade status and holdings were greatly reduced in value. Companies around the world found that they could not sell the securities available in their balance sheets as the subprime secondary markets slowed down and then collapsed. Companies were left with billions of dollars in RMBS and CDO securities they could not trade.

There were financial institutions that had large proprietary holdings of mortgage related assets. Some of these companies were Bear Sterns, Citibank, JPMorgan Chase, Lehman Brothers and Merrill Lynch. When the value of their holdings dropped, some of these

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[173] SEC, 'Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets' (2003) 40.

[174] Moody's, 'Structured Finance Ratings Transitions, 1983-2007' (2008) 4 Credit Policy Special Comment 1, 1.

financial institutions lost tens of billions of dollars and declared bankruptcy, were sold off or were bailed by the US government in order to reduce damage to the economy.[175]

There were also banks such as Goldman Sachs that shorted the mortgage market by building a large number of proprietary positions. Goldman Sachs had a large number of mortgage related products on its balance sheet. However in 2006 it had decided to change its strategy, by betting against the money market. Because of this, its mortgage department made $1.1 billion in net revenues from shorting the mortgage market. As the financial crisis appeared, Goldman Sachs despite its gains was given a $10 billion taxpayer buyout under the Troubled Asset Relief Program, tens of billions of dollars by accessing the Federal Reserve's Primary Dealer Credit Facility and billions more in government support to ensure that it continues to operate.[176] There were a number of institutions that were bailed by the government and this made the cost of the crisis even larger.

The crisis of 2007/08 unleashed seismic consequences on market economies, on both sides of the Atlantic.[177] By 2008, a swathe of major financial institutions, such as the Lehman Brothers and New Century Financial, had been declared insolvent after reporting billions in losses. Many others became the recipients of government bailouts and rescue operations.[178] Financial institutions were forced to write-off significant quantities of distressed assets in the form of collateralised debt obligations and credit default swaps.[179] Other institutions reacted to the ensuing crisis by fore-closing on their debts. In turn, major lending institutions such as Goldman Sachs and Citigroup sustained further losses.[180] In July 2007, the US government

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[175] US Department of the Treasury, Capital Purchase Program Transactions, under the Troubled Asset Relief Program <http://www.treasury.gov/initiatives/financial-stability/investmentprograms/cpp/Pages/capitalpurchaseprogram.aspx> accessed 23 July 2018.

[176] There is data that shows Goldman Sachs' use of the Primary Dealer Credit Facility 85 times in 2008. <http://www.federalreserve.gov/newsevents/reform_pdcf.htm> accessed 23 July 2018.

[177] Catherine Rampell, 'Great Recession: A Brief Etymology' (*New York Times*, 11 March 2009) <https://economix.blogs.nytimes.com/2009/03/11/great-recession-a-brief-etymology/> accessed 22 June 2017.

[178] Joseph Mason, 'Off-Balance Sheet Accounting and Monetary Policy Effectiveness' (*RGE Monitor*, 17 December 2008) <http://www.rgemonitor.com/financemarkets-monitor/254797/offbalancesheetaccounting.and-monetary-policyineffectiveness/> accessed 21 November 2009.

[179] David Ladipo and Stilpon Nestor, *Bank Boards and the Financial Crisis: A Corporate Governance Study of the 25 Largest European Banks* (Nestor Advisors 2009) 49, Exhibit 3.1.

[180] See Goldman Sachs, 'Goldman Sachs to Become the Fourth Largest Batik Holding Company' (Press Release, 21 September 2008) <http://www2.goldmansachs.com/our-firm/press/press-releases/archived/2008/bank-holdingco.html/> accessed 22 June 2017.

issued a public statement in which it was estimated that losses generated from the crisis would exceed 100 Billion dollars.[181]

As the full consequences of the global sub-prime mortgage crisis unfolded - reduced public spending, job losses, mass unemployment and instability in interest rates and currency markets, calls for the international re-regulation of the banking sector began to resurface.[182] Common regulatory challenges fostered through global financial integration spurred the need for regulatory co-operation, co-ordination and the (minimal) harmonisation of risk regulation standards on a global level.[183] Partly in response to the perceived limitations of national level regulatory responses to the effects of the crisis, members of the G20 agreed to meet to discuss co-ordinated measures and regulatory reforms. At first, members agreed to commit over a trillion dollars to the IMF in a bid to combat poor levels of employment, growth and ineffective regulation of the banking and finance sector.[184] On the question of the reform of the banking industry, the G20[185] would initiate proposals to adopt another round of accords, later known as Basel III. These reforms would be offered as a corrective to the failures and would silence the previous Basel I and II guidelines.[186]

2.2.1 The Demand for International Banking Standards

The Basel Committee is but one example of a trans-governmental institution that has been made responsible for the spread and circulation of global standards and best practices. First established in 1973, at the time when the Bretton Woods system of managed exchange rates had, in effect, collapsed, the governors of the G10 central banks formed a Committee on Banking Regulations and Supervisory Practices, which was renamed the Basel Committee on

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[181] Congressional Budget Office (CBO), 'Estimated Macroeconomic Impacts of the American Recovery and Reinvestment Act of 2009' (2 March 2009) <https://www.cbo.gov/sites/default/files/111th-congress-2009-2010/reports/03-02-macro_effects_of_arra.pdf/> accessed 17 October 2017.

[182] See, generally, Peter Fallon and Robert Lucas, 'The Impact of Financial Crises on Labor Markets, Household Incomes and Poverty' (March 2002) 17(1) World Bank Research Observer 21; Sher Verick and Iyanatul Islam, 'The Great Recession of 2008-2009: Causes, Consequences and Policy Responses Discussion' (IZA DP No 4934, May 2010) 9-10.

[183] Laurence H Meyer, 'Why Risk Management is Important for Global Financial Institutions - Speech by Mr Laurence H Meyer' (Bank of Thailand Symposium, Risk Management of Financial Institutions, Bangkok, 31 August 2000).

[184] IMF, 'Global Financial Stability Report: Containing Systemic Risks and Restoring Financial Soundness' (IMF 2008) 52; See also, IMF (n 67).

[185] G20 Organisation, 'G20 Members' <https://www.g20.org/about_g20/g20_members/> accessed 29 March 2014.

[186] Tarullo (n 41).

Banking Supervision (BCBS).[187] The Basel Committee first attempted to develop regulations and suggestions with the aim of minimising risk.[188] The Committee articulated 25 guiding principles that the Basel Committee felt must be implemented so that a supervisory system could be effective. These guiding principles stress the need for strong supervisory powers for banking authorities, including risk detection mechanisms and guidelines on monitoring institutional compliance with Basel risk assessment standards.[189]

The Basel Committee, which meets, and has its secretariat, at the Bank for International Settlements in Basel, Switzerland, has no formal authority. Rather, it works to develop broad supervisory standards and promote best practices, in the expectation that each country will implement the standards in ways most appropriate to its circumstances. As a result, transnational networks or 'epistemic communities' such as the Basel Committee depend on the mutual co-operation of its network participants by way of informal consensus building processes (rather than formal treaty based processes). In short, the Basel decision making process is, "dialogical, norm-generating and incremental [i.e. evolutionary]."[190] The shared links forged between government actors and market institutions, in turn, creates a dense web of procedural and organisational linkage between different regulatory authorities, standard setting bodies, and market experts, thereby rendering, "arbitrage between national legal systems possible".[191]

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[187] Saul Perez, 'Why the Basel Committee on Banking Supervision Came to Be' (MarketRealist, 2014) <http://marketrealist.com/2014/09/overview-basel-committee-banking-supervision-came/> accessed 12 October 2015. Today the G10 are eleven industrialised nations who meet on an annual basis to consult each other, debate and co-operate on international financial matters. The member countries are: France, Germany, Belgium, Italy, Japan, the Netherlands, Sweden, the United Kingdom, the United States and Canada, with Switzerland playing a minor role. The G10 does not include Saudi Arabia as a member.

[188] Juliusz Jablecki, 'The Impact of Basel I Capital Requirements on Bank Behavior and the Efficacy of Monetary Policy' (2009) 2(1) International Journal of Economic Sciences and Applied Research 16, 17.

[189] The 1988 Basel Capital Accord and its amendments are available on the website of the Bank for International Settlements, see 'The First Pillar – Minimum Capital Requirements' <https://www.bis.org/publ/bcbs128b.pdf/> accessed 13 August 2017. For a discussion, see Douglas J Elliott, 'Comment on Proposed BCBS Capital Standards' <http://www.brookings.edu/research/opinions/2010/04/15-capital-standards-elliott/> accessed 13 October 2017.

[190] Sungjoon Cho and Claire R Kelly, 'Promises and Perils of New Global Governance: A Case of the G20' (2012) 12(2) Chicago Journal of International Law 491, 497.

[191] Wallison (n 98). For a more general discussion, see Sabino Cassese, 'Administrative Law without the State? The Challenge of Global Regulation' (2005) 37 NYU International Law 663, 683; See also, George Fletcher, 'Regulatory Co-operation between the European Commission and U.S. Administrative Agencies' (1996) 9 Administrative Law Journal American University 933; Kalypso Nicolaidis and Gregory Shaffer, 'Transnational Mutual Recognition Regimes: Governance Without Global Government' (2005) 68 Law and Contemporary Problems 263.

As the over the counter derivative market spiralled out of control, Basel decision making processes were to lose much of their legitimacy, having failed to prevent or predict the credit crisis. One significant shortcoming of the previous Basel accords was a tendency to define and evaluate risk in highly myopic and narrow terms.[192] As Goodhart notes, "[w]hile the Basel group was fiddling with obsolete and wrong methods to measure risk, the main international banks had already developed and applied new advanced techniques."[193] Basel I and II were deemed faulty, chiefly because these agreements placed too much emphasis on institutional compliance with non-differentiated capital adequacy requirements, and not enough emphasis on the mutually destabilising effects of institutionalised risk-taking in the ever-integrating global finance and capital markets. The architects of the Basel consensus had, in effect, vastly underestimated the 'systemic' impact of the widespread trend in double leveraging, on the stability of national banking sectors.[194] As a result, when systemically important banks endured sustained pressure on their cash flows during a bank run, they were unable to absorb losses by relying on more stable and liquid sources of funding.[195]

In response to these limitations, the Basel Committee of 2013 set out an ambitious agenda of reform aimed at addressing the deficiencies of the previous Basel I and III Accords.[196] Drafted in response to the global credit crash, the newly formulated Basel III reforms introduced stricter and more transparent levels of capital management and responsibility in banking institutions for all countries that choose to implement the proposals.[197] Going further than previous accords, Basel III places greater importance on key definitions of capital and capital risk measurement, which now includes general loan-loss reserves, including raising the amount of capital finance institutions should have so as to be able to withstand market pressures and other risks affecting their institutional liquidity.[198]

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[192] Emily Lee, 'Basel III and Its New Capital Requirements, as Distinguished from Basel II' (2014) 131(1) The Banking Law Journal 27, 30.
[193] Charles Goodhart, *The Basel Committee on Banking Supervision: A History of the Early Years 1974-1997* (Cambridge University Press 2013) 510.
[194] BIS (n 15); and BIS 'Guidelines for Computing Capital for Incremental Risk in the Trading Book' (BIS, January 2009) <http://www.bis.org/publ/bcbs149.pdf/> accessed 2 October 2016.
[195] ibid; Claudia Buch and Linda Goldberg, 'International Banking and Liquidity Risk Transformation, Lessons from Across Countries' (Federal Reserve Bank of New York Staff Reports, 2014) 675; Anil Kashyap and Jeremy Stein, 'Cyclical Implications of the Basel II Capital Standards' (2004) 28(1) Economic Perspective 18, 21-23.
[196] BCBS (n 1).
[197] Adrian Blundell-Wignall and Paul Atkinson, 'Thinking Beyond Basel III: Necessary Solutions for Capital and Liquidity' (2010) 1 OECD Journal: Financial Market Trends 1.
[198] BIS (n 15); BCBS (n 108).

Whatever the need and merits for the reform of the global co-ordinated response to regulatory challenges that transgress the jurisdictional boundaries of state law, the crisis also exposed the fragility of international co-operation, particularly when sensitive questions of economic and political sovereignty are concerned.[199] Despite earlier success, the newly formed global consensus proved short lived because states began to break away in order to pursue their own economic policies and strategies. By 2010, fissures had already begun to emerge between the stronger European economies, backed by global institutions, and less developed European states, as reform efforts were pivoted away from private sector regulation and refocused on re-structuring public finances.[200] Governments in the UK, Germany, Iceland, and many other OECD members rolled out a comprehensive package of austerity measures, designed to rein in public expenditure and the resulting hike in national debt exposure.[201]

In today's world, lawyers and analysts grapple with the limited capacity of state regulation and its ability to influence and bring within its reach the new emerging worlds of 'shadow banking' - a term that describes the private law created in background markets and institutions, many of which operate in the 'shadow' of formal state regulation.[202] These private worlds encompass the remote and profit-centred corporate practice and governance of private equity firms, brokers, and hedge funds. How far can the principles of Basel capital adequacy, liquidity baselines, and other technical guidance penetrate and ultimately reform the opaque practices of private entities such as these?[203] A more challenging question is how can international bodies achieve these aims in the face of the ongoing fragmentation of banking policies that have resulted from fragmentation in the US (because of the diffusion of authority among various US regulatory entities) and in Europe (because of the subsidiary principle which allows EU member states to determine its own financial regulations)?

The Basel III framework establishes international risk regulation standards for the finance sector, but does so based on a model of procedural, rather than substantive harmonisation.

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[199] Pierre-Hugues Verdier, 'The Political Economy of International Financial Regulation' (2013) 88(4) Indiana Law Journal 1405, 1407.

[200] Stephen J Choi, Mitu Gulati and Eric Posner, 'Pricing in Sovereign Debt Contracts: A Greek Case Study with Implications for the European Crisis Resolution Mechanism' (John M Olin Law and Economics Working Paper Series 541, 2011) 1, 5-6; Nelson D Schwartz, 'US Missteps Are Evident, But Europe Is Implicated' *New York Times* (13 October 2008).

[201] See David Ibison, 'Iceland's Rescue Package Flounders' *Financial Times* (12 November 2008) 8; Desmond Lachman, 'Europe Catches Pneumonia' (AEI International Economic Outlook No 2, November 2008) 4-5.

[202] See Gillian Tett and Paul J Davies, 'Out of the Shadow: How Banking's Secret System Broke Down' *Financial Times* (16 December 2007).

[203] For a relevant discussion, see Ladipo and Nestor (n 114).

States can choose to implement Basel III norms and guidelines in a manner that least interferes with the decisional autonomy of its governing institutions, thereby reducing the possibility of conflict between international standards and the substantive (and constitutional) laws of relevant national legal systems. The appropriateness of the Basel 'solution' to global market failures is, however, often taken for granted. Technical risk regulatory standards devised under Basel III are, in other words, presented as a neutral norms and baselines formulated in the depoliticised decision-making processes. Yet, as this chapter will show, the Basel framework is premised upon assumptions which are anything but 'value neutral'.

Before we can assess the merits of proceduralised risk regulation standards as devised under the Basel framework, it is necessary to firstly foreground this analysis a deeper analysis of the very reasons why market mechanisms fail in the first place, since these are the very failures that Basel III, through its national-level implementation, is assumed to eliminate or correct.

2.2.2 Why Market Mechanisms Fail

The global financial market is, of course, a factual reality. Yet, it is also possible to argue that the global financial architecture which underpins the conventional banking system is, in some sense, an artifice, albeit one that has been accepted as a social 'fact'. Lawyers, in all fields, err when they overstate the independence of the market relations from the institutional, political and cultural contexts in which these are embedded.[204] It is important, therefore, to examine, and, thereby, render explicit, the theory of markets and the role of law in tempering market forces, as part of an enquiry into the key features and purposes of conventional banking models vis-a-vis its alternatives.

Any examination into the efficacy, or otherwise, of any banking system and its governance, must first define what it means by 'good' market outcomes versus 'bad' ones. Scholars from all schools of thought and philosophical traditions have grappled with a series of related questions. What are the functions of markets and when it is appropriate to intervene in markets which do not function as they *ought* to? More importantly, how much intervention is too much, and at what level should such decisions be taken – by states, intergovernmental

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[204] For an interesting discussion, see Calixto Filho (ed), *A Legal Theory of Economic Power: Implications for Social and Economic Development* (Edward Elgar 2011); Barry Weingast and others (eds), 'The Role of Institutions in the Revival of Trade in Law Merchant, Private Judges and the Champagne Fairs' (1990) Economics and Politics 1.

bodies or by private institutions (i.e. standard setting bodies) operating below, above and across states.[205] Of course, there is no neutral or objective standpoint from which to approach these issues. The choice of theory one subscribes will invariably prefigure our sense of the values or 'ends' that are, or should be, served by banking and finance mechanisms, on what basis, and in whose interest.[206]

For those most critical, the credit crisis presents a rare opportunity to reappraise the free market system and to seek out alternatives to the utilitarian philosophy from which it derives its force and appeal. The redistributive consequences of the global credit crash, in which many people lost their homes and savings, have caused many to question the 'morality', or lack thereof, of conventional banking practices.[207] For these scholars, leverage was exploited by banks in Europe and the United States not simply because of the paucity or fragmentation of the regulation of securities and derivative markets, but because they regard the social costs of product risks in individual financial institutions as symptomatic of the deeper limitations of neo-liberal orthodoxy, which is the prevailing ideological foundation of Western market economies today.[208] Even before the crisis, theorists challenged the neo-liberal justifications of the function of law in the marketplace.[209] These ideas tend to conceptualise the function of law, in the economic sphere, as one primarily concerned with the protection of 'natural' liberties, specifically property rights. In contrast, older theories in this vein countenance a 'natural law' justification for what they regard as 'naturalised' market freedoms.[210] Recent neo-liberal scholarship tends to conceptualise market functions in more utilitarian terms,

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[205] See Charles W Calomiris, 'The Postmodern Bank Safety Net' (*AEI*, 1997) 1-18 <http://www.aei.org/docLib/20040218_book192.pdf/> accessed 21 October 2017.
[206] See, eg, Oles Andriychuk, 'Economic Virtue as Political Virtue: An Insight from the Perspective of Value Pluralism' (2010) 3(1) European Journal of Legal Studies 129.
[207] See, eg, David Kennedy, *A World of Struggle: How Power, Law and Expertise Shape Political Economy* (Princeton University Press 2016) 23; David Kennedy, 'Turning to Market Democracy: The Tale of Two Architectures' (1991) 32 Harvard International Law Journal 373.
[208] On the social costs of economic risks, see James M Buchanan, 'A Contractarian Paradigm for Applying Economic Theory' (1975) 65 American Economic Review 225, 229.
[209] See, eg, Dibadj (n 11). See also Owen M Fiss, 'The Autonomy of Law' (2001) 26 Yale Journal of International Law 517, 518 (identifying neo-liberalism as a 'program for increasing the wealth of nations').
[210] Friedrich A Hayek, *Studies in Philosophy, Politics and Economics* (University of Chicago Press 1967) 90 (noting that, 'the only manner in which we can in fact give our lives some order [in the face of new and unforeseeable circumstances] is to adopt certain abstract rules or principles for guidance, and then strictly adhere to the rules we have adopted in our dealing with the new situations as they arise'.).

while reducing the role of law within market relationships to a mere instrument of 'wealth maximisation'[211] and its related notions of market efficiency.[212]

In the above vein, scholars such as Crotty have attempted isolate the structural failures in the 'methodological foundation' of neo-classical economics, many ideas of which were visible in the lead up to the financial crisis.[213]

The first factor identified concerns the structural relationship between the debt-fuelled nature of modern finance markets and instruments, on the one hand, and increased levels of consumer dependence on cheap credit, on the other. For scholars such as Crotty and others, the rise of unsustainable levels of private debt consumption is a reflection of the utilitarian philosophy from which conventional forms of finance draw their (implicit or explicit) impetus and justification.[214] Here, the ultimate purpose of market mechanisms is to sustain the 'invisible hand' of the free market towards the goal of unlimited consumption.

Other factors identified by scholars in the field are the moral risks which accompany the growing disenchantment with public institutions and accompanying trends towards the 'financialisation' of the market economy.[215] With the rollback of the regulatory state, national governments are now ceding more and more authority to the private sector through an ongoing policy of privatisation and de-regulation. Informal regulation in the form of 'soft' standards and guidelines are frequently preferred over the inflexibility of statutory control and punitive forms of judicial enforcement.[216] Others grow more doubtful of bank exposure to the 'soft' discourse on corporate social responsibility and accountability, arguing that the lurch to privatisation incentivises, or even ossifies, a culture of risk, speculation and profit that seeps across financial markets worldwide.[217]

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[211] On the idea of wealth maximisation being the central rationale or purpose of free markets, see Per-Olov Johansson, *An Introduction to Modern Welfare Economics* (Cambridge University Press 1991) 5.
[212] For relevant literature in this area, see Bruce A Ackerman, 'Foreword: Talking and Trading' (1985) 85 Columbia Law Review 899, 900.
[213] James Crotty, 'Structural Causes of the Global Financial Crisis: A Critical Assessment of the "New Financial Architecture"' (2008) 14 University of Massachusetts, Department of Economics 12, 56.
[214] ibid 11.
[215] ibid 17-18.
[216] Lawrence G Baxter, 'Capture Nuances in Financial Regulation' (2012) 47(3) Wake Forest Law Review 537, 558.
[217] IRRC Institute and Mercer, 'Investment Horizons: Do Managers Do What They Say?' (9 February 2010) <https://irrcinstitute.org/reports/investment-horizons-do-managers-do-what-they-say/> accessed 20 August 2017.

A third structural deficiency of the new financial architecture stems from the opacity of the expanding market in secondary finance markets. As Dam argues, "Contrary to popular impression, securitization (the pooling of loans, including mortgage loans, into securities) is common throughout the world… [ ] In Germany, mortgage-backed securities have been common for at least 200 years. In Asia, securitization markets are growing."[218]

Financial instruments such as CDOs are delinked from trade in real assets and based purely on speculation relating to the fall and rise of market values. Fuelled by speculations about rising asset prices, the housing market was destined to collapse under the weight of 'boom time' optimism. The result, as discussed above, was the failure to accurately price credit risks.

Maniruzzaman argues that:

> "The transaction of capital, properties and portfolio investments were in most cases completed against either virtual or speculative or non-existence of the real properties. Individuals and institutions traded properties on speculations while the ownership remained fluid and untraceable. This was aided, strengthened and institutionalized by sub-prime lending, CDOs and CDS. The result was that transactions were taking place, monies were circulated and consumed, yet the real existence of the properties remained non-existent.[219]

The fourth related factor identified by scholars is the correlation between excessive speculation and excessive risk accumulation in major credit institutions.[220] These risks, in turn, can have deleterious consequences for the public sector, businesses and individuals who have a stake in local and global economies. These factors have led many to believe that the new financial architecture, and the neo-liberal doctrine that inspires it, rests on increasingly shaky foundations.

The above sketch throws into sharp relief the wide-ranging consequences of financial misconduct and weak risk-regulation. Many now question whether the prevailing theories of

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[218] Dam (n 100) 581, 582.

[219] M Maniruzzaman, 'Post-Crisis Political Economy: Neo-liberalism or Islamic Alternative?' (2014) 16(4) Macrothink Institute Research in Applied Economics 163.

[220] Peter Folkman and others, 'Working for Themselves? Capital Market Intermediaries and Present Day Capitalism' (2007) 49(4) Business History 552; Ted Krager, *Skullduggery*: The *True Cause* of the *Financial Crisis* (Authorhouse 2011) 8-10.

law and economy had grossly overestimated the capacity of market institutions to self-regulate, correct failures, and produce efficient outcomes for most people.[221] The next section will consider the movement from classical to public (welfare) orientated concepts of law and legal regulations, through to the neo-liberal concepts of governance which are prevalent today.

2.3 Conventional Banking Theory

It is widely recognised that the countries who were worst affected by the global financial crisis were those who had adopted the most conventional (Western) models of banking and finance. This banking system is underpinned by neo-liberal assumptions about the function of markets more broadly. This is a vision of market economies based on the principles of free enterprise, profit maximisation, interest accumulation, and market efficiency: values given legal expression in the principle of 'procedural' or economic rule of law based around freedom of contract and party autonomy.[222] These assumptions are tacitly reinforced or legitimated by the Basel framework on risk regulation and supervision.

A plethora of neo-classical theories of market and market regulation draw their basic concepts and premises from classic liberalism, and the methodological individualism that underwrites it. 'Classical liberalism' is an unquestionable lynchpin of modern political and economic theory, and is a term which resists precise definition; it has come to mean many things to many people.[223] Embodying the lassiez-faire doctrine of market economy, the earliest incarnations of classic liberalism present a view of economic life as outside of, and prior to, the sphere of political governance.[224] With this, classical liberal thought erects an impenetrable (though ultimately artificial) boundary between state and markets.

For those who draw their impetus from the tradition of classical liberal theory, there is an intrinsic value to the ideal of an autonomous market order which goes beyond its economic

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[221] James Crotty, 'The Centrality of Money, Credit and Financial Intermediation in Marx's Crisis Theory' in S Resnick and R Wolff (eds), 'Rethinking Marxism: Essays in Honor of Harry Magdoff and Paul Sweezy' (Autonomedia 1985) 45.

[222] This 'economic' rule is most closely associated with Hayek's work (n 124); See also Amr Shalakany, 'The Analytics of the Social in Private Law Theory: A Comparative Study' (unpublished S.J.D. dissertation, Harvard Law School, International Law Library Harvard University, 2000) 186-87.

[223] Carl Becker, *The Declaration of Independence: A Study in the History of Political Ideas* (Oxford University Press 1970) 26-27.

[224] Theodore Lowl, *The End of Liberalism-Ideology, Policy, and the Crisis of Public Authority* (WW Norton 1969) 297.

functions. A thriving market order, unencumbered by burdensome regulations is, based on this view, a fundamental condition of liberty, equality and personal freedom. Individuals and corporate persons are motivated by their need and desire to further their own self-interest, for this is an inherent part of human nature.[225] Yet, for the classical or neo-classical theorist, the rational tendency among corporate and private persons to rationalise the maximisation of their own needs and preferences as having the power to benefit the whole of society, as well as the individual.[226] Market forces, based on this view, function as a 'check and balance' against the dangers of absolutist power or executive overreach, whilst simultaneously accomplishing a vital economic function: the principle of unlimited consumption which leads to wealth generation for most people.

Current iterations of this type of thinking can be found across vast swathes of contemporary regulatory and economic literature, including but not limited to rational choice theory,[227] institutional theory, and the new management paradigm associated with public choice theory.[228] Whilst these theories diverge on key issues, they do, nonetheless, coalesce around shared assumptions about the relationship between the individual, state and markets.[229] The rational choice theorist shares the classical liberal thinker's distrust of majority politics.[230] Governmental intervention, for these scholars, has the unwelcome effect of disturbing the spontaneous (supply and demand) equilibrium of the market place, reducing the autonomy of informed and rational consumers (who vote with their wallet), while rendering market institutions vulnerable to competition-impeding interest group capture, rent seeking, and monopolies.[231] Yet, as the next sections will explore, this forgets our recent experience of the

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[225] See, for instance, Amos Tversky and Daniel Kahneman, 'Rational Choice and the Framing of Decisions' (1986) 59(4) Journal of Business 251, 254.

[226] John M Gowdy, 'The Revolution in Welfare Economics and Its Implications for Environmental Valuation and Policy' (2004) 80 Land Economics 239, 240 (he states the following idea, 'assume that all individuals and firms are selfish price takers. Then a competitive equilibrium is Pareto optimal'). For one of the most influential proponents of this school of thought, see Richard Posner, 'The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication' (1980) 8 Hofstra Law Review 487 (discussing efficiency as a moral criterion); Richard Posner, 'Utilitarianism, Economics, and Legal Theory' (1979) 8 Journal of Law Studies 103.

[227] See Gary S Becker, Michael Grossman and Kevin M Murphy, 'Rational Addiction and the Effect of Price on Consumption' (1991) 103 American Economic Review 237.

[228] See, for example, Kenneth Arrow and others, 'Is There a Role for Benefit-Cost Analysis in Environmental, Health and Safety Regulation?' (1996) 272 Science 221.

[229] Taylor C Boas and Jordan Gans Moore, 'Neo-liberalism: From New Liberal Philosophy to Anti-liberal Slogan' (2009) 44(2) Studies in Comparative International Development 137.

[230] For a classic proponent of this approach, see Richard A Posner, *The Problems of Jurisprudence* (Harvard University Press 1990) 363.

[231] For a discussion, see Jon Elster, 'The Case for Methodological Individualism' (1982) 11(4) Theory and Society 452. Methodological individualism is a central tenet of neo-classical economics. The conventional

welfare state, where rights regulation and a range of social policies were developed to precisely redress market failures and social inequalities in wealth, resources and access to justice.

2.3.1 Classical Liberal Theories of Law and their Antinomies

Current theories on law and regulation are increasingly permeable to the disciplinary takeover of fields such as political science and economics, thus inflecting the regulatory and policy solutions developed in response to market failures at a domestic or international level.[232] Contemporary debates on the role of law in markets draws much of its inspiration and impetus from classical liberalism's enduring influence on the development of Anglo-American legal systems.[233] The role ascribed to (state) law in the classical liberal worldview (known as the Lochner doctrine in the United States[234]), was, by today's standards, highly circumscribed. Here, a robustly independent judiciary would defend constitutionally protected doctrines (in the case of the United States) of personal economic liberty, principally by enforcing the boundaries between public and private law. These fundamentals of classical liberal thought allow us to draw enduring distinctions between market orientated theories of regulation and the perceived opposite, the democratic principle of social consent.

Classical liberal thought stands in opposition to the broad raft of social and economic policies and conflicts that defined the beginning of the 20th century.[235] In the post-war settlement of the 'New Deal', courts were at the forefront of an expansion of 'rights' that went beyond equal protection and economic freedoms, to include social and economic rights. These rights, it was presumed, would establish a more equitable balance of power between the forces of capital and labour. It was not long before courts were called upon to perfect a more equitable

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wisdom, central to neo-classical economic theory, is that the market is self-correcting. The consumer demands of particular individuals, operating in different markets, are generalised, and used as the baseline for supply/demand ratios for the whole global economy. This ignores regional variations and non-rational market behaviour.

[232] Eg Christine Jolls, Cass R Sunstein and Richard Thaler, 'A Behavioural Approach to Law and Economics' (1998) 50 Stanford Law Review 1471.

[233] Herbert G Reid, 'Cohen's Case for Liberalism' (1971) 33(4) Review of Politics 489 (the trajectory of European history charts a similar path, though the theoretical influences on European states are more closely aligned with social-democratic models as discussed below).

[234] *Lochner v New York* 198 US 45, 56-57; see also Victoria F Nourse, 'A Tale of Two Lochners: The Untold History of Substantive Due Process and the Idea of Fundamental Rights' (2009) 97 California Law Review 751, 756-57.

[235] For a wider discussion on these issues, see Andrew Glyn, *Capitalism Unleashed: Finance, Globalization and Welfare* (Oxford University Press 2006).

balance between the rights of capital and an expanded category of represented 'interest groups' on the other side of the contractual bargain, i.e. consumer groups, environmental groups, and women etc.[236]

The twentieth century would, according to conventional narratives, instantiated a new constitutional settlement between capitalism and democracy, principally through the movement from substantive to procedural law, wherein newly empowered courts would be asked to determine issues of 'economic' justice.[237] Yet, even here we find a paradox. The birth of the modern state, after all, was founded on the principle of democratic consent.[238] The foundations of private law and ordering consequently rest on public law. It is little wonder that many critics of the classical and neo-classical perspective struggle to reconcile the idea that private ordering should remain both outside the law (through legislative oversight and judicial control) and within it (chiefly through its enforcement through private law doctrines).[239] These questions were vexing enough when the state was the principal site of legal regulation. In an era of globalisation, the debate has shifted from the public and private boundary, through to the diminished power of the state and the tempering influence of local and national regulations.

2.3.2 The Rise of Neo-Liberal Governance

The prominence of neo-liberal governance highlights the increasing influence of economic and social science theories and methods on the theorisation and practice of law and the public regulation of markets.

Neo-liberal governance is frequently aligned with the liberalisation of labour market policies; the privatisation of public services, and protection of private assets from uncompensated state ownership or control.[240] Judicial activism is, once again, discouraged. Courts are instead

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[236] See, eg, David Singh Grewal and Jedediah Purdy, 'Introduction: Law and Neo-liberalism' (2014) 77 Yale Law School Legal Scholarship Repository 1; Carlos Salinas de Gortari and Robert Mangabeira Unger, 'The Market Turn Without Neo-liberalism' (1999) Challenge 14.

[237] See, for example, Peter Calliess and Peer Zumbansen, 'Law, The State and Evolutionary Theory: Introduction' (2008) 9 German Law Journal 389.

[238] Robin W Boadway, 'The Welfare Foundations of Cost-Benefit Analysis' (1974) 84 (336) The Economic Journal 926.

[239] See, eg, James M Buchanan, 'Contractarian Political Economy and Constitutional Interpretation' (1988) 78(2) American Economic Review 135, 139.

[240] See, eg, Jedediah Purdy, 'The Roberts Court v. America' (Winter 2012) Democracy Journal 46, 47; Richard A Posner, *Economic Analysis of Law* (5th edn, Harvard University Press 1998) 20, 95-96.

expected to perform the functions ascribed to them under the classical theories of adjudication: strict enforcement of the contractual bargain, economic freedoms and formal principles of justice (i.e. equality before law and judicial conservativism).[241] At the most extreme margins of neo-liberal thought, private and market institutions are understood to autonomously construct their own sources of law within a background of economic order, outside of the reach and influence of normative and professional discourses. At the same time, decisions generated by private actors are regarded as informal private guidelines of conduct, which are not subject to judicial enforcement.[242]

At it the same time, it would be too strong to suggest that neo-liberal governance is the mere handmaiden of market fundamentalism. Contemporary strands of neo-liberal thought also embrace governmental regulation, and eschew private governance, where such methods are deemed more appropriate for achieving the 'correct' (pareto-optimal) market outcomes.[243] In other words, the neo-liberal scholar is less preoccupied with the 'who' of governance (i.e. which actors are best positioned to steer market processes), or even the 'how' of governance (i.e. state engineered 'command and control' regulations versus more participatory models of governance above or below the level of state regulation), than the site of enquiry of the 'outcomes' that governance is used to achieve.

In redirecting focus away from the efficacy or utility of market outcomes, a different set of theories offer a process-orientated account of the institutional or epistemic factors which govern or shape market behaviour.[244] Proponents of the 'new institutionalism' devote considerable attention to how institutions behave, principally through an exploration of the myriad of ways in which members of an institution, whether corporate or governmental, inculcate the rules, norms and values of that organisational structure, and change their behaviour accordingly.[245] These scholars are, once again, not primarily concerned with values which structure the market, the utility or justness of its outcomes. Rather, these scholars will

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[241] Cesar Rodriguez Garavito, *The Globalization of the Rule of Law: Neo-liberalism, Neo-constitutionalism, and the Contest over Judicial Reform in Latin America* (Routledge 2011).
[242] Gunther Teubner, 'Global Bukowina: Legal Pluralism in The World Society' in Gunther Teubner (ed), *Global Law Without A State* (Dartmouth 1997) 3.
[243] See, eg, Buchanan (n 1174).
[244] See, eg, Wolfgang Streeck, 'Taking Capitalism Seriously: Towards an Institutionalist Approach to Contemporary Political Economy' (2011) 9 Socioeconomic Review 137, 140.
[245] Ronald H Coase, 'The New Institutional Economics' (1984) 140 Journal of Institutional & Theoretical Economics 229, 231.

typically focus their analysis around the relationships between 'principals' or 'agents'[246] within an institutional configuration, focusing on those actors who are best placed to influence the behaviour of its members and participants.[247]

Sceptical about the state's capacity to control multi-national corporations against the background rise of private law and deregulated market institutions, many of these scholars deny states a strong role in the management of global financial institutions, or say little of the interstitial worlds of finance and commerce (such as the burgeoning market in collateralised debt instruments) much of which occurs in the shadow of legislative and judicial oversight.[248] While strands of new institutional theory (i.e. new governance scholarship) downplay the centrality of traditional state institutions at the level of domestic law, a variety of scholars have, nonetheless, explored the growing importance of trans-national regulatory institutions, many of which rely on co-operation between governmental agents, experts and other corporate actors.[249]

Scholars who work within the field of scholarship known as 'new institutionalism' will sometimes model their arguments on a variant of international economic (or game) theory to assess the terms of strategic bargaining among states and other regulatory actors.[250] Once again, the effectiveness of an institution is identified as a key metric of its success. Yet, effectiveness does not merely denote desirable market outcomes. Rather, institutionalist theories tend to be far more preoccupied with the responsiveness of a given institution, as evidenced by its capacity to react to dynamic market conditions and adjust its practices to reflect new social expectations and demands.[251] Here, focus turns to the 'compliance' power

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[246] For a taxonomy of different types of accountability, including principal-agent models, see Ruth W Grant and Robert O Keohane, 'Accountability and Abuses of Power in World Politics'(2005) 99 American Political Science Review 29.

[247] EL Khalil, 'Organizations Versus Institutions' (1995) Journal of Institutional and Theoretical Economics 151.

[248] For a general overview of these issues, see Alex Mills, 'The Private History of International Law' (2006) 55 International and Comparative Law Quarterly 1; Dan Danielson, 'How Corporations Govern: Taking Corporate Power Seriously in Transnational Regulation and Governance' (2005) 46(2) Harvard International Law Journal 411.

[249] For a relevant discussion see Daniel D Polsby, 'Should Government Attempt to Influence Consumer Preference?' (2000) 23 Harvard Journal of Law and Public Policy 197, 200.

[250] For a discussion on this mode of thought in the context of intellectual property rights, see Reza Dibadj, 'Regulatory Givings and the Anti-commons' (2003) 64 Ohio State Law Journal 1041. For a domestic law perspective, see Susan Rose-Ackerman, 'Triangulating the Administrative State' (1990) 78 California Law Review 1415.

[251] For a theoretical discussion on the intellectual history of these ideas, see Joseph W Singer, 'Legal Realism Now' (1998) 76 California Law Review 465, 467; Cristie L Ford, 'New Governance, Compliance, and Principles-Based Securities Regulation' (2008) 45 American Business Law Journal 1, 5-6. See also Geoffrey

of informal standards and the corporate codes of practice of global public institutions, such as the Basel Committee, which function as norms.[32]

An institution such as the Basel Committee is, accordingly, judged effective or not based on its ability to constrain or facilitate certain types of behaviour using the soft power of its rules and norms. Similarly, the efficacy of the recent Basel III reforms can be judged in accordance with the extent that these have been responsive to market events, both in respect of their ability to reform corporate practices, and their willingness to revise previous Basel standards.[12] A further indicator of the responsiveness of the Basel regulatory architecture may be gleaned from its capacity to develop a minimally harmonised system of international banking regulations which are sufficiently flexible to accommodate diversity across states and institutional contexts.[252]

2.3.3 Limitations of a Procedural Model of International Risk Regulation

The central change introduced by Basel III is the strong enforcement of liquidity risk standards, with banks now forced to meet liquidity requirements that are based around a partially equity-driven method of stress testing for all banks. Beyond establishing liquidity and capital buffers, the Basel convention focuses more on the technical aspects of risk regulation, on capital adequacy requirements, the procedural elements of risk regulation in the form of strengthened market disclosure, and transparency related standards.[253] In an attempt to promote good governance at infra-state level, global regulatory bodies such as the Basel Committee have attempted to constrain or modify state behaviour using policies, for instance by establishing guidelines on supervisory 'best practices'. Banks are required to give procedural accounts of the measures taken to comply with the good governance indicators i.e. transparency, financial reporting and auditing.[254]

Underhill, 'Keeping Governments out of Politics: Transnational Securities Markets, Regulatory Cooperation, and Political Legitimacy' (2007) 21 Review of International Studies 251.

[252] G10 Working Party on Financial Stability in Emerging Market Economies, 'Financial Stability in Emerging Economies: A Strategy for the Formulation, Adoption and Implementation' (April 1997) <https://www.bis.org/publ/gten02.htm> accessed 7 April 2017.

[253] Barr and Miller (n 10).

[254] For a discussion, see Simon Chesterman, 'Globalisation Rules: Accountability, Power and the Prospects for Global Administrative Law' (2008) 14 Global Governance 39, 42. For a relevant discussion on Basel III, see Marcilio Franca-Filho and Ílina Cordeiro de Macedo Pontes, 'A Constitutional Outlook on Basel Committee' (World Congress of Constitutional Law 2014, Workshop 12: Constitutions and Financial Crisis) <https://www.jus.uio.no/english/research/news-and-events/events/conferences/2014/wccl-cmdc/wccl/papers/ws12/w12-franca-filho&pontes.pdf/> accessed 12 October 2017.

The procedural model of regulation articulated and advanced under Basel III is not without its discontents. One popular misconception is that the prerogatives of global capital are best managed through the neutral procedures and expertise of Basel technocrats, while matters of substantive economic policy are articulated primarily through democratic processes at the level of state law.[255] It is often falsely implied that a naturalised market order floats free in the background of constituted (political) power. Yet, this image of rational market institutions has the effect of obscuring the legal architecture which structures the market order.[256] This mode of thought is, of course, reinforced by the procedural approach adopted by the Basel framework, which provides little substantive criteria with which to evaluate the strategic or distributional consequences of decision making from within specific institutional, national or global settings. As such, it is arguable that an institutionalised culture of risk-taking and poor corporate conduct cannot be remedied by procedures alone.[257] If the crisis has proven anything it is that global economic authorities can shape and influence national economy policy, in ways that impact the significantly on the rights and interests of consumers and other stakeholders.

Described in the above terms, the Basel III framework silently reinforces the classical separation of state and market, and, at a deeper level, the utilitarian philosophy of unlimited consumption on which neo-classical liberal models of finance are modelled. International financial institutions are not 'neutral' on the question of how markets should be run.[258] Institutions such as the IMF consistently issue strong condemnations of states who fail to implement structural reforms around privatisation and deregulation.[259] Developing countries are effectively forced to absorb the model of market economy as a condition of being granted

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[255] George Vojta and Marc Uzan, 'The Private Sector, International Standards, and the Architecture of Global Finance' in Geoffrey RD Underhill and Xiaoke Zhang (eds), International Financial Governance under Stress (Cambridge University Press 2003) 283.

[256] Justin Fox, *The Myth of the Rational Market: A History of Risk, Reward, and Delusion on Wall Street* (Harper Business 2011).

[257] International Corporate Governance Network, 'ICGN Statement of Principles on Institutional Shareholder Responsibilities' (2007) <http://www.icgn.org/files/icgn_main/pdfs/best_practice/inst_share_responsibilities/2007_principles_on_institutional_shareholder_responsibilities.pdf/> accessed 17 February 2017.

[258] See Susan Creane and others, *Financial Development in the Middle East and North Africa* (IMF 2003) 2 ('A modem financial system promotes investment by identifying and funding good business opportunities; mobilises savings; monitors the performance of managers; enables trading, hedging and diversification of risk; and facilitates the exchange of goods and services. These functions result in a more efficient allocation of resources, a more rapid accumulation of physical and human capital, and faster technological progress, which in turn feeds economic growth.').

[259] Said El-Naggar, 'Privatisation and Structural Adjustment: The Basic Issues' in Said El-Naggar, *Privatisation and Structural Adjustment in the Arab Countries* (IMF 1989) 1.

development funds or loan assistance by the World Bank and IMF, respectively.[260] Political economies based on strong forms of state socialism, protectionism, central planning are 'disciplined' through financial or reputational sanctions, or otherwise denied membership or participatory rights in the decision-making processes of global economic institutions, including the Basel committee.[261]

One notable example of the significant powers wielded by global economic institutions is the sharp opposition levelled against Malaysia's policy of 'Mahathirism' in the aftermath of the Asian Financial Crisis of the 90's.[262] This reflected a broader disenchantment with 'top down' financial regulation, which, in turn, turned to deregulation, liberalisation and privatisation of the finance sector in Europe and the United States.[263] Yet, only little more than a decade later, the very financial institutions which had condemned Malaysia for its attempt to engineer the marketplace through social policies and regulation, were now applying the same methods. National governments on both sides of the Atlantic responded to the banking crisis by adopting a range of regulatory, fiscal and monetary measures, including injecting vast sums of money into the economy to stabilise currencies and restore necessary levels of liquidity into a cash-starved market. Other measures included the decision to nationalise banks or establish insurance protection schemes for depositors who had lost their savings held in pension funds, as major retail banks were made insolvent.[264]

Despite efforts made to reform financial regulations, major economies such as the UK, US and Germany experienced a lengthy recession, a pattern also replicated in Asian economies such as Japan and Singapore.[265] Developing countries with strong stock exchanges, such as India and Mexico, have also suffered stagnation in their growth and development.[266] The

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[260] See also Ibrahim Shihata, 'Good Governance and the Role of Law in Economic Development' in A Seidman, R Seidman and T Walde, *Making Development Work: Legislative Reform for Institutional Transformation and Good Governance* (Kluwer Law International 1999) xvii.
[261] Roman Grynberg and Sacha Silva, 'Harmonization without Representation: Small States, the Basel Committee, and the WTO' (2006) 34(7) World Development 1223.
[262] Maniruzzaman (n 154).
[263] Patricia Jackson and others, 'Capital Requirements and Bank Behaviour: The Impact of the Basel Accord 21' (BCBS Working Paper No 1, 1999) 14.
[264] Lord Myners, 'Address to the National Association of Pension Funds' (12 March 2009) <http://www.hm-treasury.gov.uk/speech_fsst_120309.htm/> accessed 27 May 2017.
[265] Maniruzzaman (n 154) 161.
[266] See World Bank/IMF, 'Global Monitoring Report' (2009) 1. As the report puts it, 'For poor countries, this is a crisis upon crisis. It comes on the heels of the food and fuel crises. The triple jeopardy of the food, fuel, and financial crises is pushing many poor countries into a danger zone, imposing rising human costs and imperilling development prospects.' Sukumar Nandi, 'Capital Flight from India: Theory, Evidence and Determination' (1995) (January-March) Journal of Foreign Exchange and International Finance 447, 448.

crisis also impacted the energy sector, with figures suggesting that more than 100 million people in the developing world are trapped in cycles of poverty as a result.[267] In today's mobile marketplace, the role of law in perfecting the balance between market freedoms and the state's function in protecting or facilitating 'public goods' has once again emerged as a source of intense contestation and conflict.[268] In this sense, the task of governing (or managing) the economy is as fraught with economic strife and conflict as it was at the turn of the 20th century, when worker's rights were pitted against the interests of capital. How then should law intervene in the market to achieve a more equitable balance between economic and 'welfare' rights?

A constructive strategy for law involves going beneath disembodied standards and transparency related procedures to assess the political implications of financial practices and their impact on the balance of power in the global economy.[269] The above enquiry is, however, only sustainable when one avoids drawing a boundary between the jurisdictional domain of 'governance' and the background institutions and norms that structure the decision processes of public governance institutions such as the Basel Committee. A procedural approach places interests which are privileged by the current global financial architecture, and which are excluded, outside of the realm of legitimate public scrutiny: transnational capital versus labour; local or foreign investors; developed or developing nations; stability through global rules; the legitimate diversity of national laws and customs; the preferences of this set of consumers versus these ones, and so on.

As the global distribution of wealth, power and justice began to widen, rather than narrow, neo-liberal faith in the self-regulating and correcting capacities of market mechanisms now rests on unstable ground. To some extent, the Basel reforms are affirmation of this. Basel III is written for debt-based banking operations and, therefore, is, primarily, aimed at mitigating credit default risks (through capital adequacy standards). There is, however, a sector that seems to have been largely untouched by the crisis that was, in all other respects, inescapably

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[267] See the statement of the World Bank's President in April 2008 'Food Price Crisis Imperils 100 Million in Poor Countries, Zoellick Says' <http://go.worldbank.org/5W9U9WTJB0/> accessed 22 February 2017.

[268] For relevant approaches, Francis Snyder, 'Governing Economic Globalization: Global Legal Pluralism and European Law' 5 (1999) European Law Journal 334 (advancing a more pro-market, pro-liberalisation approach). For a contrasting view, see Fleur Johns, 'Performing Power: The Deal, Corporate Rule, and the Constitution of Global Legal Order' (2007) 34 Journal of Law and Society 116 (appealing for a return to a welfare-state orientated approach).

[269] Christopher Hood, 'A Public Management for All Seasons' 69 (1991) Public Administration 3.

global in its reach. In contrast with their conventional counterparts, Islamic Financial Institutions (IFIs) were, to some extent, able to insulate themselves from the worst impacts of the crisis, arguably due to the risk mitigating aspects of Islamic modes of financing.[270]

If the above is true, questions naturally arise over the relevance and applicability of Basel capital adequacy and liquidity related measures as they might be transposed into Islamic finance contexts. It is here that one can point to a certain bias even in the way that Basel conceptualises risk. By focusing its reform efforts on the pressures that conventional banks may face through poor credit risk profiles, the Basel framework, arguably, takes too little account of the unique risks posed to Islamic financial institutions and banking because of their inability to take on many forms of debt. The next sections will explore these ideas in greater detail.

Islamic finance law has a long history of development. The socio-economic model of Islamic governance is structurally and substantively distinct from neo-liberal concepts of market and governance. Once again, these differences are a mere reflection of the seemingly opposed perspectives of conventional (neo-liberal) models versus the socio-economic models of Islamic finance based on fundamental issues. These issues include the function of market mechanisms and the role of regulation within it. For its advocates at least, Islamic finance models have the distinctive claim of being more, "ethical, pragmatic and balanced; institutionally more rigorous; and socially and legally more accountable" than its alternatives.[271]

It should be kept in mind that Islamic models of governance are, generally, in favour of trade and commerce which have long been considered desirable features of Islamic life. Islamic finance instruments and products are conceptualised as having both an instrumental and formal function: the purpose of markets is to promote free trade and investment which, in turn, requires that law protects the commercial expectations of both parties to a transaction in good faith. In the Islamic model of finance law, however, market mechanisms are not typically justified in utilitarian terms: that is, as an instrument of unlimited consumerism,

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[270] Sudin Haron, 'Determinants of Islamic Bank Profitability' (2004) 1(1) Global Journal of Finance and Economics 1.
[271] Maniruzzaman (n 154) 165.

efficiency or means-end balancing. As Marar argues there is, "no doubt that many principles of the Islamic Shariah law contradict the ideology of Western-style financial systems."[272]

If we consider the distinguishing features of the socio-economic model of governance underpinning Islamic finance models, we can see that a first feature of Islamic finance is that it prohibits the taking or receipt of interest (riba) as well as risk, uncertainty and speculation (gharar).[273] Loans can only be granted to individuals with the capacity to enter into permitted transaction arrangements, and who have the means to honour their end of the financial bargain. The application of these principles is assumed to have a self-regulating effect on the economic conduct of the financier and the client.

A second distinctive feature of Islamic finance is that it is institutionally more rigorous than neo-liberal models of governance. Islamic finance does not recognise the trade of money as a 'subject-matter of trade'.[274] All finance must be asset backed. Any transactions which do not result in the transfer and acquisition of rights of ownership are rendered void and null under common interpretations of Islamic finance law. The purpose of such proscriptions is to eliminate the risk of default or speculation around the future value of the asset. Accordingly, Islamic finance principles prohibit the use of financial instruments which rely on speculation and leveraging of risk, namely CDOs and CDS.

Thirdly, the Islamic model of socio-economic government prohibits creditors from entering into unscrupulous financial transactions which are designed to mislead, exploit or inflict loss on the buyer. This principle, if applied to conventional banking systems, would diminish the risk of counter-party default, specifically by placing a limit on the interest accrued on the loan, or by nullifying any repayment terms and conditions which would impose an excessive financial hardship on the counter-party.[275] Parties are consequently deterred from entering into risky short-term transactions simply to increase their share of the profits. Instead, parties are encouraged into financial transactions which are mutually beneficial as well as socially responsible.

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[272] Amr Daoud Marar, 'Saudi Arabia: The Duality of the Legal System and the Challenge of Adapting Law to Market Economies' (2004) 19(1) Arab Law Quarterly 91, 112.
[273] Frank Vogel, *Islamic Law and Legal System: Studies of Saudi Arabia* (Brill 2000).
[274] ibid.
[275] Muhammad Usmani, *An Introduction to Islamic Finance* (Kluwer Law International 2002) xiv.

Islamic finance models are conceptualised in terms which are entirely consistent with cutting edge discourses to corporate governance which emphasise the new, for the purposes of the prudential management of public and private finance, based on a reciprocal model of corporate social accountability which involves multiple stakeholders. Take the argument put forth by Davis, Lukomnik and David Pitt-Watson, as follows:

> “We propose a new conceptualization of regulation. Regulation should enhance the robustness of the interaction between market participants, as well as the robustness of the participants themselves. It should address ethos and architecture as well as command and control type rules and regulations. We should enable the various entities within the system to be accountable to each other and to hold each other responsible. This approach might be thought of as ‘vertical regulation’ and is designed to enhance the trustworthiness and self-correcting abilities of the financial markets as a whole, as well as strengthening the individual financial institutions.[276]

In many respects, Islamic finance models would seem to instantiate and embody aspects of the ‘new institutionalism’ and ‘vertical regulation’ methods and models described above. Underpinning Islamic finance systems, and the control functions they perform, is a vision of governance in which the individual, state and market forces are closely intertwined, each facilitating and constraining the other. Since state institutions, consumers and market actors are ruled by a unifying set of laws and regulations, no separation between public and private law can be sustained.[277] Legal systems which incorporate Islamic sources of law and legislation into national law are obliged to enforce its principles, or at the very least ensure minimal levels of compliance with Shariah. Finance and banking institutions, in turn, are encouraged to adopt socially responsible corporate governance policies. Individuals too must abide by the same laws and regulations, since Islamic concepts are guided by the idea that personal rights and societal responsibilities are interdependent and indivisible. The provision of credit or finance which exceeds the borrower’s need or means is, consequently, forbidden. Paternalism, redistributive governance, collectivism, and risk-sharing are perceived to be the cornerstones of the normative ambition behind Islamic finance.

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[276] Stephen Davis, Jon Lukomnik and David Pitt-Watson, *Creating Responsible Financial Markets in Corporate Governance in the Wake of the Financial Crisis* (UN 2010) 128.
[277] Lu'ayy Al-Rimawi, ‘Middle East: Islamic Models of Islamic Markets’ (2000) 21(5) 161, 163.

On the last point above, Islamic finance models establish the rudiments of a basic system of consumer law. Islamic principles of finance law are designed to ensure that market institutions lend responsibility, thereby reducing the probability of debt accumulation and its destabilising effects on market relationships. Instead of treating economic freedoms and collective social responsibility as fundamentally opposing concepts or ideologies, Islamic finance models rely on the assumption of 'shared normativity' among all subjects of a unified and supreme legal order. Here, market, state and private actors are united under the rule of Islamic Shariah and are bound to observe the same laws, whether customary or institutionalised. Indeed, this is what institutional theory has described in other contexts as rule guided behaviour formed around the 'logic of appropriateness'.[278]

Islamic finance approaches have been gaining traction in major financial institutions in the West, including the HSBC, Goldman Sachs and Moody's (the international risk rating agency). At the level of governmental regulation, national finance authorities, most notably the US Treasury Department, have begun to explore the possible benefits of introducing certain Islamic finance principles into their public policies on ethical finance and corporate responsibility. The UK has emerged as an Islamic finance hub, having established one of the largest financial markets in Islamic products outside the Muslim world. The Islamic index on the Dow Jones Islamic Market (DJIM) has an estimated worth of over $800 billion in assets.[279] These factors suggest that Islamic finance could well establish itself as a competitive alternative to conventional banking at a global level, while, simultaneously fostering a moral economy which protects public good.

Leaving aside the perceived virtues of Shariah governed finance models relative to free market economics, national economies with developed Islamic markets will have to take measures to ensure that Islamic banks compete on levelling playing field. A common legislative framework will need to be designed to ensure that socially irresponsible behaviour or moral hazards (such as profit-driven risk taking) is discouraged, and appropriately penalised, in financial institutions. For this ambition to be realised a more systematic approach to Islamic finance will need to be developed. Moreover, these approaches will have to be harmonised or reconciled with international banking standards, including, most notably, the risk regulation standards developed under Basel III.

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[278] Maniruzzaman (n 154) 159.
[279] ibid.

2.4 Reconciling Basel and Islamic Finance in the Context of Saudi Arabia

Drawing on the above discussion of the role of law in market regulation,[280] this thesis contends that the future sustainability of the Saudi Arabian banking sector is largely dependent on the existence of a regulatory regime which can adapt to market changes, while providing new entrants and existing financial institutions with certainty around the interpretation and enforcement of rules applicable to it.[281] For the legally minded scholar, attention turns naturally to the importance of legislation, administrative oversight and the role of courts, while others seek to limit market freedoms in deference to democratic concepts of the 'public good'. As suggested above, the rise of an increasingly mobile form of global financial capitalism has, to some extent, rendered the state a marginal site for public policy. The example of Saudi Arabia is prescient in this regard. With the oil crisis, the country has had to contend with global trends which have had a more direct impact on the health and stability of its most vital export markets.

The recent policies of the Basel Committee mark a turning point of some type, signalling the beginning of a global consensus around the need for more rather than less regulation of the marketplace. Compliance with Basel III standards is now considered a de-facto condition of entry into the international banking markets. Indeed, an institution's ability to obtain large-scale state sector investor support and re-insurance is increasingly dependent on their effective implementation of the Basel requirements. National regulators, including central banks throughout the Islamic world, will also be required to enact implementing legislation and supervisory mechanisms to ensure that all banks subject to their jurisdiction comply with the new tougher Basel III standards.

The three largest and most influential global economies in the Muslim world are Indonesia, Turkey and Saudi Arabia, and all have already made commitments to implement Basel III standards.[282] Most Saudi banks are already in compliance with Basel II and are expected to fully adopt, without modification, Basel III standards by the end of the implementation phase in 2019. By modelling a reform of its financial laws on the legal instruments of free-market

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[280] Michael Levine and Jennifer Forrence, 'Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis' (1990) 6(S) Journal of Law, Economics and Organization 167.

[281] Monica Malik, 'The Role of the Private Sector' in Rodney Wilson, *Economic Development in Saudi Arabia* (Routledge 2004).

[282] Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar 2007) 122.

economies of the West, Saudi Arabia has responded to market concerns about low levels of competition, confidence, and openness, in the design and operation of the embryonic and partially stated owned and controlled finance sector in Saudi Arabia. More pertinently, Saudi Arabia has taken steps to bring its capital markets, banking laws, and regulations into compliance with Basel III related provisions relating to capital adequacy, liquidity, and market disclosure buffers and guidelines. Saudi banking reforms have, to some extent, addressed market concerns, but clearer standards and effective implementation remain wanting.[283]

Any attempt to institutionalise sector specific banking rules at an international level will inevitably have to be balanced against the regulatory cultures in which market institutions are embedded. This thesis seeks to determine whether the problems of poor coordination and absence of a consensual legal framework in Saudi Arabia may be solved by applying common standards to all banks in Saudi Arabia, both Islamic and conventional. This would require some means of reconciling international risk regulation standards issued under Basel with Islamic finance laws and customs. On the one hand, there is a need to develop finance standards that can be applied to all Islamic finance sectors and institutions. On the other hand, many scholars have recognised the need to tailor Basel standards to the specific needs or requirements of an institution or local industry. This distinction enables the researcher to ascertain the appropriate type of co-ordination required in Islamic finance

2.4.1 The Limited Applicability of Basel Standards to an Islamic Finance Context

While conventional and Islamic banks compete within the same market place in Saudi Arabia, several banks utilise Islamic finance instruments. Finance issued through Islamic contracts may carry different or even lower risks, than finance issued through conventional lending based instruments, but these are risks which must be addressed, or not trivialised, all the same.[284]

It should be recalled again that Islamic banks hold higher levels of equity which is not matched by equivalent levels of debt, thereby creating an imbalance in their risk exposure. This equity/debt imbalance may have unexplored ramifications for the efficiency and

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[283] Kuran (n 44).

[284] Zubair Hasan, 'Basel Accords and Islamic Banking: A Critical Evaluation' (IDEAS Working Paper Series from RePEc, 5 June 2014) 2.

profitability of Saudi banks. Moreover, the application of stricter capital and liquidity standards under Basel II may have a discriminatory impact on Saudi Arabian banks, for instance by creating unequal regulatory burdens for Islamic banks.[285] Furthermore, Islamic banks face operational and liquidity related challenges that are not typically present in other models of banking.

Islamic financial institutions are exposed to distinct risks, including liquidity, valuation, and capital venture exit risks.[286] These risks are closely related to the partnership model of contracting, known as Mudarabah and Musharakah contracts. In both instances, the capital provider or depositor functions in a similar capacity to a limited partner in general law.[287] As a 'limited' partner, the investor is highly exposed to an equity loss risk resulting from counter-party default or capital venture exit risks.[288] In this event, the loss risked will depend on the Islamic finance instrument applied. In Mudarabah contracts, the capital provider (investor) alone bears all the loss as a proportion of the capital invested.[289] In Musharakah contracts, the capital investor shares the loss with the bank. This exposure to capital loss intensifies the Islamic bank's exposure to capital venture and credit default risks.

The broader point, as this thesis will show, is that Islamic banks are equally exposed to credit and liquidity risks, which may go some way to explaining why Saudi Arabia, as a country, may be experiencing such risks at a macro-economic level.[290] The use of novel Shariah compliant finance instruments such as Sukuks (Islamic bonds) may play a significant role in reducing systemic exposure to liquidity and credit default risks in the Saudi banking sector,

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[285] See BIS, 'Basel III Rules, Text and Results of the Quantitative Impact Study Issued by the Basel Committee' (Press Release, 16 December 2010) <www.bis.org/press/p101216.htm/> accessed 20 July 2017; BCBS, *Progress Report on Basel III Implementation* (BIS 2011).

[286] Zurina Shafi and Nurazalia Zakaria, 'Adoption of International Financial Reporting Standards and International Accounting Standards in Islamic Financial Institutions from the Practitioners' Viewpoint' (2013) 13(1) Middle-East Journal of Scientific Research 42, 44.

[287] Limited Partnership Act 1907; Limited Liability Partnerships Act 2000.

[288] Equity holders are usually the last to be compensated in cases of insolvency. See Ross Cranston, *Principles of Banking Law* (Clarendon Press 1997) 354.

[289] In Saudi Arabia, these issues are addressed in a Ministry of Commerce Circular 11-1088 issued by the Committee for Classification of Contractors which points out that, 'to qualify under the Foreign Capital Investment Code, the Saudi partner must share proportionally in the ownership of fixed assets and have an effective role in the management of the enterprise'; Frederick W Taylor Jr, 'Alternative Legal Structures for Doing Business in Saudi Arabia: Distributorship, Agency, Branch, Joint Venture and Professional Office' (1980) 12(1) Case Western Reserve Journal of International Law 77, 92.

[290] Darryl E Getter, 'Macroprudential Oversight: Monitoring Systemic Risk in the Financial System' (CRS Report R40417, 2017).

whilst having a positive impact on the stability of the Saudi economy.[291] Yet, even here, a new set of challenges can arise. Shariah scholars have challenged the legality of secondary 'debt-hedging' instruments, arguing that the majority of the Sukuk share structural similarities with conventional bonds, and, are, thus, not permitted by Islam. Islamic jurists have expressed concerns over the widening gulf between the 'ideal' model of Islamic finance and the day-to-day conduct of banks that are formally designated 'Islamic'.[292]

2.4.2 Do Islamic Banks Need to Comply with International Risk Regulation?

The assumption that Islamic banks behave more ethically than their profit-seeking conventional counterparts is one that is often taken for granted in the existing literature on Islamic finance models and markets.[293] As suggested above, the most prevalent mode of Islamic financing takes the form of partnership agreements, based on the principle of risk-profit and loss-sharing. Islamic finance instruments are often assumed to promote equal bargaining positions between counter-parties.[294]

The virtues of Islamic finance should not be overstated, however. Indeed, it is virtually impossible to offer sweeping observations about the Islamic financial system. The risk exposure of a particular institution cannot be assessed in isolation from the national legal system in which it is embedded, as well as the governance mechanism of the bank itself. The use of profit and loss sharing agreements in Islamic contracts may well allow for a fairer and more equitable distribution of risks between the bank, borrower, and investor. It is also fair to say that Islamic finance practices may not be as fair or equitable in practice, as it might appear on paper.

Islamic banks, like conventional banks, have attracted criticism for failing to eliminate corruption from their internal operations, or to sanction bank managers for poor performance or mismanagement. Islamic financial institutions do not always conduct their activities in a

[291] BCBS, 'A Review of Financial Market Events in Autumn 1998' (Committee on the Global Financial System, October 1999); CEPS Task Force Report, *Basel II Implementation in the Midst of Turbulence* (CEPS 2008).
[292] Birgit Krawietz, 'Introduction' in Birgit Krawietz and Helmut Reifeld (eds), *Islam and the Rule of Law: Between Shariah and Secularization* (Konrad-Adenauer Stiftung 2008) 11.
[293] Adel Ahmed, 'Global Financial Crisis: An Islamic Finance Perspective' (2010) 35 International Journal of Islamic and Middle Eastern Finance and Management 306, 308.
[294] See, generally, Mahmoud A El Gamal, 'Mutuality as an Antidote to Rent Seeking Shariah - Arbitrage in Islamic Finance' (2007) 49(2) Thunderbird International Business Review 187; Haider Ala Hamoudi, 'Jurisprudential Schizophrenia: On Form and Function in Islamic Finance' (2007) 7(2) Chicago Journal of International Law 605, 617.

transparent way, for instance through regular reporting and disclosure of losses. Stakeholders, moreover, may have limited opportunities to influence the investment policies of Islamic banks or participate in decision making processes or hold directors to account. These issues are particularly relevant in the context in Saudi Arabia who has yet to establish tighter corporate governance related regulations.

There is another point to be made, which goes to the corporate practice and accountability of Islamic banks, aside from any enquiry into the applicability and relevance of Basel standards that are transposed to Islamic regulatory contexts. The danger is that Islamic banks may benefit from the patina of legitimacy that is at odds with the reality of the modern marketplace in which all banks pursue profits, sometimes irresponsibly, in order to remain competitive and to appease shareholders. As Ahmed argues:

> "[T]he products offered by the Islamic financial sector, increasingly appear to be mimicking those from conventional finance. In doing so, the contention is that Shariah requirements are diluted, whereby forms of contracts are fulfilled, but the substance and spirit of Islamic law is not. …leading to negative perceptions and damaging observations about the industry. At the extreme end of the spectrum, the Islamic financial industry has been denounced as 'deception' and 'charade' … [while others claim] that Islamic financial institutions are rent-seeking Shariah arbitrageurs using ruses to circumvent prohibitions of Islamic law."[295]

Despite the above criticisms, existing research has not fully explored how certain Islamic finance arrangements may produce an inequitable transfer of risk from Islamic banks to the investor or consumer, in ways that undermine rather than protect their rights.[296]

2.5 The Role (and Rule) of Law in Saudi Arabia

The thesis aims to contribute to existing research by examining the relationship between law, stable markets and good (corporate) governance, and to apply these insights to the legal context of Saudi Arabia. Let us return once again to the animating claims of classical liberal philosophy and the associated concept of the 'rule of law'. This concept is notoriously hard to

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[295] Habib Ahmed, 'Islamic Banking and Shari'ah Compliance: A Product Development Perspective' (2014) 3(2) Journal of Islamic Finance 15, 16.

[296] Frank Vogel and Samuel Hayes, *Islamic Law and Finance: Religion, Risk and Return* (Kluwer Law International 2008) 26.

pin down, but most definitions of 'rule of law' tend revolve around the following proposition: all governmental power should be made subject to the control of law.

By extension, the 'rule of law' has come to mean that ordinary law should take precedence over arbitrary power, and that these laws should limit the wider discretionary power of governmental agencies. To eliminate arbitrariness and unfettered discretion, laws should be general, clear, consistently applied and known in advance.[297] Generality, transparency, predictability and transparency are all integral elements of the rule of law. As Dicey and others have argued, respectively, private actors should be able to rely on fixed rules which are announced in advance, thereby ensuring that they will able to predict with reasonable certainty how the authority will exercise its powers under particular circumstances. It is only when rules are enacted and enforced in compliance with these requirements that an individual can plan their economic affairs in accordance with their knowledge of the law.[298] These ideas have been fleshed out by more economic variants of 'rule of law' theory, which foresee a strong relationship between limited government and a prosperous market economy. More substantive conceptions of the rule, including, in some ways, the socio-economic model of governance advanced under Islamic finance concepts, extends to notions of economic (redistributive) and social justice. While there will always be disagreements over the limits of power and authority, and the 'ends' or values that should be served by law, it is indisputable that uncertainty over the application and effects of law is detrimental to goals of economic efficiency, rights protection, or indeed any concept of justice.

If the financial crisis has taught us anything, it is that failures of economic policy at state level are almost always connected to failures at the level of institutions, in this case the role and behaviour of banking institutions operating in Saudi Arabia.[299] Saudi legislation, more generally, suffers from various gaps and is undergoing a process of slow reform.[300] Doctrines on private and commercial law are still being fleshed out, and Saudi regulators may still lack the capacity to effectively supervise the financial activities and risk assessment practices of banks.[301] More generally, it is not entirely obvious whether the Basel standards offer the best

[297] Bernard J Hibbitts, 'The Politics of Principle: Albert Venn Dicey and the Rule of Law' (1994) 23 Anglo-American Law Review 1.
[298] Frederick Hayek, *The Road to Serfdom* (University Chicago Press 2007) 59.
[299] Jean Seznec (ed), *Commercial Banking in the Arabian Gulf, Part II: Liabilities* (MEER 1988) 13.
[300] See Abdul-Majeed Abdu, *The Banking System in the Kingdom of Saudi Arabia* (Mahad Al-Ehab 1406) 15.
[301] Suliman Hamdan Albalawi, 'Banking Systems in Islamic Countries: Saudi Arabia and Egypt' (Dissertation, Stanford University, 2006) ch 1.

measure for capturing or assessing countries' overall stability, corporate governance and risk exposure, as these relate to regulatory policies on the banking and financial services sectors.

One of the most interesting aspects of Saudi Arabia's economic transformation is that this has led to the development not merely of a dual-market system, but also a dualistic legal system.[302] While Saudi authorities continue to emphasise the supremacy of Shariah as the primary legal system, it is equally evident that the government has created a space for Western-based commercial law systems to function under the general provisions of Saudi banking law. The paramount legal system in Saudi Arabia is the Islamic Shariah. Saudi Arabia is the only country in which Shariah is treated not merely as a principal source of legislation, but as the supreme source of all law and, thence, it is the constitutional embodiment of the state.[303] Clearly, Islamic principles of finance and credit provision provide the cultural context for the development of Saudi Arabia's legal system.[304] Take for instance Article 6 of the Saudi Arabian Monetary Agency (SAMA) Charter, which states that the, "Agency shall not charge any interest on its receipts and payments."[305] The above notwithstanding, significant questions remain as to how seriously Saudi Arabia takes its commitment to providing Shariah compliant financial services, as mandated by law, to the exclusion of a non-Shariah compliant banking service. As will be shown, the Saudi regulators and dispute settlement bodies adopt a highly selective approach to Shariah related finance rules.[306]

As will be explored in the next chapter, the Saudi government has become more accepting of commercial, banking and financial usages associated with Western systems of law. The effect has been to establish a duality in the Saudi legal system or a 'system within a system'.[307] One difficulty that has emerged is that borrowers have exploited ambiguity over the validity of certain contractual clauses under Shariah (such as late penalties, interest repayment, or future

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[302] Marar (n 207) 93.

[303] Article 7 of the Constitution provides that the 'powers of ruling the Kingdom of Saudi Arabia originate from the Book of God and the Sunna of His Apostle, both of which reign supreme over this and all the other laws of the State'. Charter of the Saudi Arabian Monetary Agency, Royal Decree No 23, 15 Dec 1957. It should be noted, however, that Saudi Arabia does not use the word 'Constitution' to describe its Basic Law. See Rashed Aba-Namay, 'The Recent Constitutional Reforms in Saudi Arabia' 42 International Law Quarterly 295.

[304] *The Basic Law of Rule* available in A Lerrick and Q Miau, *Saudi Business and Laws of Saudi Arabia* (N Karam trans, 1984) 63.

[305] Charter of the Saudi Arabian Monetary Agency, Royal Decree No 23, 15 Dec 1957, art 6(a).

[306] John Foster, 'How Shariah Compliant is Islamic Banking?' (*BBC News*, 11 December 2009) <http://news.bbc.co.uk/2/hi/business/8401421.stm/> accessed 29 March 2017.

[307] Marar (n 207) 112.

clauses) to justify, delay, or avoid repayment obligations, despite being made aware of these terms at the time the loans were taken out. To remedy the fears of foreign investors and contractors, the Saudi government has relaxed its position on Shariah compliance to allow banking dispute settlement bodies to enforce the terms of the contract. As will be discussed in Chapter 3, the Banking Control Law of Saudi Arabia implicitly recognises the existence of conventional banking in Saudi Arabia and, moreover, provides a legal basis for it.[308] Contentious issues such as the charging of interest are, nonetheless, remain ambiguous under Saudi law.[309] It is fair to say that commercial banks are not discouraged from providing loan products to the private sector, even if these do not strictly conform to Islamic restrictions on the assumption of debt. In a strategic move, the government has established the Committee for Settlement of Banking Disputes, thereby excluding the jurisdiction of Islamic Shariah courts over banking cases, without an explicit authorisation from the Ministerial Council.

Debt driven models of banking now have a strong presence in Saudi Arabia, regardless of whether Islamic banks have been more resilient in the face of the global economic crisis, to the extent that these banks now issue debt-creating instruments and derive profits from interest-based lending agreements. Therefore, it is readily apparent that such banks do not strictly adhere to the Islamic financial principles of risk and profit sharing.[310] This does not only raise questions of constitutional importance, but it also highlights the relationship between sound governance and stable markets. Risk can only be addressed if sources of capital are disclosed and accounted for.[311] This thesis will seek to show that a lack of transparency surrounding capital flow into Saudi Arabia, whether Shariah compliant or sourced from foreign capital brought into circulation through ‘back door’ investments, feeds into other types of risk, markets, credit, or liquidity.[312] More generally, Islamic finance principles are not codified under Saudi law, creating uncertainty over the applicable standards and intensifying fears around fairness, predictability, and transparency, over banking practice and applicable laws.[313]

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[308] ibid.
[309] ibid.
[310] Taylor (n 224).
[311] For example, equity holders are the last to be paid in case of insolvency. See Cranston (n 202) 354.
[312] Joel Kurtzman, Glenn Yago and Triphon Phumiwasana, ‘The Opacity Index: The Global Costs of Opacity Measuring Business and Investment Risk Worldwide’ (October 2008) MIT Sloan Management Review 1, 4.
[313] Toby Fiennes, ‘Supervisory Implications of Islamic Banking: A Supervisor’s Perspective’ in Rifaat Ahmed and Simon Archer, *Islamic Finance: The Regulatory Challenge* (John Wiley & Sons (Asia) 2007) 247.

2.6 Conclusion

In the final analysis, this thesis argues for the reform of the Saudi legal architecture and re-engineering of its finance laws. Formal recognition of the de-facto duality of the Saudi legal system will be necessary if Saudi Arabia is to adapt to new market pressures, while strengthening the components of its legal system: the Shariah and non-Shariah regulatory models. Indeed, comparison can be made between the Saudi and German banking sectors, since reform is made more difficult because of increased capital requirements and because 'co-operative and publicly-owned banks' are less likely to balance their equity assets with debt instruments tapped from capital markets."[314] These challenges extend equally to Saudi Arabia's implementation of Basel norms which are, structurally, modelled on non-Shariah based neo-liberal models of banking regulation and governance. It is only by bringing these two components into greater reconciliation that governments will be able to enhance the competitive of Islamic and non-Islamic banking practices, thereby enhancing trust and confidence in Saudi Arabia's financial system.

This thesis will therefore focus on the twin objectives of fair and effective banking regulations in the Saudi context. The first of these objectives considers the risks and liabilities of Saudi banks and the degree to which the Basel III implementation process can reduce these risks.[20] The second of the objectives reflects the need to strengthen the accountability of Saudi banks for their investors and borrowers, and emphasises the point that financial reform cannot be addressed by general capital adequacy and liquidity related measures alone. The re-engineering of Saudi Arabia's architecture requires 'bottom up' as well as 'top down' reform, specifically through strengthened corporate governance regulations and 'rule of law' reforms.

[314] James Wilson, 'German Bankers Fear Impact of New Rules' *Financial Times* (21 September 2009) 28.

Chapter III: Saudi Arabia Banking and Banking Law

3.1 Introduction

The focus of this chapter is on the financial structure and regulatory framework of Islamic retail banking in Saudi Arabia. This thesis, as suggested in the introduction, draws a comparison between the events leading up to the global financial crisis of 2008, and the state of financial management in Saudi Arabia today.

Before one can assess whether the Saudi banking system has adequately implemented the Basel III guidelines, thereby ensuring that Saudi banks are insulated against liquidity and capital adequacy risks, it is important to first gain an understanding of the regulatory framework governing financial and banking institutions, both Islamic and conventional, in the Kingdom of Saudi Arabia. Notably, the Saudi Arabian banking sector is made up of both domestic and foreign banking institutions, and each are ostensibly subject to a differentiated legal regime. Particular challenges arise from the mixed nature of the Saudi banking sector, subject to which banks offering conventional banking products and services operate alongside the more established sectors of Islamic banking.

This chapter will examine the key features of the Saudi legal framework, the historical development of its banking sector, and the composition and regulation of the same, today. Finally, the chapter will offer brief reflections on the role of the Basel standards in the context of the Saudi Arabia banking system.

One fundamental obstacle to the reform of the Saudi Arabian banking system is the apparent tension between conventional banking standards and the Islamic foundation of the Saudi Arabian legal system. Islamic finance law blurs the boundaries between law and morality, and by extension, the realm of legitimate public (state) intervention and the autonomous sphere of private and market activity. In short, Islamic finance law and practice is, in theory, rooted in paternalism, redistribution and market intervention. Conventional banking law and practice in the West is, by way of contrast, conventionally understood to be based around free competition, profit maximisation and liberalisation. The apparent tension between the competing rationales of the Islamic versus conventional paradigm of banking and finance law is, however, not the only, or even the most pressing, issue identified by this thesis.

The natural course this chapter shall now take is towards examining the validity and sources of power from where these regulatory bodies originate. In simpler words, we shall now examine the legal framework of Saudi Arabian banks and financial institutions.

3.2 The Legal System of Saudi Arabia

Saudi Arabia is an absolute monarchy. The Kingdom of Saudi Arabia was established by King Abdulaziz on 18 September 1932 by combining the Kingdom of Hijaz and the Sultanate of Najd.[315] The King of Saudi Arabia is considered a monarch and serves as the Prime Minister and Head of State. Moreover, the serves as Commander-in-Chief of the Armed Forces, and the ultimate decision-maker.[316] He can issue administrative, legislative, and executive Orders and Decrees, which take priority over all other governmental ordinances or decisions.[317] Under Saudi Arabia's basic Law of Governance, the country includes a judicial authority, a legislative authority, and an executive authority.[318] By the same token, the primary source of all legislation in Saudi Arabia is the set of common law principles of Islamic law or Shariah.

The Saudi judicial system comprises the Shariah courts, the Board of Grievances and quasi-judicial committees, including the Banking Disputes Settlement Committee of SAMA.[319] Financial regulatory laws include the Commercial Papers Law and the Anti-Commercial Fraud Law enacted by the Ministry of Commerce and Industry.[320] The source for fatwas (religious legal opinion) stems from Shariah, so the courts apply the provisions of Shariah and, therefore, laws not in conflict therewith. Saudi's Basic Law of Governance applies the

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[315] Hans Visser (ed), *Islamic Finance: Principles and Practice* (Edward Elgar 2009) 16.
[230] Joseph Kechichian, *Legal and Political Reforms in Saudi Arabia* (Routledge 2013) 26-30.
[231] Basic Law of Governance, Royal Decree No/90 dated 27/8/1412 AH, arts 45, 48, 67.
[232] ibid art 44.[233] See SAMA, 'SAMA History' <http://www.sama.gov.sa/ABOUTSAMA/Pages/SAMAHistory.aspx/> accessed 25 September 2016.
[233] See SAMA, 'SAMA History' <http://www.sama.gov.sa/ABOUTSAMA/Pages/SAMAHistory.aspx/> accessed 25 September 2016.
[234] See Ministry of Commerce and Industry, 'Laws and Regulations' <http://mci.gov.sa/en/LawsRegulations/Pages/default.aspx/> accessed 18 May 2016; see also, Basic Law of Governance, arts 45, 48, 67.

phrase 'regulatory authority' to pending cases, since God is the ultimate source of all legislation. Regarding the above, the Basic Law of Governance[321] provides that legislative authority shall be formulated in conformance with the principles of Shariah, to be shared conterminously by the King, the Council of Ministers,[322] and the Consultative Council (Majlis al-Shura).[323] The process delineated is as follows: the Majlis al-Shura proposes a draft of new law or amendment, which is studied within the Council, and then submitted as resolutions to the King.[324]

3.3 Saudi Arabian Sources of Legislation

Saudi Arabia's legal system rests on Shariah, which comes from the Quran and the Sunnah, which together are deemed the primary sources of Shariah.[325] Shariah governs all regulations and is applied and interpreted by Islamic judges (Qadis), who have been influenced by the Hanbali Madhhab (school) of Islamic jurisprudence.

3.3.1 Legislative Branches

As mentioned above, all enacted laws within Saudi Arabia must first and foremost be in compliance with Shariah, despite the presence of other legislative bodies like the King, the Council of Ministers, the Consultative Council, and the Board of the Senior Council of Ulama. The presence of such a diverse range of actors is the primary reason behind the complexity of the Saudi Legal System, adding to it a layer of vagueness and uncertainty, and creating excessive and redundant regulations and a lack of clarity in the system.[326]

What further adds to this lack of clarity is the fact that instead of laws finding their roots from a positivist man-made theology, religious scholars as well as the Board of the Senior Council of Ulama members make and amend legislation deriving authority, solely from Islamic studies.

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[321] Basic Law of Governance, art 67.
[322] ibid arts 31, 32, 36, 44, 51.
[323] Shura Council Law 1992, art 23. The Shura Council was established to be a representative of the Saudi people under Article 2 and Article 15 of the Shura Council Law.
[324] Beng Soon Chong and Ming-Hua Liu, 'Islamic Banking: Interest-Free or Interest-Based' (2009) 17(1) Pacific-Basin Finance Journal 125, 130.
[325] Basic Law of Governance 1992, arts 1, 5(A)-(B), 13.
[326] Ahron Layish, 'Saudi Arabia Legal Reform as a Mechanism to Moderate Wahhabi Doctrine' (1987) 107(2) Journal of the American Oriental Society 279, 279.

However, the King is the first legislative authority in the chain of command of Saudi legislative branches. He is the person with supreme power to make all final decisions pertaining to the law. As a monarch, the King is the ultimate arbiter. Regarding the above, the Basic Law of Governanceprovides that legislative authority shall be formulated in conformance with the principles of Shariah to be shared conterminously by the King, the Council of Ministers, and the Consultative Council (Majlis-al-Shura).[327] The process can be delineated as noted above, the Majlis al-Shura proposes a draft of a new law or amendment, it studies this within the Council, and then submits resolutions to the King.[328]

The second legislative branch consists of the Council of Ministers, which has the power to endorse and improve, where need be, the laws of the Kingdom as well as international conventions. The Council of Ministers may bring general policies to the attention of the Consultative Council, which enjoys a superior legislative role. The Consultative Council is made up of 150 members who are appointed by the King himself to play an essential role in legislative affairs. The efforts of these commands on legislation are supplemented by the Board of the Senior Council of Ulama who support the laws in cases pertaining to religious matters.

3.3.2 The Executive Branches

The King and Council of Ministers represent the executive branch in totality. The King is the Prime Minister, Chief of State, and Commander in Chief of the military in Saudi Arabia (Ziegler). The Cabinet consists of 22 ministries, the members of which are appointed by the King himself. Starting from 2009, women can be appointed to ministerial positions as well. King Abdullah made Narah Al-Fayez the first female cabinet-level official (Ziegler).

3.3.3 The Judicial Branches

The judicial system in Saudi Arabia comprises three major judicial bodies: the Shariah courts, the Board of Grievances, and the semi-judicial Committees.[329] All disputes subject to the jurisdiction of Saudi courts are heard and adjudicated under a dual judicial system. Saudi courts assert jurisdiction along traditional lines of commercial, civil and criminal law. The

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[327] Shura Council Law 1992, art 23.
[328] Soon Chong and Liu (n 259).

Board of Grievances, in part, functions to adjudicate on matters involving foreign investments and the execution of foreign judgments, while the semi-judicial committees include, in part, the Commercial Court, which handles corporate business in the Kingdom, by regulating commercial activity including land and maritime commerce, bills of exchange, bankruptcy, and commercial papers.[330]

Under the Council of Ministers' Act of 1958, and following reforms to the judicial system, as enacted under the Law of the Judiciary and the Law of the Board of Grievances,[331] the newly reformed court system in Saudi Arabia consists of Shariah Courts, which have jurisdiction over land, family, civil, and criminal matters; and the Board (or Diwan Al-Madhalem), which is the primary adjudication authority for disputes in administrative matters, and, in particular, public sector projects.[332] The court system has equal authority and the power to bind parties within their judicial decisions.

The Shariah courts also include or stand alongside special committees that have specific jurisdiction over those who perform quasi-judicial functions.[333] These often overlap with the Board of Grievances and on a case-by-case basis it is determined which tribunal has the authority of review and jurisdiction. Examples are the Committee for Banking Disputes, the Commission for Settlement of Labour Disputes and the Committee for Adjudication of Insurance Related Disputes and Violations of the Saudi Arabian Monetary Agency (SAMA).[334] The most important among these, for the purposes of this thesis, is the Banking Disputes Settlement Committee, as established under SAMA (Administrative Committees such as the SAMA Committee on Banking Dispute Resolution).[335]

As a result of legal reforms in Saudi Arabia in 2007[336] and in 2012, the jurisdiction for commercial cases was transferred from some of these tribunals, as well as the Board of

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[330] Fahad M Almajid, 'A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective' (D Phil thesis, University of Manchester, 2008) 152.
[331] Royal Decree Number M/78 on 19/09/1428H.
[332] Faisal Al-Fadhel, 'The New Judicial System of Saudi Arabia' (2009) 75(1) Arbitration Journal 91, 91.
[333] ibid.
[334] Hatem Abbas Ghazzawi & Co, 'Saudi Arabian Law Overview - Dispute Resolution' (*Saudilegal*, 2016) <http://www.saudilegal.com/saudilaw/19_law.html/≥ accessed 23 February 2017.
[335] See Ministry of Commerce and Industry, 'Laws and Regulations' <http://mci.gov.sa/en/LawsRegulations/Pages/default.aspx/≥ accessed 18 May 2016; Basic Law of Governance, arts 45, 48, 67.
[336] Law of the Board of Grievances (promulgated by Royal Decree Number M/78 of 18 Ramadan 1428H, 1 October 2007).

Grievances, to the Shariah courts, and a new commercial tribunal was established.[337] While the intent of this tribunal is to clarify adjudication and jurisdiction and procedures, it may serve to exacerbate the uncertainty that contractual parties face as to which judicial authority is appropriate when filing a claim. Banking disputes pertaining to contracts that have mixed elements, i.e. commercial, administrative, and other certain provisions, may well fall under the overlapping jurisdictions of the Shariah courts, the Board, or the quasi-judicial committees established under SAMA.[338]As will be discussed, Shariah courts may have final authority to adjudicate on civil claims on the grounds of Shariah compliance, based on the direct teachings of the Prophet and the Quran.[339]

On the whole, Saudi Arabia lacks a strong constitutional framework; both regulatory and adjudicative functions are parcelled among an assemblage of quasi-judicial committees, each responsible for reviewing various aspects of the financial sector in Saudi Arabia.[340] As a result, there is no clear division between the jurisdictions of courts, and in particular the Shariah courts, and other quasi-judicial administrative committees.

3.4 Features of Saudi Regulatory Framework on Banking and Finance Regulation

The Saudi government has made attempts to bring greater stability to its banking sector in a volatile economy. To this end, the Saudi Arabian banking sector and the governance framework that supports it have undergone significant reform in the last decade, resulting in its partial liberalisation with extended authority.[341] Prior to these reforms, as will be discussed below, the framework governing banking regulation was largely underdeveloped and was widely criticised for failing to keep pace with the innovations of the modern system of international banking and, more critically, the risk implications of liberalised credit, and innovations in credit instruments and diverse lending scenarios.[342]

Following the partial liberalisation of the banking sector, SAMA was granted independent powers to regulate and supervise the activities of companies registered and listed as banks,

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[337] ibid.
[338] Al-Fadhel (n 267).
[339] Chachi and others (n 20).
[340] ibid 340.
[341] SAMA Banking Supervision Division, 'The Saudi Banking Market Report' (SAMA, 2007) 1.
[342] Essayyad and Madani (n 33).

lenders and monetary service providers.[343] Seeking to bring its laws into alignment with international standards on risk management, banking supervision and market disclosure, the Saudi government incorporated Basel II and III guidelines into its new lending regulations and reforms.[344] In addition to developing rules aimed at structuring and stabilising its national market in banking and lending, Saudi regulators also presided over a number of reforms aimed at strengthening its governance, supervision and enforcement powers (both prior to and concurrent with the Saudi credit downgrading).[345]

3.4.1 The Regulatory Functions and Powers of the Saudi Arabian Monetary Authority

The first step towards the modernisation and liberalisation of the Saudi state controlled banking sector was signalled by the creation of the Saudi Arabian Monetary Agency (SAMA), a body established under Royal Decree, as the central bank of Saudi Arabia.[346] It is governed by a board of directors, and is headed by a Governor, Deputy Governor, and three members, appointed by the King under a Royal Decree for a term of four years.[347] Created by Charter in 1957, SAMA operates as the central bank of Saudi Arabia.[348] Its purpose is three-fold: (1) the issuance, support and consolidation of the Saudi currency, the Saudi Riyal,[349] (2) the implementation of the government's monetary policy as the central bank, and (3) and the regulation of commercial banks and money changers.[350]

SAMA has played an integral role in shaping the design and structure of the legislative framework which now governs banking and lending in Saudi Arabia.[351] Its governing charter defines SAMA's powers and functions, which includes the power to set rules and supervise a regulated entity's compliance with corporate governance rules and reporting requirements.

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[343] Gulshan Dhanani, 'Political Institutions in Saudi Arabia' (1980) 19(1) International Studies 59, 59.
[344] SAMA, 'SAMA's Final Guidance Document Concerning Implementation of Capital Reforms under the Basel III Framework' (December 2012) <http://www.sama.gov.sa/en-US/Laws/Documents/3.%20SAMA%20Basel%20III%20Program/2.%20SAMAs%20Final%20Guidance%20document%20on%20Capital%20Reforms%20under%20Basel%20III.pdf> accessed 29 March 2017.
[261] Mohamed Ramady, *The Saudi Arabian Economy: Policies, Achievements, and Challenges* (Springer 2010) 76.
[262] Royal Decree 30/4/1/1046 and No. 30/4/1/1047, on 4 October 1952.
[263] Implementing Regulations 2004, art 2.
[264] Royal Decree Number M/23.
[265] The Currency Regulation (Royal Decree No M/6, 31 December 1959) established the Saudi Riyal as the official currency of Saudi Arabia.
[266] ibid.
[267] ibid.
[268] ibid.

Subject to SAMA's enforcement powers, the Charter stipulates penalties which can be applied to banks that fail to submit monthly reports disclosing their risk positions.

All financial institutions covered by the applicable banking regulations are obliged to maintain minimal capital deposits. These measures have been in place even before Saudi Arabia began implementing Basel guidelines on minimal regulatory capital and market disclosure requirements.[352] Banks are, correspondingly, required to disclose their financial statements, in addition to the internal rating methods used to determine the capital they hold as a percentage of their risk weighted assets. These issues will be discussed in further detail in Chapter IV.

The Charter that constitutes SAMA also mandates that banks comply with Islamic Shariah law, stating expressly that, "The Saudi Arabian Monetary Agency shall not pay or receive interest," and shall not, "carry on any act which violates the principles of Islamic rites: it may not pay or receive interest on business."[353] Beyond its legislative-like duties, there is also a quasi-judicial committee under SAMA called the Banking Disputes Settlement Committee which addresses contemporary banking matters and disputes.[354]

One important limitation on the business of Saudi banks is that they cannot engage in investment activities. Under the Charter, any bank engaging in investment activity must divest itself thereof and set up a new financial entity to conduct investment activities.[355] These institutions, in turn, fall under the jurisdiction of the Capital Market Authority and not under the jurisdiction of SAMA.[356]

Saudi Arabia's compliance with Basel is influenced by a host of laws. They include but are not limited to: the Banking Control Law, Capital Market Law, the Foreign Capital Investments Law, and Saudi Company law. In what is often referred to as 'secondary' legislation, other banking rules and regulations may be found. These include: (i) Regulations governing Money Changers,[357] (ii) Rules to Enforce Banking Control Regulations,[358] (iii)

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[269] ibid.
[270] The Committee for Settlement of Banking Disputes in SAMA which was issued, formed of three competent members from SAMA under a Royal Order on 1/3/1987, a.
[271] ibid.
[355] ibid.
[356] ibid.
[357] Minister of Finance and National Economy, Ministerial Decision No 3/920 (1981).
[358] ibid, No 3/2149 (1986).

Rules covering Bank Service Charges,[359] and (iv) SAMA's Memorandum clarifying the Powers and Responsibilities of Saudi bank directors.

3.4.2 Banking Control Law

Saudi Banking Control Law (BCL) is classed the main legislation which regulates all banking and financial services in Saudi Arabia.[360] Banking control regulations specifically require SAMA to lay down general principles to regulate certain matters, provided they are approved by the Ministry of Finance and National Economy.

As previously stated, BCL provides SAMA with broad powers to regulate and supervise Saudi banks and to safeguard the banking system. As an illustration, Article 3 requires that all applications to conduct banking in Saudi Arabia be presented to SAMA. BCL defines the banking business, confers licensing powers, and determines the following: capital adequacy; the opening of current accounts; the opening of letters of credit; the issuance of letters of guarantee; the payment and collection of cheques, payment orders, promissory notes, and similar other papers of value; the discounting of bills, bills of exchange and other commercial papers; and foreign exchange transactions and other banking business.

Banking control regulations also govern deposit reserve ratios. Under promulgated ratios, banks must maintain a minimum deposit of reserve ratio.[361] This requires banks to increase their capital, and reserves should not deposit amounts that exceed the prescribed amount, and maintain deposit minimums with the central bank.[362] Furthermore, banks cannot loan any single borrower an amount exceeding (in total) 25% of the bank's total reserves and paid-up capital.[363] To protect the integrity of the Saudi banking system, all licensed banks must appoint two duly-registered Saudi auditors to regularly audit the bank's financial condition and ensure the posting of statutory reserves, and this information is included in the monthly reports mentioned above.[364]

Procedurally, banks are also required to send monthly reports to SAMA. Should a bank violate the requirements set down by banking control regulations, it may face a variety of

[359] SAMA, Circular Number M/A/1/291 (1979).
[360] Royal Decree Number M/5 (11 June 1966).
[361] ibid art 8.
[362] ibid.
[363] ibid.
[364] ibid.

penalties, from the loss of license and termination of non-complying bank officers' employment, including directors and staff, to credit and deposit restrictions, fines, and even imprisonment.[365]

Generally speaking, banking is deemed to embrace any of the business of receiving money deposits, opening bank accounts for customers, issuing letters of credit or guarantee, and processing cheques.[366] In its 26 Articles, however, BCL does not provide a specific framework for Islamic banking and financial services. Rather, Islamic banking and financial services are regulated and supervised by SAMA, together with conventional banking practices, pursuant to BCL. According to Hasan, in Saudi Arabia, Islamic financial institutions (IFIs) operate under a peculiar legal framework because the legal system is based on Shariah. This is relevant because BCL governs all banking institutions in Saudi Arabia, both Islamic and conventional, and has not been amended or repealed to regulate the establishment and the existence of IFIs.[367]

3.4.3 Capital Market Law

When the Saudi economy experienced an economic boom in the early 2000s, the Saudi government made the decision to implement the Capital Market Law[368] (CML), to create regulations that would stabilise the stock market and handle other financial issues facing the economy. Though CML is not a banking regulation per se, it does affect the banking system.[369] Passed in 2003, its purpose is to regulate and develop the Saudi financial market through improving the development of procedures that would reduce risks relating to securities transactions.[370] Pursuant to this act, the Capital Markets Authority (CMA) was established. CML delegates to the CMA broad powers to regulate the issuance and monitoring of securities. In addition, CML protects citizens and investors who invest in securities from unfair and unsound practices, or practices involving fraud, deceit, cheating or manipulation.[371] Comprised of 67 Articles, CML is designed to ensure transparency and

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[365] ibid.
[366] ibid.
[367] Maher Mohamad Hasan and Jemma Dridi, 'The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study' (IMF Working Paper 10/2010, 2010) 4-8. <https://www.imf.org/external/pubs/ft/wp/2010/wp10201.pdf/≥ accessed 9 October 2017.
[368] Royal Decree Number M/30 date 2/6/1424 H (31 July 2003).
[369] ibid.
[370] ibid; Capital Market Law 2003, art 5(A)(1).
[371] Capital Market Law 2003, art 5(A) (1).

accountability within the capital markets, and to eliminate market manipulation, insider trading and other unfair practices.[372] The CML exercises similar enforcement and investigative powers to the Malaysian Securities Commission.[373]

One apparent deficiency of the CML is its failure to provide a clear and transparent framework for the issuance of Sukuk in its articles. Currently, the issuance of Sukuk in Saudi Arabia is regulated and supervised by the CMA under the CML.[374] The current framework does not include any mention of Shariah, or acknowledge, thereby, that the basic system of law in Saudi Arabia is derived from Shariah. This lack of clarity presents a number of challenges.

The issuance of Sukuk in Saudi Arabia is currently regulated in accordance with issuance of shares and debt instruments under the Offers of Securities Regulations and the Listing Rules.[375] Despite an expanding market in Saudi Sukuks, there remains an intense debate as to whether 'debt like' instruments, including the issuance of securitised assets issued by the Saudi government, violate Shariah principles and, hence, Saudi law. The absence of a legal framework for the issuance of Sukuk in Saudi Arabia, as Al Elsheikh and Tanega assert, leads to confusion about the legal treatment, validity and differences between Islamic and conventional finance instruments, including Sukuks, shares and bonds, and conventional debt instruments.[376] Moreover, a number of commentators have suggested that the Sukuk market in Saudi Arabia is poorly regulated and has yet to be operated within a framework that takes account of the nature of Sukuk as being distinct from conventional debt instruments, despite being treated as an equivalent to debt instruments under existing capital market regulations. The distinctive structural features of Islamic derivatives, and their ineffective regulation under the existing structured regulation of capital markets in Saudi Arabia, highlights the limitations of the debt-based model of Basel risk regulation. This argument will be developed in Chapters 4 and 5.

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[372] Nicholas Foster, 'Islamic Perspectives on the Law of Business Organisations: Part 2: The Shari'ah and Western-Style Business Organisations' (2012) 11 European Business Organization Law Review 304, 304.
[373] Zulkifli Hasan, 'Regulatory Framework of Shariah Governance System in Malaysia, GCC Countries and the UK' (2010) 3(2) Kyoto Bulletin of Islamic Area Studies 86, 86.
[374] ibid; art 5(A) (4).
[375] Capital Market Law 2003, art 4.
[376] Abdullah Abdullatef, A Al Elsheikh and Joseph Tanega, 'Sukuk Structure and its Regulatory Environment in the Kingdom of Saudi Arabia' (2011) 5(3) Law and Financial Markets Review 183, 194.

3.4.4 The New Saudi Company Law

Under the earlier Saudi Companies Law,[377] the minimum share capital for joint stock companies was SR 2 million. This was amended under the new Saudi Companies Law of 2015 to decrease the minimum share capital for such companies to only SR 500,000.[378] The required minimum of paid up capital, however, is SR 2.5 million needed to acquire a license.[379] The formation of joint venture banks occurred mostly between 1977 and 1983. Prior to this, the Saudi government was highly resistant to foreign bank expansion. This was, in part, due to the religious criticisms of the growing presence of interest-based entities doing business within Saudi Arabia.

The Companies Control Law (FCCL) provides the regulatory framework under which SAMA can grant licenses to unregistered financial companies.[380] Through the exercise of these powers, SAMA is entrusted with the task of enhancing the capital adequacy and stability of the Saudi banking sector, and with promoting higher levels of consumer protection, chiefly by open channels of credit supply supported by effective risk management regulations and oversight.[381] The principles underlying SAMA's regulatory aims and duties, namely, consumer trust, financial responsibility and sound risk regulation, are entirely consistent with Shariah.

Effective from 2 May 2016, the new Saudi Company Law came into effect, followed by a few implementing regulations providing operational clarification. The implementing regulations identify measures which can be taken by SAMA to ensure effective levels of institutional capitalisation in Saudi financial institutions, including the rules regulating minimal paid up capital requirements, investment strategies, and shareholding options. Significant modifications were made to how Saudi entities are formed and regulated. The renamed Ministry of Commerce and Investment (the Ministry), and the Saudi Arabian General Investment Authority (the GI Authority), are the government agencies that have to grapple with the new changes. Some of the key issues are as outlined below.

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[377] Saudi Companies Law 2015, art 5.
[378] ibid art 54.
[379] Saudi Banking Control Law, art 12(2).
[380] Implementing Regulations of the Finance Companies Control Law.
[381] See SAMA, 'Rules and Regulations' <http://www.sama.gov.sa/sites/samaen/RulesRegulation/BankingSystem/Pages/BankingSystemFD03.aspx/≥ accessed 20 June 2017.

Article 224 provides existing companies with 12 months to conform their business operations and affairs to the new law, although, technically, penalties can be assessed immediately for non-compliance. In the above regard, the Ministry have published template for company articles of association and bylaws for the different entities that are allowed to operate, including LLCs and Joint Stock Companies. Although companies are under no formal obligation to use the template, licence approval of existing or newly-formed companies is more likely to be assured by doing so.[382]

Earlier this year (2017), in April and May, the Ministry and the CMA issued two joint statements addressing the implementation of the new law as it governs joint stock and holding companies.[383] Article 90 regulates shareholders' meetings and cumulative voting on board elections. The new regulations provide for certain restrictions on director voting, and were put into place immediately.[384] Deferred provisions address such things as the number of directors,[385] director pay[386], proper Chairman, Deputy Chairman and Managing Director functions; and Audit Committee actions[387], among other requirements.

3.4.5 Foreign Investment

It is worth mentioning, in brief, the terms of Foreign Capital Investment Law,[388] enacted on 31 December 1978. Under the terms of this law, foreign banks face significant barriers to entry into the Saudi capital market; the operation of this regulation makes it difficult for them to operate independently in Saudi Arabia. Article 52 of the old Saudi Companies Law[389] previously mandated that banks in Saudi could only be established as joint stock companies.[390] The Law provided that limited liability entities were prohibited from taking up banking or savings account businesses. This included a prohibition against making loans to the companies' partners, with such activities being beyond licensing allowances.[391]

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[382] ibid art 42.
[383] ibid art 12.
[384] ibid art 95.
[385] ibid art 68.1.
[386] ibid art 76.
[387] ibid arts 101-104.
[388] Foreign Capital Investment Law (Royal Decree No M/4 date 2/2/1399 AH (31 December 1978).
[389] Saudi Companies Law (Royal Decree No M/6 dated 22/3/1385 AH (22 July 1965)). This was further amended in 2015 by the new Companies Law of 1437AH/2015.
[390] ibid arts 3, 52.
[391] ibid art 159.

In 2015, the Saudi Arabian General Investment Authority (SAGIA) announced that all international companies should be encouraged to be established as 100% foreign-owned trading companies. In June 2016, shortly after the announcement of the Saudi Vision 2030, the Saudi Council of Ministers approved rules to implement this change. Initial indications suggested that only very large international companies, the ones employing large numbers of Saudi nationals) would qualify for 100% foreign ownership.[392] SAGIA has yet to clarify if, when, and on what basis, it will license foreign owned holding companies and foreign owned single shareholder LLCs. These clarifications are likely to have a significant impact on foreign investors who wish to structure their investments in Saudi Arabia.

3.4.6 Corporate Governance

In April 2016, the Ministry and the CMA released a draft of proposed new Corporate Governance Regulations which have now been through a consulting phase. These regulations will apply to Saudi listed companies as well as to the joint stock companies favoured by many Saudi family groups (on a best practice, voluntary basis). Once approved, these regulations will replace the existing regulations which currently apply only to Saudi listed companies. Further still, and in an expression of the Saudi government's declared commitment to maintaining transparent and accountable corporate governance, insurers are called upon to produce and submit an annual report detailing assets composition, performance, and the value of their (pooled and segregated) investment profiles.[393]

3.5 Saudi Arabia's Approach to Market Regulation

While the above discussed banking and finance regulations would seem to primarily establish a system for the transparent registration and licensing of banking and financial institutions, they can be read, more broadly, as an attempt by Saudi national authorities to articulate and implement wider policy objectives, including: strengthened protections for depositors and

[392] ibid art 81.1.

[393] Mohamed A Ramady, 'Evolving Banking Regulation and Supervision: A Case Study of the Saudi Arabian Monetary Agency (SAMA)' (2009) 2(3) International Journal of Islamic and Middle Eastern Finance and Management 235, 235.

shareholders, the promotion of fair, open and effective competition in the banking sector in Saudi Arabia and the sustainable growth of finance markets as a whole.[394]

As noted by Ramady, the regulations have been, to some extent, successful in establishing a relatively permissive and flexible environment for banks operating in Saudi Arabia, thereby strengthening the Saudi government's wider strategy to attract and retain capital investment from abroad.[395] In this narrow sense, the reforms implemented have, to some extent, addressed market concerns. Saudi and non-Saudi banks now compete from within a structured market. As evidence of this last point, there has been a rapid increase in the number of companies registered and, subsequently, listed by SAMA, in the years following the adoption of the regulations.[396] In other respects, however, as Ansari suggests, the regulations operate to constrain market freedoms by conditioning registration and market entry through the institutionalisation of minimal (paid up capital) reserve requirements, by placing limits on foreign shareholdings in Saudi companies, and through placing constraints on freedom of contract (specifically those relating to the distribution of rights to a share in surpluses) on policies and shareholders.[397]

3.6 Analysis: The Limits and Impact of Saudi Banking and Finance Regulation

As has been established, SAMA is the pre-eminent financial sector authority operating within Saudi Arabia and it wields a vast amount of power and responsibility in executing its duties, which include: the supervision of banks and financial institutions; the management of monetary policy; setting national currency rates; and maintaining the stability and integrity of the banking system.[398]

SAMA's general regulatory principles are pre-approved by the Ministry of Finance and the Council. The current regulatory and disclosure requirements include mandating that banks appoint two registered auditors, post statutory reserves, and sending monthly financial reports to SAMA. Further still, and in an expression of the Saudi government's declared commitment

[394] Foreign Investment Law (Royal Decree No M/1 dated 5/1/1421 AH (10 April 2000)). This law requires any firm in Saudi Arabia that has foreign shareholders to obtain a foreign capital investment licence. All licences for foreign capital investment are issued by the Saudi Arabian General Investment Authority (SAGIA).
[395] ibid.
[396] SAMA, Insurance Implementing Regulation (2005): Saudi Arabian Foreign Investment Law Resolution No 1 (5/1/1421 AH).
[397] Zaid Ahmad Ansari, 'Analysis of the Impact of Reforms on the Insurance Industry of Saudi Arabia' (2011) 1 Interdisciplinary Journal of Research in Business 28, 37.
[398] See SAMA (n 331).

to transparent and accountable corporate governance, insurers are called upon to produce and submit an annual report detailing assets composition, and the performance and value of their (pooled and segregated) investment profiles.[399] In addition to being able to set and vary minimum capital and deposit requirements, SAMA has set out detailed provisions on investment regulation, including solvency margins, the valuation of assets, and lending requirements, in addition to a number of technical provisions that address permitted investments, eligibility rules, and maximum cover limits for each investment category.[400]

One central limitation of the existing legal framework in Saudi Arabia is the absence of clear laws which define the scope of the supervisory powers of Saudi regulatory authorities.[401] While the new company and investment laws lay down technical rules for the taking of deposits, the valuation of assets, financial risk management, technical reserves, and the distribution of profits, no comprehensive code of rules governing financial regulation exists.[402] SAMA performs active and highly interventionist oversight and regulatory functions, but it does so in the absence of laws and legislative provisions which define the scope of financial activities, and which fall under the scope of its supervision. Instead, SAMA fills the legislative gap by issuing its own regulations and circulars containing rules and instructions, which do not have the same legally binding effect as Royal Decrees, Orders, or Council of Minister Regulations.[403] Additionally, the BCL sets forth statutory requirements for doing business, including stipulating prohibited activities.[404] In respect of its capital adequacy provisions, the relevant regulations mandate that a statutory amount of no less than 10% of the company's paid-up capital be deposited with an SAMA designated bank. The relevant regulations contain provisions which effectively establish a regulatory ceiling on the sale and transfer of Saudi owned company shares to foreign investors, but Saudi insurers can float shares within the range of no more than 25% to 49%.

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[399] Ramady (n 261).
[400] SAMA, Insurance Implementing Regulation (2005).
[401] See SAMA (n 331).
[402] Habid Ahmed, Mehmet Asutay and Rodney Wilson, *Islamic Banking and Financial Crisis: Reputation, Stability and Risks* (Edinburgh University Press 2013) 4.
[403] 'Secondary' regulations and circulars include but are not limited to: (i) Regulation for Money Changing Business, Ministerial Decision No 3/920 of the Minister of Finance and National Economy of 1981; (ii) Rules for Enforcing the Provisions of the Banking Control Regulation, Ministerial Decision No 3/2149 of the Minister of Finance and National Economy of 1986; (iii) Rules for Bank Service Charges, SAMA Circular No M/A/1/291 of 1979; (iv) SAMA Clarifying Memorandum on Powers and Responsibilities of Members of the Board of Directors of Saudi Commercial Banks; and (v) SAMA Instructions Concerning Compensation for Mutilated Banknotes.
[404] The Banking Control Law (BCL) was issued under Royal Decree No M/5 dated 11/6/1966.

The second limitation of the above aspects of Saudi banking law, concern their potentially anti-competitive effects. The practical effect of Saudi Arabia's foreign investment laws has been to limit institutional ownership rights to Saudi nationals, to the exclusion of foreign owned companies.[405] As commentators have suggested, the rules and limits that have been established under the assemblage of regulations may create excessive barriers to foreign entrants and competition, even if the economic logic of the regulations is to protect local companies from the threat of unfair competition.[406] Moreover, the lack of dedicated re-insurance capacity within in the Kingdom itself is likely to impede the effective enforcement of mandatory retention requirements. As such, and until the local Saudi reinsurance market matures, SAMA may be forced to waive statutory reinsurance limits and retention requirements, or to issue 'no objection' letters to Saudi companies who seek direct insurance offshore.[407]

As a consequence, new entrants and existing banks are unable to conduct a wide range of operational activities without SAMA's express authorisation. For instance, the finance regulations contain suggested points of reform with a bearing on the contractual and competition (or antitrust) dimensions of banking and finance sector regulation in Saudi Arabia. Firstly, under the framework legislation, companies are required to set 'fair and reasonable' prices.[408] As to the contractual aspects of financial provision in Saudi Arabia, financial institutions and lenders are encouraged to model their policies on standard form contracts, subject to prior approval by SAMA.[409] More broadly, contracts entered into require careful drafting and formulation to ensure they do not infringe the Anti Cover-Up Law. As suggested above, the objective of this law is to prevent non-Saudi entities from using a Saudi entity's licence for the sole purpose of undertaking business in Saudi Arabia.

A third limitation concerns the legal mechanisms used to control and improve the corporate mechanisms of Saudi banks. SAMA's enforcement and compliance authority also allows it full access to information from banks to conduct audits and the ability to issue penalties

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[405] ibid.

[406] Abdul Rahim Abdul Wahab, Mervyn K Lewis and M Kabir Hassan, 'Islamic Takaful: Business Models, Shari'ah Concerns, and Proposed Solutions' (2007) 49(3) Thunderbird International Business Review 371, 386.

[407] SAMA, 'Report on List of Insurance and Reinsurance Companies and Services Providers' (*SAMA*, 16 July 2011) <http://www.sama.gov.sa/sites/samaen/Insurance/InssuranceLib/English_Licinced_List.pdf/> accessed 15 November 2016.

[408] Based on Principle 7 and the NCCI Articles of Association.

[409] Abdullatef and others (n 290).

against non-compliant institutions.[410] There is, however, an inherent confidentiality to the process, however, that often leads observers to question the full disclosure and transparency of any compliance issues that may be occurring within Saudi banks and financial institutions. This is further exasperated by the ability of the Council and Ministry of Finance to exempt a bank from provisions of the Banking Control regulation and SAMA's authority, under certain undefined, but controlled circumstances.[411]

A fourth and broader criticism of the current legal framework within which banking regulation is embedded, is the absence of the clear separation of powers, rights protections, transparent decision-making and 'rule of law' accountability of Saudi banking and finance authorities to relevant stakeholders in Saudi Arabia's fledgling capital and finance market. Most notably, Saudi authorities have yet to formulate clear and predictable banking standards which are enforced consistently by independent judicial authorities based on a system of precedent and legal rationality.

The following conclusions can be drawn from the above analysis. The growth and sustainability of Saudi banks is greatly dependent on the success of the soundness and stability of the capital and financial markets which support it.[412] As it stands, however, Saudi Arabia lacks a dedicated framework for governing its fledgling finance sector, both in respect of the relevant legislative provisions for the existing banking and finance law framework, described above, or in accordance with the supervening principles of Shariah. As described above, the framework governing banking and finance is highly fragmented, and it remains unclear whether older legislative instruments such as the Banking Control Act have been superseded by new regulations that implement, for instance, the Basel II or III requirements, as will be discussed below.

This lack of regulatory precision is replicated by the uncertainty surrounding the rules, regulatory or contractual, which are applied to conventional finance institutions and that offer any distinction between these and those which govern Islamic finance institutions, products and instruments.[413] Relating to the above point, it is striking that the New Company Law and

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[410] Hasan (n 308).
[411] ibid.
[412] Lu'ayy Minwer Al-Rimawi, 'Emerging Markets of the Middle East: A Critique of Selected Issues in Arab Securities Regulation' (1999) 7(2) Journal of Financial Regulation and Compliance 149, 152.
[413] Renat I Bekkin, 'Islamic Insurance: National Features and Legal Regulation' (2007) 21(1) Arab Law Quarterly 109, 109.

previous banking regulations make seldom reference, if any, to Islamic finance principles. On the other the hand, it is difficult to underestimate the centrality of Islamic sources within the hierarchy of Saudi laws, not least because the 'basic law' (the legal instruments that establish governmental power and that which constitutes, delineates and distributes among state organs) states unequivocally that all enacted laws, instruments and rulings must be in conformity with Shariah.[414]

The effectiveness of the Saudi finance market will depend largely on the development of a singular and comprehensive approach to international commercial banking and finance, supported by consistent standards for contract construction and practice. From these grounds, this thesis opens up for critical questioning of the following proposition: to what extent is the Islamic model commensurable with conventional models of banking and finance? The question of reconcilability, or otherwise, of these two models is of relevance to the foregoing analysis, not least because many of the companies operating in Saudi Arabia offer conventional banking services and products, while remaining subject to the laws of the Saudi legal system. For instance, conventional and common principles of contract enforcement and construction generally provide for freedom of contract, providing that the contractual terms which apply to them do not fall foul of (common or statutory) the law. Islamic finance law is less permissive and more prescriptive. As the noted scholar Mankabady documents, the form of the Islamic contract regulates the distribution of rights among its participants, in addition to regulating the types of investments in which funds can legitimately be invested.[415] This theoretical tension encompasses the founding principles on which Islamic finance is based, e.g. mutuality, solidarity, risk sharing. The economic (profit maximising) rationale of conventional finance has not yet been fully explored or resolved in existing research on this subject.[416]

By introducing a further layer of complexity to the debate, we can see that the appropriate form and material scope of Islamic finance agreements itself promotes disagreement among

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[414] Article 1 of the Basic Law of Governance supports the argument which emphasises that the Kingdom of Saudi Arabia is a fully sovereign Arab Islamic State. Its religion is Islam and the Book of God and the Sunnah (Traditions) of His Messenger are its constitution. See also Basic Law of Governance 1992, arts 14, 16, 17, 18, 21.

[415] Samir Mankabady, 'Insurance and Islamic Law: The Islamic Insurance Company' (1989) 4 Arab Law Quarterly 199, 200.

[416] H Siti Faridah Abdul Jabbar, 'Islamic Finance: Fundamental Principles and Key Financial Institutions' (2009) 26 Company Lawyer 23, 23.

Muslim scholars and authorities. Islamic jurists, such as Zaman, have, for instance, directed criticism at the growing market in Islamic bonds on the grounds that these contravene principles of Islam.[417] Others have surveyed a spectrum of perspectives on the permissibility of loans or interest based products in Islamic law, grouping these into three categories.[418] Positions range from those in favour of conventional banking products such as interest based loans, to those who approve of certain Shariah compliant loan products, all the way through to the most conservative viewpoint, which argues that the majority of Islamic debt based instruments, including Islamic bonds or Sukuk non-interest based loans, or any type of insurance are in direct contravention of Islamic law, as discussed in Chapter 3.[419]

In light of the above, the most pressing question that comes to mind next is how Saudi Islamic and conventional banks have fared so far without the certainty of a safety net provided by a stable legal framework. In order to answer this question, we shall first look at the historical development of Saudi Arabia's banking sector, then we shall point out the division between Islamic and conventional banking and then draw a side-by-side comparison of both, basing the arguments on empirical data and analysis.

3.7 The Evolution of Banking in Saudi Arabia

Before the Saudi government ended its monopoly over the state-owned provision of insurance and banking services, there were no locally established Saudi banks to speak of.[420] Rather, consumer demand for traditional banking was met and serviced by foreign banks, most notably the Dutch-based Algemene Bank Nederland, or ABN. ABN expanded internationally, and in September 1977 the three former Nederlandsche Handel-Maatschappij branches in Saudi Arabia were incorporated into a new bank, Albank Alsaudi Alhollandi in Riyadh. This bank steadily increased its number of branches and changed its name in 1991 to Saudi Hollandi Bank.[421]

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[417] Asad Zaman, 'Islamic Economics: A Survey of the Literature' (Munich Personal RePEc Archive, 2008) 1104.
[418] Syed Khalid Rashid, 'Islamization of Insurance – A Religio-Legal Experiment in Malaysia' (1993) 2(1) Religion and Law Review 16, 16.
[419] Abdul Wahab, Lewis and Hassan (n 341).
[420] Al-Suhaimi (n 43).
[421] Thomas Derdak, Gretchen Antelman and Lisa Mirabile, *International Directory of Company Histories* (Vol 2, St. James Press 1990) 7.

In 1953, National Commercial Bank (NCB) became the first Saudi-owned bank following the issuance of Royal Decree of the King. NCB was formed as a partnership, in accordance with existing laws in operation at the time of its founding. At present, it continues to operate as a partnership and under the same name. Riyadh Bank was founded as a joint stock company in 1957, and it became the Kingdom's second Saudi-owned bank. The third, Al Rahji Banking and Investment Corp., was established in 1987. The above-mentioned banks are the only three commercial banks in Saudi totally owned by the Saudi government.[422]

By 1978, savings accounts had grown to 10% of total deposits, and by 1990 this figure grew to 50%.[423] As a result, despite Shariah law being nominally applied, there really was little difference in practice between how conventional Western banks and the Saudi banks operated, although ownership was concentrated upon Saudi nationals, mostly princes.[424] Thus, with the 'Saudisation' of the banks, it became difficult for foreign banks to obtain a license, or to otherwise meet Saudi company requirements. This protected Saudi bank ownership, but at the same time limited Saudi Arabia's access to the rapidly growing international banking system and the growing global economy.[425.]

The 1980s was a period of trial and error, with much unpredictability. The country experienced a rapid increase in revenues from 1979 to 1981 but suffered a decline between 1982 and 1986. During this time, there was increased expansion among commercial banks, followed by a difficult adjustment period of retrenchments and asset quality deterioration.[426] Oil prices achieved an all-time low in 1981, an historical foreshadowing of today's volatile markets, which continued until 1986. The economic fallout resulted in considerable pressure being placed on the quality of Saudi bank assets. By 1986, 20% of Saudi bank loans were non-performing, and as loan write-offs and provisions mounted (12% of all loans by 1988), profits suffered. This was not unlike the experience of Western banks in a later era.[427]

Several major events relating to mergers and restructuring occurred in Saudi banking during the 1980s that significantly impacted the system. Firstly, in 1983, the United Saudi Commercial Bank was established to take over the then remaining foreign banks, i.e., Banque

[422] Rolf Meyer-Reumann, 'The Banking System in Saudi Arabia' (1995) 10(3) Arab Law Quarterly 207, 207.
[423] ibid 213.
[424] ibid.
[425] ibid 207.
[426] Ramady (n 328).
[427] Al-Suhaimi (n 43) 128.

du Liban et di Outremer, Bank Melli Iran and United Bank of Pakistan. This allowed for foreign banks to be converted into joint venture banks, comprising Saudi and foreign shareholders. Secondly, in 1984, a full commercial license was issued to Saudi Investment Bank. Later, and in a third event in 1988, Al-Rahji Bank was given a license to convert from a money-exchange business to that of a commercial bank. During this time, banking expansion included the launch of overseas branches of Saudi banks to other countries, e.g., Bahrain, UK, Turkey, and Beirut. With the support of SAMA, the turmoil experienced in the 1980s turned into sizeable increase in bank capital.[428]

At the end of the first Gulf War, Saudi Arabia experienced growth in its economy. From 1990 to 1995, advances and loans increased to 90% and rates of return on assets and equity became stronger. Banks showed record profits. This persisted throughout the second half of the decade despite tough conditions internationally. This trend of stable and solid growth, increased capitalisation, and the banks' robust profitability continued, with three Saudi banks going to market between 1993 and 1997. By 2000, Saudi banks had reached international standards in terms of capitalisation.[429] Based on a 2013 International Monetary Fund report, Saudi's commercial banks comprised its financial system's biggest sector.[430] By 2010, the Kingdom had twenty-three licensed banks, three of which were 'inactive'. Twelve of these banks were Saudi incorporated, with assets constituting 98% of all of the banking system's assets, and 85% of Saudi's GDP.[431]

Dr. Fayaz Ahmad Lone and Salim Al-Shehri argue that three factors pushed this level of stock market activity.[432] The first of these was the Persian Gulf War, after which confidence in the Saudi economy increased because of high oil prices and better assurances of the geo-political state of affairs. This impelled local investors to expel foreign funds. Secondly, low international interest rates, coupled with analogous returns of national savings rates, augmented the appeal of the stock exchange. And lastly, the number of companies trading on the exchange increased noticeably as they tried to increase internal investment, ensuing

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[428] Albalawi (n 236) 15.
[429] ibid.
[430] IMF, Monetary Capital Markets Department, 'Saudi Arabia Financial Sector Assessment Program Update—Detailed Assessment of Observance of the Basel Core Principles for Effective Banking Supervision' (IMF Staff Country Reports, Country Report No 13, 2013).
[431] ibid.
[432] Dr Fayaz Ahmad Lone and Salim Alshehri, 'Growth and Potential of Islamic Banking in GCC: The Saudi Arabia Experience' (2015) 3(1) Journal of Islamic Banking and Finance 35, 35.

several years of depressed economic conditions. Furthermore, the constricted government budget encouraged some public enterprises to obtain capital on the domestic financial markets rather than from the state. The Saudi stock exchange was not exposed to foreign investment, and only shares from Saudi companies could be traded. The concession to the former rule was the right of citizens of GCC member states to purchase Sabic shares from 1984. In 1991, the Arab National Bank, which was partially funded by Jordanian capital, received authorisation to launch a stock fund, from which foreigners might purchase a portion. Despite growth in the stock market, the percentage of shares traded, as a percentage of the total market value of shares outstanding, has been estimated as no more than 5%, which is very low by international standards.

3.7.1 Structure and Composition of Saudi Banks

Currently, twenty banking institutions and their subsidiaries operate in Saudi Arabia. These include foreign banks, jointly-owned banks and national banks. The Table below illustrates Saudi's banking structure.

Saudi Arab Monetary Agency (SAMA)					
Saudi Banks	**No. Branches**	**Joint Ownership Bank**	**No. of Branches**	**Foreign Banks**	**No. of Branches**
1- Ahli Bank	284	9-Saudi Hollandi Bank	42	14.Intern. Gulf Bank	2
2-Al-Rajhi Bank	442	10- Saudi American Bank"Samba"	67	15-Emirate Bank	1
3-Riyad Bank	216	11- Saudi British Bank"SABB"	72	16-B. NB Perbia Bank	1
4- Albillad Bank	67	12- Saudi Fransi Bank	77	17-Morgan Bank	1
5-Al-Jazira Bank	48	13- Arab National Bank	139	18-National Kuwait Bank	1
6- Alinma Bank	75			19-Bahrain Bank	1
7.Saudi InvestmentBank	63			20-Masqat Bank	1
8-Saudi Credit &Saving Bank	NA*				

Table 1: The Structure of Saudi Banks

(Source: SAMA (2010) Annual Report)[433]

In Saudi Arabia, there are two types of banks: Islamic Banks and Conventional Banks. Islamic banks are those that must comply with Shariah law. While all banks currently

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[433] SAMA (n 48).

operating in Saudi Arabia offer Islamic banking services, a number of conventional (non-Islamic) banks conduct business in Saudi territories. Saudi banks, as described above, are embedded in a financial framework that is considerably different from other Gulf Co-operation Countries (GCC), and from other developed and developing nations more generally. Chiefly, they are able to wield significant financial power.[434]

In principle, Saudi Arabian, and in particular Islamic banks, subscribe to the universal model of banking, enabling them to offer a wide range of services 'under-one-roof', including commercial banking, security brokerage, investment banking, and investment firm management.[435] In the Kingdom, business entities rely heavily on banks as the primary source of external funds, as well as on Islamic bonds (Sukuk).[436]

3.7.2 Are all Saudi Banks Islamic?

In Saudi Arabia, only three commercial banks are fully compliant with Shariah law.[437] The rest offer a combination of conventional and Islamic banking products and services. Figures suggest that Islamic finance represents two-thirds of Saudi's banking institutions.[438] Of this number, 38% comes from banks offering Islamic services while 28% comes from conventional bank services.[439] While there remains a lack of consensus on what exactly is implied by 'Shariah Compliant' banking, institutions offering Islamic services are, in theory, obliged to earn and retain income in accordance with Islamic profit-and-loss sharing arrangements (often referred to as PLS). Islamic financial institutions, so defined, are also required to trade in goods and services instead of charging interest.[440] The function of interest-free banking is similar to that of New England's mutual savings bank or equity mutual funds, where depositors are considered, both, as equity borrowers and as business partners of the bank.[441] As such, there is an equitable sharing of risk which is proportionate to

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[434] Ramady (n 261).
[435] Charles W Calomiris, 'The Cost of Rejecting Universal Banking' in NR Lamoreaux and DMG Raff, *Coordination and Information: Historical Perspectives on the Organisation of Enterprise* (University of Chicago Press 1995) 292.
[436] SAMA (n 48). See also Abdullatef, Elsheikh and Tanega (n 311).
[437] Baamir (n 38).
[438] Fitch Ratings (n 6).
[439] Al Homoud (n 6).
[440] Meyer-Reumann (n 357).
[441] Faleh Salem B Al-Kahtani, 'Current Practices of Saudi Corporate Governance: A Case for Reform' (PhD thesis, Brunel University, 2013) 14-15.

the size of the investment.[442] This is the reason Saudi banks normally offer mutual funds shares with company stock portfolios that offer halal products.[443]

As will be detailed in the next chapter, the most salient features of Islamic banking are as follows:

1. The prohibition of interest-based loan/debt transactions.

2. The terms or performance of a contract or transaction must not result in the exploitation of either party.

3. Financial transactions cannot be speculative or purely financial in nature but should involve the exchange of 'real' goods in exchange for money.

4. Society should not be harmed by the transactions.[444]

In order to draw a performance-based side-by-side comparison of Islamic and conventional banks operating in Saudi Arabia, it is first important to highlight some key features of both Islamic and conventional banking. The following table shows verified data from the top ten banks operating in Saudi Arabia today. The names of the fully functioning Islamic banks and information relating to them, has been highlighted for greater clarity. The source of this information is the Bankscope Database.

Name of Bank	World Rank by Assets	Total Assets (Mil) USD	Listed	Market Capitalisation in USD
Al Rajhi	288	74,632	Listed	29,900,002
SAMBA FG	392	54,676	Listed	13,152,000
Saudi British Bank	460	47,281	Listed	10,888,890
Banque Saudi Fransi	477	45,348	Listed	10,076,786
Arab National Bank	557	36,783	Listed	7,733,334
Saudi Investment Bank	819	21,465	Listed	4,384,000
Saudi Hollandi	820	21,458	Listed	5,143,824

[442] Khaled Abou El Fadl, 'Islamic Law, Human Rights and Neo-Colonialism in Chris Miller (ed), *War on Terror: The Oxford Amnesty Lectures 2006* (Manchester University Press 2009) 195.
[443] Abdul Jabbar (n 351) 23.
[444] Wafik Grais and Matteo Pellegrini, 'Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options' (World Bank, 2006) 13.

Bank				
Alinma Bank	980	16,800	Not Listed	7,240,001
Bank Al Jazira	1024	15,994	Listed	3,440,000
Bank AlBilad	1387	9,686	Listed	4,704,000

Table 2: Islamic Banks

(Source: BankScope Database)

Notably, no single Saudi Islamic bank failure was reported during the financial crisis of 2008. One possible explanation for the durability of Islamic banks is their independence from traditional banking methods and trading markets, including high-risk derivative and packaged loan sales.[445]

It is also imperative to note here that Saudi Arabia stands today as the largest economy in the GCC. The strong fundamental performance of Saudi banks continued during 2013. Unaudited 2013 results show increasing trends of major performance factors like revenue generation, assets growth and net profitability. Such positive indications are vital to foster regional economic growth. Recently published reports by Fitch, Moody's, Standard & Poor's (S&P), and other major international rating agencies also affirm a stable outlook for the Saudi Arabian banking system. Moreover, it can be said that the sound supervisory role of regulating bodies (SAMA, CMA, IOB etc.) helps to provide an ideal operating environment, strong operational efficiency, sound funding dynamics, a solid deposit base, strong loss-absorption capacity, and continued growth in business activity. All these are prominent features of the Saudi Arabian banking system today, which is collectively rated as 'stable' by international rating agencies. Again, the Samba Financial Group is included among the world's fifty safest banks.[446] Al-Rajhi Bank and Riyad Bank also qualify for inclusion on the list but do not make the ranking, owing to their total assets. Al-Rajhi Bank has, meanwhile, been awarded the honour of 'best' Islamic financial institution. Al-Rajhi Bank is the largest Islamic bank globally, and boasts of the largest branch network in Saudi Arabia.[447]

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[445] Essayyad and Madani (n 33).

[446] Global Finance, 'Global Finance Names the 50 Safest Banks in the Middle East 2016 (Press Release, 28 September 2016) <https://www.gfmag.com/media/press-releases/press-release-global-finance-names-50-safest-banks-middle-east-2016/≥ accessed 9 October 2017.

[447] Global Finance, 'Best Islamic Financial Institutions 2017' (8 May 2017) <https://www.gfmag.com/magazine/may-2017/best-islamic-financial-institutions-2017-winners-write-ups/≥ accessed 9 October 2017.

In their analysis of the growth of Saudi Arabia's banking sector, Dr. Fayaz Ahmad Lone and Salim Al Shehri closely monitored the profitability, operating income, total asset holdings, and deposits of twelve of the main operating banks in Saudi Arabia.[448] In their report, published in the *Journal of Islamic Banking and Finance* in June 2015, they note that Saudi Arabia's twelve major banks generated a total profit of SR 37.6 billion in 2013, reflecting a year-on-year growth of 7.18%. Al-Rajhi Bank (Islamic Bank) and the National Commercial Bank (NCB) (a conventional bank with an Islamic banking sub-division) represented nearly 41% of the consolidated net profit. NCB's profitability rose by 21.65%, while Al-Rajhi's net profits declined by 5.67%. NCB also managed to retain a healthy level of special commission income. At the end of 2013, its top line climbed to SR 10 billion reflecting a growth of 11.3%. Among other players in the sector, Saudi Investment Bank's bottom line grew by 41.1% from SR 912 million recorded in 2012. It reported a net income of SR 1.29 billion for 2013.

Furthermore, Lone and Al Shehri note with regard to operating income that the core operating profitability of all the banks improved significantly. Al-Rajhi Bank (Islamic Bank) remain a major contributor, representing a total operating income of SR 14.1 billion for 2013, a yearly increase of 0.94%.[449] Riyad Bank and Samba (both conventional banks) have also been able to record a total operating income of over SR 7 billion for 2013, exceeding the previous year's values by 4.24% and 4.59% respectively. According to the analysis put forward by Lone and Al Shehri, on a growth basis, Alinma Bank (Islamic bank) remained at the top, posting a substantial operating income of SR 2.28 billion for 2013, up 24.81% from SR 1.8 billion a year earlier. Saud Investment Bank, with SR 2.02 billion, and a growth of 17.13%, ranked second.

With regard to deposits, Lone and Al Shehri statee that deposits for the twelve commercial banks reached SR 1.46 trillion by the end December 2013, and this marked a handsome increase of 10.16% over the SR 1.32 trillion of 2012, mainly due to deposit mobilisation and the expansion of branch networks. Major contributions in terms of deposits were made by NCB (a conventional bank), representing SR 300.6 billion or nearly one-fifth of the aggregated deposits value. NCB's deposits grew by 9.71% in 2013. Al-Rajhi Bank (an Islamic bank) reported customer deposits of SR 231.6 billion compared with SR 221.4 billion

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[448] Lone and Alshehri (n 367).
[449] See Arab National Bank, 'About Us' <http://www.anb.com.sa/aboutus.asp/> accessed 9 October 2017.

at the end of 2012, an increase of 4.6%. The Saudi Investment Bank (a conventional bank) showed an impressive 41.15% growth in deposits for 2013, reaching a level of SR 57 billion. Alinma Bank (an Islamic bank), had SR 42.8 billion and a growth rate of 32.75%, and was ranked second in terms of year-on-year growth.

More recent commentaries on the performance of the Saudi Banking industry show a slight or moderate improvement in the overall performance of the financial sector. One such report is the Financial Stability Report of 2016 issued by SAMA.[450] The report shows that despite the slowly progressing, and in some cases out right regressive, global and local economic and financial conditions, the Saudi banking sector has continued to grow, albeit moderately. In 2015, their asset base expanded by 3.6% to SAR 2.2 trillion, which is lower than the average growth of 9.3% during the past five years.

The report shows that on 31st December 2015, demand deposits represented 60.8% of total deposits, which is 1.3% lower than the preceding year. However, the percentage share of time and saving deposits and other quasi-money deposits increased to 27.0% and 12.0% respectively. Although a large percentage of demand deposits raise the risk of an asset liability mismatch, demand deposits have been associated with a high level of stability, even during periods of stress. The report further deduces that total deposits continue to grow despite the negative growth in demand deposits. In 2015, total deposits grew by 1.58%, which represents the weakest annual growth since 2009.

3.8 The Common Law Application of Shariah to Islamic Finance Instruments in Saudi Arabia

What must be brought to the forefront at this point in the discussion, is the fact that while Islamic finance instruments share commonalities with conventional commercial arrangements (most notably, mutual fund investments), there are fundamental differences between the two. In conventional finance contracts, the relationship between the bank and lender is that of buyer and seller. Banks buy debt in the form of loan packages from consumers and resell the debt back to the consumer, with interest. By way of contrast, an Islamic financial instrument (like any other Islamic contract) is permissible, only where it is found to be free from the

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[450] SAMA, 'Financial Stability Report' <http://www.sama.gov.sa/en-US/EconomicReports/Financial%20Stability%20Report/Financial%20Stablity%20Report%202016_en.pdf/> accessed 14 October 2017.

following 'impurities': Gharar, (uncertainty in contractual obligation), Jahalah, (ignorance regarding financial obligations, in addition to other prohibitions on Riba (usury)), Ghabn (fraud), and Maisir (gambling).[451] Furthermore, Islamic finance arrangements are intended to further principles of mutuality and co-operation (Ta'awun), encompassing the elements of shared responsibility, joint indemnity, common interest, and solidarity.[452]

One of the defining features of Islamic banking models, in comparison with conventional finance contracts, is the particular legal relationship in which the bank stands to the client. In the Islamic context, the bank acts as trustee by exercising fiduciary responsibilities over the management of joint funds held in savings and investment accounts.[453] In return for its services, the bank is entitled to a fee or a share in the profits generated on the operational surplus of funds held in mutual fund accounts.

In this sense, Islamic finance instruments are purposefully designed to inhibit the payment or receipt of interest or insurance cover, since the surplus returned to investors who partner in a profit and loss sharing agreement is proportional to contributions made, regardless of the amounts of capital invested under partnership agreements. Depositors are, in principle, offered protections against losses suffered by the bank. Where loss occurs, investors can be compensated through the divestment of funds held in segregated profit equalisation reserve accounts. This differentiates Islamic modes of finance from conventional banking, in which the shareholder is the sole beneficiary of profits generated from investment assets. In Islamic agreements, investors and saving depositors hold a stake or share in the losses and profits of bank financed investments and saving accounts.[454]

Broadly speaking, Islamic models of banking fall into one of two category types or models. Nagaoka attributes these differences to, "the dichotomy between those who attach greater importance to the ideal of Islamic finance and those who deem it desirable to respond to the practical demands of Islamic finance."[455]

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[451] ibid.
[452] Abdul Wahab, Lewis and Hassan (n 341).
[453] ibid.
[454] Kuran (n 44) 593.
[455] Shinsuke Nagaoka, 'Beyond the Theoretical Dichotomy in Islamic Finance: Analytical Reflections on Murłbahah Contracts and Islamic Debt Securities' (2007) 1(2) Kyoto Bulletin of Islamic Area Studies 72, 72.

The first arrangement is based on the Mudarabah contract which provides a legal basis for a range of Shariah compliant financial instruments. In essence, this type of contract sets basic terms by which profits are shared (and losses absorbed) between the depositors alone, or the depositors and the bank.

A second model known as Wakalah establishes a contract between the financial institution or bank and the participant. In this variant of Islamic banking, depositors authorise the Islamic bank to manage pooled funds in return for a fixed and predetermined subscription fee, paid for from the policyholder's contributions. This model is widely used in the Middle East.

It is worth highlighting a third model which combines the flexible contracts used in Mudarabah and the silent partner agency relationship of Wakalah in an integrated model. Here, the bank receives both a share of the profits yielded on investment activities financed by investor depositor accounts, in addition to a fixed share of the savings account contributions in the form of Wakalah fees. This model is predominantly used in Pakistan.[456]

From 2011, SAMA prohibited the use of Qard arrangements.[457] A Qard is a loan extended on a goodwill basis, with the debtor only required to repay the amount borrowed. The above discussed Saudi regulations would seem to imply that any finance operation will be deemed enforceable providing it is conducted on a profit and loss sharing basis.[458] The second limitation is consistent with the Islamic doctrine of Waqf. [459] Pursuant to the Waqf principle, net surpluses derived from banking operations are distributed among all depositors as they fall due. In all other respects, it would appear that SAMA, and all relevant implementing regulations, require only that Saudi banks operate on the basis of shared responsibility and Shariah related principles of risk and profit sharing. Beyond these requirements, the regulations fail to provide a detailed framework relating to how finance provision should be conducted.

Assuming the above conditions are strictly applied, Islamic financial institutions and conventional banks would each seem to be governed by differentiated regime of rights and responsibilities (with stricter requirements imposed on Islamic banks than on their

[456] ibid 93.
[457] Muhammad Ibraheem Almusa, *Personal Companies between Law and Shariah* (Dar Alasema 1998) 279-305.
[458] Bekkin (n 348).
[459] Nagaoka (n 390) 94.

conventional counterparts). For instance, while Islamic banks are only permitted to invest depositor funds in Shariah compliant instruments, foreign/conventional banks do not appear to be caught by the same constraints. Similarly, at the level of corporate governance, conventional banks are, presumptively, under no obligation to appoint a Shariah Supervisory Board, as is the case in other Islamic country markets.[460] By way of contrast, the decision making powers of Islamic banks are subject to the constraints of a Shariah Supervisory Board, who may sanction or reject any proposals made by the Board of Directors or Commissioners, if these are deemed to conflict with or contravene Islamic law. This supervisory board comprises eminent religious scholars who, although appointed by BOCs, are independent and have authority to reject any proposals deemed to be against Islamic law.[461]

The rulings of the Shariah Supervisory Board seem to create additional regulatory burdens and constraints on Saudi Islamic banks, which are not applied to conventional banking institutions. It is all the more remarkable, then, that the above discussed Saudi finance and banking regulations fail to distinguish between Islamic and conventional banking. Instead, the prevailing assumption has been that there are no non-Islamic banking operations in Saudi Arabia.

In practice however, formal references to Shariah in legislation may serve as a fig leaf, masking the Saudi Government's rather more ambivalent attitude towards the permissibility of Shariah compliant banking. No legislative act or instruments of state offer classificatory criteria with which to distinguish Shariah compliant capital or financing from its alternatives. Equally, Saudi banking and finance regulations are largely silent on the validity or legality of conventional finance contracts, products or transactions. It is noteworthy that SAMA has granted licenses to a number of foreign banks that offer non-Shariah investment services, derivative transactions, and who issue interest-based credit cards and loans.

Extrapolating from the above, keeping aside the success of Islamic banking and finance, it appears that conventional banks are free to operate in the Kingdom, and, beyond this, provide Saudi consumers with non-Shariah compliant products without restraint, providing these

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[460] See generally, Visser (n 250) 61.
[461] Kristen Smith, 'Islamic Banking and the Politics of International Financial Harmonization' in *Syed Nazim Ali* and AR Syed (ed), *Islamic Finance: Current Legal and Regulatory Issues* (Islamic Finance Project, Islamic Studies Program, Harvard Law School, 2005).

activities are not challenged in the courts. With this, the risk of arbitrariness, lack of transparency and interpretative consistency in the interpretation and enforcement of the raft of banking and financing regulations vis-a-vis the pre-emptory norms of Shariah law becomes increasingly acute.[462]

The Basel Committee on Banking Supervision was created by economically dominant states, referred to as the G10. However, committee membership was expanded in 2009, after the global financial crisis, and now includes, among others, Saudi Arabia.[463] As a member country, Saudi Arabia is expected to comply with the standards and guidelines established and revised under the Basel decision making processes. As will be explored in greater detail in Chapter 4, the Basel Committee on Banking Supervision developed globally benchmarked standards on risk regulation, including establishing liquidity and capital adequacy ratios, which aim to minimise banking exposure to credit, market and liquidity risks in an integrating market.[464] The most recent of the Basel Standards is referred to as Basel III. Under Basel III, as will be explained in greater detail in Chapter 4, banks are subjected to stricter capital adequacy requirements, such as an increase in the amount of capital a bank holds in reserve in order to absorb losses, or to service its financial obligations during periods of stress or market volatility.[465] Reports by the IMF and World Bank suggest that banks operating in the Kingdom have largely met, or even exceeded, Basel minimal regulatory capital requirements.[466] In another assessment made by the Regulatory Consistency Assessment Programme Committee, established by the Basel Committee in 2015, it was shown that Saudi banks are in general conformity with the first pillar of the Basel framework, which regulates the specific amount of capital banks should hold as a proportion of their risk.[467]

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[462] *Kingdom of Saudi Arabia v ARAMCO* (1963) 27 ILR 117.
[463] Chris Marrison (ed), *The Fundamentals of Risk Measurement* (McGraw Hill 2002) 340-342.
[464] See BIS, 'Basel Committee on Banking Supervision Implementation of the Compliance Principles' (August 2008) 4-7.
[465] World Bank, 'Saudi Arabia: Basel Core Principles for Effective Banking Supervision (Detailed Assessment of Observance)' (IMF Financial Sector Assessment Program Update, September 2011) 16 <http://documents.worldbank.org/curated/en/938971468152961989/pdf/807360ESW0Saud00Box379814B00PUBLIC0.pdf/> accessed 20 September 2016, 16-17
[466] RIC, 'Regulatory Consistency Assessment Programme (RCAP) Assessment of Basel III Risk-Based Capital Regulations – Saudi Arabia' (September 2015) 8-10.
[467] BCBS (n 48).

The existing Saudi banking and legal framework establishes Basel related prudential requirements, such as leverage requirements[468], which require that deposit liabilities shall not exceed capital reserves; a liquid asset requirement.[469] This is in addition to placing a ceiling on supplementary instruments or large financial exposures, e.g. subordinated debt-based liabilities. On the last point, banks are expected to offer a capital buffer of no less than 25% of a bank's risk weighted capital reserves.[470]

Banking control regulations obligate each bank to maintain a deposit with SAMA, and provides SAMA with the flexibility of increasing or decreasing such deposits within a narrow band. Furthermore, banks are prohibited from extending to any one entity, a loan or credit facility exceeding in total 25% of the total reserves and paid-up capital of the bank.[471] This significantly exceeds capital adequacy plus capital conservation requirements set up under Basel III (11.5% of the bank's risk weighted assets), as discussed in Chapter 4. In addition, certain other activities, such as providing credit facilities to other banks, are prohibited. Certain other activities, such as merging with another bank, are prohibited unless written permission is obtained from SAMA and subject to fulfilment of the terms and conditions laid down by SAMA.[472]

In the above respect, SAMA has issued a significant circular addressing the capital requirements for Saudi banks to be considered in the context of market risks, by adopting the Basel II and III capital adequacy standard.[473] The specific requirements are as follows: (1) All domestic banks must submit their market risk returns on an annual basis by year-end, and (2) Quarterly reporting will apply only to banks whose trading portfolio exceeds 5% of its total risk weighted assets, or if the overall impact on its risk asset ratio by including market risk exceeds 1%. Saudi Arabian banks have relative few positions on secondary trading markets, due to restrictions on interest-based transactions and speculative investments, both of which are highly exposed to market and credit risks. In a controversial move, the SAMA circular

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[468] Banking Control Act 1968 (Royal Decree Number M/5 dated 11 June 1966) art 6.
[469] ibid art 7.
[470] ibid art 8.
[471] ibid art 7.
[472] RIC (n 401).
[473] SAMA, 'Circular No BCS 355' (29 December 2004).

specifically states that these rules do not apply to "licensed branches of foreign banks in the Kingdom."[474]

The sustained growth and profitability of Saudi banks, particularly Islamic banks, is undermined by a number of market related factors and externalities not yet satisfactorily addressed by the Basel framework and regulations, or the policies implemented by SAMA in this regard. In brief, these factors include: (1) the sub-optimal scale of local banking institutions, particularly Islamic banks (who are not large enough to cover their costs and make healthy returns)[475]; (2) insufficiently evolved capital markets and prudential supervision[476]; (3) inadequately robust risk assessment and knowledge transfer capacity between Saudi regulators and banks; and (4) a lack of re-insurance capacity for high risk finance projects (the re-insurance retention limits are, for instance, likely to create challenges in high risk construction projects).[477]

Saudi banks and financial institutions are, increasingly, relied upon to provide syndicated loans to finance these infrastructure initiatives. At the high point of Saudi growth and liquid markets, new projects would take advantage of a 'boom' in the rapid availability of (Shariah compliant) capital.[478] With the devaluation of Saudi owned stock and over dependence of Saudi banks on illiquid sectors and investments, Saudi capital markets have taken a hit. Looking to place a ceiling on mounting public and private debt, Saudi banks have tightened up their lending policies and increased the 'commission' fees for bank financing, the costs of which are passed on to borrowers.

With these developments, the risk of credit (debt) defaults and market instability (e.g. pricing or exchange rate fluctuations and volatility) looms large.[479] The capacity of Saudi credit providers and insurance operators to underwrite credit and market risks, in turn, becomes increasingly important. It is noteworthy, therefore, that a number of conventional banks or financial bodies continue to operate in the Saudi Market, including unlisted (and non-

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[474] Beck and others (n 114).
[475] Abdul Wahab, Lewis and Hassan (n 341).
[476] Jose Luna-Martinez and Thomas A Rose, 'International Survey of Integrated Financial Sector Supervision' (World Bank Policy Research Working Paper No 3096, 2003) 4.
[477] ibid.
[478] See generally Lu'ayy Minwer Al-Rimawi, 'Emerging Markets of the Middle East: A Critique of Selected Issues in Arab Securities Regulation' (1999) 7(2) Journal of Financial Regulation and Compliance 149, 149.
[479] For a general overview of relevant issues, see Harold D Skipper, 'Foreign Insurers in Emerging Markets: Issues and Concerns, Center for Risk Management and Insurance' (Occasional Paper, 2007) 97.

Shariah) compliant insurance brokers. Indeed, statistics produced by the National Company of Co-operative Insurance in 2011 suggest that the market was serviced by 149 insurance entities, not all of whom are licensed by SAMA or regulated under the relevant implementing regulations.[480]

3.9 Conclusion

This chapter has examined the financial structure and regulatory framework of Islamic and conventional banking in Saudi Arabia. This is the framework in which the Saudi government implemented the post-crisis Basel III reforms. Chapter 4 discusses the potential outcome for Saudi banks.

It is noted above that Saudi Arabia is an absolute monarchy. The King is the first legislative authority in the chain of command of Saudi legislative branches. He is empowered to make all final decisions pertaining to the law. The King and Council of Ministers represent the executive branch. The judicial system comprises three major judicial bodies: the Shariah courts, the Board of Grievances, and the semi-judicial committees. The Shariah courts also include or stand alongside special committees that have specific jurisdiction over those who perform quasi-judicial functions. Examples are the Committee for Banking Disputes, the Commission for Settlement of Labour Disputes, the Committee for Adjudication of Insurance Related Disputes, and the Banking Disputes Settlement Committee, as established under SAMA. It is argued that the presence of such a diverse range of actors is the primary reason behind the complexity of the Saudi Legal System, adding to it a layer of vagueness and uncertainty, and creating excessive and redundant regulations and a lack of clarity in the system.

It was also noted that the primary source of law is the set of common law principles of Islamic law or Shariah which comes from the Quran and the Sunnah. All enacted laws and regulations in Saudi Arabia must therefore be in compliance with Shariah, despite the presence of other legislative bodies such as the King, the Council of Ministers, the Consultative Council, and the Board of the Senior Council of Ulama. The primacy of the Sharia may explain why Shariah courts may have final authority to entertain civil claims on the grounds of Shariah compliance.

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[480] SAMA (n 48).

Nonetheless, regarding the regulation of banks, SAMA has been granted independent powers to regulate and supervise the activities of all companies registered and listed as banks, lenders and monetary service providers in Saudi Arabia. Despite the primacy of the Shariah, neither the Charter of SAMA nor the 26 articles of the BCL provide a specific framework for Islamic banking and financial services. Rather, Islamic banking and financial services are regulated and supervised by SAMA, together with conventional banking practices, pursuant to the BCL. This is equally a problem with the CML and the Company Law of 2016. They do not provide a clear and transparent framework for the issuance of Islamic instruments. Thus, regarding the CML, there remains an intense debate as to whether 'debt like' instruments, including the issuance of securitised assets issued by the Saudi government, violate Shariah principles and, hence, Saudi law. There is also confusion about the legal treatment, validity and differences between Islamic and conventional finance instruments, including Sukuks, shares and bonds, and conventional debt instruments.

The above uncertainties may be attributed to Saudi Arabia's lack of a strong constitutional framework, and the fact that both regulatory and adjudicative functions are parcelled among an assemblage of quasi-judicial committees, each responsible for reviewing various aspects of the Saudi financial sector. Notwithstanding, the regulations have been, to some extent, successful in establishing a relatively permissive and flexible environment for banks operating in Saudi Arabia, thereby strengthening the Saudi government's wider strategy to attract and retain capital investment from abroad. There has been a rapid increase in the number of companies registered and listed by SAMA, and Saudi and non-Saudi banks now compete from within a structured market. The twenty-three licensed commercial banks and their subsidiaries comprise Saudi's financial system's biggest sector, and the Financial Stability Report of 2016 issued by SAMA shows that despite the slowly progressing, and in some cases out right regressive, global economic and financial conditions, the Saudi banking sector has continued to grow.

What this chapter shows is that despite the limited success of the regulations, the reforms implemented by the Saudi government have not resolved some key problems, including the absence of clear laws which define the scope of the supervisory powers of regulatory authorities, and the absence of parameters for the separation of powers, rights protections, transparent decision-making and 'rule of law' accountability of Saudi banking and finance authorities to relevant stakeholders in the capital and finance market. Also, there are no

ascertainable banking standards which are enforced consistently by independent judicial authorities based on a system of precedent and legal rationality. SAMA has filled the gap by issuing its own regulations and circulars containing rules and instructions. Although Saudi banks are required to comply with them, they do not have the same legally binding effect as Royal Decrees, Orders, or Council of Minister Regulations.

It is argued here that the continuous growth and durability of the Saudi finance market will depend largely on the development of a singular and comprehensive approach to regulating commercial banking and finance, supported by consistent standards for contract construction and practice. This may only be achieved if the Islamic model can be reconciled with conventional models of banking and finance. There are fundamental differences between the two models. The question of reconcilability, or otherwise, of the two models is relevant because many of the financial institutions operating in Saudi Arabia offer conventional banking services and products, while remaining subject to the laws of the Saudi legal system (Shariah). Saghedi suggests, "a pragmatic approach rests somewhere between these extremes."[481] He notes that a "visionary" reform project for Saudi financial regulation, and Islamic markets more generally, may yet adapt to the "best practices of the conventional financial system, such as openness, transparency, accountability and uniform regulations, while adhering to the principles of fairness, equity, moderation, and social justice."[482]

However, all banks in Saudi Arabia should normally comply with the Shariah given that the constitution of the Kingdom is the Quran. In this regard, the government has adopted a rather more ambivalent attitude towards the permissibility of Shariah compliant banking.

Nonetheless, as a member of the Basel Committee of Banking Supervision, Saudi Arabia is expected to comply with the standards and guidelines established and revised under the Basel decision making processes. Thus, seeking to bring Saudi laws into alignment with international standards on risk management, banking supervision and market disclosure, the Saudi government incorporated Basel II and III guidelines into its new lending regulations and reforms. The existing Saudi banking and legal framework establishes Basel related prudential requirements, such as leverage requirements, and reports by the IMF and World Bank suggest that banks operating in the Kingdom have largely met, or even exceeded, Basel

[481] Mehdi Sadeghi, 'The Evolution of Islamic Insurance - Takaful: A Literature Survey' (2010) 1(2) Insurance Markets and Companies: Analyses and Actuarial Computations 100, 103.
[482] ibid 106.

minimal regulatory capital requirements. Nonetheless, I have observed that the sustained growth and profitability of Saudi banks, particularly Islamic banks, is undermined by a number of market related factors and externalities not yet satisfactorily addressed by the Basel framework and regulations, or the policies implemented by SAMA in this regard. The factors are listed above and developed in chapter 5. However, prior to that, chapter 4 shows that a singular approach to regulating commercial banking and finance aligned to international standards cannot be fully developed without clear answers to some key questions. These include questions about the nature of Islamic finance, the effectiveness of religious-regulatory restrictions in mitigating risk, and whether the Shariah compliance process is more divergent from ethical standards compared to the conventional process.

Chapter IV: Islamic Banking and its Risk Implications

4.1 Introduction

It is often said that the financial crisis of 2008 exposed the immorality of the current system of global finance and trade.[483] The 2008 financial disaster uncovered the sharp lines dividing Islamic and conventional forms of banking and finance; rendering explicit the obvious differences between the risk profiles of these distinct models. Three questions will be posed, and answered, in this chapter. What is Islamic finance? Are Islamic finance institutions more averse to risk compared to conventional banking? Finally, is Islamic finance more ethical than conventional banking in practice? The answers to these enquiries, as traced in this chapter, are not clear cut. Islamic modes of financing carry their own risks and Islamic banks, like all banks, do not always live up to their ethical reputation.

4.2 A Brief History of Islamic Finance

Islamic banking first came into existence in the early 1970s, and has grown from a relatively modest industry to a well-established segment of the global market in banking and financial services.

The market share in Shariah compliant credit has risen from 2% in the late 1970s, to about 15% in the mid 1990's, as measured by the total number of assets held by Islamic banks as a proportion of the overall market in loan and finance products.[484] In 2010, Davies and Green estimated the total capital value of Islamic instruments at more than $500 billion. Over the last decade this has almost certainly expanded at an annual rate of between 10% and 15%.[485] Islamic banks operate in over sixty countries, with the majority in the Middle East and Asia. Three countries, Iran, Pakistan and Sudan, have modelled their banking systems exclusively on Islamic modes of banking, to the exclusion of conventional models of banking. In Saudi Arabia, however, conventional banks continue to have a significant or even dominant

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[483] Atif Mian and Amir Sufi, 'The Consequences of Mortgage Credit Expansion: Evidence from the 2007 Mortgage Default Crisis' (2009) 124(4) Quarterly Journal of Economics 1449.

[484] Mohammad Salim Al-Rawashdah, 'The Political and Financial Implications of Globalization on the Islamic Banking: Facts and Events' (2009) 12(2) European Journal of Social Sciences 192.

[485] Howard Davies and David Green, *Banking on the Future: The Fall and Rise of Central Banking* (Princeton University Press 2010) 229.

presence. This seems to be a striking state of affairs, since one could argue that the Saudi Arabian legal system – which is founded on the teachings of Islam – requires that all financial activities or transactions are in substantial compliance with the norms and requirements of Shariah.[486] Instead, one finds an easy relationship between the demure obligation by which all Saudi banks comply with the principles of Shariah and the widespread practice of non-Shariah compliant banking, to which many Islamic governments, including Saudi Arabia, have simply turned a blind eye.

Outside Muslim-majority countries, however, the appeal of Islamic finance has experienced something of a renaissance in the wreckage of the sub-prime crisis. Whereas conventional banks would be widely viewed as making a virtue out of greed, and rewarding risky conduct with generous salaries and bonuses, Islamic finance, by some accounts, seems to pursue a, "fairer distribution of wealth, greater support for the poor and needy, and less corruption and dishonesty."[487] It is noteworthy, therefore, that banking institutions in the United Kingdom (UK), Germany, France, Malaysia, Indonesia, Singapore, Japan, and Australia, as well as the entire Middle Eastern region, have begun to offer Islamic services or establish conventional banks with Islamic windows.[488] What, then, are the benefits of Islamic finance compared with its alternatives?

4.3 The Fundamentals of Islamic Financing

Under the Basel regime, the term 'risk' has multiple definitions. In its most common definition, risk typically denotes market or pricing risk exposures[489] that may impact the value of assets underlying Islamic contracts, or operational risks which impair an Islamic bank's capacity to attract income.[490] In Islamic jurisprudence, risk is usually given expression in the concept of Gharar. Unlike mainstream definitions of risk, the concept of Gharar is indeterminate and, therefore, subject to varying interpretations.[491] On the whole, the concept

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[486] Angelo Venardos, *Islamic Banking and Finance in South-East Asia: Its Development and Future* (World Scientific 2005) 78.

[406] Vogel and Hayes (n 210) 26; see also Niaz Alam, *Islamic Finance—Issues and Opportunities* (EIRIS 2004) 7.[488] ICD Thomson Reuters, 'Islamic Finance Development Report, Harmony on the Horizon' (Thomson Reuters, 2014).

[488] ICD Thomson Reuters, 'Islamic Finance Development Report, Harmony on the Horizon' (Thomson Reuters, 2014).

[489] General market risk is dealt with in Paragraph 709 of the Basel II Framework. See, BIS (2009) (n 15).

[490] BIS, 'Operational Risk – Revisions to the Simpler Approaches' (October 2014) <http://www.bis.org/publ/bcbs291.pdf/> accessed 7 October 2017.

[491] See Abdul-Rahim Al-Saati, 'The Permissible Gharar in Classical Islamic Jurisprudence' (2003) 16 Journal of King Abdulaziz University: Islamic Economics 3, 5-7.

of Gharar is used to denote unacceptable levels of uncertainty, misrepresentation or deception in the operation of a financial transaction or conclusion of a contract.[492]

In the canonical use of the term, Gharar has a more limited meaning, being the damage or risk a person suffers to his property, without the benefit of foreknowledge of the risk or damage to which they are exposed.[493] Notably, the Qur'an does not expressly prohibit Gharar. It states as follows:

> "And do not eat up your property among yourselves for vanities, nor use it as bait for the judges." (2: 188)

> "O, ye who believe! Eat not up your property among yourselves in vanities; but let these be amongst your traffic and trade by mutual good will." (4: 161)

4.3.1 Islamic Finance Instruments

A number of Islamic finance instruments (Aqd) are permitted under Islam. Murshid al-Hayran defines an Islamic finance instrument as, "the conjunction of an offer emanating from one of the two contracting parties with the acceptance by the other in a manner that affects the subject matter of the contract."[494]

Islamic finance instruments may take a number of forms, most notably, the Murabahah, Ijara, Salam, Istisna, Mudarabah and Musharakah contracts. Each of these contracts is assumed to adhere with the fundamental principles and teachings of Islam. As Elmelki and Ben Arab suggest, Islamic banking prides itself as a. "normative discipline, whereby particular ethical standards are formulated and then applied."[495]

In the context of Islamic banking, two types of contracts are widely utilised: contracts which deal with asset-based financing, such as Murabahah, Salam, Istisna and al-Ijarah, and business contracts which are based on partnership, and known as profit and loss sharing

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[492] ibid.
[493] ibid 6.
[494] Azahari Jamaludin and Raduwan Idar, 'Shariah Issues in Islamic Capital Market' (2nd International Research Management & Innovation Conference, Langkawi, August 2015).
[495] Anas Elmelki and Mounira Ben Arab, 'Ethical Investment and the Social Responsibilities of the Islamic Banks' (2009) 2(2) International Business Research 123.

schemes, such as Musharakah and Mudarabah.[496] Musharakah and the Mudarabah are both contracts that entail investment in selected projects by banks and sharing in profits and losses with entrepreneurs or owners of the projects.[497]

The Arabic term ‘Murabahah’ literally means ‘profit’ and it refers to the sale of a commodity at a price that includes a predetermined profit known by both parties. Under Murabahah contracts, both parties will agree to the sale of an asset, either a movable or immovable one, at the original cost in addition to profit.

A Murabahah contract is the most common instrument used in Islamic financing.[498] The popularity of the Murabahah contract stems from the fact that it is perceived to carry fewer risks than alternative Islamic finance contracts, such as the Musharakah and Mudarabah, because the duration of the contract and due payment dates are agreed in advance between the seller and the buyer. Moreover, the Murabahah is based on the principle of incremental cost or cost plus profit of sale.[499] These arrangements can take the form of cash Murabahah or credit-based Murabahah.[500] As has become obvious, three parties are involved in this arrangement: the seller or receiving party (the Islamic bank) who purchases the commodity; the buyer or ordering party who is the customer of the Islamic bank, and who wishes to buy commodities from the seller; and the bank who is the creditor acting as the intermediary between the seller and the buyer.

In these arrangements the client applies to the Islamic bank by requesting Murabahah finance. This request must include information about the commodity with a specified price and details. An agreement is then signed by the Islamic bank and the client, who enter into a Murabahah contract. The Islamic bank is then expected to carry out a risk assessment around the feasibility of the client’s request.

The Murabahah contract is permitted by Shariah because of its compliance with the following requirements:

i. The contract is based on the exchange of goods with a real and definable value.

[496] Jaquir Iqbal, *Islamic Financial Management* (Global Vision 2009) 217.
[497] ibid.
[498] Siti Faridah Abd Jabbar, ‘The Governance of Shariah Advisers of Islamic Financial Institutions: The Practice in Malaysia’ (2009) 30 Company Lawyer 312.
[499] The Quran, Surah 73:20.
[500] Usmani (n 189) 13.

ii. The price of the goods and the amount of the seller's mark-up is known in advance, and agreed to by both parties at the time of contracting.
iii. The bank/seller is responsible for any damage to the goods before delivery to the buyer.
iv. The bank owns and is in possession of the goods before those goods are resold to buyer.
v. All damages or defects are declared by the bank.
vi. The original price and the profit should be made known to the second buyer and the first buyer must own and possess the goods before he sells them to the second buyer.
vii. Finally, and most importantly, the bank as seller must declare the amount of profit accrued on the sale before selling the commodity to the client, in order for the contract to become a Murabahah one.

This last condition requires that the bank specify the original price and profit, which was added for the risk and the duration of the repayment. Through Murabahah, Islamic banks play a more active role in the trading of goods, which is a function that conventional banks are general prevented from undertaking.[501]

While they share common structural features, Musharakah agreements should be distinguished from fixed income investments (bonds or money market securities). In fixed income investments, an investor makes a loan to a corporate or government borrower who promises to make regular fixed interest payments on a predetermined maturity date. On maturity, the borrower is then obliged to repay the principal amount or par value of each bond to the investor.[502] Owing to the Shariah injunction on the charging of interest (Riba), Islamic banks are prevented from obtaining income from fixed income investments. Nonetheless, the Musharakah agreement shares common features with fixed-income securities which create obligations on the bank to pay dividends or other forms of income. In conventional financial markets, companies may raise money to finance acquisitions or buy equipment by giving up equity to the investor and repaying the principal on the loan at maturity.[503]

Another common mode of contracting is the Musharakah contract, also known as a partnership or joint venture contract. In this arrangement, an Islamic bank and a client agree

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[501] David J Jonsson, *Islamic Economics and the Final Jihad: The Muslim Brotherhood to the Leftist/Marxist - Islamist Alliance* (Xulon Press 2006) 146.
[502] See, Sean Simko, *Strategic Fixed Income Investment* (John Wiley & Sons 2013) 4-5.
[503] Akkizidis and Kumar Khandalwal (n 49) 42-49.

to the combining of their financial resources for the purposes of the establishing or running of a business, venture or project.[504] Once again, the Musharakah contract is based around a profit and loss sharing partnership between two parties or more, in which capital is jointly pooled and reinvested into common enterprises. Whilst not as common as other contracts, the Musharakah agreement is generally seen to be one of the most authentic and legitimate models of Shariah compliant financing.

According to the most prevalent interpretation of Shariah, and Muslim jurist consensus, any capital invested in Musharakah financed joint ventures must take the form of liquid (cash) assets, and cannot involve goods in lieu of cash-based financing.[505] There is, however, some conflict over whether this is a strict requirement under Islamic law.[506] Under a Musharakah contract, all capital investing parties are assumed to enjoy equal rights in the participation and management of the joint venture. This is to be contrasted with the Mudarabah, under which the owner of capital is not permitted to participate in the project which is being financed.[507] In this type of arrangement, partners are able to appoint a managing partner by mutual consent, a person known as the 'rabb-ul-mal'.

As with all partnership agreements permitted under Islam, all profits and losses are to be shared equally among partners in the Mudarabah contract. Two major Islamic schools, the Hannifi and Hanbali schools (the latter recognised as the most accepted interpretation of Shariah in Saudi Arabia) have issued opinions stating that the ratio and percentage of profit distribution must be definitively settled prior to the conclusion of the contract, in the absence of which the contract will be judged invalid. If losses are suffered during the course of commercial activities, these must be distributed equally in accordance with the agreed rate. Should any one of the partners wish to terminate, suspend or modify the operation of the

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[504] Mahmoud El-Gamal, *Islamic Finance: Law, Economics and Practice* (Cambridge University Press 2006) 120.

[505] Muhammd Ayub, *Understanding Islamic Finance* (Wiley 2007) 380.

[506] ibid. Imam Malik, who is the owner of the second school of Sunnah, holds a different view. He said: 'The liquidity of capital is not a condition for the validity of the Musharakah contract. This means that commodities are permissible in Musharakah.'

[507] Wahida Al-Munshid and Saif Al-Saadi, 'Evaluation Investment Tools Performance of Islamic Banks in Selected Arabic Countries' (2013) 36 The Journal of Administration & Economics 15, 18.

Musharakah, this can only be achieved with the mutual consent of all other remaining investors.[508]

Perhaps the most prevalent of Islamic finance arrangements, the Mudarabah contract is structured around principles of equity-sharing, trusteeship, profit-sharing and a sleeping partnership.[509] The Murabahah financing mode essentially revolves around buyer's credit and is used for complex structured financings in Islamic markets. This mode of financing also can be used for securitisation, whereby assets are financed on the back of fees to be paid by the buyer or borrower under long-term contracts.[510] Once again, this contract is founded on the fundamental Islamic concept of profit and loss sharing between at least two or more partners. The relevant partners in this case are: the Islamic bank/capital provider and an entrepreneur.

Under the Murabahah agreement, the entrepreneur provides capital to the bank which is charged with the responsibility of reinvesting pooled sums in a commercial enterprise. While the investment is provided by the entrepreneur/agent, known in Islamic canon law (fiqh) as the 'rabb-ul-mal', all duties relating to the labour and management involved in the enterprise is the exclusive responsibility of a third party known as a Mudarib. The Mudarib is given a share in the profit generated from this investment in exchange for his knowledge and expertise. The investor, as sleeping partner, has a more limited involvement in the project and is required only to invest capital in Shariah compliant enterprises and commercial activities (thus the sale of alcohol or pork and other haram activities are deemed illegitimate sources of capital investment).[511] The onus is on the bank to appoint a Mudarib with the necessary skills and, thus, invest the capital responsibly.[512]

In the Musharakah contract, all partners provide investment on a profit share and loss basis. By contrast, the Mudarabah financed entrepreneur (mudarib) is permitted to share in the profit only, and not in the capital, since the capital is owned exclusively by the investors.[513] In Musharakah contracts, all partners invest capital while in Mudarabah, it is the rabb-ul-mal, or bank, which provides the investment. Similarly, the partnership is founded on the principle

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[508] Ben Khoutem Jedidia and Hamza Hichem, 'Profit and Loss Sharing Paradigm in Islamic Banks: Constraints or Solutions for Liquidity Management?' (2014) 10(3) Journal of Islamic Economics, Banking and Finance 29.

[509] Brian Kettell, *Islamic Finance in a Nutshell: A Guide for Non-Specialists* (John Wiley & Sons 2010) 55.

[510] ibid.

[511] ibid.

[512] Venardos (n 405).

[513] Visser (n 250) 61.

of profit distribution and not on the amount or rate of capital invested. A Mudarabah contract is deemed lawful only to the extent that all parties have freely consented to the fixed rate for the allocation of profits, prior to the conclusion of the contract. The profit might be equally shared between the parties and they can allocate different proportions between them as agreed.[514]

Ijara is a leasing contract which is entered into by two parties: the first one is a bank or lessor and the second is the lessee.[515] In this case, the Islamic bank purchased the leased asset from the seller, and then rents it to the buyer at an agreed price plus profit for a fixed period and rental charge. One form of the Ijarah contract concerns the hire of people for services. A more relevant form of the contract for the purposes of Islamic finance is the hire of real goods and assets, for instance the transfer of property rights in exchange for a fixed price or wage from the lessee.[516]

Like conventional sale contracts, Ijarah involves the transfer of an asset or property. However, principles of Shariah prescribe general conditions before the sale is deemed valid.

1. The use of the goods should have value for both parties.[517]
2. The lessor must have full possession over the assets and must be able to deliver the contracted goods on an agreed date and have full possession.
3. The lessor should assign rights over the contracted goods to the lessee as per the agreed conditions.
4. The rental price must be fixed in respect of the contracted goods.
5. The lessee (mustajir) should have full knowledge of the goods and have opportunities to assess the good and their quality before agreeing to the terms of the lease.[518]

The Bai Bithaman Ajil contract is formed among two parties and has coverage over the sale of goods and transactions, including vehicles, houses, and the financing of goods, for which payments are made on a deferred payment. While payment made in exchange for the

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[514] Usmani Muhammad Taqi, *An Introduction to Islamic Finance* (Brill 2002) 31-37.
[515] Rosly (n 8).
[516] Fahim Khan and Mario Porzio, *Islamic Banking and Finance in the European Union: Challenge Studies in Islamic Finance* (Edward Elgar 2010) 97.
[517] Anjum Siddiqui, 'Financial Contracts: Risk and Performance of Islamic Banking' (2008) 34(10) Managerial Finance 680, 684.
[518] Abd Jabbar (n 417) 312-314.

immediate provision of goods it can be deferred under these contracts, and the actual payment period must be agreed in advance.[519]

Under the Bai Bithaman Ajil contract, the Islamic bank will purchase the real property asset and the consumer will buy the house from the bank on the basis of deferred credit, normally in the form of monthly payment instalments. While this contract seems to closely resemble a loan agreement, which is ostensibly prohibited under Islam, it is deemed valid through its classification as a sale, which is lawful in the *Qu'ran*, rather than lending agreement.[520]

The Bai Salam contract is essentially based on a forward sale concept.[521] In this case, the contract establishes a relationship between the Islamic bank (seller) and the customer (buyer) whereupon the bank agrees to supply specific goods to the buyer at a future date in exchange for a price that is fully paid in advance on conclusion of the agreement.[522] Only goods rather than commodities (e.g. precious metals) can be sold under this contract. In a reverse of the material terms of a Bai Bithaman Ajil contract, here it is the supply of the goods that is deferred, while the price is paid in advance (rather than instalments, as is the case in the Istisna and Murabahah contracts).[523] As one of the most important contracts applied in Islamic banking, these contracts are frequently used in trade activities, e.g. agricultural and for the supply of fungible manufactured goods.[524]

4.3.2 Analysis of Islamic Finance Instruments

Owing to the centrality given to partnership agreements under principles of Shariah, Islamic banks are essentially embedded within a universal model of banking, the functions of which go well beyond services traditionally offered by commercial banks. Islamic banks are chiefly responsible for receiving and administering deposit accounts on the retail side, and for providing working capital finance to entrepreneurs/borrowers on the investment banking side.[525]

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[519] Mohd Nasir bin Mohd Yatim, 'A Review on Conflicting Issues in a Deferred Payment Sale Product of a Shari'ah-Compliant Banking Business' (2009) 1(2*)* International Journal of Economics and Finance 253.
[520] Surah Al-Baqara: 'Allah has permitted trade and has forbidden interest.' The Quran, Surah 2:275.
[521] Akkizidis and Kumar Khandalwal (n 49) 58-63.
[522] ibid.
[523] Siddiqui (n 436) 684.
[524] See The Quran, Surah 2:245.
[525] KC Shekhar and Lekshmy Shekhar, *Banking Theory and Practice* (19th edn, Vikas 2005) 22.

Islamic models of banking can therefore be described as universal because of their tendency to combine commercial banking, investment banking and (limited) insurance provision. The functional remit of Islamic banks is, accordingly, expansive. Islamic banks have the capacity to service both short-term and long-term loans, finance direct investments in other firms, and utilise funds held in bonds, savings certificates and time deposits.[526] By consolidating these services within a single or universal model of banking, Islamic banks are more able to lower the average cost of marketing, while promoting higher output and relationship-building with their clients over the long term. The assumption is that where Islamic banks are able to provide stockholders with complete and accurate information about their portfolio risks, confidence in the bank is duly enhanced by corresponding risk on the bank's asset values.[527]

More problematic still, Islamic banks lack the option to manage or spread out their risks by segregating revenue produced from higher risk investments or loan provisions and that which is obtained from administering secure savings deposit accounts. Instead, the risk is concentrated at the level of individual banks.[528]

The consequence of the above is that any risks inherent in the products and services of an Islamic institution are by their nature 'systemic'. The next section considers the specific risk exposures of Islamic finance instruments to pave the ground for an examination of how these risks are addressed by the Basel framework and by the current framework on banking regulations in Saudi Arabia.

4.4 Risk Regulation of Islamic Finance

If the global financial crisis showcased what can happen when risk is excessively concentrated in certain product sectors, then, by extension of the same logic, Islamic finance models are more, rather than less, predisposed to systemic risk: the failure of one systemically important institution may threaten the stability of the 'universal' features of all Islamic banks. In order to minimise their risk exposures, Islamic banks will need to develop the necessary risk assessment expertise to identify systemic risk factors, in combination with

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[526] See Hans-Hermann Francke and Michael Hudson, *Banking and Finance in West Germany* (Routledge 2012) ch 3.

[527] Charles W Calomiris, *Co-ordination and Information: Historical Perspectives on the Organisation of Enterprise* (University of Chicago Press 1995) 292-293.

[528] Vinay Dutta and Kanhaiya Singh, *Commercial Bank Management* (McGraw Hill Education 2013) 21.

a diversified range of products which will allow them to hedge against riskier or poor performing investments.[529]

As the Islamic Financial Services Board has been eager to emphasize, Islamic banks are by no means immune to the types of risks that the Basel framework has sought to minimise in banking operations. These are the very risks that conventional banking systems have long been familiar with: credit, liquidity, operational and market risks.[530] Having said this, the form, manner and degree to which Islamic banks experience these risks is not directly analogous to the ways the risks present themselves in conventional banking operations.[531] One, of course, has to be careful not to over-stylise the differences between Islamic and conventional models. That being said, the quality and risk implications of a conventional bank's stocks, both in terms of its assets (profits generated) and its liabilities (claims on, or deductions against, the principal profit) do not bear obvious resemblance to Islamic modes of contract and finance. Certainly, the capital structure of banks, on both the liabilities and assets side, is sufficiently different from conventional banks to raise questions over the utility and applicability of the risk and capital measurements proposed under the Basel framework. One central explanation for this is whereas the financial portfolio of conventional banks tends to be structured around loan and credit provision; in Islamic banking lending activities have been replaced with investment and partnership contracts.[532]

4.4.1 Risk Exposure in Profit and Loss Sharing Instruments

In most types of Islamic contracts, neither the capital value (the principal on a loan), nor the return of a deposit is guaranteed by the bank. Rather, Islamic banks essentially operate as fund managers, acting as a financial intermediary. In many respects, therefore, Islamic banks share certain operational similarities with investment banks and institutions.[533] This superficial commonality aside, the structure of Islamic institutions, and the regularities of the contracts underlying them, can be seen as distinctive in a number of respects. While members

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[529] Islamic Financial Services Board (IFSB), 'Issues in Strengthening Liquidity Management of Institutions Offering Islamic Financial Services: The Development of Islamic Money Markets' (Technical Note 104, IFSB 2008) 5.
[530] Mohamad Hasan and Dridi (n 302).
[531] IFSB (n 448) 15-16.
[532] Abdou Diaw and Omaima Mohamed, 'The Implementation of Basel II by Islamic Banks: The Case of Bank Islam Malaysia Berhad' (2011) 1(2) International Journal of Islamic Banking and Finance 1.
[533] Asif Ahmed Qureshi, 'Analyzing the Shariah Compliant Issues Currently Faced by Islamic Insurance' (2011) 3(5) Interdisciplinary Journal of Contemporary Research in Business 279.

of the public can purchase ordinary shares in investment banks as governed under the terms of an exchange contract, Islamic banks can only accept deposits. This difference alone underscores stark differences in the corporate structure and governance of Islamic banks, assessed in light of standard principal-agent models, while folding broader variances into the form and distribution of 'rights' under Islamic contracts and financial arrangements.[534]

It is well acknowledged that the greatest risk to which Islamic banks are exposed is the risk of counter-party default.[535] Whereas the financial portfolio of conventional banks tends to be structured around loan and credit provision, in Islamic banking, "lending activities have been replaced with investment and partnership contracts." As a result, credit risk management becomes more important and critical in the context of Islamic finance.[536]

Credit risk is broadly defined in the literature to describe the probability that a bond issuer, borrower or contractual counter-party will default on a credit agreement, thereby resulting in non-satisfaction of a debt based finance agreement.[537]

As prominent scholars have outlined comprehensively, the structure of Islamic modes of financing and contracts are highly exposed to credit risk.[538]

As is evident by now, credit risk in conventional banking will typically centre upon a bank's supply of cheap credit and interest-based loans, and the correspondingly likelihood of borrower default. Islamic banks are also exposed to credit risks but these will usually derive from finance issued through Murābahah and Ijārah transactions. These risk exposures may arise from counterparty's failure to repay due sums, supply goods on time, or provide the agreed quantity. Similarly, Istisna contracts are exposed to performance related risks.[539] Tellingly, the Islamic Financial Services Board (IFSB) defines credit risks in open ended

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[534] Sahar Nasr, 'Islamic Finance in the Arab World: Challenges and Prospects' (Cambridge Business & Economics Conference, Cambridge, 2011) 14.
[535] Mohamed Ali Elgari, 'Credit Risk in Islamic Banking and Finance' (2009) 10(2) Islamic Economic Studies 3, 9; Visser (n 229) 131.
[536] Diaw and Mohamed (n 451) 11.
[537] ibid.
[538] Umer Chapra and Turiqullah Khan, 'Regulation and Supervision of Islamic Banks' (Islamic Development Bank Islamic Research and Training Institute, 2008) 13-14.
[539] Siddiqui (n 436) 685.

terms as any risk that eventuates from the failure of the counter-party to honour their obligations as stipulated under the terms of any contractual agreement.[540]

It is worth noting that the financing of mortgages in Islamic contexts is typically secured under the Musharakah contract. While conventional mortgage loans typically carry an interest charge, or riba, mortgage facilities under the Islamic system are usually provided through diminishing Musharakah. Under the diminishing Musharakah contract, a house is purchased jointly by the bank and customer. The bank rents out its share in property to the customer for an agreed amount of rent, paid in instalments. The actual value of the entire repayment consists of rental charges plus the purchase price of the real estate assets which have been purchased. Once the last instalment has been paid off, the bank's equity ownership in the financed real estate asset diminishes to nil, and ownership of the property is transferred to the customer.

The diminishing Musharakah model is assumed to provide bank consumers with a secure mode of financing, thereby reducing the credit risks which would play a heavy hand in the 2008 sub-prime mortgage crisis. This is because the diminishing Musharakah ensures the market value of property, so any losses are shared equitably by both the bank and customer, and not the customer alone. As the bank is exposed to risk, financiers are more likely to adopt a responsible attitude to lending, and are assumed to carry out diligence in their risk assessment to ensure that the customer can afford the mortgage and pay repayments, even in the event of market risks such as a decrease in housing values.

It is important to note here that Islamic banks have limited remedies should the borrower fail to make due repayments, particularly since rental repayments must be paid up in cash and borrowers are frequently required to put down large sums as a deposit. Since the borrower has no collateral to lose, the Islamic bank is left with few remedies by which to enforce loan agreements and recover losses resulting from late payment or non-satisfaction of the terms of contract.[541] The only facility available to banks in the event of breach of due payment terms

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[540] IFSB, 'Islamic Financial Services Industry Stability Report 2016' 110-112 <http://www.ifsb.org/docs/IFSI%20Stability%20Report%202016%20(final).pdf/> accessed 15 March 2017. See also Kahf (n 5).

[541] For a broader discussion, see Wendy Edelberg, 'Testing for Adverse Selection and Moral Hazard in Consumer Loan Markets' (FEDS Working Paper No 2004-09, 2004) 9 and Lieven Baele and others, 'Of Religion and Redemption: Evidence from Default on Islamic Loans' (2014) 44 Journal of Banking & Finance 141, 143.

is the option to apply an administrative charge against borrowers for the costs of delay or time lost. However, the application of this additional margin charge would not seem to be materially different from charging interest for late payment, in contravention of the principle of riba, as prohibited by Shariah. This is also the case for any penalties for late payment that the bank may impose.

In a further complication, Islamic banks cannot hedge their risks through selling their debt to third parties, or by leveraging their debt through the use of structured finance instruments which create subordinated or collateralized debt obligations (liabilities) for that bank.

In tacit acknowledgment of the high risk of counter-party default, Islamic scholars have proposed alternatives to the use of third party collateral and leveraging, which are both seen to infringe the Islamic injunction on interest taking and uncertainty. These alternatives include the use of a third-party guarantee based on tabarru (voluntarily given), and a third-party guarantee based on qardh (debts). There is some debate among Islamic scholars, however, as to whether third party guarantees results in the immediate nullification and annulment of the financing contract because of its violation of the material terms of the contract or muqtadha aqd (the main objective of a contract).[542]

The Shariah Council for Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), a leader in the development of Shariah compliant auditing and accountancy standards, has accepted that banks can guarantee deposits used to finance Mudharabah purchases, provided that the guarantee against losses is not assumed by the Mudarib or investment agent or business partner, or otherwise tied to the original Mudharabah contract.[543] Moreover, the debt obligations of a third party guarantor are valid and binding liability only when the liability of the entrepreneur/mudarib can be clearly established.[544]

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[542] Mohammad Bial Shah, 'Kafalah on Mudharabah Capital' (2006) 1(2) Quarterly Bulletin of Malaysian Islamic Capital Market by the Securities Commission <https://www.sc.com.my/wp-content/uploads/eng/html/icm/MsianICM_0608.pdf/> accessed on 7 October 2017.

[543] Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), 'Section 2/3, Standard No 2, 122' (2003) <http://www.aaoifi.com/en/about-aaoifi/sharia-standards-board/ssb-committees/AAOIFI> accessed 22 January 2017.

[544] Ahmad Zakirullah Mohamed Shaarani, 'Shari'a Contracts: Tabarru` (Charity) Contracts' (Presentation for IBIFM, 2008) <http://e-muamalat.islam.gov.my/sites/default/files/kertas_ilmiah/2011/03/tabarru_contract-zakirullah_ibfim__portal.pdf/> accessed 16 March 2017.

Alternatively, Islamic banks may favour the Musharakah mode of financing as an alternative to the Murabahah contracts because of reduced exposure to credit risk. The Musharakah is essentially a forward contract, where a bank agrees to loan sums which are guaranteed against credit notes or other forms of documentary credit. This creates future claims with a future 'procedural'[545] counter party. This is because unlike Murabahah profit and loss sharing agreements, Musharakah contracts offer banks the option to 'buy out' their share in the joint investment, should the documentary credit on which loan payments are guaranteed indicate a high probability of debtor default. Where a bank chooses to exercise this option, they are released from any future liabilities or obligations. Yet, even under this arrangement, a bank cannot guarantee against a low or non-return on the investor's original capital investment. As a consequence, investors may have little confidence in the risk assessment capacities of the bank, including their ability to assess the risk weight and value of documentary credit.[546]

In the absence of Shariah compliant forms of collateral, known as kafala, the terms of the finance agreement may have little feedback effect on borrowers. The bank's exposure to credit risk is exacerbated by the absence of effective insolvency laws and recovery regimes in countries such as Saudi Arabia. It is with some irony, therefore, that Islamic finance agreements are more likely to attract borrowers with a high appetite for risk, which is at odds with the very 'spirit' and logic of Islamic financial principles.[547] In other words, there are risks embedded in the very structure of profit and loss sharing investments; risks which are, arguably, more likely to foster irresponsible borrowing than is the case for the interest-based financing modes of conventional banks (given that interest charges and penalties are assumed to moderate the behaviour of the borrower).

The larger point is that the presence or probability of credit risk is intimately connected to the existence of other risks. In Islamic contexts, these risks take a more specific and mutually reinforcing form: Shariah compliance risks bring operational risk; corporate governance risks impact the rights of investors and account holders; market inefficiency/corporate governance risks affect the risk-to-quality of asset assessments and liquidity management, while the

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[545] See AAOIFI (n 462).

[546] Michael McMillen, 'Islamic Shari'ah-Compliant Project Finance: Collateral Security And Financing Structure Case Studies' (2000) 24(4) Fordham International Law Journal 1184.

[547] See Hennie van Greuning and Zamir Iqbal, 'Banking and the Risk Environment' in Simon Archer, Noraini Ariffin and Rifaat AAA Karim, 'Risks in Islamic Banks: Evidence from Empirical Research' (2008) 10(2) Journal of Banking Regulation 116.

ownership of assets by Islamic banks increases their exposure to the high probability of credit default risks.[548]

4.4.2 Market Risk

Islamic banks are exposed to a higher market risk than conventional banks, owing to the asset-backed nature of their finance instruments. For example, Salam and Istisnā contracts expose banks to market (pricing) and venture capital risks, especially those associated with exit, in respect to Musharakah and Mudarabah financing. These are the risks on which investors will not yield an expected return and, therefore, they seek to withdraw their capital from Musharakah and Mudarabah contracts. Venture capital exit risks can be regarded as similar to counter party credit risk, although these are partnership and not purely financing contracts.

Murabahah financing would appear, in principle, to minimise a bank's exposure to credit risks, principally because the rate of return is predetermined or fixed in advanced and because fewer resources are required for the risk assessment and evaluation of these projects. As a result Murabahah financing carries a lower risk of counter-party or credit default compared with other profit and loss financing schemes. They are also attractive to entrepreneurs because the rate of return is fixed along a specific payment period, and there is no charge per se for default; and the asset or commodity that is being purchased is treated as collateral.[549]

Unlike conventional banks, however, Islamic banks cannot adjust interest rates on fixed income contracts to account for market value rate changes. A similar situation occurs in relation to Bai Salam contracts, where, again, the bank is exposed to volatility in the pricing of goods under contract. If Islamic banks are unable to satisfy the terms of contract through delivery of goods, they are obliged to purchase the same goods at a higher price in order to fulfil their obligations. Likewise, in the Ijarah contract, a lessor is exposed to market risk on the residual value of the leased asset on the terms of the lease, which may be lower than the agreed-upon price, or rent, or if the lessee terminates the lease earlier (by defaulting during the duration of the contract). The next section will further distinguish between two main indicators of market (market to market value) risks: pricing and commodity risks.

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[548] *Islamic Investment Co of the Gulf (Bahamas) Ltd v Symphony Gems NV and others* [2008] EWCA Civ 389.

[549] Rifki Ismal, 'Assessing the Moral Hazard Problem in Murabahah Financing' (2009) 5 Journal of Islamic Economics, Banking and Finance 101, 102.

4.4.3 Pricing Risks

A pricing risk refers to change and volatility in the market value of a given asset during a given financing period. The bank purchases an asset at spot value, the price given by the first seller. The bank then resells that asset to the borrower or customer, who must be informed of the spot price which the bank paid in the first place. The resale price amounts to the spot price plus an agreed profit. However, the market price of the asset may well be subject to a significant pricing variation or increase before it is resold to the borrower. Islamic contracts will typically prevent these pricing changes from being taken into account, due to the fixed nature of the payment terms.[550] As a result, the customer or borrower may be unjustly enriched from a transaction in which the price of the financed asset or commodity has increased significantly in the period between the bank's initial purchase of that asset and its resale to the customer. However, these pricing risks go both ways, and it may be the customer who bears the risk of a drop in the market value of an asset.

4.4.4 Commodity Risks

Another risk factor linked to price and default risks is a bank's exposure to commodity risks. Islamic banks have confronted this risk with the issue of consumer loans. As previously alluded to, Shariah compliant consumer loans should be distinguished from the lending contracts of conventional or Western markets. Indeed, under accepted interpretations, a loan is only permitted or is halal if it can be described as based on the principle of charity (Qard Hasan). In practical terms, this requirement is simply an assumption of risk by the bank, including the risk that they will be unable to recover their principal amount and receive compensation for losses.[551]

Most conventional banks assume similar risks, for instance through provision of unsecured loans and credit cards. In the Islamic context, instalment-based payment agreements expose banks to hazard. Given the high demand for quick and easy cash, many customers will sell financed goods before the repayment period has expired, thereby enabling these customers to

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[550] See, Moorad Choudhry, *Bank Asset and Liability Management Strategy: Trading Analysis* (John Wiley & Sons 2007) 11, 14-17.

[551] UNCTAD, *Islamic Finance and Structured Commodity Finance Technique: Where the Twain Can Meet* (UNCTAD 2006) 27.

make a quick profit.[552] As a result, banks are exposed to higher transaction costs in instalment-based financing and repayment arrangements, than is the case with those in which payment is made up front.

4.4.5 Investor Risks in Joint Venture Projects

Under Musharakah modes of financing, profit and losses are distributed among the bank and investors/entrepreneurs in accordance with an agreed ratio. This can be contrasted with the allocation of losses under Mudarabah, where it is the capital provider alone who bears the risk. The above arrangement can be contrasted with the Musharakah contract, wherein partners are only liable for losses proportionate to the amount of capital invested, except in those rare instances where the partner has agreed to accept debts on the entrepreneur's behalf.[553]

Extrapolating from the above, partners subject to a Mudarabah contract are potentially exposed to unlimited liability. The entrepreneur, on the other hand, only suffers losses relating to the provision of already expended labour.[554]

In a striking departure from conventional banking models, banks are empowered to reinvest sums held in deposit accounts in a particular project, without obtaining the formal consent of the capital provider. Indeed, it is factors such as these that have exposed Islamic banking systems to the more systemic problem of 'capital flight' or venture exit risks.[555]

Islamic banks and their capital investors may have few incentives to participate in Mudarabah or partnership arrangements, especially when conventional finance institutions can purchase

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[552] ibid.

[553] Khan and Porzio (n 435) 53.

[554] IFSB, 'Capital Standards for Institutions (Other Than Insurance Institutions) Offering Only Islamic Financial Services' (December 2005) <http://www.ifsb.org/standard/ifsb2.pdf/> accessed 7 October 2017. The IFSB give the following definition: 'Displaced Commercial Risk refers to the risk arising from assets managed on behalf of Investment Account Holders which is effectively transferred to the Islamic Financial Institutions own capital because the IFI forgoes part or all of its Mudarib's share (profit) of on such funds, when it considers this necessary as a result of commercial pressure in order to increase the return that would otherwise be payable to Investment Account Holders.'

[555] For an analysis of the link between the rate of return and the withdrawal risk in Islamic banks, see Ahmed Habib, 'Withdrawal Risk, Market Discipline and Efficiency in Islamic Banking' in Tarioullah Khan and D Muljawan (eds), *Islamic Banking Stability: The Role of Risk Management, Regulation and Supervision* (Islamic Research and Training Institute, Jeddah, Islamic Development Bank 2005) 457, 459-460.

and resell debt with interest.[556] At the same time, savings account depositors lack equivalent rights as shareholders, e.g. voting or participatory rights and, therefore, few opportunities to shape the investment strategies of banks or hold them to account. Even when they suffer losses on their savings deposits, as many Islamic banks have been shown to do.[557] In the absence of standardised accounting and reporting mechanisms, which compel banks to produce complete financial statements (including net losses and profits) consumers have scarce opportunity to assess the performance of their investments or the long term financial outlook and strategy of the bank. Investor depositors provide Islamic banks with their main source of capital.

To the extent that funds held in savings and investor deposits constitute an Islamic bank's primary source of stable funding, account holders play a more central role in Islamic finance than shareholders do in conventional banking.[558] One would assume, therefore, that account holders would be subject to the privileges and protections given to shareholders in commercial banks, including limited rights in the governance of the bank (to censure, the power to remove directors, etc.) and formation of its corporate policies.[559] This is not always the case. The activities of Islamic Banks and their Board of Directors can be opaque, with depositors being deprived of input and a 'voice' in the strategic and day-to-day decision making of banks. As a result, consumers of Islamic banking may have little understanding of the bank's corporate strategy and policies, including whether the products they have been sold are, in fact, Shariah compliant.

Moreover, Investors may have limited sanctioning, bargaining or exit power. Capital deposited in Mudarabah investor accounts are 'locked in' for long periods at a time, owing to the Islamic banking policy of holding assets with a long maturity, usually spanning a period of no less than one year. As a result, account holders are prevented from withdrawing funds held in investor and savings accounts even where they have suffered losses, or where

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[556] Naeem Rahman, 'Attitudes of Muslims towards Islamic Banking and Finance' (PhD thesis, Durham University, 2012) 93.

[557] The Al Rayan Bank, formerly known as the Islamic Bank of Britain (IBB), in the UK, despite legislative reform efforts and institutional restructuring of the banking regulatory authorities suffered losses amounting to 25% of the Bank's deposits, see 'Discretionary Portfolio Service' <http://www.alrayanbank.co.uk/media/263286/pb1842-al-rayan-discretionary-portfolio-service-brochure.pdf/> accessed 10 January 2017.

[558] Haider Ala Hamoudi, 'The Impossible, Highly Desired Islamic Bank' (2014) 5 William and Mary Business Law Review 105, 136.

[559] Abd Jabbar (n 417) 312-314.

uncertainty or a material change in circumstances (since the finance agreement was concluded) exposes the saver or investor to risk. Further, since Islamic banks are prohibited from taking short positions and encouraged to use instruments with relatively long maturation periods, the process of estimating a return rate becomes especially difficult, particularly in government contracts such as sukuks.

By in large, the risk-to-return rate (high risk but low returns) on long term investments tends on the whole to be relatively inefficient.[560] Consumers who seek higher returns on their savings or investment deposits may well seek alternatives if Islamic banks cannot manage their funds efficiently.[561] This, in turn, exposes the bank to liquidity risks. Liquidity risk is defined as the potential loss to Islamic financial contracts arising from their inability either to meet their obligations or to fund increases in assets as they fall - for instance when there is a sharp increase in withdrawal of investments or deposits.[562] Liquidity risk is considered one of the major causes of bank failure or bankruptcy.

Investor depositors may, equally, be dissatisfied by Shariah restrictions on conventional insurance products including indemnification against potential default and other forms of seller protection. Speculative investments such as insurance products and reinsurance are, in general, presumed to infringe the Islamic injunction on uncertainty, interest taking (riba) and gambling (Gharar) in the conclusion of contracts.[563] Moreover, given that their asset structure is highly dependent on income generated from profit and loss sharing investments, Islamic banks tend to have higher exposure to these risks as compared to conventional banks that are permitted to hedge against these risks, through their trading activities in high risk-high return secondary markets.[564]

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[560] Kabir Hassan and Michael Mahlknecht, *Islamic Capital Markets: Products and Strategies* (John Wiley & Sons 2011) 320.
[561] Abdul Karim Aldohni, *The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia* (Routledge 2012) 79.
[562] Hennie van Greuning and Zamir Iqbal, *Risk Analysis for Islamic Banks* (World Bank 2008) 150.
[563] Hassan and Mahlknecht (n 479) 320.
[564] Moazzam Farooq and Sajjad Zaheer, 'On the Co-existence of Conventional and Islamic Banks: Do They Differ in Business Structure' in Sajjad Zaheer (ed), *Financial Intermediation and Monetary Transmission Through Conventional and Islamic Channels* (University van Amsterdam 2013) 41, 55-57.

4.4.6 Contractual and Property Law Risks of Islamic Contracts

As suggested above, Islamic banks are exposed to ownership risks. On the face of it, conventional banks have a greater exposure to legal risks, relative to the stronger position of Islamic banks.

Interest based loans represent one of the most important sources of a bank's asset structure, both in terms of revenues generated from the sale and repurchase of interests on the loan principles, and as a qualifying source of stable funding, as defined under Basel definitions of eligible 'structural assets'.[565] Yet, the financing of unsecured interest based loans can expose conventional banks to a high risk of default. Since the loans are not collateralised, banks cannot sell the loan asset as a means of realising or recovering unpaid debts. When a loan is secured, by contrast, the bank obtains a legal charge over the asset being offered under the terms of loan-borrower agreement, e.g. a mortgage. However, the legal charge over the underlying asset is not to be confused with the bank's right of ownership over that which is being financed. That is to say, the bank has no ownership rights per se. Rather, the bank as beneficiary of a security interest is assigned preferential rights in the disposition of secured assets.[566]

In conventional banking, therefore, constructive possession over assets is particularly important since financial assets are, in most cases, intangible and, therefore, do not change hands, which is to say that the transaction involves a cash flow between broker, bank and borrower. In Islamic contracts, by way of contrast, the bank has ownership over the asset being financed in most financial contracts. Murābahah and Ijārah transactions involve an exchange of real goods, which are pre-owned by the bank, and financed by capital investors, but leased or loaned to the borrower until the loan amount is repaid (the capital investment plus profit).[567] As a result, the Islamic bank is, therefore, able to buy and sell financed assets, and accrue a profit from these transactions, without taking actual possession of the asset.[568]

[565] BCBS (n 1) paras 34-47, 49-56.
[566] Alexey Arakcheev, Viktoria Baklanova and Joseph Tanega, 'Islamic Money Management: A Western View' (2011) 6(2) Capital Markets Law Journal 238, 248.
[567] Hamid Hosseini, 'Notions of Private Property in Islamic Economics in Contemporary Iran: A Review of Literature' (1988) 15(9) International Journal of Social Economics 51.
[568] Ismal (n 468) 101, 102.

In theory, an Islamic bank takes constructive or actual possession of the asset, with ownership passing to the borrower upon repayment of the amount borrowed, either as a fixed sum or on an instalment basis. This is the main reason why Islamic banks reported few or no losses, while liabilities resulting from default on payments, particularly in the home loan market, piled up on the balance sheets of a number of important American and British banks.

Yet, the possessory rights of Islamic banks over these assets are not entirely secure: banks cannot rescind or modify the material terms of agreements (e.g. payment amounts or profit rates) in cases of late or non-payment but are, nonetheless, expected to assume losses. The former implies that banks do not exercise absolute rights of ownership, but enjoy conditional rights of control over the financed assets held in trust. These rights diminish upon full payment by the borrower, upon which the right of (absolute) ownership is passed to the borrower/lessor. If the borrower fails to make repayment, the bank can purchase the financed assets, and resell these to a second buyer in Istisna and Iijrah contracts. Equally, if the spot price value of the purchase is not repaid with profit, the bank is required to assume the risk. Moreover, Islamic standard-setting bodies do provide a definite or settled answer to the question of ownership (and liability) in an unrestricted profit and loss sharing account, in cases where a bank fails to honour credit related obligations. This results in legal uncertainty over the risk accepting party in the event of default.[569]

In advanced legal regimes, borrowers will be subject to insolvency laws. In cases of honest default, these laws may release the borrower from any obligation to continue with the contract. As Nicholas Foster has outlined, there is no branch of law under Shariah which deals with the recovery of debt, unjust enrichment, or damages in breach of contract, or which otherwise establishes procedures relating to insolvency.[570] Islamic jurisprudence has yet to evolve on this issue, and, as such, falls outside the scope of this thesis. It is sufficient to say, however, that any breach or negligence by the bank or the borrower should attract civil or criminal penalties as appropriate. As an interim measure, a kafala will help secure the interest of the bank and its depositors. A case decided in the UK courts found that English

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[569] Zubair Hasan, 'Credit Creation and Control: An Unresolved Issue in Islamic Banking' 2008 1(1) International Journal of Islamic and Middle Eastern Finance and Management 69, 74.

[570] Nicholas Foster, 'Operating with a Truncated Legal System: Financial Law without Insolvency Law' (SOAS Law of Islamic Finance Working Paper No 5, 2013) 1.

law and not Shariah should prevail in the event of a conflict between English and Shariah law.[571]

The move to standardisation remains an ongoing obstacle in the modernised variant of Islamic finance. There have been attempts to harmonise divergent interpretations of Shariah, including standardisation of contractual transaction documentation - for instance the formulation of the AAOIFI principles or in the work of the IFSB; the system of precedent, as well as a method of codifying the permitted contractual forms (known as 'shurut') are well known to the history of Islamic law. However, the modern administration of Islamic contract law is beset by inconsistency and is largely looked upon as an incomplete and indeterminate system. Such challenges are particularly pronounced in the Saudi context.

Since banks run the risk that consumers will not take up products which are deemed unlawful or 'haram' under the norms of Islamic law and its authoritative sources, they face barriers to trade in secondary markets, including the conventional markets in derivatives or currency exchange rates. Instead, Islamic institutions tend to limit their dealings to markets in tangible assets such as markets in commodities, real estate, and energy.[572] This reflects the Islamic requirement that any exchange made under contract has real and equivalent value for each party to the agreement. However, markets in 'real' assets carry high operational risks, including price fluctuations, extractions or mining costs etc.

There is also the risk of a fatwa being issued which renders invalid or 'haram' what was previously considered valid and 'halal', with an adverse impact on Islamic rulings on repayments. Such risks should be treated as distinct from a ruling which deems a product non-compliant with Shariah ab initio.[573] What is more, a number of Islamic scholars have argued that not all interest is riba. For instance, interest charged on bank deposits or laws, it is claimed, are not unlawful per se, providing that the charge applied is proportionate to the risk

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[571] In *Islamic Investment Co. of the Gulf (Bahamas) Ltd. v Symphony Gems N.V.* unreported [2002] All ER (D) 171 it was argued that an impugned contract was contrary to Shariah and should not be enforced. However, the governing clause was clear and unequivocal. It provided that: 'This Agreement and each Purchase Agreement shall be governed by, and shall be construed in accordance with, English law.' Tomlinson J therefore rejects the argument saying, 'In my judgment, it is absolutely critical to note that the contract with which I am concerned is governed not by Shariah law but by English law.' See also to similar effect, *Beximco Pharmaceuticals Ltd v Shamil Bank of Bahrain EC* [2004] EWCA Civ 19.

[572] Alfred Kammer and others, 'Islamic Finance: Opportunities, Challenges, and Policy Options' (IMF Staff Discussion Note, April 2015) 5-6.

[573] See, for example, Arakcheev and others (n 485).

assumed by the bank or capital providers and not excessive (5-15%).[574] The fulcrum of this minority opinion is that profits generated on bank investments are in the final scenario passed on to the depositors. In this view, the application of interest is not exploitative and consistent with Islamic notions of redistributive justice.[575]

While there is some authority for this opinion in the primary sources of Islamic legal systems, the conclusion that interest is not prohibited remains highly controversial. As such, it is not likely to be explicitly endorsed by any major bank or Islamic country, even if Islamic banks have found back channels to charge interest-equivalent charges, including the fee for administering deposit accounts. In more liberal jurisdictions, such as in Malaysia, the relaxation of Islamic prescriptions on interest taking is essentially part of state policy. Malaysians who are under compulsory obligation to make investments into a mandatory pension fund (EPF) are rewarded with interest-based dividends and other streams of income that accrue a profit, despite the apparent conflict with fundamental principles of Islamic law.[576]

The wider point is that Islamic banking institutions face unique risks, which are additional and non-comparable to those faced by conventional banks, particularly as these concern requirements on profit-sharing and the uncertainty of the legal positions of Islamic scholars in this regard. In turn, this presents a special risk for investors.

4.4.7 Regulatory Risks in Islamic Banking

While conventional banks are exposed to credit, market and operational risks, the legal position of Islamic banks in cases of default is not analogous to the legal position of conventional banks. As a whole, more generally, profit and loss sharing investments carry high risks because entrepreneurs/beneficiaries are not liable for losses resulting from non-payment or breach of contract unless, or until fault or negligence can be established.

Should a borrower become insolvent or fall behind on their payments, the bank has recourse to only a few measures or legal remedies which are deemed to be Shariah compliant. The

[574] Sidney Homer, *A History of Interest Rates* (2nd edn, Rutgers University Press 1977) 80.
[575] The Qur'an, Surah 2:275; Sunan Ibn Majah and MT Ansari (trans), *Book of Inheritance* (Vol 4, No 2267 New Delhi, 2000). The relaxation of what would otherwise be a Qur'anic prescription continues for as long as it is found to be beneficial to the society because 'necessities justify that which may be unlawful'.
[576] Nurshuhaida Binti Abdul Razak and Siti Zaiton Binti Mohd Dali, 'Managing Halal and Haram Investment in The Case of EPF's Malaysia' (Proceedings of PERKEM VIII, Johor Bahru 2013) 345.

bank, for instance, may suspend the contract until the borrower is able to continue payment.[577] Equally, the bank may terminate the agreement subject to a future condition obliging the borrower to complete payment at a later date. Another remedy available to the Islamic bank is the sale of assets on the market, in accordance with the principle that the bank's constructive possession over an asset is functionally equivalent to the bank's collateral over sums owed under contract. The proceeds derived from the sale of the asset may then be used to pay all or part of the outstanding balance.[578]

In each of the above cases, however, the bank is forced to absorb the costs of recovering owed amounts, and there are no legal means of guaranteeing full recovery of the purchase price. This stands in stark contrast with the relief measures available to conventional banking institutions, including the power to sanction non-payment through a variety of civil monetary penalties, including late payment charges, interest based related measures, termination or revocation of the terms of loan or financing agreement, foreclosure of assets, or by pursuing other remedial measures through the courts.[579] However, countries such as Saudi Arabia lack a developed private law system, supported by an effective recovery regime. As such, loss bearing parties cannot depend on the grant of relief in the case of breach of contract, and other private law remedies.

In advanced legal regimes, borrowers of Islamic finance will be subject to insolvency laws. In cases of 'honest' default, these laws may release the borrower from any obligation to continue with the contract. Currently, there is no branch of law under Shariah that deals with the recovery of debt, unjust enrichment or damages in breach of contract, or which otherwise establishes procedures relating to insolvency.[580]

4.5 Are Islamic Banks More Ethical?

With the morality of conventional banking practices under attack, many commentators reflect on the corresponding effects of unethical or malfeasant practices in Western financial institutions - such as the widespread practice of issuing risky mortgage loans to customers

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[577] The Qur'an (2:280).
[578] Mariani Abdul-Majid, David Saal and Guiliana Battisti, *Efficiency in Islamic and Conventional Banking: an International Comparison* (Springer Science and Business Media 2009) 1 <https://research.aston.ac.uk/portal/files/990977/0811.pdf/> accessed 14 March 2017.
[498] Foster (n 489) 1, 3-4.
[499] ibid.[580] ibid.
[580] ibid.

with low or no income - and their role in catalysing the global credit crash.[581] Mian and Sufi go further, suggesting that loans were packaged under, to conceal interest related default risks from consumers.[582] Skreta and Veldkampon lay the blame at the door of the poor rating systems of international risk ratings agencies,[583] while Posner contends that the risky investment policies of financial institutions led to the credit crunch.[584] Others, such as Brunnermeier, blame a profits-obsessed corporate culture[585], while ministerial authorities, such as HM Treasury, have drawn a more direct link between the global financial crisis and the lack of effective governance mechanisms at both corporate and national levels.[586]

It is here that Islamic models of finance would, at least in principle, claim the higher ground. In aspiration, if in not in practice, the 'ideal' of Islamic finance promises to garner its beneficiaries and participants with a more equitable system of wealth and loss distribution, primarily because of its emphasis on profit and loss sharing (PLS). Ahmad et al. who vigorously champions the (purported) ethical superiority of Islamic modes of banking argues the following:

> "The crisis involved the concentration of profit in the hands of a few rather than any wider social sharing. Losses in the conventional system were also not shared, as although admittedly the shareholders suffered substantial declines in the value of their holdings, and there were some redundancies among junior bank staff, many of the leading investment bankers kept their jobs or soon found others as equally well paid as business as usual was resumed once the crisis passed. The main losers were bank clients who got into difficulties and taxpayers, including those of modest means but above tax thresholds." [587]

In Islamic finance, interest is equated with riba, which is explicitly forbidden. Advocates of Islamic banking such as Al-Jahri have long since argued that Islamic banks were relatively unaffected by the financial crisis of 2008, primarily because of the emphasis these institutions

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[581] Charles W Calomiris, 'The Subprime Turmoil: What's Old, What's New and What's Next?' (2009) 15(1) Journal of Structured Finance 1, 6.
[582] Mian and Sufi (n 402).
[583] Vasiliki Skreta and Laura Veldkamp, 'Ratings Shopping and Asset Complexity: A Theory of Ratings Inflation' (2009) 56(5) Journal of Monetary Economics 678.
[584] Richard A Posner, *A Failure of Capitalism: The Crisis of '08 and the Descent into Depression* (Harvard University Press 2009) 45-50, 171-179.
[585] Brunnermeier (n 9).
[586] HM Treasury, *Reforming Financial Markets, Cm 7667* (HMSO 2009).
[587] Ahmed, Asutay and Wilson (n 318).

place on risk sharing, and on prudential risk assessment before 'money changes hands', and investment in 'real' goods and services.[588] By the same token, Islamic finance principles ostensibly discourage or prohibit, all together, the sale of debt, interest based transactions, and excessive uncertainty over terms of contract, e.g. the amount or date of payment, as well as the sale or exchange of insecure assets over which the banks do not have ownership.[589] Noted scholars such as Zerban et al. have remarked on the fundamental novelty of Islamic modes of financing. Since banks, as creditors, are required to share the risk of default, they have greater incentives to develop cautious lending policies and to carry out an adequate risk assessment of the credit worthiness of borrowers before approving finance projects.[590]

Furthermore, Islamic modes of corporate and personal finance are also envisioned to promote higher levels of trust among bank managers and customers. The prevailing assumption here, at least among Islamic scholars, is that while profit-driven banking institutions in the West treat lending arrangements as little more than an item on their balance sheets, Islamic profit and loss sharing, such as Mushārakah and Mudārabah contracts, are designed to foster long term relationships between the client and bank. In contrast with conventional banking, Islamic contract arrangements will typically have a maturity of five years or more. This has led Ahmad and other supporters of Islamic modes of financing to argue the following:

> "If all banks were Islamic, financial crises would be less likely. Islamic banks not only take a longer-term perspective beyond the relatively short five-year periods of most business cycles, but they have built-in stabilisers that lower the probability of crises."[591]

For the above reasons, Islamic banks are, and were, prima facie well positioned to weather the worst effects of the financial crisis. This point is underscored by the fact that few Islamic banks failed during the financial crisis or its aftermath (although, as will be discovered, there are some notable exceptions to the rule). During the crisis, most conventional financial institutions received bailouts and other stimulus packages from national governments. As reported by Tiurvengadam in the Wall Street Journal, the US government allocated 2.98

[588] See, generally, Mabid Ali Al-Jarhi, 'Remedy for Banking Crises: What Chicago and Islam Have in Common' (2004) 11(2) Islamic Economic Studies 23, 35-39.
[589] ibid.
[590] Ayman Zerban, Eslam Elkady and Rafik Oma, 'Islamic Finance and Global Financial Crises: How to Keep Finance on Track?' (2012) 14 Topics in Middle Eastern and African Economies 190, 210-215.
[591] Ahmed, Asutay and Wilson (n 318).

trillion dollars to bank bailouts.[592] Meanwhile, the two biggest banks of Saudi Arabia, the Saudi American Bank (SAMBA) and Riyad Bank, reported no losses except for a small decline in profitability. Perhaps more surprisingly, Al-Rahji, a major Islamic bank in the Gulf, reported a small increase in profits during the peak of the crisis in 2008-2009, from 1.72bn to 1.73bn.[593] Moreover, figures published by the International Monetary Fund indicate that Islamic banks in countries like Qatar and the United Arab Emirates, where Islamic banks hold approximately 27% of their banking assets,[594] performed relatively better than conventional banks, as indicated by the fact that the, “non-performing loan ratio for Islamic Banks remained slightly higher than that for conventional banks.”[595]

The history and current practice of Islamic banking is, however, not without its pitfalls. While Islamic banks have adopted sound policies on capital adequacy, the mere fact that these banks have exceeded Basel thresholds should not be taken as grounds for complacency.[596] Herein lies the danger that the assumption that Islamic finance as somehow immune to the very risky causes and consequences of poor banking practice in the West is disproved by a number of high profile instances of banking failure. Indeed, Islamic legal systems, not least the Saudi market in banking, may exhibit many of the same deficits and systemic risk failures that would precipitate crisis in the West.[597]

There exists extensive literature which has addressed the risk-taking features of Islamic banks.[598] While advocates of Islamic finance will often point to the moral deficiencies of conventional, profit-driven banking, less attention has been paid to the failures of Islamic finance institutions, including the collapse of the Kuwait Finance House;[599] or the massive

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[592] Meena Thiruvengadam, ‘U.S. Bailouts So Far Total $2.98 Trillion, Officials Say’ (*Wall Street Journal*, 31 March 2009) <http://online.wsj.com/article/SB123851108664173877.html/> accessed 31 March 2016; RBS, ‘Annual Report and Accounts 2008’ (RBS 2009).

[593] Citigroup, ‘2008 Annual Report’; RBS, ‘Annual Report and Accounts 2008’; Samba, ‘Consolidated Financial Statements and Auditors Reports for the Year Ended 31 December 2008’; UBS, ‘Annual Report 2008’.

[594] Mohamad Hasan and Dridi (n 302).

[595] ibid 17.

[515] For a discussion, see, Mareyah Mohammad Ahmad and Dayanand Pandey, ‘Are Islamic Banks Better Immunized than Conventional Banks in the Current Economic Crisis?’ (10th Global Conference on Business & Economics, Rome, 15-16 October 2010) 1.[597] Andrew Campbell, ‘Insolvent Banks and the Financial Sector Safety Net – Lessons from the Northern Rock Crisis’ (2008) 20 Singapore Academy of Law Journal 316, 320.

[597] Andrew Campbell, ‘Insolvent Banks and the Financial Sector Safety Net – Lessons from the Northern Rock Crisis’ (2008) 20 Singapore Academy of Law Journal 316, 320.

[598] Salman Syed Ali, ‘Financial Distress and Bank Failure: Lessons from Closure of Ihlas Finans’ (2006-2007) 14(1-2) Turkey Islamic Economic Studies 1, 3.

[599] Mahmood Nathie, ‘Islamic Bank Failure: A Case Study’ (2010) 2(1) ISRA International Journal of Islamic Finance 7, 7.

losses suffered by Islamic International Bank of Denmark, resulting in a rapid devaluation of its equity holdings during 1985 and 1986.[600] In both cases, Islamic banks exhibited the very pathologies that are assumed to be the sole preserve of conventional, debt driven banking - that is, excessive risk-taking and over-reliance on repayments by large corporate borrowers.[601]

A case in point is the Kuwait stock market known, as Souk al-Mahkh, which suffered a collapse in speculative trading and short selling activities orchestrated by a number of unregulated Gulf companies. These actions precipitated the collapse of the major credit provider. Notably, the Kuwait Bank of Commerce and Credit International claim to have been engaged in the purchase of Shariah compliant assets, a fact that was later shown to be false. This, along with many other examples, illustrates a wider problem in risk management and the supervision of Shariah compliance.[602]

For its detractors, Islamic banking models impede growth and innovation because of the prescriptive or 'hands-tying' quality of Islamic finance principles and permitted contract forms. It is this feature of Islamic finance that lends itself to negative associations with political or economic systems which have long since fallen out of fashion with the end of the Cold War, such as central planning, theocratic fascism and Marxism.[603]

The reason that Islamic banks have not yet failed may have less to do with the inherent ethics, solvency or contractual aversion to risk, of Islamic banking models, relative to their conventional alternatives, and more to do the with the fact that Islamic institutions, even when poor performing, often have the backing of central banks who act as sovereign guarantors, as was the case in the recent Dubai real estate crisis.[604] One can surmise accordingly that while segments of the Islamic finance markets can suffer, country level investment in Islamic banking can remain inefficient but stable, providing that any losses or corporate governance failures can be underwritten by the state or Islamic financiers. In the

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[600] Grais and Pellegrini (n 361) 4.

[601] See Ibrahim Warde, *Islamic Finance in the Global Economy* (2nd edn, Edinburgh University Press 2010) 173-174; Tanya Andreasyan, 'Lord Eddie George: The Steady Hand behind Islamic Finance in the UK' (April 2007) New Horizons Magazine 21.

[602] The Asian Wall Street Journal, 'BCCI Creditors Granted More Time' (9 April 1992).

[603] Leonard Binder, 'Islam and Capitalism by Maxime Rodinson: Review' (1981) 87(2) American Journal of Sociology 492; Leonard Binder, *Islamic Fundamentalism: A Critique of Development Ideologies* (University of Chicago Press 1988) 341.

[604] See Warde (n 520).

above light, the governing boards of Islamic banks and high-level executives have much to learn from the root causes and catalysts of the 2008 crisis.

4.6 Conclusion: Reconciling Shariah with Basel

While the risks discussed in this chapter should be a pressing concern for Islamic banking and finance markets, what cannot be denied is the fact that the processes of Islamic banking are not marginal phenomena. It should be noted that some scholars argue that the differences between conventional and Islamic banking models are grossly overstated. Beck and others argue that while Islamic banks may appear to be less efficient, they have several advantages over their conventional alternatives.[605] These advantages include, inter-alia, higher intermediation ratios and asset quality, as compared with conventional banks.[606] Islamic banks, they argue, perform better during crises in terms of capitalisation and asset quality, and are less likely to disinter mediate than conventional banks.[607]

The above claims notwithstanding, Islamic financial institutions are nonetheless impeded by religious-regulatory restrictions, prompting intense debate as to whether, or not, a given asset or financial instrument is Shariah compliant. Shariah boards and advisory bodies have different interpretations of the Qur'an and the Sunnah. Legal rulings on compliance will, therefore, vary from country to country. Conflicting schools of jurisprudence offer their own highly subjective legal interpretations on issues of compliance, rights under contract and public interest. There have been some attempts to clarify the legal status of Islamic laws, for example in Egypt.[608] However, this does not settle the 'authority' problem: i.e. who has authority to determine the validity of a contract, or how Islamic standards ought to evolve, and to what extent reconciled with international standards such as those issued under the Basel risk-regulation framework? Would this be through jurists in Saudi Arabia, Malaysian regulators, or the Islamic Financial Services Board, for example?[609] These disputes are unlikely to be settled soon; all of these entities vie for supremacy, and claims to be authoritative within their respective jurisdictions.

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[605] Thorsten Beck and others (n 114).
[606] ibid.
[607] ibid.
[608] See, eg, Farooq Alani and Hisham Yaacob, 'Traditional Banks Conversion Motivation into Islamic Banks: Evidence from Middle East (2012) 5 International Business Research 83, 85.
[609] Shafii and Nurazalia (n 200) 42-49.

International Financial Reporting Standards have, to date, introduced viable international accounting standards.[610] Yet these are still regarded as controversial from the viewpoint of Shariah. In any case, other studies have proven that the implementation of clear and consistent best practices for financial reporting standards have generally had a positive effect on the performance of Islamic financial institutions.[611] The question posed is how can States more effectively implement international best practice in their national legal frameworks, without unduly infringing the integrity of Islamic finance and its underpinning values?

Studies in Saudi Arabia would suggest that the Islamic financial system is at best (though increasingly less and less) an Islamised version of the conventional system. In the final analysis, the central question, addressed in the next chapter, can be posed as follows: Does the Islamic financial model need to adapt to remain competitive with conventional banking and its underpinning regulations, including international standards made for conventional banks - namely the Basel framework? Or, conversely, should Basel be more responsive to the principles and practices of Islamic banking, as governed under Shariah.

As will be demonstrated in the next chapter on the relationship between Basel standards and Islamic banking, the structural features of Islamic banking are fundamentally different from those of conventional banks, as are the assumptions on which both models are based. As Islamic banks are equity rather than debt driven, they accept savings deposits. However, unlike conventional savings accounts, depositors may suffer losses as well as profits from sums deposited in profit-share accounts. This is antithetical to the very purpose of saving accounts deposited with conventional banks, in which the whole point of opening a savings account is to accrue interest on their investments in return for depositing funds held with that institution.[612]

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[610] Ihab Alsaqqa and Nedal Sawan, 'The Advantages and the Challenges of Adopting IFRS in UAE Stock Market' (2013) 8 (19) International Journal of Business and Management 1.

[612] Abraham Udovitch, *Bankers Without Banks: Commerce, Banking and Society in the Islamic World of the Middle Ages in Dawn of Modern Banking* (Yale University Press 1979) 263.

[612] Abraham Udovitch, *Bankers Without Banks: Commerce, Banking and Society in the Islamic World of the Middle Ages in Dawn of Modern Banking* (Yale University Press 1979) 263.

Chapter V: Basel III as a General Framework for Risk Management and its Applicability to Islamic and Saudi Banking Frameworks

5.1 Introduction

In 2008, the banking sector faced the worst financial crisis in a generation.[613] The far-reaching impact of the global financial crisis prompted G20 leaders to seek the creation of international rules, a document known as Basel III, which aimed to improve the quantity and quality of a bank's capital,[614] while discouraging excessive leveraging.[615] With these aims in mind, the Basel Committee recognises that capital standards should be phased progressively as the global economy strengthens. The aspiration is that more and more states will seek to fully codify and implement Basel III international regulatory and capital adequacy standards into their national law by the end of the next implementation phases in 2019.[616]

As discussed in the previous chapter, Islamic banks are vulnerable to risk exposures which are not necessarily comparable to the risks associated with conventional banking products. Viewed through this lens, this chapter considers the extent to which the Saudi Arabian banking sector, and in particular the Saudi sector of Islamic banking, is sufficiently robust to supply much needed credit to new and emerging sectors.[617] The growing market in residential mortgages in Saudi Arabia is only one example of the changing nature of financial services in Saudi Arabia. For instance, home ownership is now the ambition of many Saudi consumers. The Saudi Arabia government is all too aware of the credit risks involved in rapid growth and demand for mortgage products.[618] How then is Saudi Arabia to insulate itself against risks, as a participant in an interconnected market economy, and to what extent can these risks be more effectively managed through the Saudi government's adoption and implementation of

[613] Latham and Watkins, 'Regulatory Capital Reform under Basel III' (2011 Report) <http://www.garp.org/media/583507/regulatorycapitalreformbaseliii_nicolaides032311.pdf/> accessed 22 January 2017.
[614] Relevant instruments include BIS (2006) (n 15).
[615] BIS, 'Basel III: The Net Stable Funding Ratio' (October 2014) 1.
[616] ibid.
[617] See, IMF, 'Saudi Arabia Financial System Stability Assessment' (IMF Country Report No 17/318, October 2017) see especially 1-4.
[618] For a parallel discussion, see Abul Hassan, 'Risk Management Practices of Islamic Banks of Brunei Darussalam' (2009) 10(1) The Journal of Risk Finance 23 and for a relevant discussion on Malaysia see Muhd Ramadhan Fitri Bin Ellias, 'Pricing of Murabahah and Ijarah Product in Malaysia: A Critical Analysis from the Shari'a Perspective' (International Islamic University Malaysia 2007) 46, 47-49, 53.

Basel standards on risk regulation. Moreover, this chapter considers and critically analyses whether Basel is suitably adapted to the risk exposures of Islamic banks. These issues will be discussed in the following sections.

5.2 The Financial Crisis: The Catalyst for Basel III

As discussed in Chapter II, the origins of the most recent global financial crisis can only be fully understood when situated from within in its broader historical context. With the rollback of the 'command and control' state, the globalising moment has witnessed the turn away from state centred regulation of financial markets, and movement instead to liberalisation, deregulation and privatisation of the financial sectors.[619] The financial crisis finds it antecedents in the United States, and its governance of structured corporate finance. Driven by an urge to reap higher returns on their investments, banks would develop a range of new and innovative products that would change the landscape and structure of financial markets. The traditional model of investment banking, also known as the financial intermediation model, in which depositors provided funds to banks for investment now gave way to a new system of 'securities' backed financing.[620] Under this new model, banks would raise funds from investment in trading markets through securitisation. The most infamous of these new modes of financing was the practice of pooling loans which were then sold to investors as Mortgage Backed Securities (MBSs)/Collateralised Debt Obligations (CDOs).[621]

By 2006, around about 55% of the estimated total value of the $10.2 trillion value of mortgage loans in the United States was consolidated and sold on to local and global investors.[622] The build-up of toxic (unredeemed and written off) debts in the sub-prime mortgage market is well known to have been one of the central triggers of the 2008 financial crisis. The unregulated OTC and credit swap derivatives market would also emerge as a catalyst for the 2008 crisis, with the value of OTC contracts rising to $596 trillion by the end of 2007, and the segment in credit swap derivatives estimated to have reached $58 trillion.[623] Many of these instruments were treated as off balance sheet assets. As a result, banks would

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[619] See Wallison (n 71).

[620] For a UK perspective, see, Iwan Davies, 'The Reform of English Personal Property Security Law: Functionalism and Article Nine of the Uniform Commercial Code' (2004) 24 Legal Studies 295.

[621] For a country specific discussion, see Fitri Bin Ellias (n 553) 46, 47-49, 53.

[622] Norges Bank, 'Financial Stability 2/2007' (Report from the Central Bank of Norway, No 5/2007).

[623] Anthony Fiaola, Ellen Nakashima and Jill Drew, 'What Went Wrong?' *The Washington Post* (15 October 2008); Carmen Reinhart and Kenneth Rogoff, 'Is the 2007 US Sub-prime Financial Crisis So Different? An International Historical Comparison' (2008) 98(2) American Economic Review: Paper & Proceedings 339.

continue to hold these instruments without retaining sufficient levels of capital to support them, and would do so without having to disclose losses on their trading books and financial statements. As Crotty argues eloquently:

> "[The] dialectic of financial regulation is an inherent problem in modern state-guided capitalisms. Catastrophic economic and political events often lead to successful attempts to tightly regulate the industries believed by the public to be responsible for their problems. But as time passes, regulated firms have a strong incentive to try to weaken and evade their regulatory restraints. In financial markets, innovation is a major weapon in this game. The US and other advanced capitalist countries were thus confronted with a choice. They could either substantially reform their regulatory systems so financial markets would continue to be restrained from excessive risk taking under the new economic conditions, or they could return to the pre-1930s free-market ideology and undertake radical deregulation."[624]

This 'radical deregulation' un-leashed a domino effect that would culminate, eventually, in a sovereign debt crisis across Europe and the United States, which in turn fuelled rising levels of sovereign debt. With the above in mind, the next section will consider the role of Basel regulation in reducing risk and constraining risk behaviour on the part of banks, namely through the formulation of minimal standards on capital adequacy, liquidity and disclosure related standards.

5.2.1 The Creation of an International Framework on Banking Regulation

In the era of transnational commerce, there is, arguably, a growing need for an international banking supervisory authority.

As a prime example of the significant power wielded by global standard-setting bodies, the Basel Committee has generated a wealth of international risk regulation standards. Through national implementation, the decisions of the Basel Committee profoundly impact or circumscribe the internal policy choices of those national governments who sit on its board of directors, but equally, and in no less significant ways, the rule and policy making

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[624] Crotty (n 148).

autonomy of non–member states.[625] The Basel Committee seeks to accomplish its goals by establishing minimum standards for bank regulation and supervision; by sharing supervisory issues, approaches and techniques to promote common understanding; by improving intercontinental and cross-border cooperation; and by exchanging valuable information on developments in the banking sector and financial markets.[626]

By reflecting on the structural causes of banking crises in advanced capitalist economies, the Basel Committee has indicated that institutional failure in particular banks are linked not to broader macroeconomic conditions but to the banks' failure to accurately reflect their true capital positions. For instance, by poor accounting and valuation inadequacies in addition to the assumption of bad debt and resulting credit risks.[627] In an attempt to correct these failures, the Basel Committee has devised a framework under which existing and emerging risks to the global financial system as a whole can be identified, managed and prevented.[628] The next section will outline the main risk factors which the Basel banking regulation framework aims to correct.

5.2.2 The Purpose of Risk Regulation

Risk management is the general term given to the set of corporate governance approaches that are used to preserve and restore the value (of assets).[629] When scholars and practitioners discuss risk assessment, they are normally speaking of a concept of risk which is multidimensional and overlapping.[630] The Basel framework is, therefore, fundamentally concerned with risk assessment and risk management.[631] To this end, the Basel framework develops minimally harmonised standards on how banks should classify and measure risk both internal to the bank (e.g. operational risks), or external (i.e. market risks).

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[625] Barr and Miller (n 10).
[626] Thomas Oatley and Robert Nabors, 'Redistributive Cooperation: Market Failure, Wealth Transfers, and the Basel Accord' (1998) 52 International Organization 35.
[627] BCBS, 'Bank Failures in Mature Economies' (Working Paper No 13, April 2004).
[628] See, eg, BIS, 'Principles for Sound Liquidity Risk Management and Supervision' (2008).
[629] Michael Gordy, 'A Comparative Anatomy of Credit Risk Models' (2000) 24 Journal of Banking and Finance 119.
[630] Carol Alexander and Jacques Pezier, 'On the Aggregation of Market and Credit Risks' (ISMA Centre Discussion Papers in Finance number 2003-13, 1 October 2003) <http://www.ismacentre.rdg.ac.uk/dp/> accessed 12 February 2017.
[631] BCBS, 'Principle for the Supervision of Bank's Foreign Establishments' (Revised Concordat, 1983).

The Basel framework offers a corrective to four main categories of risks as described below:[632]

Credit Risk: this risk relates to the liabilities suffered by a bank or depositor as a consequence of a debtor's default on a loan agreement, or any other breach of contractual obligations which affects the bank's or the depositor's ability to recover the principal loan or capital investment. In particular, this thesis will focus on the transfer of credit risks to the depositor, under Islamic profit and loss sharing contracts.[633]

Liquidity Risks: these refer to unforeseen pressures on a bank's supply of capital, thereby affecting that bank's capacity to service its short or long term financial obligations. If a bank does not hold adequate reserves to offset liquidity, then shortages occurring from a bank run and the bank's solvency will be threatened.[634]

Market Risks: these include 'interest rate' risk or 'rate of return' risks and other factors affecting the profitability and competitiveness of banks, including that bank's capacity to effectively assess the quality and value of its assets. These risk exposures will affect the performance of the bank's financial assets, for instance the proportion of high quality assets which can be used to off-set loss generating credit instruments.[635]

Operational Risks: these risks refer to changes or pressures affecting the day-to-day operation of a bank with an adverse impact on the certainty of financial outcomes and the bank's capacity to retain profits and absorb losses.[636]

The governing logic and rationale of the Basel regime, since its inception, has been the advancement of internationally convergent and minimally harmonised standards for regulating the way financial institutions measure risks to determine the minimum levels of capital they should conserve and hold in reserves in order to sustain acceptable levels of

[632] The current simplified standardised approach is in Annex 11 of the Basel II framework.
[633] BCBS (n 1).
[634] For a general discussion, see Timothy Koch and Andrew Saporoschenko, 'The Effect of Market Returns. Interest Rates, and Exchange Rates on the Stock Returns of Japanese Horizontal Keiretsu Financial Firms' (2001) 11 Journal of Multinational Financial Management 165.
[635] General market risk is dealt with at paragraph 709 of the Basel II Framework. Notes on the current version are found at <http://www.bis.org/publ/bcbs158.pdf/> accessed 20 January 2017.
[636] Operational risk-capital at risk is dealt with in Annex II to BCBS, *Consultative Document Operational Risk – Revisions to the Simpler Approaches* (BIS 2014).

institutional liquidity and reduce their risk exposures.[637] However, it should be noted that above defined 'risk' categories are, as will be discussed below, by no means exhaustive and, moreover, have a reach and scope that goes beyond the internal operations of particular banks, or the applicable laws and regulations of the governing jurisdictions.[638] While the Basel framework emphasises technical and procedural standards on asset valuation, risk computation and capital measurements,[639] the overall framework, arguably, gives expression to a wider set of public policy objectives.[640] The most recent Basel proposals, advanced under Basel I and II as discussed below, call upon participating states to implement legislation aimed at enhancing the supervision of financial institutions at the national level.[641] Moreover, under Basel II, supervisory authorities are empowered to 'pierce the veil' of a financial institution's capital structure and adequacy, including by compelling banks to submit to regular auditing and reporting procedures.[642] This in turn enables supervisory authorities to accurately assess the bank's position and to scrutinise undisclosed risks.[643] In later sections, this author will argue that Basel III approaches do not go far enough. It is not clear, for instance, that Basel III provides sufficient normative standards for the overall spread and promotion of good governance practices beyond general principles on supervision, transparency and disclosure.[644] Issues which escape oversight under the Basel regime concern what constitutes a breach of the fiduciary responsibilities of banks to their stakeholders. Under British law, a loss risk which results from a bank's negligence or wilful recklessness constitutes a breach of the bank's fiduciary duties.[645] In such cases, the bank has a responsibility to make good the capital to the investor. The question of whether a bank has a duty to publicly disclose the long-term risks of a bank's investment choices remains an

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[637] Getter (n 225).
[638] See, also, BCBS (n 1).
[639] BIS (2006) (n 15).
[640] BCBS, *Core Principles for Effective Banking Supervision* (BIS 2012).
[641] BCBS, 'Capital Requirements and Bank Behaviour: The Impact of the Basel Accord' (Working Paper No 1, 1999).
[642] BCBS, *Review of the Pillar 3 Disclosure Requirements* (BIS 2014).
[643] BIS, 'The Basel Committee Minimum Standards for the Supervision of International Banking Groups and their Cross-Border Establishments' (July 1992) <http://www.bis.org/publ/bcbsc312.pdf/> accessed 3 March 2017.
[644] See Basel Committee's recommendations on corporate governance reforms: 'Principle 14 – Corporate governance: The supervisor determines that banks and banking groups have robust corporate governance policies and processes covering, for example, strategic direction, group and organisational structure, control environment, responsibilities of the banks' boards and senior management, and compensation. These policies and processes are commensurate with the risk profile and systemic importance of the bank. See BCBS (n 1).
[645] For a relevant case study, see *Lloyds Bank plc v Rosset* [1991] 1 AC 107.

intensely contentious issue.[646] These risks are particularly acute when considering the capital positions of Islamic financial institutions, as discussed below.[647]

While the purpose of Basel implementing legislation is to subject unchecked market institutions to tighter controls, such aims are to be balanced against respect for market freedoms and autonomy. The Basel Committee has, therefore, sought to develop a regulatory framework which does not create excessive obstacles to market competition or otherwise foster, directly or indirectly, competitive inequality among internationally active financial institutions.[648]

As this thesis is intended for a legal audience, much of the foregoing analysis will consider the interdependencies between these 'financial' or 'managerial' risk potentialities and what we might broadly call legal or institutional risk exposures. International financial institutions may be exposed to legal compliance risks, referring here to the high transactional costs of complying with national regulations implementing Basel standards.[649] Such costs may result from the absence of uniform or consistently applied accounting and reporting requirements.[650] Legal risks can also be expressed in terms of the risks that follow from uncertainty, unfairness or inconsistency in the application and interpretation of national rules and finance regulations.[651] Such risks also extend to the uncertainty experienced by consumers, investors or, indeed, financial institutions themselves, due to ill-defined laws and enforcement procedures at the level of state regulation and supervision.[652]

The above notwithstanding, it is indisputably the case that the Basel framework is predominantly focused on the amount and quality of capital held in reserve by a bank. This is

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[646] See, eg, Heidi Mandanis Schooner, 'Top-Down Bank Capital Regulation' (2016) 55 Washburn Law Journal 327 and Heidi Mandanis Schooner, 'Fiduciary Duties' Demanding Cousin: Bank Director Liability for Unsafe or Unsound Banking Practices' (1995) 63 George Washington Law Review 175.
[647] Alrawashdeh and Rahman (n 47).
[648] BCBS, 'Capital Requirements and Bank Behaviour: The Impact of the Basle Accord' (BIS Working Paper No 1, 1999) <https://www.bis.org/publ/bcbs_wp1.pdf> accessed 4 July 2017; see, also, Rafael Repullo, 'Capital Requirements, Market Power, and Risk-Taking in Banking,' (CEMFI and CEPR, April 2002) <https://www.bis.org/bcbs/events/b2earep.pdf> accessed 4 July 2017 and BIS (1998) (2006) (n 15).
[649] Victor Fleischer, 'Regulatory Arbitrage' (2010) 89 Texas Law Review 227.
[650] See, for instance, V Sundararajan, 'Profit Sharing Investment Accounts - Measurement and Control of Displaced Commercial Risk (DCR) in Islamic Finance' (2011) 19(1) Journal of Islamic Economic Studies 41.
[651] See David Jones, 'Emerging Problems with the Basel Capital Accord: Regulatory Capital Arbitrage and Related Issues' (2000) 24 Journal of Banking and Finance 35, 38.
[652] Blundell-Wignall and Atkinson (n 132).

because the Basel risk regulation framework is grounded on the assumption that failure to conserve adequate levels of capital does not only threaten the solvency of a systemically important institution, but, equally, the sustainability of other banks, firms or businesses who depend on the capital resilience and credit worthiness of the first bank.[653]

5.3 The Regulatory Elements of the Basel Banking Regulation Framework

The next section will briefly outline the key features of the Basel I and II to pave the way for a fuller discussion on the key innovations advanced under the newest standards advanced under the Basel III framework.

5.3.1 The Creation of the Basel Framework or Basel I: Standards and Objectives

The Basel Committee on Banking Supervision concluded the first of its banking reforms in an agreement known as the Basel Accord (Basel I).[654] A landmark in banking regulation, the first of the Basel Accords, Basel I, set out standards for the regulation of the capital of the internationally active banks.

Subject to Basel implementing national regulations, international banks and financial institutions are required to observe minimal capital requirements designed to minimise and prevent credit risks on balance and off-balance sheet payments.[655] The Basel I accord was innovative in that it standardised a working definition of capital adequacy as the ratio of a bank's capital to its risk weighted assets. The various guidelines issued under Basel III on risk weighting, capital classification and capital measurement and so forth are highly technical, detailed and complex.[656] Nonetheless, the importance of the new requirements cannot be overstated, specifically in respect of how banking assets are risk weighted and in terms of how the constituent elements of a bank's capital structure is classified and regulated.

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[653] See BIS (2009) (n 15); BIS (2009) (n 108).
[654] BIS (2006) (n 15) 30.
[655] BIS (1998) (2006) (n 15).
[656] Viral V Acharya and others, 'Capital, Contingent Capital, and Liquidity Requirements' in Viral V Acharya and others, *Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance* (Wiley 2010) 143, 146-47.

Though this has now been amended under the Basel III reform proposals, Basel I identifies three tiers of capital, which are differentiated on the basis of their ability to absorb losses.[657] Tier 1 Capital consists primarily of common stock and disclosed reserves (or retained earnings). This type of capital holds commonalities with the accounting concept of shareholder equity.[658] Tier 2 Capital is the label given to 'supplementary capital', which includes undisclosed reserves, revaluation reserves, general loan-loss reserves, hybrid (debt/equity) capital instruments, and subordinated debt.[659]

Under the Basel I framework, a financial institution's capital base is the primary value used to calculate that entity's Capital Adequacy Ratio (CAR).[660] The CAR indicator represents the sum of Eligible Tier 1 Capital and Eligible Tier 2 Capital, minus any legitimate deductions from the bank's total capital. Since all assets held by a bank are susceptible to risk, the Basel I regulations have established a regulatory floor for the amount of capital held by a bank as a percentage of the risk associated with different types of assets.[661] Assets which are classified as Tier 1 capital, such as the banks own or share capital, are considered high quality because they constitute more stable sources of financing. Under the Basel regime, banks are expected to hold more loss absorbing Tier 1 capital, and less Tier 2 (and the now abrogated Tier 3).

The financial portfolio of conventional banks will vary, but larger banks will tend to hold assets of a mixed nature. As each class of asset carries a higher or lower risk, the Basel framework benchmarks technical standards on how financial institutions subject to Basel implementing national legislation are to assign a monetary value to risk-to-capital ratios (i.e. the sum of capital that should be reserved for each risk weighted asset). Highly regulated 'safe' assets including government bonds rank low on the risk weighting scale (0%), while unsecured loans have a high risk rating of 100%.[662]

In an important innovation, the Basel I framework introduced greater uniformity and clarity over the definition of countable equity capital.[663] Moreover, by setting out coherent

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[657] BIS (2006) (n 15).
[658] ibid 37.
[659] Jones (n 586). For a further discussion, see Heidi Mandanis Schooner and Michael W Taylor, *Global Bank Regulation: Principles and Policies* (Academic Press 2009) 137-43.
[660] BIS (2006) (n 15) 818.
[661] ibid.
[662] ibid.
[663] BIS (n 199).

guidelines on asset-to-tier classifications and risk measurement, the Basel architecture can be seen as an attempt to overcome variations in risk and capital measurement approaches across different sectors and states.[664] By observing Basel approved risk measurements methods, banks are able to calculate the minimum amounts of capital a bank should hold in reserve, in order for it to withstand financial pressures. The pressures would include factors affecting the bank's capacity to supply credit during a bank run, on the assets side of its balance sheet, or which otherwise constrains its ability to service its (debt based) financial obligations, on the liabilities side of the bank's balance sheet. As suggested, Basel I clearly represented a positive move in the regulation of interconnected financial entities and their intermediaries or subsidiaries.[665]

Basel I was soon criticised for focusing too heavily on capital management at the infra-bank level, without taking account of the 'systemic' or counter-cyclical risk exposures of the Bank as a whole.[666] Excluded from the scope of Basel I capital adequacy framework were clear guidelines on how banks should manage their risk profiles through sound capital planning and product diversification (so called risk–hedging, whereby heavy losses incurred from non-viable financial products are 'netted' against more stable forms of equity based financing).[667] Otherwise put, Basel I suffered from regulatory myopia. The risk classification and measurement requirements instituted under Basel banks only allows for a superficial assessment of a bank's adherence to technical capital adequacy requirements. Yet, the capital requirements established under Basel I offers little insight into the underlying (capital) structure of the bank, and associated risk exposures, while failing to set out robust disclosure and supervision requirements which would allow for greater transparency over the credit quality of a bank's assets, and its conduct more generally (at least at an international level).

The narrow focus of Basel I can be explained, at least in part, by the way that banking is conceptualised under Basel I, which is to say the model of banking on which Basel I was

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[664] See, generally, John C Coates, IV, Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications, (2015) 124 Yale Law Journal 882, 997.
[665] Kevin Dowd, 'Moral Hazard and the Financial Crisis' (2009) Cato Journal 141, 143.
[666] Heidi Mandanis Schooner, 'Regulating Angels' (2015) 50 University of Georgia Law Review 143.
[667] FSB, 'Improving Financial Regulation' (Progress Report, September 2009) <http://www.financialstabilityboard.org/publications/r_090925b.pdf/> accessed 13 March 2017 and ISDA, 'Netting and Offsetting: Reporting Derivatives under U.S. GAAP and under IFRS' (Consultative Note, May 2012) 10-13 <https://www.isda.org/a/I0DDE/offsetting-under-us-gaap-and-ifrs-may-2012.pdf> accessed 13 March 2017.

based. The Basel I framework most closely accords with the fractional reserve banking model.[668] Under this model, it is assumed that a bank's reserve is calculated as a fraction of the total deposits held by a bank, minus its deposit liabilities. However, this model fails to take sufficient account of the liquidity risks that a bank may face when is experiencing a run – the terms used to describe a surge in the withdrawal of liquid funds such as cash reserves.[669] A bank run may occur for a number of reasons, for instance, inefficiency (poor profit performance) or corporate mismanagement may lead to a loss in confidence and trust in banking institutions, prompting savers and current account holders to withdraw deposits at unusually high levels. In these circumstances, a bank may be unable to honour its financial obligations, threatening its continued operation and solvency.[670]

A related shortcoming of the Basel I framework is one which focuses predominantly on retail banking, and less on the growing sector of investment banking, including the growth of high risk and volatile debt financed markets such as the market in securities, credit swaps and derivatives. Above all, the lessons of the financial crisis pointed to a more glaring deficiency in Basel I. The accord did little to persuade and compel banks to set weight risks and set appropriate capital requirements for the growing market in off-balance sheets (unaccounted for) tradable securities.[671] An important example of undisclosed credit transactions included, for instance, short term securities, whereby quality assets were purchased and then immediately sold to raise funds before they could be marked off against corresponding liabilities (accounted for on the balance sheets).[672]

Finally, the 'soft' character of Basel standards was widely perceived to lack 'force' or 'bite'; and the framework lacked any feedback or reporting mechanisms by which to assess the effectiveness of capital retention regulation. Basel I was conspicuously silent on whether its standards were capable, of themselves, of effectuating a change in the governance culture of a financial organisation towards the achievement of enhanced accountability, responsibility and

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[668] Stefan Ingves, 'Banking on Leverage' (Chairman, Basel Committee on Banking Supervision and Governor, Sveriges Riksbank keynote address to the 10th Asia-Pacific High-Level Meeting on Banking Supervision Auckland, New Zealand, 25-27 February 2014).

[669] Jean Dermine, 'Basel III Leverage Ratio Requirement and the Probability of Bank Runs' (2015) 53 Journal of Banking and Finance 266, 273.

[670] Sundararajan (n 585).

[671] BIS (n 199).

[672] Tariqullah Khan and Habib Ahmed 'Risk Management and Analysis of the Issues in Islamic Financial Industry' (Occasional Paper No 5, 2001) 86.

prudential management of deposits.[673] Dowd's remarks were particularly salient, in the above regard: "However good they might be, and however good the risk management systems they install, risk managers still take their orders from senior management, who often pressure them to take short-cuts, turn the other eye, produce risk low risk numbers to keep down capital requirements and generally not rock the boat."[674] The perceived limitations of Basel I would lead to another round of negotiations, culminating in the adoption of a second Basel accord, or Basel II, discussed below.

5.3.2 Reform of the Basel Framework and the Adoption of Basel II

Basel II was implemented in light of concerns over the expanding debt financed markets in securities, credit swaps and derivatives.[675] The Committee wanted to integrate Basel capital standards with national regulations better, in order to pursue minimally harmonised, robust and coherent capital measurement and capital adequacy requirements.[676] Once again benchmarks were implemented in order to reduce, manage and counter various risks that apply to the banking sector.[677] As part of the general draft of measures intended to enhance the risk sensitivity of banks, the qualitative capital requirements introduced in Basel I were now supported with two additional pillars which sought to empower the Basel Committee with enhanced supervisory powers and market discipline, including board oversight, sound capital assessment, comprehensive assessment of risks, monitoring and reporting, and internal control review.[678]

With respect to the first of the Basel II reforms, the Committee was responsive to criticisms that the Basel I capital conservation standards only created a buffer for certain kinds of credit risks. Under Basel I, market, liquidity and other risk exposures were not fully factored into the calculation of minimum capital requirements.[679] The framework also sets out capital

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[673] Steven L Schwarcz, 'Misalignment: Corporate Risk-Taking and Public Duty' (2016) 92 Notre Dame Law Review 1, 4 (suggesting that the managers of systemically important financial institutions have a 'public governance duty' to conduct their activities responsibly; and Donald C Langevoort, 'Corporate Executives Naked, Homeless and Without Wheels: Corporate Fraud, Equitable Remedies and the Debate over Entity Versus Individual Liability' (2007) 42 Wake Forest Law Review 627.
[674] Dowd (n 600).
[675] BIS (n 199).
[676] BIS (2006) (n 15).
[677] See BIS (2009) (n 15) and BIS (n 108).
[678] BCBS, 'Amendment to the Basel Capital Accord of July 1988'; Jackson and others (n 177).
[679] ibid.

charges associated with different categories of risk: credit, market or operational risks.[680] The capital charge is calculated by assessing credit, market and operational risks, separately and cumulatively, each denoting a higher charge for higher risk within each category.

Aside from its capital requirements, Basel II established, in a second pillar, a supervisory review process, the purpose of which is to enable banks to develop and utilise best practices and processes for monitoring and managing their risks.[681] Under the supervision pillar, each state should also designate a competent authority to monitor and supervise risk mitigation strategies employed by a bank. Basel II permits banks with advanced management and auditing capabilities to develop and implement their own internal risk management systems independently of formal state centred supervision processes.[682]

Under new guidelines presented to national regulators, Basel compliant (national) regulations should subject international and domestic banks to enhanced market disclosure requirements by requiring them to disclose their financial statements.[683] This measure effectively obliges banks to conduct risk-to-capital valuations transparently, and to disclose any discrepancies between the reserves held, and the amounts required under Basel approved risk computation models and ratios.

All banks subject to Basel II implementation are required to publish risk management and mitigation strategies to ensure higher levels of transparency and accountability to market stakeholders, for instance through the adoption of early warning reporting measures.[684]

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[680] ibid, Appendix E, section 3 (a) (1) (B) (2) (ii) (2).
[681] Jackson and others (n 177).
[682] BIS (2006) (n 15) 15.
[683] ibid, Appendix E, section 5 (c).
[684] BIS, 'Part 3: The Second Pillar – Supervisory Review Process' 719 <https://www.bis.org/publ/bcbs128c.pdf> accessed 4 July 2017.

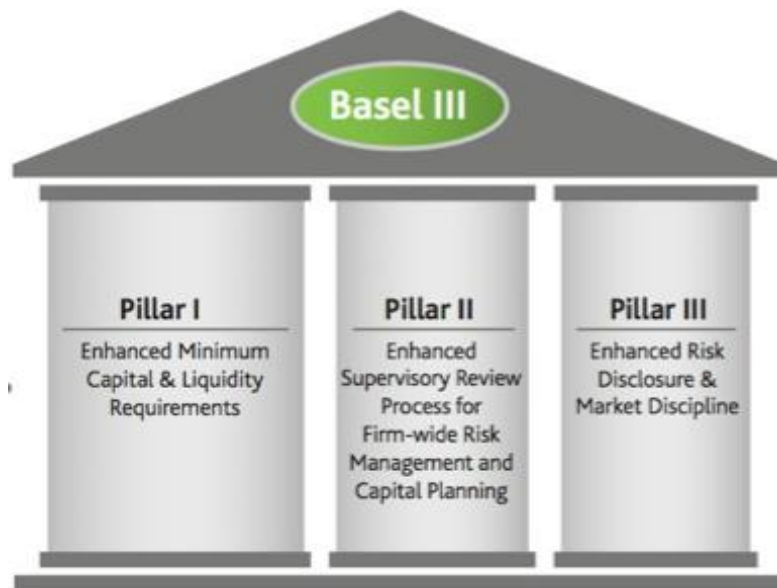

Figure 1: The Three Pillars of Basel III[685]

The revised Basel framework issued under Basel II would once again come under scrutiny. Chief among its shortcomings was the Basel Committee's failure to take seriously the problem of institutional liquidity.[686] Both Basel I and II were criticised for failing to provide guidelines on how systemically important banks were to remain resilient in the face of unexpected market pressures e.g. fluctuations in the market-to-market value of a bank's trading book assets.[687] The silence of the Basel Committee on key issues around the institutional liquidity over high and low periods of growth during a business cycle would later prove disastrous in the face of the global subprime mortgage crisis. In so doing, the Basel Committee missed an opportunity to strengthen public oversight of the more shadowy underworld of banking practice, namely the undisclosed positions taken by major banks on secondary trading markets.[688]

While Basel II has wider coverage than the previous Accord, it was nonetheless criticised for its excessive focus on balance sheet assets, thereby failing to minimise and prevent credit risks resulting from off balance sheet payments. The financial crisis of 2007/2008 made it

[685] This graph has been taken from a student thesis by Abdul-Aziz Sharbarly (n 111) 112.
[686] Ahmed Al-Darwish and others, 'Possible Unintended Consequences of Basel III and Solvency II' (IMF Working Paper No 187, August 2011) 1.
[687] Bill Allen Kai Ke Chan and Alistair Milne, 'Basel III: Is the Cure Worse Than the Disease?' (2012) 25 International Review of Financial Analysis 159.
[688] Getter (n 225).

clear that Basel II was not effective, as the requirements for Tier 1 capital did not prohibit hybridisation, so that banks were not holding enough real capital as they needed to reduce the risks they were exposed to. The limitation of Basel II was that it classified hybrid instruments – modes of financing that are both equity and debt based – as Tier 1 capital. Since Tier 1 capital has a lower risk weighting than Tier 2 capital, the risks associated with hybridized capital was not a true reflection of the capital the banks needed to hold in reserve to offset potential losses associated with these modes of financing.[689] The Basel Committee's failure to address the potential risks associated with excessive hybridisation would be a precipitating factor of the 2008 crisis.

5.3.3 The Adoption of Basel III: A Landmark in International Banking Regulation

As a consequence of the global crisis of 2008, the Basel Committee made significant amendments to Basel II, so as to ensure that the banking industry would remain secure if another crisis were to occur. [690] Even prior to Lehman Brothers' collapse in September 2008, the need for a fundamental strengthening of Basel II's framework had become obvious. The global banking sector had arrived at the financial crisis with far too much leverage and few liquidity buffers. These weaknesses resulted from bad governance and risk management, as well as incentive systems that were inappropriate. Altogether, these factors led to the mispricing of credit and liquidity risk, and excess credit growth.

In reaction to this threatening collection of risks, the very same month Lehman Brothers failed, the Basel Committee issued a set of Principles designed for sound liquidity risk management and supervision. Just short of a year later, in July 2009, the Committee further enhanced the Basel II capital framework, with respect to the treatment of certain complex securitisation positions, off-balance sheet vehicles and trading book exposures. These enhancements contributed to even broader efforts to strengthen the regulation and supervision of internationally active banks, given the weaknesses recently exposed by the crisis in financial markets worldwide.[691] The document was a 'soft' set of instructions, non-binding for members and non-members of the OECD. However, the normative influence and recognition they had was significant. This was because this standard had been adopted in the

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[689] Baltali and Tanega (n 52).
[690] See BIS (n 199).
[691] BCBS (n 1).

European Union[692] and in the United States.[693]

Aggressively moving forward, in September 2010 the Group of Governors and Heads of Supervision announced elevated global minimum capital standards for all commercial banks. This followed a consensus reached in July pertaining to the overall design of the capital and liquidity reform package, which is now called 'Basel III'.[694] The December 2010 version was set forth in 'Basel III: International framework for liquidity risk measurement, standards and monitoring,' and 'Basel III: A global regulatory framework for more resilient banks and banking systems.'[695]

One month later, in January 2012, the GHOS endorsed a comprehensive procedure proposed by the Committee to monitor Basel III implementation. Some of the key recommendations that Basel has made are to increase the CET1 ratio of required regulatory capital, to redefine acceptable regulatory capital, and to introduce leverage and liquidity ratios.[696] However, it should be noted that Basel III requirements are mostly dependent on Basel I regulations.[697] Basel III requirements are based on the following[698]:

1. Ensuring that banks calculate the minimum requirement for capital adequacy. For instance, capital adequacy should not be less than 15%.[699] In addition, capital adequacy should be balanced as per pre-set operations, financial risks and market risks.
2. The elimination of significant factors for non-fair competition between emerging banks, resulting from differences in capital adequacy requirements from one nation to another.[700]
3. Ensuring that banks are meeting the amounts of at least 25% transfers of their net profit to statutory reserves prior to declaration of dividends until the amount of statutory

[692] See European Commission, http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm#crd4/
[693] Jackson and others (n 177) 21.
[694] See BIS (n 199).
[695] For an overview, see Peter King and Heath Tarbert, 'Basel III: An Overview' (May 2011) Banking & Financial Services Policy Reports 1.
[696] Getter (n 225).
[697] Lo'ai Batainah, 'Basel III Regulations and their Impact on Arab Banks' *Oman Observer* (2014) <http://omanobserver.com/basel-iii-regulations-and-their-impact-on-arab-banks/> accessed 1 April 2016.
[698] ibid.
[699] BCBS (n 1) 58.
[700] BIS (2009) (n 15); BIS (2009) (n 108).

reserves is equal to the capital that the bank has in its reserves.[701]

While the Basel III framework builds on the pillar structure established under Basel II, it does embrace some notable innovations, including:

1. An added layer of common equity – the capital conservation buffer – that, when breached, restricts the payout of earnings to protect the minimum common equity requirement.[702]
2. A counter-cyclical capital buffer with new restrictions on participation by banks in system-wide credit booms, the goal being to reduce their losses in credit busts.[703]
3. A new leverage ratio – a minimum amount of loss-absorbing capital relative to all of a bank's assets and off-balance sheet exposures regardless of risk weighting.
4. New liquidity requirements - a minimum liquidity ratio, the liquidity coverage ratio (LCR), designed to infuse sufficient cash to cover funding needs to be over a 30-day period of stress, and a longer term ratio, the net stable funding ratio (NSFR), and designed to address maturity mismatches over the entire balance sheet. [704]
5. Strengthened risk measures for systemically important banks, including basic requirements for supplementary and augmented contingent capital, and enhanced arrangements for cross-border supervision and resolution.[705]

Some of the most important revisions made to the Basel I and II framework are assessed in more detail below.

The new Basel III framework establishes a strengthened definition of capital which is to be phased in over five years, with capital instruments no longer qualifying as common equity Tier 1 capital or Tier 2 capital would be phased out over a 10-year period beginning 1 January 2013. As to minimum capital requirements, the higher minimum for common equity and Tier 1 capital would be phased in from 2013 to 2019, many becoming effective at the beginning of 2015.

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[701] Bankque Saudi Fransi, 'Pillar 3- Qualitative Disclosures' (31 December 2013) <http://www.alfransi.com.sa/en/media/get/20140406_basel-iii-pillar-3-qualitative-disclosure-2013.pdf/> accessed 1 April 2016.
[702] BCBS (n 1) 58.
[703] BCBS (n 1).
[704] BIS (n 534)
[705] Federal Deposit Insurance Corporation, Risk Management Manual of Examination Policies 2.1-1 Capital (4/15).

The new framework establishes:

1) The new Capital Adequacy threshold that the minimum capital ratio banks are expected to institute and observe is 8%.[706]
2) A new classification of risks, and in order to reduce them, banks must have certain ratios corresponding to four different types of capital as a percentage of their risk weighted assets (RWA).[707]
3) Loss Absorption measures so that there is greater loss absorbency for unredeemed stock;[708]
4) Rules concerning liquidity, so that banks are in a reasonable position to meet payment obligations.[709]
5) An improved supervisory process for capital planning (Pillar 2).
6) Better methods and market disciplines to prevent fraud and additional disclosure rules (Pillar 3).[710]

In this way, Basel III reduces the risk of a "bank run", as different levels of reserves are required for various financial products.

The new framework introduces new guidelines for computing risk, such as new capital and solvency ratios and a new way to classify capital structures, which can be Tier 1 or Tier 2. [711]

Renewed importance has been given to forms of capital grouped under Tier 1, representing the banks own capital including hybrid capital and common equity.[712] Furthermore, the last recommendation that was made was to remove Tier 3 capital.[713] Interestingly, many central banks, such as the central bank of Kuwait, have proposed a phased approach to meeting the Basel requirements by giving banks a grace period and gradually building up the required capital (in terms of quality and quantity) to avoid credit shrinkage.[714]

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[706] BCBS (n 1).
[707] ibid 50.
[708] ibid 36.
[709] BCBS, *Basel III: The Liquidity Cover Ratio and Liquidity Risk Monitoring Tools* (BIS 2013).
[710] BCBS (n 561).
[711] BCBS (n 1) 52.
[712] Under Basel III, all additional Tier 1 and Tier 2 instruments will also be written-down or converted into ordinary shares at a point of non-viability of the bank.
[713] ibid.
[714] Central Bank of Kuwait, 'Circular Number (2/BS/184/2005) - All Local Conventional Banks and Foreign Banks Branches Regarding the Implementation of the Revised Capital Adequacy Ratio' (12 December 2005) 1.

As part of the outlined reforms, banks are encouraged to strengthen the loss absorbency of Tier 2 instruments. A guideline is implemented for determining when these instruments are no longer viable and should be converted to common equity or otherwise written off from the balance sheet. Certain financial instruments are excluded from Tier 2. Under Basel III, Tier 2 consists of hybrid instruments with a maturity of five years or greater.[715] The securities of Tier 2 will carry cumulative costs, such as loans or preference shares issued by states.[716]

As suggested in the discussion on Basel II, banks have become very efficient at constructing new instruments that can be considered Tier 1 capital, but the Basel Committee is, since the financial crisis, extremely vigilant about cases such as this. If instruments that are classified under Tier 2 capital are used to generate Tier 1 capital, they will be subject to enhanced capital requirements, and the new proposals under Basel III will establish a regulatory ceiling of 15% on the use of certain types of capital as a percentage of the bank's total Tier 1 capital. In Basel III, this will reflect a new definition for Tier Common Equity Capital.[717]

In this way, Basel III will require greater involvement and input from the market actors, in the form of new risk weighting requirements, using general market indicators on the value correlation of the assets and credit valuation for risk charges.[718] In particular, because of the new risk weighted assets, the means through which a stock portfolio will be assessed and calculated will register a significant change.

The capital buffer a bank must hold in reserve is in addition to the Tier 1 and Tier 2 capital requirements. There are two types of buffer: a capital conservation buffer and a counter-cyclical buffer that can be used to prevent questionable leverage practices and liquidity shortages.[719] The capital conservation buffer is 2.5% of the risk weighted assets of a bank.[720] Its purpose is an increased capacity of banks to absorb losses during periods of economic

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[715] BCBS (n 1) 58.
[716] BCBS (n 1) 57.
[717] BIS (n 14) 13. For a comprehensive breakdown see Allen & Overy, 'Capital Requirements Directive IV Framework Capital and Capital Adequacy' Allen & Overy Client Briefing Paper 2, January 2014).
[718] BIS (n 199).
[719] This regulatory action may also be considered macro-prudential in nature given that it would act to alleviate funding pressures that could affect the entire financial system and result in a systemic risk event. See Getter (n 225).
[720] Jackson and others (n 177).

downturn and unpredictable events.[721] In order to ensure that banks have sufficient liquidity, a counter-cyclical buffer is also implemented, with a conservation range of 0% - 2.5% of common equity or any other loss absorbing capital established under Basel III.[722] The exact percentage of the ratio will be specified according to the regulatory and financial conditions of each state.[723] The aim is to protect banks from being exposed to the macro market and corresponding risks, such as lenient credit or short loan initiatives.

Capital buffers are very useful to banks during periods of economic stress, as they will trigger before the bank absorbs substantial losses, thereby enabling it to continuously operate. If reserves are depleted so that the banks register lower levels than the agreed ones, they are subject to quantitative restrictions on their distributions and payouts. The banks will no longer be allowed to distribute dividends, share buybacks or bonus payments until the conservation buffer threshold of 2.5% of risk weighted assets is restored.[724] The restrictions can be even more severe, such as banks being subject to disciplining mechanisms and supervisory sanctions.

Under the new Basel III regulatory framework, the BCBS has now established a closer link between credit risk and other types of risk, namely liquidity, operational and market risks, by integrating each of these into the calculation of minimum capital requirements.[725] The Basel Committee has also taken a more comprehensive and in-depth approach to the risks facing commercial banks.

There are a number of areas in which commercial banks are to undertake mandatory action. Commercial banks must maintain adequate capital to account for operation and market risk. For instance, maintaining less capital for banks weakens its credit adequacy ratio in the long run, but this is a suitable position, since higher capital will increase the cost of capital. Furthermore, banks are required to undertake a more efficient assessment of the likelihood of risks to help in strategic planning. Strategic planning is to be achieved, in part, through more effective risk-based pricing and customer profitability to offset the likelihood of a bank run,

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[721] BCBS (n 1) 122.
[722] ibid 136.
[723] BCBS, *Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirements* (BIS 2011).
[724] BCBS (n 1) 142.
[725] ibid.

or deposit withdrawal risks. Finally, banks are encouraged to implement all necessary measures to improve disclosure standards that contribute to enhancing the ability of the bank to meet the needs of involved stakeholders.[726]

The capital framework also contains rules about liquidity conservation, such as an indicator for the Liquidity Coverage Ratio. In this way, the accumulation of risky and unsustainable leverage in the banking sector is reduced, while measures are introduced to enhance the solvency and stability of banks against liquidity shortages.[727] New rules are aimed at encouraging banks to use stable and reliable sources of funding. These guidelines are put together under the section Net Stable Funding Ratio (NSFR).[728] The standard allows the banking system to absorb losses to a greater extent, by introducing higher capital requirements and buffers.

The liquidity cover ratio must be over 100%[729] and its formula is:

$$\frac{\text{Stock of high quality liquid assets}}{\text{Total net cash outflows over the next 30 calendar days}}$$

The net stable funding ratio also must be over 100%[730] and its formula is:

$$\frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}}$$

The rationales for these two ratios are distinct, but complementary. The Liquidity Cover Ratio (LCR) enhances the bank's short-term liquidity profile by requiring them to hold reserves in order to cover any funding requirements that may appear over the next 30 days. The Net Stable Funding Ratio (NSFR) targets medium and long-term considerations, such as the amount of liquidity in banking institutions over a period of one year. Because banks are motivated by the desire to turn a profit, the rules on liquidity retention may limit their trading

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726 Batainah (n 616).
727 BCBS (n 628) 1.
728 BIS (n 534).
729 BCBS (n 628) 22.
730 BIS (n 534) 9.

capacity on the short term.[731] This creates a regulatory backstop which ensures that banks are effectively unable to make use of emergency liquidity reserves until they restore Basel III approved capital conservations buffers and ratios.

Requirements will not be introduced all at once, as an adjustment period will be given for capital requirement, leverage ratio and more. The requirements will be, increasingly, steady until 2019, when the final targets will be attained.

Annex 2: Phase-in arrangements (shading indicates transition periods)
(all dates are as of 1 January)

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Leverage Ratio	Supervisory monitoring		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
Minimum Common Equity Capital Ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer						0.625%	1.25%	1.875%	2.50%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)				20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.125%	9.875%	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital			Phased out over 10 year horizon beginning 2013						
Liquidity coverage ratio	Observation period begins				Introduce minimum standard				
Net stable funding ratio		Observation period begins						Introduce minimum standard	

Figure 2: Phase-in Arrangements

Source: Bank for International Settlements, available at: www.bis.org/press/p100912b.pdf/

The Tier 1 Capital Ratio is 6% from 1 January 2015.[732] The total capital containing both Tier 1 and Tier 2 has to be at least 8%, and this requirement was kept constant. The Capital Conservation Buffer is 0.625% from 1 January 2016.[733] When the requirements are fully implemented, banks will be required to hold a capital conservation buffer of 2.5% in order to withstand future periods of stress, so that the total common equity requirement will be 7%, composed of 4.5% common equity requirements, and 2.5% capital conservation buffer. The common equity requirement is set at 4.5% from 1 January 2015.[734] The minimum total capital

[731] BIS (2006) (n 15).

ratio with the capital conservation buffer is 8.625%, but it will rise to 10.5%.

New Basel Regulatory Reforms	New Requirements
Higher Minimum Tier 1 Capital Requirement	Tier 1 Capital Ratio: increases from 4% to 6%.[735] The ratio will be set at 4.5% from 1 January 2013, 5.5% from 1 January 2014 and 6% from 1 January 2015. The total capital comprising tier 1 and tier 2 must be at least 8%.
New Capital Conservation Buffer	Used to absorb losses during periods of financial and economic stress.[736] Banks will be required to hold a capital conservation buffer of 2.5% to withstand future periods of stress bringing the total common equity requirement to 7% (4.5% common equity requirement and the 2.5% capital conservation buffer). The capital conservation buffer must be met exclusively with common equity. Banks that do not maintain the capital conservation buffer will face restrictions on pay-outs of dividends, share buybacks and bonuses.
Counter-Cyclical Capital Buffer	A counter-cyclical buffer within a range of 0% - 2.5% of risk weighted assets and other fully loss absorbing capital will be implemented according to national circumstances.[737] When in effect, this is an extension to the conservation buffer.
Higher Minimum Tier 1 Common Equity Requirement	Tier 1 Common Equity Requirement: increases from 2% to 4.5%.[738] The ratio will be set at 3.5% from 1 January 2013, 4% from 1 January 2014 and 4.5% from 1 January 2015.
Liquidity Standard	Liquidity Coverage Ratio (LCR): to ensure that sufficient high

[732] BCBS (n 1) 50.
[733] ibid 122.
[734] ibid 94.b.
[735] ibid 50.
[736] ibid 122.
[737] BCBS (n 1) 139.
[738] ibid 94.b.

	quality liquid resources are available for one month survival in case of a stress scenario.[739] Introduced 1 January 2015 Net Stable Funding Ratio (NSFR): to promote resiliency over longer-term time horizons by creating additional incentives for banks to fund their activities with more stable sources of funding on an ongoing structural basis.[740] Additional liquidity monitoring metrics focused on maturity mismatch, concentration of funding and available unencumbered assets.
Leverage Ratio	A supplemental 3% non-risk based leverage ratio which serves as a backstop to the measures outlined above.[741]
Minimum Total Capital Ratio	Minimum Total Remains at 8%.[742] The addition of the capital conservation buffer increases the total amount of capital a bank must hold to 10.5% of risk-weighted assets, of which 8.5% must be tier 1 capital. Tier 2 capital instruments will be harmonized; tier 3 capital will be phased out.

Table 3: Summary of Basel Reforms and Framework for Implementation[743]

It is worth noting that the Basel III framework and the proposals contained therein, constitutes a 'soft' disciplining instrument and does not bind states who are not members of the Basel Committee, until the rules are formally implemented in national law. That being said, the 'compliance pull' of the technical standards and policies of the Basel Committee are significant.[744] Indeed, Basel III was cemented as a de facto global standard through its formal adoption and recognition by the European Union[745] and the United States.[746]

To ensure the effective implementation of the Basel framework, the Basel Committee has adopted the Regulatory Consistency Assessment Programme (RCAP) to monitor, assess, and evaluate the implementation of Basel's framework. Furthermore, since 2010, national

[739] BCBS (n 628) 1.
[740] BIS (n 534) 2.
[741] BCBS (n 1) 152.
[742] ibid 131.
[743] Sharbarly (n 111).
[744] BIS (n 14); Jackson and others (n 177); See generally BIS (2006) (n 15).
[745] See European Commission http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm#crd4/ (last accessed 12 October 2015)
[746] Jackson and others (n 177).

authorities presiding over conventional and Islamic banking systems have taken legislative steps to implement global regulatory banking standards and protocols, with the aim of subjecting to banking institutions domiciled or operational in their territories to strengthened risk management and corporate governance disciplines. For Basel III, the Committee agreed on five guiding principles for banks' and revised Pillar 3 disclosures. These are as follows:

Principle 1: Disclosures should be clear.
Principle 2: Disclosures should be comprehensive.
Principle 3: Disclosures should be meaningful to users.
Principle 4: Disclosures should be consistent over time.
Principle 5: Disclosures should be comparable across banks.[747]

One significant innovation of the Basel III framework has been to encourage higher levels of self-regulation on the part of internationally active banks themselves, thereby reducing the scope and probability of competitive inequality resulting from, for example, high regulatory-compliance costs.[748] To this end, Basel II introduces a set of exemptions for banks with advanced management and auditing capabilities, by enabling them to design and implement their own internal risk management systems.[749] This has a particular impact on the Islamic banking community, as the ability to manage, potentially, much greater exposure to the asset types and equity based finance of Islamic banking can appear fundamentally different to the debt-based asset portfolio of Western banks, as discussed below:

5.3.4 Summary

Viewed through the above lens, the Basel framework innovates in three important ways:

Firstly, the framework formulates and promotes a range of standards and guidelines which aim to 'minimally' harmonise banking practices and modalities across divergent legal systems, markets and cultures.

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[747] BCBS, *Revised Pillar 3 Disclosure Requirements* (BIS 2015).
[748] Ernst and Young, 'Basel II: The Business Impact of Basel II Sinking in as Canadian banks Struggle with Implementation' (12 April 2006).
[749] Christian M McNamara and others, 'Basel III C: Internal Risk Models' (Yale Program on Financial Stability Case Study 2014-1C-V1, 1 November 2014, revised 6 October 2015).

Secondly, it establishes an international benchmark against which the national implementation of Basel-equivalent standards at state level can be monitored and scrutinised, including the issue of periodic and publicly available reports which document the steps taken by national governments to formally comply with the Basel framework. These reporting mechanisms increase the visibility and public knowledge of national legislation that implements Basel, as well as other procedures aimed at strengthening risk regulations and the independent oversight of banks by competent administrative or judicial bodies.

Finally, the Basel regime creates a central hub around best practices, for instance, market expertise and stress testing models can be gathered and disseminated, towards the effective institutionalisation of risk mitigation and supervision strategies within banks themselves.[750]

While the recommendations of the Basel III committee look promising, some suggest that Basel III is not without criticism. For example, many financial analysts and bankers believe that Basel III contains several shortcomings. One of the shortcomings often mentioned is that there is a lack of information on the effects of Basel III on banking activities, particularly activities dependent on trade finance.[751] These same critics believe that trade finance is the driving force for recovery from any financial crisis, which is why the effects of Basel III need to be clearly outlined. Although it has not been mentioned in literature pertaining to Basel III, it can also be argued that because Basel III is being implemented in stages until 2019, the effects of Basel III cannot be truly realised until it is implemented as a whole, due to the fact that different stages of implementation produce different effects.

Another criticism of Basel III requirements is that it imposes excessive burdens on Islamic banks, or otherwise produces discriminatory effects when applied to Islamic banks, precisely because of the barriers these institutions face in respect of their limited access to revenue generating interest based accounts and other hedging debt based instruments.[752]

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[750] BCBS, 'Principles for Sound Stress Testing Practices and Supervision' (BIS 2009);
David Van Hoose, 'Market Discipline and Supervisory Discretion in Banking: Reinforcing or Conflicting Pillars of Basel II?' (Networks Financial Institute Working Paper No6, February 2007) 1, 13.

[751] Gary Gorton and Andrew Winton, 'Bank Capital Regulation in General Equilibrium' (NBER Working Paper No 5244, August 1995); Bruce Arnold and others, 'Systemic Risk, Macro-prudential Policy Frameworks, Monitoring Financial Systems and the Evolution of Capital Adequacy' (2012) 36(12) Journal of Banking & Finance 3125.

[752] See Mohammad Bitar, 'Basel III Requirements and Stability/Risk Relationship of Islamic and Conventional Banks' (GDRE Conference, June 2013) 22.

All banks, including Islamic banks, must be seen to be operating in compliance with Basel as a condition of entering the international finance market. This speaks to the significant 'compliance pull' of the global standards which have, since its adoption by the US and EU, emerged as de facto binding standards, without which it is increasingly difficult for a bank to attract investment or reinsurance provision. If one can make the claim that Basel III has now been crystallized as an international standard, questions must be raised about the extent to which the component elements of the Basel framework can be adapted to Islamic banks and IFSB standards.[753]

5.4 The IRB and SA approaches of credit risk

The Internal Rating-Based approach allows banks to use their own instruments to calculate the capital requirements of assets. In the Standardised approach banks use the external credit assessment of various rating agencies.

5.4.1 The IRB approach

The Internal Rating-Based approach is a variant for estimating credit risk. If banks are compliant with certain minimum conditions and disclosure requirements, they can receive supervisory approval to use the IRB approach.[754] In this way, they can use their own internal estimates of risk components to determine the capital requirement of a specific asset. The risk components are the probability of default (PD), loss given default (LGD), the exposure at default (EAD) and effective maturity (M). There are cases where banks have to use an estimate given by a supervisory authority as opposed to internal estimates.

The probability of default is the likelihood that a borrower defaults on its contractual obligations within one year.[755] The estimate of PD must be a conservative view on a long term average for each type of borrower. In the case of corporate and bank exposures, the PD

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[753] IFSB (n 473).
[754] Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards*. Comprehensive Version. (Bank for International Settlements, 2006), [211].
[755] Allen & Overy, *Capital Requirements Directive IV Framework. Internal Ratings Based Approach to Credit Risk in the Banking Book* (January 2014), 4.

must be at least 0.03%. Loss given default is the estimate of a loss registered by a bank in the case of borrower default.[756] This indicator is more specific than the PD, because it takes into consideration a series of characteristics of a transaction, such as collateral and subordination. The exposure at default is the amount the borrower owes when the event of default happens.[757] In the case of revolving loans this indicator will include an estimate of future lending before the default event.

It is an approach based on the measure of unexpected losses (UL) and expected losses (EL).[758] There are risk-weight functions that produce capital requirements for the UL portion. The expected losses are treated separately.[759]

The risk components are inputs to the risk-weight functions and those are different for separate asset classes. For example, there is a risk-weight function for bank exposures and another one for sovereign exposures. There are also minimum requirements that banks must satisfy in order to use the IRB approach.[760]

According to the IRB approach, banks must classify their exposures in broad classes of assets that have different underlying characteristics. These classes of assets are: corporate, sovereign, bank, retail and equity.[761] In the case of corporate and retail asset classes, a separate treatment for purchased receivables can apply if certain conditions appear.

If a bank adopts an IRB approach for a subsidiary, it is expected to extend it across the entire banking group.[762] There are also cases in which it is not practicable for a bank to implement the IRB approach across all asset classes and business units at the same time. In cases such as these, supervisors can allow banks to adopt a phased rollout of the IRB approach across the banking group. The rollout includes: adoption of the IRB across all asset classes, adoption of the IRB across all business units and a transformation from the foundation approach to the advanced approach in certain conditions.The bank must elaborate an implementation plan

[756] ibid, 5.
[757] ibid, 5.
[758] BCBS (n 673) [212].
[759] ibid, [43] and section III.G.
[760] ibid, section III. H, [387].
[761] ibid, [215].
[762] ibid, [256].

that specifies when it intends to use the IRB approach across asset classes and business units. The plan should be realistic and agreed with the supervising authority. It should be the result of practicality and efficiency considerations and not be implemented because of a reasoning to adopt an approach that reduces the capital requirements, as this can have negative effects in periods of instability.

According to the IRB approach, banks and investment companies with advanced risk management systems are allowed to compute their capital requirements based on internal risk parameters if they have the agreement of the supervising authority.[763] It is an approach that relies on a bank's internal evaluation of its counterparties and requires a series of credit risk measurement and management practices that are complex. Banks that choose this approach have to satisfy a set of minimum standards that illustrate that the credit risk capabilities are comprehensive and usable. In order for a bank to be compliant with the IRB approach it is required to have considerable internal resources. There are a lot of banks that do not fulfil this requirement.

The IRB approach offers three ways to calculate the capital requirements for equity exposures. The simple risk weight approach sets different risk weights based on the composition of the portfolio: 190% for private equity exposures in diversified portfolios, 290% for exchange traded equity exposures and 370% for all other equity exposures.[764] The second approach is based on the PD/LGD ratio but with several limitations. The third approach is based on the value at risk models but also with several limitations.

Banks can only implement the IRB approach if they have received permission from their supervising authorities.[765] The permission can be obtained only if the banks prove that their rating and risk management systems are correct, have been elaborated with integrity and comply with various systems, controls and corporate governance requirements. The bank must have an economic model that has proved to be suitable for its activities, effective for estimating risk and that can be tested with live data to validate it.

[763] Allen & Overy (n 674) 3.
[764] ibid, 6.
[765] ibid, 8.

The IRB "use" test is based on the reasoning that the bank has to implement the internal ratings and calculated risk parameters in its internal use, so the bank must use the indicators it has obtained internally in its operational activities.[766] If there is a gap between the IRB approach indicator and the tools used for internal reasons, the bank has to justify the gap to its supervising authority. This is known as the "use" test.

5.4.2 The Standardised approach

The standardised approach evaluates risk in a standardised manner that is supported by external credit assessments carried out by various rating agencies.

In the case of claims on sovereigns and their central banks the risk weighting is:

Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk Weight	0%	20%	50%	100%	150%	100%

Source: BCBS International Convergence of Capital Measurement and Capital Standards 2006, page 19.

At national discretion, a lower risk weight can be applied to the sovereign exposures of banks if they are denominated in domestic currency and funded in that currency. In such cases, other national supervisory authorities can allow banks to apply the same risk weight to domestic currency exposures to the sovereign entity in that currency.

In the case of risk weighting claims on sovereigns, supervisors can also recognize the country risk scores of Export Credit Agencies.[767] In order to qualify, an ECA has to publish its risk scores and be aligned with the OECD agreed methodology. Banks can use the risk scores published by individual ECAs that are recognized by their supervisor.

[766] Basel Committee on Banking Supervision, *The IRB Use Test: Background and Implementation* (September 2006).
[767] BCBS (n 673) [55].

Claims on the Bank for International Settlements, the International Monetary Fund, the European Central Bank and the European Community are risk weighted at 0%. Claims on multilateral development banks can also have a 0% risk weight if they satisfy the criteria of the Committee.[768] The eligibility criteria for MDBs risk weighted at 0% are: very high quality issuer ratings, the shareholder structure is composed chiefly of sovereigns with issuer credit assessment of AA- or better, strong shareholder support illustrated by the amount of contributed capital, suitable level of capital and strict statutory lending requirements and conservative financial policies, which include a structured approval process, internal creditworthiness limits, fixed repayment schedules, status review process and rigorous assessment of risk and provisioning to loan loss reserve.

In the case of claims on banks there are two variants.[769] National supervisors will apply one variant to the banks in their jurisdiction. According to the first variant, all banks incorporated in a given country will be given a risk weight that is one category less that the one corresponding to claims on the sovereign country. The second variant considers the external assessment of the bank itself with claims of unrated banks having a risk weight of 50%. Claims with a maturity of three months or less are assigned a category that is better, but not less than 20%. The exception to this rule consists in banks weighted at 150% that remain at this level.

The risk weighting of rated corporate claims, including claims on insurance companies are listed below:

Credit assessment	AAA to AA-	A+ to A-	BBB+ to BB-	Below BB-	Unrated
Risk weight	20%	50%	100%	150%	100%

Source: BCBS, International Convergence of Capital Measurement and Capital Standards 2006, page 23.

Supervisory authorities can increase the risk weight for unrated claims if they consider it warranted in their jurisdiction. Supervisors can also consider if the credit quality of corporate

[768] ibid, [59].
[769] ibid, [60].

claims should require a risk weight higher than 100%.[770] Supervisory authorities can allow banks to risk weight all their corporate claims at 100%, regardless of the external ratings. It must be ensured that the banks use a single consistent approach, either to use the available ratings or not at all. Banks should obtain supervisory approval before pursuing this route.

5.4.2.1 External credit assessment

National supervisors are responsible to ascertain if an external credit assessment institution (ECAI) meets the criteria listed below.[771] The assessments of ECAIs can be completed on a limited basis, such as by type of claims or by jurisdiction.

The eligibility criteria of an ECAI are:

- objectivity: the process of elaborating credit assessments has to be rigorous, systematic and capable of being validated with historic information and events.
- independence: The ECAI should be independent and not influenced by political or economic pressures.
- transparency: the assessments should be available to domestic and foreign institutions and the methodology should be publicly available.
- disclosure: the ECAI should disclose these pieces of information: its assessment methodology, the default rates registered in each category and the transitions of the assessments.
- resources: the ECAI should have enough resources to carry out quality credit assessments.
- credibility: the reliance of investors and trading partners on the ECAI's external credit assessments is evidence of its credibility.

The mapping process is carried out by the supervisors and consists in assigning a risk weight to an assessment category.[772] The mapping process should be objective and should result in a risk weight assignment that is comparable to the levels of credit risk outlined above. While conducting such a mapping process, supervisors should consider the size and scope of the group of issuers that each ECAI covers, the range and meaning of the assessments that it assigns and the definition of default used by the ECAI.

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[770] ibid, [67].
[771] ibid, [90].
[772] ibid, [90].

Banks should disclose what assessments they use for risk weighting their assets, how the risk weights correspond to the particular rating grades as well as the aggregated risk weighted assets for each risk weight.

5.5 Basel III and Islamic Finance

There are two ways of approaching the question of whether Basel III, and the Basel framework on banking regulation and supervision more generally, can be appropriately implemented by Islamic finance institutions. In the first sense, one can take the view that the capital adequacy standards advanced under Basel constitute a baseline rather than an attempt to impose a globalized model of regulation on diverse banking systems, and in doing so to effectively compel Islamic banks to adopt a Western model of banking.

Certainly, the Basel II agreement is designed with regulatory diversity in mind and provides national supervisors, and banks, with the tools to customize risk mitigation practices which reflect the risk profiles and operational contingencies of particular banks and entities. Accordingly, it can be argued that Basel III, as a fast-changing framework, can strengthen Islamic banking by suggesting minimum parameters on global banking scales, such as the implementation and measurement of capital adequacy ratios and risk-based considerations.

One of the ways in which Basel has been instrumental in the progression of Islamic banking is to provide quality control for investments, and to ensure integrity in the overall system. Basel has achieved this by maintaining the capital levels of individual banks and by ensuring that loan classification practices are accurate.[773] Basel III also has increased demands for capital and has transformed business models of banks internationally.[774] The greatest benefit of adopting the Basel architecture for the Islamic finance market is its potential to promote and contribute to implementing good governance practices on transparency, auditing and reporting.[775]

On the other hand, if Basel III can be now considered an international standard, questions still remain about what components of the Basel framework can be adapted in Islamic banks. To

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[773] BCBS (n 48) 4.
[774] PricewaterhouseCoopers, 'FS Regulatory, Accounting and Audit Bulletin- Q1-2014' (2014) <https://www.pwc.com/m1/en/publications/documents/being-better-informed-q2-2014.pdf/> accessed 1 April 2016.
[775] Diaw and Mohamed Omaima (n 451).

the extent that Islamic banks are denied access to non-Shariah compliant products, including hedging instruments, institutions providing Islamic financial services may already find themselves as a competitive disadvantage.

The next section offers a more detailed discussion of the some of the key challenges faced by Islamic finance markets in the implementation of the Basel Accord in conditions or regulatory or constitutional pluralism.

5.5.1 The Structural Challenges of Implementing Basel III in Islamic Finance Institutions

As discussed above, all banks must retain combined Tier I and 2 assets of no less than 8% of their risk weighted assets. Moreover, the common equity held by a bank must count for no less than 75% of the total Tier 1 assets. The governing logic of the Basel III framework can be distilled as the following: banks should retain adequate amounts of capital to enable them to offset risks. The claims made on the bank should not exceed their total assets, as reflected on the balance sheet. If the liability claim exceeds the amount of capital a bank requires to remain operative, the more vulnerable it is other types of external or third-party risks over which it has less control, i.e. market risks (commodity or foreign exchange rate risks) or counter party default risks.

To the extent that the Basel framework is essentially concerned with the prudential management of capital, it has wide applicability and appeal for market economies on both sides of the Atlantic. What is less obvious, however, is how effectively, or equitably, Basel standards can be implemented and applied by Islamic banks operating in Saudi Arabia. One can argue that the Basel baseline fails to adequately reflect important differences in the structure and principles underlying Islamic finance systems relative to conventional banks.[776] As will be discussed below, Islamic finance instruments are usually based around a profit-and loss sharing arrangement, or will involve some form of buy-back agreement in the case of the hire and sale of goods contracts. Consequently, Basel assumptions about the way most banks balance their assets against their liabilities begins to break down when applied to Islamic finance contexts.

[776] Mohamad Hasan and Dridi (n 302).

One issue concerns the financial structure of Islamic banks. Islamic banks are no different from any other bank in that they use capital from demand deposits in much the same way as any other bank. All banks, and their shareholders, are susceptible to the risk of counter party default risks. While conventional banks can accept interest or fees for loans of money,[777] Islamic banks cannot rely on revenue generated from these profit streams. The majority of their assets are from Murabahah claims, Mudarabah and Musharakah investments, investments in securities, investments real estate or Sukuk or investments in leased assets. A further distinguishing feature is that Islamic banks will often act in the capacity of a financial intermediary, and not as a direct lender who provides credit provision for large scale projects. Under an agency (wakalah) contract, the bank is responsible for managing funds which are deposited by investors in the form of profit-sharing agreements, such as the Mudarabah contract.[778] In an arrangement which is structurally similar to mutual fund investment, multiple investors will contribute funds under so called restricted investor accounts.

5.5.2 Liabilities under Profit and Loss Sharing Agreements

Islamic banks also have distinct asset and accounting practices which reflect the unusual ways in which demand and investment deposits are funded and managed under the nominate forms of investment account.[779] While Islamic profit sharing investment arrangements are structurally similar to investment accounts, they are unusual in that they do not typically create a claim against the bank.[780]

While accounting and auditing standards are not uniform across Islamic legal systems, Islamic standard setting bodies have established rules on how Islamic banks are to risk assess their assets and determine their capital adequacy thresholds. The AAOIFI has, in the above regard, emerged as a dominant player, particularly in its attempt to pursue greater harmonization of accountancy based standards across the Islamic finance sector.[781] Indeed, Standard 2 of the AAOIFI explicitly mandates against the treatment of any losses resulting

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[777] Ismal Rifiki, 'Assessing the Moral Hazard Problem in Murabahah Financing' (2009) 5 Journal of Islamic Economics, Banking and Finance 101, 102.

[778] V Sundararajan and Luc Errico, *Islamic Finance: Theory and Practice (*Macmillan 2002); IMF, 'Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead' (IMF Working Paper 02/192, November 2002) 2.

[779] Islamic Bank, Bahrain Islamic Bank, The ABC Islamic Bank, Bahrain, Shamil Bank, Bahrain and Qatar Islamic Bank for the years 2000 and 2001. Al Khaliji, 'Investor Guide' (October 2011)

[780] Sundararajan and Errico (n 678) 7.

[781] Simon Archer and Abdullah Haron, (n 111) 121.

from failed profit and loss sharing investments as liabilities on the bank. This is because a bank is only held liable for payments guaranteed by the bank, in other words, where the bank unilaterally undertakes to provide compensation against future losses, of a fixed amount, determined in advance.

In this way, even if these Islamic products are riskier when compared to conventional ones, the bank is not exposed to the risks, as it passes them over to the depositors and investors. That being said, profit and loss sharing accounts create additional operational and agency costs for Islamic banks. For instance, mutual fund deposits administered under an agency contract model yield a profit in the way that a conventional investment bank might expect. For one thing, the management of funds held in restricted investor accounts does not always attract an administrative fee. Furthermore, transactions with commodities and real assets in Islamic finance are a source of additional operational risks and an immediate issue is how to separate commercial transactions from financial intermediation to ensure stability in this segment.

It is also possible for a bank to provide its own capital towards a profit and loss sharing arrangement, known as an unrestricted deposit account. Here, the banks act not as an agent but as a co-investor, and it merges its own capital with external sources of financing, which are reinvested in projects based on the bank's own evaluation of the risks involved and profit return. The bank receives compensation from its initial investment in the form of a lump sum or as a percentage of the profits generated from a particular project of public investment enterprise.[782] In these equity-based arrangements,[783] the bank is strictly liable to make good on any financial obligation relating to an investment funded from its own capital or outsourced from external streams of financing.[784] The AAOIFI's Financial Accounting Statement sets clear guidelines on how such accounts are to be managed, and requires all banks utilising unrestricted deposit accounts to disclose the balance of the account, as well as any, "profits/losses from operations during the period."[785]As shown in the table below, the profit and loss statements of Islamic banks differs from the balance sheets of conventional banks in several important ways:

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[782] Mohammed Al Nasar, *Investment Partnership in Islamic Banks* (Scientific Press 1999) 2-4.
[783] ibid section 4/1/3.
[784] Saad A Satter Al-Harran, 'Musharakah Financing: Concept, Principles and Financing' (Institute for Policy Research, Malaysia, 1993) 4-5.
[785] AAOIFI, 'Rule 8' <http://www.aaoifi.com/en/standards-and-definitions/shari%E2%80%99a-standards/> accessed 23 January 2016.

Financial Statement	Conventional Bank	Islamic Bank
Profit & Loss	Net interest income plus financial services income, Plus capital gains. Minus operating expenses. Minus amortisation of goodwill. Minus charge for doubtful loans. Equals Gross profits. Minus income taxes. Equals net profits.	Net income Plus financial services income Plus capital gains Minus operating expenses Minus amortisation of goodwill Minus charge for doubtful loans Equals gross Profits Minus income taxes Equals net profits (from profit shares, services fees and excess over all expenses)
Balance Sheet Assets Liabilities Shareholder Capital	Loans and Advances (after provisions for non- performing loans) Fixed assets Total assets Total risk-weighted assets Deposits and other borrowing. Bonds, notes and subordinated debt	Loans and Advances (after provisions for NPL) Fixed assets Total assets Total risk-weighted assets Deposits and other borrowing Bonds, notes and subordinated debt. Floating rate notes

	Floating rate notes Ordinary shares Equity instruments Total equity	Ordinary shares (musharakah) Equity instruments Total equity (musharakah)

Table 4: Classification of Islamic Banking using Financial Statements[786]

In the above light, one criticism is that the Basel framework does not take into account differences between Islamic modes of financing and conventional banking instruments and capital structures.[787] The capital structure of banks on both the liabilities and assets side is different from conventional banks, so that raises some questions about the utility and applicability of risk and capital measurements provided under the Basel framework. While conventional banks balance claims with equity and debt, Islamic banks have a third component, which is neither a claim nor a share of the owner's equity. The above features also have significant implications for an Islamic finance institution's capacity to mitigate and manage their liquidity risks, as discussed below.

The above features have several consequences in respect of the valuation and quality of an asset for the purposes of evaluating the Tier capital requirements under Basel III. One significant issue is profit sharing from an unrestricted investment account, and is not linked to the performance of the underlying assessment, but is determined instead in accordance with a market rate known as an index lined return rate. While investors may suffer a loss from poor performance, the Islamic bank may have higher loss exposures than those typically experienced by investment banks. This may occur when the forward price or spot value of the asset acquired through profit share does not correlate accurately to the performance of a linked asset on the stock market. In this way, unrestricted investor accounts may carry a liquidity risk which is not present in the agency based contract model for restricted deposit accounts.

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[786] See (n 606). Similar ideas have also been expressed by Mohammed Ariff, 'Islamic Banking: A Variation of Conventional Banking?' (2007) 3(1) Monash Business Review 1.
[787] M Luthfi Hamidi, 'The Theory and Practice of Islamic Management Style: The Experience of Bank Muamalat Indonesia' (2006) 10(2) Review of Islamic Economics 115; Abul Hassan, 'Risk Management Practices of Islamic Banks of Brunei Darussalam' (2009) 10(1) Journal of Risk Finance 23.

5.5.3 The Liquidity Risk Exposures of Islamic Banks

As part of the package of reform introduced under Basel III, all banks are now expected to increase the amounts of minimum common equity they hold, with an additional capital conservation buffer factored into these capital requirements. By formulating these reforms, the Basel Committee is responding directly to the practice of excess leveraging, and other liquidity risk exposures that would play an integral role in the 2008 sub-prime mortgage crisis.[788]

Liquidity risk refers to the exposures faced by individual banking institutions if they fail to satisfy commitments and contractual obligations, on the liabilities' side. An example is paying dividends, or refunding deposits to counterparties. Market disruptions can also influence these exposures, through credit shortages or a reduction in the quality of credit, which can in turn reduce the institutional liquidity of a given financial institution or bank. This risk can be addressed with diversity, as an asset profile in which speculative sources of funding are hedged against more secure assets and can reduce the need for high amounts of cash held in reserve.

One of the major failings of previous Basel Accords was the pre-2010 failure to establish robust standards for regulating and measuring levels of institutional capital and liquidity over the whole of a bank's financial cycle, rather than measuring its financial position periodically, in moments of stability or stress. Under Basel III, banks are now being required to implement liquidity ratios which are themselves based on a partly equity driven model of evaluating the capital adequacy of all banks (the so called 'stress test' model). Through the introduction of the Net Stable Funding Ratio[789] and the Liquidity Coverage Ratio[790], bank supervisors are able to utilise a standardised method for measuring the stability of a bank as a whole, thereby allowing for a more complete picture of the health of bank's assets and the performance of the bank over periods of growth or stagnation.[791] The decision to establish a ceiling for the permitted amount of balance sheet derivatives and repos is clearly in the

[788] See Federal Reserve System, 'Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies' (5 January 2012) <https://www.federalregister.gov/documents/2012/01/05/2011-33364/enhanced-prudential-standards-and-early-remediation-requirements-for-covered-companies> accessed 23 June 2016.
[789] BIS (n 534) 1.
[790] BCBS (n 628) 1.
[791] ibid and Al Nasar (n 682).

interest of consumers and stakeholders, who now shoulder a reduced amount of risk.

Controversy remains, however, over the ease with which the new leveraging and liquidity standards can be globally implemented across diverse legal systems. Implementation of the new liquidity related buffers and ratios will pose operational challenges for traditional banking institutions.[792] The new Basel III regulations include strong enforcement mechanisms for the reduction of liquidity risks, and these standards will be most effective for banks whose asset structure is balanced by the more usual levels of debt and default risk exposure. It is less obvious how such provisions will apply to the fundamentally asset and equity backed model of Islamic banking.

On the surface at least, Islamic banking institutions should, in theory, experience few difficulties in implementing Basel III liquidity related standards, given that their capital structure tends to be held in the form of common equity capital, with the implication that they have lower debt exposures, and this is the case for a Western bank. However, it is possible to argue that Islamic banks are exposed to liquidity risks and to an unusually high degree for reasons that may seem counterintuitive. Because asset portfolios are heavily skewed toward equity based instruments, they are less able to manage or minimise their risks through hedging instruments or through the assumption of debt. Again, it is these features of Islamic banking and finance which are not necessarily mitigated under Basel III liquidity buffers and ratios.[793]

Islamic banks can use certain debt based contracts but any lending is typically used to service the needs of a highly specialised market which will, moreover, vary from one jurisdiction to another, depending on the way in which national law is used to structure and regulate Islamic finance sectors and products. Moreover, Islamic finance institutions do not tend to use leveraging for commercial ventures, since religious-regulatory restrictions limit market access to financial instruments such as credit default swaps, repos and interest rate swaps.[794] Since debt derived instruments held by Islamic finance institutions are fewer in number, market barriers are created for prospective investors and consumers who wish to use those

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[792] See, eg, Abdullah Saeed, *Islamic Banking and Interest: A Study of the Prohibition of Riba and its Contemporary Interpretation* (Brill 1996) 84; for a country specific discussion see (n 536) 46, 47-49, 53.

[793] See standards of the IFSB, 'Guiding Principles on Liquidity Risk Management for Institutions Offering Islamic Financial Services (excluding Islamic Insurance Takaful Institutions and Islamic Collective Investment Schemes)' (IFSB-12, 2012).

[794] Al-Harran (n 684).

products and services, while also having a negative influence on the profitability and competitiveness of Islamic markets and institutions as compared with interest driven banking.

One specific challenge is that Islamic banks cannot balance their equity driven portfolios by diversifying their risks through the acquisition of high quality debt based instruments. This in turn would negatively impact an institution's long-term stability through reduced exposure to systemic risk. Because Islamic banks cannot assume debt in order to maintain necessary levels of capital with high quality credit, they can run into greater difficulties during a bank run than is usually the case for a conventional bank.

On the whole, Islamic banks tend to have lower quantities to high quality (loss absorbing) assets, in part because of an overdependence on commodity stocks and real estate assets which are especially exposed to pricing risks.[795] Even in basic hire or sale contracts such as Istisna contracts, which are essentially a forward contract, there may be a significant difference in the forward price (the prices at which the goods are purchased for resale to the borrower) and the spot price (the resale price) of the delivered goods. The cumulative effects of the risks of under-pricing, systemic risks through third party financing and non-diversification in products have a significant impact on the profitability of Islamic banks, the overall performance of their portfolios, and their ability to withstand pressure on institutional liquidity. Moreover, as suggested above, counterparties can also be more likely to default in joint venture projects. Agency costs can also be higher for profit-sharing arrangements.

Islamic banks often lack the institutional expertise and capacity needed to evaluate the quality of their assets as measured against the risk profile of the institution as a whole. Both Islamic and conventional banks are likely to experience challenges in determining when the trigger threshold for non-viability has been reached. Interestingly, the previous classification of Tier 3 capital has been removed under the new Basel guidelines. This may prove to be a missed opportunity to reassess the quality of Islamic assets given that Islamic banks may have a less developed risk rating and asset quality review systems.

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[795] ibid.

5.5.4 The Inadequacy of Basel III in Addressing the Systemic Risk Exposures of Islamic Banks

The use of profit and loss sharing accounts creates two kinds of inefficiencies for the Islamic bank. In the case of restricted investment accounts, investors will assume the loss risk of decree in the value of an underlying asset. This may deter depositors from investing in Islamic profit and loss share agreements from the outset. The long maturity of Islamic finance instruments has the effect of locking in capital for long periods of time, without opportunity to renegotiate profit share returns for an underperforming investment.

On the other hand, in the case of unrestricted deposit accounts, the bank may have to pass its own share of the profit to the account holder to cover losses. This is consistent with standards and guidelines developed by the Islamic Financial Services Board (IFSB) which require Islamic banks to maintain a Profit Equalisation Reserve (PER) and Investment Risk Reserve (IRR), whereby any losses resulting from a risky or poor performing investment can be mitigated through the use of Tier 2 supplementary capital held in these reserves.[796]

While such reserves can protect demand and investor account holders from any resulting from loss in the market to market value of an underlying asset, they do expose Islamic banks to the very systemic risks which Basel III is designed to eliminate. Losses covered by deposit reserves will weaken the bank's overall financial position and deplete its profits over a financial cycle. If investors then withdraw their funds, the probability of a bank run increases. Moreover, the bank will have to maintain PER and IRR reserves in addition to the capital requirements established under Basel. This is likely to increase an Islamic finance institution's exposure both to operational risks stemming from the costs of maintaining and reinvesting profits for both types of reserves.[797] Crucially, the requirement to reinvest profits will reduce the institution's access to liquid capital; the very capital it needs to remain operational.

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[796] The reserves needed are referred to in the 3 and 4 IFSB as Profit Equalisation Reserve (PER) and Investment Risk Reserve (IRR). Sheila Nu Nu Htay and Syed Ahmed Salman, 'Practice of Profit Equalization Reserve and Investment Risk Reserve by Islamic Banks' (2013) (2) International Journal of Research In Social Sciences 15, 16.

[797] MPBM Isa, A Ab Rahman, HMB Hashim and AMB Embong, 'Shari'a Views on the Components of Profit Rate in Al Murabahah Asset Financing in Malaysian Islamic Bank' (2012) 6 The World Academy of Science, Engineering and Technology International Journal of Social, Education, Economics and Management Engineering 7.

A second set of challenges occurs when an Islamic bank is exposed to, or is required to share in loss risk with a credit provider or financier. In Gulf countries credit is supplied through government backed loans as was the case in the Dubai crisis. In principle, however, the bank shares counterparty and liquidity risks with the financing company, a risk that is most likely to affect a state-owned bank or local subsidiary of foreign owned bank. In this respect, an Islamic subsidiary may seem to have healthier balance sheet 'on the books' than is actually the case.

Any systemic risks that arise from bad debt as a result of its association with lending institutions who provide finance for risky investments do not have to be disclosed on the bank's balance sheet under the agency Wakalah model, since the bank does not act as a guarantor.[798] In this way, Islamic accountancy practices may not allow for an accurate assessment of the quality of assets held by the bank, or reflect the systemic risk liabilities of a bank. The flight to high quality assets, i.e. marketable securities does not necessarily eliminate this threat. At the same time, the profit equalisation reserve may further exacerbate liquidity related challenges, while at the same time failing to provide adequate protections for investor account holders in restricted deposit accounts.

As Basel standards gain more general recognition, institutions such as the Islamic Finance Services Board have a greater incentive to standardize their own capital thresholds and risk mitigation strategies. The Basel framework establishes a global benchmark, as it opens and is revisable in order to enable regional actors such as the IFSB to construct and implement their own standards that are more suitable to a specific region or country. There are also Islamic guidelines on finance and banking practices, such as the Accounting and Auditing Organization for Islamic Institutions (AAOIFI's) accountancy Standard and accounting Standard.[799]

However, as the experience of the Dubai housing crisis has demonstrated, Islamic institutions have not always responded effectively to market volatility, largely due to failures in tier and asset evaluation practices and the formulation of sound capital planning strategies for dealing

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[798] AAOIFI (n 462).
[799] AAOIFI, 'Guidance Statements on Accounting for Investment and Amendment in FAS' (2008); AAOIFI, 'Consultation Paper on Financial Accounting Standard' (2012).

with loss exposure from distressed assets. Indeed, the Dubai crisis seems to sharply expose just how poorly assets were valued in the first place; the implication being that Islamic financial institutions are as susceptible to the same moral hazard risks that Western banks were accused of in the run up to the crisis – i.e. under-pricing their systemic risks and overvaluing their assets by 'cooking the books'.[800]

Studies investigating the practices of foreign and domestic banks in the UAE prior to the Dubai housing crisis have proved instructive in the above regard.[801] Just as the asset side of the balance sheets of foreign banks proved to be less healthy than implied, Islamic banks were also shown to have severely underestimated their systemic risks, despite maintaining equity based capital ratios which were already compliant with Basel III ratios. These and other risks factors should be integrated into future revisions of the Basel framework, to ensure that capital risks faced by Islamic finance are more evenly reflected in the global baseline.

The critical point is that Islamic banks face unique risks due to their failure to develop diversified finance products to enable them to better manage their risks and absorb losses from distressed assets. The lack of diversity in turn heightens the exposure of Islamic banks to volatility in certain market segments, while depriving them of the means to hedge against pricing and other market risks. Banks in Dubai, as with banks in the United States and the UK, were only saved from failure from government bailouts, an expense borne by the taxpayer and which impacted on the stability of market economies as a whole.[802] It is arguable that Saudi Arabia is exposed to similar risks.

5.6 Basel Implementation in Saudi Arabia

According to the annual reports of SAMA, and of several banks, Saudi Arabia has ostensibly met, and exceeded, Basel established capital reserve requirements. To the extent that much of Saudi Arabia's Tier 1 asset base appears to be held either in bank shares or government bonds, the financial position of the Saudi government would appear, at first glance, to be secure, and its banks viable.

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[800] Khan and Bhatti (n 51) 40, 51.
[801] Hassan Al-Tamimi and others, 'Banks' Risk Management: A Comparison Study of UAE National and Foreign Banks' (2007) 8(4) The Journal of Risk Finance 394.
[802] Mohamad Hasan and Dridi (n 302).

In May 2014, the International Monetary Fund (IMF) released its Mission Statement at the Conclusion of a Conference in Saudi Arabia where Saudi Arabia announced that its economic outlook looked favourable, particularly for the private sector.[803] Some critics note that although SAMA has been actively trying to meet the requirements of Basel III as per required timelines, there have been issues along the way. Thus far, SAMA has introduced leverage liquidity, and capital adequacy ratios.[804] According to Basel's 2012 Progress report, Saudi Arabia had, at the time, issued their final regulations to the bank, receiving a stellar grade in 2012.[805]

5.6.1 Pillar 1 (Capital Adequacy) Implementation in Saudi Arabia

In October 2013, Saudi Arabian lenders reported that they already met Basel III requirements and have secured themselves against any future sovereign credit risks. "Banks [in Saudi] are meeting the current Basel III requirements," said Fahad al-Mubarak, SAMA governor, to Al Arabiya during an exclusive interview.[806] He added, "They have previously also met Basel II requirements since 2005, which show the ability of SAMA to supervise banks and maintain powerful balance sheets." Mr. Al-Mubarak indicated that SAMA was not worried about doubtful loans held by Saudi banks, "Our policy states to always support these provisions. Doubtful loans make up less than 1.5% of the total loans, and the doubtful loans are 150 percent covered. So we stand in the safe zone in terms of volume and coverage of doubtful loans." [807]

However, the financial situation in Saudi Arabia is less promising than the above statement suggests. As reported by the Guardian newspaper, in the period between February 2015 and October 2015, the Saudi government deficit rose dramatically from 5% of GDP to 20% of

[803] IMF, IMF Mission Statement at the Conclusion of 2014: Article IV Discussions with Saudi Arabia' (Press Release No 14/229, 2014) <http://www.imf.org/external/np/sec/pr/2014/pr14229.htm/> accessed 1 April 2016.
[804] Sultan A Al-Bogami, Najmul Hoda and Muhammad K Al-Numary, 'An Analysis of Saudi Banks Compliance with BASEL III' (2015).
[805] BCBS (n 199).
[806] Al Arabiya, 'SAMA Chief: Saudi Banks Ready for Basel III, Doubtful Loans (20 October 2013) <http://english.alarabiya.net/en/business/banking-and-finance/2013/10/20/SAMA-chief-Saudi-banks-ready-for-Basel-III-doubtful-loans-.html> accessed 16 October 2015.
[807] ibid.

GDP.[808] But how do these broader macroeconomic developments impact on the ability of Saudi banks to mitigate their risks?

In discussing the future outlook of banking in Saudi Arabia, it is imperative to discuss SAMA's Internal Capital Adequacy Assessment Process (ICAAP). The ICAAP has been charged with the function of considering how the deficiencies and implementation related challenges of Basel II can be avoid with the rollout of the new framework under Basel III.

As discussed, the first pillar of the revised Basel framework calibrates its capital adequacy requirements to a risk weight of particular assets. In accordance with these requirements, Saudi Banks should strive to implement formal internal processes for determining overall capital adequacy for their risk profiles.[809] Further to these proposals, SAMA has implemented Internal Capital Adequacy Assessment Process (ICAAP) to assess the compliance of Saudi banks with Basel III approved risk identification and quantification processes during key periods in capital planning. Subject to the recommendations issued by the ICAAP in Saudi Arabia, banks are encouraged to develop their own internal rating and stress testing strategies to enable them to withstand market risks.

In a 2015 Report written by the Basel Committee on Banking Supervision, it has been noted that SAMA has taken several initiatives in an incentivising framework to increase and strengthen bank capital.[810] It has also noted that SAMA has implemented the Basel III risk-based capital regulations by meeting internationally-set timelines.[811] As discussed, new rules and criteria have also been formulated in respect of Tier 2 capital under the Basel III framework, for instance, by requiring banking institutions to strengthen the loss absorbency of Tier 2 instruments. Thus, at first glance, it appears that the Basel Committee is working together with SAMA, signposting that transparency in intergovernmental agencies is imperative for ensuring the fluidity and strength of Saudi banks and finance institutions operating in Saudi Arabia

5.6.2 Pillar 2 and 3 (Supervision and Market Disclosure) Implementation in Saudi Arabia

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[808] Larry Elliott, 'Oil Price Slump Turns Saudi Surplus into Huge Deficit IMF Report Shows' *The Guardian* (London, 8 October 2015).
[809] ibid.
[810] ibid.
[811] ibid.

As will be fleshed out in subsequent chapters, good institutions and an appropriate regulatory framework are essential pre-requisites for an efficient stock market. Levine indicates that inappropriate corporate governance and the lack of an adequate regulatory environment, especially in relation to property rights and the protection of creditors are strongly associated with low levels of financial and stock market development.[812] Capital markets in Saudi Arabia, and its system of government as a whole, are not always transparent.[813] Corruption is also widespread both according to Transparency International's "Corruption Perception Index"[814], and the World Bank "Worldwide Governance Indicators".[815]

Strikingly, SAMA notes that with regard to Pillar 2, risk management processes and mitigation should be assessed with a wider lens, rather than through a narrow perspective as it was the case in the past.[816] One way in which SAMA can improve its position in the implementation of Basel III requirements is by reconsidering the leeway that it affords banks. For instance, Pillar 2 risks include financial and non-financial risks such as strategic, reputational, liquidity, concentrations, and interest rates.[817] Furthermore, pillar 2 risks allow banks to attribute and measure capital to cover the economic effects of the above risks by taking activities and aggregating Pillar 1 and Pillar 2 risks.

As will be discussed in later, SAMA should borrow from the approach taken by Malaysia, specifically by setting baseline capital adequacy standards which are then tailored to the risk profiles of particular banks, rather than allowing banks themselves to select and design the manner in which these requirements are met. It is arguable that if banks are left to their own devices in selecting and designing their own capital requirement schedules, conflict can arise as to whether the Basel III requirements have been met. If Basel III processes are streamlined by SAMA, it is arguable that banks will meet on a level playing field in which all banks must

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[812] Elton M Nagy and Mustafa Babiker, 'Arab Capital Markets Development and Institutions' (2005) 21(1) Journal of Economic and Administrative Sciences 42.

[813] John Heron and Peter Reason, 'A Participatory Inquiry Paradigm' (1997) 3(3) Qualitative Inquiry 274.

[814] Transparency, 'Corruption Perceptions Index 2016' <www.transparency.org/research/cpi/overview/> accessed 12 October 2017.

[815] Saudi Arabia ranks worst of the six Gulf countries in the Gulf Cooperation Council. Duha Al-Kuwari, 'Mission Impossible? Genuine Economic Development in the Gulf Cooperation Council Countries' (London School of Economics and Political Science, No 33, 2013).

[816] SAMA, 'Guidelines Document on the Internal Capital Adequacy Assessment Plan (ICAAP)' (Circular No 581, 2008).

[817] ibid.

meet and implement the requirements in a consistent and transparent manner. Thus, it is recommended that SAMA should take a more active approach in ensuring that Basel III requirements are implemented across the board and uniformly for all banks in Saudi Arabia.

With regard to Pillar 2, SAMA has applied the Supervisory Review Process (SRP) to individual banks in determining capital adequacy in order to assess whether additional capital is required to mitigate risks not covered under Pillar 1 minimum capital requirements.[818] Further evidence of this task can be seen in SAMA's annual meetings in which banks' ICAAP is discussed via bilateral meetings.[819] Within these meetings, SAMA evaluates whether the methodology used to discern capital positions is in compliance with SAMA requirements channelled through Basel regulations. This methodology is also concerned with assessing SAMA's requirements in deducing risk identification, risk measurement, and risk aggregation in meeting Basel Capital requirements.[820]

With regard to Pillar 3, SAMA has implemented guidelines in line with the Basel requirements for capital. Any bank established or trading in Saudi Arabia which fails to maintain a ratio of 8% CAR can face regulatory penalties. Another important ratio which banks must abide by is the Annual Target CAR.[821] The CAR is determined by a bank's risk profile, its strategies, and its business plans.[822]

5.6.3 The IRB and SA approach in Saudi Arabia

In 2006, the Saudi Arabian Monetary Authority allowed banks to use the Internal Rating Based Approaches for credit risk by issuing a circular.[823] The requirements set in that document are applicable to banks operating in Saudi Arabia which use or intend to use the IRB approach to measure capital charges for credit risk.

[818] ibid.
[819] ibid.
[820] BCBS (n 199).
[821] ibid.
[822] ibid.
[823] Saudi Arabian Monetary Agency, *SAMA detailed guidance document relating to Pillar 1*, 2006.

The IRB approach to credit risk relies on the internally obtained inputs of banks in determining the capital requirement for an exposure.[824] If banks satisfy the minimum qualifying requirements, the can seek SAMA's approval to use their internal estimates of risk components in the calculation of capital. There are a series of complex rules and guidance documents related to the transitioning to the IRB approach for banks in Saudi Arabia. As a general principle, SAMA will not require or mandate any specific bank to adopt the IRB approach.[825] It is best that banks create their own feasibility studies and examinations of the corresponding costs and benefits in order to decide to use this approach. In the case of banks that are building the IRB systems, adopting this approach will require significant changes to the existing capabilities, the collection of extensive data as well as fulfilling many other quantitative or qualitative requirements.

Banks wishing to adopt the IRB approach should discuss their plans with SAMA and meet the specific requirements. SAMA will conduct on site visits to ensure that the bank internal rating systems and the corresponding risk estimates satisfy the Basel requirements. It should be noted that the primary responsibility for validating and ensuring the quality of the bank's internal rating systems rests in its management and its leaders.

In order for banks to be eligible to use the IRB approach for capital suitability purposes they should comply with a set of minimum qualifying criteria.[826] These requirements cover the criteria for transitioning to the IRB approach and other requirements about the qualitative and quantitative aspects of the IRB systems. Banks have to adopt the IRB approach except for immaterial exposures that have been exempted by SAMA. A critical mass of the bank's risk weighted assets has to be on the IRB approach before the bank can transition to that approach for capital suitability purposes. The amount of immaterial exposures that can be exempt from the requirements of the IRB approach is subject to a maximum limit of 15% of a bank's risk weighted assets.

A bank can be allowed to adopt a phased rollout of the IRB approach across its banking group with a transition period of up to three years subject to SAMA agreeing with its final

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[824] ibid, 34.
[825] ibid, 59.
[826] ibid, 61.

implementation plans.[827] The implementation plan should specify the extent and timing for rolling out the IRB approach across significant asset classes and business units over time. The plan must be approved by SAMA and be precise and realistic.

The overarching principle behind the requirements of the rating system is that it should provide a meaningful assessment of borrower and transaction characteristics, a meaningful differentiation of credit risk and reasonably accurate and consistent quantitative estimates of risk.[828] If a bank uses the IRB approach then it should be able to measure the key statistical drivers of credit risk. Banks should construct a process that enables them to gather, store and use loss statistics over time in a reliable way.

There are two basic methods by which ratings are assigned: a model process and an expert judgement process. It can be said that the first is a mechanical process, relying on quantitative techniques such as credit scoring or default probability models or specified objective financial examination. The second relies on personal experience and the subjective judgement of credit officers.

In the case of the IRB approach, credit scoring models are allowed as the primary or partial basis of rating assignments and can be useful in estimating loss characteristics.[829] Regardless of the models that are used, human judgement and supervision is required to ensure that all relevant information is considered and the implementation is suitable. The optimal way is to use both approaches, the first as an initial way of estimation and the second in cases that are more complex.

In February 2014, SAMA issued a consultative document about IRB approaches corresponding to Basel III in which it required bank comments by 30 April 2014.[830]After receiving the comments from the banks, SAMA issued another circular in which it stated that no Saudi Bank has transitioned to the IRB approach.[831]

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[827] ibid, 62.
[828] ibid, 67.
[829] ibid, 87.
[830] Saudi Arabian Monetary Agency, *SAMA consultative draft concerning Basel III Internal Rating Based approaches for credit risk*, February 2014.
[831] Saudi Arabian Monetary Agency, *SAMA's final document concerning Basel III Internal Rating Based approaches for credit risk*, 2014.

In the present nothing has changed, so the banks in Saudi Arabia use the SA approach in estimating credit risk. After elaborating the rules and documentation about transitioning to the IRB approach, SAMA realises that they are not used by almost all of the banks.

It is understandable because the procedure for transitioning to the IRB approach is complex and banks have to satisfy a series of requirements before SAMA can give its approval. The approach also requires internal resources from the bank, such as credit risk models and credit risk specialists. Banks that are transitioning toward the IRB approach will have to change their existing capabilities, the data collection procedures and satisfy quantitative and qualitative requirements and these are not changes that can be applied by all banks.

Because of the inherent complexity of the IRB approach the banks in Saudi Arabia didn't implement it. There have been facilities such as a rollout period that intended to encourage banks to adopt the approach, but they have not been enough to create a noticeable effect. Banks in Saudi Arabia use the SA approach, which is easier and more convenient. It also requires a smaller number of resources from the bank.

There are also a series of disadvantages when using this approach. Banks do not build their internal capabilities with the standardised approach. There are no complex models used to estimate credit risk that are customized for the region. Building such models would allow banks to examine the risks in a more objective way. Banks could also participate in the professional development and training of credit risk specialists, but there are little reasons to do so with this approach.

The SA approach also has the disadvantage that banks rely too much on credit rating agencies. There are US agencies such as Standard & Poor and Moody's that know little of the situation in Saudi Arabia. There are also subsidiaries in Saudi Arabia, such as S&P Global Rating, but these do not have a long working history in the region. There are only a small number of companies in Saudi Arabia that have a credit rating. If banks rely on credit rating agencies too much they will use incomplete or unsuitable information.

Banks in Saudi Arabia have a reason to calculate their own credit risk as they know a lot about the characteristics of a region. Their exposure can also differ and be centred on

corporate, sovereign or retail. Banks have to construct their own instruments to evaluate credit risk as this will allow them to have a clearer impression about the credit risk of various clients and institutions.

5.6.4 Remaining Issues in the Implementation of Basel III in Saudi Arabia

There have, nonetheless, been criticisms regarding the extent to which Saudi Arabia's implementation of Basel III standards will sufficiently protect it against future risks. Saudi Arabian banks appear to have complied with Basel capital ratios and are making good progress to meet the 2019 implementation targets. Mere compliance with Basel III requirements, however, does not necessarily eliminate the risk of its future failure or insolvency. Indeed, key Western financial institutions were found to have met and even exceeded Basel II capital adequacy requirements prior to their financial collapse. As Baltali and Tanega, point out: Northern Rock was, "declared insolvent and taken over by the UK government in 2007, it had reported the highest capital ratio of any leading British bank…just fifteen days before its bankruptcy" while "Lehman Brothers boasted a Basel-type Tier 1 capital ratio of… almost three times the regulatory minimum."[832]

It is open to some dispute whether the revised capital structure standards developed under Basel III have eliminated some of the weaknesses of the previous Basel framework, including through strategies aimed at enhancing the capital resilience of banks over the longer term. Under the Basel III framework, a guideline is issued for assessing the trigger point at which financial institutions and instruments should be deemed non-viable and, correspondingly, converted to common equity, regulated under Tier 1, or otherwise written off from the balance sheets.[833] Under Basel III, in the future, a bank's profitability will be linked to these provisions. As banks grow their profitability, they will be required to allocate larger amounts for such provisions.

However, Basel III threshold deduction rules may expose Saudi Arabia to significant risks, as it exempts three major types of investments for the purposes of calculating common equity tier capital thresholds: mortgage related financial services and equity rights, short term and

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[832] Baltali and Tanega (n 52) 9.
[833] See generally BIS (2006) (n 15).

deferred tax assets resulting from imbalances in taxation rates and common shares from unconsolidated financial entities.[834] Because these assets are removed from consideration, there can remain a variety of risks corresponding to them, undermining the stability of the banking system.[835] This is all the more significant in view of the fact that SAMA received over 13 license applications from companies and banks to provide mortgage and finance services. Questions remain, for instance, over whether Saudi banking supervisors and regulators are able to accurately assess the tier and quality of the growing market in commercial real estate and other infrastructure enterprises.

Moreover, under Basel III, certain financing instruments are excluded from Tier 2. Tier 2 securities usually take bond like forms, in carrying cumulative costs, for instance loans or preference shares issued by states (involving structured distributions which have the characteristic of being non-viable at the point of loss absorption, non-deferrable and cumulative). Most instruments defined as Tier 2 capital will tend to have a longer maturity. However, regulatory amortisation applies in the final five years to maturity.

It is arguable then that, given current economic circumstances, the Kingdom of Saudi Arabia faces significant solvency risks within five years. In an attempt to prevent this, the Saudi government introduced new economic austerity measures to be implemented across all government ministries, including the banning of official purchases of cars and furniture and slashing travel budgets and infrastructure spending as it faces its gravest fiscal crisis for years because of low oil prices, according to Secret Saudi policy memos issued by King Salman to the Finance Minister.[836]

One key finding in the 2015 report is that SAMA applies a zero (0%) risk weight for banks' sovereign exposures to the Gulf Cooperation Council (GCC).[837] As GCC banks hold more Tier 1 capital and common equity, the capital definition requirements set out by Basel will

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[834] BCBS, *Basel III Definition of Capital – Frequently Asked Questions* (BIS 2011).

[835] Adel Harzi, 'The Impact of Basel III on Islamic Banks: A Theoretical Study and Comparison with Conventional Banks' (Paper presented at Ethics and Financial Norms, Paris, 2011) <http://cenf.univ-paris1.fr/fileadmin/Chaire_CENF/pdf/ The_impact_of_Basel_III_on_Islamic_banks_-chaire_Paris_1.pdf/> accessed 22 February 2016.

[836] Hugh Miles, 'No More New Cars, Furniture Says King as Oil Slump Forces Cuts on Saudi Arabia' *The Guardian* (London, 8 October 2015) <https://www.theguardian.com/world/2015/oct/08/no-more-new-cars-furniture-king-oil-slump-forces-cuts-saudi-arabia> accessed 15 October 2015.

[837] BCBS (n 48) 8.

impact Saudi Arabia the most.[838] As a result, any decrease in the value of Saudi debt will, in turn, lead to a drop in value of not only Saudi Tier 2 debt but, remarkably, Saudi Tier 1 capital too. This is precisely because the scope and coverage of the regulatory framework established under Basel III *does not* extend to sovereign risk. These issues will be discussed in further detail later in this thesis.

5.7 Future Directions of Reform: Enhancing Liquidity in Islamic Banks

The performance of a bank is assessed in accordance with market indicators, such as the efficiency of a bank. Banks are, generally speaking, only efficient when their net profits exceed their net losses. The above idea has been developed in a number of strands of mainstream economic theory. One such prevalent, though disputed, theory is the risk-to-return theory, which has also been given a mathematical formulation known as the Capital Asset Pricing Model (CAPM).[839] According to the CAPM model, the level of risk assumed by the investor is, or should be, directly proportional to income or profit generated in return, so that a high risk will yield high return for the investor, or the inverse.[840]

On the question of the motivations of investors, economic or otherwise, the CAPM model takes much for granted. These theories have gained much traction but are susceptible to criticism because of their tendency to treat the preferences of diverse market actors - demand depositors, investors and institutions - as individualistic, unitary, fixed, and, largely, if not exclusively, profit motivated. If this is true, what reason is there for consumers to invest their savings with Islamic banks at all? However, such a proposition rests on the mistaken belief that all consumers, banks and investors are alike.

5.7.1 Why the Efficiency of Islamic Banks Matters?

Many of those who bank with Islamic institutions may well be seeking more responsible, cooperative and ethical alternatives to conventional banking. That being said, it is also has to be stressed that the poor efficiency of Islamic banks may well *deter* future custom. Studies assessing risk perceptions of Islamic banking, i.e. how consumers of Islamic banking assess the probability of risk, have proven highly suggestive. Equity-based profit and loss sharing

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[838] PricewaterhouseCoopers (n 709).
[839] Zvi Bodie and others, *Investments* (7th edn, McGraw-Hill 2008) 303.
[840] Abd Ghafar Ismail and Mohd Saharudin Shakrani, 'The Conditional CAPM and Cross-Sectional Evidence of Return and Beta for Islamic Unit Trusts in Malaysia' (2003) 11(1) Journal of Economics and Management 1.

agreements, most notably Musharakah and Mudarabah modes of financing are perceived to carry the highest risk, even if it is assumed that banks assume an equal share in the risk.[841] Whereas conventional finance instruments can lure investors with the prospect of high returns, Islamic banks hold fewer attractions in the above regard. As Christine Walsh argues:

> "[E]ntrepreneurs are not likely to share their profits when optimistic, and capitalists are of course hesitant to bear risk knowing that the opportunity signals the improbability of its success...Profit and loss sharing is a risky investing vehicle because banks lack the right to monitor the operations of the firms in which they are invested. The concept of control-rights is at the heart of who should be earning a profit or incurring risk or loss. Without the conventional guarantee of return, profit and loss sharing represents a risk."[842]

In the above light, it is notable that Saudi banks have attempted to develop loan products which are Shariah compliant. These product innovations include the provision of interest free loans, the use of Wa'ad based contracts, and the use of Sukuks.

In view of their risks and perceived inefficiencies, a number of banks in Saudi Arabia will offer facilities in back-to-back interest free loans. To this end, Saudi banks have taken acquisition over a small portfolio of 'fungible' commodities that are sold to customers on the basis of deferred payment. That customer then appoints the bank as its agent for selling the same commodities, and the bank is contractually obliged to honour its agency/fiduciary duties.[843] Yet, the structural limitations of these types of products are plain to see, making it difficult to imagine how such products are to compete with the more efficient loan packages offered by conventional banks. For instance, back-to-back interest free loans do not carry any interest and are unlikely to be utilised by conventional markets or used to finance large investments, given that these instruments are typically highly illiquid, locking capital in for long periods of time, while at the same time exposing capital providers who supply large sums of money to the risk of loss or low return.

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[841] Heiko Hesse and Martin Cihak, 'Islamic Banks and Financial Stability: An Empirical Analysis' (2008) 8(16) International Monetary Fund 8.

[842] . Christine Walsh, 'Ethics: Inherent In Islamic Finance Through Shari'a law; Resisted In American Business Despite Sarbanes-Oxley,' (2007) 12(4) Fordham Journal of Corporate & Financial Law 753, 760.

[843] ibid.

5.7.2 Enhancing the Institutional Liquidity of Islamic Banks

Basel III liquidity standards and ratios require banks to understand funding strategies from a structural sense, in addition to understanding funding from a short term liquidity management perspective.[844]

Overall, Islamic banks need to strengthen their capital and liquidity positions by holding higher quality capital (even if the banks have hybrid or complex structures) in order to ensure that dependency on money market instruments is reduced.[845] The Islamic Financial Services Board has issued its own standards on capital adequacy. As an improvement to two previous IFSB standards, the IFSB-15 proposes greater standards on capital adequacy requirements.[846] The Islamic Financial Services Board (IFSB) has been apprehensive about three factors which could affect the performance and competitiveness of Islamic banking through conventional financial institutions.[847] The three factors are: i) shortages of Shariah compliant securities, ii) the lack of active Sukuk trading (discussed below), and iii) the lack of a reliable Shariah-compliant deposit insurance program.[848]

With regard to the shortage of Shariah compliant securities and active Sukuk trading, many Islamic banks have tried to maintain increasing amounts of cash and non-earning liquid assets, in comparison to their conventional banking institution counterparts. In jurisdictions where Shariah-compliant securities and Sukuk instruments are available, the absence of an active trading and a repurchase (repo) market continues to be an ongoing problem for the Islamic Banking sector.[849] With regard to the lack of reliable Shariah-compliant deposit insurance programs, this has been a major concern due to the fact that the soundness and stability of the Islamic market is at stake as liquidity ‘stress’ could occur as a result of inadequate insurance programs.

One way to address the liquidity related exposure of Islamic banks is to develop a more diverse set of Shariah compliant products, specifically those which are backed by high quality liquid assets. Islamic finance institutions are, increasingly, availing themselves of these

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[844] ibid.
[845] Sutan Emir Hidayat, *The Important Role of Sukuk in the Basel II Era* (Thomson Reuters 2015).
[846] ibid.
[847] ibid.
[848] ibid.
[849] ibid.

instruments to enhance the loss absorbency of their financial investments, and to balance out their over-dependence on largely equity driven profit and loss/partnership asset holdings.

Islamic banks will sometime use profit rate swap agreements as a risk control mechanism, thereby enabling them to hedge against volatility in borrowing rates whilst remaining Shariah-compliant.[850] Under this mechanism, Islamic institutions with fixed and floating rates agree to exchange profit rates through the execution of a number of contracts known as Wa'ad contracts. By virtue of the Wa'ad contract, each counterparty bank unilaterally promises to exchange profit rates until the swap reaches maturity or expires.[851] Islamic swap agreements are complex to administer, however, resulting in higher agency costs for the bank that would be expected under the usual forms of structured finance agreements. The promissory element of Wa'ad agreements also creates uncertainty as to which bank has ownership over intangible swap assets under a Wa'ad contract.[852] Furthermore, a unilateral promise may not satisfy conditions of a valid contract under Shariah as applied in many Islamic countries, as well as under the law of contract of many conventional jurisdictions such as the UK. Rice argues the following:

> "Capitalization on arbitrage… requires the payment of various transactions costs. In Islamic finance, those transactions costs are incurred due to conducting otherwise unnecessary transactions …as well as the additional legal and jurist fees required to structure a product and certify it. Although it is perhaps not sufficient, the profitability of Shariah arbitrage is certainly necessary to get bankers and lawyers involved in Islamic finance."[853]

Financial institutions offering Islamic financial services have also utilised Murabahah based liquidity management mechanisms for transactions carried out on the international market.[854] In local markets, these mechanisms equip Islamic banks with the capacity to assess their working capital requirements by buying and selling inventories to the end users of the financing. However, the cost of incorporating an asset or commodity in the transaction may

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[850] ibid 47-49.
[851] Mushtaq Ahmad Qazi, 'The Binding Nature of Wa'ad (Promise) and its Application in Islamic Finance' (2012) 3 International Journal of Business and Social Science 206, 208.
[852] Adapted from Seng Kiong Kok, 'Islamic Finance in the Global Economy: An Exploration of Risk Management and Governance within Shari'a Finance' (PhD thesis, University of Liverpool, 2014) 244.
[853] Mahmoud A El-Gamal, 'Limits and Dangers of Shari`a Arbitrage' (Proceedings of the Sixth Harvard University Forum on Islamic Finance, 2004) 9.
[854] Choudhry (n 485) 11.

be prohibitive, thus, compelling Islamic banks to seek other means of hedging their exposures.

Attempts have also been made to establish an alternative form of Shariah compliant forms of collateral based financial guarantees known as Sukuks.[855] Here, sovereign issued trust certificates are used to guarantee loans used to finance large scale public investment projects, e.g. development or infrastructure projects. Essentially, the state provides a collateralised security against any losses incurred by a lender in the event of counterparty defaults or contract non-performance.

To date, a number of Basel-Sukuk instruments have been issued since Basel III's initial implementation in January 2013.[856] During the initial phases of Basel III's implementation, three issuances of the Mudharabah-Sukuk took place in three of the following banks: Saudi Hollandi Bank (SHB), Saudi British Bank (SAAB), and the National Commercial Bank (NCB). While such assets are treated as marketable securities under the current risk weighting system, such assets may not be able finance or secure all financial transactions. They do provide, however, a short-term source of liquidity and therefore should be acquired as a part of more balanced portfolio.

In Islamic banking, the benefit of acquiring fungible (highly liquid) non-cash based assets such as the emerging market in Sukuks is that they are given a risk rating of 0% under Basel II while providing banks with easily convertible source of cash based income with no or negligible risk of lost value. Some analysts note that unlike the Emirati banks, banks in Saudi Arabia have issued Sukuk certificates to increase their Tier 2 capitals, as per Basel III requirements.[857] In Malaysia, the issuance of Basel III-compliant Sukuk by AmIslamic Bank, Maybank Islamic and others, has paved the way for other Islamic banks to follow suit. Further, the intake of these Sukuk instruments boosts banks' Tier 2 capital, and thus points to more issuances of Sukuk in the near future, which ensures greater financial activity for Islamic banking as a whole.

While the growing market in Islamic securities can decrease in value, the value can also

[855] Christophe J Godlewski, 'Sukuk vs. Conventional Bonds: A Stock Market Perspective' (2013) 41 Journal of Comparative Economics 745.
[856] ibid.
[857] Emir Hidayat (n 780).

increase as the bank acquires higher quality stocks. A case in point, the world's first Basel III compliant Sukuk was issued in November 2012 by Abu Dhabi Islamic Bank (ADIB) in UAE. The issuance was worth $1 billion and was compliant with Basel III's additional Tier-1 (AT1) capital requirements. This issuance generated an overwhelming response from the investors - an order book of $15.5 billion (more than 30 times over-subscribed on the initial benchmark size) and with expected profit rate of 6.375 percent, the lowest ever coupon for an instrument of this type.

While these innovations point to the dynamism of Islamic finance law as a 'living and breathing' entities, the market in Islamic derivatives and securities remains embryonic. Moreover, many of these instruments simply transfer the risk of the lender to the sovereign trust issuer who acts as guarantor, as will be discussed in more detail in the context of Saudi Arabia.[858] Another possible criticism is that overdependence on the Sukuk markets as a counterweight to an excess growth of the equities market in the Islamic finance sector is an excessively costly way of reducing liquidity risks. This may be effectively addressed through a portfolio in which equities are more sensibly balanced against debt based financing.[859] Islamic banking institutions also have to appoint qualified personnel with sufficient resources to evaluate risks and assess the credit quality of Sukuk instruments. Currently, Saudi Arabia lacks an effective framework for regulating the issuance of Sukuks.

5.7.3 Regulatory Issues in Meeting Basel Liquidity Requirements

From a 'top down' perspective, the Basel Committee has deliberately avoided encroaching on state autonomy, by electing to frame its standards as a regulatory baseline, rather than as 'hard or fixed' rules. Accordingly, it might be argued that Islamic states, and Islamic financial institutions, have the freedom to decide how they will flesh out and implement these standards as determined by their own laws, values and culture.[860] This presents a challenge for Saudi Arabian banks due to the fact that Basel liquidity parameters impose a calculation of ratios that must meet Shariah requirements, particularly when banks are considering their balance sheets. From a 'conflict of law' perspective, each country will designate its own

[858] V Coudert and M Gex, The Interactions between the Credit Default Swap and the Bond Markets in Financial Turmoil. Centre d'Etudes Prospectives et d'Informations Internationales, no. 2011–02 (2012) 1, 3
[859] Shamsher and others (n 32); Van Hennie and Zamir (n 497).
[860] Mohamad Hasan and Dridi (n 302).

supervisory body and, in Islamic contexts, Shariah experts. This may result in contradictory statements on the legality of a given financial instrument, project or product.

On the whole, Gulf countries have made excellent progress in aligning their regulatory frameworks with global standards.[861] Following regulations set out by the Financial Stability Board (FSB), the Basel Committee on Banking Supervision (BCBS), and the International Organisation of Securities Commission (IOSCO),[862] the UAE Central Bank announced a 2014 initiative to introduce new rules on liquidity and a subsequent consultation with the Basel III committee. SAMA has yet to establish equivalent rules for addressing the equity based profiles of Islamic banks, including by placing greater weight on paid up capital, retained earnings, and disclosed reserves.[863]

This is in addition to the Non-Viability Loss Absorption (NVLA) mechanism, which can be triggered when banks fail to maintain adequate levels of institutional liquidity.[864] This enables states to take preventative measures against their exposure to macro-economic or regulatory risks, including the irresponsible supply of credit (e.g. in the housing market), in addition to other factors that can lead to unsustainable credit growth.[865]

Regardless of whether banks are conventional or Islamic, they can experience challenges when determining if the trigger threshold for non-viability has been reached. While SAMA is entrusted with emergency liquidity management powers, the task of setting minimal liquidity conservation levels which is to be applied to all banks, regardless of the circumstances, cannot be easily designed. This evaluation along with the power vested in the relevant authority to apply it is subjective powers is liable to attract administrative law related criticisms of possible arbitrariness, uncertainty, and lack of transparency.

The new Basel III proposals on liquidity conservation may also, adversely, result in jurisdictional conflict, particularly in respect of the Saudi subsidiaries of foreign banks. Depending on state laws, regulators in different jurisdictions may well reach different

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[861] PricewaterhouseCoopers (n 709).
[862] ibid.
[863] ibid 5.
[864] Susana Kijang and Bank Negara Malaysia, 'Basel III Implementation: Challenges and Opportunities' in JPR Karunaratne (ed), *Basel III Implementation: Challenges and Opportunities* (SEACEN 2013).
[865] BCBS (n 1) 142.

conclusions around the continued viability of a financial institution or instrument.[866] Home and host regulators may, for example, have dissenting views about the trading book value of a distressed asset, whether this should be written down due to overvaluation or whether debts should be written off.[867] In order to address the possibility of regulatory arbitrage, the Basel framework is applied on a consolidated basis to internationally active banks. This allows for the risk of an entire banking group to be examined.[868]

Challenges remain, however. While the framework states the need for suitable capitalisation, it does not specify how to measure the capital requirements applicable to specific banks, which is decided by supervisory authorities[869] In Saudi Arabia, for instance, bank supervisors may lack the knowledge or capacity or knowledge to assess whether, for example, distressed assets underlying a mortgage contract should be written off or converted as different tiered capital, which attracts a high risk rating and, therefore, stricter capital requirements.

In addition to the capital adequacy issues addressed above, SAMA will likely encounter a number of broader legal and regulatory obstacles to the effective implementation of the Basel II and III frameworks. One concern relates to insurance standards which Saudi Arabia has been slow to adapt in comparison to other countries. For instance, PwC argues that Insurance regulators have adapted International Association of Insurance Supervisors (IAIS) standards at a slow pace in Saudi Arabia.[870] Whilst it is unclear as to why insurance standards have been implemented gradually, the reasons could be due to issues of communication and data sharing between agencies. Viewed through the above lens, Basel III does not provide a solution to jurisdictional conflict or the ineffective implementation of Basel standards at the level of national legislation and adjudication.

5.8 Conclusion

In essence, the Basel framework is directed primarily to national governments.[871] It is through their formal incorporation in national law and through the legislative process that the 'soft' character of Basel standards acquires a formal status and binding effect. There are,

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[866] Marliana Abdullah and others, 'Operational Risk in Islamic Banks: Examination of Issues' (2011) 3(2) Qualitative Research in Financial Markets 131.
[867] BCBS (n 1) 57.
[868] ibid 51.
[869] BCBS (n 1) 80.
[870] ibid.
[871] Blundell-Wignall and Atkinson (n 132) 9.

nonetheless, serious questions to be posed over the extent to which Basel reforms can transform or discipline the internal culture of specific banking systems and institutions.

For the Western private law jurist, 'credit' is a legal relationship between two persons in which one person promises to deliver a payment in the future. But in the global context, the supply chain is more complex. When more than one legal relation is involved, it becomes even more important to consider the inequitable or distributive effects of private contractual agreements negotiated among chains of interconnected lenders and borrowers. In so far as banking operations are made, subject to strengthened state oversight and public scrutiny, the Basel framework can be also seen as attempt to export public law type values to the typically closed or autonomous domain of private contractual relations in a self-regulating or correcting market place.

On the other hand, there is the enduring challenge of legal pluralism: one might argue that the Islamic model of banking is simply too different from conventional banking law, and associated theories and principles of contract law. Broadly speaking, neo-liberal conceptions tell us that banks are profit motivated. One way in which banks are able to realise profit is by acting as financial intermediaries. Due their capacity to gather information banks and pool funds can purchase deposits at a low interest rate and then resell them at a higher rate of interest. Since interest charges comprise a significant part of a conventional bank's revenue flow, they benefit from a clear competitive advantage over Islamic financial institutions that, as it will be recalled, are prohibited from the taking and receipt of interest on deposits.[872]

The regulatory principle guiding Islamic banking, in theory if not in practice, is the maximisation of shareholders' and depositors' wealth, because they are treated as joint partners with the bank.[873] Because the requirement of collateral is absent, Islamic banks have to contend with a high degree of risk. As such, Islamic banks can adopt Basel III, but they need to customise it to the regulatory practices and market standards of AAOIFI and the Islamic Financial Services Board on capital adequacy.

Currently, Saudi Arabia's unbanked population is estimated to be in the range of 35% and 60%, and reveals the potential role that awaits Islamic banking in resource mobilisation and utilisation for economic development. As Chapra suggests:

> "Since the existing architecture of the conventional financial system has existed for a long time, it may perhaps be too much to expect the international community to undertake a radical structural reform of the kind that the Islamic financial system envisages. However, the adoption of some of the elements of the Islamic system, which are also a part of the western heritage, is indispensable for ensuring the health and stability of the global financial system."[874]

On the other hand, the additional regulatory burdens placed on Islamic banks due to the dual operation of Basel and Islamic finance standards, or regulatory arbitrage resulting from

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[872] Shamsher and others (n 32).
[873] Abu Hussain Hameeda and Jasim Al-Ajmi, 'Risk Management Practices of Conventional and Islamic Banks in Bahrain' (2012) 13(3) The Journal of Risk Finance 215.
[874] Umer M Chapra, 'The Global Financial Crisis: Some Suggestions for Reform of the Global Financial Architecture in the Light of Islamic Finance' (2011) 53(5) Thunderbird International Business Review 565.

conflicts between them, may have the effect of stifling the competitiveness and growth potential of Islamic finance sectors, from one market economy to another. This is because Islamic banks are essentially required to render their practices compliant with not one but two sets of regulatory frameworks, or dualistic legal frameworks in many countries, such as in Malaysia.

If, indeed, it can be said Basel III has garnered enough acceptance to be considered an international standard, challenges still remain as to the degree to which the constituent elements of the Basel banking regime finds support in the Saudi Arabian and Malaysian legal systems, respectively.[875] As will be discussed in relation to Saudi Arabia, there is less certainty over the mandatory status of Shariah compliance in respect of banking disputes given the more permissive attitude of SAMA and the dispute settlement bodies on the legality of Islamic securities and Sukuk instruments.

The technical standards developed under Basel are largely silent on what the purpose of banking regulation is or should be, and on whose interests are privileged by current banking frameworks and practices, and whose are not, and, finally, what role, if any, law should play in furthering these aims, or constraining them. More generally, Basel III can be criticised for failing to incorporate this within its regulatory framework or indicators of risk, including the efficiency (profitability) of bank, as well as other principles of good corporate governance. The emphasis on the architectural features of a bank's capital structure provides little insight into whether implementation of Basel standards will have an effect on the governance culture. As the study of Saudi Arabia will show, the Basel framework has proceeded with insufficient attention to the fact that it is difficult to measure a change in governance culture.[876] A national regulatory authority may exercise their administrative power to enforce compliance with capital baselines, or impose an order of indemnification, reimbursement or restitution for losses suffered by depositors in the event of, for example, insolvency or capital loss. Yet, administrative authorities will rarely take action unless some personal gain or wilful wrongdoing can be attributed to senior management.[877] The wider point, reinforced throughout this thesis, is that capital risk regulation is by no means a 'cure all' and should be

[875] IFSB (n 473).
[876] Rachel M Gisselquist, 'Developing and Evaluating Governance Indexes: 10 Questions' (2014) 35(5) Policy Studies 513.
[877] Schwarcz (n 608) 4.

complemented by laws which impose stricter personal liability on shareholders, and in the final instance, bank managers. If bank managers are rewarded for excessive risk taking with perverse incentives i.e. healthy remuneration packages, then no amount of capital risk regulation will remedy this. Higher levels of capital in short must be implemented in tandem with personal accountability and responsibility for poor risk management, and must ultimately fall with senior management.

These issues will be discussed in the next chapter. It seeks to establish the strengths of the Malaysian banking sector to allow a lesson to be drawn for Saudi Arabia, and to ensure the stability of its banking sector in the face of market stability and macroeconomic change. In light of the above discussion, the next two chapters proceed to offer a comparative analysis of two apparently distinct legal and financial systems.

Chapter VI: Banking Regulation and Basel Compliance in Malaysia: A Model of Governance?

6.1 Introduction

This thesis is generally concerned with an assessment of whether the Basel measures have been effectively implemented in the Kingdom of Saudi Arabia. However, an even more important question may exist as to whether Basel III by itself should be considered an adequate framework for addressing the specific risks faced by the Saudi Arabian banking system, because it is not conventional and it operates according to Islamic principles. In order to understand this contrast, it is important for us to compare the financial/legal system of Saudi Arabia with another Islamic banking and finance oriented country. The legal system of Saudi Arabia can be argued to be relatively underdeveloped as compared to the regulatory and structural elements of the Malaysian finance sector which is more robustly embedded in the institutional and risk regulatory mechanisms which protect its banks from financial crisis, while safeguarding the rights and interests of stakeholders in the Malaysian banking system.

Moreover, Malaysian regulators and standard setting institutions have achieved these goals, in part, because of a more transparent initiative to formalize and effectuate Islamic standards and principles as applied to the growing Malaysian Islamic finance sector. As to the more innovative aspects of the legal framework that governs banking regulations in Malaysia, national regulators and key banking institutions have taken the welcome step of adapting Basel standards to meet the needs of local banking institutions, thereby crafting a financial and legal strategy which is tailored to the specific structures and risks exposures of Islamic finance institutions and modes of financing.

To understand the applicability and effectiveness of Basel III on the Saudi Arabian system, it is vital to focus on Islamic international comparisons to identify the strengths and weaknesses of the Basel III measures on Islamic banking and to identify other important developments needed for the healthy development of the Saudi model. As such, this chapter focuses on the historical development of modern Islamic banking in context of the regulatory compliance and risk management environment in the Malaysian banking sector. Malaysia, in addition to implementing the Basel measures, also has a highly developed legal framework of financial

regulation that provides for more standardisation, oversight, and transparency; Basel measures alone do not offer stability to the Islamic banking model of Malaysia. Finally, it is argued that because the finance sector in Malaysia has in place a well-developed risk management and governance environment, supported by a strong legal system and a culture of compliance, consumer confidence remains steadfast, thereby making Malaysia a leader in Islamic banking.

Finally, correlations will be drawn in this chapter between SAMA and Bank International Malaysia Berhad (BIMB), Malaysia's first Islamic Bank. BIMB has developed its own non-Basel dependent tools and internal systems for assessing and managing factors such as capital, risk, and liquidity; all of which can provide important instructions to Saudi Arabia's system of assessment and regulation. Again, this chapter introduces the concepts and practices used in Malaysia, while creating a comparative framework that shall be used in this, as well as subsequent chapters to fully evaluate Saudi Arabia's financial system.

6.2 The Malaysian Legal System and Financial Services

In the years following the Asian financial crisis, significant reforms led to a strong, well founded financial structure, with appropriate dual-dealing regulations (and legal definitions) for the conventional and Islamic banking sectors so they could coexist and effectively operate. The focus of this thesis is on the Basel regulations and the potential stabilising effects of their implementation, but as the Malaysian study shows, what is perhaps more important is the necessity for a well-developed legal system that instills confidence in the banking industry that Saudi Arabia could stand to learn from.

Much of Malaysia's legal framework finds it roots in the British legal system instituted during colonial rule. When Malaysia gained independence from the British in 1957, the well-established British common law system formed the foundation of the Malaysian legal system as it is today. Many British laws prior to independence were converted to similar local implementation. The Civil Law Ordinance for example became the Civil Law Act 1956.[878]

Malaysia has a Shariah system of Islamic Law that specifically operates for Muslims, and has jurisdiction in several areas. This unique hybrid legal system is permitted under the

[878] For an overview, see BNM, 'Governance, Communications and Organisational Development: The Central Bank of Malaysia Act 2009' <https://www.bnm.gov.my/files/publication/ar/en/2009/cp05_001_whitebox.pdf> accessed 21 November 2016.

Constitution of Malaysia and mainly applies in civil, personal and in some judicial areas.[879] Relevant to this discussion, the Malaysian hybrid system also serves as the basis of financial law, with separate an implementation framework for Islamic and non-Islamic finance, as will be discussed later in this section. However, this should not be casually dismissed as the key strength of the Malaysian model, because Malaysia has also adopted Basel standards, which are upheld by the Bank Negara Malaysia (BNM) (as the Malaysian banking regulator) and implemented by the majority of the domestic banks since the release of the original Basel I and later Basel II guidelines for improving capital adequacy.[880] Similar to Malaysia's BNM, Saudi Arabia has the Saudi Arabian Monetary Authority (SAMA), which serves as the central bank for the Kingdom, acts as a regulatory authority, and oversees banking matters within the country.[881] SAMA's jurisdictional responsibility would include the adoption, compliance, and enforcement of any suggested international models or Shariah adapted banking industry standards.[882]

While overarching standards, such as those developed by the Basel Committee for Banking Supervision (BCBS) and the Islamic Financial Services Board (IFSB) are imperative, the recommended standards are not automatically self-enforcing upon banks in a national setting unless adapted through legislative or statutory regulations. It is, therefore, necessary that national regulators enforce them through legislative instruments and implement those accordingly. The regulations that have been developed and enforced by the BNM in Malaysia are considered to be the model by which other Islamic banking systems can craft regulations that cater to the specific needs of their financial setting.

Interestingly, the IFSB, as an international body, is intimately connected to Saudi Arabia through SAMA, and the Kingdom is one of the founding members of the Board.[883] The

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[879] Federal Constitution of Malaysia (31 August 1957, last amended 1 November 2010) art 121 (1A).
[880] BNM, 'BNM/RH/NT 007-25: Implementation of Basel III' <https://www.bnm.gov.my/index.php?ch=57&pg=137&ac=26&bb=file>accessed 20 March 2017.
[881] See SAMA, 'SAMA Functions' <http://www.sama.gov.sa/en-US/About/Pages/SAMAFunction.aspx> accessed 13 October 2017.
[882] ibid; see also, Meshal Faraj, 'Toward New Corporate Governance Standards in the Kingdom of Saudi Arabia: Lessons from Delaware' (University of Tabuk Grant No 23-06, Chair for Islamic Financial Market Studies, Saudi Arabia, 2014).
[883] See, for general reference, IMF, 'Saudi Arabia: Financial System Stability Assessment – Including Reports on the Observance of Standards and Codes on the Following Topics, Monetary and Financial Policy Transparency, Banking Supervision and Payment Systems' (Staff Country Reports, 5 June 2006) section 13.

Governor of SAMA is a sitting Member of the Council Board.[884] Saudi Arabia, therefore, has a direct relationship with standardisation body by which Malaysia has successfully implemented its regulations. The prudential standards promulgated by IFSB are much like those issued under the Basel framework because they likewise promote the effective functioning and capital integrity of Islamic financial banking institutions, capital markets and the insurance industry.[885] The standards set by IFSB correlate with the regulatory and fiscal goals of Organisation of Economic Cooperation and Development (OECD) and BCBS in respect of the banking sector. However, unlike Malaysia, and despite its direct connections to the very regulations that have arguably solidified the Malaysian banking industry, neither the full set of IFSB standards nor compliance with the best practices of BNM have been adopted in Saudi Arabia by SAMA. A critical purpose of this case study is to examine these differences and the comparative motivations behind any such decision-making by the Kingdom.

6.2.1 Financial Market Structure

While Saudi Arabia does not have a hybrid system of laws regulating two distinct banking systems, it is beneficial to look at Malaysia's financial structure because its unique cultural and legal positioning in the banking industry has led to an ingenuity worthy of consideration in the Kingdom. Malaysia has well-developed domestic and international banking sectors, accounting for approximately 9% of its national GDP.[886] A dual-banking system of conventional and Islamic banks operates, with three types of banking institutions - commercial banks, Islamic banks and investment banks, supplemented by Development Financial Institutions (DFI).[887] Additionally, Malaysia models its Islamic banking products after existing conventional bank products, and for every conventional product there is a

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[884] IFSB, 'Council Membership List' <http://www.ifsb.org/council.php/> accessed 20 March 2017; see also, Arab News, 'Saudi Arabia Replaces SAMA Governor' (7 May 2016) <http://www.arabnews.com/news/saudi-arabia-replaces-sama-governor/> accessed 30 March 2017.

[885] Ken Baldwin, 'Basel III & IFSB Regulations for Islamic Financial Institutions' (Nasdaq Dubai Conference, Dubai, November 2016).

[886] Muhammad Syukri bin Shamsuddin, 'Chapter 6: Basel III Implementation: Challenges and Opportunities in Malaysia' (SEACEN Report 96, December 2013) <http://www.seacen.org/content.php?id=54&pid=702003-100328/> accessed 30 March 2017.

[887] Debbie Pozzobon, 'The Financial System in Malaysia' (*Leaderonomics*, October 2014) <https://leaderonomics.com/functional/the-financial-system-in-malaysia/> accessed 30 March 2017.

corresponding Shariah compliant Islamic substitute. Specifically, these products adopt conventional risk and return profiles, subject to Shariah constraints, such as riba.[888]

There are no state-owned banks in Malaysia, yet the State plays an important role in the health of the system.[889] Firstly it maintains stakes in large financial groups to keep an oversight over all internal matters. Secondly a critical component in Malaysia's market structure is that they maintain an injection of liquidity by state-linked corporations or initiatives such as the Employment Provident Fund (EPF), a government run pension agency, which assists in providing a 'cushion' for the system.[890] This results in a Shariah compliant risk management strategy that will be addressed below.

Banking business as defined in the FSA is, "the business of accepting deposits, paying or collecting cheques drawn by or paid in by customers, and provision of finance or such other business as BNM, with the approval of the Minister, may prescribe."[891] As reported by Bank Negara Malaysia (BNM) these banks are made up of twenty seven commercial banks, of which nineteen are foreign owned banks and eight are domestic banks. These conventional banks account for around 80% of total assets in the Malaysian banking sector and the activities of these banks include the acceptance of deposits, issuing loans and credit cards, and offering private debt securities.[892]

There are twenty one Islamic banks (both domestic and foreign owned) that together account for around 16% of the total banking assets in the country. These banks provide a wide array of services and in many cases a single bank can run multiple services. It is common for conventional banks to operate 'windows' that offer Islamic Services. However, all activities are individually licensed by the BNM, e.g. securities, advice on finance, and fund

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[888] Mohamed Arriff, 'Islamic Banking in Malaysia: Industry at Crossroads' (2014) 3 INCEIF Research Bulletin <http://www.inceif.org/research-bulletin/islamic-banking-malaysia-industry-crossroads/> accessed 31 March 2017.

[889] Export.gov, 'Malaysia - Banking Systems' (Malaysia Country Commercial Guide, 19 July 2016) <https://www.export.gov/article?id=Malaysia-Banking-Systems/> accessed 31 March 2017.

[890] Laws of Malaysia Act 758, The Financial Services Act 2013, section 1.

[891] ibid, section 2, interpretations.

[892] ibid; See also BNM, 'Financial Stability: Commercial Banks' <http://www.bnm.gov.my/index.php?ch=li&cat=banking&type=CB/> accessed 1 April 2017; see also, BNM, 'Financial Stability: Islamic Banks' <http://www.bnm.gov.my/?ch=li&cat=islamic&type=IB&lang=en/> accessed 1 April 2017.

management etc. Special legal provisions have been granted under the Capital Markets and Services Act 2007 that allow banks to operate without licenses for every separate activity.[893]

Investment banking as defined in the FSA is, "the business of: (i) accepting deposits on deposit account and providing finance; (ii) any regulated activity carried on pursuant to a Capital Markets and Services Licence under the Capital Markets and Services Act 2007 (CMSA); and (iii) such other business as BNM, with the approval of the Minister may prescribe".[894] Investment banking is the smallest sector, with fifteen banks together accounting for only 4% of the total assets. Investment banks offer securitized products and consultation on corporate matters. This sector is notably smaller than in other markets, such as that in United Kingdom, but is growing due to the increasing adaption of products to be acceptable under Shariah law. Investment banks are allowed to carry out traditional investment banking activities and, in addition, may undertake fund management and unit trust businesses. Lastly, Development Financial Institutions or DFIs are separately governed specialised institutions, which do not compete with other banking institutions. These are focused on the development of specific sectors of the economy (such as agriculture, SME activity, export/import and maritime activity) to support government economic goals.[895] They are governed by the Development Financial Institutions Act 2002.

6.2.2 The Comparative Growth of the Malaysian Banking Sector

In contrast with Saudi Arabia's more centralized approach to its banking sector, which remains largely state owned and controlled, in Malaysia there has been strong commitment from the government and appetite from the banks to grow the banking sector in key ways in recent years. The extensive mix of domestic and international banks, as well as conventional and Islamic banks, makes for a competitive environment and has encouraged growth and the development of new products. The Islamic banking sector in Malaysia has grown rapidly to 16% of total banking assets in 2012 from a level of 7.1% in 2000.[896]

Ongoing government support for Islamic banking is a key feature of its growth, as has been demonstrated by the establishment of the Malaysia International Islamic Finance Center

[893] Laws of Malaysia Act 758, The Financial Services Act 2013, Division 1, Licensing.
[894] ibid, section 2, interpretations.
[895] Development of Financial Institutions Act 2002, Laws of Malaysia Act 618.
[896] ibid 886.

(MIFC).[897] This initiative promotes the development of Islamic banking and Shariah compliant products. These products include Sukuks, Islamic fund and wealth management, International Islamic banking, human capital development, International Takaful, Retakaful, and professional ancillary services.[898] The Rahmat firm reports, “[t]he MIFC initiative has gained global recognition for its efforts in shaping the Islamic finance industry, and the Malaysian Government remains strongly committed to positioning Malaysia as a leading international Islamic finance hub.”[899]

It is not solely the hybrid combination of Islamic and conventional banking that has led to a stable banking system in Malaysia. Additionally, the blend of domestic and international banks also encourages more competitive behavior in the domestic banking market. Moreover, because Malaysian domestic banks maintain a presence in neighboring Singapore, as well as in eighteen other countries worldwide, the integration into other systems aids these banks in reinforcing banking systems back home.[900] Assets for Malaysian banks overseas have increased from RM 3.3 billion in 2002 to RM 258 billion in 2010.[901]

This chapter argues that the ability of the Malaysian banking industry to grow and compete both domestically and internationally is due partly to the strong governance and risk management practices in place within banks that are overseen and regulated by the central bank, BNM. Contrarily, the structure of financial markets in Saudi Arabia, and the regulatory framework governing it, has failed to narrow the gap between Islamic models of banking and the paradigmatic form of interest based banking of the West, nor knit its own domestic policies into the international norms and realities of the modern global banking industry. Saudi banks, therefore, operate in a comparatively less stable, competitive and high growth banking environment.

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[897] See general information on the Malaysian Islamic Finance Community and Marketplace at Malaysia: World’s Islamic Finance Marketplace (MIFC) <http://www.mifc.com/index.php?ch=ch_header_contact_us&pg=pg_header_aboutus/> accessed 1 April 2017

[898] ibid, see also section on Malaysian International Islamic Finance Centre Regulators (1 November 2006) <http://www.bnm.gov.my/index.php?ch=en_press&pg=en_press&ac=766&lang=en> accessed 1 April 2017.

[899] Rene Bosch Homburger (ed), *Banking Regulation Jurisdictional Comparisons* (2nd edn, Thomson Reuters 2014).

[900] IMF, ‘Malaysia: Financial Sector Assessment Program’ (IMF Country Report No 14/95, April 2014).

[901] ibid 1, see also, BNM, ‘The Financial Stability and Payment Systems Report 2015’ <http://www.bnm.gov.my/files/publication/fsps/en/2015/fs2015_book.pdf> accessed 1 April 2017; See also Ministry of International Trade and Industry (MITI), ‘Malaysia: International Trade and Industry Report’ (2010).

6.2.3 The Regulatory Architecture of Malaysian Banking System.

As has been shown, a robust legal framework has been in place for many years for the finance sector in Malaysia, consisting of a dual operating banking system of conventional and Islamic banking. To best facilitate this dual-banking system, the legal structure regulates each group separately, each with their own laws. Under conventional banking, commercial banks were governed by the Banking and Financial Institutions Act of 1989.[902] Investment banks are governed by the same act and, in addition, the Capital Market and Securities Act 2007.[903] Additional legislation was added to this through the comprehensive Financial Services Act 2013.[904]

Islamic banks are governed by the Islamic Banking Act 1983, and the amendments introduced by the Islamic Financial Services Act in 2013. The banking sector is regulated by Bank Negara Malaysia (BNM), which is empowered to act as the Central Bank and the national regulator. BNM was established in 1959 as the Central Bank, under legal powers defined under the Central Bank of Malaya Ordinance 1958.[905] These powers were extended to cover financial regulation in 1989 under the Banking and Financial Institutions Act 1989.

BNM's current legal oversight authority is set forth by the Central Bank of Malaysia Act 2009 (replacing earlier laws and ordinances), which describes BNM's legal powers to intervene in the markets to reduce systemic risk and to stem market liquidity shocks.[906] To achieve this, BNM employs a risk based approach and monitors institutions on their risk profiles and the sufficiency of their risk management systems.[907] This Act also ensures that BNM remains operationally independent and can exercise power without any external influence.[908]

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[902] Shaikh Mohamed Noordin and Shanthi Supramaniam, 'Update: An Overview of Malaysian Legal System and Research' (NYU Hauser Global Law School Program, June 2016) <http://www.nyulawglobal.org/globalex/Malaysia1.html> accessed 1 April 2017.

[903] ibid.

[904] ibid.

[905] Laws of Malaysia Act 519, Central Bank of Malaysia Act 1958 (revised, amended and repealed in part in 1994 and 2009).

[906] Laws of Malaysia Act 701, Central Bank of Malaysia Act 2009; see also section 5 and Akhand Akhtar Hossain, *Central Banking and Monetary Policy in Muslim-Majority Countries* (Edward Elgar 2015) 224.

[907] ibid, section 25.

[908] ibid.

BNM supervises both conventional and Islamic banks in addition to other financial institutions. This joint treatment ensures consistent and equivalent treatment of all banks, however there is a clear legal distinction in operation and control. This enables BNM to achieve oversight over financial conglomerates and, thus, reducing the risks of large scale defaults. Within BNM, a separate oversight body has been established as the highest authority to deal with Islamic Banking. The Shariah Advisory Council (SAC) controls Islamic finance legal issues, contracts, product definition, and the governance of the Islamic finance sector. The main legislation for this, the Bank Negara Malaysia Bill of 2009 ("BNM Bill 2009"), sets this out in several areas.[909]

In Section 27, BNM Bill 2009 states how, "the financial system shall consist of conventional and Islamic financial systems", while Section 56 (1) explains the separate and binding legal oversight within BNM, stating that, "[t]he court or arbitrator shall take into account published ruling of BNM's SAC and refer any Shariah questions to SAC for its ruling". Lastly, Section 57 commits to Islamic banking institutions by explaining, "[r]ulings of SAC shall be binding on Islamic finance institutions, courts or arbitrators and these rulings are final."[910] As the next chapter will show, Saudi Arabia lacks equivalent provisions, leading to much uncertainty over the applicability and applicable scope of Shariah standards, particularly, as these relate to an aspect of Basel implementation or the interpretation and application of the relevant company, finance, and corporate governance laws.

In respect of the Malaysian policies and laws on corporate governance, BNM has achieved considerable success by conducting only supervision exercises through thorough risk management, placing importance on the institutions' own internal oversight functionalities.[911] To achieve this, the BNM regularly uses external auditors and actuaries to anticipate and assess risks and rectify emerging problems.[912] In addition, BNM has taken steps to build the

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[909] ibid.

[910] Laws of Malaysia Act 701, Central Bank of Malaysia Act 2009; see also, on the effect of Act 701, The Oxford Business Group, 'The Report: Malaysia 2010' (2009) 84.

[911] Penyampai Muhammad bin Ibrahim, 'Governor's Keynote Address at the Future Finance Conference 2016' (BNM, 23 September 2016) <http://www.bnm.gov.my/index.php?ch=en_speech&pg=en_speech&ac=700&lang=bm/> accessed 13 October 2017; see also, Siti Muawanah Lajis and others, 'Chapter 11: Regulatory Framework for Islamic Finance: Malaysia's Initiative' in Muhamad Zulkhibri and others (eds), *Macroprudential Regulation and Policy for the Islamic Financial Industry* (Springer International 2016) 177; See also, Salinah Hj Togok and others, 'Enterprise Risk Management Adoption in Malaysia: A Disclosure Approach' (2016) 9(1) Asian Journal of Business and Accounting 83, 85.

[912] Central Bank of Malaysia Act 2009, section 3.

capacity and the knowledge of the board members and the senior management of financial institutions to ensure adequate knowledge of the processes. In this process, BNM has fostered a greater work ethic and an increased awareness to the risks involved.[913]

Apart from the BNM, the Minister of Finance has been given substantial powers under the Central Bank of Malaysia Act 2009 (CBA). The office of the finance minister is the authority for granting banking licenses and setting out the terms and conditions of those licenses.[914] They also have the power to revoke licenses as and when required and initiate investigations into any matter as may arise.[915] These licenses are separate from the powers of BNM which have issued guidelines and notifications in this regard that relate to money laundering, prudential limits, financial reporting and capital adequacy for licensing.[916]

In addition, the banks of Malaysia are also regulated by the Securities Commission which is a statutory body established by the Securities Commission Act 1993. This body regulates the activities of the capital markets.[917] The Securities Commission works closely with BNM to regulate investment banks and other capital markets. They have jointly issued Guidelines on Investment Banks to ensure safety of the investors and promote the integrity of the market.[918]

Apart from the commission, financial activity is redirected to the IBFC in Labuan. The governing law for IBFC is the Labuan Financial Services Act. Labuan banks are governed by the Labuan Financial Services and Securities Act 2010 and the Labuan Islamic Financial Services and Securities Act 2010 for conventional and Islamic banking respectively.[919]

The development of financial markets (as well as financial regulation and wider corporate governance in Malaysia) has changed dramatically over the past two decades. The government, and with it, the BNM as the central bank and regulator, remain committed to the

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[913] See, generally, BNM, 'Recent News and Statistics Sections' <http://www.bnm.gov.my/> accessed 14 October 2017.
[914] Central Bank of Malaysia Act 2009, section 2.
[915] See, Malaysian Ministry of Finance, 'Ministry's Profile: History' and 'Client's Charter' sections on <http://www.treasury.gov.my/index.php/en/> accessed 14 October 2017.
[916] Central Bank of Malaysia Act 2009, section 59.
[917] Suruhanjaya Sekuriti (Securities Commission Malaysia) <https://www.sc.com.my/> accessed 1 April 2017.
[918] Securities Commission Malaysia, 'BNM/RH/GL/018-2: Guidelines on Investor Protection' <https://www.sc.com.my/wp-content/uploads/eng/html/resources/guidelines/investor/gl_investorProtection_101217.pdf> accessed 10 April 2017.
[919] For information on Labuan regulatory history and roles, see Labuan International Business and Financial Center (IBFC) and Financial Security Authority (FSA) <https://www.labuanibfc.com/> accessed 10 April 2017.

development of a more robust and more diversified financial system. The motives for this include the desire for economic growth, to adapt to regional competition, technological improvements, and more discerning local customers. The major driver behind the re-engineering the banking system was the Asian Financial Crisis of 1997, with the most dramatic and focused changes having taken place in the years immediately thereafter.

The next section identifies these post-crisis changes, the new laws and regulations introduced to strengthen the Malaysian markets, and the initiatives that have gone along with this to develop a better, more stable, and more internationally competitive financial services sector.

6.2.4 Banking Regulations in Malaysia Prior to the Asian Crisis

Prior to the Asian Financial Crisis of 1997, banks in Malaysia were operating well against a thriving economic backdrop.

There were, however, shortcomings in several areas even prior to the 1997 crisis. A study carried out in 1998 by the Asian Development Bank took a retroactive look at corporate governance in Malaysia and other Southeast Asian countries, and reported a number of key weaknesses.[920] These included: ineffective operation within board and director level oversight, weak internal controls, insufficient legal enforcement, and weak disclosure requirements and procedures across all corporations.[921]

In July 1997, Malaysia was hit hard by contagion from the financial crisis.[922] Following the devaluation of the Thai currency, the Malaysian 'Ringgit' halved in value. To re-build a more impervious financial sector, the Malaysian government launched initiatives in two main areas. The first of these was restructuring to assist the financial sector in its recovery and to better equip institutions for future growth and competitiveness. The second was to launch a long-term plan to improve financial stability, the so-called Financial Sector Master Plan.

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[920] Asian Development Bank, 'A Study of Corporate Governance and Financing in Selected Developing Member Countries' (November 1998) 4.

[921] ibid.

[922] Zubair Hasan, 'The 1997-98 Financial Crisis in Malaysia: Causes, Response, and Results' (2002) 9(2) Islamic Economic Studies 1; See also Mohamed Ariff and Syarisa Yanti Abubakar, 'The Malaysian Financial Crisis: Economic Impact and Recovery Prospects' (1999) 37(4) The Developing Economies 417; see also, Asish Saha and others, 'Evaluation of Performance of Malaysian Banks in Risk Adjusted Return on Capital (RAROC) and Economic Value Added (EVA) Framework' (2016) 12 Asian Academy of Management Journal of Accounting and Finance 25.

As discussed in the next chapter, the Saudi Arabian financial sector currently shows very similar weaknesses to that of Malaysia in its pre-financial crisis in 1997, i.e. ineffective operation of board and director level oversight, weak internal controls, insufficient legal enforcement, and weak disclosure requirements and procedures across all corporations.

6.2.5 Reforms to Banking and its Regulation after the Crisis

In 1998, the Malaysian government took several measures to restructure the damaged financial sector.[923] In 1999, an initiative was launched in Malaysia to consolidate the large and fragmented banking industry.[924] Pre-crisis there were more than fifty five banking institutions in Malaysia. Through consolidation this was reduced to thirty institutions, organized into ten banking groups. This reform was complete by 2002. Saudi Arabia, unlike Malaysia has an advantage for the purposes of effectively implementing regulatory framework because there are only currently twenty four licensed banking institutions in the Kingdom.[925] In theory, with fewer licensed financial institutions, Saudi Arabia could more easily develop, implement, and oversee the financial industry and could thereby provide more stability than its Malaysian comparison.

The massive overhaul of the industry laid the foundation for the re-emergence of the financial sector characterised as a potent global finance player, and a stable, well capitalised operation. Recalling the early success of these restructuring operations, Zamani writes in a BIS publication how the, "early and comprehensive intervention [by the government] proved to

[923] Barbara Casu and others, 'Post-Crisis Regulatory Reforms and Bank Performance: Lessons from Asia' (2016) The European Journal of Finance 1; see also, Shazida Jan Mohd Khan, 'Chapter 12: Southeast Asia and Financial Crisis: Causes, Experiences and Challenges' in Norhayati Zakaria and others (eds), *Handbook of Research on Impacts of International Business and Political Affairs on the Global Economy* (IGI Global 2016).

[924] Mah-Hui Lim and Soo-Khoon Goh, 'How Malaysia Weathered the Financial Crisis: Policies and Possible Lessons' (The North-South Institute, 2012) <http://www.nsi-ins.ca/wp-content/uploads/2012/09/2012-How-to-prevent-the-next-crisis-Malaysia.pdf> accessed 14 October 2017; see also, Tinfah Chung, 'Malaysia's Central Bank Response Post 1997 Asian Financial Crisis' (2014) 4(1) Taylor's Business Review 31; see also, Fauzias Mat-Nor and others, 'Financial Performance and Efficiency Changes of Malaysian Banking Institutions in Mergers and Acquisitions' (2006) 1(1) Banks and Bank Systems Business Perspectives 102.

[925] Jeddah Chamber, 'Saudi Arabian Banking Sector Report (November 2015)' 4; see also, Oxford Business Group, 'Growth Continues as Saudi Arabia's Banks Diversify their Revenues and Banking Sector Shifts Towards Increased Use of Technology' (2016) <https://www.oxfordbusinessgroup.com/overview/position-strength-growth-continues-banks-diversifying-their-revenues-while-there-has-been-shift/> accessed 14 October 2017.

be fruitful - the key to this success has been the timely, prompt and holistic approach adopted."[926]

Additionally, increasing the capacity and efficiency of financial institutions has helped Malaysian banks grow despite intense international competition. Group synergies have led to cost reductions as well as enhanced product selling. Legislative changes were also made to assist the larger group structures to work more efficiently. These changes made it possible for a single legal entity to conduct banking services as well as finance company operations. Finally, greater flexibility was introduced by allowing more outsourcing of certain core services to third parties, subject to regulatory oversight and compliance with standards.

In addition to undergoing coordinated restructuring, the Malaysian government showed its commitment to the long-term restructuring and growth of the financial sector through the early development of a comprehensive plan for the sector. Launched in 2001, the Financial Sector Master Plan ("FSMP") was a ten-year plan designed to improve financial stability, resilience and competitiveness. The first phase focused on strengthening skills, the capacity of domestic financial institutions, and the strengthening of the regulatory and supervisory framework. The second phase then promoted competition of the sector by improving efficiency, including expansion of banking services and products offered. The last phase integrated Malaysia's financial system with the global economy.[927]

The FSMP included a comprehensive plan for the growth and future direction of the capital markets, known as the Capital Market Masterplan ("CMP"). This ten-year FSMP, along with the restructuring of markets, has gone a long way towards creating the reliable and strong financial sector of today. BNM reports that over the ten-year period of FSMP implementation, the capitalisation of domestic banks rose from 11.7% of risk-weighted assets to 14.2%.[928] Additionally, the non-performing loans ratio of domestic banks fell from 9.2% to

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[926] Abdul Ghani Zamani, 'Re-engineering the Malaysian Financial System to Promote Sustainable Growth' (BIS Paper No 28) 269.

[927] BNM, 'Financial Sector Masterplan 2001-2010' (2001) chapters 1 and 2 <http://www.bnm.gov.my/index.php?ch=en_publication&pg=en_fsmp&ac=7&en/> accessed 10 April 2017.

[928] BNM, 'Financial Sector Blueprint 2011-2020' (2011) 32 <http://www.bnm.gov.my/index.php?ch=en_publication&pg=en_fsmp&ac=8&tpt=9&en/> accessed 14 October 2017.

2.6%. Further, the financial sector in Malaysia grew exponentially at an average annual rate of 7.3%.[929]

To support the augmentation and stability of the sector, a number of lasting initiatives have been introduced. These have all been integrated into the legal framework of the Central Banking Act 2009, the Financial Services Act 2013, and the Islamic Financial Services Act 2013. Some of these will be looked at further as examples of the strength of financial markets in a later section. Initiatives include: improvements in financial consumer protection, introduction of deposit insurance schemes, development of the bond market, development of reliable and secure payment systems, the introduction of financial literacy and education programs, enhancement of anti-money laundering initiatives, aligning prudential regulations to international standards, including accounting standards (FRS 139) and, improvements in risk regulation and implementation of Basel standards.[930]

Culminating from the restructuring of the markets and the initiatives set forth in the FSMP, in 2010, the BNM, through its role as the Central Bank, released a new ten-year plan for the continued development of the financial services sector. This plan is known as the Financial Sector Blueprint.[931] The Financial Sector Blueprint contains nine overall focus areas, sixty nine specific recommendations, and over two hundred initiatives.[932] It aims to strike a balance between improving the regulatory environment and stability, and opening up areas to increase competition, including through increasing lending to lower income depositors, the international branch of Islamic finance led by the IFSB and Malaysian banks such as the BIMB.[933]

The Financial Blueprint was to be further reinforced by the introduction of new laws for financial services legislation through the Financial Services Act 2013 ("FSA") and the separate Islamic Financial Services Act 2013934 ("IFSA") also came about as part of this Financial Sector Blueprint. The FSA was drafted under this blueprint as a controlling legislation that repealed and replaced the previous Exchange Control Act, Insurance Act, Payment Systems Act and the previous Financial Services Act 1989. Similarly, the IFSA was

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[929] ibid.
[930] ibid.
[931] see BNM (n 819).
[932] ibid.
[933] ibid.
[934] Laws of Malaysia Act 759, Financial Services Act 2013.

introduced for governing all aspects of Islamic banking and subsequently repealed and replaced many statutes that include the previous Islamic Banking Act 1983 and the Takaful Act.

Such action demonstrates Malaysia's continued commitment to being an Islamic financial hub, increasing financial inclusiveness, and reducing vulnerabilities in its financial system.[935] Unlike Malaysia, Saudi Arabia does not have a specific blueprint for financial growth, but in 2016 the Kingdom did announce a National Transformation Plan ('Vision 2030') to overhaul its economy and strategically grow industries.[936] This could be an introduction to specific reforms such as those implemented by Malaysia via their Blueprint. Additionally, while SAMA publishes annual reports on the status and progress of Saudi Arabia's financial sector, they lack the specific details seen in Malaysian documentation, such as the blueprint.[937]

Malaysia has shown vigorous commitment to developing regulations and guidelines that are specific to Islamic finance. As well as having a separate legal framework for Islamic finance through the Islamic Financial Services Act 2012, Malaysia and BNM, collaborates with the Islamic Financial Services Board (IFSB). Established in 2003, the IFSB has been incorporated into all restructuring and long-term initiatives of the FSMP and the 2011 Blueprint. Although the IFSB is based in Malaysia, it is considered to be a standard-setting body for the entire Islamic financial industry, operating with banks on a global level. Saudi Arabia also has direct association with IFSB, thereby providing relational and functional comparisons between the financial systems of both Malaysia and Saudi Arabia.

On the whole Malaysian banks are seen as industry leaders in the development of Islamic standards.[938] For instance, the Bank International Malaysia Berhad (BIMB), which is the first Islamic Bank to be established in Malaysia, provides a clear example of BNM's oversight and regulatory strength in action. BIMB falls under the authority of BNM, but has also taken autonomous steps to design and implement its own Islamic financial tools and standards including by establishing its own risk management guidelines, which highlights six factors of

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[935] ibid.

[936] Simon Kerr, 'Saudi Arabia Reveals Plan to Transform its Economy' *Financial Times* (4 June 2016).

[937] SAMA, 'Financial Status Report' (2016) <http://www.sama.gov.sa/en-US/EconomicReports/Financial%20Stability%20Report/Financial%20Stablity%20Report%202016_en.pdf> accessed 10 April 2017.

[938] Nafis Alam and Christine Ennew, 'Islamic Finance Goes Global, But Malaysia Still Leads the Way' (*The Conversation*, 14 September 2014) <http://theconversation.com/islamic-finance-goes-global-but-malaysia-still-leads-the-way-27347/> accessed 10 April 2017.

market risk, including: rate of return or profit risk, equity investment risks, interest and foreign exchange related risks, displaced commercial risks, trading book risks, and liquidity risks.[939] Most importantly, the BIMB has taken the innovative step of calibrating its IFSB standards to ensure compliance with both Shariah and Basel requirements, and capital measurement and risk weighting requirements.[940]

Along with the development of the Financial Sector Blueprint, the Malaysian government set targets for the structure and composition of the financial sector by the year 2020.[941] Looking at this illustrates both where the financial sector is aiming to be, and the impressive joint strategy of the government, central bank, regulator and individual financial institutions to achieve the goals set forth in the Blueprint, namely to be the global industry leader in Islamic Banking by 2020.

The market in Islamic services is expected to increase up to six times GDP (up from 4.3 times GDP in 2010), with the financial sector then contributing around 10% to 12% of GDP.[942] The financial targets are designed to fully serve Malaysian domestic needs, as well as growth in the ASEAN region first, then in emerging Asian economics and the wider international markets. In contrast with Saudi Arabia's less diverse market, Malaysian Banks such as BIMB have lead the charge to wider range of Islamic products and services to meet the demands of their consumers, leading to higher levels of saving deposit rate and profitability. This will include the expansion/introduction of Islamic funds, infrastructure funds, venture capital and the private equity industry. Activity is also expected to increase in domestic debt securities, particularly originating from domestic banks. This can be contrasted with the currently conservative approach to debt based lending in Saudi Arabia, as discussed in the next chapter.

Countries like Saudi Arabia, U.A.E., Iran and Bahrain have yet to develop comparable financial plans, and supporting regulations, and are generally viewed to be lagging behind

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[939] ibid.

[940] Faridah Najuna Misman and M Ishaq Bhatti, 'Risks Exposure in Islamic Banks: A Case Study of Malaysia Berhad (BIMB)' (La Trobe University, School of Economics and Finance: Faculty of Law and Management, Unpublished Study, 2010) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1632849> accessed 14 October 2017.

[941] BNM (n 819) 50-57.

[942] Measured as of loans outstanding, stock market capitalisation and bonds outstanding, relative to GDP; see also, KPMG, 'Malaysia: High Growth Markets Country Profile' (2014) <https://assets.kpmg.com/content/dam/kpmg/pdf/2015/02/malaysia-hgm.pdf> accessed 14 October 2017; see also, Capital Markets Malaysia, 'Malaysian Economy: Domestic Demand Underpins Healthy Growth of 4.3-4.8% in 2017' (4 April 2017) <http://www.capitalmarketsmalaysia.com/malaysian-economy-domestic-demand-underpins-healthy-growth-of-4-3-4-8-in-2017/> accessed 14 October 2017.

Malaysia's high growth, which is well-regulated and capitalised, and, consequently, investor friendly banking.[943] One of the main strategies for financial sector development has been the improvement of consumer protection. The high level strategic goals of this have been the protection and education of customers.[944]

6.2.6 The Strengths of the Malaysian Framework of Risk Regulation and Governance

A well-developed legal framework is important to the successful implementation and operation of deposit insurance. In a review of PIDM implementation in 2013, the IMF reported on the strength and appropriateness of this legal setup in Malaysia.[945] In particular, the following aspects of the legal system were highlighted: oversight of insurable loss claims by an independent, professional judiciary backed by an adequate remuneration system; a legal framework for handling banking failures and effective resolution; sufficient legal protection to safeguard information exchange between deposit insurance scheme participants and the supervisor;[946] the statutory protection of a consumer's or investor's right to pursue legal action against the management of a failing bank, including in respect of Islamic profit and loss sharing schemes; and a regular review and updating of laws to ensure they remain relevant to a rapidly changing industry.[947] The IMF report on Malaysia emphasises the depth of the accountability, transparency, and means of addressing abuses, fraud or negligence by banks, and by regulators themselves, in respect of the management of consumer funds and investor deposits.

Saudi Arabia has not yet implemented equivalent deposit based protections, which, as the next chapter will demonstrate, has several impacts on the distribution and allocation of risk (between the bank, investor or saving depositor) under Islamic finance arrangements, and on the exposure of Saudi banks, Islamic and conventional, to liquidity and credit related risks.

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[943] IMF, 'GCC Surveillance Note: Economic Prospects and Policy Challenges for the GCC Countries' (Annual Meeting of Ministers of Finance and Central Bank Governors, 26 October 2016) 18; for a discussion on Bahrain see also, Michael C Ewers and others, 'Creating and Sustaining Islamic Financial Centers in the Wake of Financial and Political Crises' (2016) Urban Geography Journal 1.

[944] Suhaimi Ali, 'Market Conduct Regulation & Supervision: The Malaysia's Experience' (BNM Presentation during International Seminar on Market Conduct: A New Era of Conduct Supervision: Consequences, Challenges & Opportunities, Bali, September 2014).

[945] World Bank, 'Malaysia - Detailed Assessment of Observance of Core Principles for Effective Deposit Insurance Systems: Detailed Assessment of Observance' (World Bank, Working Paper 79212, 2013).

[946] Malaysia Deposit Insurance Corporation Act 2005 (PIDM Act) section 24.

[947] ibid.

6.3 Compliance with International Standards: Malaysia as a Model of Good Governance?

Preserving financial stability is a key aim of the Malaysian government and its regulators. A major part of this is increasing the alignment between local practices and international standards in the areas of supervisory frameworks, risk-based regulation and prudential standards. The Basel II and III regulations are implemented in line with Basel Committee standards, and this will be discussed in detail in a later section as it is of additional relevance to this thesis.

Malaysia has followed international prudential regulations and accounting standards since 1978, and the International Accounting Standards of IAS 39 are implemented as local regulations.[948] There have been challenges with parts of this integrating to local markets, and an emphasis on maintaining and improving such standards will remain as part of new initiatives and plans.[949] The international accounting standards, in particular, signify the maturity of the system. In a similar effort, in 2016, Saudi Arabia announced plans to incorporate international accounting standards within its system, beginning in January 2017.[950]

In line with global efforts in recent years, Malaysia has implemented new anti-money laundering measures. A central committee has been established to deal with these issues, resulting in the release of new legislation, the Anti-Money Laundering Act 2001. These laws are implemented through BNM,[951] and apply to all listed financial institutions. The regulations include requirements to report details of suspicious transactions, and comply with 'know your customer' guidelines, and implement comprehensive policies and procedures for

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[948] Malaysian Institute of Accountants, 'Financial Instruments: The Acclaimed Mother of All Standards, Effective 1 January 2010)' (January 2010, MIA/ 4/2009); see also IFRS, 'IFRS Application Around the World Jurisdictional Profile: Malaysia' (8 February 2017); see also, Hajah Mustafa Mohd Hanefah and Jaspal Singh, 'Convergence Towards IFRS in Malaysia: Issues, Challenges and Opportunities' (2012) 1 International Journal of Business, Economics and Law 43, 45.

[949] ibid.

[950] Dominic Dudley, 'Saudi Arabia is About to Adopt International Accounting Standards and it Could Cause Problems' (*Forbes*, 10 April 2016) <http://www.forbes.com/sites/dominicdudley/2016/04/10/saudi-arabia-is-about-to-adopt-international-accounting-standards-and-it-could-cause-problems/#73049a002ea8/> accessed 10 April 2017.

[951] BNM, 'Malaysia Anti Money Laundering & Counter Financing of Terrorism Regime' < BNM, 'Malaysia Anti Money Laundering & Counter Financing of Terrorism Regime' <https://www.bnm.gov.my/guidelines/07_msb/05_policy_msb_amlcft.pdf> accessed 10 April 2017> accessed 10 April 2017.

customer and transaction monitoring. Given the successful implementation in this area, BNM has been called upon to assist other banks in the region with their AML issues. They have assisted the establishment of a similar program with the State Bank of Pakistan, and have acted as expert evaluators for other jurisdictions including Macau, China, Fiji, and the Philippines.[952]

6.3.1 Basel Implementation and Consideration of the IFSB in Malaysia

Malaysia has fully implemented Basel regulations since their outset, but has simultaneously maintained Shariah specific adaptations to its regulations, which align to the conventional Basel standards. This section looks at this implementation and the changes made to suit the local market. Malaysia is a leading example of a country that has made changes to the regulations to better match its specific banking system and products. This has been ongoing since Basel I and Basel II implementation. These changes and adaptations are now mostly complete and will be shown here to highlight the progress made by BNM and the implementing banks in adapting the regulations. Similar changes are ongoing and are planned for Basel III, and current proposals in this area will be explained below.[953]

The strength of Malaysia's current banking system can be attributed to its ability to safeguard its assets and retain high levels of institutional liquidity. Or in other words, Malaysia has engineered a system of preserving capital above required limits by investing high quality assets, taking advantage of higher profits, and utilising the infusion of governmental investment from state-linked entities, such as the pension fund. The result is a smart and stable marriage of Shariah and Basel compliance mechanisms. Malaysia blends regulatory components from the Islamic standard setting authority, the IFSB, with the recommendations of the Basel Committee to achieve its financial strength and resilience. Recent statistics reflect the success of this approach: overall banking in Malaysia has exceeded a 15% capital ratio threshold over the past 4 years.[954] In fact, Malaysia has consistently held an excess of the minimum 8% capital threshold as set by Basel standards, and even exceeded such liquidity standards during the 2008 global financial crisis with an average RWCR of

[952] Zamani (n 817) 269.
[953] BNM (n 771).
[954] ibid.

13.1%,[955] thus proving the consistency and tenacity of its reformed system, post-Asian Financial Crisis.

While Malaysia maintains a dual system with dual standards unique to each 'branch', i.e. one for conventional banks and one for Islamic banks, this system does not isolate each 'branch' but rather mandates cross-regulation between the two as a means of reinforcing the entirety of the system. BNM as the ultimate oversight authority mandates that all financial institutions operating in Malaysia, including Islamic financial institutions, are subject to the Basel framework.[956] BNM additionally regulates that Islamic banking institutions also remain subject to the rule and decision-making authority of the Islamic Financial Services Board (IFSB), but it should be noted that BNM is the only banking regulatory authority within Malaysia.[957] BNM adheres to IFSB's standard setting practices because they provide good governance and risk management templates for a clear legal framework, supervisory review, transparency and other elements into Islamic finance, while prioritising higher regulatory expectations for more transparency, and the need for the effective management of risks and capital.[958]

IFSB has delineated four standards that all Islamic financial institutions should observe when operating in commercial banking activities. As will be discussed in further detail in the next chapter, standards set forth by IFSB demonstrate the pragmatic approach of Malaysia's Shariah Advisory Council in researching methods on how fatwas can be made in-keeping with Islamic tradition, whilst concurrently conforming to the regulatory structure and requirements formalised under Basel.[959] The first standard set forth by IFSB is the introduction of capital adequacy standards for all entities offering Islamic financial services, except insurance companies. The second are provisions that give guidance regarding finance-sector-specific risk management that are applicable to Islamic institutions. However, these provisions exclude Takaful (or Islamic insurance). Third, are the new rules governing

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[955] BCBS, *A Framework for Dealing with Domestic Systemically Important Banks* (BIS 2012).
[956] BNM (n 771).
[957] IFSB, 'Revised Capital Adequacy Standard For Institutions Offering Islamic Financial Services: Excluding Islamic Insurance (Takāful) Institutions And Islamic Collective Investment Schemes' (March 2014) <http://www.ifsb.org/standard/IFSB-16%20Revised%20Supervisory%20 Review%20Process_March%202014%20(final-clean).pdf> accessed 14 October 2017.
[958] BNM, 'Governor's Welcoming Address at the 10th IFSB Summit 2013 - The Future of the Islamic Financial Services Industry: Resilience, Stability and Inclusive Growth' (16 May 2013) <http://www.bnm.gov.my/ index.php?ch=en_speech&pg=en_speech&ac=465&lang=en/> accessed 14 October 2017.
[959] IFSB (n 473).

corporate disclosures regarding capital structure and risk management profiles; the purpose of this standard is to promote accountability and transparency, but also excludes Takaful related services. The final standard gives regulatory guidance on the supervisory control and oversight of Islamic financial services, except for the insurance industry and mutual funds.

While the IFSB standards set forth above are influential, they nonetheless remain open-ended and unbinding.[960] Because of the lack of an obligatory nature of IFSB standards, BNM has developed guidelines that allow for better integration of IFBS standards to the Basel framework. In contrast with the IFSB standards, which are voluntary and 'soft' in nature, the guidelines issued by the BNM are de facto binding on Islamic banking institutions within the realm of authority of the BNM.

As will be demonstrated in the next chapter, Saudi Arabia has yet to institutionalise adequate corporate governance and enforcement mechanisms, buttressed by relevant rule of law safeguard and a consensus driven approach to standard setting.[961] As a result, it is doubtful whether Saudi Arabia has the institutional capacity and governance framework to articulate and implement Shariah and Basel compliant standards that are comparable to those currently 'mainstreamed' in banks across Malaysia. Nonetheless, Malaysia's BIMB and BNM, the banks used for this case study, can be looked upon as a prime 'model' of a modernised Islamic banking system, and one, moreover, which Saudi Arabia could plausibly emulate. Advancements in technology, rising customer expectations, geopolitical pressures, market reforms, and increased competition from alternative financiers have redrawn the financial landscape.[962] IFSB and BNM strive to achieve a sound and effectively regulated Islamic financial system, that shall not only evolve but stabilise through the next global or regional financial market crisis. For example, the IFSB systematically reviews specific measures put forward by the Basel Committee for possible adoption in Islamic finance.[963] Resultantly, the interaction between Basel and Islamic banking regulation in Malaysia is not one of conflict

[960] Jaseem Ahmed, 'The Islamic Financial Services Board: Setting Standards for Islamic Finance' (IAASB Consultative Advisory Group Meeting, 7-8 March 2017) 17; see also, Nawal Kasim and others, 'Comparative Analysis on AAOIFI, IFSB and BNM Shari'ah Governance Guidelines' (2013) 15 International Journal of Business and Social Science 220.

[961] Zulkifli Hasan, 'Regulatory Framework of Shari'a Governance System in Malaysia, GCC Countries and the UK' (2010) 3(2) Kyoto Bulletin of Islamic Area Studies 82.

[962] Reserve Bank of Australia, 'Submission to the Financial System Inquiry' (March 2014) 43 <http://www.rba.gov.au/publications/submissions/financial-sector/financial-system-inquiry-2014-03/pdf/financial-system-inquiry-2014-03.pdf> accessed 14 October 2017.

[963] Governor's Welcoming Address (n 849).

or competition, but of mutual accommodation and adjustment. Islamic authorities, standard setting bodies, and industry leaders learn from the weaknesses and strengths of the others towards the goal of modern system of banking regulation and governance which is grounded in overarching principles of economic efficiency and governance and fairness.

Set against this background, this section specifically looks at the status and the challenges of Basel implementation in Malaysia through the lenses of the BNM, IFSB, BIMB, and conventional international banks. This includes capital adequacy levels as well as compliance with new ratios introduced in Basel III for measuring leverage and liquidity. Building on the previous chapter, which introduced the Basel system and requirements, some analysis will also be shown to highlight status in implementation of Pillar 2 and Pillar 3 requirements. As a brief recap from Chapter 4, Basel III established four sets of reforms, including increasing capital adequacy thresholds to 8%;[964] delineated classification of risks for types of capital held by banks in proportion to risk weighted assets;[965] loss absorption measures for unredeemed stock; liquidity rules; and pillars for capital planning as well as market disciplines.[966] The next section of this chapter considers whether Malaysia can be said to have fully and effectively implemented Basel III standards, and, moreover, done so, in a manner that best reflects the needs and requirements of Shariah compliant banking.

6.3.2 Basel Implementation in Malaysia

Since the release of Basel regulations by the Basel Committee on Banking Supervision (BCBS), BNM as the banking regulator has supported the national adoption of Basel standards in Malaysia. As previously discussed, the rollout of Basel II began in 2008, with transition to the Internal Ratings Basel (IRB) approach using an internally developed ratings system starting in 2010. Basel II implementation included full implementation of Pillar 1 (capital calculation) as well as Pillar 2 (supervisory review) and Pillar 3 (disclosure requirements).

Importantly, Malaysia is under no formal obligation to implement Basel guidelines as national law. While international guidelines stipulate BCBS regulations should be adopted by the twenty seven member countries and all G20 nations, Malaysia is not one of the chartering

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[964] BCBS (n 1) para 94.a.
[965] ibid para 50.
[966] BCBS (n 561).

or core members of the Basel Committee.[967] By electing to observe 'soft' guidelines issued under Basel, Malaysia is but one more country that has sought to bring its own laws into line with international standards which exert a growing 'compliance pull' on developed and developing, Islamic and conventional, banking systems alike.

In respect of the above point, the Central Bank of Malaysia, the Bank of Malaysia has demonstrated its willingness to phase in various capital measurement, risk supervision and market disclosure standards and techniques, over each successive phase of Basel III implementation, ending in 2019.[968] However, in a departure from the universal model of banking regulation, Malaysian banking regulators have adopted a more flexible approach to adopting Basel standards, principally by allowing for greater levels of customization, adaption and integration of Basel regulatory baselines to the specific operational needs and risk exposures of particular banks. Accordingly, Basel capital and liquidity ratios are assessed and adjusted, within regulatory parameters, to allow for accommodation of the financial structure and risk potentialities of local banks. Accordingly, Malaysian banking authorities, operating under the regulatory supervision of the BNM, are expected to adhere to and implement Basel approved revised capital ratios for Tier 1 (common equity) capital in the range of 2.5% of risk weighted assets, while still allowing for some flexibility by national regulators to set precise limits to reflect changes in the local market.

Enhanced Pillar 1 rules for trading books, complex securitization exposures and counterparty credit risk from such activities will not be implemented yet due to their lower relevance to the Malaysian finance market. Finally, liquidity ratio rules will be fully implemented (both the short term LCR and longer term NSFR) and operational risk will remain on the Basic Indicator Approach (BIA) as per Basel II standards.

6.3.3 Malaysia's Path to Basel III Compliance and Implementation

BNM has developed multiple guidelines for successful integration and coherence of standards issued under Basel and the standards developed by the IFSB.[969] Both Basel and IFSB address capital adequacy ratios and measurement methodologies within their standards

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[967] See Jonas Nemeyer, 'Basel III: What and Why?' (2016) 1 Sveriges Riksbank Economic Review 61.
[968] BNM (n 771).
[969] ibid.

and procedures.[970] BNM assimilates both approaches into its own risk weighted capital framework and internal risk rating system. This also means that BNM has been highly selective in which elements of all three phases of Basel to adopt, adapt, or reject.

Along with other regulators in countries with significant Islamic banking activities, BNM chose not to implement Basel I or II as explicitly defined by BCBS. To do so would misrepresent domestic capital requirements, as Islamic products have different credit risk and market risk qualities than conventional products. For example, certain risks in Islamic finance are not addressed in Basel II Pillar 1, which subsequently requires BNM to strategically adapt the Pillar I standards to Islamic guidelines and products while still bringing to affect the animating financial objectives of Pillar 1 capital requirement. This section looks at the main changes made to Basel I and II regulations to date in Malaysia and expands on BNMs integrations into its dual system.

One reform of central importance has been the joint implementation of BCBS and IFSB standards. As has been shown, Malaysia operates a dual-banking system of conventional and Islamic banks. The banking system and BNM as the regulator have worked closely with ISFB in setting rules and standards for the banking sector. The focus of this has been to ensure fair and non-discriminatory treatment of Islamic banking products, and also to minimise any potential regulatory arbitrage across different Islamic legal systems. In a system where many banks offer both conventional and Islamic banking, either through Islamic subsidiaries of a conventional bank, or through Islamic banking ‘windows’ in a conventional bank, this has been particularly complex.

6.3.4 Adapting Basel III Rules for the Malaysian Market

Conventional banks and banking holding companies in Malaysia are subjected to the BCBS Basel III treatment without adjustment. In other words, Basel III is applied directly to conventional financial institutions that benefit from different rules on interest taking, profit distribution and access to debt based and secondary markets. For full Islamic banks, or Islamic banking subsidiaries, the ISFB rules defined in IFSB Capital Adequacy Standard (CAS) are used. [971] By adopting the guidelines in IFSB and CAS, BNM ensures that Islamic

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[970] Bosch Homburger (n 790) 84.
[971] IFSB (n 473).

products are treated appropriately under Pillar 1 capital calculations. A full discussion of the techniques and changes in CAS is beyond the scope of this thesis, but can be referenced in the CAS documentation.[972]

There have also been further enhancements to the IFSB Capital Adequacy Standards based on Malaysian contract law. BNM, as the Malaysian regulator, has further adapted the IFSB Capital Adequacy Standards (2013).[973] These regulations do not materially alter the core recommendations of the Basel Committee or their implementation, but build on Malaysian application of Islamic contracts. In particular these amendments clarify that credit risk capital charges should be applied to Islamic contract types, particularly those with unique risk elements for banks or investors, such as Mudharabah funding, as discussed in Chapter III.[974] In particular, the appropriate treatment of Islamic contracts has been considered. These local guidelines supersede any from IFSB and BCBS guidelines on the risk weighted value of assets. They are defined for seven contract types: Murabahah, Baibithaman Aji (BBA), Salam, Istisna, Ijarah, Musharakah, Mudarabah, Sukuk and Qardh.[975]

There are also amendments to the IRB methodologies to be adopted for Islamic Banking Assets. In particular, if a bank uses the same internal credit risk rating model for conventional and Islamic banking, they must provide market data to support that the rating values are appropriate to each Shariah contract type.[976] This highlights the active role played by the BNM in developing risk weight categories which are more appropriately calibrated to the structures, products and assets of Islamic finance institutions.

There have also been updates to Islamic banking ‘windows’. The use of an Islamic compliant banking ‘window’ within a conventional bank is common in Malaysia. As such, BNM has focused on developing rules to best handle this for Basel compliance. The direct application of Basel capital adequacy requirements to Islamic accounting arrangements would, as discussed in Chapter IV, present a number of challenges. Aside from failing to account for the specific risks associated with profit and loss sharing schemes, the exclusive or direct

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[972] ibid.
[973] BNM, ‘Capital Adequacy Standards’ (revised 2013).
[974] ibid.
[975] ibid for full treatment, see BNM (n 864) section B 2.3
[976] ibid section B 3.1.

application of either Basel or IFSB rules would require compliance with two different standards within the same bank. This approach would be extremely impractical to implement.

To resolve the potential conflict, BNM proposed the use of an 'Enhanced Basel II' method. This enables banks to implement a less rigid version of Basel Pillar 1 capital adequacy and measurement guidelines, thereby enabling Islamic banks to apply alternative capital adequacy standards developed by the ISFB CAS where relevant.[977] In their original guidelines on Basel II implementation,[978] BNM specified to delay the implementation of the Advanced Measurement Approach (AMA) for Operational Risk.[979] This approach (which is permitted by Basel Committee) allows banks to use their own data to estimate losses for operational events. By postponing the implementation of the Basel II guidelines on operational risk, BNM was able to focus its attention on mitigation of credit risk in Islamic banks as a priority."[980]

BNM has been as proactive with Basel III as it was with the Basel II regulations in adapting the guidelines to better match the local market. These adaptations have been in collaboration with IFSB and have followed published guidelines on Basel III for Islamic banks. The key issue for this thesis is not establishing a comprehensive list of issues and solutions, but rather demonstrating the commitment and involvement of BNM in addressing such issues as they arise, and working with ISFB and the Malaysian banking sector to find a solution that can be implemented in their legal regulations.

As Basel III focuses on liquidity risks and capital, BNM's current plan sets out standardized approaches for assessing and measuring credit, market, and the assessment of operational risks using a Basic Indicator Approach. This reduces the scope and potential for discretionary decision making as well as arbitrariness in the determination of the viability of banking instruments in its version of a Non-Viability Loss Absorption (NVLA) trigger; and continued enforcement of disclosures pertaining to their trading book, PSIAs and rate of return.[981] Due to the structure of banks in Malaysia this is a more significant issue than in BCBS

[977] BNM, 'Basel II Implementation in Malaysia' (26 May 2015).
[978] Ahmed (n 851) 17; See also Kasim and others (n 851).
[979] Shamsuddin (n 777) 184.
[980] BCBS (n 1) para 94.a.
[981] BNM (n 868).

jurisdiction countries (BNM estimated previously a 3% effect on CET1).[982] Domestic banking groups in Malaysia operate in different holding company structures – either with an operating or non-operating financial holding company.[983] BIMB in their Basel implementation have opted for the conservative approach of full deduction.[984] BNM has permitted this approach, but will also allow banks to progressively phase in deduction to minimise the impact.

Perhaps the most important measure introduced by Basel III is the measurement of liquidity. According to Basel III, banks must calculate both a short-term ratio (the Liquidity Coverage Ratio, LCR), and a long-term ratio (Net Stable Funding Ratio, NSFR) reflecting their ability to meet obligations.[985] There have been issues with this across the Islamic Finance Sector, in particular with regards to the LCR and what assets can be defined and treated as highly liquid (LCR measures highly liquid assets held by financial institutions in order to meet short-term obligations).[986]

The Malaysia regulator, however, had been looking at measurement of liquidity for some time before the introduction of Basel III.[987] The legal guidelines in the Financial Services Act 2012 contain requirements for measurement and reporting on liquidity. These have been in place since 1988, before Basel implementation took plan. This existing liquidity framework from 1988 aimed to raise awareness of liquidity measurement and management for both conventional and Islamic banks.[988]

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[982] BNM, 'Capital Adequacy Framework (Capital Components) Concept Paper' (BNM/RH/CP 032-5, July 2015).

[983] BNM (n 771); see also, Amy Tan Ai Fen and Stella Lee Siew Tsin, 'Malaysia's New Financial Services Regulatory Framework' (*Financier Worldwide Magazine*, July 2013) <https://www.financierworldwide.com/malaysias-new-financial-services-regulatory-framework/> accessed 10 April 2017.

[984] BIMB Holdings Berhad, 'Who We Are - Corporate Overview' <http://www.bimbholdings.com/about-us/who-we-are/> accessed 10 April 2017.

[985] Mohammad Alsharif and others, 'Basel III: Main Issues for GCC Banks' (2016) 4(11) International Journal of Economics, Commerce and Management 548.

[986] ibid, 557-558; see also, Abozer Majzoub, 'Understanding Key Features of Basel III and its Implications on Islamic Banking Industry' (IFSB Lecture Materials, IAIS, Malaysia, 29 January 2016) 24-29 <http://www.iais.org.my/e/attach/2016/basel3_29JAN2016/Basel_III_Impacts_on_IFSI.pdf> accessed 10 April 2017.

[987] BNM, 'BNM/RH/CP 029-6: Concept Paper-Liquidity Coverage Ratio' (30 September 2014) <https://www.bnm.gov.my/guidelines_old/01_banking/04_prudential_stds/Concept%20Paper_Liquidity%20Coverage%20Ratio.pdf/> accessed 14 October 2017.

[988] BNM, 'BNM/RH/GL 002-12: Liquidity Framework' <http://www.bnm.gov.my/guidelines/01_banking/04_prudential_stds/03_liq_i.pdf> accessed 14 October 2017.

The current Malaysian regulations are more restrictive than those listed under Basel III. Rules published by BNM for LCR calculation are otherwise broadly in line with BCBS definitions. [989] The challenge of finding sufficient high quality liquid assets (HQLA) is one of the major issues with Islamic banks and Basel III.[990] Malaysian banks such as BIMB have created various strategies to manage liquidity, including diversifying the bank's deposit base and lengthening the maturity on deposits.[991] While Islamic banks such as BIMB appear to be less exposed to market or credit defaults risks associated because of restrictions on interest taking and short selling, it may be that BIMB and its contemporaries are nonetheless exposed to such risks indirectly through the competitive advantaged gain by conventional banks.[992]

Whilst BNM has elected to modify the capital and risk measurements baselines established under Basel II and III Pillar 1 requirement in respect of particular risk categories or products, it has, in all other respects, achieved full compliance with Basel Pillars 2 (supervisory review) and Pillar 3 (disclosure).[993]

As well as promoting good risk management, another role of Pillar 2 is to act as a check on Pillar 1 capital requirements. These include errors and inaccuracies in capital calculations or the assignment of assets, a failure to anticipate or mitigate risks through early warning systems or to implement stress testing and internal risk-management systems to prevent against future volatility or market shocks. Such checks are important in any banking environment, but in a mixed Islamic banking environment such as Malaysia it is perhaps particularly important to ensure all risks are adequately captured in the dual regulation environment.

BNM has developed its own guidelines to integrate Pillar 2 and Pillar 3 into Islamic banking.[994] Demonstrating its role as an active supervisor, BNM retains the right in these

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[989] BNM, 'BNM/RH/STD 029-9: Liquidity Coverage Ratio' (31 March 2015) <http://www.bnm.gov.my/guidelines/01_banking/04_prudential_stds/Liquidity_Coverage_Ratio.pdf> accessed 14 October 2017.

[990] Osama M Al-Hares and Kashif Saleem, 'Islamic Banks Financial Performance and Implications of Basel III Standards in the GCC: An Empirical Analysis' (2016) Review of Economics & Finance 80.

[991] Fathiyah (n 61).

[992] Hennie van Greuning and Zamir Iqbal, 'Global Perspectives on Islamic Banking & Insurance Balance Sheet Analysis: Islamic vs Conventional' (2009) New Horizon Islamic Banking, Institute of Islamic Banking and Insurance 1.

[993] Shamsuddin (n 777) 184.

[994] BNM, 'Capital Adequacy Framework for Islamic Banks – Disclosure Requirements (Pillar 3) BNM/RH/GL 007-18, 2007' (28 November 2012) <http://www.bnm.gov.my/guidelines/01_banking/01_capital_adequacy/02_gl_capital_adequacy_framework_islamic.pdf> accessed 14 October 2017.

regulations to impose higher capital thresholds on banks depending on the results of the supervisory review process. In practice, this could happen if BNM is not satisfied with the approach or calculations a specific bank has in place for certain asset classes.

BNM has also fully supported the Internal Capital Adequacy Assessment (ICAAP) process. This is a crucial part of Basel Pillar 2, whereby banks assess and report their internal risk assessment processes, controls and risk considerations, including by establishing procedures for monitoring and reporting risk and capital, independent review of the ICAAP process, and inputs (by qualified functions not involved in the original ICAAP process).[995] To ensure compliance with this important procedure, the ICAAP has been implemented as a legal requirement in Malaysia for all banks licensed under the Banking and Financial Services Act (1989).

The key strengths of Basel implementation in Malaysia have been the full and committed adoption of market disclosure requirements and their implementation by banks. This section looks at the ways Malaysia continues to demonstrate strong and successful implementation. The first is the comprehensive review and feedback process put in place by the regulator, BNM. In many areas of its implementation of BCBS standards and principles into appropriate local regulations, extensive review and feedback has been undertaken with affected banks. This shows strong governance and ambition to correctly tailor rules for the local market, as well as the intention for supervisors to override or intervene when genuinely required locally.

Secondly, some third party evidence is available to support the claim of the strong embedding of Pillar 2 and Pillar 3 standards within banks. In a report submitted for the 8th International Conference on Islamic Economics and Finance,[996] Ariffin and Kassim look at risk management practices within Islamic banks in Malaysia and suggest high levels of compliance overall in: risk management, mitigation, monitoring, and internal control.

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[995] BNM, 'BNM/RH/GL 001 – 33: Risk Weighted Capital Adequacy Framework (Basel II)–Internal Capital Adequacy Assessment Process (Pillar 2)' <https://www.bnm.gov.my/index.php?ch=57&pg=137&ac=24&bb=file> accessed 10 April 2017.

[996] Noraini Mohd Ariffin and Salina Hj Kassim, 'Risk Management Practices and Financial Performance of Islamic Banks: Malaysian Evidence' (8th International Conference on Islamic Economics and Finance, Qatar, 2011).

6.5 Islamic Products and Basel Compliance in Malaysia

The BNM has adopted a more flexible approach to its implementation of Basel regulations to suit Islamic banking products and the Malaysian model, which include the introduction of new Shariah compliant high quality liquidity assets which meet Basel compliance.[997] This occurred with the Basel II regulations and has continued for Basel III. Overall, this highlights the adaptive nature of the regulator to meet local conditions, and the commitment of the government to promote and develop Malaysia as the hub of Islamic finance.

One of the major influences Basel has had on Islamic Finance products is the rapid growth of the Sukuk market, or as explained in a previous chapter, the Islamic alternative to an interest-based bond. As early as 2012, but mostly since 2014, there has been a dramatic growth in the issuance of Basel III compliant Sukuk in Malaysia as well as in other Islamic banking (IB) countries.[998] The need for Basel III compliant Sukuk is required in order to meet new capital targets. As discussed in previous chapters, Basel III minimum capital requirements are made up of several elements. The 8% minimum capital (before the inclusion of additional capital buffers specified by Basel III) is to be made up of 4.5% common equity Tier 1 capital (CET1), 1.5% additional Tier 1 capital (AT1) and 2% Tier 2 capital (T2).[999] Prior to Basel III, Malaysian banks held very little suitable loss absorbent capital that could be classified as AT1 or T2. Secondly, the new Basel III liquidity rules require an enhanced stock of highly liquid assets to satisfy the short-term Liquidity Coverage Ratio (LCR), of so-called High Quality Liquid Assets (HQLA). To meet both needs, new Sukuk products have been developed which have the required loss absorbency characteristics to be classified as AT1 or T2 capital, and, additionally, are highly rated and tradable to meet the requirements of HQLA.

Such Sukuk is issued through the International Islamic Liquidity Management Corporation (IILM), a new body formed by several central banks of IB countries.[1000] Malaysia has been

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[997] Mohd Edil and others, 'Malaysian Sukuk: Issues in Accounting Standard' (2008) 16(1) Journal Syariah 63, 67.

[998] Habib Ahmed, 'Basel III Liquidity Requirement Ratios and Islamic banking' (2015) 16 (4) Journal of Banking Regulation 257.

[999] BCBS (n 1) 12; see also 'An Introduction to Basel III – Its Consequences for Lending' (Norton Rose Fulbright, October 2010) <http://www.nortonrosefulbright.com/knowledge/publications/31077/an-introduction-to-basel-iii-its-consequences-for-lending/> accessed 10 April 2017.

[1000] International Islamic Liquidity Management Corporation, 'About Us' <http://www.iilm.com/about-us/> accessed 14 October 2017.

one of the country's leading this Sukuk issuance.[1001] As of August 2014, a total of 14 Basel III compliance Sukuk have been issued (raising US$6.93 billion) in association with IILM, eleven of which were issued by Malaysian banks.[1002] Despite the lack of secondary markets for Sukuks and varying interpretations of Shariah compliance, IB countries continue to invest in new products.

In 2015, the National Commercial Bank (NCB) in Saudi Arabia was the first domestic institution to issue a Tier 1, capital Basel III-compliant perpetual Sukuk.[1003] A handful of Tier 2 Sukuks have been issued in recent years. Unlike Malaysia, Saudi Arabia is relatively new to the Sukuk market and is just now exploring the possibilities and impact such financial tools may have on their banking system. This issuance is unique, not just as an entrance to the practice, but because it signifies a willingness to consider preferred stock as a Shariah compliant instrument, something many other Islamic systems have reluctance to do. While sceptics persist, including some leading Saudi scholars who believe Sukuk to be a violation of Shariah law, the interplay Sukuks could provide may establish more conventional interactions and capital flexibility for Saudi Arabia, and SAMA as its regulatory body. These possibilities and the example set by Malaysia, have led some Saudi leaders to defy the Shariah debate and perceive Sukuks to be advantageous for diversifying Saudi Arabia's economy, as will be further discussed in the next chapter.

Generally speaking, Malaysia is expected to remain the leader in Sukuk products for the near future, but the curiosity and interest of other Islamic countries has been piqued.[1004] BNM is actively aware of this increase in demand for highly liquid Shariah products and has expressed its intention to monitor the development of these products. There is a possible feedback loop here where market liquidity could be affected by increased demand altering instrument characteristics and with it their availability to meet liquidity needs.[1005] What will

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[1001] Ambrose, 'Malaysia Remains Biggest Sukuk Market as Record Number of Global Corporates Tap Sukuk' (*Sukuk*, 9 April 2017) <https://www.sukuk.com/article/malaysia-remains-biggest-sukuk-market-as-record-number-of-global-corporates-tap-sukuk-5067/> accessed 14 October 2017.

[1002] MIFC, 'Basel III Capital Adequacy Standards: Sukuk Innovated' (14 August 2014) <http://www.mifc.com/?ch=28&pg=72&ac=84&bb=uploadpdf/> accessed 14 October 2017.

[1003] Lizzie Meager, 'Saudi Arabia's First Basel III AT1 Sukuk Explained' (*International Financial Law Review*, 9 July 2015) <http://www.iflr.com/Article/3469367/Saudi-Arabias-first-Basel-III-AT1-sukuk-explained.html/> accessed 10 April 2017

[1004] Simko (n 421).

[1005] BNM (n 771).

be interesting to monitor is Malaysia's domestic market demand, international demand, and demands of other Islamic countries.

Malaysia was chosen as a case study and comparison with Saudi Arabia because of its financial system and well-established Islamic banking system. This chapter has outlined some of the key strengths seen in Malaysia that have led to a reliable financial sector and with it, spearheaded the growth of financial markets and an improvement in their quality.[1006] Each of the following observations and conclusions offer a point of comparison and contrast with Saudi Arabia and its legal system, which is shown to be deficient, to some extent, in the below outlined respects.

Many of those strengths seen in the Malaysian finance and regulatory environment are centred on viable risk assessment capabilities. While Basel III has been one key feature in assessing risk, there is a much broader approach to the Malaysian model of creating and maintaining a consumer-confident banking industry, than is the case in Saudi Arabia. One of the key areas of difference between Saudi and Malaysia is that the latter has created a well-defined and respected legal system. Laws are clearly defined and there is an established, efficient judiciary system. Such a legal system enables regulatory processes to be defined and embedded and also enables the fully-independent operation of a banking regulator.

The next chapter will explore these same questions in relation to Saudi Arabia, but it is important to consider that current capital adequacy ratios are even higher than those in Malaysia with 1st quarter reports as high as 18% in 2016.[1007] This should boost confidence in the Islamic banking sector in Saudi Arabia, but with a one-horse economy and other factors considered below, Saudi Arabia still has much work to do.

It is the suggestion of the author that implementation in Malaysia will not be a significant challenge, and is likely to be smoother than in many other countries. In establishing the effectiveness of Basel III implementation, there are several things that need to be looked at. Firstly, BNM will need to examine capital ratios, buffers and other new ratios required by Basel III. With a predominately equity-based rather than debt-based asset system, and past history of over-capitalisation it is unlikely that new capital ratios will pose a challenge.

[1006] Edil and others (n 888) 63, 67.

[1007] Argaam, 'Saudi Banks' Capital Adequacy Ratio Jumps to 18% in Q1' (18 May 2016) <http://www.argaam.com/en/article/articledetail/id/427154/> accessed 18 May 2016.

Furthermore, BNM has been very active in enhancing bilateral and international co-ordination and co-operation to identify dangerous trends in the markets, to identify risks, and provide warnings and enforcements against rule breakers. BNM has also taken into account standards by bodies such as the International Association of Insurance Supervisors, The International Organization of Securities Commissions and other organizations of industry best practices.

If these ratios and capital levels are successfully met, then the effectiveness of Basel turns to two other areas. Namely, the integration into banking culture and processes as well as promotion of good risk management rather than just 'number compliance', and the legal enforceability and robustness of the regulations. These factors are linked to both the success of Basel regulations to improve risk understanding, management and culture and to the external view of the strength of the banking sector, and its ability to compete in a global market.

Under the new Basel framework, the shift in capitalisation moves very much to a stronger focus on reserves of top quality Tier 1 capital. Again, the Malaysian banking sector is unlikely to have a problem with this since Malaysian banks typically have high equity based portfolios meaning there is a high proportion of CET1 amongst Malaysian banks. Shamsuddin provides a good estimate of these levels in his paper.[1008] This is already being addressed through strong growth in the Malaysian Sukuk markets offering AT1 and T2 compliant products. As BNM has reported, "Based on their current profiles, all banking institutions are expected to comfortably meet the 3% leverage level." [1009]

Malaysia can also boast a strong culture of compliance and control from the regulator and within banks. This can be seen through the well-embedded implementation of Basel Pillar 2 and 3, and the regular feedback and dialogue between BNM and banking sector. In fact, the strength of Malaysia's system leaves minimal concern for their ability to meet Basel III capital and leverage ratios. With a strong proportion of capital already held as common equity, both Islamic and conventional domestic banks will easily meet new capital ratios. Confidence exists in the system and in any issues which may arise with meeting liquidity

[1008] ibid.
[1009] BNM (n 885).

ratios shall be addressed though consideration of product definitions, and development of new products.

Another benefit of the current system is that the culture and functionality is already present for measurement and management of liquidity. New products, such as Sukuk, are being developed to enhance the existing framework, including products appropriately tailored for Islamic Banking and regulatory compliance. The focus here has been to ensure that Shariah compliant products are made available in all areas to grow the Islamic banking sector, and help position Malaysia as an Islamic Finance centre, but also to ensure Basel standards are met.

The application of Malaysia as a comparison for Saudi Arabia is immediate and tangible. Faced with international competition, Malaysia has strengthened its market share in Islamic Banking by its strict regulation, its strong capital buffers and by a standardised approach to Shariah which provides authoritative fatwa, and which supports new innovations in financial products and services.[1010] Saudi Arabia must and can equip itself to do the same if it hopes to cultivate an agile, robust, and sustainable system. As will be seen in the next chapter, using Sukuk, which is a contentious practice in itself, and having a weak regulatory structure without the backing of the rule of law, is not likely to provide a banking system which can compete with Malaysia, Dubai, or even with the UK.

As the next chapter will show, Saudi Arabia has indicated its desire to pursue a more developed and sophisticated financial system, with which to grow its Vision 2030 and to diversify its economy. Further, Saudi Arabia maintains compliance with the Basel framework, but faces challenges as it does not have a dual track financial system as practiced in Malaysia, but instead treats all financial institutions the same, using the same standards, guidelines, and practices. This unity of oversight presents challenges to regulatory consistency, transparency, and access. These challenges are exasperated by the Kingdom's poor comprehensive record-keeping and disclosure practices, as well as a non-uniform governance structure.

[1010] For an example of a new and innovative financial product, see the Mubādalah al-Arba`ah Profit Rate Swap (PRS), and see the Product Standard for that product appearing in the Malaysian IFSB, 'Islamic Financial Services Industry Stability Report' (2013) appendix 3.

Chapter VII: Discussion – Lessons from Malaysia: A Critical Appraisal of Basel Implementation and the Governance of Financial Institutions in Saudi Arabia

7.1 Introduction

This chapter will show that while Saudi Arabia is minimally compliant with Basel III standards on capital adequacy, its framework on banking regulations remains vulnerable to a number of risks and challenges: legal, financial and managerial. Bank financed lending in Saudi has decreased below expected levels, and is well below other banking sectors in advanced economies such as the UK. Saudi corporate bonds, known as Sukuk funds, have also experienced a downturn, with one major fund experiencing a 25% loss in earnings in one recent quarter alone.[1011] By the end of 2017, the financial deficit in Saudi Arabia is projected to reach in excess of 20% of the national GDP.[1012] The magnitude of Saudi Arabia's economic peril is no trifling matter. Now having taken out a loan of 10 Billion US dollars with the IMF, rising unemployment, credit shortages and rising levels of sovereign, the IMF itself has predicted that Saudi Arabia may deplete all its assets within five years and be forced to declare bankruptcy.[1013] Of course, Saudi Arabia may yet survive these gloomy predictions but to do so it will have to undertake substantial, and indeed, substantive legal and economic reforms.

Building on the analysis developed in the previous chapter, this thesis has considered whether the Basel framework of international banking regulation is sufficiently adaptable to Islamic based systems and principles. Whatever the limitations of the Basel framework, it has been established that Islamic countries such as Malaysia and Saudi Arabia have elected to

[1011] Abdullatef and others (n 292).
[1012] Standard & Poor's Ratings Services, *Islamic Finance Outlook 2015* (McGraw Hill 2014) 1.
[1013] Adam Leyland, 'Saudi Arabia Could be Bankrupt Within 5 Years, IMF Predicts' *The Independent* (23 October 2015) <http://www.independent.co.uk/news/world/middle-east/saudi-arabia-could-be-bankrupt-within-five-years-imf-predicts-a6706821.html/> accessed 22 January 2016. See IMF (n 536) see especially 14-16.

implement Basel standards into their legal framework.[1014] What has yet to be fully established is whether mere compliance with Basel III standards offers adequate security and rights protections to those subject to jurisdictional control of Saudi authorities, whether financial institutions or their consumers or investors.

This chapter attempts to unravel the remaining 'gaps' or limitations of the existing framework on banking regulations in Saudi Arabia, including by highlighting 'gaps' in the regulatory supervision of banking practices and corporate governance related concerns. This chapter will also seek to reflect more generally on the wider difficulty of fully adapting to Basel standards, because of the corporate governance structures of Saudi Arabia. It will be argued that the existing the Basel regulatory regime is myopically focused on formal compliance with technical capital adequacy requirements.

Two key issues will be discussed in the above regard. The first challenge emerges from divergent scholarly interpretations of what does or does not constitute Shariah compliant financial or banking practices. The second challenge relates to the corporate governance mechanism established under relevant Saudi laws. The hypothetical questions that shall be posed are whether Saudi Arabia's financial system can maintain compliance with Basel III standards by creating uniform criteria and definitions for Shariah compliant financial activities; and whether Saudi Arabia's corporate governance structure will infuse enough 'mandatory' provisions within its current financial framework to fortify and legitimise its regulatory activities, thereby promoting international investor confidence in its banking system.

Comparisons will be made between Saudi Arabia and Malaysia to serve as lessons on reforms that are still required to render the banking system of Saudi Arabia fully compliant with Basel III, and to provide stronger protections for investors and depositors. Such reforms may include strategic plans, transparency between governing bodies, mandatory reporting mechanisms, and consistency in the classification of Islamic banking tools.

7.2 Basel Implementation and Compliance in Saudi Arabia

Saudi Arabia is a member of many worldwide organizations including the United Nations (U.N), the International Monetary Fund (IMF), the World Bank (WB), and the World Trade

[1014] BNM (n 771); BCBS (n 48).

Organization (WTO). Even after the 'global financial meltdown', as Almatri explains, Saudi Arabia became a member of the G20 as 'one of the top twenty economies in the world.'[1015] Yet despite the Kingdom's membership in key financial institutions, Saudi Arabia is still an emerging market, with a relatively embryonic financial system.

As indicated in Chapter II, Saudi Arabia's financial and banking continues to operate under a series of Council of Ministers regulations, defined regulatory bodies and agency powers to those regulatory bodies. It specifically consists of the Saudi Arabian Monetary Authority (SAMA central bank)[1016], the Capital Markets Authority (CMA), commercial banks, specialised lending institutions, and stock markets. The two main regulatory authorities, SAMA and CMA, are responsible for regulating and supervising financial and banking activities, insurance and finance, including Islamic finance instruments such as the capital markets in Sukuks. Under the authority given by the Banking Control Law of 1966, SAMA exercises regulatory oversight and control over the banking and financial activities of Islamic financial institutions (IFIs) and conventional commercial banking businesses.

On the specific issue of Basel compliance, some of the techniques, such as higher capital reserve thresholds, initiated by SAMA in the 1980s are still in use today and correlate to the objectives of Basel III. In recent financial reports, SAMA has announced further reforms, regulations, and the implementation of a National Transformation Plan (Vision 2030), all indicating SAMA's continued commitment to a central plan and the design of all aspects of its economy, including the financial sector, through high levels of state intervention, control and ownership of financial assets.[1017]

In common with the Malaysian regulated banking sector, the relevant Saudi regulators have also established national requirements which comply with capital measurement and risk assessment standards established under Basel II and III.[1018] It will be recalled, as outlined in Chapter IV, Basel III has set forth three Pillars of objectives: 1) enhanced minimum capital and liquidity requirements, 2) an enhanced supervisory review process for firm-wide risk-

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[1015] Yahya Ali Al-Matari and others, 'Corporate Governance and Performance of Saudi Arabia Listed Companies' (2012) 9(I) British Journal of Arts and Social Sciences 3.

[1016] Established in 25/5/1372H corresponding to 20/4/1952G; the first Law of SAMA issued by Royal Decree No 23 dated 23/5/1377 H (corresponding to 16/12/1957 G) (SAMA's Law) and the Banking Control Law issued by Royal Decree No M/5 dated 22/6/1386H (corresponding to 8/10/1966 G) (BCL).

[1017] SAMA (n 367).

[1018] BNM (n 886); BNM (n 885).

management and capital planning, and 3) enhanced risk disclosure and market discipline (or to put it another way, Basel III deals with credit risk, market risk, operational risk, and liquidity risk.)

The Bank of International Settlements (BIS) has determined that Saudi Arabia currently complies with all three of these pillars, but how that standard has been met or will be maintained is not clear. In its report to G20, the leaders of the implementation of Basel standards, as released by the Basel Committee on Banking Supervision in November 2015, (released in 2016), BIS, lists Saudi Arabia as being 'compliant' or 'largely compliant' with Basel III requirements and recommendations. Furthermore, the report finds that the Saudi Arabian Monetary Authority (SAMA) has undertaken a series of legislative and regulatory measures and amendments, "to strengthen alignment of its capital and liquidity rules with the Basel III framework."[1019]

Broadly speaking, therefore, Saudi Arabia has, by most metrics, effectively implemented its obligations under Basel while reforming its own regulatory framework towards the achievement of prudential supervision and sound corporate governance within financial institutions and across the banking sector as a whole. SAMA after all has boasted 'abundant capital buffers, high profitability, and ample liquidity' in its financial system, each a benchmark against which a country's ability to meet Basel related capital, risk and liquidity coverage standards can be measured and assessed. [1020]

While the creation of a regulatory capital minimum may be sufficient to address the most serious failures in risk regulation, it cannot be held-up as a panacea or cure all. There is no question that Saudi Arabia's practices lend themselves to sound capital adequacy standards; their liquidity risk levels, corporate governance structure, and lack of cohesive standards through consistent judicial application leave it vulnerable to market 'shocks'. The next section will argue that mere compliance with Basel III requirements is not evidence of the fact that these risk-mitigating measures are being implemented effectively, or legitimately.

[1019] BCBS, 'Implementation of Basel Standards: A Report to G20 Leaders on the Implementation of the Basel III Regulatory Reforms' (August 2016) 10-11. See also, for general reference, BCBS, 'Basel III Monitoring Report' (February 2017).
[1020] SAMA (n 367).

7. 3 Going beyond Capital Adequacy: Why Saudi Arabia Needs to Reform its Laws and Regulatory Institutions.

The most important question raised to further the course of this discussion is what is the relationship between law, good governance and stable markets? To fixate purely on financial criteria, in other words, is to take law out of the equation, thereby reducing the role of state regulator to a mere 'transmission belt' for the implementation of financial standards set by unelected international bodies, in settings which escape direct oversight by national authorities and their citizenry. On the other hand, the state cannot design markets simply to serve its own purposes, or trample on market freedoms, suppressing along the way the very engine of free market liberalism: profitability, property rights, open competition, and freedom of contract – all of which are enabled and guaranteed through "rule of law".

Partly because Saudi Arabian banks have already proven to be well capitalised and have remained stable, while banks in Europe and North America have reaped the consequences of excessive risk-taking, there is a tendency to overlook the tight connection between 'command and control' regulation – in the case of Basel III implementation, clear legislative rules on risk regulation which is judicially enforced – and the creation of a framework of regulation which aims to encourage effective forms of self-regulation at the level of banks themselves, or, in other words, corporate governance.[1021] These deeper conflicts lie at the very heart of any enquiry into what Basel does or does not achieve or bring to effect in Saudi Arabia.

In the remaining sections of this chapter it will be argued that Saudi regulatory authorities have not adequately addressed the Pillar 2 requirements of the Basel II and III framework, specifically in respect of market disclosure. Effective market disclosure and prudential supervision can only be achieved when it is supported by robust national laws and initiatives on transparency, auditing and related corporate governance discourses. By way of comparison with equivalent regulations, procedures and initiatives are implemented under the Malaysian system, rule of law issues, including: arbitrariness in the exercise of governmental power, independence from state organs, adequate forms of judicial review. This is to avoid the opaqueness of the decision-making processes and to gain prominence in the Saudi context, because of the central role played by state organs and state affiliated interest groups

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[1021] Amr Mohamed El Tiby Ahmed, *Islamic Banking: How to Manage Risk and Improve Profitability*, vol 640 (John Wiley & Sons 2011) 184.

in the control and management of Saudi institutions, assets and markets.[1022]

7.3.1 Corporate Governance Regulations in Saudi Arabia

Corporate governance, in short, is the set of norms, codes and practices which affect the way corporations (or companies) are directed, administered or controlled. In this sense, corporate governance is the term used to describe the legal relationships which exist between the corporate management structure (usually comprised of three constituent elements: the Board of Directors, managers and shareholders) and the company goals or objectives under which it is governed. As will be detailed below, a financial entity's conduct can, and often does impact the rights and interests of a range of stakeholders including customers, creditors, investors and the public at large. Discourses on corporate governance are commonly understood as the set of norms used to identify the role and responsibilities of a corporate organisation to its stakeholders, including its commitments to ensuring accountability, transparency, and fairness in the management of a company by its Board.[1023] These governance principles are given effect through the protections that financial institutions have afforded to their stakeholders, including efforts to eliminate unnecessary barriers to capital access to 'exit' and through policies that aim to minimise 'conflicts' between the private interests of a corporate entities and its management (bank managers and the governing Board of Directors) and the interests of their shareholders, customers and investors. As Choudhury and Hoque argue:

> "Corporate governance has to do with those legal and organizational structures [relating to the] internal integrity of a corporation [which is] an organisation and hence an institution. It is, thereby, a bundle of contracts and rules under which it functions, and is legitimated by legal enactment and protected by the legal tenets of any government and state. The implications of such legal obligations and protection may be limited nationally or extended internationally under agreed upon globalization rules."[1024]

[1022] For a general discussion, see Hamid Mehran and others, 'Corporate Governance and Banks: What Have We Learned from the Financial Crisis?' (Federal Reserve Bank of New York Staff Reports No 502, June 2011).

[1023] Hennie van Gruening and Sonja Bratanovic, *Analysing Banking Risk: A Framework for Assessing Corporate Governance and Risk Management* (3rd edn, World Bank 2009) 258.

[1024] Masudul Alam Choudhury and Mohammad Ziaul Hoque, 'Corporate Governance in Islamic Perspective' (2006) 6(2) Corporate Governance: The International Journal of Business in Society 116.

Corporate governance can be classified as good or bad, and has the power to either drive participation from outside investment or to undermine investor confidence. A well-structured and healthy regulatory framework, "reduces vulnerability to financial crises, reinforces property rights, reduces transaction costs and the cost of capital, enhance[s] the performance of companies and leads to capital market development."[1025] As both SAMA and CMA reinforce their authority against the international backdrop of a competing globalised market, the effectiveness of Saudi Arabia's implementation of Basel banking standards will depend, to a great extent, on the effectiveness of national corporate governance regulations.

To set this discussion in motion a good starting point will be to take a look at the strengths of corporate governance law and governance in Malaysia.

As well as looking at financial risk regulation and governance in the financial sector, there is also relevance in looking at governance in the wider corporate environment in Malaysia. In general, Malaysia has a compelling culture of corporate governance, with established legal and administrative frameworks covering the operation and disclosure of all companies. Malaysia has long been an outward looking country, with guidance in law and framework settings and governing body models being taken from other countries. In an article examining Corporate Governance in Malaysia, Kamini Singam notes that, "[t]he principles of corporate governance laid down…reflects several principles expounded by the Organization for Economic Cooperation and Development (OECD), the Asian Development Bank (ADB), the World Bank and other corporate governance committees from the United Kingdom." [1026]

It should be noted that as a general practice corporate governance has received much attention and has been greatly improved in the past two decades following the Asian Financial Crisis. Prior to this there were many failings and shortcomings. A study carried out in 1998 by the Asian Development Bank looked at corporate governance in Malaysia and other South East Asian countries and reported a number of key weaknesses.[1027] These included the ineffective operation of board and director level oversight, weak internal controls, insufficient legal enforcement and weak disclosure requirements and procedures

[1025] Al-Matari and others (n 906) 2.
[1026] Kamini Singam, 'Corporate Governance in Malaysia' (2003) 15 Bond Law Review 314.
[1027] Caesar G Saldana, 'A Study of Corporate Governance and Financing in Selected Developing Member Countries' (Paper submitted to Asian Development Bank, 1999).

across all corporations. In addition, problems such as bribery, corruption and favoritism were commonplace.[1028]

During 1998 the Malaysian government commenced work on establishing a guiding framework for corporate governance. A committee, the High-Level Finance Committee, was established to improve governance, set best practices, and to move these into legal requirements.[1029] This initiative led, amongst other things, to the enactment of the Malaysian Code on Corporate Governance (MCCG 2012). The MCCG builds on previous policy to be the current leading government guidance on governance. It sets out broad principles and specific recommendations that companies should adopt in their business dealings, company operations and company culture. The main objectives are to achieve excellence in corporate governance through strengthening self and market discipline while promoting good compliance and corporate governance culture. It also focuses on strengthening board structure and composition.[1030]

These objectives are achieved through eight main principles. These are summarised in reporting from accountancy firm Price Waterhouse Coopers (PWC) as follows, "[t]he MCCG 2012 sets out eight broad principles followed by twenty six corresponding recommendations. Among other points, the principles and recommendations focus on: laying a strong foundation for the Board and its committees to carry out their roles effectively, promoting timely and balanced disclosure, safeguarding the integrity of financial reporting, emphasising the importance of risk management and internal controls, encouraging shareholder participation in general meetings. The guidance in MCCG 2012 goes beyond mere legal minimum requirements. Whilst these enhanced guidelines are not, therefore, a legal requirement, all listed companies are required to report on their compliance with MCCG 2012 in their annual report, and also explain any areas that they do not observe.[1031]

As a result of these guidelines Malaysia now has strict standards of corporate governance. Any director, chairman, or CEO of any bank must now be approved by the BNM first and all

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[1028] ibid.

[1029] Securities Commission Malaysia, 'Finance Committee Report on Corporate Governance' <https://www.sc.com.my/finance-committee-report-on-corporate-governance/> accessed 10 April 2017.

[1030] Securities Commission Malaysia, 'Malaysian Code on Corporate Governance 2012' iv-xiv <https://www.sc.com.my/wp-content/uploads/eng/html/cg/cg2012.pdf/> accessed 10 April 2017.

[1031] Effiezal A Abdul Wahab, Janice CY How and Peter Verhoeven, 'The Impact of the Malaysian Code on Corporate Governance: Compliance, Institutional Investors and Stock Performance' (2007) 3(2) Journal of Contemporary Accounting & Economics 1.

guidelines must be adhered to, to ensure transparency, accountability, and responsibility.[1032] Every bank must now adhere to at least four forms of supervision for enhanced accountability. These forms include: (a) independent risk assessments, compliance checks and audits, (b) oversight by persons not involved in the daily business of the banks, (c) supervision by the board of directors, and (d) a responsible chain of supervisors.[1033]

The ultimate responsibility of a bank has been given to its board of directors and, therefore, plenty of checks have been introduced to make certain that the board of directors performs with responsibility and diligence. Every bank should, according to their size, operations and structures, ensure that there are sufficient board members and that they carry the necessary competence in the fields of law, finance, accounts, IT, management and investments. Furthermore, every board is required to establish committees with oversight functions. These committees include:

a) Risk Management Committee. This extremely important committee supervises the senior management's operations in managing credits, markets, risk, liquidity and other such matters. They are responsible for introducing, reviewing, implementing and recommending risk management tools. They are charged with identifying and measuring any risks as they may arise and are directly responsible for those. BNM has issued various guidelines for this committee to ensure reliable and comprehensive risk management.[1034]

b) Nominating Committee. This committee establishes and decides on the skills and competence required in the board for judging the state of operations. They decide the requirements of the CEO and resolve the size and setup of the board of directors. They also assess the work being done by the directors to ensure that it is on par with the requirements.[1035] BNM has issued guidelines in this regard and has included many rules, such as: one third of the directors must be independent, and there must be a separation of director powers, not more than one executive director[1036] and guidelines on how committees should be set up. [1037]

[1032] Securities Commission Malaysia, principle 1 (n 921).
[1033] ibid recommendation 1.1.
[1034] ibid principle 6.1.
[1035] ibid recommendation 3.1.
[1036] ibid recommendation 3.4, 3.5.
[1037] ibid principle 2.

c) Audit Committee. This committee reviews all transactions of the bank and provides independent oversight into the functions of the bank. They also ensure that all checks and balances are in order.

d) Remuneration Committee. In the past, Malaysia suffered from serious corruption scandals and a culture of red tape. The remuneration committee looks to change the culture by ensuring that formal, fair and transparent remuneration packages are made available to all directors. The remunerations of every bank differ, but must consider aspects of culture, strategy, success, profits, performance, and similar issues. They report to the BNM with reports on why and how they decided the remunerations.[1038]

e) Shariah Committee. All Islamic banks are required to have a committee that decides if all products being offered by the banks are in line with the rules of Shariah.

f) Audits. Apart from the audit committee, the BNM has issued guidelines on internal audits for the banks as an extra layer of protection.[1039] Furthermore, to augment the internal auditors, the BNM requires external audits as per guidelines. These guidelines include restrictions, such as not allowing the same auditor to audit a bank more than five years in a row.[1040]

Similar to Malaysia, Saudi Arabia does have a modicum of regulatory-based corporate governance. Saudi Arabia has established the Capital Market Authority (CMA), which oversees corporate activity, and both the Companies Law and the Capital Market Law that authorises such activities.[1041] Overall, Saudi Arabia strives towards some of the same international and domestic standards as Malaysia, but again it remains focused on a predominantly Islamic financial system, not on the more robust dual-system of Malaysia, as we will now continue to examine and explore. In a bid to establish effective mechanisms of self-regulation, Saudi banks and financial entities have begun to articulate and implement prudential finance policies in addition to institutionalising annual auditing and monitoring procedures.[1042] The Capital Markets Authority (CMA) is responsible for ensuring compliance with governance regulations, including by requiring companies to formalise and publish their

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[1038] ibid recommendation 2.3.
[1039] ibid principle 6.2.
[1040] ibid recommendation 5.2.
[1041] See Companies Law, Royal Decree No M/6 of 1385H as amended; see also Capital Market Law, Royal Decree No M/30 dated 2/6/1424H.
[1042] BAHRI, 'Corporate Governance Regulations' (20 December 2009).

governance procedures in accordance with the revised corporate governance regulations, as discussed below. One of its most important functions is to prescribe rules for the disclosure of information related to securities, and their issues for the benefit of investors.

In 2015, the CMA released its four-year strategic plan designed to, “improve the stability of the capital market, develop debt and derivative markets and enhance internal as well as external risk management.”[1043] In the above regard, the CMA oversees the Saudi Stock Exchange (‘Tadawul’ or the ‘Stock Market’), which is the equivalent to the ‘Bursa Malaysia Berhad’ (BMB) which is the controlling entity of Malaysia’s stock exchange market.[1044] CMA’s Strategic Plan outlines initiatives for the Saudi capital market, including reforms in private sector access to capital, and disclosure requirements for listed companies, ‘authorised persons’, and family-owned companies in Saudi Arabia[1045]

While the CMA provides oversight, the Tadawul is effectively a self-regulating entity, whose nine-member board is nominated by the CMA, and appointed by the King. Accordingly, the CMA performs weaker oversight functions to the Malaysian Securities Commission, a fact made more striking because it is the only entity of its kind which is authorised to conduct securities trading in Saudi Arabia.[1046] An example is the strategic plan devised by the CML, which is akin to the approach taken in Malaysia, where the BNM has implemented a ten-year Financial Sector Master Plan. However, it falls short of the comprehensive detail provided in the Malaysian plans. This is most likely due to the maturity of Malaysia’s system, and its ability to enforce mandatory provisions in order to execute its plans. The CMA has authority to penalise entities that fail to adhere to the implemented regulations. However, Saudi Arabia’s regulatory and financial structure has yet to give effect to ‘mandatory’ disclosure standards which are uniformly applied to all Saudi financial institutions and entities as discussed below.

In response to concerns over transparency, accountability, and weak oversight of the Tadawul, the Saudi Capital Market Authority (CMA) has recognised that additional regulatory and procedural measures are needed to help grow the capital market and ensure the

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[1043] SAMA (n 367).
[1044] See BNM <http://www.bnm.gov.my/> accessed 13 October 2017.
[1045] Capital Market Authority, ‘Capital Market Authority Strategic Plan 2015-2019’ (Strategy and Research Division Strategy and Program Management, 2015) 1.
[1046] Al-Matari and others (n 906) 10.

credibility of the securities market with investors. To address these issues, the Saudi government has implemented Corporate Governance Regulations and reformed its Capital Market Law[1047], and the Companies Law[1048].

As the Kingdom of Saudi Arabia has transitioned from its national infancy into a globally minded leader in the Gulf region, it needed a corporate governance structure that was strong enough, yet flexible enough to foster growth.[1049] On November 9, 2015, a New Companies Law (New Law)[1050] was published by the Ministry of Commerce and Industry (MOCI) and came into effect on 2 May 2016.[1051] Most importantly, the new law requires enhanced corporate governance. For example, Article 81 lays out the requirements for an audit committee and develops an enhanced role for the Capital Market Authority in the oversight of joint-stock companies.[1052]

In addition to the new law, the CMA issued Corporate Governance Regulations ('CGR'), in November 2006 to raise Saudi corporate governance regulations closer to global standards. CGR is divided into four parts: 1) shareholder rights, 2) disclosure and transparency, and 3) boards of directors.[1053] These regulations are to be followed by every company listed on the Saudi Stock Exchange, and the main objective of the regulations are to ensure compliance with best corporate governance practices for the protection of the rights of shareholders and other stakeholders, ultimately strengthening the stability of the financial market. However, still, the regulations are considered to be more of a set of guiding principles that are not mandatory, except for in very limited circumstances. Instead of requiring mandatory compliance, the regulations operate on a 'comply or explain' basis.

The listing rules promulgated by CMA are also used to supplement the Corporate Governance Regulations, but these are not introduced in detail due to space constraints within this thesis.

[1047] Capital Market Law, Royal Decree No M/30 dated 2/6/1424H.
[1048] Companies Law, Royal Decree No M/6 of 1385H as amended.
[1049] Mushtaq H Khan, 'Governance, Economic Growth and Development since the 1960s' (DESA Working Paper No 54, ST/ESA/2007/DWP/54, 2007) 2 <http://www.un.org/esa/desa/papers/2007/wp54_2007.pdf/> accessed 13 October 2017.
[1050] New Companies Law (1437H/2015G).
[1051] Capital Market Law 2003, art 5 (A-1).
[1052] Francis Patalong, 'New Saudi Arabia Companies Law: Effective 2016' (*Tamimi*, 2016) <http://www.tamimi.com/en/magazine/law-update/section-14/december-january-3/new-saudi-arabia-companies-law-effective-2016.html/> accessed 13 October 2017.
[1053] Abdullah Wahtan Alkahtani, 'Corporate Governance Standards in Saudi Financial Sector: Achievements and Challenges' (2016) 7(12) International Journal of Business and Social Science 124.

In general, CGR's main objectives are to clean up the function of the corporate board of directors and to protect the rights of shareholders by: requiring the disclosure of board of directors' reports, mandating directives for the formation, function, responsibilities and meetings of the board of directors, and focusing on the development of internal corporate committees of the board of directors, including audit, nomination and remuneration committees and conflicts of interest of directors. There are some mandatory requirements contained within the CGR, including Article 9, which requires the board of directors to issue a report.[1054] Article 10, paragraphs 'b' through to 'd', mandate that corporate boards create internal control systems related to risk management, and prepare an internal corporate governance code, and a method for supervising that internal code.

As a key provision, Article 12 mandates that corporate boards be comprised of a majority of members that are set apart from the executive oversight of the company. More specifically, Article 12 states that boards are to include non-executive and independent directors, including individuals who hold less than 5% in shares of the company. This feature of independence and use of non-executive directors is recognised as being a significant contribution to the decision-making of a board, mitigating conflicts of interest, while ensuring directorial autonomy from the influences of corporate executives and natural disclosure of board activities.[1055]

It is important to note that the New Company Law does not make mention of the character and composition of board members. All provisions of the governance of corporate boards are voluntary, thereby limiting the true effectiveness of reforms, as will be discussed below.

Corporate audit committees are vital for reviewing a company's financial data, to ensure that the banks and other financial institutions have the appropriate internal controls and accounting practices to maintain the quality of the information surrounding the profitability of the company. Studies that examined the role of audit committees in Saudi Arabia pre the 2007 global crisis found the following shortcomings: inadequate terms of reference and restrictions on their scope of work; a lack of independence, poor working relationships with

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[1054] Jonathan Reardon and Asim Almalik, 'Corporate Governance and Directors' Duties in Saudi Arabia: Overview' (*Practical Law*, April 2015) <http://uk.practicallaw.com/8-608-8945?source=relatedcontent/#> accessed 13 October 2017.

[1055] ibid.

external and internal auditors; and a lack of expertise.[1056]

Despite these shortcomings and the enactment of the CGR in 2006, Saudi Arabia underwent significant shifts in corporate governance, and has made some progress in the improvement of transparency and disclosure. The audit committee is an example of Saudi Arabia's effort to create more independence and to lessen the risk of corruption between external auditors and corporate boards.

Malaysia's BMB goes significantly further than Saudi Arabia and sets best practice standards for audit committee regulations and oversight. Chapters 3 to 4 of BMB's Corporate Governance Guide provides extensive guidance to corporations on how to set-up, organise, and manage such committees.[1057] In particular, the guidelines emphasise independence, transparency and consistency.[1058] While like Saudi Arabia, it requires non-executive directors and experienced professionals to fully disclosure in accounting and report practices, and in the Malaysian system, the Bursa maintains direct supervision over auditors and the authority to intervene in committee activities.

While Saudi Arabia recommends the implementation of AAOIFI Accounting and Audit Standards, its governing laws, regulations, and corporate guidelines are inconsistent in the application and enforcement of such standards, instead primarily defaulting to National accounting standards as developed by experts at Saudi universities or through the Saudi Organisation for Certified Public Accountants (SOCPA).[1059] SOCPA's standards include disclosure requirements, revenues, inventory, and auditing standards which are designed to bolster the competence and independence of external auditors, enhance audit quality, and provide concise yet comprehensive audit reports.[1060] However, accounting and auditing practices remain subjective and non-uniform across corporate and government entities in Saudi Arabia, as no governing body, whether SAMA or SOCPA or CMA have created and implemented a universal and uniform set of accounting and auditing standards, which are to

[1056] Abdulrahman Al-Twaijry, John Brierley and David R Gwilliam, 'An Examination of the Role of Audit Committees in the Saudi Arabian Corporate Sector' (2002) 10(4) Corporate Governance an International Review 288.
[1057] Bursa Malaysia Berhad, 'Corporate Governance Guide: Strong Business Ethics, Sound Policy & Effective Monitoring' (2012).
[1058] See BNM, 'Financial Reporting and Concept Paper' (BNM/RH/CP 032-2, 31 October 2014); See also BNM, 'Fit and Proper Criteria' (BNM/RH/GL 018-5, 28 June 2013).
[1059] Noor Inayah Yaakub and others, 'Asset Ownership and Investor's Protection under Sukuk Ijarah' (2011) Middle East Journal of Scientific Research 23.
[1060] Al-Matari and others (n 906) 11.

be mandatorily used.[1061] This, arguably, means that corporate governance is ineffective in evaluating, much less adhering to transparent and predictable accounting practices.

Saudi Arabia has gone through a significant period of transformation in recent years, with new versions of its Companies Law and CGR being issued in the past eighteen months alone. To its credit, Saudi Arabia may well have the makings of a strong, stable, and transparent system. SAMA and CMA work well together and they have issued reformed regulations aimed at improving the financial system. Challenges remain, however. Conventional banking institutions have come under fire for enabling a culture of 'risk taking' and poor accountability to directors. And yet, the Saudi banking sector is not immune to similar accusations, given the historical levels of poor transparency and judicial enforcement of penalties for fraudulent or negligent corporate conduct.[1062] A culture of good governance and good corporate governance, enforced under national law and courts, has yet to be fully realized in Saudi Arabia, despite its compliance with Basel III Pillar 1 reforms (capital adequacy and risk weighting requirements).

One limitation of Saudi Arabia's newly adopted company and corporate governance law is the failure to integrate relevant standards on transparency, disclosure, and enforceability rules into the broader framework on banking and finance regulations. Instead, we find an incomprehensive and fragmented approach to the implementation of corporate governance standards.[1063] The system of governance in Saudi Arabia has undergone a series of free market reforms which aim to enhance the openness, competitiveness, and independence of financial institutions subject to the laws and jurisdiction of Saudi authorities. But Saudi Arabia has a long way to go before its financial sector can be said to have achieved an appropriate degree of independence from governmental institutions. Market failures such as corruption, rent seeking and excessive state control continue to plague the Saudi financial sector, which has, since the creation of the modern state of Saudi Arabia, remained largely state owned and controlled.[1064] There are some grounds for optimism, however. State owned companies are increasingly being brought under the shadow of law and are being held to

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[1061] Muhammad Umer Chapra and Tariqullah Khan, 'Regulation and Supervision of Islamic Banks' (Islamic Research and Training Institute, 2000) vii-93.
[1062] Luca Errico and Mitra Farahbaksh, 'Islamic Banking: Issues in Prudential Regulations and Supervision' (IMF Working Paper WP/98/30, 1998) 3-29.
[1063] Corporate Governance Regulations in Saudi Arabia issued by the Board of Capital Market Authority Pursuant to Resolution No 1/212/2006, 8.
[1064] Abou Al-Shamat (n 54) 1.

strengthened forms of public accountability, namely through ‘soft’ compliance mechanisms, i.e. optional reporting mechanisms.[1065]

It is difficult to escape the conclusion, nonetheless, that Saudi Arabia remains a closed society. Regulators such as SAMA still seek to control the flow of information, thereby diluting the effectiveness and efficiency of its newly adopted financial disclosure policies. The IMF in the 2016 Financial Stability Report identified major gaps in SAMA reporting and monitoring practices, highlighting a failure by SAMA to disclose ‘the good with the bad’.[1066] Otherwise put, SAMA, most likely with the support of the Saudi government, seeks to ‘control’ any output of information, such as the poor performance of banks or risk exposures, in order to avoid any reputational damage that this may bring.

Disclosure and related standards are adopted on a voluntary basis by financial entities, that choose to comply with them for reputational reasons, rather than enforced compliance.[1067] Accounting practices are also a significant issue. For its detractors, voluntary reporting and auditing requirements lacks ‘bite’, creating a patina of legitimacy for those companies who formally adopt ‘good’ governance guidelines, without the threat of judicially applied sanctions.[1068] One disturbing trend seems to be that companies and institutions are much less motivated to disclose non-financial information, in accordance with *voluntary* guidelines, due to the lack of foreign competition and the pervasive participation of family-owned corporations.[1069] Inadequate protection measures have similarly led to spikes in insider trading, conflict-of-interest issues (e.g. such as failure to disclose property interests in financial assets,) and unsupervised actions by ‘authorised persons’ in non-listed companies.[1070]

Lessons can be learned from the Malaysian banking sector, wherein capital guidelines and other corporate governance related matters require acquired formality through the statutory

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[1065] Kun-Ho Lee and Shakir Ullah, ‘Integration of Islamic and Conventional Finance’ (2007) 3(5) International Review of Business Research Papers 245.
[1066] IMF (n 536) 5.
[1067] Grais and Pellegrini (n 361) 2.
[1068] Sheharyar Sikander Hamid, ‘Efficacy of Corporate Governance Theories in Determining the Regulatory Framework for Islamic Finance Institutions’ (PhD thesis, University of Warwick, 2014).
[1069] Ahmed Galal and Bernard M Hoekman, *Arab Economic Integration: Between Hope and Reality* (Brookings Institution Press 2003) 25.
[1070] See, Listing Rules of 2004. Listed companies, however, are controlled in a stronger, more beneficial manner, with mandatory reporting and disclosure requirements.

provisions of Malaysian Central Banking Act 2009, the Financial Services Act of 2013, and the Islamic Financial Services Act of 2013.[1071] In contrast to Saudi Arabia, Malaysia's 'Code on Corporate Governance'[1072] is considered to be a more comprehensive and credible system because it strengthens self and market discipline, and has a clear chain of authority, transparency, disclosure, and enforcement mechanisms in areas such as corporate accounting and auditing practices, and the consistent use of penalties for non-compliance.

As discussed earlier in this chapter, it focuses on eight main principles and goes beyond minimum legal requirements and guidelines, instead, making adoption and adherence of the principles by listed companies mandatory, not voluntary. It also intertwines international accounting practices and standards, instead of relying on nationally developed provisions. Stricter compliance with the Code means more accountability in reporting mechanisms, strengthened protections for shareholders, and overall fairness, as well as transparency in the system.[1073]This spurs cross-market co-operation between conventional and Islamic institutions, and provides for a stable system with which Malaysia can predict and control growth.

As Khalid et al. have argued, Malaysia has been relatively successful in its attempt to balance a strong culture of good corporate governance (and risk management), on the one hand, with a flexible approach to market regulation, "which has gradually moved away from overly prescriptive regulations and a one-size-fits-all approach to a more principled-based regime that is adaptive to changing market conditions and innovations."[1074] Notably, the relevant Saudi authorities, the Council of Ministers, Minister of Commerce and Labour, and SAMA have not yet constituted similar legislative provisions, thereby creating another area of potential reform for Saudi Arabia.

This should not be taken to mean that the Malaysian model is without flaws. For example, the BMB 2016 report for corporate governance compliance of listed companies suggests ongoing room for improvement on disclosure and reporting activities, citing that out of 280

[1071] Soon Chong and Liu (n 238).
[1072] Hasan (n 289).
[1073] Ramady (n 261).
[1074] Nurhayati Mohd Khalid, Diana Paharodzi and Raymond Yeo, 'Pro-Cyclicality Impact of Basel II in Malaysia' (SEACEN, 2008) 71 <http://www.seacen.org/GUI/pdf/publications/research_proj/2008/rp72/5-chap4.pdf> accessed 22 January 2017; Pungky Purnomo Wibowo, *Understanding and Addressing the Pro-Cyclicality Impact of Basel II* (SEACEN 2008) 47.

listed companies, only, "56% disclosed the criteria for evaluation of individual directors, 40% disclosed criteria for evaluation of board committee, and 65% disclosed criteria for evaluation of the board."[1075]

The wider point is that Saudi Arabia is not alone in its efforts to articulate sound corporate governance policies which enhance the corporate accountability of bank managers and their Board of Directors towards their shareholders through policies to ensure standards of good practice in relation to board leadership and effectiveness, performance and public trust. When made subject to any overarching legislative and judicial oversight, corporate governance standards (spanning auditing, due diligence and disclosure standards, or the provision of the 'voice and exit' rights of shareholders and the right to hold a vote of no confidence, remove directors or shape investment strategy) are part of the wider package of legal reforms necessary to establish a sound, transparent and just framework of banking regulations, thus realising the broader principles and goals which inspired the international Basel regime in the first place.

Strengthened opportunities to influence investment policy and censure the Board decisions of Bank or to penalise the mismanagement of funds by lower level bank managers is especially vital in Islamic profit and loss arrangements, given that it is the investor who assumes most of the risk. Despite the apparent imbalance in rights protections, described above, the Banking Regulations Act and Capital Markets Law fails to make explicit reference to Islamic forms of finance and banking. Moreover, SAMA and CMA have yet to issue regulatory guidelines pertaining to the operation and conduct of Islamic financial services or companies.

The silence of Saudi authorities on these key issues stands in sharp contrast to the practice of the central bank of Malaysia (Bank Negara Malaysia (BNM)), and the Securities Commission Malaysia (SC), or even the Financial Services Authority (FSA) in the UK. As suggested, in the previous chapter, Malaysian regulators have developed Basel influenced or equivalent financial and regulatory strategies for addressing the risks associated with Islamic instruments. Even prior to the voluntary adoption of Basel II and III standards, the BNM

[1075] M Hafidz Mahpar, 'Listed Companies Show Progress in Corporate Governance Disclosures' *The Star* (Kuala Lumpur, 2016) <http://www.thestar.com.my/business/business-news/2016/12/22/listed-companies-show-progress-in-corporate-governance-disclosures---bursa-malaysia/> accessed 13 October 2017.

introduced an interest free banking scheme under which Shariah compliant banking products can be circulated through existing market distribution networks.[1076]

Of crucial importance, the BNM has paved the way for the development of corporate governance guidelines which are specifically targeted to improve the transparency and disclosure practices of Islamic banks. Under the BNM's guidelines, Islamic banks are required to disclosure their financial statements on a regular basis.[1077] As will be discussed below, this represents an important step by Malaysian regulators because of the way certain losses/liabilities are to be recorded on the balance sheets of Islamic banks under the exiting accounting rules of the AAOIFI. Under the existing rules, Islamic banks are under no obligation to state any losses assumed by an investor under profit and loss sharing investment accounts on their balance sheets, and such losses are typically treated as off balance liabilities which are only disclosed on trading books.[1078] Through its implementation of the Central Bank of Malaysia Act 2009, the BNM has endorsed and implemented several standards and market instruments which are deliberately intended to assure, both, higher levels of Shariah compliance and risk reduction.[1079]

As will be discussed later in the chapter, the creation of a dual-character banking system would also bring urgent need for the development of a more transparent set of guidelines on the legality of certain products, including Islamic debt based instruments and derivatives i.e. Sukuks. The creation of a dual legal system, however, should be supported by robust corporate governance standards of general ability and scope.[1080] As the IMF has reported, credit concentration in the leveraged construction and real estate sectors, along with a failure to distinguish between 'hybrid' banks offering a mix of conventional and Islamic products and banks offering exclusively the latter has the potential to undermine Saudi Arabia's already weakened economy.[1081] The legislative and regulatory framework governing banking law in Saudi Arabia, in other words, should be underpinned by a robust framework of

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[1076] Abd Jabbar (n 417) 312, 316.
[1077] Zulkifli Hasan, *Shariah Governance in Islamic Banks* (Edinburgh University Press 2012) 109.
[1078] BNM, 'Guidelines on Corporate Governance for Licensed Islamic Banks (GP1-i)' (BNM/RH/GL 002-1, 2011).
[1079] Zulkifli Hasan and Mehmet Asutay, 'An Analysis of the Courts' Decisions on Islamic Finance Disputes' (2011) 3(2) International Journal of Islamic Finance 44.
[1080] Arakcheev and others (n 485) 252.
[1081] IMF (n 536) 5.

corporate governance which has reach over all banking institutions and activities in Saudi Arabia, Islamic or conventional.

The IMF and World Bank report on Basel implementation strategies in Saudi Arabia have indicated that Saudi regulators continue to compel on financial disclosures on an ad hoc and selective basis. When financial information on the overall health of the Saudi banking and finance sector is published, it is done so irregularly and incompletely. The implication is that consumers, investors and global financial stakeholders cannot accurately assess or verify the overall performance of banks (i.e. the rate of return on investments, or the losses suffered by a bank affecting the consumer to deposit funds with the banks). In a global economy, any policy which tacitly supports the withholding of key risk related data will severely undermine any oversight and supervision of a financial entity or sector's compliance or non-compliance with Basel standards on risk weight and capital adequacy requirements.[1082]

This problem is aggravated in the case of Islamic banking where accountancy standards are non-standardised, and otherwise can be criticised for failing to ensure that bank officials exercise due diligence in the management of client finances.[1083] At any rate, as the above discussion suggestions, Saudi regulatory requirements on financial disclosure are less robust and effective than those enacted under Malaysian legislation.

One significant factor missing from SAMA's regulatory function and publication, is that it does not have a comprehensive or published set of guidelines for what constitutes being Shariah compliant. This is problematic because, as will be discussed further in this chapter, it leaves open a chasm for competing religious interpretations. It means that everything from an Islamic banking tool or product issued by individual banks, to a financial institution is vulnerable to non-compliance risks or the pseudo-practice of 'shopping around' for the best Shariah interpretation. In other words, the underlying consideration of Saudi Arabia's financial structure is that without such clear guidelines, disclosures and definitions, is it possible that any institution or SAMA itself be Shariah compliant, much less predictable, transparent, and stable?[1084]

[1082] Van Greuning and Iqbal (n 481) 5.
[1083] Cattelan (n 435) 79-80.
[1084] Nazim S Ali and Rahman Syed, 'Post-9/11 Perceptions of Islamic Finance' (2010) 39 International Research Journal of Finance and Economics 27.

The pertinent issues to discuss in Saudi Arabia's 'risk' management and Basel implementation plans, relate to whether Saudi Arabia can truly be compliant with both Basel and Shariah law, as well as designed to withstand unforeseen economic pressures[1085]. The next section will consider the impact of Shariah on Saudi banking and finance regulations.

7.4 The Effects of Basel Compliance on Sovereign Credit Risks

Saudi Arabia has, in its 2030 vision, declared its intent to mitigate any risk exposure resulting from the decreased value of its public stocks and oil revenue through expansion and diversification of economy, principally through large scale investments in new growth industries such as construction. It is predicted that GCC banks, including Saudi banks and financial institutions, are expected to issue $43 billion of Basel III compliant debt by 2019 in order to improve the quantity and quality of their capital base.[1086] This will mean more reliance on high quality liquid assets, and the use of equity funds, which would decrease banks' profitability because it would require banks to reduce its supply of funds to riskier borrowers such as small and medium companies. This contradicts Saudi Arabia's efforts to diversify its industries and increase financing for small and medium companies. Efforts to remain Basel compliant may then prove to be problematic and create strain on the operational health of Saudi Arabia's financial system.

Keeping a tight grip on assurances for the repayment of loans is important to any financial institution's ability to maintain stability and solvency. SAMA currently reports that its rate of non-performing loans (NPL) is at a record low due to its prudent monitoring and the high creditworthiness of borrowers, thereby increasing the quality of the 'credit risk' of banks established in Saudi Arabia. Specifically, total bank credit grew by about 9% in 2015, while the stock of non-performing loans rose by about 6% in the same period, with only a slight increase in the NPL ratio to 1.2% in 2015 from 1.1% in 2014.[1087] But this low NPL ratio is deceptive. Saudi Arabia currently has 2169.9 billion SAR of net foreign assets[1088], but unfortunately, credit risks are on the rise.

[1085] Kun-Ho Lee and Shakir Ullah, 'Integration of Islamic and Conventional Finance' (2007) 3(5) International Review of Business Research Papers 241, 265.
[1086] Alsharif and others (n 878) 553.
[1087] SAMA (n 367).
[1088] ibid.

Around 80-90% of Saudi Arabia' government revenue is generated from the proceeds of petroleum related activities. It is well documented that the price of oil has plummeted in the last decade. On the basis of existing data, Saudi Arabia holds sufficient reserves to compensate for losses in oil proceeds. That being said, there is some evidence to suggest that dwindling oil sales may expose the Saudi government and its population to significant, or even permanent, financial risks. Public finances in Saudi Arabia have suffered significant losses recently.[1089] It would, moreover, be dangerously short-sighted to underestimate the possible impact of market shocks on the soundness of the Saudi economy, and to the liquidity of Saudi banks, given that in 2015 around 90% of government and export revenues were derived, exclusively, from oil proceeds.[1090] Comparisons can be made with natural resource dependent economies such as Venezuela, wherein a drop in market values for natural commodities lead to a devaluation of the national currency.[1091]

The combined factors of a sluggish economy, the downgrading of Saudi Arabia's credit rating and currency shocks may further exacerbate the venture capital 'exit' risks to which Islamic financial institutions are already disproportionately exposed. This is the risk that may prompt investors to start withdrawing their capital from Islamic Profit and Loss Investment Agreements, because of the relatively low profits yielded from high risk ventures. Falling commodity prices can also impact joint ventures and projects, including those financed by Shariah capital. For instance, hire and purchase agreements on plant equipment may be significantly impacted by oil prices, with a knock-on effect on employment levels and housing. The wider macro-economic factors described above may not be fatal in themselves, but rather exacerbate certain risk anomalies which are inherent in the structure of Islamic modes of investment and finance. For Islamic institutions, this means utilizing Shariah compliant means to do so. This is all the more significant because a number of Shariah compliant modes of financing are largely ignored or passed over by existing international banking regulatory regimes.

[1089] Larry Elliott, 'Recession in Russia, Revolt in Venezuela? The Knock-on Effects of Tumbling Oil Prices' *The Guardian* (London, 16 October 2014) <http://www.theguardian.com/news/datablog/2014/oct/16/datablog-low-oil-prices-chill-producer-economies/> accessed 13 October 2017.
[1090] Economist Intelligence Unit, 'Saudi Arabia Country Risk Report' (May 2015).
[1091] Elliott (n 980).

7.4.1 The Challenges of Applying Basel Capital Adequacy Requirements to Islamic Finance Institutions in Saudi Arabia: A Comparative Perspective

Each phase of Basel has been designed to strengthen the financial systems of the participants, with Basel III focusing on capital and liquidity standards and risk. The difficulty is that the Basel III regulatory framework has, arguably, yet to address the potentially discriminatory application of Basel capital measurement and risk weighting techniques to Islamic trading book assets.

The uniform and inflexible adoption of Basel risk and capital measurement standards would only make sense if all banks structured their debts and liabilities in a more or less equivalent fashion. A key distinction between Islamic and conventional banking institutions in evaluating and managing credit risk, however, is that Islamic banks, such as in Saudi Arabia, operate on an asset-based, risk-sharing model; while conventional banks operate on a debt-based, risk transfer model For Islamic institutions attempting to assimilate Basel and international standards, this poses substantial governance problems, in addition to the challenges in maintaining compliance with credit, liquidity, and market risk standards.

7.4.2 The Risk Challenges Associated with Islamic Banking

As Arakcheev, Baklanova and Tanega have explained, a number of Islamic finance instruments are exposed to high levels of credit risk.[1092] In banking terms, this means that Islamic banks have to use equity based lending practices whereas conventional banks can use 'derivative' contracts to hedge the reduction of capital requirements. In a bid to circumvent Islamic barriers to trading instruments i.e. short selling or the use of collateralised debt obligations i.e. securities, Islamic financial institutions in Saudi Arabia are often forced to raise finance through profit and loss sharing agreements instead of high interest-bearing loans and secure their debts against Shariah compliant securities such as Sukuks instead of traditional (interest based) bonds.[1093]

Islamic banking institutions in Saudi Arabia tend to utilise profit-sharing investment accounts (PSIAs) or profit and loss sharing investments (PLS contracts) to address capital risk i.e.

[1092] Arakcheev and others (n 485) 248.

[1093] Ashraf Wajdi Dusuki and Abdelazeem Abozaid, 'Fiqh Issues in Short Selling as Implemented in the Islamic Capital Market in Malaysia' (2008) 21(2) JKAU: Islamic Economics 63, 78.

profit and loss sharing and investment agreements i.e. Mudarabah, and Musharakah investments. Similarly, Malaysian Islamic banks such as BIMB offer products and hold assets with unique elements and risks.[1094] These include investments in forms of real estate which are typically sold in property markets[1095], long term investments in the development of business and public sector enterprises and investments in sister companies.[1096]

When examining this practice under Basel III capital regulation, the question is whether Islamic banks need to develop additional or separate risk weighting and valuation standards if a large percentage of their revenues are generated from profit and loss sharing schemes. Abdou Diaw and Mohamed suggest that national supervisory authorities such as SAMA or the BNM in Malaysia will only be effective at addressing credit risks if they are able to establish adequate reserves to mitigate risks inherent to profit sharing investments, particularly the risks associated with unrestricted deposits.[1097] As discussed below, the liability claims that can be levied against an investor under PLIA or PLS arrangements serve to complicate the matter of how to quantify the minimum capital held by that bank as a percentage of it risk weighed assets under existing Basel rules.

7.4.3 Current Approaches to Risk Valuation of Islamic Finance Agreements in Saudi Arabia and their Limitations: A Comparative Perspective

One set of credit related risks to which Islamic banks are uniquely exposed concern trading book risks. As discussed previously, Islamic banks are generally prohibited from trading on secondary markets, including the trading of commodities on the stock market. Since short-selling is deemed 'haram', Islamic banks are not generally exposed to trading book risks associated with volatility in the stock markets or market risks associated with short term securities.[1098] On the whole, Islamic banks have a small share in stock markets and even when stock is acquired, these asserts are converted from temporary assets and recorded as debts which are then sold to consumers for a deferred or instant payment under a Maharajah

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[1094] Mareyah Mohammad Ahmad and Dayanand Pandey, 'Are Islamic Banks Better Immunized than Conventional Banks in the Current Economic Crisis?' (10th Global Conference on Business & Economics, Rome, October 2010).
[1095] Bank Islam Malaysia Berhad, 'Annual Report 2013' 42.
[1096] ibid, 'Annual Report and Financial Statement' (2014).
[1097] Diaw and Mohamed (n 451).
[1098] Shahid MK Ghauri, *The Rightful Way of Banking* (Cambridge Scholars 2015) 169.

agreement.[1099]

While the market risks associated with Islamic investments such as investments in subsidiary companies[1100] can be, to some extent, integrated into the existing Basel III risk-weighting frameworks, [1101] many will have risk-related characteristics which are distinct from the kind of investments which the Basel model primarily looks to address.[1102] Reform is essential because research indicates a trading book and direct investment of between 5% and 26.3% of the total market of Islamic financial assets. [1103]

A further complicating factor is the inequitable distribution of loss risk in investment agreements in which investors raise sums which are deposited through joint venture and other partnership agreements. As discussed in Chapter IV, profit and loss sharing schemes (PLS) or profit and loss investment schemes (PLIS) such as i.e. Mudharabah, and Musharakah investments create far higher risks for the investor/depositor than they do Islamic banks.

One possible solution to these challenges would be to assign different risk weights to unrestricted investment deposits than restricted deposits. This is the practice in Malaysia. Demand deposits might then appear on the balance sheet in the banking book, and investment deposits would then be reported off balance sheet via the trading book, which is the position currently endorsed by the AAOIFI. This approach also has its limitations, however, because it does not account for any discrepancy between the realised value of a security on loan and the trading book value (i.e. on balance sheet values).

Under the existing accountancy standards of the AAOIFI, a distinction is made between lease agreements, which are still in effect and those which have been concluded following repayment, and the transfer of ownership from the bank to the leaser. The value of purchased property is, under Islamic law, should be no more than the sum value of any aggregate rental installments.[1104] But such an arrangement, as discussed in Chapter IV may not reflect the true value of the rented asset on the maturity of the rented asset, nor account for any losses

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[1099] ibid.
[1100] Aniss Boumediene, 'Is Credit Risk Really Higher in Islamic Banks?' (2011) 7(3) Journal of Credit Risk 97.
[1101] Basel Capital Risk Measurements Standards Categories 11 and/or 12.
[1102] Ghauri (n 989).
[1103] Harzi (n 726); Archer and others (n 227) 233.
[1104] ibid.

incurred by the lessor, upon re-sale of that asset as a result of a decrease in market values. While Islamic banks can pledge to taking ownership of distressed assets under a Waab agreement, or non-binding promise, existing Islamic accounting rules provide little guidance on how these promises can be recorded in the balance sheets of a bank.[1105] Currently, any unilateral commitment to take ownership of assets, including non-performing assets, is generally accounted for in off-balance sheet transactions. So far, Islamic accountancy and valuation standards have, thus far, failed to address discrepancies between the actual value of pledges as security and the book values.[1106]

It is nonetheless important to remain cognizant of the structural dissimilarities in Islamic versus conventional debt securities, and the disputed legality of Islamic securities among Shariah authorities from one legal jurisdiction to the next. A case in point is the burgeoning market in Sukuks, which is largely unfamiliar to conventional debt markets[1107] and are, accordingly, not recognised as trading book assets as they are conventionally defined under the existing Basel framework.[1108] While Islamic banks tend to hold comparatively few trading book assets, those financial institutions which do hold them are exposed to disproportionately high risks.[1109]

7.4.5 The Effects of Shariah Compliance Risks on the Liquidity of Saudi Banks

If the approach of Malaysian regulators is to be followed, Islamic assets ought to be categorised and risk-weighted in a different way from conventional interest-based lending. The internal ratings system developed under Basel III has, to some extent, addressed this challenge, thereby improving upon Basel I and Basel II, under which assets were grouped together under undifferentiated categories. As a result, profit and loss sharing investments were mis-characterised as part of Tier 2 capital instead of Tier 1 capital. SAMA has applied Basel III definitions for capital (Tier 1 and Tier 2), in an attempt to address risk weight inadequacies according to Basel standards by increasing its own capital adequacy ratio

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[1105] ibid.
[1106] Siddiqui (n 436) 694.
[1107] Juan A Sole, 'Introducing Islamic Banks into Conventional Banking Systems' (IMF Monetary and Capital Markets Department Working Paper WP/07/175, 2007) 7.
[1108] Abdullatef, Al Elsheikh and Tanega (n 311).
[1109] Jeroen PMM Thijs, 'Risk Management in Islamic Banking' (Bank Islam Malaysia Berhad, 2010) <http://www.bankislam.com.my/en/Documents/shariah/RiskMgmtinIslamicBkg.pdf> accessed 13 October 2017.

(CAR).[1110]

The risks associated with the asset portfolios of particular Saudi banks can, therefore, be more accurately determined through the use of risk weighting models which allow for the quality of each asset (the probability of default) to be assessed individually. In an attempt to address variation, Basel III now establishes a standard method or risk evaluation, known as the effective EPE model. This model requires banks to utilise a market date to predict possible exposure to risk, including through the adoption of risk 'benchmarks' which identify the main risk factors to which the bank is exposed, including: historical and current fluctuations in market prices over a three year 'stress testing' period.[1111]

The question of how determine the risk weighted capital that should be held in reserve to offset losses resulting from a joint venture or partnership financed through Shariah compliant capital is a complex and structurally linked to the problematic manner in which Islamic banks assess and evaluate risk. While international risk rating and valuation systems such as the Basel EPE model or, in accountancy terms, the International Accountancy Standards Board, are able to determine market values through linking these to global interest rates, Islamic equivalents such as the AAOIFI and IFSB cannot directly rely upon interest based valuation and risk measurement methods. The equivalent Islamic standard requires that banks write off impaired assets only when the value of an asset has already changed, based on a market baseline or index. This is a notoriously unreliable and reactive method of measuring valuation risks, which exposes investor depositor funds to pricing, exchange or currency risks.[1112]

One could argue that banks in Saudi Arabia should adopt the valuation model proposed above, under Basel III, and apply these to both Islamic and non-Islamic asset classes. This would certainly provide one possible means by which to protect Saudi banks, which would be expected to apply a standard model of risk valuation technique that is specifically designed to eliminate liquidity risks resulting from major defaults or a bank run. Basel II and III approved risk methodologies for measuring and calculating capital to risk requirements, as explained earlier, are not sufficiently tailored to the specific risks associated with profit and loss sharing agreements. As such, it is not entirely obvious that risk valuation models developed under

[1110] BCBS (n 48).
[1111] BCBS (n 1) 30.
[1112] Vinnicombe and Park (n 4).

Basel III, provide adequate buffers against future threats or pressures on the solvency of Saudi financial institutions, particularly those with high quantities of Shariah compliant assets.

The Basel model of risk valuation is based on stress testing data which is accumulated over a medium-term period of three years. This, however, does not account for short term risks i.e. commodity risks resulting from Saudi Arabia's dependence on oil commodity markets or long-term valuation risks associated with, for instance, commercial and residential housing arrangements which are typically financed through the profit and loss sharing agreements as detailed below.

On one end of the spectrum, Basel stress testing models do not necessarily provide protections against short term risks i.e. currency or pricing related risk. It will be recalled that a significant proportion of Islamic banking revolves around trade in real goods, i.e. the commodities market including, revenues from agriculture, minerals, and crucially, petroleum based products.[1113] Islamic finance is structurally biased to support the trade in commodities, since Shariah compliant debt transactions must be backed by real assets or goods. However, the commodities market is notoriously volatile. Volatility in the relevant markets market may significantly impact the prices of commodities over short intervals of time.[1114] Moreover, the market of commodities is very sensitive to wider geopolitical and environmental shifts, and by changing patterns of consumer demand.

On the other end of the spectrum, Islamic finance instruments e.g. profit and loss sharing contracts tend to have a long maturity, making it difficult to assign a fixed value to assets over long periods of time, for instance, the market value of a mortgaged property over a longer year term period. The experience of the Dubai housing crisis proves salient in the

[1114] Hela Miniaoui and Gaston Gohou, 'Did Islamic Banking Perform Better During the Financial Crisis? Evidence from the UAE' (2013) 9(2) Journal of Islamic Economics, Banking and Finance 115; and Nasdaq Dubai, 'Trading Book Market Risk Management for Financial Institutions' (Course, 9th-10th September 2015, 9:00am-5:00pm, Jumeirah Emirates Towers, Dubai, UAE) <http://www.nasdaqdubai.com/assets/media/academy-brochures/Trading%20Book%20Market%20Risk%20Management%20for%20Financial%20Institutions.pdf> accessed 20 January 2017.

above respect. The Dubai housing crisis was triggered in part because of excessive liquidity in the banking sector, and because of an unsustainable rise in housing prices which, significantly, exceeded their actual market value.[1115] In these situations, Islamic financial institutions are exposed to higher levels of risk because of their tendency to offer fixed rate mortgages i.e. with fixed repayment schemes which are not calibrated to account for rising prices through variable interest rate schemes.[1116]

If risks were being consistently managed across all Islamic banks, one solution would be to treat profit and loss sharing investment agreements as 'on balance sheet' Tier 1 (and not Tier 2) capital. This would effectively create a two tier system, meaning that a higher minimum shareholder equity requirement under Basel III (Tier 1 Equity) with lower risk weighting asset thresholds would apply to Islamic banks as well as conventional banks under the existing framework[1117] A higher capital reserve may function as a de-facto 'deposit scheme', similar to the one implemented by Malaysian banks, thereby obliging Islamic banks to 'lock in' capital as protections against future losses.

Any regulatory gains won from the strengthened protection of investor or demand deposits against pressures on a bank's ability to absorb losses through adequate levels of institutional liquidity would have to be balanced against considerations of how such a rule might impair the efficiency (profitability and adaptability) of a bank, since it is economic efficiency that allows banks to remain viable enough to operate as they should do i.e. by financing their obligations and providing sources of financing. In other words, a higher minimum capital equity requirement may impose an unfair regulatory burden on Islamic banks who are already struggling to remain competitive and attractive to future investors, from which a large portion of their revenues are generated, given the restrictions on profits generated from debt based instruments. Furthermore, a uniform application of the higher Tier 1 threshold would increase the operational risks (and costs) assumed by Islamic banks, relative to conventional banking services.

[1115] May Khamis and Abdelhak Sendhaji, *Impact of the Global Financial Crisis on the Gulf Co-operation Council Countries and Challenges Ahead* (IMF 2010).
[1116] ibid Khamis and Sendhaji.
[1117] Dhalia El-Hawary and others, 'Diversity in the Regulation of Islamic Financial Institutions' (2007) 46(5) The Quarterly Review of Economics and Finance 778.

The above discussion allows us to consider the quality of assets in emerging Saudi markets. The Saudi Vision 2030 sets out Saudi government's commitment to diversify its financial assets and investments. One area of significant growth, accordingly, is the Saudi construction market. But, investments in the capital intense construction market, even those financed through Islamic modes of financing, are by no means immune to the very risks that conventional banks were exposed to in the run up to the sub-prime mortgage crisis. Such a scenario is unlikely to play out in Saudi Arabia, due to the relatively conservative lending limits implemented in Saudi Arabia, as set and supervised under the regulatory authority of SAMA. Nonetheless, it should be emphasised that the supply of cheap credit and, correspondingly, the excessive liquidity of the conventional banking system was not the sole cause of the ensuing upswing in house prices and the resulting credit crash. This is revealed by the fact that housing prices in Western markets have remained stable despite regulatory restrictions on lending.[1118] The implication is that the Basel approved internal risk rating system is, in fact, broadly reliable, and, thus, able to insulate financial institutions against macroeconomic instability and sovereign credit risks.

The situation is, however, less stable in the Kingdom of Saudi Arabia. The construction market will need to absorb the increased supply of liquid cash into this sector, which may result in a similar volatility in transactional, operational and the market value of land and goods exchanged in hire and purchase agreement.[1119] One possible impact of the increased flow of capital resource is a decrease in real estate prices, resulting in the unavailability of affordable housing or government provision of construction loans. These, among other factors, may set the conditions for a real estate bubble in Saudi Arabia. The broader point to be made is that a blind faith in SAMA's lending policies do not necessarily immunise Saudi banks from the future prospect of a credit crash or crisis. Therefore, is important to consider the connection between legal, including corporate governance regulations, and long-term macro-economic trends.

7.4.6 Summary: Reconciling Basel Methodologies with Shariah

Malaysian regulators, under the auspices of the Malaysian Bank Berhad, are leading the charge to harmonise Basel and IFSB capital measurement guidelines and best practices,

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[1118] Turner (n 29).

[1119] Abdulhadi Habtor, 'Saudi Real Estate: Major Price Correction Ruled Out' (*Arab News*, 29 June 2015) <http://www.arabnews.com/economy/news/768906/> accessed 13 October 2017.

including by developing customised risk rating systems, including liquidity related measures, which are more sensitively calibrated to the risk exposure of Islamic financing arrangements, assets and contracts. To this point, IFSB's GN-6 Guidance provides liquidity risk management measures which are specifically designed for financial institutions, providing Islamic financial services, while also bridging the gap between the risk-regulation approaches of the AAOFIA standards and those embodied by Basel II and III guidelines.[1120] These guidelines specifically target muḍārabah or wakālah instruments[1121] but also borrow from Basel recommendations. Crucially, the guidelines encourage Islamic banks to diversify their portfolios with higher quality assets such as Sukuks, and balance the equity side of their financial portfolios through wider use of Shariah compliant hedging assets (e.g. Islamic swaps).[1122]

Saudi banks will still have to consider how to balance their equity heavy portfolios with hedging assets that protect them from credit default or markets risks. A key difference between hybrid banking systems like Malaysia, and Shariah law driven systems, such as those in Saudi Arabia, are that Malaysia utilises both conventional banking products and customized Shariah compliant, Islamic banking products. Therefore, part of the strength of Malaysia's system is being able to match Islamic products to conventional products and increase overall offerings to any investor; whereas in Saudi Arabia, the offerings are limited to Shariah compliant products such as Sukuks, Mudarabah, Musharakah, and Wakala.

Sukuks in particular are considered to be high quality assets, and countries such as Malaysia have made significant inroads in the development of so called Shariah compliant debt based instruments.[1123] In 2015, the National Commercial Bank (NCB) in Saudi Arabia was the first domestic institution to issue a Tier 1, capital Basel III-compliant perpetual Sukuk[1124] and with more Sukuk expected to be issued, the standardisation of Shariah compliant practices through legislative and corporate governance acts becomes more critical.

[1120] IFSB, 'Guidance Notes on Quantitative Measures For Liquidity Risk Management in Institutions Offering Islamic Financial Services (excluding Islamic Insurance Takāful Institutions and Islamic Collective Investment Schemes)' (April 2015).
[1121] IFSB standards part 2.3.1.1, from para 52, 17.
[1122] ibid para 121, 32.
[1123] Arakcheev and others (n 485).
[1124] Meager (n 894).

The reasons for the absence of Islamic financial derivatives in Saudi markets is the lack of a system (law) for the Shariah Supervisory Board (SSB) of Islamic banks, where the Saudi banks unilaterally choose the members of the SSBs of the bank. In other words, the IFIs have founded a self-regulatory process within each institution. In addition, they are free to adopt their own Shariah governance without adhering either locally to SAMA or CMA standards or internationally to AAOIFI standards. This lack of uniformity around Islamic rulings leads to uncertainty over whether a product developed in one jurisdiction is Shariah compliant in a neighbouring jurisdiction.

A key example is the market in Sukuks which, while thriving, remains controversial amongst religious scholars in Saudi Arabia, as is described below.[1125]

> "The issuance of Sukuk in Saudi Arabia is not being regulated, issued or operationalized from within a framework that takes account of the nature of Sukuk as distinct from conventional debt instruments, which means that Sukuk in Saudi Arabia are issued as debt instruments… [furthermore] there is no single legislation specifically regulating the implementation of Sukuk issuance, even though there were fifteen Sukuk issuances in 2000 to 2008 and huge Islamic mutual funds in Saudi Arabia."[1126]

Saudi Arabia will have to remain sensitive to the fact that the lack of consistent fatwa can lead to conflicting 'halal' and 'haram' certifications of products by scholars.[1127] However, if Saudi Arabia expects to become a banking and financial hub for the Middle East, it has to continue to grow its financial system through innovative Islamic products and services. So whilst Shariah law does not prevent a bank from making a profit or creating customised banking tools, there is need for uniformity on what is 'halal' and what is, and is not, 'haram'. How might Saud Arabia then simultaneously address 'fatwa shopping' to maximise its use of customised banking products and services, and standardise the evaluation of Shariah compliance?

[1125] Usmani Foster is the leading proponent of modern day Islamic finance. There are, however, online comments alleging that Usmani himself has sold fatwas to the highest bidder.
[1126] Ali Alshamrani, 'Sukuk Issuance and its Regulatory Framework in Saudi Arabia' (2014) 2(1) Journal of Islamic Banking and Finance 3286.
[1127] Arakcheev and others (n 485).

The final portion of this discussion chapter will reflect upon and draw final conclusions on the limitations of the Saudi banking sector and lessons learned from the Malaysian experience.

7.5 Embedding Saudi Financial Markets and Regulation in the Rule of Law

As commonly seen in international development projects in MENA countries, when events like the Arab Spring of 2011, or even the Dubai financial crisis occur,[1128] broad-level country risk factors, such as government corruption may adversely impact direct foreign investment, contract tendering or market pricing.[1129] Saudi Arabia has attempted to address investor concerns around corruption in the government and finance sectors, including by passing the 'Combating Bribery Law', 'Anti-Money Laundering' Law, and by creating the National Anti-Corruption Commission (Nazaha) in 2011.[1130]

On the whole, however, Saudi Arabia may have to contend with criticisms over the legitimacy of its institutions and decision-making processes as a whole. Any attempt to regulate the banking sector, and subject it to independent standards of legality, can be deemed both effective and legitimate if it achieves both market efficiency (profit) and rights protection. Indeed, any perceived failings of Saudi Arabia banking and finance law and policy cannot be examined in isolation from the weaknesses of the constitutional aspects of the overall Saudi legal system.

Malaysia has a developed a legal system in which a court bases its decision on common law and exercises sufficient independence from the executive and administrative branches. In Saudi Arabia, banking policies are effectively set by SAMA, which constitutes absent judicial oversight. Moreover, where the law is applied it is applied inconsistently, chiefly because of the failure to base judicial reasoning on a system of precedent that is based on the doctrine of rationality and stare decisis. A larger problem is the lack of openness in Saudi governmental affairs, a fact reinforced by Saudi Arabia's relatively poor ranking on World Bank

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[1128] See, for example, Thorston Nestmann and others, 'Political Risk and Export Promotion: Evidence from Germany' (Research Notes Working Paper Series, 1: Economic Studies No 36/2006) 1.

[1129] CBRE, 'Emerging Markets Offer Excellent Shopping Centre Development and Investment Opportunities' (2013) <http://www.cbre.de/de_en/news_events/news_detail?p_id=15892/> accessed 12 February 2017.

[1130] This law, known as 'Nazaha', was established by Royal Order A/65, issued by His Highness Abdullah bin Abdulaziz Al Saud on 18 March 2011.

'Worldwide Governance Indicators'[1131] and the low progress made towards robust competition and liberalisation policies.

Administrative committees established under the authority of SAMA, such as the Banking Disputes Settlement Committee, have been created precisely in an attempt to depoliticise the issue of Shariah compliance. However, the decisions of the Banking Disputes Settlement Committee are not widely published or buttressed by the usual requirements of reason giving to which ordinary courts are made subject. SAMA Committees have, essentially, created administrative back-channels through which interest-based contracts can be enforced without the need for judicial comment on the constitutionality of non-Shariah compliant contracts.[1132]

This approach has not fully resolved the potential for dispute, not least because of the limited jurisdiction of administrative courts. While SAMA, and the Banking Disputes Resolution Committee, have authority to hear disputes relating to traditional areas of banking law i.e. letters of credit, non-repayment of loans etc.[1133] these actors do not have exclusive jurisdiction over matters which fall outside the scope of 'banking business' as defined under Article 1 (b) of the Banking Control Law (BCL).[1134] Thus, SAMA can assert exclusive jurisdiction over disputes only where it involves the actions or transactions of a foreign or national bank. Aside from this requirement, no other legislative guidance comprises the scope and meaning of the term 'banking business', and this raises questions over whether more novel credit instruments such as Sukuks fall under SAMA'S supervisory and regulatory control.

One final aspect of Saudi law which should be noted is the absence of a legal framework or procedures dedicated to insolvency or bankruptcy related actions or disputes. Insolvency procedures are currently indirectly regulated under Chapter 10 of the Commercial Court Law (CCL)[1135] and Law of Settlement Preventing Bankruptcy (LSPB)[1136]. Each of these laws has coverage over insolvent banks, insurance firms and finance companies. For instance, Article 22 of the Banking Control Law 1966 vests SAMA with emergency powers to assist failing institutions through recapitalisation or by lifting the statutory limits on capital requirements

[1131] Al-Kuwari (n 715).
[1132] Zulkifli and Asutay (n 970) 47.
[1133] Abdullatef, Al Elsheikh and Tanega (n 311).
[1134] Royal Order No 4/110 of 1988.
[1135] Royal Decree Number (M/2) dated 15/1/1390H.
[1136] Royal Decree M/16 of 1416.

and shareholdings. International reports issued from the World Bank have, however, commented upon the ineffectiveness and infrequent application of bankruptcy in Saudi Arabia, as compared with other legal systems such as Malaysia. These, among factors discussed below, continue to undermine levels of trust and confidence in Saudi regulators, the banking sector itself, and in the regulatory framework that structures it.

7.5.1 Reform of Corporate Governance Regulation

Without sound company and investment regulations that can eliminate barriers to market access and protect shareholder rights, or effective corporate governance mechanisms that hold directors and managers to account for poor performance or fault, there is a significant risk that investors will stop doing business with Saudi Arabia. Regulatory overreach in the banking sector or judicial dysfunction will only compound these concerns, particularly if foreign parties are treated differently from nationals in respect of rules regulating the conditions under which a company can be established, in addition to licensing, paid up capital, or stock purchase barriers, as discussed in Chapter III.

By the same token, banks and other financial entities should be subject to effective oversight and held to account for misconduct and poor performance. The Saudi Arabian Monetary Agency has taken action to address corporate misconduct in Saudi banks, including the Saudi Cairo Bank. This case involved the attempts of senior level managers to conceal elements of fraud, misrepresentation and other irregularities in the operations of Saudi Cairo Bank.[1137] While these measures are to be welcomed, low levels of accountability or transparency in government leaves it vulnerable to corruption and abuse, while diminishing public trust in legal or regulatory institutions. This can be contrasted with the legal system Malaysia has implemented, which is a clear system of rule of law with substantive statutes, precedent, and severe enforcement mechanisms.

The above discussion has attempted to demonstrate that Saudi regulators, such as SAMA and CMA, have failed to introduce or incentivise a culture of good corporate governance. Issuing standards as mere guidelines instead of mandatory practices sends a message of complacency. Further, auditing and accounting practices are not standardized and reporting and disclosure standards are periodic rather regular. For instance, in contrast with Malaysian

[1137] Al-Suhaimi (n 43).

banks, Saudi financial institutions do not regularly publish their financial statements for auditing by national regulators, making it difficult to gauge the performance of banks (e.g. losses and returns). This, in turn, has a corrosive impact on levels of consumer trust, investor confidence and deposit retention in Saudi banks and financial institutions.

7.5.2 The Need for Consistent Standards in Dispute Settlement

In classical theory, a sharp divide is maintained between the domains of public and private law: public law is the domain state regulation in the public interest, while contract law aims to protect the rights and legitimate expectations of private entities. But the divide between public and private law is transgressed in the common expectation that both banks and their customers have prospective knowledge of their rights and duties under the laws of a legal system.

Islamic banks and even conventional banks operating under the jurisdiction of Islamic laws, as is the case in Saudi Arabia, are subject to other kinds of externalities, including legal-regulatory risks. The sheer absence of clear authorities or clear standards on what is or is not lawful i.e. what is mandated under Shariah is both a failure of governance and a threat to market expectations.

As implied throughout this thesis, Shariah abhors an uncertain contract. For a contract to be valid under Shariah law, it must be free from uncertainty.[1138] This is also known as 'the rule against Gharar'"[1139] In this regard Saleh states, "any transaction should be devoid of uncertainty and speculation, and this ... [can] only be secured by the contracting parties' having *perfect* knowledge of the counter-values intended to be exchanged as a result of their transaction ..."[1140] Accordingly, Islamic contract conceptions place great emphasis on good faith contract constructions. Confronted with asymmetries in disclosure and supervision practices across Islamic states and markets, loss bearers may come to disregard legal avenues for restitution as inefficient and the costs associated with it prohibitive. There are, however, a

[1138] Quran 2:275.
[1139] Nabil A Saleh and Ahmed Ajaj, *Unlawful Gain and Legitimate Profit in Islamic Law* (Graham & Trotman 1986) 81.
[1140] ibid.

few notable cases that address these issues.[1141]

In *Investment Company of the Gulf (IICG) v Symphony Gems NV & Ors*, IICG and Symphony Gems entered into a Murabahah financing agreement, whereby the Gems Company was contracted to inspect precious stones and supply these to their sellers.[1142] The judgement of the English High Court is noteworthy because while the Court did not enforce the Murabahah contract per se, the reasoning of the Court was such that specific principles of Shariah were interpreted as terms of the contract.[1143] Malaysian courts have also taken an interesting view towards contracts containing elements or principles of Shariah law. In the case of *Bank Islam Malaysia Bhd v Azhar Osman*,[1144] the Malaysian court interpreted the Malaysian Contracts Act 1950 as permitting grounds for what is effectively the doctrine of equitable relief whereby if a party avoids a contract on grounds related to Shariah, it must nonetheless provide relief to the counter-party, even if the underlying contract is void. In this way, the Malaysian legislators have looked to bridge the gulf between Malaysian common law, which is largely influenced by UK and other common law systems, and constitutional references to Shariah. They have done so by amending the previous legislation through the enactment of new provisions into Part VII of the Central Bank of Malaysia Act which seeks to resolve lack of clarity over Shariah matters[1145].

While it might be optimistic to suppose that Saudi Arabia will follow these reforms, the Malaysian example would seem to provide a good model for dealing with issues around contractual interpretation and constitutional references to Shariah. In any event, parties to Islamic finance contracts will expect further clarity over the rules of contract interpretation in addition to strengthened remedies in instances of default and non-performance.[1146] Absent

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[1141] Mohammad Saad Lahlou and Joseph Atangan Tanega, 'Islamic Securitisation: Part II - A Proposal for International Standards, Legal Guidelines and Structures' (2007) 22(7) Journal of International Banking Law and Regulation 359, 360-364.

[1142] *Investment Company of the Gulf (IICG) v Symphony Gems NV & Ors* [2008] EWCA Civ 389.

[1143] For an in-depth analysis of this case, see Umar F Moghul and Arshad A Ahmed, 'Contractual Forms in Islamic Finance Law and *Islamic Investment Company of the Gulf (IICG) v Symphony Gems NV & Ors*: A First Impression of Islamic Finance' (2003) 27 Fordham International Law Journal 150.

[1144] Reported in 2010 Malayan Law Journal 9; The Court followed *Beximco Pharmaceuticals Ltd and Ors v Shamil Bank of Bahrain EC* [2004] EWCA Civ 19 by noting that where the parties in the United Kingdom wish to apply Shariah in their financial contracts, it must be specifically incorporated into the contract and the English courts will interpret the contract according to the rules of English contract law.

[1145] Islamic Finance Knowledge Repository <http://ifikr.isra.my/home/> accessed 13 October 2017.

[1146] Alfred Kammar et al, 'Islamic Finance: Opportunities, Challenges, and Policy Options' IMF Discussion Note, SDN/15/05, April 2015 pp 9, 17

standards or remedies and contracting parties are exposed to significant enforcement risks, particularly with concern to poorly drafted contracts, in which the application of Shariah related conditions are not expressed clearly or fairly. These problems will subsist even when contract adjudication is embedded in a more developed judicial system supported by effective recovery regimes and insolvency regimes, since a court cannot enforce a contract which it cannot interpret.[1147] As such, parties will be denied opportunities of effective remedies and judicial resolution of disputes.

7.5.3 The Need for Consistent Standards in Regulation

Malaysia operates a simple system under their Shariah Advisory Committee (whose role is to provide criteria, rulings, and fatwa to give consistency to what is or is not Shariah compliant – 'halal' or 'haram'). Their fatwa appears on a single website, accessible primarily by subscription but with the most important fatwa listed free to the public.[1148] The collection includes over one hundred and fifty fatwas, for example issued to the Central Bank of Malaysia. Saudi regulators can learn from this practice, and adopt the aforementioned proposal for a Saudi Shariah Advisory Council. This would dramatically improve the strength of its financial system because it would provide stability, accountability, and consistency.

As discussed above, however, banks in Saudi Arabia have developed products or instruments with many similarities to conventional debt based banking i.e. the sale of debt which is purchased against debt. For instance, banks may loan the customer a cash advance with which to purchase goods, rather than taking ownership over the asset underlying the resale agreement. The client is then required to repay the principal loan along with an additional 'mark-up fee. The surcharge applied to each repayment amounts to a disguised form of interest taking. As Razali has remarked, the mark up on the sale often equals, or even exceeds the interest that a borrower would have to pay under conventional lending instruments.[1149]

[1147] See generally, Kim Eun-Jung, 'Islamic Law in American Courts: Good, Bad, and Unsustainable Uses,' (2014) 28 Notre Dame Journal of .Legal Ethics & Public Policy 287, 301-302 Available at: http://scholarship.law.nd.edu/ndjlepp/vol28/iss1/7

[1148] See Shariah Advisory Council to the Bank Negara Malaysia (Central Bank of Malaysia) website at <http://www.bnm.gov.my/index.php?ch=en_about&pg=en_thebank&ac=439&lang=en>
Mohd Izxat, Amysar Mohd Arif and Ruzian Markom, 'Role and Status of Shariah Advisory Councils in Enhancing the Islamic Finance System in Malaysia,' (2013) 38 Malaysian University Journal of Pengurusan 127

[1149] Siti Salwani Razali, 'The Principles of Ghārār in Bai Bithaman Ajil Contract' (MFA Conference Parallel Session III (D), 2008).

In the absence of a dedicated legal framework for governing Saudi Arabia's embryonic financial derivatives market, whether conventional or Islamic, the most likely assumption is that SAMA itself has final authority to determine whether the activities of a bank falls under its exclusive jurisdiction or the jurisdiction of other courts and tribunals. However, as discussed, the legal status of financial derivatives is the subject of much interpretative controversy among the Shariah boards of different Islamic financial institutions.[1150] At the same time, if economic efficiency is the overriding aim, then it is not clear whether Saudi authorities should place any regulatory or religious limits on the ways in which Saudi banks increase their profitability or offset their losses, including by acquisition of debt based 'hedging' assets, as outlined below.

7.5.4 Enhancing the Efficiency and Risk Capabilities of Islamic Finance Institutions in Saudi Arabia

Banks continue to be propelled by profit incentives, and they have good reason to be so. Shareholders hold banks to financial accountability and a poor performing bank will suffer reputational costs which will impact on the bank's finances. Saudi Arabia will have to balance market values of efficiency, profit-seeking and the stabilisation of market expectations, with public law values of legality and legitimacy, in this case by respecting constitutional commitments to Shariah. How then is it to overcome public resistance to modernisation of its banking systems through, for instance, the acquisition of high quality debt based assets? As the above suggests, the restriction on debt-based instruments undermines the profitability and risk regulating capacities of Islamic institutions, specifically in respect to Basel approved thresholds and guidelines on the quality of capital, capital ratios, and liquidity ratios.

In an attempt to sidestep Shariah related restrictions which impact the liquid and capital adequacy of Islamic financial institutions, the Malaysian Central Bank offers the following fatwa on the issue of permitted forms of interest based form of banking:

> "The sale of debt with debt [is] is prohibited by the Shariah…but may be permitted when the transfer of ownership takes place and the underlying asset used in the

[1150] Abdullatef, Al Elsheikh and Tanega (n 311).

> transaction is the lender's remaining legal interest in the property. ... Therefore, the investor has the right to sell the asset to a third party without referring to or executing the transfer of ownership with the borrower [on the basis of a] floating rate of interest, due to the principle of Muoasah (offset) which arises where two parties are indebted to each other and the debts are settled based on the payment of the difference between the two debts amount. [1151]

By applying a similar swap rate, banking institutions trading in Saudi Arabia could mitigate credit risks inherent in both non-Islamic in addition to Islamic instruments such as Muḍārabah or Murabahah investments. As explored in Chapter III,_Murahabah contracts involve the purchase of an asset by a bank which is then resold to a borrower.[1152] Under the fundamental principles of Islamic contract law, the contract is only valid if the bank takes ownership of the asset before it is resold to the customer.

Once again, the problem boils down to the way in which Saudi banks value assets against their risks. For example, it is difficult to conceive a Shariah compliant method of valuing property assets that underlies a long-term mortgage or commercial leasing agreement, without some form of speculation, which is forbidden in Islam. The more likely scenario is that Islamic banks will peg their own valuation to an interest rate set by the market. In short, Islamic banks do apply a form of interest by another name, usually by applying a disguised 'administrative fee', while still professing fidelity to Islamic prescriptions on interest taking and uncertainty.

These difficulties could, however, be addressed through the formulation of a clear and transparent method of calculating installments according to an Islamic market rate indicator, similar to the Islamic Swap rates levied by the Central Bank of Malaysia's on debt transactions.[1153] The key innovation of this Malaysian fatwa on debt securities is to permit the installment payment to be adjusted to reflect any gains and losses in the market value of an asset, essentially by enabling the lender to apply a penalty for any additional loss incurred by

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[1151] Islamic Finance Knowledge Repository, 'Islamic Profit Rate Swap Based on Bai'inah' (27 October 2005) <http://ifikr.isra.my/fatwa/-/fatwa/getFatwa?_7008_WAR_fatwaportlet_fatwaId=4043/> accessed 13 February 2017.

[1152] Institute of Islamic Banking and Insurance, *Murabaha on Shari'ah Ruling* (Islamic Banking 1990).

[1153] Salwani Razali (n 1040).

the lender following default in payment by the borrowing party in the form of a floating interest rate. Floating charges applied to repayment installments do not necessarily violate Shariah injunctions against interest taking (riba), or uncertainty i.e. gambling (gharar) providing that both parties agree to such a term in advance. It has been suggested by some fatwas, in Malaysia for instance, that the idea of debt securities such as a benevolent loan for the purchase of a house by a borrower is not dissimilar to profit and loss sharing schemes structured between Islamic banks and capital investors because:

> "Islamic restructuring of debt through a separate issuance of debt securities to the original financier involves a scenario in which the existing contracting parties enter into another separate and independent contract. … The issuance of debt securities…to the original financier is viewed as a transaction which does not affect the validity of the existing financing contract." [1154]

One can argue that the more flexible Malaysian interpretation of the permissibility of debt sale or debt based transactions do not only adhere to Shariah injunctions and usury, but are, furthermore, entirely consistent with Islamic values of concepts of compassion and humanity.[1155] Generally speaking, this Malaysian perspective is considered to be rather generous, flexible, and unconventional in terms of normal Shariah perspectives. As such, it is not clear whether this scenario would be acceptable within the Saudi financial system, but it does demonstrate the interplay of Shariah law in Islamic capital markets. Drawing on the above hypothetical scenario, if installment payments in a contract are fixed, and if sale transactions as well as contracts of exchange with deferred payments are clearly allowed in Shariah law, then, by definition, debt is created through Shariah compliant obligations. One could then conclude that an Islamic form of collateralised debt obligation would be 'halal', provided it eliminates all other elements of riba, gharar, and injustice.[1156]

The broader implication of the Malaysian fatwa and the approach taken by national regulators more generally under IFSB standards is that interest based charges and other penalties only

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[1154] Islamic Finance Knowledge Repository, 'Financing Settlement Through New Financing' <http://ifikr.isra.my/fatwa/-/fatwa/getFatwa?_7008_WAR_fatwaportlet_fatwaId=4091/> accessed 22 January 2017.

[1155] Qu'ran, Surah 2, Verse 275.

[1156] Ustaz Mohd Bahroddin Badri, 'Islamic Financing: Are Debt-Based Instruments Not Islamic?' (2014) 2 ISRA Islamic Finance Space 16.

fall foul of Islamic principles of contract law when the subject matter of the contract is known in advance. This is when the transaction is backed by real assets, in which the seller has a vested property interest, and when the adjustment in repayment terms does not materially affect the quantum of goods, date of performance or identity of the contract parties. It is in this 'grey' area that Islamic banks can look to the example of Malaysia through the development of new contracts and banking tools, fit for the demands of Shariah and conventional clients.

There is a connection here between the fundamental tenets of Islamic contract law and the implicit need for transparent and equitable accountancy and risk valuation standards. For instance, an adjustment to repayment reflecting losses assumed by the seller on the resale of goods on a defaulted hire or sale contract will require a fixed Islamic market rate indicator. Any penalty applied on repayment terms, as a result of late or non-payment will equally necessitate commonly applied accountancy standards. Any loss risk assumed by investors through their participation in profit and loss sharing agreements could be hedged against Islamic debt based securities without infringing the injunction against gambling or uncertainty i.e. maysir. The use of Islamic securities would enhance the overall quality of capital held by Islamic and non-Islamic banks which may also be encouraged to utilise these hedging assets. Further, if the Islamic banks were to sell its interest in the contract, it would not be a collateralised debt obligation, but an actual share in real estate, which has greater value and more flexibility on an open market.

7.6 Conclusion: The Limits of Basel Regulation

The search for sound and globally adaptable banking regulations and standards is, in some sense, always a losing game. Global regulatory schemes such as those developed under the Basel III regime do not only have to account for tremendous variation in national legal systems, cultures and economies, these must also reflect, and be responsive to the interconnections between different kinds of risk: managerial, market related and legal. At the level of market or finance related risks, the above analysis is intended to reveal the obvious and not so obvious correlations between valuation risks, liquidity risks and sovereign credit risks. Basel III or indeed any global framework cannot be designed in such a way to integrate these issues, or at least it cannot do so by constantly updating and revising standards after 'learning' from crisis. Regulators, whether at national, regional or global level, struggle to

develop a comprehensive set of regulatory solution to a problem that has a legal, financial, managerial and, in the case of Saudi Arabia, a religious-constitutional dimension.

This thesis has aimed to show that the failures of the legal framework and Basel debt based model of banking regulation reinforces the blind-spots of the other: Basel continues to focused on debt based forms of banking and associated credit risks, at the expense of integrating into its regulatory framework broader legal and regulatory considerations, i.e. the relationship between risk regulation and good governance, or the financial structure of banks and their impact on the overall stability of the banking sector as a whole.

The above issues expose a familiar tension between the legality and effectiveness of the current international framework on banking regulation. These tensions are best expressed by the ongoing (and as yet unresolved) debate over the role and limits of law and legal regulation of market institutions. More relevantly, others have pondered the balance to be struck between the harmonising the pull of common banking regulatory standards, as a necessary accompaniment to an increasingly integrated global economy, on the one side, and with a more flexible approach to regulation which respects the legitimate autonomy and diversity of national legal systems, regulation and markets, on the other.

With the above in mind, the final chapter will offer the researcher's final conclusions and suggestions on how to bring about much needed reform to Saudi Arabia's financial sector and regulatory framework to ensure it meets the effective and legitimate implementation of Basel norms and the fundamental principles of Islam. Following on from the above analysis, the next chapter sets out some final recommendations.

Chapter VIII: Conclusion and Recommendations: A Roadmap for Reform

8.1 Introduction

By synthesising insights drawn from theoretical, comparative and statistical analysis, the pre-eminent consideration of this thesis has been whether the Basel framework is an adequate financial and regulatory model for Saudi Arabia. This study has questioned and critically analysed the assumption that Basel III is sufficient to protect Saudi Arabia's banking and financial industries from market pressures, such as those the western world experienced in the 2008 sub-prime mortgage crash. This question is more relevant today as it has ever been because Saudi banks, and conventional and Islamic banks, are confronted by the downstream effects of declining export markets and sovereign credit risks. In one sense, this thesis has problematised the utility of 'one size fits' international risk regulation, which can appear to lack the necessarily malleability needed to design regulatory approaches suited to local contexts against the backdrop of an increasingly unpredictable marketplace.

While yet to be fully implemented in Saudi Arabia, Basel III in its current form may, in effect, discriminate against Islamic banks, or otherwise fail to take due account of differences in the asset structure and risk profile of conventional and Islamic financial institutions. At the very least, this thesis has attempted to demonstrate the specific ways in which the Basel III framework has been designed to address risk exposures which are more commonly associated with debt-based instruments, thereby implicitly privileging a model of governance which is inextricably linked to conventional banking models and associated theories. At the more normative levels of analysis, this thesis also makes appeals for a more holistic approach to finance regulation, buttressed by meaningful substantive reform to corporate responsibility and liability and accompanying rights protections. In the final analysis, this thesis has arrived full circle to defend values which are closely associated with classic 'rule of law'. Market stability relies on the stabilisation of commercial expectations and legal certainty, in combination with other 'rule of law' inspired values of generality, publicity and consistency in rule application and enforcement. It is in this domain that Saudi Arabia has most work to do.

Building on the above, this research has made vigorous claims suggesting that mere compliance with Basel requirements on capital reserves is not a solution to prevent poorly regulated, non-transparent or poorly performing banking institutions from failure. Ineffective risk regulation threatens the rights of stakeholders, and deters them from banking or investing in banks with a poor track record of making good on their investments. Negligent bank management, as the 2008 financial crisis has readily exposed, undermines the stability of the banking sector as a whole. Financial risks are a symptom of a system of weak laws, and not the other way around. In the case of Saudi Arabia, over regulation does not equate to sound regulation, and the presence of corruption, closed markets and state monopolies and rent seeking simply concentrate power in the hands of regulators, without producing market efficient outcomes. With this, the altruistic vision that ostensibly lies behind the Islamic finance vision, and the utilitarian principle of prosperity, innovation and wealth creation which imbues the neo-liberal orthodoxy, is duly compromised and surrendered.

While Saudi Arabia is fully compliant with Basel standards, such as capital ratios and liquidity risks, the weaknesses in its financial system emerge when risk management, valuation and corporate governance are more closely examined. Chapter VII has explored these weaknesses in depth, providing that certain suggestions could alleviate both the domestic risk management and corporate governance 'gaps'. Further, Chapters Four and Five indicate that it is only by strengthening mutual recognition and equivalence among standards developed within the 'closed' worlds of Islamic and conventional finance that each can learn from the other.

In its comparative analysis, the thesis has reflected on the successes of Malaysia's banking system. The Malaysian model, of course, is not a panacea and its banking sector has also experienced its own periods of instability and devaluation risks at the height of Asian banking crisis.[1157] No regulatory model is complete or infallible. These experiences can also provide a model for reform in Saudi Arabia, whose Riyal currency has similarly experienced a more dramatic drop in value since 2014, thereby threatening its leadership status in the GCC.[1158]

[1157] Timothy Lane and others, 'IMF-Supported Programs in Indonesia, Korea, and Thailand: A Preliminary Assessment' (IMF Occasional Paper 178, 1999).

[1158] See Simon Kerr, 'Oil Price Drop Leads to Renewed Speculation on Saudi Riyal' *Financial Times* (25 August 2015); see also, Samuel Potter and others, 'Oil Recovery Hits Saudi Devaluation Bet' (*Bloomberg*, 27 March 2016) <https://www.bloomberg.com/news/articles/2016-03-27/traders-out-of-pocket-as-oil-recovery-hits-saudi-devaluation-bet> accessed 23 July 2016; see also, for a general discussion of oil prices affecting

The comparative sections of this thesis have taken much inspiration from Malaysia's successes and the reform it has implemented to revitalise its economy and financial systems, each embedded in a robust legal system based on objective legal standards (e.g. rights protection, judicial rationality. Malaysian regulators and authorities have also cultivated a more balanced approach to harmonising local standards with international commercial best practices, standards and usages). Malaysia's system highlights corporate governance, and Shariah adapted banking tools, and a robust framework of regulatory oversight, accountability, and transparency. One could argue that it is precisely because Islamic and conventional banks compete on a level playing field, and are treated afforded substantive equal treatment before the law, that Malaysia's governing system has been able to promote transparency, stability, and stakeholder participation across all segments of its national banking markets and sectors.

In a more general sense, the Malaysian model offers a fascinating example of how to marry the benefits of Basel with the religious tenets of Shariah law into a dual system of Islamic and conventional banking institutions. There is a clear attempt here to reconcile local and particularistic standards i.e. Islamic finance standard with minimal international requirements, and to strike a more equitable compromise between the regulatory goals of market oversight and open competition. The influx of alternative influences in Malaysia have, arguably, made it more adaptable to conventional Basel standards, e.g. a broad interpretation of Sukuks or profit and loss sharing agreements. This is in direct competition between Islamic or non-Islamic institutions and gives the Malaysian investor more choices and provides commercial incentives for Islamic financial institutions to diversify their financial portfolios with high quality liquid assets.

One important nuance and argument for the distinctions between Saudi Arabia and Malaysia, is that Saudi Arabia, as the GCC leader, actually has a larger share of the Muslim investor market for that region than Malaysia has in its ASEAN market, based Islamic banking, system, therefore bringing one to question the value of the comparison of Malaysia in this thesis.[1159] Saudi Arabia has, historically, intervened heavily into financial markets, largely

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Saudi Arabia's market, Clifford Krauss, 'Oil Prices: What to Make of the Volatility' *The New York Times* (10 March 2017).

[1159] Ernst & Young, 'World Islamic Banking Competitiveness Report 2016' 5, 10, 11 <http://www.ey.com/Publication/vwLUAssets/ey-world-islamic-banking-competitiveness-report-2016/$FILE/ey-world-islamic-banking-competitiveness-report-2016.pdf/> accessed 28 March 2017.

due to state ownership over all major assets, which extends chiefly to its control over oil related commodities. Rapidly dropping prices and the need to diversify industry have placed Saudi Arabia in a position where it has little choice but to open up its markets to conventional banking products, while integrating its national policies with international financial systems.

As was discussed in Chapter IV, Shariah is subject to varying interpretations across Islamic bodies, authorities and countries, thereby hindering development of industry accepted standards for the Islamic finance sector. By isolating Shariah standards and governance to individual countries, the overall growth of global Islamic banking is inhibited. Regardless, to some extent, developed economies such as Saudi Arabia and Malaysia, have adapted or modified robust internationally accepted banking standards to be compliant with Shariah law, thereby serving as a poor substitute for a more standardised approach to Shariah. Often these international standards pre-date all three Basel accords, and might help to protect depositors in Saudi Arabia. For instance, as suggested in Chapters Five and Seven, depositors and investors may be better protected if valuations are calibrated to take account of the portentous state of the Saudi economy and adapted towards Basel standards with Shariah risk interpretations in mind.

As was originally presented in the introduction chapter, reform in Saudi Arabia is important to the longevity and vitality of its economy. Instead of competing with conventional or international standards, Saudi Arabia has the means to harmonise its domestic practices to international standards, while respecting the traditions and values of Shariah. By meeting, exceeding, and incorporating Basel standards with Shariah principles, Saudi Arabia can better promote the functionality of Saudi financial institutions against market, credit and liquidity risk exposures; as well as protect the rights of consumers and investors. More importantly, taking specific measures to strengthen risk assessment, disclosure and corporate governance disciplines in all financial institutions will inevitably standardise not only sound financial practices, but their interpretations by local courts or review bodies such as a Saudi Shariah Advisory Council. Saudi Arabia can then tout an ethical, highly profitable, and Shariah compliant path forward for Islamic modes of financing.

Strategically speaking, this means Saudi Arabia must proffer risk management and corporate governance practices, which are mandatory, enforceable, and punishable. Risk management

measurements must be precise, and this will mean that clear duties and responsibilities should be defined and properly enforced under SAMA and CMA's regulatory guidelines. Further, board of director positions must continue to be removed from opportunities of self-interest from within financial institutions, and stakeholders must be given a stronger voice for accountability. More importantly, each rule or proposed regulation set forth in the Corporate Governance Act must become a mandatory provision, not a suggested guideline. Saudi Arabia's efforts to improve its corporate governance provisions are an empty threat unless or until they become mandatory.

8.2 Reforming the Saudi Banking System: Reform Proposals

The following discussion presents further, specific recommendations for reform and expands on the justification for each reform based on the research of the previous chapters within this thesis. The final consideration for reform will then be the importance of Shariah compliance and oversight bodies.

8.2.1 Risk Assessment, Valuation, and Management

While each stage of Basel is built upon the next, Basel III culminated into four sets of reforms focused on increasing capital adequacy thresholds as follows:[1160] the classification of risk for types of capital held by banks in proportion to risk weighted assets;[1161] loss absorption triggers; and liquidity rules. More specifically the Basel framework has set expectations of conventional risks such as credit, liquidity, operational and market risks.[1162] These risks, capital adequacy ratios, and use of Shariah banking products such as Sukuks have been the most controversial topics of this study, as well as the heated discourse over the true measure of vitality of Saudi Arabia's financial market, because each of these concepts has been convoluted based on competing measurements or definitions from Basel standards or Shariah law.

The general concept of financial risk, as presented throughout this thesis, under Basel standards presents the illusion that Saudi Arabia is a steadfast market. However, examination of valuation and risk under Shariah standards, in direct comparison to Basel understandings, demonstrates the truly vulnerable nature of Saudi Arabia's capital integrity and asset

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[1160] BCBS (n 1) 94.a.
[1161] ibid 50.
[1162] Mohamad Hasan and Jemma Dridi (n 302).

liquidity. It is the difference of risk sharing versus risk transfer or equity-driven versus debt-driven instruments. Merely setting strong capital buffers and maintaining higher than Basel required capital adequacy ratios, is not enough to compensate for the difference in risk valuation. Only by shifting its own practices to accommodate for both Basel and Shariah understandings of this risk, can Saudi Arabia, like Malaysia, cultivate an agile and sustainable system, capable of withstanding economic crisis.

As was discussed in Chapters Four and Seven, when examining Islamic modes of contract and finance, the capital structure of conventional banks as opposed to Islamic banks differs greatly in terms of liabilities and asset management, e.g. what would appear to be a debt in a conventional ledger or trade book becomes a shared risk and asset in an Islamic bank calculation. Profits are based on tangible assets in Islamic banks, whereas conventional banks can use more speculative, interest and collateral-based measurements.

The basic principle of Islamic banking is based on risk-sharing, which is in contrast to the risk-transfer model of conventional banking, e.g. profit and loss or partnership agreements rather than debtor and creditor agreements [see Chapters Four and Seven]. Islamic banking concepts include profit sharing (Mudharabah), joint venture (Musharakah), cost plus (Murabahah), and leasing (Ijirah) [see Chapter III].[1163] Risk management in Islamic systems tend to be concentrated in certain product sectors, thereby increasing susceptibility to systemic risk or 'universal' failures within the overall system. Islamic banks are particularly vulnerable because there are a few large institutions mixed with predominantly small institutions, making the smaller institutions more sensitive to any actions or failures of the larger ones. In contrast, conventional institutions have predominantly larger footprints, in addition to debt structures that allow them to quickly access liquid assets. The global sub-prime mortgage crisis of 2007 showcased what can happen when risk is excessively concentrated in one area of the economy. Diversity of products, accurate risk assessments and expertise, and flexibility in managing investment risks and performance will help to alleviate strain on the smaller institutions, as well as the effects of a concentrated economy.[1164]

[1163] Shereef Ellaboudy, 'The Global Financial Crisis: Economic Impact on GCC Countries and Policy Implications' (2010) 4 International Research Journal of Finance and Economics 177 as cited by Fatma Zehri and Noura Ben Mbarek, 'Banks Performance in KSA during Financial Distress: A Comparative Study Islamic and Conventional Banks' (June 2016) Arabian Journal of Business and Management Review S1:009.

[1164] International Organization for Standardization (ISO), 'ISO 31000:2009 – Risk Management' <https://www.iso.org/obp/ui/#iso:std:iso:31000:ed-1:v1:en/> accessed 20 April 2017.

Establishing a, "benchmark yield curve would similarly encourage the development of the domestic debt market" and increase the direct competitiveness of Islamic finance and banking markets in ASEAN and the GCC.[1165] Further, by enhancing credit risk assessments, Saudi Arabia can improve its accounting and valuation methodology, which, in turn, will enrich the quality of their liquidity assets, including cash, current deposits, other deposits, and SAMA bills, despite lack of access to interest-based assets, collateral assets, or risk transfer techniques, such as borrowing from or depositing funds with other institutions.

8.2.2 Risk Assessment, Valuation, and Management Recommendations

- Entrepreneurs or borrowers seeking bank funding financed from PSIA or PLS schemes should be made subject to strict due diligence and disclosure requirements.
- Saudi regulators such as SAMA should strengthen supervision and disclosure in requirements for financial institutions, Islamic or otherwise, and submit financial institutions to strengthen reporting, auditing and inspection requirements on a quarterly basis.[1166]
- While taking note that the current capital adequacy ratios (CAR) for Saudi banking institutions sit at or above 18%,[1167] far exceeding the Basel III requirements, it is nonetheless recommended that the required risk-weighted capital adequacy ratio for an Islamic bank should be set at higher levels than currently required in order to offset the higher exposures to credit default and operational risks of Islamic banking. [see Chapters Five and Seven]
- On the reform of accountancy practices, a higher risk rating should be accorded to the most loss-prone Islamic finance instruments, namely profit and loss sharing and investment agreements i.e., Mudarabah, and Musharakah investments, for the purpose of determining minimal capital reserve and loss absorption thresholds.
- Greater standardisation should be achieved in capital measurement and classification, thereby ensuring that Saudi Arabia is able to effectuate greater oversight and supervision over banking practices and liability, for instance by according different risk weighting categories to unrestricted and restricted deposit accounts, thereby assigning high risk value.

[1165] ibid, 8-9.
[1166] ibid.
[1167] See SAMA (n 367); also Argaam (n 898).

- Saudi Arabia should continue to diversify its Islamic banking products in order to provide equity, debt and interest-based alternatives to both Muslim and non-Muslim investors, including but not limited to Sukuks.
- There will also be the need to train Islamic financial system regulators and supervisors within Saudi Arabia for developing effective internal risk management, rating and control systems and appropriate corporate culture in these banks, as well as the mandatory adoption of such systems and punitive provisions for regulators or supervisors who fail to do so. This will, in turn, improve the external rating of these banks and help them not only utilise their equity capital more efficiently but also enhance their growth and stability. This is also a matter of improved corporate governance standards, as discussed below.

Saudi Arabia should be motivated by its current economic status to quickly integrate reforms.[1168] The unique expertise of Islamic Banks in providing Shariah compliant investments and tools attracts prudent investors who want to manage risk in their portfolios. Islamic banks are directed by Shariah compliance to source investments more carefully, and can only invest where a tangible asset exists, thus balancing out riskier portfolios for both the financial institution and the individual investor.

Accordingly, by implementing the above recommended calculated risk assessment, valuation, and management reforms, Saudi Arabia may be able to diversify its investor base, grow its private debt market, and still maintain its Basel compliance of capital threshold to risk-weighted assets, thereby cultivating impregnable financial integrity against any impending crisis.

8.2.3 Corporate Governance

Corporate governance goes beyond questions of regulatory competence and standardisation. As discussed in Chapter II, corporate governance in financial institutions is also a question of ethics. But how far can Saudi banks, embedded in an Islamic legal system, really claim to be better regulated, more ethical, fairer or transparent only according to the aspiration that this is what Islamic banking models aspire to achieve. As was directly seen during the 2008 sub-prime mortgage crisis, difficult lessons have been learned in the global economy when

[1168] For a general example of increased interest by investors see Riyadh Mohammad, 'Hot Trends in 2017: Rise of Islamic Banks on Main St. USA' (*CNBC*, 2 December 2016) <http://www.cnbc.com/2016/12/02/under-the-radar-islamic-banks-rise-in-th.html/> accessed 27 March 2017.

corruption controls financial institutions. The fact that Saudi Arabia has not yet developed effective remedies for those who have suffered losses due to mismanagement of their funds, nor the means to apply for insolvency on default or bankruptcy, is not evidence of a healthy banking system. Consumers have deposited fewer savings with Saudi banks. Investors are not making the returns that they used. Banks are not as profitable as they used to be, and lending, both state and private, is reduced. Debt is increasing. By the same logic, financial institutions do not voluntarily choose to adopt corporate governance standards, but this does not mean that malfeasance, corruption, or simple mismanagement is not taking place.

Money, greed, and profit margins are powerful temptations, which may seduce even those institutions or entities with the best intentions. The important question is: are Saudi banks really championing the rights and interests of their consumers, irrespective of whether they are Islamic in structure and orientation, or otherwise? The trust placed in financial institutions and their regulator is the key to a bank's long-term success by any measure.[1169] By closely following corporate governance rules, establishing internal controls, and visibly enforcing these regulations; operators of a banking system can promote ideals of trustworthiness, honour, and security. As discussed in Chapter VI, it is necessary to counter risk or mismanagement with an open and transparent system of governance, from top to bottom. Banks will continue to have perverse incentives to take risks with their depositors or investor money, if they do not share in the risks, or are held account to regulators who are themselves held account to the public. Saudi Arabia's current system has all the proper provisions in place, but lacks the necessary elements of an open and transparent system of governance, by failing to:

1. Tackle inequitable risk distributions vis-a-vis banks, borrowers and investors, or turn a blind eye to practices which are substantively at odds with Islamic principles, e.g. through use disguised 'interest' equivalent administrative fees;
2. To formally recognise formal rules governing the dual banking sector, including establishing clear rules on the legality and rules applicable to conventional banking as distinct from traditional Islamic finance practices.

[1169] For a general assessment relating to credibility and morality in Saudi financial institutions, see Eid Sharidah Musad Alanazi and Fayaz Ahmad Lone, 'Social Satisfaction towards Islamic Banking in Saudi Arabia: A Survey' (December 2015) 12(1) Asian Social Science 182.

3. To ensure the proper delegation of oversight authority to ensure that SAMA cannot exploit ambiguities in their interpretation of Shariah for personal or commercial reasons that conflict with the overall security of the financial system and stakeholders rights.
4. Establish common rules on compliance, subject to regulatory oversight and a judicial review of laws that already exist, that are supported by efforts to devise consistent legal standards on, for example, Shariah compliance, risk regulation and good governance.

Laws which are not applied consistently, or use an opaque decision processes, in the absence of effective oversight, rights protections or mechanisms for enforcing penalties or sanctioning corporate conduct, by regulators or in the courts, will by all possible indicators, be neither effective or legitimate. These ‘rule of law’ elements are, of course, not particular to the laws applied to banking regulation at national law level, nor the implementation of international best practices, around which there is broad based consensus. However, there are constituent elements of any legal order which seek to compel obedience or govern effectively.

Given the findings of this thesis, effective corporate governance can be memorialised in the following claims:

The organisational structure of a bank should include four important forms of oversight in order to ensure appropriate checks and balances: (i) oversight by the board of directors; (ii) oversight by individuals not involved in the day-to-day management of the different business areas; (iii) direct line supervision of various business areas; and (iv) independent risk management, compliance and audit functions.[1170]

While Saudi Arabia’s Corporate Governance Regulations, Capital Market Law, and new Company Law promote these four areas of oversight [see Chapter VII], the checks and balances contained within these legislative vehicles are insufficient to develop proper oversight and independence because the regulations or provisions contained therein are not mandatory, nor do they have serious enough consequences to serve as a deterrent; a proverbial slap on the hand or warning is not as intimidating as criminal charges for directors who contemplate illegal acts or feats of intentional mismanagement. Further, as seen in Chapters Four and Six, Saudi Arabia has been criticised for a lack of shareholder rights. Shareholders are an integral part of risk management and oversight in Islamic financial

[1170] Othman Luk and others (n 792) 269.

institutions because shareholder equity is a primary funding mechanism, as opposed to external funds provided by debtors in conventional banking institutions. Therefore, shareholders' rights should carry equal if not greater weight than those of the directors themselves.[1171] Again, the Corporate Governance Act attempts to alleviate these concerns, but the voluntary nature of the provisions eviscerates their effectiveness. Finally, reporting requirements have a poor voluntary compliance rate, for instance not more than 25 out of 150 companies on the stock exchange recognise self-regulatory compliance, and only 57.1% apply corporate governance policies in internal codes, practices and procedures in Saudi banks.[1172] The following recommendations support the research of this thesis and serve as the basis of a conclusion about how Saudi Arabia might reform its Corporate Governance structure in general accordance with the above four forms of oversight, accountability, and transparency.

8.2.4 Corporate Governance Recommendations

- The adoption of any and all corporate governance rules and regulations issued by SAMA or CMA should be mandatory, not voluntary or discretionary in nature. This should apply to all financial or banking institutions in Saudi Arabia, including, but not limited, to reporting requirements.
- The enforcement of the punitive provisions of the Corporate Governance Act, rules and regulations should be escalated by SAMA and CMA to demonstrate that any violations will be stringently acted upon.
- Reporting requirements should be increased to at least a quarterly or semi-annual basis, and shareholders should be given full access to any such reports.
- Accounting and auditing standards as suggested by the AAOIFI and IFSB should be fully and mandatorily adopted by SAMA, CMA, and any Saudi Arabian financial institution.
- Stricter penalties for corporate misconduct for both Board of Directors and Managers, including strengthened 'voice and exit' rights for investors and shareholders including oversight of corporate investment strategy and day-to-day management of deposits.

[1171] Katia D Hulster, 'The Leverage Ratio: A New Binding Limit on Banks' (Crisis Response Note, No 11, 2009).
[1172] Al-Kahtani (n 358) 129.

- The implementation of a deposit insurance scheme to protect the financial interests of consumers and investors against poor performance, low return rates and mishandling of funds.
- A freeze on state funding or backing for financial institutions who fail to implement an effective a corporate governance strategy, or otherwise violate the Corporate Governance Act or internal governance strategies. This warrants a review and the possible freezing of any funds issued by CMA or SAMA.

In essence, Saudi Arabia embraces severe corporate governance loopholes that must be closed, and can easily do this by first converting laws from a voluntary to a mandatory status. Further, there should be an astute enforcement regime capable of remedying any 'design defects' in the current regulations or legal provisions, including, but not limited to, violations against shareholder rights, lackadaisical reporting practices, or self-interested acts by Board Directors comprised primarily of family related members.[1173] By creating a more adaptable system based on solid disclosure, reporting, and enforcement practices, Saudi Arabia can ensure that its financial bodies, including SAMA and CMA can continue to detect infringements to the rights of shareholder, firms, investors, or customers as well as monitor and address any compliance or enforcement issues. Thereby Saudi Arabia may not only mitigate regulatory risk within its system, it can convey confidence in its corporate governance regime.

8.2.5 Shariah Advisory Council

As discussed in Chapter V, Malaysia's Shariah Advisory Council provides a critical function for ensuring Islamic banks comply with Islamic principles. Its certification process as well as its efforts to standardise such instances of certification has greatly improved the credibility of Malaysia's financial system. As further suggested in Chapter VII, Saudi Arabia would similarly benefit from the creation of the Saudi Shariah Advisory Council (SSAC) to serve as standard bearers on agreed rulings on compliant financial instruments and contractual arrangements, and any other relevant financial mechanism.[1174] This entity would not replace the Islamic Development Bank (IDB), or the roles of other relevant institutions, but it would

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[1173] Robert Baldwin and Martin Cave, *Understanding Regulation: Theory, Strategy, and Practice* (Oxford University Press 1999) 96.
[1174] Alshamrani (n 1017) 3289.

fill a gap in Saudi Arabia's current system. None of these entities address the consequences caused by inconsistencies in the treatment of conventional and Islamic banking practices.

As discussed in Chapter IV, examples persist from Saudi Arabia where a Shariah compliant instrument that is accepted by one financial institution or board may be rejected by another. Saudi Arabia needs an independent advisory board entrusted with authority to establish a certification process for financial products and practices that is akin to rigid but transparent financial and corporate governance standards. However, this is an 'uncomfortable' idea for many Islamic scholars as it seemingly contradicts the independent and time-tested practices of the religious schools of thought, yet by following examples set by Malaysia's Shariah Advisory Council and that of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) or the Islamic Financial Services Board (IFSB), there is precedent for a more predictable certification process, without violating the tenets of Shariah.[1175] Further, by having an independent Council, different schools of thought could be represented, and debate in accordance with the *Sunnah* and *Quran*, could be honoured. Diversity of opinion would be embraced but consensus for the common good could be found.

Short of an independent SSAC in Saudi Arabia, there should also be the creation of an international Shariah Advisory Council, which embraces the different interpretations of Shariah law espoused by individual Islamic states. As reflected in the examples of the AAOIFI, IFSB, IDB, or even Malaysia's SAC, there are many approaches that can be taken by members of a Shariah advisory board in order to ensure that the banking products under their certification comply with Shariah guidelines.[1176] This would represent a 'globalist' approach to the practical challenges of the modern world and the changing nature of contract making and finance in an ever globalising, e-commerce driven world.

- Saudi Arabia should form a Shariah Advisory Council (SSAC), that is accorded the status of the sole authoritative body on matters pertaining to Islamic banking, takaful and Islamic finance.
- The rulings of SSAC should prevail over any contradictory ruling given by a Shariah body or committee constituted in Saudi Arabia, including SAMA and the CMA.

[1175] BNM, 'Sharia Advisory Council of the Bank' (28 March 2017) <http://www.bnm.gov.my/index.php?ch=en_about&pg=en_thebank&ac=439&lang=en/> accessed 22 January 2016.

[1176] ibid.

- The Shariah courts, Board of Grievances, quasi-judicial bodies, and arbitrators should also be required to refer to the rulings of the SSAC for any proceedings relating to Islamic financial business, and such rulings shall be binding.
- Members of the SSAC should be comprised of prominent Shariah scholars, jurists and market practitioners.
- Any certification process, decision, or fatwa set forth by the Shariah should be fully documented, including the reasons or justifications for their decisions, and made available to requested and approved persons or entities of the financial industry or general public.
- An international Shariah Advisory Council should be similarly formed, whose membership comprises representatives from all Islamic states with financial systems, and whose resolutions are fully disclosed as above and below.
- When an authoritative ruling cannot be reached by a Shariah supervisory council ruling, representatives from Islamic countries should, nonetheless, seek to develop common guidelines and best practices, and in the absence of even this, publish and support with reasons, the jurisprudential position or fatwas of Shariah authorities at a national level and produce key guiding principles.
- All fatwas or Shariah rulings should be supported by 'rule of law' type requirements including reasoned justification based on objective standards, to allow for scrutiny among scholars and to avoid abuses (e.g. fatwa shopping).

The creation of both a Saudi and an international Shariah Advisory Council, or at the very least an SSAC, would enhance and magnify both the success and presence of Islamic Banks in the global financial market. Instilling the Council with mechanisms for transparency and consistency is critical for effective corporate governance. As previously discussed, there is a need for an independent and sole authority on religious matters pertaining to Islamic banking in Saudi Arabia (aside from SAMA and the CMA), but even this body requires accountability and transparency. In financial matters arguments and decisions from the SSAC should be presented in terms that customers and investors, including depositors and borrowers, are able and, indeed, compelled to, evaluate and question. Thus, customer and investors may ascertain the nature and certainty of the Shariah compliance of a deposit, loan, banking tool or practice.

A more standardised approach to the certification of Shariah compliant banking and financial products through the creation of a Council would be promoting the use of the best scholarly

minds and experts available to partake in evaluation, debate, and reflection of how best to continue to adapt evolving business and financial matters to Shariah.

8.3 Summary

While Saudi Arabia considers its proverbial economic blueprints for the next five to ten years, whether this be a master plan set out by SAMA, or the Vision 2030 plan for the Kingdom, Saudi authorities must undertake swift structural and substantive reforms. Failure to improve financial oversight or to adequately address weaknesses in its approach to risk management will amputate any immediate stability and long-term projected growth that Saudi Arabia might otherwise realise. However, by adopting even a few of the reforms recommended within this thesis, Saudi Arabia may increase its credibility in the global investment market, improve its transparency, and strengthen its currency against a diversifying economic base. Thus, it will not only be able to compete with conventional banking systems head-to-head, it will become the financial hub for the Arab states, possibly surpassing even Malaysia in its stability, capital integrity, and capacity for thriving in a domestic as well as global financial market.

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